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Taxation of Fringe Benefits of Employees

Lawrence R. Bloomenthal*

To attract and hold well-qualified personnel, management is finding it increasingly important to offer numerous "fringe benefits." These may include payment of moving costs, country club memberships, providing temporary living expense allowances and even reimbursement for benefits surrendered upon leaving a previous employer. While of chief importance for officers and executive agents, these benefits are also important to all other employees.

In 1954, the Revenue Service ruled that a payment or reimbursement received by an employee for moving his family and household goods from one place of employment to another permanent post will not be considered as additional compensation if the move was primarily for the employer's convenience. Any amount received in excess of actual moving costs, however, must be included in gross income. However, if a new employer pays moving expenses, the Treasury Department's rule is that the employee is in receipt of additional income. No corresponding deduction is allowable to him. 2

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1 Tax Consequences to employer and employees of many fringe benefits are controlled by specific provisions of the Internal Revenue Code:
(a) Section 61 (a), I. R. C., 1954—Gross Income defined; Regulations 1.61-1
(b) Section 101 (a), I. R. C., 1954 (life insurance proceeds excluded from gross income)
(c) Section 101 (b), I. R. C., 1954 (employees death benefits up to $5,000.00 excluded from gross income)
(d) Section 102, I. R. C., 1954 excludes gifts from gross income
(e) Section 104 (a), makes proceeds of Health & Accident Insurance non-taxable, except when paid for by employer; Section 105 (a), Health & Accident proceeds attributable to employer's contributions are includible in gross income; subject to exceptions in
(1) Section 105 (b), for medical care reimbursements;
(2) Section 105 (c), permanent disability payments unrelated to absence from work; and
(3) Section 105 (d), wage continuation plans
(f) Sections 401 to 404, inclusive, deal with deferred compensation including pensions, profit sharing and stock bonus plans
(g) Section 421—employee stock options.

2 Rev. Rul. 54-429 1954-2 CB 53 (convenience of employer controls exclusion); Rev. Rul. 55-140 1955-1 CB 317 (reimbursement from new employer taxable).
The Mills and Woodall cases, decided in 1958, agree with the Treasury rule. Mills and Woodall moved from Kentucky and Texas respectively to Albuquerque, New Mexico, to accept employment with the Sandia Corporation and were reimbursed by their new employer for actual moving expenses and family transportation. They were assessed additional income taxes on the theory that there was no existing employment relationship at the time of moving, so that convenience of the employer was not a factor. To this, the taxpayers replied that acceptance of the offers of employment was upon the express condition that all relocation expenses would be met by Sandia. Consequently, they realized no gain or profit from the transaction; since they claimed no deduction, this was simply a readjustment of personal expenses. Upon appeal from a decision of the District Court in favor of the plaintiffs, the Circuit Court denied refunds. These payments were in the nature of a cash bonus as an inducement to accept employment and were taxable income.

Employers may now find it practical to put new employees on the payroll while they are still located in the city of their previous employment. Then, when a move is ordered, at company expense, there can be no question that it is solely at the direction of and for the benefit of the employer.

Loss on Housing

When considering new employment or a transfer to another city, the prospective employee usually checks the cost of housing comparable to that which he is presently occupying. In larger communities especially, the cost of relocating may tend to offset the proffered salary increase. To help overcome this problem, management sometimes finds it expedient to absorb any loss resulting from a quick sale. In the case of Otto S. Schairer, his employer directed him to move to another suburb nearer the plant, so that he would be on call for emergencies at all times. To overcome Schairer's reluctance, he was promised that he would be reimbursed for any loss incurred in the sale of his home.

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Schairer sold his house for $20,000, sustaining a loss of $14,000. The commissioner insisted that the reimbursement Schairer received from the R. C. A. Corporation was additional compensation, but the Tax Court disagreed. It was held that the $14,000 should be treated as part of the sale price realized from disposition of the old home. Accordingly, no additional compensation had been received. The Court pointed out that there was nothing in the Revenue Code that required the sale price of property to originate from the vendee only. There was no reason why the employer could not furnish part of the sale price.

**New Home Purchases**

A distinction is made between absorbing part of an employee's loss and providing funds to help with the purchase of a new home. The latter amount is considered additional compensation for services and is taxable to the employee. Two recent cases sustain the Commissioner's position.

In the decision of Jesse S. Rinehart,\(^5\) the Tax Court ruled that $4,000 which the taxpayer received from the Owens Illinois Glass Company to assist him in purchasing a house when transferred from Vineland, New Jersey to Toledo, Ohio was taxable income. The taxpayer had contended that the $4,000 represented a reduction in the cost of his house, rather than a gift or additional salary. However, Judge Murdock pointed out that unlike the Schairer case, Rinehart was not being compensated for any loss upon selling an old home. The $4,000 paid to him was for the sole purpose of purchasing a new house which thereafter belonged entirely to him.

Under comparable facts in the LeGrand case,\(^6\) a similar result was reached. When LeGrand found no housing available for rent at this new post of duty, his employer agreed to assist him in buying a house. Again, there was no loss to be absorbed and the U. S. District Court sustained taxation on the ground that LeGrand had acquired a valuable asset.

**Special Allowances**

The Commissioner of Internal Revenue has ruled that amounts received as allowances or reimbursement for meals and lodging of an employee and his family while awaiting permanent

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\(^5\) (1952) 18 TC 672, CCH Dec. No. 19,070.

\(^6\) (D. C., N. D. Ohio, 1952) 105 F. Supp. 177, 52-2 USTC Par. 9419.
quarters at the new location are includible in gross income. Here again, the basic theory is that the employer is making these payments only because it wishes to obtain or retain the services of the individual. Obviously, the amounts so received are intended as additional compensation. It follows that it would be the duty of the employer in such instances to withhold tax on these amounts.\(^7\)

**Entertainment and Travel**

While entertainment and travel expenses are a familiar feature of business life, the attitude of the Revenue Service toward the reporting and deducting of reimbursed expenses has tightened considerably. Early in 1958, the Commissioner proposed that all employees receiving expense reimbursements be required to submit detailed substantiation of all expenditures as a part of their individual income tax returns. Shortly thereafter, these requirements were somewhat modified, but the new Regulations finally adopted still impose definite obligations.\(^8\)

An employee must "account" to his employer for reimbursed travel, transportation, entertainment and similar expenses. Upon compliance with this rule, the amount of reimbursement received need not be reported on Form 1040 and no deduction need be shown for these expenses. According to the Regulations, a proper accounting is made by submission of a written statement of reimbursable expenses on a daily, weekly or monthly basis. The exact form of such statement is not prescribed, but an examiner probably will not be satisfied with the type of general summary furnished in the past. It is more likely that an itemized accounting, at least in broad categories, will be requested. For this reason, it is advisable that employees be instructed to retain and submit with their expense accounts ticket stubs, hotel bills and other such substantiating data.

For the convenience of management, and to relieve employees of paper work, the Revenue Service has stated that it will approve any reasonable business practice under which an employee receives a fixed per diem while away from home or a definitely stipulated amount to be spent for entertainment of customers. A fixed mileage allowance for the use of a privately owned automobile on company business is permitted. A daily

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\(^7\) Rev. Rul. 54-429, supra.

\(^8\) Regulation 1.162-17; proposed March 12, 1958, finally adopted August 27, 1958 by Treasury Decision 6306.
diary or log book would be a proper means of accounting for the use of any such flat allowance arrangements.

Automobiles

Occasionally, an employee will be allowed to take home a company-owned car without restriction on personal use. If the employer pays the entire operating expense, and it subsequently appears that there has been substantial personal usage of the car, the employee must assume a part of the expense as his personal income.

The Tax Court made this clear in the case of Rodgers Dairy Company\(^9\) where the evidence showed that a corporate-owned automobile was used approximately 10% of the time for the personal benefit of one of the officers. Accordingly, the Commissioner was sustained in taxing this individual with 10% of the operating expenses as well as 10% of the depreciation.

Recreational Facilities

When company-owned recreational facilities are made available to employees and their families, ordinarily there is no tax problem. But, if outside social activities, such as country club memberships, are paid for by the employer and used freely by the employee and his family without being restricted to entertainment of business guests, the Revenue Service may insist upon allocating part of the expense as additional income to the employee.

Vacation Allowances

In some industries, labor agreements provide for the establishment of vacation funds which are built up by contributions from the employer. In Revenue Ruling 57-316,\(^10\) the question was whether vacation allowances paid to eligible employees from such a vacation fund constituted additional taxable wages to the employee. Under the terms of the labor agreement, management paid in a specified sum based on the number of hours worked each month by union members.

No one connected with the fund—employer, employees or trustee—had any vested rights in it, until the trustees determined the amounts to be paid to eligible employees. Although the vacation allowance contributions were in addition to hourly wage

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rates, the Revenue Service concluded that these payments were definitely part of the wage structure. The most significant factor was held to be the relation between services rendered, as shown by the number of hours worked, and the amount which the individual employee received from the fund.

Advertisements have appeared in magazines and newspapers describing "tax deductible" rehabilitation plans for corporate executives. In Revenue Ruling 57-130,\textsuperscript{11} the Commissioner ruled that the cost of vacations, health-institute fees, or athletic club expenses incurred by an individual to assist him in keeping fit, are not deductible medical expenses. Such activities may be beneficial to a man's general health, but the Commissioner stated that these did not qualify as "medical care" within the meaning of Section 213 (e) (1) of the Internal Revenue Code of 1954.

However, should an employer choose to pay such expenses for an executive, the corporation will be allowed to deduct this cost as additional compensation to the executive. This is not an unmixed blessing, since the executive must then include the amount in his own gross income for Federal income tax purposes.\textsuperscript{12}

\textbf{Life Insurance Premiums}

Premiums paid on group life and hospitalization insurance for its employees do not represent additional compensation but are deductible by the employer.\textsuperscript{13} On the other hand, if ordinary life insurance is carried by a corporation on the life of a particular officer or employee, and the corporation is neither a beneficiary nor entitled to any rights of ownership in the policy, the presumption is that additional compensation was intended. Consequently, the amount of such premiums paid in any taxable year, after reduction for dividends on the policy, is includible in the employee's income.\textsuperscript{14}

\textbf{Special Inducements}

One of the standard provisions in retirement plans is that full benefits are not payable unless the employee remains with the

\textsuperscript{11} I. R. B. 1957-13, 9, 575 CCH Standard Tax Serv. Par. 6375.
\textsuperscript{12} Rev. Rul. 57-130, supra; Kartsen vs. Commr., 13 TCM 1042.
\textsuperscript{13} GCM 16069 XV—1CB 84, Rev. Ruling 54-165. 1954-1 CB 17 (conversion privileges in group insurance approved).
\textsuperscript{14} Yuengling vs. Commr. (CA-3, 1934) 69 F. 2d 971, 4 USTC Par. 1257; Canaday vs. Gaitteau (CA-6, 1936) 86 F. 2d 303, 36-2 USTC Par. 9513. Rev. Ruling 55-357, 1957—1 CB 13; Mim. 6477, 1950—1 CB 16.
company until the specified retirement date. Should he voluntarily terminate his employment, the contract may provide either for forfeiture of his share of the employer's contributions or for smaller payments over a limited period of time.

As a special inducement to a prospective employee unwilling to give up substantial pension rights, some employers may guarantee reimbursement for these lost benefits. In one such case, an employee of the National Biscuit Company was hired by a competitor. As a special incentive, he was paid a sum of money to reimburse him for disability retirement pay and pension rights which he forfeited. The Tax Court held that this sum was additional compensation and represented taxable income.

In Sutro vs. United States, a rather unique arrangement was made with an employee of the Standard Oil Company of California. At the time Sutro accepted employment, he was guaranteed that the company would carry a $100,000 life insurance policy payable to his widow or specified dependents. He paid no part of the premiums, the Corporation was never a beneficiary, and the premiums which it paid were deducted as administrative expenses.

After six years, Sutro died. His widow contended that the $100,000 of insurance was not taxable to her but was a gift from her husband's employer. However, the Commissioner rejected this argument. Mrs. Sutro paid the taxes demanded and then sued for refund. The U. S. District Court refused to grant a refund, holding that an enforceable obligation existed in favor of Sutro. The payments of premiums were intended solely as inducements for accepting and continuing as an employee of Standard Oil.

Although this case was decided in 1942, the same result would follow under the present statute, since the $5,000 exclusion for death benefits does not apply when there is a vested or guaranteed right existing during the employee's lifetime.

Annuities

Sometimes, an executive joins a firm at an age when it would be too expensive for him to be brought under its regular pension plan. When there is a specific written agreement that provision is

15 BTA Memo op. CCH Dec. No. 5132-C.
16 (D. C. 1942), 42-2 USTC Par. 9523.
17 Sec. 101 (b), I. R. C., 1954.
to be made for retirement allowances, based upon length of service and compensation earned, there can be no question that the cost of annuity contracts purchased to fund this agreement would be taxable as additional compensation to the executive.

In the case of Charles D. Gott, the issue was whether $41,869.51 paid by the Self-Winding Clock Company, Inc., for two annuity contracts of which Gott was the beneficiary, represented additional compensation for services rather than a gift. The resolution of the directors authorizing the purchase of these annuities expressly stated that this action was being taken in recognition of long and faithful services to the company. Both the Tax Court and the Circuit Court of Appeals sustained the Commissioner in assessing a deficiency of more than $26,000 for the year in which the contracts were purchased.

Stock Options

Another form of incentive compensation is an option to purchase stock of the employer corporation at less than market value. The Supreme Court ruled in the case of P. J. LoBue that the exercise of an employee's option to purchase stock at a bargain price results in immediate taxable income. Under the LoBue case, the employee is taxable on an amount equal to the difference between the purchase price and the fair market value on the date he exercises his option.

To overcome this obstacle and still permit the employee to purchase stock below market values, the employer may grant a "restricted stock option." The option price must be at least 85% of the fair market value on the date the option is granted. It is not transferable during the employee's lifetime but can pass to his heirs or his estate. Any individual owning stock, with more than 10% of the total combined voting power of all of the corporation's stock, cannot be granted a restricted stock option unless the price is fixed at 110% of fair market value on the date of the option. Instead of a fixed market value being used, a "variable price" option may be granted.

Once the foregoing requirements are met, there is no tax to the employee at the time the shares are transferred to him. However, these shares lose their special tax status if they are sold

18 (C. A. 2, 1954) 212 F. 2d 205.
20 Sec. 421, I. R. C., 1954.
TAX OF EMPLOYEE FRINGE BENEFITS

within six months after transfer or within two years after the option was granted, whichever occurs later. Disposition during that period will make the entire gain taxable as ordinary income.

If the option price is at least 95% of fair market value on the date it was granted, all profits realized upon sale after being held the required time, are taxable as long term capital gain. When the option price is between 85% and 95%, only a part of the profit is considered capital gain and the balance is treated as ordinary income.

There are several other technical points which must be fully considered in granting restricted stock options. Nevertheless, this type of incentive compensation can produce substantial tax breaks for both the corporate employer and its key personnel.

Incentive Plans

There are other incentive compensation programs, involving pension funds, profit-sharing plans, cash and stock bonus plans and so on. The basic principle in all deferred compensation arrangements is to postpone payment of part of an employee's earnings until he is no longer drawing his usual salary and is in a lower tax bracket. These plans have a double appeal: the employer can offer a real incentive for continued employment without any immediate tax cost to the employee and still maintain certain tax advantages for management.

Under a qualified pension or profit-sharing plan, the employee pays no tax on the benefits until he receives them, and the earnings of the trust fund on its investments are tax-exempt. However, there are certain technicalities which must be considered. Ordinarily, there must be a formal, written plan, the details of which are communicated to all eligible employees. This plan must not discriminate either from the standpoint of contributions or benefits in favor of highly paid employees, stockholders or those in supervisory positions.

The Revenue Service scrutinizes all proposed plans to ascertain whether, in actual operation, the benefits are weighed too heavily in favor of executives and "top brass." On the other hand, it is permissible to exclude low-salaried employees whose individual annual wages do not exceed the amount subject to F. I. C. A. tax. That means that under present law, employees

earning $4200 annually in 1958 and $4800 in 1959, or less, may be excluded completely.

Among other requirements are limitations on the amounts contributed each year which the employer can claim as a tax deduction. If the plan provides for pensions based on future service only, the top limit of deductible contributions is 5% of the entire annual compensation paid or accrued to all employees covered by the trust. There are certain exceptions and qualifications to this general rule which are not too common and need not be considered here.

When past service credits are included also, the limit of deductible contributions is increased to 10% of the cost of such credits, plus the normal cost of the other features in the plan. Once a pension plan is adopted and approved by the Revenue Service, regular annual contributions to a trust fund are required. Profit-sharing and stock bonus plans also are eligible for special tax treatment if they too meet the special requirements of the Internal Revenue Code.\textsuperscript{22}

**Severance Benefits**

Employment contracts often provide that if services are terminated before expiration of a stipulated period without fault on the part of the employee, certain severance benefits shall be paid by the employer. This may involve turning over of a paid-up life insurance policy, continuation of all or a part of the agreed salary for a certain period of time, or a lump sum settlement. Whatever the form of severance pay, the employee is taxable on the proceeds, since such payments obviously are being made for services rendered, or to compensate for loss of employment.

Another clearly compensatory arrangement is the awarding of dismissal pay under a union labor contract. Supplemental unemployment benefits paid for out of employer contributions also are taxable as compensation. The borderline cases, however, are those in which a terminated or retired employee is voted some form of cash honorarium, gift or recognition. Whether such sums are to be considered outright gifts or salary depends entirely on the intention and surrounding circumstances.

In the case of *Hampton Leedom*,\textsuperscript{23} the Board of Directors voted in favor of a retirement bonus contract for the benefit of

\textsuperscript{22} Sec. 404 (a) (3) I. R. C., 1954.

\textsuperscript{23} (1956) 15 TC M 1180, TC Memo op. 1956-224.

http://engagedscholarship.csuohio.edu/clevstlrev/vol8/iss1/15
an officer who was also a director. It was stated in the corporate resolution that the payments called for were in recognition of the employee's long and active association with the firm. Nothing was mentioned in the minutes about additional salary or compensation and the payment was entirely voluntary. Consequently, Mr. Leedom argued that he was justified in considering this retirement bonus as a gift, even though he received it in regular installments over a four-year period. Upon consideration of the entire record, the Tax Court decided that the resolution of the Board of Directors failed to show that the amount awarded Leedom was intended as a donation or gift. It was obvious that remuneration for past services was the motivating factor.

Even when the corporate resolution states that the sum given a retiring employee is a "gift," that does not automatically exclude it from the employee's taxable income. In the case of L. Gordon Walker, an officer of a railroad company resigned for reasons of ill health after nearly five years of service. The Board voted him a sum equivalent to six months' salary, which it termed a gift, to be paid in two equal installments. According to the corporate minutes, Mr. Walker was being given a "token of appreciation" for his loyalty to the best interests of the company during his employment.

The Commissioner determined that there was actually no gift, but that Walker had received compensation subject to tax. Two reasons were given by the Tax Court. First, the payment was measured by salary previously paid and then was deducted as an expense on the corporation's books. These facts indicated strongly that a gift was not intended. Secondly, the necessary approval of the stockholders for donating part of the corporation's property had never been obtained. Had this been a bona fide gift, the stockholders should have been notified and asked to concur in the action taken by the directors. Merely referring to the amount as a "gift" carries little weight with the Tax Court.

Sometimes, there is a difference of opinion between the ex-employee and his former employer as to the status of severance pay. In Deasy vs. Smith, a lump sum payment of $15,000 was received by a former officer of the Pennsylvania Railroad after his retirement for ill health. The resolution passed by the Board of Directors stated flatly that the $15,000 represented compensation for past services.

24 (1956) 25 TC 832.
25 (D. C. Pa., 1956), 56-1 USTC Par. 9120.
Deasy denied this, claiming the payment was a gift on the grounds that there was no company policy for making such payments, that it had not been called for by any existing employment agreement, and that the Railroad had failed to deduct income tax or report the sum as wages on Withholding form W-2. He pointed out that he was also receiving a regular pension which was unaffected by the $15,000. Deasy paid the deficiency, but filed suit for refund.

A jury in the District Court of Pennsylvania found in favor of the government. All the taxpayer's arguments were rejected by the court, since it was brought out that the Railroad had filed a 1099 information return, showing the $15,000 as payment for salaries, fees, commissions or other fixed or determinable compensation. Finally, the by-laws of the Pennsylvania Railroad did not authorize directors to make gifts.

Inadequate Compensation

Can a severance bonus be considered as a gift when it is voted in recognition of faithful services and because of inadequate compensation in prior years? In Carragan vs. Commissioner, the chief operating executive retired after 27 years of continuous service, including a number of years with a predecessor corporation. The Tax Court agreed with the Treasury Department that additional compensation had been received. Upon appeal, the Second Circuit Court affirmed the decision of the Tax Court.

The taxpayer's principal argument was that at least a part of the $19,200 paid him was a gift, because it pertained to services for a predecessor employer many years ago. Since there was no direct benefit to his present employer, Carrigan claimed that this portion of the bonus was excludable from gross income. However, the Court ruled that the entire amount was taxable.

Death Benefits

Since 1951, the Internal Revenue Code has provided a special tax exemption for death benefits paid by or on behalf of an employer to the beneficiaries or estate of a deceased employee. An aggregate of $5,000 in death benefits is excludable from the gross income.

26 (C. A. 2, 1952) 197 F. 2d 246, 52-1 USTC Par. 9317; See also: Malcolm Hart (1943) 12 TCM 1307 (employer had severance pay custom).
income of the recipients, provided the employee did not have any forfeitable rights to the money during his lifetime.27

Between 1951 and 1954 only those benefits which were paid pursuant to a contract qualified for this special exemption. Consequently, there was considerable litigation involving payments made voluntarily to the widows of deceased employees in recognition of past services. Usually, the facts did not show any fixed plan or custom amounting to a contract or condition of employment. The Commissioner's argument was that unless a deduction or exemption was authorized by Congress in plain language, taxable income resulted from payments based on length of service, character of responsibilities, salary of the deceased employee, or any other factors related to past services. The Courts disagreed, and the majority of cases were decided adversely to the Commissioner.28

Nevertheless, until August 25, 1958 the official attitude of the Revenue Service was that a widow was taxable on benefits paid by the employer of her deceased husband in recognition of past services, even though such payments were voluntary. On that date, however, the Service announced a change in policy, and it will no longer litigate cases involving widows of employees who died between 1951 and 1954.29

Cases arising under the 1954 code, which became effective on August 16, 1954, are not governed by this new ruling. Unlike the 1951 statute, no distinction is made under the 1954 code between voluntary and contractual payments. Because of this change in the law, the Commissioner probably will argue in future cases that the exemption under the 1954 code is limited only to death benefits not exceeding $5,000, whether the payment is voluntary or contractual. A literal reading of Section 101 (b) of the 1954


code and the report of the Senate Finance Committee indicates that this interpretation probably will be approved by the Courts.\textsuperscript{30}

To avoid controversy when a death benefit in excess of $5,000 is voted to the widow or estate of an ex-employee, management should be sure that the resolution of the Board of Directors authorizing such payments specifically states that a gift is intended, that the decedent was a loyal and faithful employee, and that the amount in question is not based on his past services, since he was fully and adequately compensated during his lifetime. Following such resolution, and before actual payment, the matter should be submitted to the stockholders and approved, especially if a large sum is being voted. An alternative procedure would be to include in the corporate by-laws, with shareholder approval, a general authority enabling the Board of Directors to make gifts or non-compensatory arrangements for the benefits of widows, dependents and estates of deceased employees up to, but not exceeding, some fixed limit such as $10,000. Any sums over that limit would have to receive express shareholder approval. Also, such a by-law might specify that the sum voted could be paid over a period of time, in a lump sum, through the purchase of annuity contract, or by such other means as appear reasonable and proper under the circumstances. Observance of these precautions certainly would be a sound way of assuring valuable employees that their families would be in line for tax free death benefits.

\textsuperscript{30} See: Radner case (1957), 57–1 USTC 9392. A comprehensive discussion of death benefits is to be found in Vol. 586 CCH Standard Federal Tax Reports, Par. 8934.