FREQUENT FLYER BENEFITS
Substantive and Procedural Tax Consequences

I. Introduction

In 1981, the airline industry developed a new marketing technique to combat increasing competition for passengers—the frequent flyer bonus program.[1] Designed to create "brand" loyalty,[2] the programs allow travelers to accrue mileage on a specific airline for the purpose of "spending" the mileage on designated awards.[3] As more mileage credits are accrued, more valuable prizes[4] become available to the program participant. The bonuses primarily take the form of free flights but can also include free hotel accommodations,[5] free use of rental automobiles[6] or even cash.[7]

In 1984, airlines reported an estimated ten million participants in frequent flyer programs.[8] In 1985, airlines reported that an estimated 100 million dollars of frequent flyer bonuses were awarded.[9] In 1986, the value of the average frequent flyer bonus was $500 while the number of reported participants had remained constant at ten million.[10] Because of the popularity of the programs,[11] it appears that the frequent flyer bonus has become a permanent economic factor in the airline industry.

An unforseen issue raised by the implementation of frequent flyer bonus programs is the taxability of the bonus awarded to the recipient.

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[1] *See, e.g.*, McNatt, *The Richer Rewards of Frequent Flying*, Money, Apr. 1985, at 89 [hereinafter *Richer Rewards*]; Sherman, *The Airlines' Flying Jackpots*, Fortune, Nov. 29, 1982, at 106 [hereinafter Sherman]; *The Sky's the Limit in Luring the Frequent Flyer*, Bus. Wk., Oct. 18, 1982, at 152 [hereinafter *Sky's the Limit*]. The term "flyer" appears in some publications as "flier." For consistency, unless directly quoting such a publication, this Note uses "flyer."

[2] *Richer Rewards*, *supra* note 1, at 89.

[3] *The Frequent Flier Game: Now Winning Is a Lot Easier*, Bus. Wk., April 2, 1984, at 93 [hereinafter *Game*].

[4] This Note will use interchangeably the terms "award," "prize" and "bonus" to refer to a frequent flyer free flight. Unless clearly indicated, the terms "prize" and "award" are not being used as technically defined by the Internal Revenue Code of 1986.

[5] McNatt, *Cashing in on New Deals for Frequent Fliers*, Money, May 1986, at 161 [hereinafter *New Deals*].

[6] United Airlines, Inc., Mileage Plus Program Guide 33 (1987).

[7] Midway Airlines, Inc., Flyers First Program (1986).

[8] *Does the Frequent-Flier Game Pay Off for Airlines?*, Bus. Wk., Aug. 27, 1984, at 74 [hereinafter *Frequent-Flier Game*].

[9] *New Deals*, *supra* note 5, at 160.

[10] *Id.*

[11] *Frequent-Flier Game*, *supra* note 8, at 74. Each airline with a frequent flyer bonus program claims the program has boosted business 20% to 35%. *Id.*

If the receipt of 100 million dollars of bonuses in 1985 had been subject to income taxation, as much as fifty million dollars of tax revenue could have been generated.[12] Furthermore, many variations of frequent flyer bonus programs are being created as other industries follow the airlines' lead. For example, several hotel chains are rewarding frequent guests with free lodging.[13] Also, AT&T has initiated "Opportunity Calling," a program that awards merchandise discounts for increased AT&T long distance telephone usage.[14] As these variations on the bonus program concept expand, the resulting tax implications compound. Therefore, taxpayers and tax professionals will increasingly be called upon to determine the taxable status of frequent flyer bonuses and their progeny.

The purpose of this Note is to examine the mechanism and background of frequent flyer bonus programs and analyze the tax effects of the receipt of a frequent flyer bonus. The first issue for resolution is whether the receipt of a bonus constitutes gross income to the recipient who paid for the flights upon which the bonus is awarded. Second, the income recognition issue will also be analyzed in light of the employment relationship, a situation in which the party who is paying for tickets, the employer, is not the individual using the free flight. Third, this Note will discuss whether bonuses, if considered to be income, are excludible under one of the exclusionary sections of the Internal Revenue Code of 1986[15] (Code). Fourth, this Note will determine whether such bonuses, when received from an employer, constitute wages subject to withholding. Finally, this Note will propose an equitable solution to the question of who should be responsible for reporting receipt of these bonuses to the Internal Revenue Service.

II. The History and Mechanics of the Bonus

For those who do not travel by air, the concept of the frequent flyer bonus is a novel one requiring further explanation and a brief history. In 1981, American Airlines implemented its AAdvantage Program, a new marketing concept, to combat the anticipated increase in competition in the travel marketplace caused by the deregulation of the air travel industry.[16] The theory behind the program is that awarding

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[12]*See* I.R.C. § 1 (Supp. III 1985). This section contains the tax rate schedules used to compute federal income tax for individuals. Because the maximum possible tax rate was 50% in 1985, the maximum tax on $100 million of bonuses would have been $50 million, assuming all taxpayers were subject to the maximum tax rate.

[13]*Game*, *supra* note 3, at 93.

[14]AT&T Communications, Inc., AT&T Opportunity Calling (1986).

[15]26 U.S.C., the Internal Revenue Code, was most recently amended on October 2, 1986 by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

[16]*See, e.g.*, *Richer Rewards*, *supra* note 1, at 89; Sherman, *supra* note 1, at 106; *Sky's the Limit*, *supra* note 1, at 152. Airline fares were deregulated by the Airline Deregulation Act of 1978, which required that deregulation be completed by December 3, 1981. Pub. L. No. 95-504, 92 Stat. 1705 (1978) (codified in scattered sections of 49 U.S.C.).

free flights and other bonuses to repeat customers will create brand loyalty, thereby increasing business for the company.[17] Over time, because of increased competition and new, cut-rate airlines, the programs were not terminated as originally planned.[18] Instead, the programs were continued and expanded to allow travelers to include mileage flown on affiliated airlines as credit toward a single award.[19] By 1986, six major airlines were competing for the bulk of the frequent flyer business,[20] with other airlines instituting programs in self-defense.[21]

Although this Note will assume that the bonus received is a free flight, many other types of bonuses are available. For example, the six principal frequent flyer plans[22] offer an upgrade to first class at 10,000 miles.[23] Therefore, after the traveler has flown 10,000 miles, a program participant will pay coach fare but will obtain a first class seat. Other benefits include reduced rates for rental cars and hotel lodging.[24] In addition, bonus miles are awarded for patronizing affiliated hotel chains and car rental agencies.[25] For instance, a Delta program participant earns 1,000 extra miles each time he rents a National Rent-A-Car or stays overnight at a Marriott,[26] while United Airlines awards a 1,000 mile credit for each night spent on board a Holland America cruise ship.[27] Finally, Midway Airlines, in addition to offering a seven-day, six-night trip for two in the Virgin Islands, offers one of the more unique bonuses—$2,000 in cash.[28]

Procedurally, all frequent flyer bonus programs operate in a similar manner. American Airlines is noted for accuracy in record-keeping be-

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[17]*Richer Rewards*, *supra* note 1, at 89.

[18]*Game*, *supra* note 3, at 93.

[19]*Id.*

[20]*See New Deals*, *supra* note 5, at 170-72. The six competing airlines are American, Delta, Eastern, Pan Am, TWA and United. *Id.*

[21]*See Frequent-Flier Game*, *supra* note 8, at 79. For example, Continental and Northwest Airlines had to continue their frequent flyer programs because of business lost when the programs were discontinued. Also, Braniff instigated the first promotion that allowed credit for miles flown on competitor's airlines because of a belief that the major impediment to their success in attracting passengers was American's AAdvantage Program. *Id.*

[22]The six major frequent flyer programs are American, Delta, Eastern, Pan Am, TWA and United. *New Deals*, *supra* note 5, at 170-72.

[23]*Id.* at 170.

[24]*Richer Rewards*, *supra* note 1, at 89.

[25]*New Deals*, *supra* note 5, at 161. Some strategies can be used to increase the available bonus mile points. For example, frequent flyers will turn in a rental automobile and rent a different one daily or check into a different hotel daily because each automobile rental and hotel room rental earns bonus miles. *Id.* at 165.

[26]*Id.* at 161.

[27]UNITED AIRLINES, INC., MILEAGE PLUS PROGRAM GUIDE 26 (1987).

[28]MIDWAY AIRLINES, INC., FLYERS FIRST PROGRAM (1986).

cause of its computerized mileage log.[29] United Airlines issues a Mileage Plus card that is used like a credit card to ensure that the traveler is credited with the accrued mileage.[30] Trans World Airlines' sticker system requires that the traveler attach a sticker to the ticket stub and redeem the stub for mileage credit.[31] Midway does not compute the traveler's accrued mileage; instead, each round trip is one credit, and a bonus is awarded on the basis of round trips flown.[32]

These programs are subject to some limitations. Pan American offers the most varied program because of the availability of scheduled flights to exotic destinations; however, its program costs twenty-five dollars to join.[33] American's AAdvantage Program offers a variety of prizes but limits the availability of free travel to certain locations, particularly during the Christmas holidays.[34] Midway's literature states that rewards are subject to change without notice.[35] United's cruise awards are subject to availability and may not be booked until ninety days prior to departure.[36] Despite these restrictions, airlines attribute sudden business increases of twenty to thirty percent to the programs,[37] which indicates a strong consumer demand for continuation of frequent flyer bonus programs.

In addition to the economic inducement of *free* flights, another reason for the increasing popularity of the bonuses is their marketability.[38] For those travelers who would prefer cash to a free trip,[39] forty-four independent ticket brokers buy and resell the free travel coupons issued by the airlines to a frequent flyer bonus winner.[40] A $1,900 New York-

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[29]*See New Deals*, *supra* note 5, at 170-72.

[30]UNITED AIRLINES, INC., MILEAGE PLUS PROGRAM GUIDE 3 (1987).

[31]TRANS WORLD AIRLINES, INC., FREQUENT FLIGHT BONUS MEMBERSHIP MATERIAL (1985).

[32]MIDWAY AIRLINES, INC., FLYERS FIRST PROGRAM (1986).

[33]*New Deals*, *supra* note 5, at 170.

[34]AMERICAN AIRLINES, INC., AADVANTAGE PROGRAM, (1987).

[35]MIDWAY AIRLINES, INC., FLYERS FIRST PROGRAM (1986).

[36]UNITED AIRLINES, INC., MILEAGE PLUS PROGRAM GUIDE 26 (1987).

[37]*Frequent-Flier Game*, *supra* note 8, at 74. *But see* Dahl, *Frequently Frustrated: Travelers Find Frequent-Flier Plans Less Rewarding*, Wall St. J., July 15, 1987, at 29, col. 3. Recent restrictions imposed on awards by the airlines, including blackout days and limiting available number of sets per flight for award winners, may make the awards less valuable. *Id.*

[38]*See, e.g.*, Toy, *A Storm Warning for Frequent Fliers*, BUS. WK., Nov. 10, 1986, at 88 [hereinafter Toy]; McGrath, *The Frequent Flier Coupon Market*, U.S. NEWS AND WORLD REPORT, May 19, 1986, at 73 [hereinafter McGrath]; *Frequent Flyer Programs: Who Should Reap Benefits?* DUN'S BUS. MONTH, Apr. 1986, at 77 [hereinafter *Who?*]; *Richer Rewards*, *supra* note 1, at 92; Sherman, *supra* note 1, at 106.

[39]McGrath, *supra* note 38, at 73; Sherman, *supra* note 1, at 106. A travel agent states, "Many of our customers tell us the last thing they want is more flying." *Id.*

[40]Toy, *supra* note 38, at 88.

Honolulu round-trip can be sold for $600 to a broker, who resells it for $900.[41] Alternatively, the coupons can be bartered in private transactions.[42] One frequent flyer traded his free trip to Hawaii to his dentist in exchange for bridgework.[43] Some airlines are attempting to restrict transferability,[44] but the coupon market, which has grown into a fifty million dollar a year industry,[45] is resisting the airline's attempts.[46] Despite the uncertain future of the coupon market and the limitations the airlines impose on their programs, the demand for the bonuses suggests that frequent flyer programs are here to stay.

III. Bonus Flights in General—Income or Not?

Before considering the income treatment of frequent flyer bonuses in the context of the employment relationship, it is necessary to determine if the private individual who purchases and uses airline tickets, and thus earns a free flight, realizes income upon receipt of the free flight. There are two possible income treatments applicable to the receipt of a bonus flight. First, receipt of the free flight could trigger the recognition of income to the recipient.[47] Second, the flight could be considered a discount, in which case the receipt of the flight does not force the recognition of income but is a reduction of the cost of the underlying flights that earned the bonus.[48]

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[41]*Richer Rewards*, *supra* note 1, at 92. However, prices on the coupon market vary with the season and with supply and demand. *Id.*

[42]Sherman, *supra* note 1, at 106.

[43]*Id.*

[44]For example, Delta Airlines requires that a traveler appear personally at the ticket office in order to get a ticket transferred. *Who?*, *supra* note 38, at 74. Both United and TWA allow transfers only within families. Toy, *supra* note 38, at 88.

[45]Toy, *supra* note 38, at 88.

[46]Details of pending lawsuits concerning program participants' rights to sell their awards are beyond the scope of this Note. Generally, American Airlines and TWA have brought lawsuits to enjoin the largest coupon broker, The Coupon Bank, from selling bonus coupons. Brown, *American Airlines Files Suit Against Coupon Bank*, Travel Weekly, June 16, 1986, at 3. American Airlines was successful in obtaining a temporary restraining order against one of Coupon Bank's affiliated travel agencies; however, it expired October 14, 1986. Godwin, *Coupon Bank to File Counterclaims*, Travel Weekly, October 16, 1986, at 8 [hereinafter Godwin]. Coupon brokers have filed counterclaims alleging anti-trust violations, which one California observer believes the brokers have a 50-50 chance of winning. Toy, *supra* note 38, at 88. Also, three class actions against carriers arguing for program participants' rights to sell the coupons have been filed. Godwin, *supra* at 2.

In a recent Wall Street Journal article discussing the mounting liability of the airlines resulting from unused awards, it was noted that one lawsuit brought by American Airlines, TWA and United Airlines against a California broker was settled. Brown, *New Airline Figures Show Unused Awards Mounting*, Wall St. J., July 15, 1987, at 29, col. 5. Without additional details, it is not possible to assess the effects of this settlement on marketability.

[47]*See infra* text accompanying notes 49-61.

[48]*See infra* text accompanying notes 62-91.

A. The Bonus Flight as Income

The Code defines gross income as "all income from whatever source derived."[49] The Treasury regulations (regulations) further clarify this definition of gross income as follows: "Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, *or other property*, as well as cash."[50] On its face, therefore, the expansive statutory definition of gross income indicates that frequent flyer bonuses, whether taken in the form of flights, cash or other services, may constitute gross income to the recipient.

The contention that frequent flyer benefits constitute gross income to the recipient is bolstered by the United States Supreme Court's construction of gross income. First, the Court often construes gross income broadly by beginning its gross income determinations with the statements that Congress intended "to use the full measure of its taxing power" when it created the income tax.[51] Then, after using this broad phraseology, the Court holds that the taxpayer's argument for distinguishing the income item at issue as nontaxable is not relevant because the income item falls within the scope of Congress' broad taxing power which the Court cannot overrule.[52] For example, in *Commissioner v. Glenshaw Glass Co.*, the respondent attempted to characterize punitive damages as non-taxable because the damages were created by the "culpable conduct of third parties."[53] However, the Court refused to consider the source of the damages as a reason to distinguish them from other income items or as relevant to the issue of their taxability because

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[49]I.R.C. § 61(a) (Law. Co-op. 1986). All Internal Revenue Code citations which cite "Law. Co-op 1986" as the source are referencing U.S.C.S. TITLE 26 INTERNAL REVENUE CODE OF 1986 PAMPHLET (reflecting the Code as amended through Dec. 31, 1986).

[50]Treas. Reg. § 1.61-1(a) (1957) (emphasis added).

[51]Commissioner v. Kowalski, 434 U.S. 77 (1977) (state trooper's meal allowances taxed). *E.g.*, HCSC-Laundry v. United States, 450 U.S. 1 (1981) (cooperative hospital laundry taxed); Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) (punitive and treble damages taxed); Helvering v. Clifford, 309 U.S. 331 (1940) (trust taxed to grantor); Helvering v. Midland Mut. Life Ins. Co., 300 U.S. 216 (1937) (interest bid by mortgagor at successful foreclosure taxed); Douglas v. Willcuts, 296 U.S. 1 (1935) (alimony taxable to payor); Irwin v. Gavit, 268 U.S. 161 (1925) (stock transfer held taxable).

[52]*See HCSC-Laundry*, 450 U.S. at 8; *Kowalski*, 434 U.S. at 83; *Glenshaw Glass Co.*, 348 U.S. at 432-33; *Clifford*, 309 U.S. at 337-38; *Midland Mut. Life Ins. Co.*, 300 U.S. at 223; *Douglas*, 296 U.S. at 9; *Irwin*, 368 U.S. at 166.

[53]*Glenshaw Glass Co.*, 348 U.S. at 429. Two cases, *Glenshaw Glass Co.*, 18 T.C. 860 (1952), and *Commissioner v. William Goldman Theatres, Inc.*, 19 T.C. 637 (1953) were consolidated and heard *en banc* by the Third Circuit Court of Appeals (211 F.2d 928 (1954)) which ruled that exemplary damages for fraud and treble damages for injury to business through violation of anti-trust laws were non-taxable because the payments were outside of the scope of the gross income section of the Internal Revenue Code of 1954. 348 U.S. at 427-29. The Supreme Court reversed. *Id.* at 428.

Congress intended to retain its broad taxing powers.[54] The Court stated, "[C]ongress applied no limitations as to the source of taxable receipts, nor restricting labels as to their nature."[55] By the same reasoning, the source of a frequent flyer bonus as a promotional mechanism has no bearing on whether the flight should be considered to be income if its receipt falls within Congress' broad taxing powers.

Second, the Court construed gross income broadly in *Glenshaw Glass Co.* when it defined punitive damages as income because they were "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[56] Similarly, the Court has defined meal allowances[57] and embezzled funds[58] as such "accessions." By analogy, bonus flights could be considered accessions to wealth that are totally under the control of the frequent flyer, and thus are taxable as gross income to the recipient.

Third, the Court has broadly construed the definition of gross income by stating that it is Congress' intent to tax gains unless specifically exempted.[59] As the Court has explained, "[u]nder our system of federal income taxation . . . every element of gross income of a person, corporate or individual, is subject to tax unless there is a statute or some rule of law that exempts that person or element."[60] Therefore, courts strictly construe any Code section which circumvents taxation in order to enforce Congress' broad taxing powers.[61]

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[54]348 U.S. at 430.

[55]*Id.* at 429-30.

[56]*Id.* at 431.

[57]Commissioner v. Kowalski, 434 U.S. 77, 83 (1977). The Tax Court held that the meal allowances were gross income under I.R.C. § 61 (1982) and were not excludible under I.R.C. § 119(a)(1) (1982), which exempts meals for the convenience of the employer from taxation. *Id.* at 81. The Third Circuit Court of Appeals reversed. *Id.* at 81-82. Because of a conflict between the circuits, the Supreme Court granted certiorari. *Id.* at 82. The Supreme Court reversed the Third Circuit. *Id.* at 97.

[58]James v. United States, 366 U.S. 213 (1961); Rutkin v. United States, 343 U.S. 130 (1951). The *Rutkin* Court further defined control over a receipt as when, "as a practical matter, [the recipient] derives readily realizable economic value from it." *Id.* at 137.

[59]Commissioner. v. Glenshaw Glass, 348 U.S. 426, 430 (1955).

[60]HCSC-Laundry v. United States, 450 U.S. 1, 5 (1981). The Court refused to exempt a cooperative hospital laundry from taxation as an exempt organization because I.R.C. § 501(e) (1982) did not specify laundry and linen services in its listing of activities that an exempt hospital could perform. 450 U.S. at 5-6. Thus, the court narrowly construed an exemption allowed by the Internal Revenue Code.

[61]*See* Bingler v. Johnson, 394 U.S. 741 (1969) (tuition payments made in exchange for promise of future services not exempt as scholarships); Commissioner. v. Jacobson, 336 U.S. 28 (1949) (corporation's buy-back of its own indebtedness results in a taxable gain); Helvering v. American Dental Co., 318 U.S. 322 (1943) (cancellation of debt not exempted as gift); Helvering v. Northwest Steel Rolling Mills, Inc., 311 U.S. 46 (1940) (statutory exemption allowing corporations credit against income for "undistributed profits surtax" not allowed).

Thus, frequent flyer bonus flights could be considered as income because they are income "from any source" that is in the form of property or services. If the bonuses fall within the ambit of Congress' broad taxing power or are an accession to the wealth of the party receiving them, they will be taxable even to the person who paid for the original tickets unless they fall within an exemption created by statute or rule of law.

B. The Bonus Flight as Reduction of Cost

In order to perceive the frequent flyer bonus as a discount or a reduction of cost, some knowledge of accounting principles is required. Basis is the accounting concept by which a dollar value is assigned to an asset.[62] All property must have a basis so that the owner of the property is able to compute taxable gain or loss upon sale of the property[63] and to compute expenses such as depreciation.[64] As defined by the Code, one of the possible bases of property is its cost.[65] A discount reduces cost; therefore, a discount cannot be income to the recipient because it simply reduces the basis of an asset.[66]

The purchaser will record the purchase of an asset at the discount price. Then the asset is expensed or depreciated on the basis of this discounted cost. This reduction of expenses results in an increase in the

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[62]*See* I.R.C. §§ 1012-15 (Law. Co-op. 1986). These four sections define the four bases used in the Internal Revenue Code—cost, inventory, death and gift. A discussion of the last three is beyond the scope of this Note.

[63]I.R.C. § 1011(a) (Law. Co-op. 1986) states: "The adjusted basis for determining gain or loss from the sale or disposition of property, whenever acquired, shall be the basis (determined under section 1012 [cost basis] or other applicable sections . . .) . . . ." Therefore, the basis for calculating gain or loss under section 1011 begins with one of the basis sections. *See supra* note 44.

[64]I.R.C. § 167 (Law. Co-op. 1986). Section 167(g) states: "The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property."

[65]*See* I.R.C. § 1012 (Law. Co-op. 1986) (basis of property shall be the cost of such property). *Cf.* I.R.C. §§ 1013-15 (detail of the inventory, death and gift bases which are for use when cost is unavailable or not applicable). *See generally* W. MEIGS, & R. MEIGS, FINANCIAL ACCOUNTING 15 (5th ed. 1983); D. KIESO & J. WEYGANDT, INTERMEDIATE ACCOUNTING, 5 (5th ed. 1986) [hereinafter KIESO] (One of the four basic principles of accounting is the historical cost principle that requires that assets and liabilities be accounted for and reported on a basis of acquisition price because it has the advantage of being "definite and verifiable").

[66]*See* KIESO, *supra* note 65, at 330. Purchase discounts have been treated either as income or as a reduction of the inventory purchases account. However, comparison of methods shows that "the arguments for a reduction of purchases are stronger than those usually presented in support of financial revenue" because a business does not realize income upon purchase of goods, but upon their later sale. *Id.*

purchaser's income related to such expensed or depreciable assets. If the asset is later sold, the gain or loss on the sale is computed on the basis of the discounted cost. The purchaser recognizes more income because of the initial lower, or discounted, basis.[67] As applied to airline bonus flights, the recipient of a frequent flyer bonus will not recognize income if the bonus flight is considered to be a discount; instead, the recipient has a lower basis in the underlying flights upon which the bonus was earned.

As will be shown, a discount can be economically defined as the reduction of an asset's price to its fair market value.[68] In the economic terms of supply and demand, if the retail price of an item is overstated, demand for the item is reduced because of the excessive price and the item will not sell unless the price decreases.[69] Therefore, the discount is a mechanism that a seller can use to reduce the item's price to true fair market value in the competitive marketplace.[70]

After airline deregulation in 1981, frequent flyer benefits came into being as one response by airlines to increased competition and cut-rate airfares in the changing marketplace.[71] According to senior airline sales personnel, the bonus programs were "initiated defensively" and are viewed as "a necessity" to effective competition.[72] For instance, both Continental and Northwest lost so much business after they discontinued their discount programs that they were forced to reinstate them.[73] Thus, frequent flyer bonus programs are, in effect, discounts that are being used by the airlines as a mechanism to match the price of a commodity, public air transportation, with the demand for that commodity.

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[67]*Cf.* I.R.C. § 167 (Law. Co-op. 1986) *supra* note 64; I.R.C. § 62 (Law. Co-op. 1986). If the depreciation deduction as computed under section 167 is smaller because it is computed on a lower cost item, then adjusted gross income as computed under section 62 will be larger because the deductible trade and business expenses under section 62(1) will be smaller.

[68]*See infra* text accompanying notes 69-73.

[69]*See generally* R. LIPSEY, P. STEINER & P. PURVIS, ECONOMICS 58-74 (8th ed. 1987) [hereinafter LIPSEY]. One factor that affects demand is the price of the item. As there is excess supply of a commodity in the marketplace, demand will decrease and suppliers will be forced to lower their prices in order to sell excess commodities. When supply equals demand, prices will remain constant at equilibrium price. *Id.*

[70]*See id.*

[71]*See supra* text accompanying notes 16-21. "[Equilibrium price] will persist once established, unless it is disturbed by some change in market conditions." LIPSEY at 70. Increased competition caused by deregulation of air carriers is a change in the market condition because regulation was a governmental restriction holding price above the equilibrium. When such a "price floor" is removed, the retail price will drop to reach the free-market equilibrium level. *See id.* at 99-100.

[72]*Frequent-Flier Game*, *supra* note 8, at 75.

[73]*Id.*

Tax commentators have characterized frequent flyer bonuses as non-taxable volume discounts.[74] A volume discount is a discount offered to encourage purchase of larger quantities because it rewards the purchaser by reducing cost of purchases as more of an item is purchased.[75] For example, if the purchaser buys one apple, the price is forty cents; if he buys three, the price is one dollar.[76] One tax commentator states "Frequent flyer programs are basically just complicated discounts for the purchase of multiple airline tickets. Discount purchases generally do not have income tax consequences."[77] That author also asserts that the only difference between a regular volume discount and a frequent flyer award is that the frequent flyer programs allow the purchasers to spread their expenditures for individual airline tickets over time instead of having to buy them all at once, as would be required by a "regular" volume discount.[78] Another author states that, "[f]requent flyer programs are elaborate volume discount mechanisms, whereby participants obtain air transportation at a reduced price. Since no deductions are taken with respect to personal travel, where an award is received on account of such travel, its utilization should not give rise to taxable income."[79] This reasoning indicates that the free flight is not income, but rather is a volume discount because it is a reduction in the cost of all previously purchased tickets.

While frequent flyer bonuses are a relatively new phenomenon, their taxability may be determined by reference to analogous concepts.[80] The

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[74]*E.g.*, Aidinoff, *Frequent Flyer Bonuses: A Tax Compliance Dilemma*, 31 TAX NOTES 1345 [hereinafter Aidinoff]; Forman, *Income Tax Consequences of Frequent Flyer Programs*, 26 TAX NOTES 742 [hereinafter Forman].

[75]J. SMITH & K. SKOUSEN, INTERMEDIATE ACCOUNTING 248 (8th ed. 1984).

[76]*Id.* In a volume discount situation, each rate is applied to the balance after subtracting the result of applying the prior discount rates, as follows:

	Discount	*New Invoice Amount*
$5,000 X 20%	$1,000	$5,000 – $1,000 = $4,000
$4,000 X 10%	$ 400	$4,000 – $ 400 = $3,600
$3,600 X 5%	$ 180	$3,600 – $ 180 = $3,420

Thus the buyer only remits $3,420.

[77]Forman, *supra* note 74, at 742.

[78]*Id.*

[79]Aidinoff, *supra* note 74, at 1347.

[80]One somewhat analogous idea, the windfall, is a taxable event. In Commissioner v. Glenshaw Glass, 348 U.S. 426 (1955), the respondent attempted to claim that punitive damages were not within the scope of the gross income section because they were a windfall. *Id.* at 429-30. This approach was not accepted by the court. *Id.* at 430. The fair market value of another windfall, finding buried treasure, should be computed in United States dollars and included in the gross income of the finder. Rev. Rul. 53-61, 1953-1 C.B. Also, finding money is a taxable windfall. In Cesarini v. United States, 428 F.2d 812 (6th Cir. 1970), an amount of money found in an old piano belonging to petitioner was includible in petitioner's gross income in the year it was found. *Id.* at 814.

concept of a bargain purchase, which is a non-taxable event akin to a discount, supports the treatment of frequent flyer bonuses as discounts.[81] In a bargain purchase situation, the purchase price of an asset is less than its fair market value.[82] By comparison, a discount reduces the purchase price of an asset to its fair market value in order to promote its sale.[83] For tax purposes, the bargain purchaser recognizes no income at the time of the purchase.[84] Instead, the low bargain purchase cost is assigned as the basis of the property.[85] Similarly, a frequent flyer bonus flight recipient should recognize no income because the award is a volume discount that reduces the traveler's cost in the underlying tickets.[86]

In addition to the bargain purchase concept, the Internal Revenue Service's treatment of rebates[87] supports the assertion that frequent flyer bonuses are merely a reduction of cost, not gross income. According to the IRS, a purchaser does not recognize gross income upon receipt of a cash rebate.[88] Instead, the rebate reduces the basis of the purchased asset.[89] Even the cash refund received by a new car buyer from an automobile manufacturer is not considered to be income because the actual purchase price of the automobile is reduced by the amount of the rebate, thus giving the automobile a lower basis in the hands of the buyer.[90] The receipt of a rebate is similar to the receipt of a bonus flight because, in each case, the seller returns a valuable interest to the buyer after a purchase has been made.[91] Therefore, a frequent flyer

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However, the windfall analysis is weakened in the case of bonus flights because the taxpayer has given something for the underlying flights upon which the bonus is based. Therefore, the receipt of a frequent flyer bonus does not appear to be a taxable event similar to a windfall.

[81]*E.g.*, Commissioner v. Lo Bue, 351 U.S. 243 (1956); Palmer v. Commissioner, 302 U.S. 63 (1937).

[82]*Palmer*, 302 U.S. at 69.

[83]*See supra* text accompanying notes 68-79.

[84]*Lo Bue*, 351 U.S. at 248. Stating that no current income recognition is required in an arm-length bargain purchase transaction, the Court held the transfer of stock options to Lo Bue to be taxable because the employment relationship is not at arm's length. *Id.*

[85]*Id.*

[86]*See supra* text accompanying notes 74-79.

[87]Rev. Rul. 76-96, 1976-1 C.B. 23.

[88]*Id.*

[89]*See supra* notes 62-67 and accompanying text.

[90]Rev. Rul. 76-96, 1976-1 C.B. 23 states: "[R]etail customers who . . . receive the rebates . . . are not in receipt of gross income. However, under section 1016 of the Code, a downward adjustment to the basis of the new purchased automobile is required." *See also* I.R.C. § 1016(a)(1) (Law. Co-op. 1986). "Proper adjustment in respect of the property shall in cases be made—(1)for expenditures, *receipts*, losses or other items properly chargeable to the capital account . . . ." (emphasis added). *Id.*

[91]*See* Rev. Rul. 76-79, 1976-1 C.B. 23; *see also supra* text accompanying notes 38-46.

bonus is comparable to a rebate and should receive the same non-taxable treatment.

In conclusion, when the person who uses the bonus flight is the same person who paid for the underlying tickets, there should be no recognition of income by the recipient. Although the concept of gross income as promulgated by Congress and supported by case law is extremely broad,[92] analysis of discounts[93] and examination of the many similarities between frequent flyer benefits and other concepts that have no tax consequences, such as the rebate[94] and the bargain purchase,[95] indicate that bonuses should also be non-taxable. Therefore, frequent flyer bonuses are a type of volume discount that is non-taxable as long as the person who uses the bonus flight is the same person who paid for the underlying tickets.

IV. The Addition of the Employment Relationship to the Frequent Flyer Situation

The issue of income recognition of frequent flyer bonuses is most likely to arise in the context of the employment relationship because the majority of the frequent flyer bonuses are earned by business travelers.[96] In fact, more than ninety percent of frequent flyers are business travelers, and twenty percent of all airline passengers supply seventy percent of several major airlines' traffic.[97] Therefore, the target market of frequent flyer programs is the businessman[98] who flies at least 12,000 miles a year.[99]

Furthermore, the airlines concede that the programs were structured to benefit individuals, not their corporate employers, because the strategy of bonus programs is brand loyalty among individual travelers.[100] One airline vice president has said, "'Obviously, we wanted the traveler to get the award . . . . If companies forced people to turn in their prizes, we'd try to curtail the program.'"[101] Thus, the bonus flight is most likely to be earned in the context of the employment relationship.

The conclusion that a frequent flyer bonus is not gross income[102] does not necessarily follow when a third party, the employer, pays for

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[92]*See supra* text accompanying notes 49-61.
[93]*See supra* text accompanying notes 62-79.
[94]*See supra* text accompanying notes 87-91.
[95]*See supra* text accompanying notes 80-86.
[96]*Sky's the Limit*, *supra* note 1, at 89.
[97]*Id.*
[98]*Richer Rewards*, *supra* note 1, at 89.
[99]Sherman, *supra* note 1, at 106.
[100]*Id.* (quoting Brian J. Kennedy, TWA vice president for advertising and sales).
[101]*Id.*
[102]*See supra* text accompanying notes 47-94.

the employee's tickets and then allows the employee to retain the bonus flight. Generally, if the person who paid for the underlying tickets gives the free flight earned on those tickets to a third party, the third party will not recognize income because of the Code provision which exempts gifts from inclusion in gross income.[103] For instance, if a frequent flyer gives a bonus flight to a friend, it will be a gift unless the donor receives something in return. On the other hand, if the recipient of the bonus sells it to a third party, there is no question but that the seller has realized gain or loss that qualifies as taxable income or loss.[104] However, when an employer pays for an employee's business related travel as an "ordinary and necessary business expense,"[105] then allows the employee to retain the bonus flight for personal use, it must be determined whether the employee has received taxable income.[106]

A. The Award's Receipt—Who is the Recipient?

Once the employment relationship is added to the frequent flyer bonus scenario, the preliminary issue for resolution is the identity of the award recipient. The airlines technically issue the free ticket to the individual passenger, and not to the employer,[107] for at least two reasons. First, if the individual has purchased the underlying tickets and was subsequently reimbursed by the employer, the airline has no knowledge of the employment relationship.[108] In fact, the airlines refuse to police allocation of the bonuses because they view the issue as "an employer/employee relationship problem."[109] Second, in line with the airlines' policy of targeting the traveling businessman market,[110] most airlines restrict membership to individuals.[111]

Because frequent flyer bonus flights are awarded by the airline directly to the traveler[112] it appears that the employee received income from the airline, a third party, and not from the employer. However, because

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[103]*See infra* text accompanying notes 149-64.

[104]*See* I.R.C. § 1011 (Law. Co-op. 1986). Because the frequent flyer bonus recipient who paid for the underlying flights is considered to have received a volume discount that reduces his basis in the underlying flights, his basis for figuring gain or loss upon the sale of the bonus flight is the amount allocated as discount to the underlying flights. *See id.*; *see also supra* notes 63-64 and accompanying text.

[105]*See* I.R.C. § 162 (Law. Co-op. 1986); *see also infra* note 122.

[106]*See supra* text accompanying notes 56-58.

[107]Sherman, *supra* note 1, at 106.

[108]Many employees enrolled in frequent flyer bonus programs have their mileage statements sent directly to their homes. *Id.*

[109]*Who?*, *supra* note 38, at 74.

[110]*Richer Rewards*, *supra* note 1, at 89.

[111]Sherman, *supra* note 1, at 106; Dubin, *Guess Who Wants Your Frequent Flier Coupons*, Bus. Wk., Aug. 5, 1985, at 37.

[112]Sherman, *supra* note 1, at 106.

the employer has paid for the underlying tickets as ordinary and necessary expenses of doing business,[113] it will be shown that the employer has the right to the income realized or the discount created by the receipt of the bonus flight.

In *Fritschile v. Commissioner*,[114] the United States Tax Court has held that the person in a position analogous to the employer's is the one who earned income.[115] In that case, the petitioner contracted to make award ribbons such as those awarded for winning athletic events.[116] Her children made most of the ribbons and the taxpayer allocated seventy percent of the income to them; therefore, her tax return reflected only thirty percent of the income from the ribbon-making enterprise.[117] The court held that the income was allocable to the parent because the parent contracted to do the work, was responsible for the work, and had the right to the proceeds of the work.[118] In so holding, the court followed the "fruit and tree doctrine" of *Lucas v. Earl*,[119] which requires that income must be taxed to the individual by whom it is earned. However, the *Fritschile* court extended that doctrine and stated: "Recognizing that the true earner cannot always be identified simply by pointing 'to the one actually turning the spade or dribbling the ball,' this Court has applied a more refined test—that of who controls the earning of the income."[120] Because Mrs. Fritschile "managed, supervised, and otherwise exercised total control over the entire [ribbon-making] operation," the Tax Court attributed all the ribbon-making income to her.[121]

By comparison, the earning of a frequent flyer bonus is under the total control of the taxpayer who is paying for the tickets upon which the bonus is earned. If an employer decides not to pay for the underlying tickets, the employee cannot earn the bonus flight. The employer allocates plane tickets to frequently traveling employees in the same way that

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[113]I.R.C. § 162 (Law. Co-op. 1986), *infra* note 122.

[114]Fritschile v. Commissioner, 79 T.C. 152 (1982).

[115]*Id.* at 158-59.

[116]*Id.* at 154.

[117]*Id.*

[118]*Id.* at 155-56.

[119]281 U.S. 111 (1930). In 1901, Lucas and his wife contracted that all of their assets, present and future, were to be held as joint tenants with rights of survivorship. *Id.* at 113-14. Because of this contract, Lucas and his wife each claimed half of Lucas' salary for tax purposes. *Id.* at 114. The Court held that Lucas should be taxed on the total salary because, despite the contract, "fruits" could not be separated from the "tree" on which they grew. *Id.* at 115.

[120]*Fritschile*, 79 T.C. at 155 (quoting Johnson v. Commissioner, 78 T.C. 882, 890 (1982) *aff'd without op.*, 734 F.2d 20 (9th Cir.), *cert. denied*, 469 U.S. 857 (1984)). The *Johnson* court held that a personal service corporation created by a professional basketball player was not the true earner of basketball related income and would not be taxed on the income. Instead, the player would be taxed. 78 T.C. at 893-94.

[121]*Fritschile*, 79 T.C. at 156.

Mrs. Fritschile allocated work and ribbon-making materials to her children. Without her allocation, the children could not earn money by making ribbons; similarly, without the employer's allocation of plane fare, the salesmen could not earn enough time in flight to be awarded the bonus trip. It follows, then, that even the employer who is unaware that a bonus flight has been awarded to an employee is the "true earner" of the flight because he paid for the underlying tickets. Therefore, if the employee receives, retains and uses a frequent flyer bonus for a personal purpose, it was received from the employer, not from the airline.

B. Taxability of Employer Awarded Bonus Flights

Once it has been determined that the free flight was, however briefly or constructively, the property of the employer, the thrust of the income recognition analysis must center on the actual or implied transfer of the bonus from the employer to the employee.[122] If the traveling employee appears to have received an accession of wealth that qualifies as "all income from whatever source derived,"[123] the employee must include the flight in gross income and it will be subject to taxation unless a statute or rule of law exempts it.[124] The following analysis and precedents specifically refer to and define taxability of various employer payments to the employee.

The Supreme Court has stated that the definition of gross income, "is broad enough to include in taxable income any economic or financial benefit conferred on an employee as compensation, whatever the form or mode by which it is effected."[125] In the frequent flyer situation,

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[122]Although a transfer, whether actual or implied, also occurs when the bonus, however briefly, is owned by the employer, analysis of the employer's income recognition should result in the conclusion that the employer has received a volume discount, not income. *See supra* text accompanying notes 62-95. Furthermore, even if the opposite conclusion that the employer has received income is reached, there will be no tax effect on the employer because if income must be recognized, an equal offsetting deduction for an ordinary and necessary business expense will accrue when the employee receives the free flight. *See* I.R.C. § 162(a) (Law. Co-op. 1986). "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—(1) a reasonable allowance for salaries or other compensation for personal services actually rendered . . . ." *Id.* The employer will be entitled to the deduction regardless of whether the trip is considered to be sales expense when used as another business trip or as salary or bonus if it is given to the employee to use as he wishes. *See* I.R.C. § 162(a)(1) (Law. Co-op. 1986). Thus, there is no net taxable effect to an employer who allows the bonus flight to be used by an employee for any purpose. *See* I.R.C. § 62(a)(1) (Law. Co-op. 1986).

[123]I.R.C. § 61 (Law. Co-op. 1986); *see also supra* text accompanying notes 56-58.

[124]*See supra* text accompanying notes 59-61.

[125]Commissioner v. Smith, 324 U.S. 177, 181 (1945).

because the employer is considered to have a right to retain the bonus, an economic benefit is conferred by the employer when the employer allows the employee to retain the bonus for personal use.[126] Therefore, gross income, by definition, is broad enough to include a frequent flyer bonus flight as compensation for the employee.

This reasoning is supported by the Supreme Court's analysis in *Commissioner v. Lo Bue*.[127] In that case, the Court held that a distribution of stock options to employees could not be considered a gift because the lack of "detached and disinterested generosity."[128] Reasoning that the employer must have distributed the stock options to the employees to "secure better services,"[129] the court characterized the distribution as compensation.[130] In *Lo Bue*, the Court declined to recognize the existence of any gratuitous motives in the employment relationship.[131]

Similarly, an employer who allows an employee to retain a frequent flyer bonus should not be imputed with gratuitous motives. For instance, the employer may believe that the employment relationship might be damaged if the employee is forced to release the bonus.[132] However, if the employee is allowed to retain the bonus to maintain a satisfactory employment relationship, the employer is attempting to "secure better services" under the *Lo Bue* definition.[133] Thus, the bonus is not gratuitous, is received as compensation and should be included in the employee's gross income.

Furthermore, the employer may not intend to compensate the employee but may allow the employee to retain the bonus for other reasons.[134] For instance, the employer may allow all employees to retain frequent flyer bonuses earned because the employer believes that the cost of implementing a fair monitoring system to reclaim the bonuses is too high.[135] However, because of the Supreme Court's construction of the intent of Congress to use the full measure of its taxing power, courts will not consider as relevant the fact that the employee is only retaining the bonus because of the employer's record-keeping problems[136] and the bonus flight will be included in gross income.

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[126]*See id.*
[127]Commissioner v. Lo Bue, 351 U.S. 243 (1956).
[128]*Id.* at 246.
[129]*Id.* at 247.
[130]*Id.*
[131]*See id.* at 245-48.
[132]Sherman, *supra* note 1, at 106; *Who?*, *supra* note 38, at 74.
[133]*Lo Bue*, 351 U.S. at 247.
[134]*See Who?*, *supra* note 38, at 74.
[135]*Id.*
[136]*See supra* text accompanying notes 51-55.

Finally, the employer might choose to allow the employee to retain the bonus as additional compensation.[137] Frequent flyer bonus flights are analogous to any other taxable incentive bonus trips includible in the employee's gross income as compensation for services rendered.[138] Employer and employee are receiving equivalent benefits regardless of the source of the flight—improved performance for the employer and a free vacation for the employee.[139] Therefore, it is irrelevant whether the trip was earned through a frequent flyer program or whether the employer paid for the vacation as a bonus for services rendered; the trip should be included in the employee's gross income.

In conclusion, for income determination purposes, the employee has received a free flight from the employer, not the airline. Because of a lack of gratuitous motives by the employer, the bonus must be considered to be compensation to the employee. Thus, it must be included in the employee's gross income.

IV. Exclusion of the Frequent Flyer Bonus from Gross Income

Once it has been determined that the frequent flyer bonus constitutes gross income to the employee who is allowed to retain the flight for personal use, it must be decided whether the income is excludible under an exception to one of the income inclusionary sections of the Code[140] or under one of the income exclusionary sections of Code.[141] However, the applicability of these sections must be discussed in light of Congress' intention, as interpreted by the Supreme Court, to create broad income inclusionary powers; therefore, these exceptions should be strictly construed so that the intent of Congress to include all income will be followed.[142]

A. General Exclusionary Sections

The inclusionary Code section concerning certain nontaxable prizes and awards may provide a basis for a claim of exclusion for frequent

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[137] *Who?*, *supra* note 38, at 77. As long as it does not cost the company anything beyond the loss of the free flight, most companies do not mind letting the traveling employee retain the bonus for personal use. *Id.*

[138] *See, e.g.*, McCann v. United States, 696 F.2d 1386 (Fed. Cir. 1983) (trips that were primarily vacations furnished to employee were taxable to the employee despite some business purpose); Lynch v. Commissioner, 45 T.C.M. (CCH) 1125 (1983) (Japan seminar and vacation was includible in gross income).

[139] *See McCann*, 696 F.2d at 1389.

[140] *See* I.R.C. §§ 71-89 (Law. Co-op. 1986). These sections comprise Part II of the Code subtitled "Items specifically included in gross income."

[141] *See* I.R.C. §§ 101-35 (Law. Co-op. 1986). These sections comprise Part III of the Code subtitled "Items specifically excluded from gross income."

[142] *See supra* text accompanying notes 49-61.

flyer bonuses.[143] Code section 74 was amended by the Tax Reform Act of 1986[144] so that an award can be excluded in only two situations. First, the recipient of any award, even previously non-taxable awards such as the Pulitzer or Nobel Prize, will be taxed on the amount received unless it is donated to charity.[145] Second, the award may be excluded if it qualifies as an employee achievement award.[146] These awards, as defined in the new tax act, are exempt only if they are items of personal property given to the employee for length of service or safety achievement and which are awarded as a part of a meaningful presentation under circumstances that do not create a significant likelihood of the payment of disguised compensation.[147] The definition of employee achievement awards is too narrow to allow frequent flyer benefits to qualify because they are unlikely to be presented for length of service or safety achievement in a meaningful ceremony.[148] Therefore, an employee who receives a frequent flyer bonus will not be able to exclude it as a non-taxable prize or award.

Code section 102, an exclusionary section concerning gifts, states that gifts are not generally includible as gross income.[149] However, it must be determined whether a frequent flyer bonus given to an employee is truly a "gift" within the meaning of section 102. In *Helvering v. American Dental Co.*,[150] the Supreme Court defined the relationship between income and gifts in light of section 102 by stating: "Gifts, however, is a generic word of broad connotation, taking coloration from the context of the particular statute in which it may appear. Its plain meaning in its present setting denotes, it seems to us, the receipt of financial advantages gratuitously."[151] Therefore, if the frequent flyer

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[143]I.R.C. § 74(a) (Law. Co-op. 1986) ("Except as otherwise provided in this section . . . gross income includes amounts received as prizes and awards.").

[144]I.R.C. § 74(a) (Law. Co-op. 1986). This section prior to amendment in 1986 had provided that various recognition awards were not included in gross income if the recipient met certain tests. I.R.C. § 74(a) (1982).

[145]I.R.C. § 74(b) (Law. Co-op. 1986). Recognition awards exempt under prior law, are not exempt unless the award-winner was selected without action on his part, he is not required to render "substantial future service" as a condition of receipt, and the award is transferred to a governmental unit or a qualified charitable organization. *Id.*

[146]I.R.C. § 74(c) (Law. Co-op. 1986). This section exempts from income employee awards to the extent they are an allowable deduction under § 274(j) (Law. Co-op. 1986).

[147]I.R.C. § 274(j) (Law. Co-op. 1986). This section sets monetary limits for the awards. Therefore, even if a frequent flyer bonus could qualify as a safety or length of service award, it would not qualify if it was worth more than the upper limit for an employee achievement award.

[148]*See* I.R.C. § 74(c) (Law. Co-op. 1986).

[149]I.R.C. § 102 (Law. Co-op. 1986).

[150]318 U.S. 330 (1943).

[151]*Id.* at 330.

bonus is given gratuitously, it will be excluded from the employee's income under Code section 102.[152]

In *Commissioner v. Duberstein*,[153] the Court further defined gifts and added a standard for determining whether a transfer is gratuitous. First, the term "gift" does not have the same meaning in tax law as it does in common law;[154] therefore, the colloquial meaning of the term gift as a transfer without consideration is not controlling if other factors indicate insufficient donative intent.[155] Second, a gift must be made from detached or disinterested generosity.[156] Third, the transferor's intention is the most critical consideration in whether or not there is a gift; however, that intention should be judged by objective, not subjective, criteria.[157] Finally, wishes or agreements of taxpayers as to tax treatment are not controlling; instead, the criteria should be an objective inquiry into the substantive reason for transfer.[158] In applying these concepts to frequent flyer bonus receipts, the intent of the airline is to create brand loyalty among individual travelers in order to generate business[159] and the intent of the employer is to encourage the employee's performance.[160] Viewed objectively, neither of these reasons for awarding the bonus show sufficient donative intent to support the finding that the free flight is a gift subject to exclusion under Code section 102.[161]

Finally, a new subsection has been added to the Code section 102[162] that states in pertinent part: "[This section] shall not exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee."[163] Thus, the new law, supported by the *American Dental* and *Duberstein* cases, provides that frequent flyer benefits

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[152]However, in Commissioner of Internal Revenue v. Lo Bue, 351 U.S. 243 (1956), the Supreme Court reasoned that there are few gratuitous transfers in the context of the employment relationship. *Id.* at 245-48; *see also supra* text accompanying notes 127-39.

[153]363 U.S. 278 (1960).

[154]*Id.* at 285.

[155]*Id.* at 286.

[156]*Id.* at 285.

[157]*Id.* at 286.

[158]*Id.*

[159]*See supra* text accompanying notes 16-21.

[160]*See supra* text accompanying notes 132-39.

[161]363 U.S. at 286. Another case, Robertson v. United States, 343 U.S. 771 (1952), further defined excludible gifts. In that case, the Court held that the winner of a prize for composing a symphony did not receive a gift because the transfer was considered to be payment for services rendered in writing the symphony; payment was simply a release of the contract created by the contest entry. *Id.* at 713. Similarly, free flights are a contract between airline and passenger to award a free flight if a certain number of miles are flown; therefore, the receipt of the flight should not be exempted from income as a gift.

[162]I.R.C. § 102(c) (Law. Co-op. 1986).

[163]*Id.*

will constitute "any amount transferred by or for an employer to, or for the benefit of, an employee,"[164] and therefore will not be excluded from gross income as a gift.

B. Fringe Benefits

A final exclusionary Code section under which an employee could attempt to exempt the income from frequent flyer bonus awards was created by the Tax Reform Act of 1984.[165] Section 132[166] lists specific fringe benefits that may be excluded from an employee's income. The general rule is that fringe benefits are taxable.[167] Before determining if frequent flyer benefits qualify under the exclusionary exception to this general rule, it must be determined whether frequent flyer bonuses are fringe benefits to the employee.

Fringe benefits must be defined by examples because they are not generically defined in the Code or accompanying regulations. In 1984, the Joint Committee on Taxation named various items as examples of employee benefits.[168] This list included employee benefits specifically exempted by the Code such as health plan benefits, cafeteria plans, and lodging for the convenience of the employer.[169] In addition, the Committee listed many fringe benefits that have been held to be includible in the employee's gross income such as personal use of a company automobile, airplane or yacht; employer provided clothing; reimbursement of lunch expenses; reimbursement of expenses for convention trips not primarily for business purposes; and reimbursement of loss on sale of a personal residence.[170] All of these items are of benefit to the employee and are given by the employer; similarly, frequent flyer bonuses are given by the employer for the benefit of the employee.[171] Thus, it appears that

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[164]*See id.*

[165]I.R.C. § 132 (Law. Co-op. 1986) (originally enacted as the Tax Reform Act, Division A, Deficit Reduction Act of 1984, Pub. L. 98-368, 98 Stat. 494-1210).

[166]*Id.*

[167]I.R.C. § 61(a) (Law. Co-op. 1986). Section 531(a) of the Tax Reform Act of 1984 specifically modified I.R.C. § 61 to identify fringe benefits as a taxable component of gross income because of taxpayers' erroneous belief in the non-taxable status of fringe benefits. *See infra* text accompanying notes 175-80. Before the Act, I.R.C. § 61(a)(1) (1982) included in gross income "compensation for services, including fees, commissions, and similar items." After the Act, I.R.C. § 61(a)(1) (Supp. III 1985) included in gross income "compensation for services, including fees, commissions, fringe benefits, and similar items."

[168]JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 838 (Comm. Print 1985) [hereinafter EXPLANATION].

[169]*Id.*

[170]*Id.* at 838 n.68.

[171]*See id.*

frequent flyer bonuses have the characteristics of other employee fringe benefits and should be classified as such.

Because of the breadth of the concept of gross income, all fringe benefits are taxable unless specifically excluded.[172] As yet, there is no case law to help to determine whether Congress intended frequent flyer bonuses to be a type of fringe benefit that fall within the scope of the exclusion provided by Code section 132.[173] Therefore, Congress' intent must be determined by examining Committee reports, which indicate that Congress was influenced by the history of fringe benefit taxation.[174] In 1975, the Treasury Department promulgated a discussion draft of regulations to ensure that fringe benefits would be properly included in gross income; however, no permanent regulations ensued.[175] Apparently, Congress did not agree with the intent of these regulations because, in 1978, it issued a moratorium on the issuance of fringe benefit regulations that extended until January 1, 1984.[176] Thus, despite Code section 61's all-inclusive income concept,[177] both employers and employees have believed that many fringe benefit items were non-taxable even though the benefits fell within the broad definition of gross income.[178] Also, because of this confusion as to the tax treatment of various benefits, tax law administrators have not treated taxpayers in similar situations equally.[179] In enacting the fringe benefit legislation, Congress intended to cure these inequities.[180] Furthermore, Congress intended to strike a balance between two competing objectives, the valid business purpose of the employer and the delineation of clear boundaries outside of which an employee cannot be compensated without tax consequences.[181]

First, Congress realized that businessmen often have valid business reasons other than compensation for giving employees discounts.[182] The Committee Report states, "For example, a retail clothing business will want its salespersons to wear, when they deal with customers, the clothing which it seeks to sell to the public, rather than clothing sold by its competitors."[183] Congress intended that under these types of circum-

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[172]*See supra* notes 49-61 and accompanying text.

[173]I.R.C. § 132 (Law. Co-op. 1986).

[174]EXPLANATION, *supra* note 168, at 839.

[175]*Id.*

[176]*See id.* at 839-40.

[177]*See supra* notes 49-61 and accompanying text.

[178]EXPLANATION, *supra* note 168, at 840. In many industries, there are long established practices of providing employees free, or discounted goods and services "which the employer sells to the general public." *Id.* These practices in the past "have been treated by employers, employees, and the Internal Revenue Service as not giving rise to taxable income." *Id.*

[179]*Id.* at 841.

[180]*Id.*

[181]*Id.* at 840-41.

[182]*Id.* at 840.

[183]*Id.*

stances both employers and employees might continue to act in the best interests of the business without penalty.[184] Therefore, if a frequent flyer bonus is given to an employee for a valid business purpose other than compensation, it should be excluded from the employee's gross income.[185] If, however, an employee retains a frequent flyer bonus for personal use and there is no corresponding benefit to the employer, then Congress' intent to protect the business purpose of the employer would not be served by allowing the employee to exclude the bonus from gross income.[186]

Second, by promulgating section 132 to exempt certain fringe benefits from taxation, Congress intended to define the non-taxable fringes in order to "set forth clear boundaries for the provision of tax-free benefits."[187] Congress further intended to prevent an unwanted tax increase from occurring by preventing the shifting and shrinking of the tax base[188] that might occur if some employees received considerable compensation in the form of unregulated non-cash fringe benefits.[189] Congress was concerned that the tax burden might shift and fall unevenly on employees in jobs not encouraging receipt of fringe benefits because those in jobs with fringe benefits would receive more income in a non-taxable form.[190]

To be excluded under section 132, frequent flyer benefits must qualify as one of the four excludible fringe benefits defined in the section.[191] First, an employee may exclude the value of an additional no-cost service received from his employer.[192] Generally, because airplanes usually fly at only sixty percent of capacity,[193] frequent flyer bonuses involve no additional cost to the airlines.[194] However, although the exemption seems tailor-made for airlines, this benefit applies only to the employees of

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[184]*See id.*

[185]*See id.*

[186]*See id.*

[187]*Id.*

[188]*Id.* at 841.

[189]*See id.*

[190]*Id.*

[191]I.R.C. § 132(a) (Law. Co-op. 1986) states: "Gross income shall not include any fringe benefit which qualifies as a—(1) no-additional cost service, (2) qualified employee discount, (3) working condition fringe, or (4) de minimus fringe."

[192]I.R.C. § 132(b) (Law. Co-op. 1986) states:

> [T]he term 'no-additional cost service' means any service provided by an employer to an employee for use by such employee if—(1) such service is offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services, and (2) the employer incurs no substantial additional cost (including forgone revenue) in providing such service to the employee . . . .

[193]*See* Sherman, *supra* note 1, at 108.

[194]*See New Deals*, *supra* note 5, at 170-72.

the *airlines*,[195] not to employees of other business; therefore, this exemption cannot apply to frequent flyer bonus flights.

Second, the exemption for qualified employee discount fringe benefits applies to employees who receive discounts on goods or services that the employer sells.[196] This exemption cannot apply to benefits received by the general frequent flyer because the recipient must be an employee of the airline to qualify under this section.[197] Furthermore, the temporary regulations have plugged a potential loophole by stating that an exclusion of income due to a qualified employee discount does not apply to reciprocal agreements between employers.[198] Even if the airline receives discounts for its employees from the employer whose employees receive bonus flights, the goods and services exchanged will not be excludible from gross income for the employees of either company. The temporary regulation imposes a final constraint on the exempt status of employee discounts when it states that quantity (volume) discounts are not reflected by this benefit unless the employee himself purchases the requisite quantity of the product or service;[199] therefore, because the employer paid for the flights, the employee must include any bonus flights received in gross income.

Third, an exemption from gross income is provided for a working condition fringe benefit. This exemption applies to property awarded to the employee which would have been deductible as a business expense,[200] or subject to capitalization and depreciation,[201] if the employee had been

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[195]*Cf.* Temp. Treas. Reg. § 1.132-2T (1985). Subsection (b) provides that reciprocal agreements between employers to provide no-additional cost service fringe benefits to each other's employees are allowed if the services meet the requirements of I.R.C. § 132(b)(1) & (2). Because this is the only way a no-additional cost service fringe benefit can be made available to non-employees of the employer providing the service, frequent flyer benefits made available to the public cannot qualify for exclusion under this section.

[196]I.R.C. § 132(c)(1) (Law. Co-op. 1986) states:

> The term 'qualified employee discount' means any employee discount [on property or services offered for sale in the employer's ordinary course of business] to the extent the discount does not exceed—(A) in the case of property, the gross profit percentage of the price at which the property is being offered by the employer to customers, or (B) in the case of services, 20 percent of the price at which services are being offered to customers.

[197]*See id.*

[198]Temp. Treas. Reg. § 1.132-3T(a)(3) (1985).

[199]Temp. Treas. Reg. § 1.132-3T(b)2(ii) (1985) states: "The price . . . cannot reflect any quantity discount unless the employee actually purchases the requisite quantity of the property or service."

[200]I.R.C. § 162(a) (Law. Co-op. 1986) states: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."

[201]I.R.C. § 167(a) (Law. Co-op. 1986) states: "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear . . . (1) of property used in a trade or business, or (2) of property held for the production of income." *See supra* note 64 and accompanying text.

required to pay for the property or service.[202] Thus, according to the wording of the statute, a flight appears to be deductible to the employee so long as the employee uses it for business, *anyone's* business.[203] However, the Internal Revenue Service immediately plugged this loophole in the law; a temporary Treasury regulation ensures that the exemption is only available if the fringe benefit is used for the *employer's* business and not for a side business belonging to the employee.[204] As the previous discussion shows, although the name "working condition fringe benefits" seems to imply that flights earned by travel during working hours should be exempt because the right conferred came about as a condition of work, they cannot be excluded from gross income under this subsection.

Fourth, the final exemption, de minimus fringe benefits,[205] excludes the amount of fringe benefits received if the amount of the benefit is small or the record-keeping required is so complex as to be burdensome.[206] In order to determine whether frequent flyer bonuses qualify for exclusion under this provision, the methods of analysis suggested by the Treasury regulations must be applied to frequent flyer bonuses and the intent of Congress in passing the fringe benefit legislation must be re-examined.

The first method of analysis provided by the regulations is based on three factors that are weighed to determine whether a fringe benefit is impracticable to track, thus qualifying for exclusion as de minimus.[207] The first factor is the value of the benefit: as it increases, the benefit is more likely to be taxable.[208] Therefore, if the frequent flyer bonus is a vacation worth thousands of dollars,[209] it does not appear to meet the requirement of small value.

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[202]I.R.C. § 132(d) (Law. Co-op. 1986) states: "[T]he term 'working condition fringe' means 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 payment would be allowable as a deduction under section 162 or 167."

[203]*See id.*

[204]Temp. Treas. Reg. § 1.132-5T(a)(2) (1985). The illustration in the regulation concerns a payment by company A for an employee's airline ticket so that the employee, who is a director of company B, can attend the board of director's meeting of company A. The flight is not excludible from the employee's income as a working condition fringe.

[205]I.R.C. § 132(e)(1) (Law. Co-op. 1986) states: "The term 'de minimus fringe' means 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."

[206]Temp. Treas. Reg. § 1.132-6T(a) (1985).

> Gross income does not include the value of a de minimus fringe provided to an employee. The term 'de minimus fringe' means 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. *Id.*

[207]*Id.* at (b)-(c).

[208]*See id.* at (a)-(f).

[209]*See id.*

The second factor is the frequency of receipt: the more infrequently the fringe benefit is supplied, the more likely it is to qualify as de minimus.[210] For example, the receipt of a daily free lunch by one employee as compared to the receipt of a free lunch only once a month by another employee may result in a de minimus fringe benefit to the occasional recipient and gross income to the daily recipient.[211] However, if each employee's receipts under fringe benefit programs cannot be ascertained, frequency of all similar fringes may be looked at together.[212] For instance, employee use of a company Xerox machine may be very unequal, but employers may ignore that inequality so long as the entire non-business use does not exceed 15% of all of the machines.[213] Frequent flyer bonuses are received infrequently because of the large amount of miles required to be flown;[214] therefore, the requirement of infrequent receipt has been met.

The third factor is impracticality of administration: any benefit which is not excluded by another section and is not unreasonable or administratively impracticable to account for must be included in the employee's income.[215] For example, cash fringe benefits, regardless of size, are not excludible.[216] By comparison, however, any benefit that is unreasonable or administratively impracticable to account for should not be included in the employee's income.[217] Bonus flights definitely meet this requirement because it is extremely difficult for employers to track frequent flyer bonuses received by employees. Because the airlines have aimed the bonus programs at individual business travelers[218] and because the airlines send the bonuses directly to those travelers,[219] administration of the awards by the employer is burdensome.[220] Therefore, the requirement of administrative impracticality is met. However, because the outcome of the value factor analysis conflicts with the outcome of the frequency and practicality factors, further analysis is required.

The second method of analysis provided by the regulations is a list of excludible and nonexcludible fringe benefits.[221] Excludible benefits listed are coffee and doughnuts, occasional typing of personal letters by

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[210]Temp. Treas. Reg. § 1.132-6T(b) (1985).

[211]*Id.*

[212]*Id.*

[213]*Id.*

[214]*Who? supra* note 38, at 77. "A huge amount of mileage is required to qualify for a free ticket." *Id.*

[215]Temp. Treas. Reg. § 1.132-6T(c) (1985).

[216]*Id.*

[217]*Cf. id.* This premise is the converse of the one actually stated in the regulation.

[218]*See supra* notes 96-101 and accompanying text.

[219]*See supra* notes 107-12 and accompanying text.

[220]*See* Temp. Treas. Reg. § 1.132-6T(c) (1985).

[221]Temp. Treas. Reg. § 1.132-6T(f) (1985).

a company secretary, occasional use of a copying machine, occasional cocktail parties or picnics, occasional tickets to theater or sporting events, and low cost holiday presents;[222] all of which have low market value. By contrast, includible fringe benefits are more valuable—they include season tickets for sporting events or the theater, athletic or country club memberships, the commuter use of a company vehicle and use of an employer-owned hunting lodge, apartment or boat for a weekend.[223] Although one form of frequent flyer bonus, an upgrade to first class,[224] resembles an excludible fringe benefit because of its low value, frequent flyer bonus flights, because of their high value and usual personal use, either as a vacation trip or as a commodity to be sold,[225] resemble the non-excludible types of benefits more than the excludible ones.

Finally, Congress' goals in passing the fringe benefit legislation must be considered to determine if fringe benefits should be excludible as a de minimus fringe benefit. Congress' first objective was to allow compensation without taxation if there was a valid business purpose besides compensation.[226] Most employers allow employees to keep the bonuses for compensation and employee relations;[227] thus, bonus flights do not meet Congress' first objective for fringe benefit legislation. Congress' second objective was to ensure that no shifting or shrinking of the tax base could occur.[228] Allowing frequent flyer benefits to be excluded under the de minimus fringe benefit exclusion shifts the tax base from those whose jobs favor the earning of the flights to those whose jobs do not because the frequent flyer is not taxed on an awarded two thousand dollar vacation while a non-travelling co-worker is taxed on the two thousand dollars he earned to pay for a similar vacation.[229] Therefore, bonus flights do not meet the second objective, either.

Thus, despite the infrequency of receipt and the difficulty of the employer's record-keeping, frequent flyer bonuses do not qualify for exclusion under section 132. Because of the high value of the bonuses, their similarity to the examples of non-excludible fringe benefits listed in the regulations and Congress' goals in passing the legislation, frequent flyer bonuses will be includible in the employee's gross income.

V. The Amount of Income—What is the Bonus Worth?

After determining that a frequent flyer bonus constitutes income to recipients, the dollar amount of income must be determined. The first

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[222] *Id.* at (f)(1).

[223] *Id.* at (f)(2).

[224] *See infra* text accompanying notes 239-40.

[225] *See supra* text accompanying notes 22-28; *see also supra* notes 38-46 and accompanying text; *see also supra* notes 137-39 and accompanying text.

[226] Explanation, *supra* note 168, at 840.

[227] *See supra* text accompanying notes 132-39.

[228] Explanation, *supra* note 168, at 841.

[229] *See id.*

step in the analysis is the rule that the fair market value of the property or service received must be included in income.[230] In *McCoy v. Commissioner*,[231] fair market value was defined by the Tax Court as the going rate at which the commodity can be purchased, not its retail price.[232] In that case, the IRS claimed that the retail price of an automobile given to an employee must be included in the employee's gross income.[233] The court held that fair market value is not necessarily retail price; it is the market price.[234] The court took judicial notice of the common fact that an automobile, once sold, is worth less than retail even if it has no miles on the odometer.[235] Therefore, because the employer who awarded the car was the original purchaser, the fair market value of the car was not equal to retail price when received by the employee.[236] Thus, fair market value is the going rate at which the commodity can be purchased, not its retail price.[237] As applied to frequent flyer bonuses, *McCoy* suggests that an award recipient may be required to include only the amount of income generated by using the price of a similar flight on a less expensive airline because the lower price is the market price.[238]

Furthermore, one tax commentator suggests that a different type of frequent flyer bonus, an upgrade from coach class seating to first class at no extra charge, should not be considered a taxable event because it is minor, incidental, impossible to keep track of, and costs the airline nothing extra.[239] By analogy, if the awarded bonus flight is a first class flight, only the coach rate should be included in taxpayer's gross income. An airline's willingness to upgrade seating[240] demonstrates that coach fare is the market value of an airline trip; subjectively, the taxpayer should not be charged more.

Finally, in *Turner v. Commissioner*,[241] the Tax Court held that because a trip to South America could not be transferred to a third

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[230]Treas. Reg. § 1.61-2(d)(1) (as amended in 1979). "[I]f services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation."

[231]38 T.C. 841 (1962).

[232]*Id.* at 844.

[233]*Id.* at 843.

[234]*Id.* at 844.

[235]*Id.*

[236]*Id.*

[237]*See id.*

[238]*Cf. id.* Fair market value is a price at which a commodity is available in the marketplace; therefore, the lower priced airfare reflects fair market value. *See id.*; *see also supra* notes 38-46 and accompanying text.

[239]Aidinoff, *supra* note 74, at 1348.

[240]The six major frequent flyer programs, American, Delta, Eastern, Pan Am, TWA and United, all offer an upgrade to first class at 10,000 miles. This upgrade is the first award available and 10,000 miles is the lowest number of miles that will win any award in all of the programs. *New Deals*, *supra* note 5, at 170.

[241]13 T.C.M. (CCH) 462 (1954).

party, it was income only to the extent of its subjective worth to the recipient.[242] Because the taxpayers could prove the subjective worth of the trip was very small and because they could not sell it, the court held that an amount less than the fair market value of the trip should be includible in the taxpayer's gross income.[243] Similarly, if a frequent flyer bonus flight is not readily transferable[244] and a traveler is being issued a bonus of small subjective worth,[245] receipt of the bonus should only slightly increase the recipient's gross income. However, this rule will not reduce the employee's income recognition below the amount for which the traveler could sell the bonus.[246]

VI. Wages or Not?—The Withholding Dilemma

If a bonus flight is included in the gross income of the employee because it passes from the employer to the employee and cannot be excluded under any of the previously discussed exclusionary sections, the next question for consideration is whether or not the flights are to be considered "wages" under the Code. Generally, if any payment from the employer to the employee is considered wages, the employer must withhold social security and federal income tax on the payment.[247] The Code states that wages includes all remuneration, including non-cash remuneration, "*for services performed by an employee for his employer.*"[248] Case law helps delineate the difference between wages and other types of income.[249] In *Royster v. United States*,[250] the Fourth Circuit Court of Appeals rejected as overbroad the Internal Revenue Service's contention that the primary question in determining whether

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[242]*Id.* at 463.

[243]*Id.*

[244]*See supra* notes 44-46 and accompanying text. The fair market value of frequent flyer bonuses upon their sale is somewhat constrained by the limits on their marketability, such as airlines that permit only same surname transfers. Toy, *supra* note 38, at 88.

[245]Sherman, *supra* note 1, at 106. A travel agent states, "Many of our customers tell us the last thing they want is more flying." *Id.*

[246]*See supra* notes 38-46 and accompanying text.

[247]I.R.C. § 3402(a) (Law. Co-op. 1986) states: "[E]very employer making payment of wages shall deduct and withhold a tax . . . ."

[248]I.R.C. § 3401(a) (Law. Co-op. 1986) (emphasis added). "For the purposes of this chapter, the term 'wages' means all remuneration performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash . . . ." *Id.*

[249]Central Ill. Pub. Serv. v. United States, 435 U.S. 21 (1978) (lunch reimbursements not wages for withholding purposes); Allstate Ins. Co. v. United States, 530 F.2d 378 (Ct. Cl. 1976) (indirect moving expenses not wages for withholding purposes); Royster Co. v. United States, 479 F.2d 387 (4th Cir. 1973) (meal reimbursements not wages for withholding purposes); Acacia Mut. Life Ins. Co. v. United States, 272 F. Supp. 188 (D. Md. 1967) (convention trips not wages for withholding purposes).

[250]479 F.2d 387 (4th Cir. 1973).

amounts were wages was to determine if amounts paid were "due to the employment relationship."[251] The court held that not all payments from employer to employee were necessarily wages subject to withholding.[252] In another case, *Acacia Mutual Life Insurance Co. v. United States*,[253] the U.S. District Court for the District of Maryland stated that it is the purpose of the employer that controls in determining whether payments are wages.[254] Therefore, if frequent flyer bonuses are given as remuneration, they should be considered wages.

Furthermore, in *Central Illinois Public Service v. United States*,[255] the Supreme Court held that withholding is a narrow concept and is definitely not required unless a payment constitutes wages.[256] The Internal Revenue Service wanted to enforce withholding on taxable lunch reimbursements paid to employees by their employer;[257] although taxable to the employees, the amounts were not wages because they were not remuneration for services.[258] The Court conceded that if a payment was considered to be wages the employer would be obligated to withhold,[259] but reasoned that there was a large gap between the premise that income was taxable and the conclusion that the employer was therefore responsible for withholding simply because he made the payment.[260] Therefore, if frequent flyer bonuses are wages in remuneration for services rendered, the employer will be required to withhold on them; in contrast, if the bonuses are by way of expense reimbursement or some other payment not recognizable as wages, then the employer need not withhold.[261] Because the employer is usually allowing the employee to keep the bonus flight as an incentive to produce,[262] it is remuneration for services performed. Thus, despite the employer's difficulty in tracking the employee's receipt of frequent flyer bonus income, the bonus con-

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[251] *Id.* at 390. The court stated, "We are of the opinion that the term wages is narrower than the term income as used in the provisions relating to how an individual must treat payments to him. Wages are merely one form of income." *Id.* The court continued, "We believe that the question here is whether the payments at issue were made to the employees of Royster as remuneration for services performed." *Id.* The court held that the lunch reimbursements were not attributable to the service of the employee because the salesmen were not on call during lunch and received the lunch reimbursement whether or not they made sales on that day. *Id.* at 391-92.

[252] *Id.* at 390.

[253] 272 F. Supp. 188 (D. Md. 1967).

[254] *Id.* at 195.

[255] 435 U.S. 21 (1978).

[256] *Id.* at 29.

[257] *Id.* at 23.

[258] *Id.* at 28.

[259] *Id.* at 25.

[260] *Id.* at 29.

[261] *See id.*

[262] *See supra* text accompanying notes 132-39.

stitutes wages and it appears that the employer is required to withhold on it.

However, although frequent flyer bonuses are wages because they are remuneration for services performed for the employer, they are not wages for the employer's withholding purposes because of a statutory exception to the definition of the word "employer."[263] Section 3401(d) of the Code states that if the employer for whom the services were performed does not have control of the payment of the wages, the payor of the wages becomes the employer for the purposes of withholding.[264] Although redefining the word "employer" solves the employer's withholding difficulty, it appears to shift the burden of withholding to the airlines, which are statutorily considered to be the "employer" because they made the payments.[265] Unfortunately, the airlines have an even greater burden in withholding than the employer because the airline has no information about the frequent flyer's status as an employee and has none of the traveler's funds from which to withhold.

However, two 1970 Revenue Rulings discuss situations that are analogous to the frequent flyer bonus situation. In one ruling,[266] the IRS held that a distributor's award of "prize points" to its dealer's salesmen, under a system that allowed salesmen to earn points toward cataloged merchandise prizes to be sent directly to the salesmen, was income to the recipient.[267] However, the IRS also held that the value of the points awarded was not "wages" for withholding purposes.[268] In the second ruling,[269] a manufacturer paid sales volume bonuses to its dealer's salesmen even though it did not have control over the salesmen or a common law employment relationship with them. The IRS held that section 3401(d) did not require the manufacturer to withhold because the bonuses "are

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[263]I.R.C. § 3401(d) (Law. Co-op. 1986) states:

> For purposes of this chapter, the term 'employer' means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that—(1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term 'employer' means the person having control of the payment of such wages. . . .

[264]*Id.*

[265]Notice that for gross income inclusionary purposes, the *employer* awards the bonus when he allows the employee to keep a benefit that is an accession to the employee's wealth and gross income because the employee did not pay for the underlying tickets and so cannot treat the bonus as a volume discount. *See supra* text accompanying notes 122-39. However, for employment tax purposes, the *airline* is considered to have awarded the bonus because the Code redefines the word "employer" as being the person who controls the payments. I.R.C. § 3401(d) (Law Co-op. 1986).

[266]Rev. Rul. 70-331, 1970-1 C.B. 14.

[267]*Id.* at 15.

[268]*Id.*

[269]Rev. Rul. 70-337, 1970-1 C.B. 191.

not remuneration for services performed for the dealer who employs the salesmen, but are remuneration for services rendered to the [manufacturer] and as such are not wages subject to withholding."[270]

Similarly, for withholding purposes, the award of a bonus flight by the airlines is not remuneration for services performed for the employer who paid for the flights even though the employer's reason for allowing the employee to keep the bonus may be remunerative.[271] Instead, by awarding the bonus, the airline, with no right to exercise control over the employee, is rewarding that employee for brand loyalty.[272] Thus, it appears that neither the airline nor the employer is required to withhold on a frequent flyer bonus award.

VII. The Reporting Burden—Employee, Employer or Airline?

The final issue for consideration is who should be required to report the gross income generated by the issuance and receipt of a frequent flyer bonus to the Internal Revenue Service. Three possibilities exist: the employee, the employer, or the airline could be required to report. First, the employee could be responsible for the reporting function. Despite the fact that it would be least burdensome for all parties to require the employee to report, past experience shows that the individual is least likely to comply with reporting requirements.[273] Therefore, the frequent flyer should not be responsible for the reporting function.

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[270]Rev. Rul. 70-331, *supra* note 266, at 15 (interpreting Rev. Rul. 70-337, *supra* note 269). Rev. Rul. 70-337, *supra* note 269, explained the reasoning of the IRS as follows:

> Section 3401(d)(1) of the Code provides in part, that if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" . . . means the person having control of the payment of such wages.
>
> Under the fact presented, the [manufacturer] is not the employer of the salesmen within the meaning of section 3401(d)(1) of the Code.
>
> The "bonuses" paid to the salesmen by the [manufacturer] whether directly or through an agent (the dealer), are not remuneration for services performed for the dealer who employs the salesmen, but are remuneration for services rendered to the [manufacturer]. Under the facts presented, the salesmen are not employees of the [manufacturer] under the usual common law rule and, therefore, the "bonuses" paid by it to the salesmen employed by the dealers are not wages for the purposes of [withholding]

Id. at 192.

[271]*See supra* text accompanying notes 132-39.

[272]*Richer Rewards*, *supra* note 1, at 89.

[273]For example, Congress has found it necessary to implement many penalties for individuals' failure to report and pay tax. *E.g.*, I.R.C. § 6651 (Law. Co-op. 1986) (penalty for failure to file return or pay tax); I.R.C. § 6653(a)(1) (Law. Co-op. 1986) (penalty for negligence or intentional disregard of the rules and regulations); I.R.C. § 6653(b) (Law. Co-op. 1986) (penalty for fraud); I.R.C. § 6654 (Law. Co-op. 1986) (penalty for underpayment of estimated tax); I.R.C. § 6661 (Law. Co-op. 1986) (penalty for substantial

The second option is to require employers to report, however, employers are not required to withhold because the payment is received from a third party.[274] Similarly, the employer should not be required to report because the payment is received from a third party.[275] Because employers cannot track the employee's use of frequent flyer bonuses without excessive cost in order to reclaim the bonuses from the employees,[276] it would be impossible to require an employer to track the bonuses for reporting purposes. Therefore, the employer should not be required to report the frequent flyer bonuses awarded by airlines.

The third option, requiring the airlines to report, is the most practical in terms of accessibility of information. The airlines already possess the centralized records that would yield most of the information necessary.[277] Because the airlines send monthly statements to program participants' homes showing the balance of miles flown and bonuses available,[278] the airlines must have the participants' names and addresses. Similarly, the airlines must keep track of the amount and nature of bonuses awarded to maintain the participants' mileage balances.[279] Therefore, the only additional information the airlines need to enable them to report is the social security number of the recipient.[280]

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understatement of liability). Moreover, Congress has also implemented a multitude of reporting and withholding requirements by payors of income. *E.g.*, I.R.C. § 6041 (Law. Co-op. 1986) (reporting of information at source); I.R.C. § 6042 (Law. Co-op. 1986) (reporting of dividends); I.R.C. § 6044 (Law. Co-op. 1986) (reporting of patronage dividends); I.R.C. § 6045 (Law. Co-op. 1986) (reporting of broker and barter transactions); I.R.C. § 6049 (Law. Co-op. 1986) (reporting of interest); I.R.C. § 6050E (Law. Co-op. 1986) (reporting of state and local income tax refunds); I.R.C. § 3402(o) (Law. Co-op. 1986) (withholding on supplemental unemployment compensation, annuities and sick pay); I.R.C. § 3402(q) (Law. Co-op. 1986) (withholding on gambling winnings).

[274]I.R.C. § 3401(d) (Law. Co-op. 1986); *see supra* note 263 and accompanying text.

[275]*See id.* If an employer is not required to withhold because the payment is made by a third party, then the employer should not be required to report because the payment is made by a third party. *See also infra* note 263 and accompanying text.

[276]*E.g.*, *Who?*, *supra* note 38, at 77; Sherman, *supra* note 1 at 108. Travel agencies have created services to track the number of bonus miles flown by getting information from the airlines and matching it to employer's employee listings. There has been little demand for the services, apparently because of high cost and employee relations aspects. *See also supra* text accompanying notes 132-39.

[277]*E.g.*, UNITED AIRLINES, INC., MILEAGE PLUS PROGRAM GUIDE 6 (1987). United sends a monthly statement if activity is recorded in a frequent flyer's account. Included is a detailed listing of mileage activity and Bonus Bank activity.

[278]*Id.*

[279]*Id.* For discussion of problems related to fair market value of the bonus, *see supra* text accompanying notes 241-46; *see also infra* text accompanying notes 281-87.

[280]*Cf.* I.R.C. § 6042 (Law. Co-op. 1986) (reporting of dividends); I.R.C. § 6044 (Law. Co-op. 1986) (reporting of patronage dividends); I.R.C. § 6045 (Law. Co-op. 1986) (reporting of broker and barter transactions); I.R.C. § 6049 (Law. Co-op. 1986) (reporting of interest). Reporting requirements for all of these payments consist of name, address, social security number, and amount.

Furthermore, there is precedent for requiring the airlines to report the total amount of bonus awarded, regardless of taxability, by comparison with the reporting requirements for patronage dividends. A member of a farmer's cooperative earns monetary patronage dividends due to purchases and sales entered into by the cooperative.[281] State statute requires that the cooperative, a non-profit organization, share its profit with its members through patronage dividends.[282] Dividends paid because of the member's purchase of personal or depreciable assets are not gross income to the recipient.[283] Other dividends earned on the member's sales through the cooperative and by sales the cooperative makes to non-members are treated as gross income by the recipient.[284] However, for reporting purposes, the cooperative is not required to determine which amounts are income to the member.[285] Instead, the cooperative is required to report the amounts to its members and the IRS.[286] The members are responsible for allocating the dividends into taxable and non-taxable portions.[287] A similar system should be adopted for the reporting of frequent flyer bonuses because the airline would not be responsible for deciding who received income. Instead, it would only be responsible for preparing a statement for everyone who received a frequent flyer benefit.

Finally, if the airline reports the fair market value of frequent flyer bonuses awarded, the treatment of frequent flyer bonus income will be consistent with the "Information at Source" reporting requirements of the Code.[288] Under these requirements, payments of $600 in any year

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[281]INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY, PUB. NO. 225, FARMER'S TAX GUIDE 10 (1983) [hereinafter FARMER'S TAX GUIDE].

[282]IND. CODE § 15-7-1-13(f) (1982). This section provides that all net earning or savings in excess of amount needed to restore a deficit, pay stock dividends and maintain reserves shall be distributed on a patronage basis, either to members and non-members or to members only.

[283]FARMER'S TAX GUIDE, at 10.

[284]*See id. See generally* THE INDIANA FARM BUREAU COOPERATIVE ASSOCIATION INC., COOPERATIVES THE AMERICAN WAY ¶¶ 8-10; THE INDIANA FARM BUREAU COOPERATIVE ASSOCIATION INC., FACTS ¶¶ 8, 12-15.

[285]Treas. Reg. § 1.6044-5(b)(1) (as amended in 1977). The statement shall "[s]how the aggregate amount of payments shown on the return as having been made to such persons. . . ."

[286]Treas. Reg. § 1.6044-3 (1962) (lists amounts required to be reported to the IRS by cooperative organizations).

[287]*See* Treas. Reg. § 1.6044-5(b)(1) (as amended in 1977).

[288]I.R.C. § 6041(a) (1986) states:

> All persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits and income . . . of $600 or more in any taxable year . . . shall render a true and accurate return . . . setting for the amount . . . and the name and address of the recipient of such payment.

must be reported at the source of the payment by the payor.[289] When it awards a bonus, the airline is the preliminary source of the bonus and is making a payment in connection with its trade or business because the bonuses are paid and deducted by the airline as a promotional expense.[290] Thus, the airline should be required to send information statements to the recipient and to the Internal Revenue Service in order to be consistent with other information at source requirements. Also, the airline is in a better position to report than the employer because the airline is reporting information already collected in the course of everyday transactions.

VIII. Conclusion

Frequent flyer bonus awards are not income to a person who purchases the underlying flights because the bonus should be considered to be a rebate or volume discount taken over time. Therefore, no income is realized by frequent flyers who buy their own tickets to earn flights. Furthermore, generally, if the purchaser of the underlying flights transfers an earned bonus to a third party, the purchaser of the underlying flights will recognize income only to the extent of any compensation received for the bonus given up.

If, however, the "purchaser" of the underlying flights is an employer, and if the employee who earned the mileage credit is allowed to retain the bonus, the employer should properly be considered the purchaser because without the employer's payment for the underlying tickets, the bonus could not have been earned. Therefore, the employer has "transferred" the bonus to the employee even if the employee receives it directly from the airline. Furthermore, the employment relationship requires that the employee recognize gross income to the extent of the fair market value of the bonus received as adjusted by the subjective worth of the bonus to the employee. Because the courts have consistently been reluctant to infer gratuitous motives to the employment relationship, the bonus has been transferred to the employee as a form of remuneration and not as a gift.

The income thus allocated to an employee by the receipt of a bonus flight for personal use cannot be excluded under the gift or prize and award exclusionary sections of the Code. Furthermore, despite the fact that a literal reading of the de minimus fringe benefit rules implies exclusion, Congress' intent when they promulgated the rules indicates that the inclusive gross income concept requires the recognition of the bonuses as income.

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[289] *Id.*

[290] *See supra* notes 16-21 and accompanying text.

If bonus flights are transferred to the employee for the purpose of "remuneration for services performed" instead of for some other business purpose, frequent flyer bonuses are not simply income; they are also "wages." However, because of the statutory exception that an employer who is not in control of the payment of the wages cannot be an employer for the purposes of withholding on those wages, the employer is not required to withhold on the income generated. The airline is not required to withhold, either; it does not meet the common law definition of employer because it has no control over frequently flying business travelers. Thus, neither the employer nor the employee is required to withhold on the amount received as a frequent flyer bonus.

Finally, the recipient should not be required to report the income received. Past experience shows that irregularities in tax treatment would result as income recipients often do not properly report income received. Similarly, the employer should not be required to report because acquiring the necessary information would be too burdensome. Therefore, because most of the information required for reporting has been accumulated by the airlines, it is logical to put the burden of reporting the amount of income due to the awarding of frequent flyer benefits on the airlines.

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