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Note, Are Frequent Flyer Benefits Really Benefits: An Analysis of the Frequent Flyer Tax Debate and a New Theory of Taxability for Frequent Flyer Benefts, 47 Clev. St. L. Rev. 281 (1999)

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ARE FREQUENT FLYER BENEFITS REALLY BENEFITS?: AN ANALYSIS OF THE FREQUENT FLYER TAX DEBATE AND A NEW THEORY OF TAXABILITY FOR FREQUENT FLYER BENEFITS

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I. INTRODUCTION

It seems almost too good to be true. After spending two years juggling travel schedules, waiting in airports hoping to get on a flight as a stand-by, telephoning her boss to explain why she's stuck in Chicago for one more night, and forgoing the lowest available fares to her destination just for the opportunity to travel with a particular airline, the harried business traveler finally acquires enough frequent flyer miles to take her family to Disney World for that long-coveted vacation in the Magic

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Kingdom.[1] As the family flies off into the sunset, the harried business traveler chuckles to herself, satisfied that her patience and savvy in dealing with the airlines have allowed her to get something for nothing

What appears at first glance to be the proverbial free lunch for travelers has created quite a debate among tax professionals and academics. Some argue that whether the value of earned mileage should as a matter of tax theory be included in gross income when the recipient files his or her tax return depends on exactly how those miles were earned. Although the Internal Revenue Service has yet to formally address the taxability of frequent flyer mileage, the prevailing opinion to date is that mileage earned on personal, non-business-related flights represents a "rebate of part of the cost in consideration of flying on a particular airline, or as a purchase price adjustment that is tax free."[2] However, mileage earned by an employee on flights taken while on business for an employer is considered to be a taxable employee fringe benefit if it is subsequently used by the employee for personal travel.[3]

This Note will argue that the prevailing opinion is flawed. Both types of mileage should be taxable regardless of how they are earned, because all frequent flyer mileage is actually taxable award or prize income as set forth under section 74 of the Internal Revenue Code.[4] This Note will begin with a brief history of frequent flyer programs and an explanation of how they operate, followed by a closer look at the traditional arguments for nontaxability of mileage earned on personal flights, taxability of mileage earned on business flights for an employer, and proposed theories for valuing the taxable mileage. Next, it will summarize failed attempts by both the courts and the legislature to resolve the issue.

After establishing this background, the Note will explore the concept of gross income, particularly as reflected by section 61 of the Internal Revenue Code and interpreted by case law and Internal Revenue Service Revenue and Letter Rulings. Next, it will address the specific provisions of section 74 of the Internal Revenue Code, together with supporting case law decided both before and after the enactment of section 74. Finally, this Note will conclude with an analysis of the language of several frequent flyer programs. It will show how the structure and policy of these programs suggests that the earned miles are really taxable award or prize income as described in section 74, regardless of whether the mileage is earned in a business or personal context, and *not* taxable fringe benefits or tax-free purchase price adjustments.

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[1]*See* Jonathan Barry Forman, *Income Tax Consequences of Frequent Flyer Programs*, 26 TAX NOTES 742 (1985) (mentioning a United Airlines study showing the inconveniences and expenses travelers are willing to endure for the opportunity to earn free miles).

[2]Kathy Krawczyk & Lorraine Wright, *How Should Frequent Flyer Miles be Taxed?*, 79 TAX NOTES 1029 (1998).

[3]Forman, *supra* note 1, at 742. In one of the first articles to discuss the taxability of earned frequent flyer mileage, Forman's editorial gives a summary of the view that still persists among most academics and tax professionals to date.

[4]I.R.C. § 74 (1998).

II. FREQUENT FLYER PROGRAMS—GENERAL BACKGROUND

A. History of the Frequent Flyer Program

The Airline Deregulation Act,[5] enacted in 1978, signaled a turning point for the way airlines approached advertising and marketing. No longer subject to heavy regulation by the Civil Aeronautics Board, airlines were free for the first time since the enactment of the Federal Aviation Act of 1958[6] to decide their own interstate airfare rates and flight routes.[7] The Civil Aeronautics Board was subsequently abolished in 1985.[8]

In 1981, American Airlines became the first commercial airline to adopt a Frequent Flyer program offering free travel in return for customer patronage.[9] The AAdvantage® program was designed to increase sales and improve customer "brand loyalty" to American Airlines in the highly competitive atmosphere spurred by this governmental deregulation of the airline industry.[10] Following American's lead, almost every other major airline soon launched its own version of the frequent flyer program and began offering repeat customers free flights or other benefits in return for their continued use of the same airline.[11] Most airlines have also expanded their programs to allow customers to earn mileage by using "tie-in services."[12] For example, United Airlines' Mileage Plus® program lets members earn mileage through patronizing its "partners," which include several hotel chains, car rental companies, and even other airlines.[13] In 1994, approximately forty-eight percent of awarded miles were earned through patronage of airline marketing partners rather than the airlines themselves.[14]

Frequent flyer programs have enjoyed enormous success and are extremely popular with both passengers and airlines. As of 1994, it was estimated that thirty million people in the United States were members of at least one frequent flyer program.[15] "[F]requent flyer programs have been widely acknowledged as the most

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[5]49 U.S.C. § 1302 (1998). This Act was enacted to "further 'efficiency, innovation, and low prices' as well as variety [and] quality . . . of air transportation services. . . ." Morales v. Trans World Airlines, Inc., 504 U.S. 374, 378 (1992).

[6]49 U.S.C. App. § 1301 (1998) (repealed 1999).

[7]*See generally Morales*, 504 U.S. at 378 (discussing in dicta the history of airline deregulation).

[8]*Id.* at 379.

[9]Lee S. Garsson, *Frequent Flyer Bonus Programs: To Tax or Not To Tax - Is This the Only Question?*, 52 J. AIR L. & COM. 973 (1987).

[10]*See Morales*, 504 U.S. 374 (1992). Justice Scalia's opinion sets forth in dicta an extensive history of airline deregulation, as well as a detailed summary of its effects on airline advertising and frequent flyer programs.

[11]Forman, *supra* note 1, at 742.

[12]Tax Analysts, *A History of the Frequent Flyer Program*, 38 TAX NOTES 1311 (1988).

[13]*See* UNITED AIRLINES, WELCOME TO MILEAGE PLUS (1996).

[14]Krawczyk & Wright, *supra* note 2, at 1029.

[15]*Id.*

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successful marketing programs in airline industry history."[16] Even some non-airline companies, recognizing the enormous advertising power of frequent flyer programs, have jumped on the bandwagon and adopted their own "frequent flyer" programs, independent of any one airline. Capital One Visa's MilesOne Visa® Platinum card, for example, (allegedly) allows qualifying cardholders to earn "one mile for every dollar you spend . . . [which can be redeemed] for free tickets on any U.S.-based airline."[17] There are usually no special requirements to join frequent flyer programs, although a few charge a yearly fee.[18] Most airlines are so eager to attract new customers that signing up with a program is as quick as making a phone call to the airline's main information number; many airlines do not even require that an applicant make flight reservations before joining.[19]

Of course, this seeming cash cow is not without its costs. A Shearson Lehman estimate from 1993 stated that approximately three percent of all airline traffic now results from redemption of frequent flyer awards.[20] This has resulted in an estimated long-term liability of approximately $700 million[21] for each of the four largest U.S. carriers.[22] Notwithstanding the expense, airlines are reluctant to give up their frequent flyer programs, as they are an extremely powerful incentive for consumers to go out of their way to patronize a particular airline even when it might not be convenient or economical to do so.[23] The typical frequent flyer member is a business traveler, a full-fare passenger whose flight is being paid for by his or her employer.[24] Thus, it is a win-win situation for both the passenger and the airline. It costs the passenger nothing extra out-of-pocket to fly with a particular airline, and the airline is able to charge full-price for a ticket in an industry where frequent airfare wars make it very easy for a potential passenger to shop around for a cheaper fare.[25]

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[16]Morales v. Trans World Airlines, Inc., 504 U.S. 374, 407 (1992).

[17]CAPITAL ONE FINANCIAL CORPORATION, THE MILES ONE CARD FROM CAPITAL ONE®: WE'RE MILES ABOVE THE REST (1999). Like any other junk mail solicitation, this is subject to numerous "restrictions and limitations" and should be taken with a grain of salt.

[18]Tax Analysts, *supra* note 12, at 1311.

[19]While conducting research for this Note, I joined four different frequent flyer clubs to get information about their programs. Only one of the airlines even asked for a flight booking before it would mail literature.

[20]Lee A. Sheppard, *Collecting the Tax on Frequent Flyer Benefits*, 59 TAX NOTES 1140 (1993).

[21]*Id.* at 1140.

[22]These are American, United, Delta, and Northwest. *Id.*

[23]*Id.*

[24]*Id.*

[25]*See generally* Continental Airlines, *CO.O.L. Travel Assistant*™ (visited Jan. 5, 1999) <http://cooltravelassistant.com/pub/eta.dll?qscr=fsch> (listing fare advertisements on Jan 5, 1999, for round-trip coach fares between Cleveland and Dayton, Ohio, for travel on January 11, 1999, ranging from $129 to $617); *see also* Morales v. Trans World Airlines, Inc., 504 U.S. 374, 406-07 (1992).

B. How Frequent Flyer Programs Operate

The concept behind frequent flyer programs is relatively simple. Although details can differ from airline to airline, most programs operate in roughly the same manner.[26] Participants in Continental Airlines OnePass® program, a typical frequent flyer program, give their program account number to the reservation clerk when they book a flight and again to the representative at check-in.[27] The participant earns either 500 miles for each flight or the number of miles traveled in the flight, whichever is greater.[28] A participant can also earn additional mileage by giving his or her account number to OnePass program partners when renting a car, registering at a hotel, or making credit-card purchases.[29] Occasionally, airlines will offer temporary special promotions to make their programs stand out from the frequent flyer clones. In 1988, Delta Airlines became the first airline to offer a triple mileage program, and the special was soon copied by most of the other major airlines.[30]

Once a participant has accrued enough mileage, he or she can cash the mileage in for free flights or class upgrades.[31] For example, participants in United Airlines Mileage Plus® program who have accrued 20,000 miles can trade in their miles to upgrade from a coach ticket to first class.[32] Alternatively, they can wait until they have 25,000 miles and redeem them for one free domestic economy class ticket, or 60,000 miles and redeem them for a free domestic first class ticket.[33] Many programs also offer international flight awards to participants who have accrued higher mileage levels or achieved preferred customer status.[34]

C. Legal Implications of Frequent Flyer Programs

The unexpected popularity and expense of maintaining a frequent flyer program has prompted some airlines to modify their programs to include significant restrictions, such as blackout periods and mileage expiration dates.[35] These changes have led to challenges of state statutes which attempt to regulate frequent flyer programs and consumer fraud claims by frequent flyer program members.[36]

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[26]*See* Garsson, *supra* note 9, at 973.

[27]*Continental Airlines One Pass Info Center: Earning Miles* (visited Jan. 5, 1999) <http://www.flycontinental.com>.

[28]*Id.*

[29]*Id.*

[30]Tax Analysts, *supra* note 12, at 1311.

[31]*See generally* UNITED AIRLINES, CURRENT MILEAGE PLUS AWARDS ON UNITED AIRLINES (1996) (award chart showing mileage requirements and award levels).

[32]*Id.*

[33]*Id.*

[34]*Id.; see also Continental Airlines One Pass Info Center: 1999 Reward Chart* (visited Jan. 5, 1999) <http://www.flycontinental.com>; U.S. AIRWAYS, DIVIDEND MILES AWARDS (1997). Airlines may have different names for their preferred customer status, such as "Premium" or "Elite."

[35]*See* Morales v. Trans-World Airlines, Inc., 504 U.S. 374, 407 (1992).

[36]*See id.* at 374.; American Airlines, Inc. v. Wolens, 513 U.S. 219 (1995).

In *Morales v. Trans World Airlines, Inc.*,[37] the most widely cited frequent flyer case, the United States Supreme Court granted certiorari to the Attorney General of Texas's appeal from a Fifth Circuit Court of Appeals decision holding that the Airline Deregulation Act of 1978 (ADA) pre-empts any state statute prohibiting deceptive airline fare advertisements.[38] The "statute" at issue was not actually a law at all but merely guidelines adopted by the National Association of Attorneys General (NAAG) to "'explain in detail how existing state laws apply to air fare advertising and frequent flyer programs.'"[39] Among other provisions, the guidelines provided that airlines must give frequent flyer program members adequate notice that programs were subject to change if they wanted to reserve their rights to modify the programs in the future.[40]

Despite objections from the Department of Transportation and the Federal Trade Commission, the attorneys general of seven states, including the petitioner's state of Texas, sent memoranda to the major airlines doing business in their jurisdictions stating that the airlines were in violation of the guidelines and that "enforcement actions" would be initiated if they failed to come into compliance.[41] The Supreme Court affirmed the judgment of the Fifth Circuit and held that the ADA pre-empts the NAAG guidelines, thereby preventing states from attempting to regulate the advertisement and operation of frequent flyer programs.[42]

In 1995, the Supreme Court addressed another issue arising out of a frequent flyer program in *American Airlines, Inc. v. Wolens*.[43] In this consolidation of two class-action cases, the plaintiffs, members of American Airlines frequent flyer program, brought suit against American for breach of contract stemming from changes to the AAdvantage® program, which plaintiffs contended devalued credits they had already earned prior to the modifications.[44] The Illinois Supreme Court had affirmed the lower court's holding that the Airline Deregulation Act pre-empted plaintiffs' claim under the Illinois Consumer Fraud and Deceptive Business Practices Act.[45] The Supreme Court of the United States, citing *Morales*, affirmed the Illinois Supreme Court's holding regarding pre-emption, but distinguished its prior holding in *Morales*. It reversed the Illinois Supreme Court's judgment regarding the breach of contract claim but held that the plaintiffs still had a legitimate common-law claim.[46]

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[37]504 U.S. 374 (1992).

[38]*Id.* at 378.

[39]NAAG Guidelines, Introduction (1988) (*quoted in Morales* 504 U.S. at 379).

[40]*Morales,* 504 U.S. at 407.

[41]*Id.* at 379-80.

[42]*Id.* at 391.

[43]American Airlines, Inc. v. Wolens, 513 U.S. 219 (1995).

[44]*Id.* at 224-25.

[45]815 Ill. Comp. Stat. § 505 (1992) (*cited in* American Airlines, Inc. v. Wolens, 513 U.S. 219, 225 (1995)).

[46]*Wolens*, 513 U.S. at 226.

III. Arguments Surrounding the Taxability of Frequent Flyer Benefits

Although breach of contract and consumer fraud claims, such as those addressed in *Morales* and *Wolens*, have generated the most litigation around frequent flyer programs, the most disputed legal question raised by the advent of frequent flyer programs is whether the earned mileage should be included as taxable income by recipients on their tax returns. Although the question has generated a great deal of scholarly analysis and even more disagreement, it has led to surprisingly little litigation. In fact, the only case addressing the tax treatment of frequent flyer miles to reach the United States Tax Court is *Charley v. Commissioner*,[47] discussed below. Difficulty in determining the procedure for valuing frequent flyer benefits, as well as obvious political considerations, have prevented the IRS and Congress from taking any official position on the issue, much less attempting to collect taxes on the mileage.[48] However, most tax specialists and scholars believe (albeit mistakenly, as I will show) that miles should be treated differently depending on whether they are earned through personal or business travel.

A. Benefits Earned Through Personal Travel

Frequent flyer mileage earned through personal travel is generally viewed by tax academics as a "rebate of part of the cost in consideration of flying on a particular airline or as a purchase price adjustment" and is therefore considered to be nontaxable.[49] In other words, the alleged "free" travel that an airline passenger receives in return for other purchased travel on the airline should be viewed not as a genuine "accession to wealth,"[50] includable under section 61 of the Internal Revenue Code, but as a bargained-for reduction in price for all flights, both those actually purchased and those that are "free."[51]

The theory of the commercial bargain purchase can be clearly illustrated through the following example: "[I]f one pencil costs 10 cents, but three pencils cost only 25 cents, the five-cent savings is not treated as income, but rather it is a simple volume discount with no income tax consequences."[52] It simply reduces the true cost of the pencils to eight and one-third cents apiece, provided the purchaser buys three and not just one. This concept can be easily translated to the frequent flyer arena. An airline patron can purchase tickets from Cleveland to London for $800, to Caracas for $650,

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[47]66 T.C.M. (CCH) 1429 (1993).

[48]*See generally* George Guttman, *IRS Moves Slowly on Frequent Flyer Issue*, 38 Tax Notes 1309 (1988) (discussing the reasons why both the IRS and Congress have resisted officially addressing the taxability of frequent flyer benefits and suggests some ideas for adopting a procedure to tax these benefits).

[49]Krawczyk & Wright, *supra* note 2, at 1029.

[50]*See* Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). (holding that nonexempt "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" are includable and taxable as gross income). *Id.* at 431.

[51]For a concise explanation of the concept of tax-free "commercial bargain purchases," *see* Joseph M. Dodge et al., Federal Income Tax: Doctrine, Structure and Policy 71-73 (2d ed. 1999).

[52]Forman, *supra* note 1, at 742.

and to Albany for $225, for a total cost of $1675. But if the patron is a frequent flyer member, the flights to London and Caracas might earn her enough miles to get the ticket to Albany for free, resulting in a total price of $1450. Rather than viewing the flight to Albany as a free trip, a proponent of the bargain purchase theory would argue that the "true" cost of the flights were $696 to London, $565 to Caracas, and $189 to Albany.[53]

In order for the bargain purchase theory to apply, the price reduction must arise from an arms-length negotiation between the parties to the transaction.[54] Frequent flyer programs as arrangements between the airline and prospective passengers generally satisfy this arms-length requirement.

B. Benefits Earned Through Business Travel

Tax experts and the IRS (though unofficially) generally view frequent flyer miles earned by employees in the course of business travel not as tax-free commercial bargain purchases but as taxable income.[55] The key to this differentiation between miles earned through personal travel and miles earned while on business seems to be that the business flights are paid for by the employer and not the employee. Hence, the experts argue, the awarded mileage really represents disguised compensation for services from the employer and not a bargain purchase price negotiated between the airline and the passenger.[56] This opinion predominates notwithstanding the fact that employers incur no additional business expense by allowing employees to retain their frequent flyer miles, and the airline receives no consideration from the employer. The frequent flyer benefits are usually classified by tax theorists as "employee fringe benefits" that are not excludable under the provisions of section 132 of the Internal Revenue Code.[57] Benefits that are not specifically excluded under section 132 are taxable under sections 61 and 83.[58]

The argument for taxability of frequent flyer mileage is based in part on the tax benefit theory.[59] Under the tax benefit theory, if there is an 'event' related to a

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[53]The figures in the foregoing example were reached by calculating what percentage of the total cost each flight represented as determined by the ticket prices for each destination if purchased independent of the others.

[54]DODGE ET AL, *supra* note 51, at 72.

[55]Guttman, *supra* note 48, at 1310.

[56]*See generally* Krawczyk & Wright, *supra* note 2, at 1031 (arguing for the tax-free fringe nature of employee-retained frequent flyer benefits).

[57]*See* Forman, *supra* note 1, at 742-43 (quoting IRS officers, including attorney-advisor Annette J. Guarisco who said, "[w]hen a frequent flyer pass is provided in connection with the performance of services, it is a fringe benefit and so income").

[58]Krawczyk & Wright, *supra* note 2, at 1031. Section 83 of the Internal Revenue Code provides that "property transferred in connection with performance of services" is generally includable in the income of the individual performing services, even if the property is transferred, not to the taxpayer, but to someone else. I.R.C. § 83 (a) (1998). Hence, frequent flyer miles could be taxable to an employee even if the benefits are ultimately used by a family member.

[59]*See* Joseph M. Dodge, *How to Tax Frequent Flyer Bonuses*, 48 TAX NOTES 1301, 1302 (1990).

particular situation in the current year that is 'fundamentally inconsistent' with tax treatment of that situation in a prior year the taxpayer must 'disgorge' the benefit realized in the prior year by including it in year-2 income to the extent it produced a year-1 tax benefit.[60]

To illustrate how this operates, consider the following hypothetical: A taxpayer, a lawyer in a new solo practice, takes a section 162 deduction in 1997 for business expenses arising from the purchase of colored copier paper to be used to create announcements for her clients to advertise that she has moved from her old firm to her new solo practice. In January 1998, before the taxpayer has had an opportunity to use the paper, her former firm learns of her plan to take some of their clients and threatens to sue her. The taxpayer decides not to make the announcements and instead takes the paper home for her children to use for school projects. The taxpayer's business deduction in 1997 is inconsistent with her subsequent conversion of the paper to personal use. Therefore, the tax benefit rule requires that she include as income on her 1998 tax return the amount that she deducted in 1997 to the extent that the deduction reduced her tax liability for 1997.[61]

Those who would support applying tax benefit theory to the accrual and redemption of frequent flyer benefits argue that because the flights on which the benefits were earned were deducted by the employer as section 162 business expenses, and any free flights resulting from redemption of frequent flyer mileage really represent purchase price reductions,[62] then the claimed business deductions are actually attributable to both the business flight on which the miles were earned and the personal flight taken with the frequent flyer award.[63] But no business expense deduction is allowable for the portion of the original purchase price attributable to the personal flight. Thus, the tax benefit rule requires inclusion to this extent. In other words, if the frequent flyer benefits are subsequently used to take a flight for personal reasons, an event inconsistent with the prior business deduction, either the employer or the employee needs to include the value of that later personal flight on its tax return for the year in which the bonus flight was taken in order to prevent this personal expense from escaping taxation.[64] The employee is the one taking the personal trip and not the employer, so most experts maintain that the employee must include the value of the flight in his or her income in order to recoup the deduction that is no longer proper in light of the employee's transfer of deducted expenses to personal use.[65] This presents a difficult problem; requiring the employee to recognize income to recoup a deduction from which he did not personally benefit

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[60]DODGE ET AL., *supra* note 51, at 777.

[61]*See id.*; *see also* Dobson v. Commissioner, 320 U.S. 489 (1943) (holding that a taxpayer who received a settlement from a fraud lawsuit against the seller of unregistered stock did not have to include any of the recovery, because, although he had sold some of the stock in previous years and taken capital loss deductions, the loss deductions did not change his total tax liability for the years in which the deductions were allowed).

[62]*See supra* notes 49-54 and accompanying text (discussing the taxation of bargain purchases).

[63]*See* Dodge, *supra* note 59, at 1301-02.

[64]*Id.*

[65]*Id.*

unfairly increases the employee's tax liability, while the employer is able to retain the tax benefits bestowed by the improper earlier deduction. On the other hand, forcing the employer to recognize the income would unfairly increase its tax liability, because the employer would be recognizing income for consumption enjoyed by the employee. In spite of this obvious dilemma, most arguments for taxing frequent flyer benefits, including those from the Internal Revenue Service itself, have simply assumed that the employee, and not the employer, should ultimately foot the tax bill.[66]

Academics and tax professionals seeking to justify this lack of symmetry have decided that frequent flyer benefits earned in a business context and subsequently used for personal travel are taxable "fringe benefits," an inaccurate assessment which will be explored further below.[67] The belief that frequent flyer benefits earned while on company travel are compensatory fringe benefits apparently arises from the belief that employers are free to structure their business travel and employee compensation systems such that the frequent flyer benefits accrued by the employee while traveling for the employer are turned over to the company's account rather than remaining in the name of the employee. Notwithstanding this option, very few employers, other than the federal government, actually prohibit their employees from keeping their frequent flyer benefits.[68]

But assuming for a moment that the experts are correct, and frequent flyer benefits really are fringe benefits, it is important to understand why they are deemed taxable fringe benefits and not the "certain fringe benefits" excluded from taxable income by section 132. Section 132 sets forth the following six different kinds of fringe benefits that are excludable from gross income: "no additional cost services," "qualified employee discounts," "working condition fringes," "de minimis fringes," "qualified transportation fringes," and "qualified moving expense reimbursements" (a category which obviously does not apply to frequent flyer benefits and, thus, demands no further analysis in this Note).[69]

Frequent flyer benefits fail to qualify under the "no additional cost service" and "qualified employee discount" provisions, because these subsections require that the fringe benefit in question be a service offered in the "ordinary course of the line of business" of the employer.[70] Unless the employer happens to be an airline, this is not going to be the case. Frequent flyer benefits cannot qualify as a "working condition fringe" because this provision applies only to "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

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[66]Thomas J. St. Ville, *Final Regs. on Fringe Benefits Fail to Resolve Many Substantive Issues,* 72 J. TAX'N 210, 213 (1990).

[67]*See* T.G. Linderman, *Frequent Flyer Awards are Not Fringe Benefits*, 26 TAX NOTES 1055 (1985). The author of this letter to the editor exposes many incorrect assumptions that have led experts to label frequent flyer mileage as taxable fringe benefits. Interestingly, the author's analysis has been virtually ignored in academic circles.

[68]Sheppard, *supra* note 20, at 1141.

[69]I.R.C. § 132 (a) (1998).

[70]I.R.C. § 132 (b), (c) (1998); *see also* Forman, *supra* note 1, at 743.

176."[71] Frequent flyer benefits used for personal travel cannot be deducted under section 162 or 176, as section 262 specifically disallows deduction of personal expenses.[72]

"De Minimis fringe benefits" apply only to "property or service[s] the value of which is . . . so small as to make accounting for [them] unreasonable or impracticable."[73] Although the Treasury Regulations give little guidance as to what constitutes a "small value" as set forth under section 132 (e), common sense dictates that free airline flights probably do not fall into this category.[74] Finally, "qualified transportation fringes" are limited to transit passes, transportation between an employee's residence and workplace, and "qualified parking."[75] Frequent flyer benefits obviously do not qualify for any of these categories.

If frequent flyer benefits are indeed to be treated like fringe benefits and do not fit into any of the section 132 exclusions or any other provision for allowable exclusions under the Internal Revenue Code, then they are necessarily taxable fringe benefits.[76]

C. Valuing and Taxing Frequent Flyer Benefits

Despite the potential revenue represented by this new species of fringe benefit created through application of the tax benefit rule, the Internal Revenue Service has been slow to officially hold that frequent flyer benefits are taxable, much less to actually enforce this taxability.[77] This is striking, as the IRS is "normally quick to rule that new forms of income are subject to tax, and to ensure that taxable income is properly reported by the recipient."[78] One Congressional aide reported in 1985 that "[t]o the extent that the tax-writing committees were ever asked about it, [they] ducked the issue."[79]

Although much of the unwillingness to address the issue originates from a fear on the part of politicians to do anything that might alienate their constituents—taxpayers who are quite fond of what they see as a freebie from the airlines—the delay also springs from a reluctance to delve into an area where there are no clear precedents for valuing and administering the taxation of the benefits.[80] According to George Guttman, a staff contributor to Tax Analyst's weekly periodical Tax Notes, the

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[71]I.R.C. § 132 (d) (1998), *quoted in* Forman, *supra* note 1, at 264.

[72]*Id.*

[73]I.R.C. § 132 (e) (1998). De minimis fringe benefits include such things as free copying from the office copier, coffee, local telephone calls, and occasional office parties or other group activities. Treas. Reg. § 1.132-6 (e) (1998).

[74]Treas. Reg. § 1.132-8 (1998).

[75]I.R.C. § 132 (f) (1) (1998).

[76]*See* I.R.C. § 61 (a) (1) (1998) (requiring inclusion of fringe benefits in gross income unless "otherwise provided in this subtitle").

[77]Guttman, *supra* note 48, at 1309.

[78]*Id.*

[79]Forman, *supra* note 1, at 743.

[80]Guttman, *supra* note 48, at 1310.

taxation of frequent flyer benefits would be an immensely complex project.[81] First, the IRS would need to promulgate guidelines on how to calculate the value of the benefits.[82] This is not a modest undertaking considering that the value of the same seat on any given flight can vary by the hour.[83] The IRS would also need to determine the timing of the taxable event: Does it occur when the mileage is earned, when the mileage is redeemed, or when the free travel occurs? And who is responsible for reporting the taxable event?[84]

There have been several schemes proposed for calculating the value of frequent flyer benefits. The most celebrated of these is a method set forth by University of Texas School of Law Professor Joseph M. Dodge.[85] In his article, How to Tax Frequent Flyer Bonuses,[86] Dodge demonstrates an algebraic technique for determining the amount an employee should include in his or her taxable income to account for frequent flyer mileage earned on business trips for an employer.[87] Basing his formula on the tax benefit theory for taxation of frequent flyer mileage, Dodge argues that the amount the employee should include on his tax return is equal to the proportion of the employer's allowable business deduction which is attributable to the employee's free personal flight.[88] He illustrates this formula with the following hypothetical:

> A taxpayer earns 30,000 frequent flyer miles which he cashes in for a free 6,000 mile flight on the airline. In order to earn the 30,000 miles, the taxpayer had to take flights with the airline worth a total of $10,000. Of the $10,000 total, $8,000 is attributable to flights the taxpayer earned while on business trips paid for by his employer, and $2,000 is attributable to personal vacation flights.[89]

To remain consistent with the tax benefit and commercial bargain purchase theories, the includable portion of the value of the free flight can derive only from the fraction of mileage earned through the business travel that yielded a tax benefit to the employer. In his example, Dodge assumes that only $7,500 of the $8,000 cost of

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[81] *Id.*

[82] *Id.*

[83] *See* Paint vs. Airlines (forwarded Jan. 10, 1999). A friend of mine recently e-mailed this joke to me relating what would happen if the price for housepaint was structured like airfare rates. In short, the price for a gallon of paint would range from $9 to $200 depending on whether the painter wants regular or premium, what days of the week the painter wants to paint on, and how soon the painter buys the paint. I am unsure of the origin of this joke and cannot provide a URL for it, but I would be happy to provide a copy of it on request.

[84] Guttman, *supra* note 48, at 1310.

[85] *See, e.g.* Bernard Wolfman, *Flying Through the Fog*, 59 TAX NOTES 1555 (1993) (noting Dodge's important contribution to the frequent flyer tax debate).

[86] *See* Dodge, *supra* note 59.

[87] *Id.* at 1302.

[88] *Id.*

[89] *Id.*

business travel yielded a tax benefit.[90] To reach a final includable value, Dodge employs the following formula:

$$\frac{\text{award miles}}{\text{total cost}} \times \text{total cost} \times \frac{\text{cost of total business miles yielding tax benefit}}{\text{total cost}}$$[91]

Plugging in the appropriate values from above, the formula becomes the following:

$$\frac{6{,}000}{36{,}000} \times \$10{,}000 \times \frac{\$\,7{,}500}{\$10{,}000} = \$1{,}250$$[92]

Hence, under Dodge's formula, the taxpayer has $1,250 of includable income in the year that he redeems the frequent flyer benefits.[93]

At first blush, Dodge's proposal seems to offer a straight-forward solution to the perplexing problem of valuing frequent flyer benefits, but it is based on the faulty assumption that the number which appears at the end of the calculation is the true value of the benefits to the taxpayer. Common-sense notions of income suggest that if the receipt of in-kind items (i.e., non-cash items of value, such as frequent flyer benefits)[94] is to be included in a taxpayer's income, the amount reported should be equal to the actual value of the in-kind items to the taxpayer, not to a number derived from the previous deduction of an entirely separate tax entity. Furthermore, if frequent flyer miles are to be treated as taxable fringe benefits, they are a form of "compensation paid other than in cash."[95] Therefore, the United States Treasury Regulations require that the fair market value of the benefits be included in the taxpayer's income.[96]

Ironically, Canada, but not the United States, has recently adopted this fair-market-value approach for valuing frequent flyer awards.[97] The Tax Court of Canada accomplished three years ago what the U.S. Internal Revenue Service has been evading for eighteen years. In the November 1995 case, *Giffen v. The Queen*,[98] the court held that personal flights received from mileage accumulated on employer-paid flights are taxable to the employee when the mileage is redeemed.[99] While the Canadian Tax Court agrees with most U.S. tax experts that the mileage is taxable because the employer paid for the flights on which the mileage was earned, there was

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[90]*Id.*

[91]Dodge, *supra* note 59, at 1302.

[92]*Id.*

[93]*Id.*

[94]*See* DODGE ET AL. *supra* note 51, at 87(defining concept of in-kind benefits as "the receipt of [anything valuable] . . . that would be nondeductible . . . if the taxpayer had paid for it himself.") *Id.*

[95]Treas. Reg. § 1.61-2 (d)(1998).

[96]*Id.* The Regulations provide that "if services are to be paid for in property, the fair market value of the property . . . must be included in income." *Id.*

[97]Krawczyk & Wright, *supra* note 2, at 1032.

[98]Giffen v. The Queen, [1995] C.T.C. 53, 57 (Can.).

[99]Krawczyk & Wright, *supra* note 2, at 1031.

little debate over how the mileage would be valued; the court simply determined that the correct includable value was the "price the employee would have paid for a ticket on the same flight in the same class service and subject to the same restrictions as the ticket obtained with the mileage."[100] The court also recommended that the value of a coach ticket for a particular flight be limited to the "most heavily discounted economy ticket sold for the flight in question," thereby eliminating any dispute over how to determine the fair market value of the tickets.[101]

D. The Charley Decisions

In the United States, the IRS has pursued only one case dealing with the taxation of frequent flyer benefits. In *Charley v. Commissioner*,[102] the respondent Commissioner of the Internal Revenue Service assessed an income tax deficiency in the amount of $3,149.93 against the petitioners.[103] The deficiency was attributable to frequent flyer benefits which Mr. Charley "sold" to his employer for cash.[104] Most airlines have structured their frequent flyer programs so that the accrued benefits belong to the passenger whose name appears on the ticket and not to the person or entity who paid for the ticket. However, many employers effectively "purchase" frequent flyer benefits from their employees by paying the employee to use the benefits in a certain way.[105] Such arrangements allow employers to pay lower costs for business travel than they would otherwise pay, and employees are able to receive cash for frequent flyer miles they might not otherwise have the opportunity to use.

In *Charley*, petitioner Philip Charley worked as an inspector and investigator for a company that specialized in chemical testing.[106] His position required him to travel frequently to accident sites to inspect mechanical devices suspected of failure.[107] Petitioner would bill the client for a first class airline ticket but book his ticket in coach.[108] Charley would then use accumulated frequent flyer benefits to upgrade his coach ticket to first class and instruct his travel agent to transfer the difference in price between the coach and first class ticket to his personal account.[109] It is unclear whether the employer company was ever aware of Mr. Charley's scheme or ever gave consent to his actions.[110] The Tax Court upheld the IRS's judgment of

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[100]*Id.*

[101]*Id.*

[102]66 T.C.M. (CCH) 1429 (1993).

[103]*Id.*

[104]*Id.*

[105]Sheppard, *supra* note 20, at 1141.

[106]Charley v. Commissioner, 66 T.C.M. (CCH) 1429 (1993).

[107]*Id.*

[108]*Id.*

[109]*Id.*

[110]*Id.*; *see also* Charley v. Commissioner, 91 F.3d 72 (9th Cir. 1996).

deficiency and imposition of an additional negligence tax for "intentional disregard of rules or regulations."[111]

The petitioners appealed the Tax Court's decision to the United States Court of Appeals for the Ninth Circuit.[112] The Court of Appeals upheld the Tax Court's judgment regarding the deficiency but reversed the imposition of a negligence penalty.[113] The Court emphasized in its reasoning that the frequent flyer benefits represented an increase in wealth over which petitioner had sole control and were, therefore, taxable income.[114] In an opinion by Circuit Judge O'Scannlain, the Court set forth two ways of analyzing the case, both of which resulted in a finding of taxable income.[115] The first characterized the receipt of the cash from the employer as additional compensation in the form of an account upon which he could withdraw up to the disputed amount.[116] Because Mr. Charley was simply transferring from his employer to his personal account the difference between the amount paid by his clients and the actual amount paid for the airline tickets, the frequent flyer benefits become irrelevant to the analysis.[117]

On the other hand, if one does not wish to view the transaction as receipt of compensation from the employer, the court asserted that it can alternatively be viewed as receipt of taxable gain from the disposition of Mr. Charley's own property.[118] In other words, the sale of the frequent flyer miles would be treated from a tax perspective as if he had disposed of some other property, such as a piece of real estate or stock in a corporation, in exchange for cash in an amount greater than his basis[119] in the property. Mr. Charley received the frequent flyer miles at no cost; he had a zero basis in them.[120] Therefore, the court held that he must include the entire $3,149.93 in his gross income.[121]

Although the court of appeals upheld the judgment of the lower court regarding the tax deficiency, it reversed the finding of negligence on the part of the Charleys and abrogated the negligence penalty.[122] The court stated that "[t]here [was] nothing

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[111]*Charley*, 66 T.C.M. at 1429.

[112]*See Charley*, 91 F.3d at 73.

[113]*Id.*

[114]Krawczyk & Wright, *supra* note 2, at 1030.

[115]*Charley*, 91 F.3d at 74.

[116]*Id.*

[117]Sheldon I. Banoff et al., *How Not to Deal With Frequent Flyer Miles for Tax Purposes,* 85 J. TAX'N 319 (1996) (giving a description of the *Charley* decisions).

[118]*Charley*, 91 F.3d at 74; *see also* I.R.C. § 61 (1998). Section 61 includes in gross income "[g]ains derived from dealings in property." *Id.*, *quoted in Charley*, 91 F.3d at 74.

[119]*See* I.R.C. § 1011-1012 (1998). Section 1011 provides that the "basis for determining gain or loss from . . . disposition of property . . . shall be the basis . . . determined under section 1012." *Id*. I.R.C. § 1012 provides that the "basis of property shall be the cost of such property, except as otherwise provided . . . ." *Id.*

[120]*Charley*, 91 F.3d at 74.

[121]*Id.*

[122]*Id.* at 75.

in the record which would cause a reasonable person to conclude that the travel credit conversion would constitute taxable income."[123] In rendering its decision, the court cited the Commissioner's brief in which it conceded that "the tax treatment of frequent flyer bonus programs is still under consideration."[124] Therefore, the petitioners could not have reasonably foreseen the possibility that the cash received from the sale of the benefits would be taxable income.[125]

Although the petitioners' brief argued that because the tax treatment of frequent flyer bonus programs had not yet been decided, the IRS could not rightfully assess a tax deficiency against them,[126] the court was not able to reach the issue of taxability of frequent flyer miles in general.[127] The specific facts of the case simply would not allow the court to address this issue without overstepping its bounds in violation of the ripeness doctrine. While the Internal Revenue Service has thus far managed to dodge the question of the tax treatment of frequent flyer miles, the courts have been unable to step in and create a common law solution.

E. Legislation

Like the Internal Revenue Service, Congress has also been slow to make any decisive move regarding the taxability of frequent flyer benefits. U.S. Representative Barbara Kennelly, a Democrat from Connecticut, introduced legislation in March 1996[128] that if passed would end the frequent flyer mile debate.[129] The legislation, which was reintroduced in February 1997 as H.R. 533, was proposed in response to the IRS's ruling in Technical Advice Memorandum 9547001.[130] This TAM, issued on November 24, 1995, ruled that an employer who allowed its employees to retain frequent flyer benefits earned during business travel had a "nonaccountable" plan for purposes of section 62(c).[131] Deeming a plan nonaccountable has the effect of making the frequent flyer benefits includable in the employee's income as reimbursement in excess of substantiated business expenses.[132] The IRS's controversial ruling in TAM 9547001 "aroused a storm of protest"[133] from politicians and tax professionals who strongly oppose any IRS

[123] *Id.*

[124] *Id.*

[125] *Charley*, 91 F.3d at 75.

[126] Adam Rosenzweig, *Employee-Owner of Company Taxable on Frequent Flier Miles "Sold" Back to Company: Charley v. Commissioner*, 50 TAX LAW. 677, 682 (1997). This student note analyzes the potential ramifications of *Charley* on the future debate over taxability of frequent flyer miles.

[127] *Id.*

[128] H.R. 3111, 104th Cong. (1996).

[129] Krawczyk & Wright, *supra* note 2, at 1031.

[130] *Id.*; Tech. Ad. Mem. 95-47-001 (Nov. 24, 1995).

[131] *Id.*; *see also* I.R.C. § 62 (1998).

[132] *See* Krawczyk & Wright, *supra* note 2, at 1030.

[133] Tom Herman, *A Special Summary and Forecast of Federal and State Tax Developments*, WALL ST. J., Mar. 20, 1996, at A1.

movement towards taxing frequent flyer benefits.[134] In response to the uproar, the IRS decided in November 1995 to "reconsider the controversial memo."[135]

The purpose of H.R. 533, which would become new section 137 to the Internal Revenue Code if passed, would "clarify that frequent flyer mileage is not taxable to the employee and travel plans are not unaccountable merely because they allow employees to retain frequent flyer benefits."[136] It would have the effect of making all frequent flyer benefits, whether earned through personal or business travel, nontaxable to the passenger recipient.[137] Mrs. Kennelly argued in her statement before the House of Representatives that attempting to tax frequent flyer benefits would "raise a myriad of questions for which there is no single correct answer." These questions would include how to value the benefits, what is the proper timing of inclusion, and who has the responsibility of reporting.[138] Mrs. Kennelly was also careful to mention the prevalent suspicion among the general population that the Internal Revenue Code is inequitable and hopelessly confusing,[139] thereby reinforcing her popularity with her constituents, taxpayers who naturally desire to keep their liabilities to the government at a minimum.

Like the half-hearted attempts of the IRS itself to shed some light on exactly whether and how to tax frequent flyer miles, H.R. 533 has accomplished little to resolve the issue of taxability of frequent flyer benefits. After its introduction, the bill disappeared into the abyss of Congressional committees, never to be seen again.[140] Congress appears to be no more anxious than the Internal Revenue Service to tackle this complicated question.

IV. Overview of the Basic Concepts of Taxable Income

In order to understand why the above traditional arguments for and against the taxability of frequent flyer benefits are incorrect, one first needs to understand rudimentary concepts of taxable income. Section 61 of the Internal Revenue Code sets forth the most common items includable in gross income.[141] Other sections, including the section 74 Prize and Award income provision, elaborate on additional items includable under section 61 but not specifically alluded to in that section.[142] The fundamentals of sections 61 and 74 are explained below in this section, together with illustrative case law.

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[134]*See* Lisa Miller & Tom Herman, *IRS Plan to Tax Frequent Fliers Falters Again*, WALL ST. J., Nov. 29, 1995, at B1; Tom Herman, *Frequent-Flier Miles May Become IRS Target*, WALL ST. J., Nov. 28, 1995, at A3.

[135]Miller & Herman, *supra* note 134, at B1.

[136]*Id.*

[137]*See* 143 CONG. REC. E130 (daily ed. Feb. 4, 1997) (statement of Rep. Kennelly).

[138]*Id.*

[139]*Id.*

[140]Neither H.R. 533 or H.R. 3111 have been passed. Hence, there is no additional history for the bills.

[141]*See* I.R.C. § 61 (1998).

[142]*See* I.R.C. § 74 (1998).

A. Section 61 Gross Income

Section 61 is the heart of the Internal Revenue Code. Section 61(a) defines "gross income" as "all income from whatever source derived, including, (but not limited to) the following items. . . ."[143] The "following items," among other things, include compensation for services (i.e., wages and fringe benefits), gains from transactions in property, interest, and rents.[144] Section 61 (b), a cross reference section, refers the reader to sections 71-86 for items specifically included in gross income.[145] Section 61 gross income becomes "taxable income" as defined under section 63 of the Code after any above-the-line deductions allowed by section 62[146] have been deducted and any below-the-line or "itemized" deductions have been taken.[147] This taxable income is the tax base to which the tax rates in section 1 of the Code are applied to calculate the amount of tax owing for a given taxable year.[148]

The following is a simple hypothetical demonstrating how taxable income is computed: a taxpayer, an unmarried electrician, has earned a total of $40,000 in wages for the 1998 tax year. In addition, the taxpayer has $2,000 in interest and dividends from his savings account and stock portfolio. Under section 61, the taxpayer's gross income is the sum of the income from all of these sources; his gross income for 1998 is $42,000.[149] The taxpayer is not itemizing deductions. Therefore, he takes the standard deduction of $3,000 allowable under section 63(c)(2),[150] resulting in a 1998 taxable income under section 63 of $39,000.[151]

As demonstrated above, section 61 gross income plays a critical role in determining how much tax a taxpayer owes. Congress, however, has left vague what exactly qualifies as income under the "catch-all" language of section 61 - neither the statute nor the regulations explain what "all income from whatever source derived" means.[152] Nevertheless, several landmark cases have served to clarify the meaning of this language and bring the four corners of section 61 into sharper focus.

Commissioner v. Glenshaw Glass Company[153] is one of the most frequently cited cases pertaining to gross income. In *Glenshaw Glass*, the taxpayer-respondent, a

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[143]I.R.C. § 61(a) (1998).

[144]*Id.*

[145]I.R.C. § 61(b) (1998).

[146]*See generally* I.R.C. § 62 (1998) (allowing deductions from gross income for certain types of business expenses, including those in section 162, retirement savings as defined under section 219, and other miscellaneous deductions).

[147]I.R.C. § 63(d) (1998).

[148]DODGE ET AL., *supra* note 51, at 39; *see generally* I.R.C. § 1 (1998) (giving the tax brackets for taxpayers according to marital status and taxable income level).

[149]*See* I.R.C. § 61(1998).

[150]This example does not include adjustments for inflation under section 63(c)(4), as this is too complicated and unnecessary to demonstrate the concept of taxable income.

[151]*See* I.R.C. § 63(1998).

[152]*See* DODGE ET AL., *supra* note 51, at 59.

[153]348 U.S. 426 (1955).

glass bottle manufacturer, was awarded punitive damages in settlement of a antitrust lawsuit against a machinery supplier.[154] Glenshaw did not report the portion of the settlement attributable to punitive damages in its income for 1947, the tax year in question, and the Commissioner determined a deficiency.[155] The Tax Court rendered a decision in favor of the taxpayer, which the Commissioner appealed to the Supreme Court.[156]

The taxpayer reasoned that punitive damages are a "windfall flowing from the culpable conduct of third parties" and, therefore, fall outside the scope of section 22 (the predecessor to section 61) gross income.[157] The taxpayer based this argument on the source-based definition of income set forth in *Eisner v. Macomber*,[158] which states that "income may be defined as the gain derived from capital, from labor, or from both combined."[159] This definition, the taxpayer argued, does not include accessions to wealth arising from other sources, including court-awarded damages,[160] but the Commissioner disagreed and noted that the statute says that gross income encompasses all "'gains or profits and income derived from any source whatever.'"[161] The Court, in reversing the judgment of the Tax Court, agreed with the Commissioner and held that there was an "undeniable accession to wealth . . . over which the taxpayers have complete dominion."[162] "The mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients."[163]

The item at issue in *Glenshaw Glass* was the plain-vanilla receipt of cash. This is clearly an accession to wealth includable under the catch-all language of section 61. Whether in-kind consumption enjoyed by a taxpayer at no cost is an accession to wealth under section 61 is a little trickier, however. The scope of the section 61 catch-all language was further clarified in 1968 when The Court of Appeals for the Fifth Circuit addressed the issue of nonmonetary, in-kind compensation for services in *United States v. Gotcher*.[164] In *Gotcher*, the taxpayer-respondent and his wife were given an all expense paid trip to Germany worth $1372.30 to tour the

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[154] *Id.* at 427-28.

[155] *Id.* at 428.

[156] *Id.* at 426.

[157] *Id.* at 429.

[158] 252 U.S. 189, 207 (1919). The Supreme court held in this case that a stock dividend consisting of new shares issued to shareholders in proportion to their previous holdings was not "income" within the meaning of the Sixteenth Amendment, because, unlike a cash dividend which the stockholders could choose to reinvest in stock or use for other purposes, a stock dividend transfers "nothing of value . . . from the company's assets . . . and . . . [is not] subjected to [the stockholders'] disposal." *Id.* at 215.

[159] *Id.* at 207.

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

[161] 26 U.S.C. § 22 (a) (1939), *quoted in Glenshaw Glass Co.*, 348 U.S. at 431.

[162] *Glenshaw Glass Co.*, 348 U.S. at 429.

[163] *Id.*

[164] 401 F.2d 118, 119 (5th Cir. 1968).

Volkswagen facilities in that country. The cost of the trip was split among Mr. Gotcher's employer, Economy Motors, Volkswagen of Germany, and Volkswagen of America in an effort to persuade Gotcher to invest in Volkswagen.[165] Gotcher did not report the value of the trip on his tax return, and the Commissioner assessed a deficiency.[166]

The IRS argued that the trip constituted an economic gain to the taxpayer and, therefore, should be included in gross income.[167] The Court, however, stated that the true test is whether the "economic gain benefit[ted] the taxpayer personally."[168] In this case, the purpose of the trip was really to persuade Gotcher to invest in the company.[169] The Court affirmed the lower court's holding that the trip did not constitute income for Mr. Gotcher, as his trip was primarily for the benefit of Volkswagen; but it reversed the lower court regarding Mrs. Gotcher's portion of the trip, as the trip was essentially a vacation for her, and her presence served "no bona fide business purpose for her husband" or the company.[170] Thus, Gotcher further clarified the scope of section 61 gross income by asserting that an in-kind benefit that is not remuneration for services, is not includable in gross income if the primary purpose of the benefit is to further the business interests of the benefit provider.

This "convenience-of-the-employer" test, as it has come to be known, did not originate with *Gotcher*. In the 1937 case *Benaglia v. Commissioner*,[171] which has since become one of the most cited cases in "convenience-of-the-employer" disputes, the United States Board of Tax Appeals reversed the Commissioner's assessment of an income tax deficiency against the taxpayer, the general manager of a Hawaiian resort hotel chain.[172] The taxpayer in Benaglia was required as a condition of his employment to live and eat his meals in one of the hotels, so that he would be immediately available any time of day should his services be needed outside of regular business hours.[173] At trial the taxpayer testified that his job could not be performed properly by someone living outside the hotel, as the needs of guests "are numerous, various, and unpredictable," and "the manager must be alert to all these things day and night."[174]

The Commissioner argued that the taxpayer was simply being relieved of an expense that he would otherwise have to pay out of his salary.[175] Therefore, the value of the meals and lodging should be included in his taxable income. The court,

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[165] *Id.* at 119-20.

[166] *Id.*

[167] *Id.* at 120.

[168] *Id.* at 121.

[169] *Gotcher*, 401 F.2d at 121-24.

[170] *Id.* at 124.

[171] 36 B.T.A. 838, 841 (1937).

[172] *Id.* at 841.

[173] *Id.* at 839-40.

[174] *Id.*

[175] *Id*. at 840.

however, disagreed and stated that the taxpayer's incident enjoyment of an advantage does not change the fact that the dominant purpose for the provision of meals and lodging was for the "convenience of the employer."[176] Based on these special circumstances of the taxpayer's employment, the court held that the meals and lodging were "solely for the convenience of [the] employer and as a necessary incident of the proper performance of his duty . . . [and] the value thereof is not taxable income."[177]

The Supreme Court of the United States modified the scope of the convenience-of-the-employer doctrine forty years after its birth in *Benaglia*, with its holding in *Commissioner v. Kowalski*.[178] In *Kowalski*, the taxpayer was a New Jersey state police trooper.[179] The State of New Jersey provided the troopers with a cash meal allowance so that they could remain on call during their meal breaks and remain within their patrol area.[180] The meal allowance was paid as part of a trooper's paycheck, although it was stated separately.[181]

The taxpayer, who had failed to include the amount of his meal allowance on his 1970 tax return, argued that because the meal allowance was provided for the "convenience of his employer" as set forth in section 119 of the Internal Revenue Code,[182] he did not have to include it in his gross income.[183] The Supreme Court granted certiorari, reversed a Court of Appeals for the Third Circuit holding, and held that the meal allowance was includable in gross income.[184] The Court consulted the legislative history of section 119 and reasoned that cash allowances do not fall under the section 119 "convenience-of-the-employer" exclusion, because the Senate had only intended meals provided in kind to be subject to the exclusion.[185] Therefore, cash allowances do not fall within the scope of section 119 or the convenience-of-the-employer doctrine and are includable in section 61 gross income.[186]

As demonstrated above, the scope of section 61 gross income encompasses accessions to wealth from punitive damage judgments and most forms of compensation from employers to employees, but it also includes other miscellaneous

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[176]*Benaglia*, 36 B.T.A. at 840.

[177]*Id.* at 838.

[178]Commissioner v. Kowalski, 434 U.S. 77 (1977).

[179]*Id.* at 79.

[180]*Id.* at 80.

[181]*Id.*

[182]I.R.C. § 119 (1998). This section excludes the value of meals and lodging provided by an employer provided that the meals are furnished on the business premises of the employer and the employee is required to accept such lodging as a condition of his employment.

[183]*Kowalski*, 434 U.S. at 81.

[184]*Id.* at 77.

[185]*Id.* at 92.

[186]*Id.*

items set forth in their own sections of the Code. Section 74 Prize and Award Income is one of these sections.

B. Section 74 Prize and Award Income Analysis and Application to Frequent Flyer Programs

Section 74 of the Internal Revenue Code, one of the sections of the Code referred to in section 61(b) as a section containing items specifically included in gross income, states, with minor exceptions not relevant to this argument, that the value of "prizes and awards" received is to be included in gross income.[187] However, the Code and Treasury Regulations give surprisingly little guidance regarding what kinds of receipts constitute "prizes and awards" for income tax purposes. Section 74 does allow for exceptions in the case of "certain prizes and awards transferred to charities" (e.g., a $500 check received as a prize in a contest and then gratuitously transferred to a library) and "certain employee achievement awards" (e.g., a gold watch given to an employee on her thirtieth anniversary of employment with a company).[188]

Case law from the Tax Court and the Supreme Court has served to clarify some of the vagueness of section 74. In *Robertson v. United States*,[189] a case decided prior to the enactment of section 74, the Supreme Court held that $25,000 received by the taxpayer-petitioner as a prize for winning a symphony writing contest was not a gift and therefore was includable in gross income under section 102 of the Internal Revenue Code of 1939.[190] In an opinion written by Justice Douglas, the Court reasoned that the payment of a prize to a winner of a contest is the discharge of a legally enforceable contract, created by the acceptance of the contestants of the offer by the sponsor to give the prize to the winner.[191] The opinion then explained how to properly allocate the award over a number of taxable years. However, the broader implication of *Robertson* is that receipt of a monetary prize from a contest voluntarily entered by the recipient is indeed includable in gross income.[192]

Less than two years after the Supreme Court's decision in *Robertson*, the Tax Court addressed the includability of the value of an in-kind prize in gross income in *Turner v. Commissioner*.[193] In Turner, the taxpayer-petitioner won two first-class tickets with a retail value of $2,220 for a cruise between New York City and Buenos Aires when he correctly identified a song in a radio contest.[194] The petitioners, who had family in Brazil, traded in the two first-class tickets to Buenos Aires for four

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[187]I.R.C. § 74 (a) (1998).

[188]*See* I.R.C. § 74 (b), (c) (1998); *see* I.R.C. § 170 (c) (1998); I.R.C. § 274 (j) (1998).

[189]343 U.S. 711 (1952).

[190]*See Id.*

[191]*Id.* at 713.

[192]*Id.*

[193]13 T.C.M. (CCH) 462 (1954).

[194]*Id.*

tourist-class tickets to Rio de Janeiro so that they could take a family vacation with their sons.[195]

Somehow, the petitioners determined that the tickets were worth $520 to them and included that amount in their gross income on their tax return.[196] The opinion in Turner is extremely short, however, and gives no reasoning for the taxpayer's assertion, except for a vague argument that the trip was a luxury to the taxpayers that they would not otherwise have indulged in, so the value of the tickets to the petitioners was not equal to their retail cost.[197] The Tax Court recognized that the tickets were nontransferable and that even if the taxpayers had been able to sell them, they never would have been able to get the full retail value for them. Nevertheless, in the interest of requiring the taxpayers to recognize the free room and board and enjoyment the trip afforded them, the Court, without giving any basis for its calculation, determined the includable value of the tickets to be $1,400.[198]

In spite of the rather unusual and haphazard method employed in *Turner* for computing the includable value of the prize (the general rule is that inclusion is at the fair market value),[199] the broader implication of *Turner*, like *Robertson*, is that prizes are includable in gross income - even if the prize is in the form of in-kind consumption.

V. Analysis and Application to Frequent Flyer Programs

Now that a basic framework for examining the taxability of frequent flyer benefits has been established, this Note will finally return to the core of the debate and propose a theory of taxability that matches the characteristics of most frequent flyer programs more closely than the theories supported by most experts explored in this Note above. First, it will argue that frequent flyer miles earned during business travel for an employer cannot be taxable fringe benefits because of the nature of the relationships among the airline, employee-passenger, and employer. Next, it will show that the benefits earned on personal trips are not really tax-free commercial bargain purchases. Finally, it will scrutinize the language used in the literature of several frequent flyer programs to establish that the programs are actually devices for giving section 74 prizes and awards to loyal customers at the sole discretion of the airlines.

A. Frequent Flyer Miles Earned on Employer-paid Flights Are Not Taxable Fringe Benefits

Fringe benefits are not explicitly defined anywhere in the Internal Revenue Code or Regulations. However, Black's Law Dictionary defines them as "non-wage benefits which accompany or are in addition to a person's employment such as paid insurance, . . . sick leave, profit-sharing plans, . . . vacations, etc."[200] Fringe benefits

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[195] *Id.*

[196] *Id.*

[197] *Id.*

[198] *Turner*, 13 T.C.M. (CCH) at 462.

[199] *See* Rev. Rul. 58-347, 1958-2 C.B. 878 (holding that the includable value of property or services received is the fair market value, not the subjective value to the recipients).

[200] BLACK'S LAW DICTIONARY 667 (6th ed. 1990).

are includable in gross income under section 61 unless explicitly exempted by another section of the Code.[201] The language of section 61 indirectly states that "fringe benefits" are a form of "compensation for services."[202] Compensation for services necessarily arise out of a contract between an employer and an employee, whereby the employer agrees to pay agreed-upon compensation, whether in the form of cash or other benefits, in consideration of performance of services by the employee. Unless participation in a frequent flyer program is made a necessary precondition of employment, benefits earned through participation in frequent flyer programs fall outside the scope of this contract between an employer and an employee. It logically follows that frequent flyer benefits, regardless of how they are earned, cannot be compensation for services and, thus, cannot be taxable fringe benefits. Whether the travel by which the benefits were accrued is paid for by the passenger herself or her employer is irrelevant.

The structure and operation of most frequent flyer programs support the theory that the contract for awarding frequent flyer benefits, if there can be said to be a contract at all, is between the passenger and airline, not the passenger and her employer. For example, most airlines have designed their frequent flyer programs such that any benefits earned are "personal to the passenger whose name appears on the ticket."[203] Furthermore, probably in an effort to attract additional members, the airlines often make it difficult to transfer accrued mileage to anyone other than a family member.[204] If a passenger changes employers, the accrued mileage stays with the passenger, not the employer.[205] An employer never has any ownership interest in the frequent flyer benefits earned by an employee.[206] Thus, it is impossible for the benefits to be compensation from the employer unless the employer has a preexisting arrangement with the airline by which the airline agrees to pay compensation to the employee in return for some sort of consideration from the employer. This is almost never the case, as airlines and employers rarely have any incentive to cooperate with each other in providing fringe benefits to an employee.[207]

The theory that the contract for awarding frequent flyer benefits is between the passenger and the airline is also supported by Private Letter Ruling 9340007.[208] The central issue in PLR 9340007 is whether an airline which awards frequent flyer benefits to its passengers is required to file an information return under section 6041

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[201]*See, e.g.*, I.R.C. § 132 (1998)(excluding "certain fringe benefits"); I.R.C. § 117 (d) (1998) (excluding tuition-reduction plans for employees of education's institutions); I.R.C. § 107 (1998) (excluding rent-free use of a church parsonage).

[202]I.R.C. § 61 (a) (1) (1998) (stating that gross income includes "[c]ompensation for services, including . . . fringe benefits, and similar items").

[203]Sheppard, *supra* note 20, at 1141.

[204]*Id.*

[205]Linderman, *supra* note 67, at 1055.

[206]*Id.*

[207]*See id.*

[208]Priv. Ltr. Rul. 93-40-007 (Oct. 8, 1993).

of the Internal Revenue Code.[209] The IRS ruled that the airline requesting the private letter ruling was not required to file information returns, because the airline was unable to determine when and to what extent the benefits provided represented gross income to the recipient.[210] Although this letter ruling concedes that an employee will realize gross income in the form of a fringe benefit if he receives a cash payment in consideration of traveling with a particular airline on an employer-paid flight, it does not address the taxability of frequent flyer mileage that is earned from employer-paid flights and subsequently used for personal travel.[211]

More important than the IRS's ruling, though, is the assumptions underlying the ruling. The very fact that the airline felt obliged to even request such a ruling acknowledges the existence of an arrangement between the airline and passenger whereby the airline awards the passenger benefits with economic value. If the arrangement to pay benefits were between the passenger and his employer, the airline would obviously not be required to file an information return. This, however, is not the reasoning the IRS gives for its ruling. Instead, it rules that an information return is not required because the cash value of the award is not "fixed and determinable."[212] Thus, the IRS is acknowledging that the awarding of frequent flyer benefits indeed arises from the relationship between the airline and the passenger, but there is no way for the airline to ascertain a value exact enough to require filing an information return.

The Federal Court of Australia has acknowledged that frequent flyer benefits are not taxable fringe benefits.[213] In the 1996 case, *Payne v. FCT*,[214] the court held that travel benefits earned while traveling for an employer are not employment benefits, because the benefits were not transferable, could not be exchanged or sold for cash, and arose solely out of the employee's membership in the frequent flyer program, not out of her employment.[215]

Given the above analysis, it is impossible to characterize frequent flyer benefits, even if earned during employer-paid travel, as compensation for services. In order to characterize the benefits as compensation for services there would need to be a specific agreement between the employer and the airline whereby the airline will provide benefits on behalf of the employer, or an overt agreement between the employer and employee whereby the employee agrees that any frequent flyer benefits earned while traveling for the employer will be considered part of her compensation package. Hence, frequent flyer benefits are not fringe benefits.

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[209]*Id.*; *see also* I.R.C. § 6041 (1998) (requiring that any "person . . . making payment[s] in the course of [a] trade or business . . . of $600 or more in any taxable year" must file an information with the Secretary of the Treasury). *Id.*

[210]*Id.*; *see also No Information Reporting For Frequent Flyers*, 52 TAX'N FOR ACCT. 47 (1994) (giving a summary of PLR 9340007).

[211]Priv. Ltr. Rul. 93-40-007 (Oct. 8, 1993).

[212]*See Id.*

[213]Krawczyk & Wright, *supra* note 2, at 1031.

[214]NG 461 of 1995; 239 of 1995, 1996 Fed. Ct. Austl. LEXIS.

[215]Krawczyk & Wright, *supra* note 2, at 1031.

B. Frequent Flyer Benefits Earned on Personal Travel Are Not Commercial Bargain Purchases

A commercial bargain purchase is simply the dickering down of the price of a good or service, such that the price reached in the negotiation, not the original asking price of the seller, represents the true economic value of the good or service to the consumer.[216] For example, if a taxpayer goes to a car dealer to purchase a car, and succeeds in negotiating a purchase price that is $3,000 lower than the sticker price, she is not required to include the $3,000 she did not have to pay in her gross income.[217] She has not received a true accession to wealth; she has merely avoided paying the higher price.[218]

The Internal Revenue Service addressed the issue of commercial bargain purchases in Revenue Ruling 76-96.[219] In this Ruling the IRS held that rebates paid by an automobile manufacturer to customers who purchase or lease new cars are not includable in the gross income of the customers.[220] Rather, the rebate simply represents a reduction in the purchase price of the automobile reached through arms-length negotiation between the car dealer and the customer.[221]

But unlike the above situations, frequent flyer benefits do not represent any reduction in purchase price for the flights involved. First, there is no arms-length negotiation between the passenger and the airline. The passenger was simply offered the opportunity to participate in a program with which there were no guarantees that he would ever receive any benefit. Most airlines reserve the right to modify or cancel their programs at their discretion.[222] Therefore, the passenger has no vested right to his accrued mileage; he can effectively only use it at the pleasure of the airline.

Second, the passenger is not really receiving a reduced price for any tickets. The prices paid by a passenger for the flights on which he accrues his frequent flyer mileage are set prices (at least for the day, hour, and minute that they are purchased). They are the same whether or not the passenger is a frequent flyer member. Unlike the automobile situations, the taxpayer's receipt of a benefit is entirely contingent on whether he is able and willing to redeem his earned mileage for a free ticket. Hence, any benefit the passenger receives is more akin to a windfall than the calculated result of any effort of his own.

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[216] *See* DODGE ET AL., *supra* note 51, at 71-73.

[217] *See id.*

[218] *See id.*

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

[220] *Id.*

[221] *Id.*

[222] *See generally* UNITED AIRLINES, WELCOME TO MILEAGE PLUS PROGRAM RULES SUMMARY (1996) (setting forth in small print the airline's right to cancel the program at anytime, regardless of a member's participation); *Continental Airlines One Pass Info Center: Member Advisory* (visited Jan. 5, 1999) <http://www.flycontinental.com> (setting forth the airline's right to cancel the program with six month's notice).

Because of the absence of arms-length negotiation and the lack of any true reduction in purchase price, frequent flyer benefits earned through personal travel cannot be commercial bargain purchases.

C. Frequent Flyer Benefits as Section 74 Prize and Award Income

Finally, the language in the membership literature and promotional ads for most frequent flyer programs, as well as the structure of most programs, strongly suggests that any benefits realized, regardless of whether they are earned in a business or personal context, are intended to be purely awards or prizes from the airline to the passenger. Therefore, they should be includable in gross income under section 74's provision for prizes and awards.

For example, United Airlines' Mileage Plus® program characterizes free flights obtained by cashing in mileage as "travel awards."[223] It also refers to extra benefits a member can earn when they achieve "Premier®" status as "mileage bonuses," which again sounds a great deal as though it should be accorded treatment under section 74.[224] Like United Airlines, American Airlines' Aadvantage® program also refers to its frequent flyer benefits as "awards."[225] Continental Airlines' OnePass® program, in a twist on the same theme, issues "reward certificates" which are redeemed for free flights.[226] The word "award" echoes the language of section 74, while "certificates" often accompany the bestowing of prizes or awards.

Although the language of the frequent flyer programs seems to indicate tax treatment under section 74, it is in no way dispositive. More persuasive than the language of the programs is the structure and function of the programs. As noted previously, the passenger is completely at the mercy of the airline regarding whether she will ever be able to receive a benefit from her accrued frequent flyer mileage. There is not a true contract between the airline and the passenger, because the airline is not bound to perform its end of the bargain and can revoke earned mileage and cancel its programs at any time it wishes. A passenger who loyally flies with a particular airline in order to earn free travel has little recourse if the airline cancels or modifies its program before the passenger can redeem his mileage.

Given the foregoing analysis, frequent flyer benefits appear to be discretionary awards, in which the passenger has no vested ownership interest, issued by the airline as part of its advertisement program in the hope of attracting customers and retaining their patronage. Hence, such benefits should be taxable under section 74.

VI. CONCLUSION

Although the most logical and legally sound theory for taxing frequent flyer benefits is inclusion in gross income as section 74 prizes or awards, it is unlikely to capture serious attention from the Internal Revenue Service or the courts anytime soon. Enforcing the tax would be logistically difficult, as it would place the

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[223] *See* UNITED AIRLINES, WELCOME TO MILEAGE PLUS (1996).

[224] *See id.*

[225] *See* AMERICAN AIRLINES, AMERICAN AIRLINES AND AMERICAN EAGLE TRAVEL AWARDS (1997) (listing awards available upon redemption of various mileage levels).

[226] *Continental Airlines One Pass Info Center: Member Advisory* (visited Jan. 5, 1999) <http://www.flycontinental.com>

responsibility for reporting the income on the taxpayer herself. The average taxpayer, who already believes that the Internal Revenue Service is guilty of overreaching in its tax policies, is unlikely to report such income when the possibility of getting caught is minute, if not completely nonexistent. As flawed as the analysis is, the IRS would have a better chance at collecting at least some revenue if it ruled that frequent flyer benefits earned during employer-paid travel are taxable fringe benefits. Employers have little impetus for failing to report the benefits, as they have easy access to the required information and, unlike their employees, do not stand to lose anything economically by revealing the information.

Nevertheless, it is important to recognize the inherent flaws in the traditional approaches to the taxability of frequent flyer benefits. When the errors in analysis are brought to light, it prevents the Internal Revenue Service and lawmakers from relying on faulty established precedent in creating new tax policy that stretches the scope of the income tax beyond its rightful domain.

JENNIFER A. CUNNINGHAM