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THE PROPOSED FEDERAL TAXATION OF FREQUENT FLYER MILES
RECEIVED FROM EMPLOYERS: GOOD TAX POLICY BUT BAD POLITICS

by

Dominic L. Daher*

I. INTRODUCTION

Since frequent flyer plans were conceived in 1981, they have unarguably matured into one of the most successful marketing tools ever invoked in any industry at any time in history. As the years have progressed, frequent flyer miles have nearly become a second national monetary system in the United States, especially for business travelers. The first frequent flyer program was initiated by American Airlines in 1981; however, shortly thereafter every major airline in the industry began similar frequent flyer programs to remain competitive.1

Frequent flyer programs allow travelers to earn points each time they travel. The number of points earned by a traveler during any given trip depends upon the following: (1) the number of actual miles flown, (2) the type of ticket purchased; and (3) the price paid for the ticket.2 These frequent flyer miles are thereafter accumulated by the traveler to obtain free air travel at a later date.3

Moreover, generally speaking, these points almost never expire4

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2 Telephone Interview with Nancy Coates, Trans World Airlines Customer Service Representative (Feb. 15, 1999).
3 Although frequent flyer miles can be accumulated and utilized for goods and services outside of the airline industry, this paper will focus strictly on their redemption for free airline travel. It should be noted however, that the policy implications are the same in either situation.
4 Frequent flyer miles can be accumulated and utilized for class-upgrades as well; however, this paper will focus exclusively on free airline travel.
and can be used at almost any time by an employee to obtain free air travel.\textsuperscript{5} As will be discussed in detail hereinafter, allowing employees to keep frequent flyer miles earned in the ordinary course of business while traveling for their employers has become commonplace in Corporate America.\textsuperscript{6}

The tax treatment of frequent flyer miles earned by employees while traveling for their employers has been the source of a great deal of controversy in recent years, and yet the Internal Revenue Service has failed to quell this debate. This paper will recount the history of this controversy, and thereafter attempt to resolve it in a fair, equitable, and plausible manner.

Frequent flyer programs have been overwhelmingly successful in achieving their stated goal of acquiring and maintaining customer loyalty,\textsuperscript{7} but the airline industry has created a myriad of accounting, fairness, and legal enigmas through the operation of frequent flyer programs. The airline industry is basically an oligopolistic market structure. As an oligopoly, a few sellers that are effectively able to set market prices characterize the airline industry, and the buyers in this industry are price takers. Many corporate executives have argued that frequent flyer programs cost Corporate America an untold fortune each year in the form of over-inflated fares.\textsuperscript{8} Because nearly every airline has a frequent flyer program, the consumer is forced to pay over-inflated prices or choose alternative modes of transportation. Unfortunately, for most corporate executives there is no real alternative to air travel; it is a necessary evil. Hence, the airline industry has effectively passed its marketing costs onto Corporate America; this is due to the fact that, but for frequent flyer programs, airlines' prices would be lower. Intuitively, one can only logically assume that maintaining an accounting information system that is capable of keeping track of the millions of frequent flyer accounts is very expensive. Arguably, the business traveler market is rather inelastic in nature, and therefore the airlines are able to pass the cost of operating this complex accounting information system onto Corporate America.

Currently, there is no definitive Internal Revenue Service pronouncement that addresses accounting for frequent flyer programs.\textsuperscript{9} This

\textsuperscript{6} “Corporate America” is used here and throughout to mean “Fortune 500” type companies.  
\textsuperscript{7} Robert McNatt, \textit{The Richer Rewards of Frequent Flying}, \textit{MONEY}, Apr. 1985, at 89.  
\textsuperscript{8} Note: the term “over-inflated fares” is used to depict the added cost of airline tickets due to the evolution and maintenance of frequent flyer programs.  
\textsuperscript{9} Tech. Adv. Mem. 9547001 (July 11, 1995) attempted to address accounting for frequent flyer programs, but it was quickly abandoned and all but recanted by
paper will concentrate on the tax policy issues that arise when an employer purchases an airline ticket for use by an employee in the ordinary course of business, and the employee is then allowed to use the frequent flyer miles earned for his or her own personal use. I contend that failing to tax employees when they redeem frequent flyer miles that were obtained while on business travel for personal use is inequitable and violates the "fairness canon" of taxation.

Moreover, allowing employees to keep frequent flyer miles obtained on company-funded trips provides a windfall to both the employee and employer. It is inequitable for the Internal Revenue Service to allow companies to deduct corporate travel as an ordinary and necessary business expense pursuant to I.R.C. § 162(a)(2), and thereafter not include the value of the redeemed frequent flyer miles in the gross income of the employee. It is directly contrary to the general timing rules which are pervasive throughout federal tax law—i.e., A can only deduct an otherwise deductible amount when B includes said amount in his or her gross income. This point is best demonstrated by way of analogy; for example, pursuant to I.R.C. § 83(h) employers are not allowed to deduct amounts expended for property transferred in connection with the performance of services under I.R.C. § 162(a)(2) until the employee includes the corresponding amount in his or her gross income under I.R.C. § 83(a). Frequent flyer miles that are available for personal consumption are basically a disguised form of compensation for services, or alternatively, a taxable fringe benefit. Hence, frequent flyer miles should be taxed like any other form of compensation for services or taxable fringe benefit under the general rule of I.R.C. § 61(a)(1), as they are not specifically exempted by another section of the Code.

The purpose of this article is to dissect the plausibility of taxing frequent flyer miles that were earned by employees on employer-paid travel and later used for personal travel. The first issue for resolution is whether the accrual and utilization of frequent flyer miles earned by an employee while on company-paid travel constitutes compensation for services, and hence gross income, within the meaning of I.R.C. § 61(a)(1). The second issue for resolution is whether the accrual and utilization of frequent flyer miles earned by an employee while on company-paid travel...
constitutes a taxable fringe benefit, and hence gross income, within the meaning of I.R.C. § 61(a)(1). The third issue for resolution is whether the accrual and utilization of frequent flyer miles earned by an employee while on company-paid travel constitutes a taxable gift within the meaning of I.R.C. § 102(c)(2). Ultimately, this paper will purvey an equitable solution to the many accounting, legal, and policy issues raised by the personal use of frequent flyer miles obtained on company-paid travel.

II. THE INCLUSION OF FREQUENT FLYER MILES IN GROSS INCOME

I.R.C. § 61(a) states: "Except as otherwise provided in this Subtitle, gross income, means all income from whatever source derived, including (but not limited to) the following items: (1) compensation for services, including fees, commissions, fringe benefits, and similar items." Frequent flyer miles earned by an employee while on company-paid travel and later used for personal travel are arguably compensation for services. Alternatively, these frequent flyer miles are a fringe benefit. Hence, under either scenario the frequent flyer miles in question should be fully and completely taxable, per I.R.C. § 61(a)(1).

A. Frequent Flyer Miles as Compensation

Compensation is defined as, "direct and indirect monetary and nonmonetary rewards given to an employee, which are taxable under the general rule of I.R.C. § 61(a) unless specifically exempted elsewhere in the Internal Revenue Code."\textsuperscript{13} Frequent flyer miles earned by an employee while on company-paid travel are nonmonetary rewards given to an employee, and consequently they should be taxable under the general rule of I.R.C. § 61(a)(1).

The term "gross income" is further defined in Commissioner v. Glenshaw Glass\textsuperscript{14} as follows:

Gross income includes gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit,

\textsuperscript{13} DICTI\textsuperscript{O}NARY OF T\textsuperscript{AX} TERMS 60 (1994).
or gains or profits and income derived from any source whatever.

Glenshaw Glass demonstrates that the Supreme Court has clearly taken a very expansive view of I.R.C. § 61(a). Frequent flyer miles earned by employees on company-paid travel could be classified as one or more of the components of gross income as defined by the Supreme Court in Glenshaw Glass. For example, frequent flyer miles earned by employees on company-paid travel and later used for personal use could arguably be classified as either: (1) “compensation for personal services,”15 or (2) “gains or profits and income derived from any source whatever.”16

Employees receive many different forms of remuneration for the services they provide to their employers. If an employee is compensated in the form of cash, clearly it is considered gross income under I.R.C. § 61(a)(1). If an employee is compensated in the form of an incentive or bonus trip, it is considered taxable compensation for services rendered.17 Moreover, the Supreme Court in Commissioner v. Smith18 held includible as taxable income “any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected.” Consequently, it is irrelevant whether an employee obtained a free trip though the use of employer-provided frequent flyer miles or whether the employer paid for the trip outright; in either case, compensation for services within the meaning of Glenshaw Glass will result upon redemption of said miles.

Additionally, Treasury Regulation § 1.61-21(a)(3) explicitly states: “a fringe benefit provided in connection with the performance of services shall be considered to have been provided as compensation for such services.” Hence, it is not even necessary that the employer-provided frequent flyer miles were actually given to the employee as a form of compensation; rather, it is sufficient that the employer transferred the frequent flyer miles to the employee in “connection with the

15 Id.
16 Id.
17 See Rudolph v. United States, 370 U.S. 269, 272 (1962) (holding that the value of trips provided by employers to employees as an incentive or bonus were includible in the employee’s gross income as taxable compensation for services rendered within the meaning of I.R.C. § 61(a)(1)).
18 See Commissioner v. Smith, 324 U.S. 177, 181 (1945) (holding that the amount of the bargain-element with respect to employer-provided non-statutory stock options was taxable compensation for services rendered and therefore gross income to the employee within the meaning of I.R.C. § 61(a)’s predecessor, § 22(a) of the Internal Revenue Code of 1938).
B. The Sale of Frequent Flyer Miles—Charley v. Commissioner

In Charley, the Service took the position that the sale of employer-provided frequent flyer miles to a third party results in gross income within the meaning of I.R.C. § 61(a)(1). The taxpayer in question worked for a company that required him to travel frequently for legitimate business purposes. The company allowed the taxpayer to accumulate his work-earned frequent flyer miles in his personal frequent flyer mile account. These miles were utilized at the sole discretion of the taxpayer and were considered property to be owned by him and not the company. Instead of utilizing these frequent flyer miles to obtain free airline tickets, the taxpayer created a complex and morally questionable system, which allowed him to receive cash when his company required him to fly to a client’s location for corporate business. The system worked as follows:

1. The taxpayer-employee would bill the client of the company for a first-class airline ticket.
2. The taxpayer-employee would have the travel agent procure a coach-class ticket for him, but charge him for a first-class ticket.
3. The taxpayer-employee would apply his employer-provided frequent flyer miles to upgrade the coach ticket to a first-class ticket.
4. The travel agent would transfer the difference in ticket prices to the employee-taxpayer’s personal travel account, which could be converted into United States currency at any time.

For the year in question, the employee received over $3,000 by utilizing this system of upgrading. The Internal Revenue Service argued that the $3,000 was taxable on either of two theories: (1) The Service argued that the $3,000 was additional compensation within the meaning of I.R.C. § 61(a)(1), and hence it was taxable as such; or (2) that the transaction could be viewed as the sale or exchange of property which had a zero basis. Pursuant to I.R.C. § 1001(a), a gain from the disposition of property is equal to the amount realized from the disposition minus the property’s adjusted basis. Under I.R.C. § 1001(b), the amount realized

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20 Charley v. Commissioner, 91 F.3d 72 (9th Cir. 1996).
21 Id. at 74.
22 Id.
23 Id. at 75.
from a disposition of property is the sum of any money received plus the fair market value of any property (other than money) received.\textsuperscript{24} Moreover, pursuant to I.R.C. § 1012, the adjusted basis is determined by reference to the cost.\textsuperscript{25} Because the taxpayer received the frequent flyer miles at no cost, he had a zero basis in the miles; hence his exchange was completely taxable.

Although the court declined to state which argument it found more persuasive, it held for the Service and it stated that the sale of frequent flyer miles produced gross income within the meaning of I.R.C. § 61(a)(1). \textit{Nota bene:} the court specifically declined to comment on whether employer-provided frequent flyer miles in the abstract constituted gross income. The issue of the taxability of frequent flyer miles accrued through business travels and later used for personal travel has yet to be specifically addressed by the judiciary. However, the Ninth Circuit certainly made it clear in \textit{Charley} that the outright sale of frequent flyer miles obtained from business travel will be treated as a taxable event. This holding demonstrates that employer-provided frequent flyer miles are clearly an economic or financial benefit conferred upon the employee as remuneration for services rendered, and are therefore gross income within the meaning of I.R.C. § 61(a)(1).

\textbf{C. Frequent Flyer Miles as a Fringe Benefit}

Alternatively, it can be argued that frequent flyer miles earned by an employee while on company-paid travel\textsuperscript{26} are fringe benefits, which are defined as indirect compensation provided to an employee in addition to his or her regular salary or wages.\textsuperscript{27} As Treasury Regulation § 1.61(a)(1) states: "Section 61(a)(1) provides that except as otherwise provided in Subtitle A of the Internal Revenue Code of 1986, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. . . . \textit{Examples of fringe benefits include: . . . an employer-provided free or discounted commercial airline flight.}"\textsuperscript{28}

Although certain fringe benefits are specifically exempted from tax by I.R.C. § 132, frequent flyer miles earned by an employee while on company-paid travel are not eligible for any of the specific exclusions set forth

\begin{itemize}
\item \textsuperscript{24} \textit{Id.}
\item \textsuperscript{25} \textit{Id.}
\item \textsuperscript{26} Sometimes hereinafter referred to as "employee miles."
\item \textsuperscript{27} This definition is a compilation of definitions offered in the \textsc{Dictionary of Tax Terms}, \textit{supra} note 13, at 33; \textsc{Black's Law Dictionary} 667 (6th ed. 1990).
\item \textsuperscript{28} Emphasis added.
\end{itemize}
in I.R.C. § 132. I.R.C. § 132(a) states: “Gross income shall not include any fringe benefit which qualifies as a—(1) no-additional-cost service, (2) qualified employee discount, (3) working condition fringe, (4) de minimis fringe, (5) qualified transportation fringe, or (6) qualified moving expense reimbursement.”

1. No Additional-cost Service

I.R.C. § 132(b) defines a no-additional-cost service as any service provided by an employer to an employee for use by such employee if: (1) such service is offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services; and (2) the employer incurs no substantial cost. Nowhere in the Internal Revenue Code of 1986, or the Treasury Regulations thereunder, is the term “service” defined; but assuming arguendo, that employee miles are capable of being classified as a “service,” they still fail to meet the requirements of I.R.C. § 132(b). Employee miles fail to meet this definition because frequent flyer miles are not offered for sale to customers in the ordinary course of any business. Also, the employer does incur a substantial additional cost by allowing employees to keep frequent flyer miles for personal use rather than mandating that frequent flyer miles accrued during company-paid travel remain with the company for its utilization in subsequent ordinary and necessary business travel. Therefore, employee miles cannot be excluded from gross income under the rubric of I.R.C. § 132(b).

2. Qualified Employee Discounts

I.R.C. § 132(c)(1) defines qualified employee discount as:

any employee discount with respect to qualified property or services to the extent such discount does not exceed—
(A) in the case of property, the gross profit percentage of the price at which the property is being offered by the employer to customers, or (B) in the case of services, 20 percent of the price at which the services are being offered by the employer to customers.

Employee miles are property rather than a service, hence it may appear that they are an excludible fringe benefit, per I.R.C. § 132(c)(1)(A). Notwithstanding the foregoing, employee miles fail the test set forth in I.R.C. § 132(c)(1)(A) because employers do not offer frequent flyer miles for sale to their customers in the ordinary course of business. Moreover, I.R.C. § 132(c)(1)(B) does not apply because employee miles
do not meet the definition of a service. Therefore, employee miles cannot be excluded from gross income under the rubric of I.R.C. § 132(c).

3. Working Condition Fringe

I.R.C. § 132(d) defines a working condition fringe as: "any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under I.R.C. § 162 or I.R.C. § 167." This Subsection of the Code is inapplicable to employee miles because they are neither trade or business expenses as defined by I.R.C. § 162 nor depreciation as defined by I.R.C. § 167. Therefore, employee miles cannot be excluded from gross income under the rubric of I.R.C. § 132(d).

4. De Minimis Fringes

I.R.C. § 132(e)(1) defines de minimis fringes as: "property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable." Furthermore, Treasury Regulation § 1.132-6(e)(1) illustrates benefits excludable from income as de minimis fringes:

29 BLACK'S LAW DICTIONARY defines "service" as follows: "Duty or labor to be rendered by one person to another, the former being bound to submit his will to the direction and control of the latter." BLACK'S LAW DICTIONARY 1368 (6th ed. 1990).

30 I.R.C. § 162(a) (1999) states:

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year carrying on any trade or business, including — (1) a reasonable allowance for salaries or other compensation for personal services actually rendered; (2) traveling expenses while away from home in pursuit of a trade or business; and (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, or property to which the taxpayer has not taken or is not taking title or in which he has no equity.

31 I.R.C. § 167(a) (1999) states: "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income."
Examples of de minimis fringe benefits are occasional typing of personal letters by a company secretary; occasional personal use of the employer's copying machine, . . . occasional cocktail parties, group meals, or picnics for employees and their guests; traditional birthday or holiday gifts of property (not cash) with a low fair market value; occasional theater or sporting event tickets; coffee, doughnuts, and soft drinks; local telephone calls; and flowers, fruit, books, or similar property provided to employees under special circumstances.

Thereafter, Treasury Regulation § 1.132-6(e)(2) illustrates benefits not excludable from income as de minimis fringes:

Examples of fringe benefits that are not excludable from gross income as de minimis fringes are: season tickets to sporting or theatrical events; the commuting use of an employer-provided automobile or other vehicle more than one day a month; membership in a private country club or athletic facility; . . . employer-provided group-term life insurance on the life of the spouse or child of an employee; and use of employer-owned or leased facilities (such as an apartment, hunting lodge, boat, etc.) for a weekend.

Employee miles are not similar in nature to those benefits specifically excluded from gross income by Treasury Regulation § 1.132-6(e)(1). The value of employee miles is anything but de minimis, as employee miles can conceivably be worth thousands of dollars. It would be irrational to attempt to compare the use of employee miles to the occasional use of an employer's copy machine or other de minimis fringe listed in Treasury Regulation § 1.132-6(e)(1). Alternatively, employee miles are similar in nature to those benefits specifically includible in gross income by Treasury Regulation § 1.132-6(e)(2). The value of the fringe benefits listed in Treasury Regulation § 1.132-6(e)(2) are substantial; it would be reasonable to compare the use of employee miles to the use of any of the fringe benefits listed in Treasury Regulation § 1.132-6(e)(2). Therefore, employee miles cannot be excluded from gross income under the rubric of I.R.C. § 132(e).

5. Summary

Employee miles fail to meet any of the exclusions from gross in-
come set forth in I.R.C. § 132(a). That is, employee miles do not qualify for exclusion from gross income as: (1) a no-additional-cost service; (2) a qualified employee discount; (3) a working condition fringe; (4) a de minimis fringe; (5) a qualified transportation fringe; or (6) a qualified moving expense reimbursement. Consequently, employee miles, whether classified as fringe benefits or compensation for services, are fully taxable pursuant to I.R.C. 61(a)(1).

III. FREQUENT FLYER MILES AS A GIFT FROM EMPLOYER TO EMPLOYEE

I.R.C. § 102(a) provides: "Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance." At first glance, it would appear that employees could effectively argue that employee miles were a gift from their employer, and hence are not subject to federal income tax. A gift is defined as "the voluntary transfer of property made without financial consideration; i.e., no value is received in return." The Supreme Court began to define the meaning of the term gift in Bogardus v. Commissioner, where it stated: "what controls is the intention with which payment, however voluntary, has been made." The Supreme Court further defined the term gift in Robertson v. United States, and stated: "where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it." In Commissioner v. LoBue, the Supreme Court continued to enhance its interpretation of the term gift and proclaimed that a genuine gift is made in: "detached and disinterested generosity."

In Commissioner v. Duberstein, the Supreme Court applied a comprehensive definition of the term gift, compiled from each of the aforementioned cases. In Duberstein, the Court proffered that a genuine gift is one made out of "detached and disinterested generosity... out of affection, respect, admiration, charity, or like impulses." The Supreme Court, in Duberstein, held that an expensive luxury vehicle which was received

32 Although I.R.C. §§ 132(a)(5) and (6) were not specifically addressed, it is self-evident that neither of these sections could possibly apply to employee miles.
33 It should be noted that this proposition does not assume that inapplicability of the federal income tax necessarily means inapplicability of the federal gift tax; however, the federal gift tax is beyond the scope of this paper.
34 DICTIONARY OF TAX TERMS, supra note 13, at 135.
39 Id.
from a business associate as a reward for past business favors was includi-
ble in the gross income of the donee, and that such transaction did not
meet the previously-defined\(^{40}\) judicial interpretation of the term gift. More-
over, courts are generally suspicious of any transaction that is claimed to
be gratuitous in nature when it occurs in the business context. Through
the years, courts were forced to make this facts and circumstances differ-
entiation on a number of occasions.

The Tax Reform Act of 1986, through the addition of I.R.C. §
102(c)(1), attempted to further clarify the issue of whether a transfer
from an employer to an employee could be gratuitous in nature. I.R.C. §
102(c)(1), states: “Subsection (a) [which provides a general exclusion
from gross income for gifts] shall not exclude from gross income any
amount transferred by or for an employer to, or for the benefit of, an em-
ployee.” There are exceptions to the general rule of I.R.C. § 102(c)(1),
which allow excludible transfers from employer to employee in two cir-
cumstances: (1) certain de minimis fringes from gross income governed
by I.R.C. § 132(e); and (2) certain employee achievement awards which
are excluded from gross income by I.R.C. § 74(c).

Neither of the two exceptions of I.R.C. § 102(c)(1) are applicable
to employee miles. First, as discussed \textit{supra}, employee miles are not ex-
cludible from gross income under the guise of I.R.C. § 132(e). Second,
employee miles cannot be considered an employee achievement award.
I.R.C. § 74(c) excludes from the gross income of an employee the value
of an employee achievement award as defined by I.R.C. § 274(j) which
states: “the term ‘employee achievement award’ means an item of \textit{tangible}
personal property.”\(^{41}\) Accordingly, because employee miles are intangible as-
sets,\(^{42}\) they are ineligible for the exclusion from gross income provided by
I.R.C. § 74(c). I.R.C. § 102(c) effectively prohibits employees from claim-
ing that employee miles are gifts from their employers; hence, the per-
sonal utilization of frequent flyer miles that were attained while on com-
pany-paid travel are gross income within the meaning of I.R.C. §
61(a)(1).\(^{43}\)

\(^{40}\) \textit{LoBue}, 351 U.S. at 246; \textit{Robertson}, 343 U.S. at 714; \textit{Bogardus}, 302 U.S. at 43.
\(^{42}\) “Intangible asset” is defined by \textit{Black's Law Dictionary} as: “Property that is a
‘right’ such as a patent, copyright, trademark, etc., or one which is lacking phys-
ical existence, such as goodwill.” \textit{Black's Law Dictionary} 808 (6th ed. 1990).
\(^{43}\) I.R.C. § 61(a) (1999) states: “Except as otherwise provided in this subtitle,
gross income means all income from whatever source derived, including (but
not limited to) the following items: (1) Compensation for services, including
fees, commissions, fringe benefits, and similar items . . . .” I.R.C. § 61(a) (1999).
IV. PREVIOUS EFFORTS TO EFFECTIVELY TAX FREQUENT FLYER MILES

The taxation of frequent flyer miles accumulated by employees while on company-paid airline travel, as well as other non-statutorily excluded fringe benefits, has long been a thorn in the side of the Internal Revenue Service.

As it stated in Smith, the Service has historically held the belief that the language of I.R.C. § 61(a) was “broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected.” Much to the chagrin of the Service however, over the course of the last several years, it became a customary practice of many taxpayers to incorrectly exclude non-statutorily excluded fringe benefits.

In 1975, the Treasury Department issued a discussion draft of Proposed Regulation § 1.61-16 which essentially memorialized the position it had taken in Smith. The discussion draft was criticized by many as being inequitable; therefore in 1976 the Service officially withdrew Proposed Regulation § 1.61-16. In 1978, Congress responded with a statutory moratorium via Public Law No. 95-427 that prohibited the issuance of Regulations in this area prior to 1980. Thereafter, Congress created the Task Force on Employee Fringe Benefits in order to further study non-statutorily excluded fringe benefits. As of 1981, the Task Force on Employee Fringe Benefits still had not authored legislation which addressed non-statutorily excluded fringe benefits. In a further attempt to settle the controversy surrounding the taxation of non-statutorily excluded fringe benefits, the Treasury Department issued a discussion draft of Proposed Regulations §§ 1.61-17–1.61-20 in 1981. Congress reacted shortly thereafter by amending the statutory moratorium in Public Law No. 95-427 via Public Law 97-34 so as to prohibit the issuance of Regulations in this area prior to 1984. In 1984, Congress passed the Deficit Reduction Act of 1984, which amended I.R.C. § 61(a) as follows: “except as otherwise provided in this Subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, fringe benefits, and similar items.” The Deficit Reduction Act of 1984 also added I.R.C. § 132 which provides several statutory exceptions to the general rule contained in I.R.C. § 61(a).

Essentially, I.R.C. § 61(a) was amended, and I.R.C. § 132 was added, to eliminate the uncertainty as to the taxability of non-statutorily excluded fringe benefits heretofore discussed. Hence, as a result of The Deficit Reduction Act of 1984, the Service’s position in Smith was essentially adopted statutorily. In 1985, the Service issued Proposed Regulations on employee fringe benefits, and it requested comments on the taxation of frequent flyer miles which were accrued by employees while on company-paid travel and later used for personal travel. Despite countless comments
submitted by the public, the Internal Revenue Service did not provide any instruction on the issue, and in 1988 the Service, without explanation, officially withdrew all plans to specifically tax employer-provided frequent flyer miles. To date, Congress has failed to promulgate legislation that specifically targets the inclusion of employee miles in the gross income of the employee.

A. Technical Advice Memorandum 9547001

The Service’s next attempt to regulate frequent flyer miles came in November 1995, when it issued Technical Advice Memorandum (TAM) 9547001.44 The situation described in TAM 9547001 involved an employer that reimbursed its employees for all ordinary and necessary business-related travel expenses, including air travel expenses. Additionally, the employer allowed its workers to keep frequent flyer miles that they received during company-paid travel for their own personal use. The Service in its TAM articulated that, because employees were allowed to retain the frequent flyer miles earned while on corporate business for their own personal use, the employer’s travel reimbursement plan violated I.R.C. § 62(c). I.R.C. § 62(c) sets forth rules which reimbursement plans must meet in order to be exempt from federal income tax. Because of this violation the reimbursement plan was found to be subject to federal income tax:

I.R.C. § 62(c) forbids reimbursement plans that: (1) do not require employees to substantiate expenses45 and (2) allow employees to retain any amount in excess of the substantiated expenses46 from being considered “accountable plans.”47 As a “non-accountable plan” per Treasury Regulation § 1.62-2(c)(3)(i), this specific employer’s reimbursements paid to its employees under its employee travel reimbursement plan were held to be taxable. This

44 When a taxpayer is audited, the Internal Revenue Service revenue agent engaged in the audit or the taxpayer may request technical advice from the National Office of the Internal Revenue Service. The response is a Technical Advice Memorandum that interprets the law and applies it to the specific set of facts submitted by the agent and the taxpayer. It is binding on the Internal Revenue Service even if the local Internal Revenue Service authorities do not agree with its conclusions. See GWENDOLYN GRIFFITH, BASIC INCOME TAX 15 (1997).
47 An accountable plan is simply a reimbursement plan which meets the requirements of I.R.C. § 62(c).
TAM had a legally binding effect only on the employer in question, and not on taxpayers as a whole. Nonetheless, Corporate America quickly became very concerned by the position taken by the Service in TAM 9547001.

B. The Fallout from TAM 9547001

Amid a swift and severe public outcry, the Service quickly backed away from its position on November 28, 1995, a mere four days after having issued TAM 947001. Internal Revenue Service spokesman Wilson Fadely stated the following in an attempt to quell mounting public fear that the Internal Revenue Service may attempt to tax their beloved frequent flyer miles: “Although frequent flyer benefits have technically always been taxable... we are not launching any special enforcement program into this area.”48 Mr. Fadely further stated that the Internal Revenue Service was concerned that there may be some misunderstanding about the TAM, which was issued to resolve a specific issue with a specific taxpayer, and is not binding on any other taxpayer.49 Additionally, the spokesman stated: “The Internal Revenue Service is reconsidering the analysis in this technical advice memorandum, in part because it does not address the full range of regulations potentially applicable to employee reimbursement plans involving frequent flyer miles.”50

Even though it was not applicable to the public as a whole, the issuance of TAM 9547001 created pandemonium on Capitol Hill. Corporate executives quickly surmised that if the Internal Revenue Service could hold one taxpayer’s employee miles taxable, then the Service might later attempt to hold all employee miles taxable. In my opinion, the reaction in the press to the possible taxation of employee miles was expeditious and harsh. It was only a matter of time until lobbyists were sent to Capitol Hill in an attempt to curtail this brash movement toward the effective taxation of employee miles.

On March 19, 1996, Congresswoman Barbara B. Kennelly introduced H.R. 311151 in which she stated: “I believe that frequent flyer miles are not taxable under current law and should remain that way. My bill

49 Id.
50 Fringe Benefits: Internal Revenue Service Backs Away from Technical Advice on Taxability of Frequent Flyer Miles. 14 TAX MGMT. WEEKLY REP. 1741 (Dec. 4, 1995).
51 H.R. 3111, 104th Cong. (1996). This identical resolution was reintroduced as H.R. 533 in February 1997.
Congresswoman Kennelly stated that she introduced this bill in response to TAM 9547001.\textsuperscript{53} Congresswoman Kennelly attacked the Internal Revenue Service’s position taken in the aforementioned TAM, and she further stated that she felt taxation of employee miles would be pointless because of the myriad of questions\textsuperscript{54} which it would raise, such as valuation, timing, and segregation of personal and business frequent flyer miles. Congresswoman Kennelly raised several valid issues in H.R. 3111; but she erred in her contention that employee miles are not taxable under current law.

As discussed \textit{supra}, employee miles should be considered taxable income under the current Code and Treasury Regulations, but at this time there is no \textit{effective} taxation of employee miles. To date, Congress has not enacted H.R. 3111, and currently there is no pending legislation that would specifically exempt employee miles from taxation. Undoubtedly, any law which would attempt to explicitly tax employee miles would need to resolve the issues of valuation, timing, and segregation of personal and business frequent flyer miles raised by Congresswoman Kennelly, and my proposal will set forth plausible solutions to these issues.

\section*{V. The Daher Proposal for Taxing Frequent Flyer Miles}

Air Travel expenses for 1996:\textsuperscript{55}

\begin{enumerate}
\item IBM $350 million
\item Lockheed Martin $300 million
\item General Electric $295 million
\item Anderson Worldwide $220 million
\item Hewlett-Packard $190 million
\item General Motors $165 million
\item Motorola $165 million
\item AT&T $150 million
\item Ford $145 million
\item Lucent Technologies $131 million
\end{enumerate}

\textsuperscript{52} \textit{Id.}
\textsuperscript{53} \textit{Id.}
\textsuperscript{54} Congresswoman Kennelly stated in her bill that issues of timing, valuation, segregation, and public opposition would make any attempt to tax frequent flyer miles which were earned by employees during company-paid travel impractical. H.R. 3111, 104th Cong. (1996).
As the foregoing chart illustrates, Corporate America spends billions of dollars per year on commercial air travel. Each dollar spent on air travel indubitably yields frequent flyer miles, and furthermore 88 percent of employees are allowed to keep the frequent flyer miles earned on company-paid travel for their own personal use. Under the Code, employee miles are technically taxable; although, they are effectively not taxed. Merely by stepping up enforcement on the ten companies listed above, the Internal Revenue Service could raise millions of dollars in additional revenue each year. Although Congressional revenue estimates are unavailable for this matter, I would estimate that rigorous enforcement would produce billions of dollars in additional tax revenue each year; this is one of the primary reasons I am an advocate of the effective taxation of employee miles. I make the following proposal, which will hopefully clarify the issues previously mentioned by former Congresswoman Kennelly that need to be resolved prior to any effective taxation of employee miles.

A. Current Valuation of Employee Miles

Treasury Regulation § 1.61-21(b)(1) provides the following scheme for the valuation of fringe benefits:

An employee must include in gross income the amount by which the “fair market value” of the fringe benefit exceeds the sum of—(i) the amount, if any, paid for the benefit by or on behalf of the recipient, and (ii) the amount, if any specifically excluded from gross income by some other section of subtitle A of the Internal Revenue Code of 1986.

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56 Id.
58 Treas. Reg. § 1.61-21(b)(2) (as amended in 1992) defines the term “fair market value” as:

In general, fair market value is determined on the basis of all the facts and circumstances. Specifically, the fair market value of a fringe benefit is the amount that an individual would have to pay for the particular fringe benefit in an arm's length transaction. Thus, for example, the effect of any special relationship that may exist between the employer and the employee must be disregarded. Similarly, an employee’s subjective perception of the value of a fringe benefit is not relevant to the determination of the fringe benefit’s fair market value nor is the cost incurred by the employer determinative of its fair market value.
Although the Internal Revenue Service has not typically enforced the taxation of employee miles in the past, as I.R.C. § 61(a) and Treasury Regulation § 1.61-21(b)(1) demonstrate there is no legal basis which would prohibit them from implementing a program of strict enforcement in the future. I concede that the present valuation scheme set forth in Treasury Regulation § 1.61-21(b)(1) is not necessarily the best method available for the valuation of employee miles. The current valuation system is rather vague and ambiguous, and in my opinion it is better suited for valuing other types of fringe benefits. Therefore, an alternative valuation method will be proposed, which will more accurately depict the value of employee miles. Moreover, this system will be more concrete and systematic in nature.

B. Proposed Valuation System for Employee Miles

First, I propose the amendment of Treasury Regulation 1.61-21(b)(1), so as to remove from its bailiwick the valuation of employee miles. Thereafter, I would encourage the Secretary of the Treasury to draft a new Treasury Regulation that would value employee miles as provided by the subsequently discussed method. The valuation method I propose is straightforward; I recommend the valuation of all employee miles at $.01 per mile.\(^5\)

Hence, employees would simply multiply the number of employee miles used\(^6\) for personal travel throughout the year by the factor $.01, and include that amount in gross income. Additionally, any employee miles which are sold to third parties throughout the year should be valued in the same manner as those used by employees for personal travel. For example, if an individual accrued 100,000 employee miles during 1998 and utilized 50,000 employee miles for a first-class domestic flight he would include an additional $500 in gross income.

\(^5\) $.01 is utilized because it yields tax liabilities which are slightly lower than what an average would spend on a comparable airline ticket if purchased. See Domestic Airline Fares Consumer Report, U.S. Department of Transportation (1997). Similar information is now available online at Office of Airline Information (last modified Apr. 17, 2000) <http://www.bts.gov/programs/oai/>.

\(^6\) Under my proposal, employee miles would be taxable only when actually used. This is because I believe the employee has failed to realize an accession to wealth by the mere possession of employee miles. Therefore, employee miles are not subject to tax when earned.
C. Timing Issues

Employee miles should only be included in a taxpayer's gross income when the taxpayer actually utilizes said miles for personal travel. Theoretically, employee miles should be included in gross income upon receipt. However, prior to redemption, the value of employee miles is simply too administratively impractical to discern; because of this, gross income should not be realized until the employee miles are actually redeemed for free air travel. Therefore, accrual of employee miles is treated as a non-taxable event; only when travel is actually effectuated should the value of the employee miles be included in the taxpayer's gross income pursuant to I.R.C. § 61(a). Additionally, the employer would only be allowed a I.R.C. § 162(a)(2) compensation deduction in the year in which the employee includes the proper amount in his gross income. This is consistent with the general timing rules of federal taxation, such as those enumerated in I.R.C. § 83(h), discussed supra.

D. Segregation of Personal and Business Frequent Flyer Miles

For there to be effective taxation of frequent flyer miles earned by employees while on company-paid travel, there must first be a segregation of personal and business frequent flyer mile accounts. This could be effectuated by the current accounting information systems used by airlines to maintain customer frequent flyer accounts. After the effective date of the legislation, any employee who was allowed to accrue employee miles would do so in his or her business, rather than personal account, and all frequent flyer miles accrued prior to the effective date would be considered personal or nontaxable. Additionally, the legislation should mandate that each business entity submit a written statement to any airline it employs that outlines the official company policies regarding frequent flyer miles.

For companies that do not allow their employees to keep frequent flyer miles for their personal use, there would be no tax consequences from this new legislation. However, for companies which do allow their employees to accrue employee miles for personal utilization, employees would be required to include the value of these miles in gross income at the time of utilization. I further propose that any airline ticket that is purchased by a business enterprise which allows employees to accrue employee miles must accrue those frequent flyer miles in the business frequent flyer miles account of the named traveler. This segregation requirement is necessary if the airlines are to be able to fulfill their reporting requirements listed below.
E. Reporting Requirements

All major airlines already have complex and sophisticated accounting information systems which monitor customers' frequent flyer accounts. I propose that Congress compel the airlines to issue customers 1099-MISCs that detail all free travel that resulted from the use of employee miles during the year. Airlines would not report unused employee miles on the 1099-MISCs of employees. Additionally, employee miles should be considered taxable only when actually used, and in the year actually used; hence the reservation date is of no relevance to the taxability of frequent flyer miles.

VII. Application of the Daher Standard

The following example demonstrates how the Daher Standard could be effectively employed to tax the personal use of employee miles.

A. Facts

Bill is an account who is a partner in the firm, Cairney, O'Mally, and Mc Millen, LLP. Bill, as director of national recruiting for Cairney, O'Mally, and Mc Millen, LLP, is required to travel over two million air-miles each year. Moreover, Cairney, O'Mally, and Mc Millen, LLP has a written policy in their employment handbook which states:

All partners and associates of Cairney, O'Mally, and Mc Millen, LLP are hereby allowed to keep any and all frequent flyer miles earned through ordinary and necessary business travel, as defined by I.R.C. § 162(a)(2), for their own personal utilization. Additionally, at the time the frequent flyer miles are earned from said ordinary and necessary business travel, they are to be considered the sole property of the partner or associate in question.

61 The airline industry already has in place an accounting information system that is capable of tracking individual frequent flyer accounts; therefore, is preferable that the airline industry carry out the reporting requirements. Employers could not cost-effectively comply with the reporting requirements set forth herein; hence, the airline industry is responsible for fulfilling these reporting requirements.

62 Employee miles are of no value until they are used by the employee for personal travel. Therefore, employee miles should not be included in income until they are used for personal travel.
B. Application

The year is 1999, and the United States Congress has just passed the Daher Standard; additionally the President has signed the bill into law. Cairney, O'Mally, and Mc Millen, LLP has an exclusive air travel agreement with XYZ Airlines, hence any and all ordinary and necessary air travel is undertaken exclusively on XYZ Airlines. At the time the Daher Standard was enacted into law, Bill had previously accrued eight million frequent flyer miles while traveling on official business for Cairney, O'Mally, and Mc Millen, LLP. Under the Daher Standard, all eight million of these frequent flyer miles will be considered personal miles, and therefore they will be nontaxable. However, in the year 1999, Bill will be required by law to segregate his personal frequent flyer miles from his business frequent flyer miles.

Additionally, Cairney, O'Mally, and Mc Millen, LLP will be required to send a written statement to XYZ Airlines advising them of their company policy regarding the employee utilization of frequent flyer miles which were earned on business travel. Thereafter, each time Bill embarked on a company trip the miles would accrue in his business frequent flyer account. Let us further assume that Bill flew two million miles during 1999 for Cairney, O'Mally, and Mc Millen, LLP, and that all of this air travel took place after January 1, 1999, the effective date of the adoption of the Daher Standard.

During the year, Bill utilizes 1.5 million frequent flyer miles from his business frequent flyer account for personal travel, including several trips to Europe, Africa, Asia, South America, and Central America. At the close of business on December 31, 1999, XYZ Airline would issue Bill a 1099-MISC in the amount of $15,000 (1.5 million x $.01). It should be noted that Bill is not taxed on the remaining 500,000 frequent flyer miles which have accrued in his business frequent flyer account, and he will not be taxed on these miles unless he later uses these frequent flyer miles for personal travel.

VIII. Conclusion

There is absolutely nothing in the current tax law that would prohibit the Internal Revenue Service from launching a campaign of strict enforcement in this area of taxation. I realize that any attempt to enforce the taxability of employee miles in the past has been met with staunch opposition from Corporate America. Business travelers have come to see employee miles as a splendid fringe benefit, which they mistakenly assume is nontaxable. Given the reaction to several previous attempts to tax employee miles, Congressional adoption of the Daher Standard seems unlikely. This is not to say that the Daher Standard is not sound tax policy.
but rather that members of Congress will look out for their own self-interests. I do not expect any new legislation which would explicitly tax employee miles; Corporate America simply contributes entirely too much money to the Congress for its members not to address its concerns.

As I have stated previously, I believe that the Internal Revenue Service could effectively tax employee miles as either compensation within the meaning of I.R.C. § 61(a)(1) or as a taxable fringe benefit within the meaning of I.R.C. § 61(a)(1) and Treas. Reg. § 1.61(a)(1). From a tax policy standpoint, it is simply unfair to discriminate in favor of the employees who receive frequent flyer miles as compensation from their employers rather than cash.

It is inequitable to tax an individual's cash compensation and not to tax an individual's free air travel received as compensation. Above all, it is inequitable for the Internal Revenue Service to allow companies to deduct corporate travel as an ordinary and necessary business expense under I.R.C. § 162(a)(2), and thereafter not include the value of the employee miles in the gross income of the employee. This provides a windfall to both the employee and employer. Unfortunately, what gives rise to sound tax policy does not always give rise to good politics.