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TAX FREE INCOME: COMPENSATION IN KIND AND QUASI-IN-KIND*

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For purposes of the present discussion three assumptions must be accepted:

1. Taxation of income is more conducive to an equitable apportionment of the tax burden than other forms of taxation,

2. Progressive taxation is the only equitable form of income taxation,

3. Broadly speaking, income taxation is an instrument of economic control, a means of reducing economic imbalance and economic inequality.

Acceptance of these assumptions do not however solve the problem of determining what is income, or more restrictively, what is, or ought to be, taxable income.¹ Many attempts have been made to formulate a definition of the word "income", but it is almost an impossible task to delimit the concept in its application to specific fields or problems. One of the most comprehensive definitions, pertinent to the limited subject herein discussed, is that of Professor Simons:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the re-

* The term "Quasi-in-kind" is used in respect to property which is non-cash at the time received or accrued, but is transformed into cash at the time of realization.

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¹ As indicated by the title, this paper is limited to an examination of non-cash items of income, and no attempt will be made to discuss the income nature of gifts, inheritances, tax exempt interest, capital gains, social insurance benefits, etc., etc.

sult obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning. The *sine qua non* of income is *gain*, . . .—and gain to someone during a specified time interval.²

Admittedly, use of this definition as the formula for the tax base is legally and administratively not feasible. As a matter of fact, the Internal Revenue Code and the Regulations define gross,³ net,⁴ and taxable⁵ income in great detail, so as to include income from all possible sources and thus maximize revenue to capacity. Yet, through statutory exclusions, regulatory interpretations, administrative rulings and court decisions the tax base has been constantly eroded with the result that not only have sources of revenue been diminished, but the equitable nature of progressive taxation has been reduced and distorted. A specific examination of the various eliminations from the tax base follows.

Meals and Lodging

The value of meals furnished an employee is to be excluded from his gross income if they are furnished on the business premises of the employer for the convenience of the employer.⁶ Living quarters furnished an employee are also to be excluded if, in addition to the two tests aforementioned, acceptance of such lodging is a condition of his employment.⁷ Although section 119 was introduced into the statute as recently as 1954, the question of taxability of this form of "compensation" has been the subject of rulings, regulations and court decisions for over 40 years. An office decision⁸ of 1919 stated that board and lodging

² SIMONS, PERSONAL INCOME TAXATION 50 (1938).

³ Int. Rev. Code of 1954, section 61.

⁴ Referred to as "adjusted gross income", Int. Rev. Code of 1954, section 62.

⁵ Int. Rev. Code of 1954, section 63.

⁶ Int. Rev. Code of 1954, section 119(1); Treas. Reg. section 1.119-1 (a) (1956).

⁷ Int. Rev. Code of 1954, section 119(2); Treas. Reg. section 1.119-1 (b) (1956).

⁸ O.D. 265, 1 Cum. Bull. 71 (1919).

furnished seamen in addition to their cash compensation is considered as having been paid for the convenience of the employer and is not taxable income to the employee. But under prior law the question whether the meals or lodging were paid as additional compensation was of crucial importance⁹ in determining their taxability. Regulation 118 provided:

If a person receives *as compensation* for services rendered a salary and in addition thereto living quarters or meals, the value to such person of the quarters and meals so furnished constitutes income subject to tax. If, however, living quarters or meals are furnished to employees for the convenience of the employer, the value thereof need not be computed and added to the compensation otherwise received by the employees.¹⁰ (emphasis added)

Whereas under section 119 of the 1954 Code, the "convenience of the employer" test is the primary test, under prior determinations it was "simply an administrative test to be applied only in cases in which the compensatory character of such benefits is not otherwise determinable".¹¹ This ruling has been confirmed by Tax Court decisions in (*inter alia*) *Joseph L. Doran*,¹² *Charles A. Brasher*,¹³ *Leslie*

⁹ The new provisions of section 119 do away with this problem by specifying that contractual provisions or state statutes are not to be determinative of the question whether the meals and lodging are intended as compensation. The question is one of fact and intent in each instance.

¹⁰ Treas. Reg. 118, section 39.22(a)-3(1953); Treas. Reg. 111, section 29.22(a)-3(1943); Treas. Reg. 103, section 19.22(a)-3, as amended by T.D. 4965 (1940).

¹¹ Mim. 6472, 1950-1 Cum. Bull. 15, modifying Mim. 5023, 1940-1 Cum. Bull. 14 and Mim. 5657, 1944 Cum. Bull. 550, both of which held that the "convenience of the employer" rule is applicable to situations in which it was evident that living quarters or meals are furnished to an employee as compensation.

¹² 21 T.C. 374 (1953), maintenance engineer of a state college with a condition of employment that he occupy quarters on the grounds. Since South Carolina statute considered rental allowance as part of gross salary, court held that "convenience of employer rule" is not applicable.

¹³ 22 T.C. 637 (1954), staff doctors of a state sanatorium whose civil service rating and salary was determined by adding to a base pay the value of meals and quarters furnished at the sanatorium, which they were bound to take as a condition of employment. Held taxable as compensation.

Dietz,¹⁴ and *Herman J. Romer*,¹⁵ in spite of the fact that in the earlier *Benaglia*¹⁶ case the opposite view was held. The Second Circuit refused to accept the 1950 ruling¹⁷ and interpreted Treasury Regulation 111, § 29.22¹⁸ in the light of the interpretation placed upon it by the Treasury itself (the convenience of the employer test) in rulings between 1919 and 1950, saying:

Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially re enacted statutes, are deemed to have received congressional approval and have the effect of law.¹⁹

However, in the area of cash allowances for meals and lodgings, the compensation test is still important. The Committee Reports²⁰ as well as the Regulations hold such allowances includible in gross income to the extent that such allowances constitute compensation.

Assuming that the "convenience of employer" test is met, is it essential that the employee be under an express requirement to accept the lodging furnished? The practical and factual problems of the specific situation will be de-

¹⁴ 25 T.C. 1255 (1956), where occupancy of an apartment was the sole consideration for janitorial services. In this case it was obvious that it was compensation, rather than for convenience of the employer.

¹⁵ 28 T.C. 1228 (1957), hotel manager who was required "to live in the hotel since his services were required on a 24 hour basis". Held taxable compensation.

¹⁶ *Arthur Benaglia*, 36 B.T.A. 838 (1937).

¹⁷ *Supra* note 11.

¹⁸ Referring to the quoted material to which n. 10 *supra* applies.

¹⁹ *Diamond v. Sturr*, 221 F. 2d 264, 267 (2d Cir. 1955) citing *Helvering v. Winmill*, 305 U.S. 79, 83 (1938). The court cited the following Treasury rulings applicable to the period 1919-1950: O.D. 265, 1 Cum. Bull. 71 (1919); O.D. 814, 4 Cum. Bull. 1459 (1921); O.D. 915, 4 Cum. Bull. 1634 (1921); I.T. 2253, V-1 Cum. Bull. 32 (1926) I.T. 3420, 1940-2 Cum. Bull. 40; I.T. 2232, IV-2 Cum. Bull. 144 (1925).

²⁰ Senate Finance Committee Report No. 1622, 83d Cong., 2d Sess. 190 (1954).

²¹ Treas. Reg. section 1.119-1 (c) (2) (1956).

terminative of this question. In *Setal*²² miners were furnished meals and lodging at the mining camp which was located 67 miles from the nearest inhabited locality. Acceptance of meals and lodging was not an express requirement of employment, but without such facilities the employer could not have maintained an adequate labor force, nor could the employees have performed their work. The value of the accommodations was held to be excludable from the miners' gross income. On the other hand, the rental value of a company-owned home occupied by the controlling stockholders²³ of a granite company was taxable income, although the area lacked the normal residential public facilities,²⁴ since his duties did not require his living in a company house.²⁵

To what extent may the family of the employee enjoy tax free income in the form of meals and lodging furnished by the employer? Neither the statute nor the Regulations indicate that any such accommodations would be tax free, and Revenue Ruling 59-409²⁶ specifically provides that "the value of the meals and lodging furnished the faculty members' wives and children constitute additional compensation which is includible in the gross income of the faculty members."²⁷ However, in 1960, this ruling was withdrawn,²⁸ without explanatory remarks. Does this mean that under special circumstances free meal and lodging privileges of the family of the employee are to be tax free? It would appear to be an unreasonable extension of the exclusion provided for in section 119.

Approaching section 119 from a technical point of view, we are faced from the outset with a knotty question: What

²² *Manuel G. Setal*, 20 T.C.M. 780 (1961).

²³ All key employees were furnished rent-free company-owned homes.

²⁴ "Rion is not a desirable place to live for anyone not connected with either Winnsboro Granite or Rion Crush Stone Corporation"—statement by the court in findings of fact.

²⁵ *Mary B. Heyward*, 36 T.C. 739 (1961), *aff'd per curiam*, 301 F.2d 307 (4th Cir. 1962).

²⁶ 1959-2 Cum. Bull. 48.

²⁷ *Ibid.* The faculty members of a boarding school were required to accept meals and lodging as a condition of employment.

²⁸ Rev. Rul. 348, 1960-2 Cum. Bull. 41.

is "convenience of the employer"? The Regulation ²⁹ state that it is a question "of fact to be determined by analysis of all the facts and circumstances in each case". Ordinarily, if meals are furnished during the working day or immediately before or after working hours, provided in the latter case that it serves a business purpose of the employer other than providing additional compensation, it will be considered as having met the test. But meals furnished on non-working days, or at times when the employee's presence on the employer's business premises does not serve a business purpose of the employer, do not qualify for the exclusion. However, if the condition of employment requires that the employee live on the business premises of the employer, the exclusion applies to the value of any meals furnished the employee even if acceptance of such meals is not a condition of the employment.³⁰ There is indication that these conditions, which are complex enough as they now stand, will become even more complicated if the proposed regulations ³¹ will be finalized in their present form. Thus under present regulations ³²

A waitress who works from 7 a.m. to 4 p.m. is furnished without charge two meals a workday. In order to insure that the waitress will commence work on time, the employer encourages her to have her breakfast on his business premises before starting work, although she is not required to have her breakfast there. She is required to have her lunch on such premises. The waitress is permitted to exclude the value of these meals from her gross income. . . .

Under the proposed regulations ³³ under the same circumstances

. . . The waitress is not permitted to exclude from her gross income the value of the breakfast but she can exclude the value of the lunch.

²⁹ Treas. Reg. section 1.119-1(a)(2) (1956).

³⁰ *Ibid.*

³¹ Proposed Treas. Reg. section 1.119-1, 27 Fed. Reg. 12836 (1962).

³² Treas. Reg. section 1.119-1(d) Example 1 (1956).

³³ *Supra* note 31.

On the other hand the proposed regulations do clarify some of the murkier portions of the present regulations. Section 1.119-1 (c) (2)³⁴ provides that the exclusion "applies only to meals and lodging furnished in kind, without charge or cost to the employee," (notwithstanding the fact that Code Section 119 says "value of *any* meals or lodging." Emphasis added). Until 1959 it was therefore not clear whether meals or lodging on premises of the employer (for his convenience) furnished at a (nominal) cost to the employee would be includible in gross income. The Commissioner³⁵ and the Tax Court in *Boykin*³⁶ held that it is. In the *Boykin* case the court interpreted the last sentence³⁷ of section 119 as referring to meals and lodging furnished *without charge*! To bolster its argument, the court quoted the following remarks of the Chairman of the House Ways and Means Committee made in introducing this legislation:

Under present law, if an employer furnishes an employee meals or lodging, the employees may have to include their value in his income even though they are furnished for the convenience of the employer if there is any evidence that they were taken into account in computing the amount of the employee's wages. The new code will remove this inequity. Under the new code, the employee will not be taxed on the value of his meals or lodging if they are received at his place of business, and he is required to accept them in connection with his job.

How the Tax Court interpreted these passages to read as it construed them to read is rather mystifying. Its interpretation retains the repudiated "compensation" test and repudiates the Code "convenience for employer" test. Ap-

³⁴ Treas. Reg. (1956).

³⁵ In Rev. Rul. 545, 1958-2 Cum. Bull. 50.

³⁶ J. Melvin Boykin, 29 T.C. 813 (1958).

³⁷ The sentence reads: "In determining whether meals or lodging are furnished for the convenience of the employer, the provisions of an employment contract or of a State statute fixing terms of employment shall not be determinative of whether the meals or lodging are intended as compensation".

parently, it could not break away from its pre-1954 Code decisions.³⁸ The Eighth Circuit however was not willing to be bound by shackles which were legislatively removed. It reversed the Tax Court³⁹ and interpreted section 119 in light of the "convenience of employer" rules. In effect the court said that the obvious, natural and clear meaning of the Code section is that "there is excluded from the gross income of an employee the value of meals or lodging furnished to him for the convenience of his employer whether or not such meals or lodging are furnished as compensation. . . ."⁴⁰ It also pointed out the phrase in the regulation on which the Commissioner relies⁴¹ is inconsistent with the regulation as a whole. The last sentences of paragraphs (a) and (b)⁴², and example (3) in paragraph (d)⁴³ state that the exclusion shall apply irrespective of whether the employment contract refers to the accommodations as compensation. Apparently the logical reasoning of the court convinced the Commissioner that he was in error. In Revenue Ruling 59-307⁴⁴ the Commissioner announced that he will follow *Boykin* in cases where the facts are similar. The proposed regulations give effect to this decision⁴⁵ and give examples of its application.⁴⁶ Furthermore the proposed regulations lay to rest the problems raised in situations where the employer is required to furnish meals and lodg-

³⁸ See notes 12, 13, 14, 15, *supra*.

³⁹ *Boykin v. Commissioner*, 260 F.2d 249 (8th Cir. 1958).

⁴⁰ *Id.* at 253.

⁴¹ Quoted in text to which note 34 *supra* applies.

⁴² Of Treas. Reg. section 1.119 (1956).

⁴³ *Ibid.*

⁴⁴ 1959-2 Cum. Bull. 48.

⁴⁵ Proposed Treas. Reg. section 1.119-1(a)(3), 27 Fed. Reg. 12836 (1962).

⁴⁶ *Id.* section 1.119-1(d) Example (4): A bank maintains a cafeteria on its premises where its employees may obtain their noon meals. The bank charges its employees for the meals an unvarying rate per meal by subtracting such amount from their stated compensation, regardless of whether they ate in the bank cafeteria. Employee A's duties require him to be available for consultation and to answer inquiries during his lunch period. Employee B's duties do not require him to be available during his lunch period. Neither A nor B would include in gross income the amount so paid as part of his compensation. A would not be required to include the value of the meals he received for such flat charge in his gross income, but B would be required to include the value of the meals he received in his gross income.

ing to his employees not because of the normal convenience of the employer reasons, but because the job site is so remote that the work could not be performed without the furnishing of these accommodations.⁴⁷ Query: is a company house furnished to an employee rent free in order to provide facilities for entertaining customers?⁴⁸ Since section 119 does not provide for apportionment⁴⁹ of the value of accommodations provided to an employee for the convenience of the employer, is all of this benefit tax free?

Section 119 applies to meals and lodging furnished to employees. It is well established that partners and proprietors are not employees but owners. The Treasury's position is that such accommodations furnished to a partner, even though for the convenience of the employer, are not deductible costs of the partnership business (and therefore must be eliminated from the computation of its net income) and the resulting increase in the partnership income must be included in the recipient partner's gross income.⁵⁰ Interestingly enough the Tax Court rejects this position and

⁴⁷ See Manuel G. Setal, 20 T.C.M. 780 (1961); William J. Olkjer, 32 T.C. 464 (1959); George I. Stone, 32 T.C. 1021 (1959). Example 7 of the proposed regulations gives the situation of "a construction worker employed at a construction project at a remote job site in Alaska. Due to the inaccessibility of facilities for the employees who are working at the job site to obtain food and lodging and the prevailing weather conditions, the employer is required to furnish meals and lodging to the employee at the camp site in order to carry on the construction project. The employee is required to pay \$40 a week for the meals and lodging. The weekly charge of \$40 is not, as such, part of the compensation includible in the gross income of the employee, and . . . the value of the meals and lodging is excludible from his gross income."

⁴⁸ It is assumed that the facility is used primarily for the furtherance of the business and it is directly related to the active conduct of such business. See Int. Rev. Code of 1954, section 274.

⁴⁹ But as to pre-1954 situation see Olin E. Ellis, 6 TC 138 (1946), in which the rental value of the apartment of a realty corporation officer was apportioned into taxable and non-taxable parts: He could exclude a portion equivalent to the rental value of the apartment of the former night manager whose duties he had taken over.

⁵⁰ Rev. Rul. 80, 1953-1 Cum. Bull. 62.

has held in *Papineau*⁵¹, *Doak*⁵², and *Moran*⁵³ that meals and lodging furnished, not for his personal convenience but because the needs of the business required it, is excludible from the gross income of a proprietor or partner, and is deductible as a business expense of the business entity. The Tax Court tenaciously adheres to its position even though it has been reversed in three Circuits.⁵⁴ These reversals were bottomed on the principle that "[t]he expenses incurred by these taxpayers are expenses which everyone must incur to live, regardless of business requirements, and are, we think, personal and thus not deductible."⁵⁵ The obvious remedy (from the taxpayer's point of view) is to incorporate the business entity, thereby converting himself from ownership status to "employee" status. Should the deductibility of and inclusionary nature of an item depend on the formalities of the relationship between the bestower of and the enjoyer of the accommodation furnished?

Even though only a tiny fraction of the litigated cases have been referred to in the foregoing analysis, it is obvious that the question of taxability of meals and lodging furnished by an employer to an employee is a very compli-

⁵¹ 16 T.C. 130 (1951). Petitioner, a partner and manager of a hotel, lived and took his meals in the hotel. This arrangement was essential in order to manage the hotel to the best advantage of the partnership during all hours of the day and night. The court said: "[i]t is at once apparent that if a partner is a proprietor who cannot employ himself or compensate himself by a salary for services rendered to himself, neither can he compensate himself by furnishing himself meals and lodging. A sole proprietor can not create income for himself by buying himself meals and providing himself with lodging any more than he can lift himself by his own boot straps." (Emphasis added).

⁵² 24 T.C. 569 (1955). Relying on *Papineau* the court held that "[i]t was there [in *Papineau*] said in that connection that "it is in accordance with sections 22 and 23 of the Internal Revenue Code [of 1939] that the expenses of operation be computed *without eliminating* small portions of depreciation, cost of food, wages, and general expenses to represent the cost of his meals and lodging" (Emphasis added).

⁵³ T.C.M. 1955-202. Substantially on all fours with *Doak*.

⁵⁴ *Commissioner v. Doak*, 234 F.2d 704 (4th Cir. 1956); *Commissioner v. Moran*, 236 F.2d 595 (8th Cir. 1956); *U.S. v. Briggs*, 238 F.2d 53 (10th Cir. 1956). After these decisions, it reviewed this problem in *Thomas Robinson*, 31 T.C. 65 (1958) and decided over six dissents to maintain its view.

⁵⁵ *Commissioner v. Doak*, 234 F.2d 704, 708 (4th Cir. 1956).

cated one. The factual circumstances of each case will be determinative of the issue. The Revenue Service itself has recognized this problem, and in its Revenue Procedure 62-32⁵⁶ announced that it "will not issue advanced rulings or determination letters because of the inherently factual nature of the problems involved."

Travel and Entertainment

For the group of employee-taxpayers who wish to maximize personal consumption tax free there is no more fertile field to till than the acreage provided by section 162⁵⁷ which permits him to partake in cost-free entertainment and travel closely connected with his business activities. And this is so notwithstanding new section 274⁵⁸ which does limit such endeavors to activities directly related to the active conduct of business. In other words the new section does not set forth or fashion a new class of deductions but merely tightens and augments the "ordinary and necessary" requirements of section 162. Therefore an analysis of the decisions, rulings and regulations under pre-section 274 law is still pertinent in an evaluation of the tax free benefits obtainable under present law.

Although it is common knowledge that an expense⁵⁹ to be deductible must be "ordinary and necessary," it would not be superfluous to briefly review the interpretations placed upon that phrase by the courts and the Commissioner. In light of these interpretations, an examination of the cases in which a deduction has been claimed for the type of expenses under discussion would then be more meaningful and perhaps more instructive in arriving at a conclusion as to what limitations ought to be placed on such deductions (resulting in tax-free enjoyment of consump-

⁵⁶ 1962-2 Cum. Bull. 527.

⁵⁷ Int. Rev. Code of 1954.

⁵⁸ *Ibid.* (effective as of January 1, 1963).

⁵⁹ In order to eliminate the necessity of constant reference to "expenses incurred in a trade or business of the taxpayer", the word "expense" is herein used in that context only, impliedly excluding personal expenses and capital expenditures.

tion). The classic "definition" was given by the Supreme Court in *Welch v. Helvering*:⁶⁰

We may assume that the payments were necessary [The taxpayer] certainly thought they were, and we should be slow to override his judgment. But the problem is not solved when the payments are characterized as necessary There is need to determine whether they are *both* necessary *and* ordinary Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit . . . may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, . . . , are the common and accepted means of defense against attack The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part.⁶¹ (Emphasis added).

The Tax Court⁶² and the Commissioner⁶³ follow this rule that the expense must be both ordinary and necessary. The word "necessary" has been held to mean "appropriate" and "helpful" rather than necessarily essential to taxpayer's business⁶⁴. In an interesting "twist" the Second Circuit held that an expense which is not an ordinary and necessary nonbusiness expense may nevertheless be an ordinary and necessary business expense.⁶⁵

⁶⁰ 290 U.S. 111 (1933).

⁶¹ *Id.* at 113, 114. In *Deputy v. DuPont*, 308 U.S. 488, 495 (1940) the Court, in reference to the once in a lifetime occurrence, said: "Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved."

⁶² *Foye Lumber & Tie Company*, 33 B.T.A. 271 (1935).

⁶³ A.R.R. 444, 4 Cum. Bull. 159 (1921).

⁶⁴ *Blackmer v. Commissioner*, 70 F.2d 255 (2d Cir. 1934).

⁶⁵ *Commissioner v. Macy*, 215 F.2d 875 (2d Cir., 1954). The case involved a trustee who because of mismanagement (not involving bad faith or dishonesty) had to pay surcharges to the beneficiaries for losses incurred through his negligence. Full import to the statement in *Commissioner v. Heininger*, 320 U.S. 467 (1944) that what "is ordinary and necessary are doubtless pure questions of fact in most instances" has thus been given effect in this decision.

Neither the various Revenue Acts, nor the 1939 Code, nor the 1954 Code specifically provide for deductibility of entertainment expenses, but they are deductible if they meet the ordinary and necessary tests. In *Hal E. Roach Studios*⁶⁶ one half of the expense of maintenance and upkeep, including depreciation, supplies, and wages of the crew of a yacht were allowed. The boat was acquired solely for business purposes (production of marine pictures), but during the year in litigation very few films were produced due to cancellation by the film distributor. To prevent deterioration the vessel was used for considerable entertainment. The boat was kept available at all times for picture production. The court held that "though the evidence was not precise on the relative costs incurred for business and pleasure use, we are satisfied that at least one-half of the expense was an ordinary and necessary expense of petitioner's business, and accordingly we allow the sum of \$8776.67 as a deduction."⁶⁷ In a more recent case⁶⁸ the court was not willing to accept evidence which was "not precise" and held that "the amounts deductible by petitioner as ordinary and necessary expenses in the two allowable categories of entertainment and cabin cruiser expenses and depreciation are 25 per cent of those now claimed by him." It is immediately apparent, even from the two cases above cited, that the principal difficulties in determining the deductibility of entertainment expenses is in distinguishing between the personal and business nature of the expenditures. Examples of flagrant claims of personal expenditures as business expenses may be found in *Challenge Manufacturing Company*⁶⁹ and

⁶⁶ 20 B.T.A. 917 (1930).

⁶⁷ *Id.* at 919. The deductibility or nondeductibility under new section 274 will be discussed *infra*.

⁶⁸ Richard A. Sutter, 21 T.C. 170, 174 (1953).

⁶⁹ 37 T.C. 650 (1962). Taxpayer was a corporation owned wholly by one stockholder. The corporation "owned" a luxury cabin cruiser used by the stockholder for pleasure cruises and parties. Some of the participants at a few of the activities were persons who had some connection with the business of the taxpayer, but their presence on board did not necessarily have any proximate relationship to the business of the taxpayer. During the two years in question the corporation took deductions totalling \$56,000 in respect to expenses incurred in operating and maintaining the

*American Properties, Inc.*⁷⁰ But in *Rodgers Dairy Company*⁷¹ it was not obvious whether the exhibiting of show horses was merely a hobby of its controlling stockholder or a bona fide promotional activity. The evidence sufficiently convinced the court that it was an ordinary and necessary business expense. In the same case it was found that an automobile owned by the corporation but used by the controlling stockholder was operated for the conduct of the business of the company even though there was a small amount of nonbusiness use during two out of the three years in contest. As to the third year, since the shareholder could not prove that his personal use was inconsequential, an allocation was to be made between business and nonbusiness use according to the Cohan⁷² rule. The court further found that liquor furnished for the entertainment of suppliers of the company was an ordinary and necessary business expense, especially in view of the fact that the amount involved was not large in relation to the purchases of the company.⁷³

cruiser. The Commissioner disallowed one half of the sum on the grounds that that portion related to the personal use and enjoyment of the sole stockholder. The Tax Court approved the disallowance saying: "Indeed, we think that the Commissioner has been exceedingly generous in allowing deductions for one-half the depreciation and boat expenses paid by the corporation. Had he allowed a considerably smaller deduction, we would have approved his determination on this record." (p. 659).

⁷⁰ 28 T.C. 1100 (1957). In this sole stockholder case the full deduction of expenses of operation and capitalization of the cost of a race boat totalling \$33,000 was disallowed to the corporation and taxed as income to the stockholder. The facts showed that the stockholder was a speed boat enthusiast who used the boat for racing purposes, and used the corporation to give the activity the appearance of a business transaction under the guise that there might be profit in the designing, construction, and sale of racing boats. The evidence clearly showed however, that he had no intention of selling such boats, and in fact turned down a good price offered by a prospective buyer for two boats similar to his (which won the Gold Cup races). See also *Greenspon v. Commissioner*, 229 F.2d 947 (8th Cir. 1956) in which an industrial pipe corporation claimed deductions for expenditures on the farm-house of its dominant stockholder allegedly used for promotional purposes in the form of a horticultural show place.

⁷¹ 14 T.C. 66 (1950).

⁷² *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930). In the principle case the allocation was 90% business and 10% personal.

⁷³ See also *Johnson v. U.S.*, 45 F. Supp. 377, 380 (D.C. Cal. 1941) in which country club dues and entertainment expenses were al-

Section 62 (2) (A) ⁷⁴ provides that an employee may deduct from his gross income expenses paid or incurred by him in connection with his employment if he is reimbursed by his employer. Therefore an employer could furnish an employee with facilities of entertainment (yacht, cars, hunting lodge) in which the employee could entertain his customers and then obtain a reimbursement for sums he expended for their entertainment (food, drink, etc.). Although reimbursement by an employer does not conclusively establish the business nature of the entertainment, it does weigh in favor of that conclusion. A sole proprietor would find it more difficult to prove the business purpose of the entertainment activity than the reimbursed employee. By incorporating, he would attain the employee status, and even if reimbursement were not feasible, written evidence that the salary is established at a high enough level to absorb such expenditures, would qualify them for deduction (as if there had been reimbursement).⁷⁵ In *Walter E. Ditmars* ⁷⁶ the Commissioner allowed all the reimbursed travel, meals and lodging while away from home expenses (which would be allowable whether reimbursed or not) of the president of a widely held corporation, but disallowed that portion of the reimbursed expenses which represented entertainment, club dues, club charges and telephone expenditures. (The president devoted his full working time to the business.) The evidence was clear that all the travel, and a substantial portion of entertainment, was connected with the business. The Tax Court, using the *Cohan* ⁷⁷ rule allocated the disallowed amounts between business and personal expenditures, allowing a deduction

lowed in full, the court stating: "The Government demanded and received large income taxes on the fees collected by the plaintiff's expenditure in club dues, and the Government cannot refuse to allow plaintiff a deduction as a business expense of the money which produced the business. To rule otherwise would revive the fable of the goose and the golden eggs."

⁷⁴ Int. Rev. Code of 1954.

⁷⁵ See *Grover Tyler*, 13 T.C. 186 (1949); *Fred N. Fischer*, 6 T.C.M. 520 (1947). *Contra* I.T. 3728, 1945, Cum. Bull. 78; Treas. Reg. section 1.62-1(f) (1) (1957).

⁷⁶ 20 T.C.M. 495 (1961) *rev'd on other grounds* 302 F.2d 481 (2d Cir. 1962).

⁷⁷ *Supra* n. 72.

for the former *under Section 212 (1)*.⁷⁸ Whereas heretofore such deductions were allowed under section 162 (trade or business of employer), this decision by recognizing deductibility under section 212 may alter the test of what is ordinary and necessary as regards employees' expenditures for producing their income (i.e., their salaries).

The Code specifically provides for deductibility of traveling expenses.⁷⁹ The phrase "traveling expenses" applies to transportation costs, including baggage transfer, taxis, and porters, meals and lodging, telephone and telegraph, tips, and other such expenditures. The travel must have been undertaken in pursuit of business while away from home overnight.⁸⁰ The "away from home" requirement has given cause to endless litigation. The Commissioner has steadfastly maintained that "home" is the taxpayer's post of duty and if he lives somewhere else the travel between the two locations is nothing more than commuting and the meals and lodging are also personal in nature.⁸¹ The Tax

⁷⁸ Int. Rev. Code of 1954. Section 212(1) allows a deduction for all ordinary and necessary expenses paid or incurred for the production or collection of income.

⁷⁹ Int. Rev. Code of 1954, section 162 (a) (2).

⁸⁰ The overnight requirement applies to deductibility of meals and lodging only.

⁸¹ See, e.g. O.D. 1021, 5 Cum. Bull. 174 (1921); I.T. 1264, I-1 Cum. Bull. 122 (1922), secretary of Congressman who maintains permanent residences elsewhere, but lives in Washington during sessions of Congress; I.T. 3314, 1939-2 Cum. Bull. 152, baseball player whose club headquarters is in city other than his hometown; but G.C.M. 23672, 1943 Cum. Bull. 66, distinguishes between full time post of duty and temporary post of duty: In connection with wartime dollar a year men it stated that "if an individual continues in private employment at his original place of business and renders only intermittent services to the Federal Government, his "home", for Federal income tax purposes, continues to be his original place of business, and any traveling expenses, including the cost of meals and lodging, incurred in serving the Federal Government while away from such "home" will be deductible as business expenses. . . . If, however, an individual serving the Federal Government has severed his connection with the private organization which he previously served, or if he does not continue to render active service to the private organization with which he is connected, it will be considered that his business location, post, or station, and therefore, his "home", is at Washington . . . with the result that amounts expended for meals and lodging at such post of duty are not deductible. . . ." Rev. Rul. 497, 1954-2 Cum. Bull. 152; Rev. Rul. 147, 1954-1 Cum. Bull. 51; Rev. Rul. 236, 1955-1 Cum. Bull. 274; Rev. Rul. 604, 1955-2 Cum. Bull. 49; Rev. Rul. 49, 1956-1 Cum. Bull. 152.

Court also consistently expresses this same view.⁸² However the Courts of Appeals for the Ninth Circuit,⁸³ Sixth,⁸⁴ and Fifth⁸⁵ do not agree with this interpretation. The Supreme Court has not as yet expressed its opinion as to what the statutory meaning is, although in two cases⁸⁶ it would have had the opportunity to do so. It can be expected that litigation in this area will continue *en masse* until a clearer and more contextual meaning will be developed regarding the situs of the "tax home" of a taxpayer. Litigation will also continue in respect to the question of the requirement that meals and lodging can be deducted only if the taxpayer was away from home overnight.⁸⁷ However since this paper is less concerned with the technicalities of the problem than with the tax free benefits obtainable under these provisions, it shall now turn to review some exemplary cases where such benefits have been obtained.

⁸² The cases are too numerous to cite. One the latest is *George Riscalla*, T.C.M. 1963-117, on appeal to 5th Cir.

⁸³ *Harvey v. Commissioner*, 283 F.2d 491 (1960). The court said that the Tax Court's application of the "indefinite" versus "temporary" test to determine whether the job site is the employee's "home" is too mechanical. The determination should be based on the reasonable probability of long employment at the locus of the job. The Commissioner, in Rev. Rul. 95, 1961-1 Cum. Bull. 749, announced that he will not follow this decision. In an earlier Ninth Circuit decision (*Wallace v. Commissioner*, 114 F.2d 407 (1944)) the court said that the Tax Court invaded the domain of Congress in construing the word "home" as the taxpayer's place of business, employment, or post of duty, and that the word is to be understood in its ordinary sense. The Tax Court refused to follow this definition.

⁸⁴ *Burrus v. Gray*, 287 F.2d 698 (1961).

⁸⁵ *Williams v. Patterson*, 286 F.2d 333 (1961).

⁸⁶ *Peurifoy v. Commissioner*, 358 U.S. 59 (1958) and *Flowers v. Commissioner*, 326 U.S. 465 (1946). In both cases the decision was grounded upon the question whether the travel was necessitated by the "exigencies of the business". See note 7 in *Williams v. Patterson*, *supra* n. 85. See also 4 Mertens, Law of Federal Income Taxation section 25.93 (1960).

⁸⁷ In *Williams v. Patterson*, *supra* n. 85 the court had this to say: "Second, we note particularly that there is no language in the statute limiting its application to 'expenses incurred while . . . away from home overnight'. The 'overnight' gloss was dreamed up by the Department. Third, there is nothing in the statute indicating any Congressional intent that 'away from home' means either overnight or away from home for a period substantially longer than an ordinary working day, . . ." (All italicized in original; footnotes omitted). For the *contra* view of the Commissioner see Rev. Rul. 495, 1954-2 Cum. Bull. 75 and I.R.S. Publication No. 300, 5 CCH 1956 Stand. Fed. Tax Rep. paragraph

In *Sanitary Farms Dairy, Inc.*⁸⁸ all the costs of an African safari taken by the principal officer and his wife were allowed as an advertising expense deduction. The publicity attending the trip, the films that were made and exhibited, the display of animals captured or killed, the newspaper reports of the trip, and animal naming contest of one of the captured animals, were found to be of such great advertising value that the court held the expenditures to be ordinary and necessary business expenses. What a wonderful way to take a \$16000 tax-free trip! Surprisingly enough the Commissioner acquiesced to this decision. However, *Sheldon*,⁹⁰ president of the National Association of Insurance Agents, was not as fortunate. His duties required him to attend meetings and conventions in various parts of the country. His wife accompanied him and assisted him in carrying out his duties by being a partner at dances and receptions and acting as hostess for the wives of other members. It was held that her traveling expenses were of a personal nature.⁹¹ But in *Allenberg Cotton Company, Inc.*⁹² the cost of travel, meals, and lodging of the wife of the president of the taxpayer corporation on world-wide business trips was held deductible by the corporation and not includible in his income because the diabetic husband required a travel companion and in the doctor's opinion his wife was the person best able to care for him.⁹³

Hundreds of illustrations could be cited to show the widespread practice of luxury spending claimed as business deductions. It reached the point that the President of

6347. See also Rev. Rul. 221, 1961-2 Cum. Bull. 34 in which the Commissioner states that it will follow the Williams decision in similar railroad conductor cases.

⁸⁸ 25 T.C. 463 (1955).

⁸⁹ Rev. Rul. 583, 1956-2 Cum. Bull. 117.

⁹⁰ *Sheldon v. Commissioner*, 290 F.2d 48 (7th Cir. 1962).

⁹¹ Similar holding in *Patterson v. Thomas*, 289 F.2d 103 (5th Cir. 1961).

⁹² —F. Supp.—(D.C. Tenn. 1960).

⁹³ See also *Faitoute Iron & Steel Co.*, 11 B.T.A. 818 (1928) in which the amount by which a corporation reimbursed its president for his and his wife's expenses while on a business trip to South America was deductible by the corporation. No showing was made that the wife's presence was required at all.

the United States expressed his concern in his message to Congress:

In recent years widespread abuses have developed through the use of the expense account. Too many firms and individuals have devised means of deducting too many personal living expenses as business expenses, thereby charging a large part of their cost to the Federal Government. Indeed, expense account living has become a byword in the American scene.

This is a matter of national concern, affecting not only our public revenues, our sense of fairness, and our respect for the tax system, but our moral and business practices as well. This widespread distortion of our business and social structure is largely a creature of the tax system, and the time has come when our tax laws should cease their encouragement of luxury spending as a charge on the Federal Treasury. The slogan—"it's deductible"—should pass from our scene.⁹⁴

Congress reacted by passing section 274.⁹⁵ Its objective is to tighten the deduction requirements. The tests of section 162 (ordinary and necessary) are retained and are to be met before section 274 becomes operative. But a host of new tests and new terminology is introduced. "Activity" is distinguished from "facility", "directly related to" and "associated with" qualifying the former term and "used primarily for the furtherance of taxpayer's trade or business" refers to the latter. "Business meals" must be served in surroundings "of a type generally considered to be conducive to a business discussion". The Section and the Regulations⁹⁶ pertaining thereto express in great detail the new requirements and the exceptions thereto. The committee reports⁹⁷ are very specific also, and make it clear

⁹⁴ The President's Message on the Federal Tax System, H.R. Doc. No. 140, 87th Cong., 1st Sess. (1961) as reprinted in 1 United States Code Congressional and Administrative News, 1136 (1961).

⁹⁵ Int. Rev. Code of 1954.

⁹⁶ Treas. Reg. section 1.274-1 through -8 (1963).

⁹⁷ S. Rep. No. 181, 87th Cong., 2d Sess. (1962); H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1962); H.R. Rep. No. 2508, 87th Cong., 2d Sess. (1962).

that the Cohan⁹⁸ rule is abolished as is the deductibility of the *Sanitary Farms*⁹⁹ type of expenditure. Unfortunately the very specificity of the terminology will give rise to litigation for years to come until their meaning shall have been judicially and administratively settled. Nor does the new section eliminate the enjoyment of tax free income, it merely prevents flagrant abuses. Thus the cost of facilities maintained on the company premises to furnish food and beverage to employees and executives continues to be deductible to the company and non taxable to the recipients.¹⁰⁰ Recreational facilities, such as company theatres, swimming pools, golf courses, athletic fields, picnics, dances, Christmas parties, art clubs, photography clubs, are excepted from the over 50% rule of section 274, if the facility is for the benefit of employees other than officers, highly compensated employees or ten percent shareholders.¹⁰¹ A company owning yachts or hunting lodges has not necessarily lost all deductibility of upkeep costs. If under the ordinary and reasonable tests more than 50% of its use was for business entertaining, then the proportion of cost applicable to use *directly related* to business activity is deductible. If less than half of the entertainment expense is attributable to business entertainment then no deduction whatsoever is permitted, even as to directly related entertainment.¹⁰² Club dues and fees "shall be treated as items with respect to facilities".¹⁰³ Therefore if the taxpayer establishes that more than 50% of his use of the club is business use under section 162, then all expenses directly related to business use will continue to be deductible. Dues

⁹⁸ Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930).

⁹⁹ *Supra* n. 88.

¹⁰⁰ Int. Rev. Code of 1954, section 274(e) (2).

¹⁰¹ Int. Rev. Code of 1954, section 274 (e) (5). In Slaymaker Lock Company, 18T.C. 1001 (1952) the company experienced difficulty in retaining foremen because of higher salaries offered by competing companies. To alleviate this condition it built a \$36,000 facility and conveyed title to it to its foremen's association to be used by its members. The full cost was allowed as a deduction in the year of transfer. Under section 274 it could retain title and still obtain an annual deduction equivalent to depreciation and maintenance including all expenses connected therewith.

¹⁰² S. Rep. No. 1881, 87th Cong., 2d Sess. (1962) as reported in 1962-3 Cum. Bull. 737.

¹⁰³ Int. Rev. Code of 1954, section 274 (a) (2) (A).

paid to civic clubs such as Kiwanis, Lions, Rotary, Civitan, or clubs used solely for business lunches, or professional and trade association clubs are exempt from the rules of section 274.

The "entertainment associated with trade or business" rule refers to situations where substantial business discussions directly preceded or followed the entertainment activity. The Finance Committee explained it as follows:

When the taxpayer conducts lengthy negotiations with a group of business associates and that evening the group goes to a night club, theater or sporting event for relaxation, such entertainment expenses are regarded as directly related to the active conduct of business. Moreover, if a group of business associates with whom the taxpayer is conducting business meetings comes from out of town to the taxpayer's place of business to hold substantial business discussions, the entertainment of such business guests prior to the business discussions also is directly related to the conduct of the business. Similarly, if in between business meetings at a convention the taxpayer entertains his business associates attending such meetings, such expenses will be allowable.¹⁰⁴

Abuses in deduction of traveling expenses,¹⁰⁵ including meals and lodging, have been sought to be remedied through section 274(c). If the travel lasts longer than one week and more than 25% of the time of the trip was spent in pursuit of personal gratification, an allocation of the expenses is required. Thus, where taxpayer flew from New York to London for a two day business transaction and then flew to Stockholm for a fourteen day vacation and then back to New York, the trip lasting eighteen days, 14/18 of the cost attributable to transportation to and from London is disallowed. The cost of food and lodging for the two days in London is allowable. In another example,

¹⁰⁴ S. Rep. No. 181, 87th Cong., 2d Sess. (1962) as reported in 1962-3 Cum. Bull. 735.

¹⁰⁵ Vacation trips being charged off as business trips.

taxpayer flew from New York to Brussels where he spent fourteen days on business and five days on personal matters and then returned to New York, the entire trip lasting 21 days. The taxpayer is allowed the total cost attributable to transportation to and from Brussels and the food and lodging for fourteen days, but not the food and lodging for the five days spent on personal matters. Although the trip exceeded a week, the time spent on non-business activities (5/21) was less than 25% of the time of the total trip.¹⁰⁶ No allocation of transportation expenses is required if the trip lasts less than a week.¹⁰⁷ Although flagrant abuses will not be possible under these rules, it is obvious that one can still obtain vacation trips in which the cost of transportation will be tax free consumption.

Accident and Health Plans

As can be gathered from the discussion on travel and entertainment expenses, expenditures by an employer for the *personal* expenses of an employee are taxable income to the employee.¹⁰⁸ However, an exception to this rule is made in sections 105 and 106.¹⁰⁹ Moreover, this exception extends not only to the employee but his wife and dependents as well. These sections provide that the cost of the following employer financed health and accident plans are not includible in the employee's income:¹¹⁰

(a) Accident and health plans to compensate the employee for personal injury or sickness incurred by him, his wife or his dependents

(b) Medical care reimbursement plans for medical expenses incurred by the employee, his wife, and his dependents

(c) Plans to pay for permanent loss of, or loss of use of, a member or function of the body or the perma-

¹⁰⁶ *Supra* n. 104 at 876.

¹⁰⁷ Int. Rev. Code of 1954, section 274(c).

¹⁰⁸ And see Treas. Reg. section 1.61-2(d)(2) (1957).

¹⁰⁹ Int. Rev. Code of 1954.

¹¹⁰ And under section 162 is deductible by the employer.

ment disfigurement of the employee, his wife or his dependents. The payments are to be computed in relationship to the nature of the injury, not absence from work

(d) Wage continuation payment plans during illness, popularly referred to as "sick pay".

Another unique feature of this exception is that it can be highly discriminatory and limited to highly paid executives.¹¹¹

Not only is the cost of these insurance programs or non-insured plans non-taxable to the employees, but proceeds of these benefits are not taxable to him if the payments are received for the following:

(a) To reimburse him for expenditures for medical¹¹² care of himself, his wife, or his dependents

(b) Amounts paid to him, his wife, or his dependents for the permanent loss of a member or function of the body or for permanent disfigurement

(c) To the extent of \$100 a week, amounts paid as "sick pay".

Benefits obtained under circumstances other than the three above are taxable income to the employee.¹¹³

Group Life Insurance

Another exception to the rule that payments by an employer for the personal expenses of an employee is taxable

¹¹¹ Treas. Reg. section 1.105-5(1956) states: ". . . A plan may cover one or more employees, and there may be different plans for different employees or classes of employees." Normally discriminatory employee-benefit plans do not qualify for tax deduction.

¹¹² The expenses which may be reimbursed tax free are quite diverse. They include any type of expense which would qualify as a deductible medical expense under section 213 (see Int. Rev. Code of 1954 section 105(b) and 213(e)). Therefore dental reimbursement plans are permissible.

¹¹³ But under employee financed plans no proceeds of any kind are taxable. Under employer-employee financed plans the portion attributable to the employer's portion of the premiums is taxable. Where the premiums paid by the employer are included in the employee's income, all types of proceeds are tax free.

income to employee is the non-taxability of premiums paid by an employer on group term life insurance covering the employees. This exception arose not through statutory enactment (as did the health and accident plan exception) but through administrative rulings. A 1920 law opinion¹¹⁴ ruled that group term life insurance premiums paid by the employer is not income to the employee. Moreover, no anti-discrimination provisions were made in the various rulings issued,¹¹⁵ and thus higher coverage (i.e., higher multiples of annual compensation) may be given to executives and officers than is afforded to lower paid employees. In this connection it might be noted that some states have statutes limiting the maximum amount of group insurance which may be written per person, usually in terms of a ratio of insurance to the salary of the employee covered. Pennsylvania permits maximum coverage per person of \$20,000 or one and one-half times the employee's salary to a maximum of \$40,000 whichever is greater.¹¹⁶ This situation could be avoided by having the policies issued to and held by an out of state trustee.¹¹⁷ But in such a situation the non-taxability feature of the premium payments might be lost since the rulings seem to indicate that this feature is limited to plans involving direct payments by the employer, and the imposition of a trust entity between the employer and employee might change the situation.¹¹⁸ Furthermore, in a letter ruling¹¹⁹ the Commissioner indicated that highly discriminatory plans will not qualify for tax-free status.

¹¹⁴ L.O. 1014, 2 Cum. Bull. 88 (1920). The reasoning behind this ruling is very interesting: "The financial benefits under these policies do not move to the employees personally, but only to their heirs or dependents after their deaths The employee has no option to take the amount of premiums paid . . . instead of the insurance. The policy has no paid up value The premium paid therefor is in no sense "gain derived" or realized . . . in dollars and cents, but only in the feeling of contentment that provision has been made for dependents. It is paid by the employer *not as compensation* to the employee, but as an investment in increased efficiency." (Emphasis added).

¹¹⁵ See for e.g. G.C.M. 16069, XV-1 Cum. Bull. 84 (1936).

¹¹⁶ Pa. Stat. Ann. tit. 40, section 532.2 (1954).

¹¹⁷ Most statutes limit only policies issued within the state.

¹¹⁸ Mim. 6477, 1950-1 Cum. Bull. 16; Rev. Rul. 52, 1954-1 Cum. Bull. 150; Rev. Rul. 634, 1956-2 Cum. Bull. 291.

¹¹⁹ To Century Planning Corporation, P-H 1962 Fed. Tax Serv. paragraph 54857. The plan proposed insurance of \$100,000 on

No tax exemption is applied to premiums paid for group permanent policies where the employee receives increasing values of paid-up life insurance except under special circumstances.¹²⁰ There is a method however whereby permanent life insurance can be obtained with at least a partial tax benefit. It is the split dollar plan, under which the premiums are divided between the employer and the employee, the employer paying the premium which is equal to the increase in cash value each year. The employer owns the portion equal to the cash surrender value and the employee the balance. The Commissioner ruled¹²¹ that such premium payments are merely interest free loans and therefore do not result in taxable income to the employee. This reasoning is somewhat less surprising, especially in light of other rulings in respect to life insurance benefits. No administrative difficulty would arise in trying to determine the value of the benefit conferred since the employee's saving could be measured by comparison with rates of term insurance. Furthermore, under section 101 (a), (2) (B)¹²² life insurance policies can be transferred between a corporation and a stockholder executive without adverse income tax effects on the proceeds, and thus such an employee could obtain the policy upon retirement and his beneficiary would obtain all the proceeds tax free.

Miscellaneous Items

There are hosts of other fringe benefits which afford tax free income to various classes of taxpayers. Restricted stock options, pension, profit sharing and other qualified plans, although the most popular and extensive of fringe benefits, are beyond the scope of this discussion, since the

each of two shareholder-executives and only \$2,000-\$3,000 on all other employees. Said the ruling, referring to L.O. 1014 (*supra* n. 114): "The payment by you of premiums on group term life insurance, insofar as the premiums are for insurance on the lives of your two stockholders, cannot be said to be likely to bring about a feeling of contentment to your employees who own none of your stock."

¹²⁰ See Mim. 6477, 1950-1 Cum. Bull. 16; Rev. Rul. 165, 1954-1 Cum. Bull. 17; Rev. Rul. 193, 1955-1 Cum. Bull. 266.

¹²¹ Rev. Rul. 713, 1955-2 Cum. Bull. 23.

¹²² Int. Rev. Code of 1954.

complexities and ramifications of these devices would merely tend to blur whatever points may emerge. A brief general statement will have to suffice. As regards profit sharing and pension plans, the statutory requirements¹²³ against discrimination (in favor of executives) are strict. But the benefits gained make it worthwhile to observe them so that the plan become "qualified". The benefits are:

(1) The employee is not taxed on the employer's contributions to the fund.¹²⁴

(2) The employer receives a current deduction for the amounts contributed to the plan.¹²⁵

(3) The earnings of the trust are exempt from income tax.¹²⁶

(4) If the employee receives the accumulated funds in one taxable year on account of termination of service, he obtains capital gains treatment rather than ordinary income.¹²⁷

(5) If the employee dies, a lump sum distribution of \$5000 will be tax exempt.¹²⁸

(6) If the employee dies while a participant in a qualified plan, the value of his interest attributable to the employer's contribution and payable to a beneficiary will be exempt from estate tax.¹²⁹

Another means devised by employers to retain key executives is the stock option method of compensation. In order to defer income taxation of these options the requirements

¹²³ See Int. Rev. Code of 1954, section 401 and regulations thereto.

¹²⁴ Int. Rev. Code of 1954, sections 402 and 403.

¹²⁵ Int. Rev. Code of 1954, section 404.

¹²⁶ Int. Rev. Code of 1954, section 501.

¹²⁷ Int. Rev. Code of 1954, sections 402 (a) (2) and 403 (a) (2).

¹²⁸ Int. Rev. Code of 1954, section 101 (b) (2) (A).

¹²⁹ Int. Rev. Code of 1954, section 2039 (c).

of section 521¹³⁰ must be observed. The tax result of such "restricted options" is that the optionee will, under certain circumstances, obtain favorable capital gains treatment upon the sale of the stock thus acquired, or under other circumstances, limited taxable income at the time of exercise of the option and capital gains rates at the time of sale of such stock.

Other tax-free items of income that might be mentioned under this heading are:

(1) Rental value of a home furnished to a minister, or a rental allowance included in his compensation in lieu of a parsonage,¹³¹ and an allowance included in his compensation for utilities.¹³²

(2) The value of the improvements made by a lessee is excluded from the gross income of the lessor acquired by the latter upon the termination of the lease.¹³³

Conclusion

As pointed out in the opening remarks, if individual income taxation is to be equitable, it should be imposed with reference to total net income from all the various sources obtained, because the economic status of taxpayers is best measured by their total net income. Especially is this so if a consistent system of progressive rates, exemptions, credits and deductions is to be followed.¹³⁴ A reading of section 61¹³⁵ gives the impression that Congress in one broad sweep accomplished this goal. Too, under such an encompassing basis the administrative problems of collecting the tax would be simple and conducive to efficient execution. Professor Groves' objectives of fair taxation, di-

¹³⁰ Int. Rev. Code of 1954.

¹³¹ Int. Rev. Code of 1954, section 107.

¹³² Rev. Rul. 350, 1959-2 Cum. Bull. 45.

¹³³ Int. Rev. Code of 1954, section 109.

¹³⁴ BUHLER, PUBLIC FINANCE 495 (3d ed. 1948).

¹³⁵ Int. Rev. Code of 1954: "... gross income means all income from whatever source derived . . .".

rect taxation, widely shared ¹³⁶ taxation would also be easily accomplished. But these purposes are frustrated by sections 101 through 119 ¹³⁷ listing items excludible from gross income; and sections 162, 212, and 274 ¹³⁸ may lead to unintended exclusions.¹³⁹ Does the "convenience of the employer" make the free meals and lodging furnished to the employee any less beneficial income than if he were to pay a higher salary from which the employee would have to purchase these necessities? In fact, does the employee not accept a lower salary knowing that he is to receive the free meals and lodgings? Or is there logic in not taxing the value of the meal if eaten on the premises of the employer, but taxing the reimbursement therefor if eaten across the street (in an arrangement whereby the employee had to eat there so that he would be available to his employer during the meal time)? And even in situations where the job site is in a remote place, are not the meals and lodging consumption by the recipient although it may be necessary or expedient for the employer to provide them? Admittedly, placing a valuation on meals and lodging furnished would be a monstrous task, if each situation were to be determined separately. But standards of measure could be prescribed based on another standard. For example, the salary of the employee could be the basis of the valuation. Tables could be published by the Internal Revenue Service placing valuations on meals and lodgings on the same wage and salary ranges as it now publishes for withholding tax purposes. Employers could then compute the total salary they are in effect paying, and withhold the taxes accordingly. By this means the lessening of the progressivity of the tax rates is eliminated ¹⁴⁰ (as pertains to this portion of

¹³⁶ GROVES, POSTWAR TAXATION AND ECONOMIC PROGRESS, 373 (1946).

¹³⁷ Int. Rev. Code of 1954.

¹³⁸ *Ibid.*

¹³⁹ This paper does not extend to the myriad other preferences such as capital gains, depletion, gifts, social security, tax exempt interest, etc., etc.

¹⁴⁰ An executive whose marginal tax rate is 50% receives a \$250 tax advantage if he consumes (in a year's period) \$500 worth of food in an employer furnished dining room, whereas an employee in the 25% tax bracket obtains only a \$125 tax advantage for the same quantity of consumption.

tax free income) as is the discriminatory treatment relative to taxpayers who are not fortunate enough to be fed and sheltered by their employers.

Not even the "convenience of the employer" justification could be applied in defense of tax free group term life insurance and health and accident plans. The social advantages and benefits of those plans are undisputed, but no one has ever satisfactorily explained why an employee who is relieved of using after-tax dollars to provide such protection is not held to have realized taxable income. Moreover, these plans are permitted to be discriminatory in favor of the highly paid executive-stockholder, and grossly discriminatory against self employed proprietors or partners who cannot obtain them on a tax free basis.

The cost of traveling expenses are as much a cost of doing business as the cost of raw materials, labor, or any other factor of production, and therefore any suggestion that they be disallowed would be ridiculous. But entertainment stands on other ground. Business is business. It should be conducted in the business office. *Any* entertainment is personal in nature. The very concept of the two activities are in juxtaposition. How can entertainment be directly related to or associated with business? The very purpose of entertainment is to bring about relaxation and personal gratification. It is the tax laws themselves (by allowing deductions therefor) that brought about the idea that entertainment of prospective customers is a business activity. It is the tax laws that sanctioned entertainment expenses with a false aura of legitimacy.

Neither is there justification for the capital gain features afforded to certain transactions resulting from stock options, stock bonus plans, pension plans and other qualified plans. Employers bestow these benefits upon their recipients as a form of compensation and therefore should be taxed as any other compensation.

Aside from the questions of equity and fairness regarding all the aforementioned exclusions and deductions and

tax advantages, the administrative problems created by them are tragic. The sheer waste of human effort put into litigation of thousands of cases in which the issues were whether it was or was not for the convenience of the employer, whether it was or was not an ordinary and necessary expenditure, whether it was or was not a personal expense, is appalling. The abuses¹⁴¹ to which this portion of the tax law led can only be characterized as shameful.

It is hereby suggested that the tax free nature of meals and lodging, health and accident plans, group term insurance, and the deductibility of entertainment expenses, and the capital gains feature of the various executive compensation plans, and the preferential tax treatment of all those various items not within the scope of this paper, be abolished. A revision of the tax law along these lines would broaden the tax base to such an extent that the very high tax rates could be eliminated, which in itself would reduce the incentive to devise schemes of avoidance by using the "loop-holes" afforded by these provisions. It would eliminate the vast administrative problems of enforcement posed under the present conditions. Litigation would be reduced to a fraction of what it is now. And most importantly it would achieve a most fundamental requisite of taxation: There would be equal taxation of persons with equal incomes.

¹⁴¹ Repealed section 120 of the Code is a classic example of taxpayer eagerness for evasion. This section provided for exclusion of statutory subsistence allowance to law enforcement officers. Suddenly states and municipalities rewrote their compensation laws to include in the salary of all such officers a per diem subsistence allowance, whether such allowance was in fact warranted or not.