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The Case For (And Against) Surrogate Taxation

Julie Roin

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Abstract

The 2017 Tax Cut and Jobs Act significantly revised long-standing rules regarding the tax treatment of many employer provided in-kind benefits. Instead of including the value of these benefits in the recipients' taxable income, for the most part the new rules disallow employers a deduction for the cost of providing the affected benefits. This article argues that the two components of this legislative scheme – relying on cost of provision as the measure of taxable income and on imposing the nominal tax obligation on providers rather than recipients – are distinct policy decisions. It argues that the better approach would be to require employers to allocate their costs of providing benefits among recipients of those benefits.

Introduction

If a law firm provides its associates with lunch when they attend an in-house continuing legal education seminar, should those associates be taxed on the market value of those lunches? Should it matter whether the well-fed associates normally go out to lunch, or bring their lunches from home, or simply skip the mid-day meal altogether? If the associates are not taxed, should the law firm be allowed to deduct its cost of providing those lunches? Should a law firm be allowed to decide between forgoing its deductions or requiring its associates to include the value of those lunches in income? And what if the employer is a tax-exempt enterprise, indifferent to the penalty of a loss of deductions?

Questions about the proper tax treatment of employer provided in-kind benefits have long troubled scholars and Congress.[1] On the one hand, many such benefits—like employer-provided lunches--indubitably directly reduce the normally nondeductible personal, family or living

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* Seymour Logan Professor of Law, University of Chicago Law School. I am grateful for comments received from Saul Levmore, and for the research support provided by the Samuel J. Kersten Faculty Fund.

[1] Michael J. Graetz, et al, Federal Income Taxation Principles and Policies 100 (8th ed. 2018) ("The taxation of fringe benefits has been troublesome since the beginning of the income tax in 1913 and has proven to be surprisingly complex."); Yehonatan Givati, Googling a Free Lunch: The Taxation of Fringe Benefits, 69 Tax L. Rev. 275, 277 (2016) ("the most recent academic works on the subject date back over thirty years"); Kim Brooks, Delimiting the Concept of Income: The Taxation of In-Kind Benefits, 49 McGill L. J. 255, (2004)(arguing for taxation of benefits at fiar market value); Avery Katz & Gregory Mankiw, How Should Fringe Benefits be Taxes, 38 Nat'l Tax J. 37, 37 (1985)("[T]he treatment of fringe benefits…has posed persistent theoretical and practical difficulties for the federal income tax system….The valuation problem has attracted significant attention from policy-makers dating back at least to the Kennedy administration…"); Daniel Halperin, Broadening the Base—The Case of Fringe Benefits, 37 Nat'l Tax J. 271 (1984); Karla W. Simon, Fringe Benefits and Tax Reform: Historical Blunders and a Proposal for Structural Change, 36 U. Fla. L. Rev. 871 (1984); William D. Popkin, The Taxation of Employee Fringe Benefits, 22 B.C.L. Rev. 439 (1981); John S. Nolan, Taxation of Fringe Benefits, 30 Nat'l Tax J. 359 (1977); Joseph H. Guttentag, et al, Federal Income Taxation of Fringe Benefits: A Specific Proposal, 6 Nat'l Tax J. 250, 250 (1953) ("[T]his increase [in the use of fringe benefits] has generated a substantial amount of controversy as to the taxability of some types of fringe benefits…").

expenses of recipients.[2] Allowing such benefits to escape taxation risks the development of a vicious spiral, in which ever more employers substitute such benefits for cash salary, gutting the tax base.[3] And yet, the difficulties involved in discerning the appropriate amount to include in income has made Congress wary of mandating any income inclusion, fearing it will merely create different distortions.[4] This policy dilemma is not limited to business related meals and entertainment. One can see similar problems arising in other contexts, such as employer-provided uniforms[5], reimbursements or other assistance for commuting expenses[6], and employee discounts. To what extent should employers be allowed to confer economic benefits on employees without those employees having to include the benefits in income? This is not an easy question, and the answers that Congress has provided to it has changed over time. Its most recent position, found in the Tax Cuts and Jobs Act of 2017[7], or the TCJA, is decidedly less taxpayer-friendly than prior law. Yet as the Article argues, it may remain more taxpayer-friendly than it ought to be.

The underlying rationale for these new restrictions on deductions and exclusions is that the affected benefits defray otherwise nondeductible personal expenses, and should be included in the income of their recipients without an offsetting deduction. However, the new statutory regime, like some of its predecessors, does not provide a direct route to that end. It rarely requires employees to include the value of employer-reimbursed or provided benefits in their gross income without an offsetting deduction. Rather, the new rules generally serve to increase the taxable income of—and the tax paid by--employers rather than employees by eliminating employer deductions for the cost of providing such benefits. In the first instance, it will be employers rather than employees who suffer the fiscal burden of most of the tax increases imposed by the TCJA. This sort of "substitute" or "surrogate" taxation is far from unknown in the income tax system; indeed, a commonly held view of the corporate tax is that it is a surrogate for taxing shareholders.[8] The aim of this Article is to evaluate surrogate taxation in the context of

[2] See I.R.C. §262(a) ("Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.").
[3] See Michael J. Graetz, supra note 1, at 100 ("It is clear that excluding all noncash compensation from income, while simple, would very quickly produce a barter economy for labor income.").
[4] See id.("On the other hand, taxing any economic benefit, no matter how closely related to an employee's work, would violate public perceptions of fairness and would dramatically increase the costs of tax compliance….").
[5] The general rule is that uniforms can be excluded from income as long as they are not suitable for "street wear". Yet, in many if not most cases, even uniforms which are not suitable for "street wear" defray employees' personal, family or living expenses by eliminating the recipients' need to purchase and maintain "street" clothes for use during working hours. This can lead to significant savings on wardrobe expenses. There are some exceptions to this general rule. The provision of academic robes for use at graduations and other formal university events does little if anything to reduce clothing expenses as normal clothing has to be worn under such robes. The same is true of doctors' coats—but usually not of nurses' uniforms.
[6] Commuting expenses are regarded as a function of employees' choice of living accommodations, and thus a component of personal, family or living expenses. However, they are at least as much a function of where employers choose to locate their operations: near affordable housing and/or access to public transportation, or in semi-rural areas, or Silicon Valley, with a severe lack of housing affordable by most employees. In prior years, Congress acceded to some pleas for relief with limited exclusions for employer-provided commuting assistance; these have been scaled back or eliminated in the TCJA.
[7] Pub. L. 115-97.
[8] See Citizens for Tax Justice, Fact Sheet: Why We Need the Corporate Income Tax, June 10, 2013, at https://www.ctj.org/fact-sheet-why-we-need-the-corporate-income-tax/ ("If Congress simply repealed the corporate income Tax and did nothing else, this would create an enormous *personal* income tax loophole"); Eric Toder & Alan

employer provided, or reimbursed, fringe benefits. It is in a sense a re-examination of earlier intuitions about surrogate taxation[9] in light of the TCJA—a statute that will come as a great and unpleasant surprise to many who enjoy and provide free lunches and other benefits.

I. The Problem of Mixed Motive Expenditures

Income taxation would be much simpler if there was a clear line separating "business" from "personal" expenditures. Unfortunately, no such clear line exists. Many expenditures which advance non-compensatory business goals also benefit individual taxpayers. The same air conditioning which keeps computers from overheating also makes employees more comfortable, less cranky, and undoubtedly more productive—and reduces their dry-cleaning bills. Although emplooyers routinely deduct air conditioning costs, no deduction would be allowable if workers brought their own air conditioners to an un-air conditioned workplace.[10] Free coffee keeps employees awake and at their desks longer, while simultaneously reducing the amount of (otherwise nondeductible) money they spend at Starbucks. Even taxpayers may be uncertain as to which of the two motivations (increasing productivity or covering employees' personal expenses) is the predominant, or motivating one. But allowing an employer-side deduction coupled with an income exclusion for the employee provides opportunities for tax-favored compensation. For example, a taxpayer may bring a firm's client[11] to a sporting event in order to lobby the client to invest more funds with her investment management firm. Tickets to the event cost $100 each. If the taxpayer's marginal tax rate is 35% and she would have paid $100 to see the event, she is much better off than she would have been had she received or earned $100 in taxable cash. After tax, she would have been left with only $65 in cash, as opposed to enjoying the $100 ticket. Or, to look at it from another angle, she would have had to receive $153.85 in

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D. Viard, Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax, at 1 -2, April 4, 2014, available at SSRN:https://ssrn.com/abstract=2426657 or https://dx.doi.org/10.2139/ssrn.2426657 ("In a textbhook version of a neutral income tax system, there would be no separate corporate income tax. All business profits would be allocated to owners of businesses, who would include them in their income subject to individual income tax….But there are severe practical problems with applying the flow-through method to large publicly-traded corporations."). The corporate tax's inadequacies as a surrogate—its introduction of tax-induced distortions of corporate finance and behavior—underlie various proposals for its reform. See Eric J. Toder & Alan D. Viard, supra, at 1 (advocating cdurrent taxation of "American shareholders of publicly traded companies at ordinary income tax rates on their dividends and accrued capital gains"); Alvin Warren, Jr., Reporter's Study of Corporate Tax Integration, ALI Federal Income Tax Project, Integration of the Individual and Corporate Income Taxes, March 31, 1993, at 12 (advocating integration proposal because "*conversion of the separate U.S. corporate income tax into a withholding tax would reduce economic distortions and troublesome legal distinctions that arise under current law*").

[9] See Jay A Soled, Surrogate Taxation and the Second-Best Answer to the In-Kind Benefit Valuation Riddle, 2012 B.Y.U. L. Rev.153 (2012).

[10] At best, the expense would be allowed as a below-the-line employee business expense. Even before enactment of the TCJA, which "suspends" all deductions for employee business expenses for tax years between 2017 and 2025, employee business expenses were treated as "miscellaneous itemized deductions," deductible only to the extent that they, together with other miscellaneous itemized deductions, exceeded 2 percent of a taxpayer's adjusted gross income. I.R.C. §67(a). Just as importantly, both the IRS and courts tended to regard employee provided office improvements as personal in nature. See Henderson v. Commissioner, 1983 Tax Ct. Memo Lexis 419, at 4 - 5, 46 T.C.M. (CCH) 566, (disallowing deduction for amounts paid by South Carolina assistant attorney general for office decoration expenses).

[11] The tax treatment of the firm's client—and the appropriateness of a deduction by the payor for such expenses—is a separate and complicated issue that I hope to deal with in a subsequent article.

cash salary to afford (after tax) that ticket. The employee would even come out ahead if she values her ticket at only $80.[12] And the employer also was once able to come out ahead. Not only could it deduct the ticket costs,[13] but it might have been able to reduce the employee's cash salary to take into account the benefits derived by the employer in noncash form. If an employee valued the ticket at $100, the employer could have structured the compensation package to include both the ticket and a cash salary that was $130 less than what it would have had to pay in the absence of the ticket. Such implicit (or explicit) trades split the value of the tax favor (deduction plus exclusion) between the employer and employee.

In many (and hopefully most) of these situations, there is more at stake than simply paying compensation to an employee. Businesses need a noncompensatory rationale for providing tickets or meals, or these items would have to be included in the income of the recipients.[14] If a business' aim is to corral the client into a situation where a sales pitch could be delivered, paying its own employee $100 in cash will not achieve the goal—nor will paying an additional $100 to the client or customer suffice. A ticket (or perhaps a nice meal) is required.[15] If attaining this business objective is valuable enough, such tickets or meals might continue to be provided even if the recipient employee attaches no or negative value to them. It might be worth $200 (or $200 less taxes) to the employer to create the sales pitch opportunity. But the more value the recipient employees attach to the tickets or meals, the more valuable the benefit of combining deductions with non-inclusion, and the greater the incentive for employers and employees to collude in manufacturing situations in which business can be mixed with pleasure.

Neither employers nor employees are likely to have total control over many of these expenditures. In the case of business entertainment and meals, for example, the clients' preferences often have to be taken into account. However, the greater a recipient's control over the choice of entertainment or dining venue, the more likely it is that she will attach substantial value to its receipt. It is unsurprising that both courts and Congress have been particularly suspicious of employees' attempts to deduct unreimbursed employee business expenses. If the expenditures were truly "necessary" to the business, they wonder, why were employers not paying for them? Courts often concluded that such expenditures bore only "some remote or incidental connection" to business goals and that they therefore constituted a nondeductible "personal" expense.[16] Even before the TCJA, Congress had relegated unreimbursed business expenses to below-the-line status,[17] and included them in the category of "miscellaneous

[12] She would have to receive $123.08 in pre-tax cash to be left with $80 post-tax.
[13] In recent years, that deduction was limited to 50 percent of the costs of the ticket. The TCJA disallows all deductions for entertainment expenses.§ 274(a).
[14] See Treas. Reg. §1.61-2(d)(1) ("[I]f services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation.").
[15]The appropriate tax treatment of the client is, as noted supra note 11 a separate and somewhat different issue.
[16] Henderson v. Commissioner, supra note 10, at 4 – 5 (disallowing deduction for amounts paid by South Carolina assistant attorney general for framed print and live plant used to decorate office); Duggan v. Commissioner, 77 T.C. 911 (1981) (no business deduction allowed for voluntary contributions to firehouse mess); Sibla vs. Commissioner, 68 T.C. 422 (1977) (fireman allowed to deduct mandatory (under regulations promulgated by the L.A. Board of Fire Commissioners) contributions to firehouse mess as a business expense).
[17] Prior to 1986, select categories of unreimbursed employee business expenses were allowed as above-the-line deductions. However, the Tax Reform Act of 1986 required all unreimbursed employee business expenses to be treated as itemized deductions. See Staff of the Joint Comm. on Tax'n, General Explanation of the Tax Reform Act

itemized deductions."[18] The TCJA effectively did away with them entirely by "suspending" the deductions for all miscellaneous itemized deductions including employee business deductions between 2018 and 2026.[19]

By contrast, greater latitude traditionally has been granted when the employer made the choice of the entertainment, or at least ratified the expense by reimbursing the employee for it. Reimbursed business expenses of employees were (and are) treated as above the line deductions, offsetting the reimbursements required to be included in employees' income.[20] It is more plausible in such cases that the employee's benefit is smaller than the market value of the transferred item or experience, and could even be negative. The employee may be dragooned into entertaining a client at a football game, even though she hates the sport or at a musical event that she finds excrutiating. Requiring an employee to include the market value of a ticket thrust upon her could easily lead to her over-taxation. And even where the employee chooses the activity or the meal, the employer is likely to place limits on the expenditure to prevent employees from making unnecessary and self-serving, extravagant expenditures that would not increase the likelihood of further business from the entertained client.

But one should not be carried away by this positive description of tax law. While employer reimbursement can provide a limited check on employee misbehavior, plenty of opportunity and motivation remains for employers and employees to collude at the expense of the government. As explained earlier, the nontaxation of any benefit derived by an employee provides a tax gain that can be split between the employer and the employee.[21] The result is both a reduction in tax revenues and a distortion of consumption patterns, as employees and employers opt for shows, restaurant meals, and parking over cash salary and other goods (or services). Moreover, because

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of 1986, Joint Comm. Print, May 4, 1987 [1986 GENERAL EXPLANATION], at 79. The current statute continues to exclude unreimbursed expenses attributable to a taxpayer's business of performing services as an employee from above-the-line status. See I.R.C. § 62(a)(1) (excluding unreimbursed business expenses attributable to the trade or business of "the performance of services by the taxpayer as an employee" from trade or business deductions allowable as a deduction when reducing gross income to adjusted gross income). The consequences of being relegated to below-the-line, or section 63 status, are profound. Most importantly, such deductions can be claimed only by taxpayers who elect to itemize their deductions. In 2014, about 30 percent of taxpayers itemized, with the remainder claiming the standard deduction. Chenzi Lu, Itemized Deductions, Tax Policy Center, Urban Institute & Brookings Institution, January 27, 2017, at https://www.taxpolicycenter.org/publications/itemized-deductions/full. Further, between 1990 and 2017, high income taxpayers were required to phase-out up to 80 percent of their itemized deductions as their incomes exceeded a statutory floor. See I.R.C.§68 (2017). This phase-out is scheduled to resume in 2028.

[18]Section 67(a), which provides that itemized deductions falling within the category of "miscellaneous itemized deductions" could be deducted only to the extent that the aggregate of such deductions exceeded 2 percent of the taxpayer's adjusted gross income, was also added by the Tax Reform Act of 1986. 1986 GENERAL EXPLANATION, supra note 17, at 79. See I.R.C. §67(a).

[19] Joint Committee on Taxation, General Explanation of Public Law 115-97, JCS-1-18, December 2018, at 74 [2017 GENERAL EXPLANATION].

[20] I.R.C. § 62(a)(2)(A). In fact, taxpayers may exclude both reimbursements under an "accountable plan" and the associated expenses from their tax returns.Treas. Reg. § 162-2(c)(4).

[21] For example, if an employee in the 35 percent bracket receives a ticket worth $80 (to her), that is the equivalent of $123 in taxable cash salary. If the employer reduces her cash salary by $100, both come out ahead. This mutual gain is clearest when the employer's cost of acquiring the ticket is less than $100, but it is not necessarily limited to such situations. If the employee's presence at the event fulfills some independent business purpose worth $40 to the employer, the employer would still come out ahead if the ticket cost $140.

some types of employers are uniquely positioned to provide valuable nontaxable fringe benefits (think airlines and restaurants), overall patterns of business investment are likely distorted because their pre-tax wage expense is lower.

II. Statutory Developments

Neither the IRS nor Congress has been blind to the problems posed by mixed motive expenditures. The IRS regularly polices the boundary between personal and business expenditures and receipts.[22] But such policing has been difficult and uneven,[23] hampered by doctrinal and statutory tests that often turn on complex factual determinations[24] or the subjective motivations of taxpayers.[25] Its efforts have been buttressed by periodic statutory reforms enacted by Congress.

The first major[26] statutory reform came in 1962, with the addition of section 274 of the Code.[27] This Code section took aim at the contexts in which Congress perceived the most egregious tax abuses: business travel, meals, entertainment and gifts. The original version of section 274 utilized a tripartite approach. First, it flatly disallowed deductions for some specific expenditures, such as the costs of business "gifts" in excess of $25 per recipient per year[28] and for facilities used less than one-half the time for business entertaining.[29] Second, it required taxpayers seeking deductions for those expenses which were not automatically disallowed to demonstrate a closer relationship between the expenses and specific business transactions than had been previously

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[22] See Yehonatan Givati, supra note 1, at 276 ("the IRS and Treasury intended to focus on employer-provided meals as one of their top tax priorities for the 2014 – 2015 tax year"); .Richard Schmalbeck & Jay A Soled, Elimination of the Deductions for Business Entertainment Expenses, __ Tax Notes 757, 761 (May 11, 2009), at https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2733&context=faculty_scholarship (noting "the substantial number of court cases in which this issue has been litigated").

[23] Richard Schmalbeck & Jay A Soled, supra note 22, at 757 ("the business nexus claimed to justify the expense cannot, as a practical matter, be adequately policed by the IRS").

[24] For example, the exclusion provided under section 119 for certain meals and lodging provided on the business premises of the employer incorporates the common law requirement that the items be provided "for the convenience of the employer." See MICHAEL J. GRAETZ, ET AL, supra note 1, at 116-120 (discussing evolution and interpretation of I.R.C. § 119).

[25] Famously, the Supreme Court allowed for the possibility of the deduction and exclusion of "business gifts" as long as they "proceed[] from a 'detached and disinterested generosity'" as determined by the transferor's "intention." Commissioner v. Duberstein, 363 U.S. 278, 285 - 286 (1960).

[26] Section 119, which imposed some limitations on the common law doctrine that employees could exclude from gross income the value of food and lodging provided on the employer's business premises "for the convenience of the employer," was added by the Internal Revenue Code of 1954. See MICHAEL GRAETZ, ET AL., supra note 1, at 117 ("the first legislative treatment of the problem").

[27] Section 274 was added to the Internal Revenue Code by the Revenue Act of 1962, Pub. L. 87-834 §4, 76 Stat. 960.

[28] I.R.C. §274(b) [1963]. The $25 limit remains in place today.

[29] I.R.C. §274(a)(1)(B) [1963] (taxpayer must establish that facility used "primarily for the furtherance of the taxpayer's trade or business….and such deduction shall in no event exceed the portion of such item directly related to….the active conduct of the taxpayer's trade or business"). Congress entirely eliminated the deduction for "entertainment facilities" in the Revenue Act of 1978 (P.L. 600).

deemed acceptable as grounds for a deduction.[30] Finally, it enhanced the documentation required to substantiate the existence and amount of expenditures for which deductions were claimed.[31]

When crafting section 274, Congress excluded from its scope both "reimbursed expenses"[32] and "expenses treated as compensation."[33] These exclusions were described as necessary to prevent the double disallowance of a single expenditure;[34] no one at the time seems to have noted that taken together, these exclusions effectively allowed employers to choose between accepting the disallowance of their own deductions—and increasing their income by the amount of the disallowed deductions—or qualifying for those deductions by reporting the expenditures as additional compensation to recipient employees. The affected employees would not be allowed to offset any such inclusion with a business deduction so that they, rather than their employers, would bear the resulting tax obligation. Essentially, the statute allowed employers to choose between bearing the fiscal burden of the newly added deduction restrictions or passing them onto their employees.

It is a tax policy truism that allowing taxpayers options always costs the government money, and it is easy to see that taxpayers would take advantage of this opportunity to ensure that the additional income generated through the deduction limitations and disallowances contained in section 274 ended up in the income of the taxpayer facing the lowest marginal tax rate. The only context in which this opportunity for tax arbitrage seems to have been noted, however, was business gifts. Such gifts continued to flourish in contexts in which the effective loss of the deduction for business gifts under section 274(b) had no effect: where "donors" were tax-exempt or loss-making entities or where deductions would have been unavailable in any case due to the "personal" nature of the employment relationship, such as payments to household employees. But it took years for Congress to take action even in this context. Congress did not enact section 102(c), which expressly provides that the exclusion from gross income generally applicable to gifts "shall not exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee," until 1986.[35]

[30] See I.R.C. §274(a)(1)(A) [1963] (business entertainment must be "directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion….such item was associated with, the active conduct of the taxpayer's trade or business"). As originally crafted, this statute allowed deductions for "good will entertainment." See Michel G. Emmanuel & Norman H. Lipoff, supra note 34, at 439. ("The words 'or associated with' were added by the Senate….to permit deduction of expenses…which are incurred in the creation or maintenance of good will."). "Good will entertainment" did not survive the Tax Reform Act of 1986. See 1986 GENERAL EXPLANATION, supra note 17, at 56 (taxpayer "must have had more than a general expectation of deriving some income or other business benefit (otyher than merely goodwill) at some indefinite time").

[31] I.R.C. §274(d) (requiring detailing substantial requirements).These requirements were among the most controversial—likely because they were the most effective at preventing abuse—provisions of the new law. See Michel G. Emmanuel & Norman H. Lipoff, supra note 34, at 516 (1963) (substantiation requirements "stimulated the most vehement public reaction").

[32] I.R.C. § 274(e)(3) (2018).

[33] I.R.C. §274(e)(2) (2018).

[34] See Michel G. Emmanuel & Norman H. Lipoff, supra note 34, at 497 ("The purpose of the exception is to avoid double disallowance of a single expenditure, once to the employee or practitioner, and a second time to the client, customer, or employer.")

[35] See Tax Reform Act of 1986, P.L. 99-514, §122(b).

Neither section 274 nor section 102(c) eliminated the concerns about the proliferation of "tax free" fringe benefits. Doubts about the proper boundary between personal and business expenditures were not limited to business entertainment, meal and travel expenses and business gifts.[36] Employers came up with a number of other avenues for transferring value to employees that fell outside the specific proscriptions of section 274 while plausibly falling within the confines of a "business expense." Employers provided discounted (or free) air fare, hotel rooms, cars and merchandise, and increasingly absorbed work-related costs such as commuter parking and in-service meals. Congress reacted to this this creativity in 1984 with the enactment of section 132 of the Code.[37] It operates to exclude a wide variety of benefits from employees' gross income, without any corresponding loss of the employer's deduction. But the permitted exclusions are hedged with a variety of restrictions. Some types of benefits can only be provided on a tax-free basis if offered to a "nondiscriminatory" group (which is to say a large group, not all of whom are high-income, high marginal tax bracket) employees;[38] others could only be offered by some types of employers;[39] and employee discounts on goods and services sold in the regular course of the employer's business are capped.[40] Overall, section 132 seemed designed to continue the favorable tax treatment (exclusion plus deduction) of then-existing fringe benefit arrangements, while seeking to prevent their growth or their spread to new contexts.

In addition to explicitly authorizing a wide variety of employer provided tax free fringe benefits once certain conditions were met, section 132 contains a residual escape clause for benefits that do not fit into one of the broadly described, but carefully cabined fringe benefit categories described in the statute. Section 132(d) allows taxpayers to exclude from income "any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167." This phrasing—and conditioning the exclusion solely on the ability to pass the initial screen of sections 162 and 167-- allows employees to exclude from income some benefits the

[36] Moreover, many of the rules contained in section 274 came to be seen as too favorable to taxpayers. Congress completely eliminated the deduction for entertainment facilities in 1978, see Revenue Act of 1978, P.L. 95-600, §361(a), restricted the availability of deductions for the cost of attending conventions outside the United States in 1976, see Tax Reform Act of 1976, P.L. 94-455, §602(a) (adding I.R.C. §274(h), and disallowed deductions for scalpers' fees, luxury water transportation, and the travel expenses of family members accompanying a business traveler in 1986. See Tax Reform Act of 1986, P.L. 99-514, §142(b) (adding I.R.C. §§ 274(l) & (m)). The Tax Reform Act of 1986 also disallowed 20 percent of otherwise deductible business entertainment and meal expenses, see id; I.R.C. § 274(n); a disallowance which was raised to 50 percent in 1993, as part of the Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, § 13209(a)..

[37] The Deficit Reduction Act of 1984, P.L. 98-369, §531(a)(1).

[38] High-income employees receiving benefits falling within the definition of "no-additional-cost services" and qualified employee discounts can exclude those benefits from gross income only if such benefits were "available on substantially the same terms to each member of a group…which does not discriminate in favor of highly compensated employees." I.R.C. §132(j).

[39] "No-additional-cost services" could only consist of "service[s] offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services." I.R.C. §132(b)(1). Commercial airlines could offer their employees free plane trips, but manufacturing companies could not. Likewise, "qualified employee discounts" could only be offered with respect to goods or services "offered by the employer to customers." I.R.C. §§132(c)(1)(A) & (B). Brooks Brothers could offer its employees a discount off list price for suit purchases, but a law firm could not do the same for its attorneys even if they were expected to wear Brooks Brothers suits.

[40] I.R.C. §§132(c)(1)(A) & (B) (limiting discount on property to the employer's "net profit percentage" and on services to 20 percent of the price charged customers of the employer).

cost of which would not in fact have generated an offsetting deduction. In particular, taxpayers can claim the benefit of the exclusion even if the offsetting deduction would have been partially or fully unavailable by operation of section 274.[41] As in other situations in which section 274 applied, the employer has the option of absorbing the tax costs associated with the loss of the deduction, or inflicting it on the employee by including the cost of the benefit in the employee's W-2 income.

Between the mid-1980's and 2016, Congress made numerous minor revisions to the statutory rules for the exclusion and deduction of employer-provided benefits. The TCJA contains the first major changes to those rules. The TCJA withdraws employees' ability to exclude certain fringe benefits from income for taxable years beginning after 2017 and before 2026, it reduces employers' ability to deduct the cost of still-excludable items, and it eliminates the deductions for others beginning in 2026.

Among the benefits immediately losing their favorable tax-exempt status are employer payments of, or reimbursements for, the expenses of moving to a new place of employment[42] and bicycle commuting expenses.[43] Employers can continue to deduct the costs of providing the benefits,[44] inasmuch as the reimbursements are fully includable in the income of recipients. A deduction on one side is matched by an inclusion on the other. As with conventional cash compensation, single inclusion is the rule.[45]

But in the case of other benefits, Congress decided to preserve the existing exclusions for employees, while reducing or eliminating the deduction formerly allowed employers for the cost of providing in the benefits. As a mechanical matter, these deduction limitations are imposed through additions or amendments to section 274 of the Code. For example, employers can still provide employees with "tax free" parking. Parking or parking reimbursements meeting the definition of "qualified parking benefits" remain excludable from the income of employees under

[41]Taxpayers also avoided being caught by the floors and disallowances applicable to itemized deductions under section 62 and 68 of the Code, but this merely put the employees on the same footing as employees with reimbursed business expenses. See supra TAN 20 (taxpayers allowed above the line deductions for reimbursed business expenses). Certainly employees receiving employer-provided benefits are more analogous to employees whose expenses have been reimbursed by their employers than those whose expenses have not been reimbursed.

[42] See I.R.C. § 132(g)(2) (exclusion "suspended" for taxable years 2018 through 2025), IRS Publication 15-B, Employer's Tax Guide to Fringe Benefits (2019), December 18, 2018, at 2 (same) at https://www.irs.gov/pub/irs-pdf/p15b.pdf, . Individual taxpayers, other than members of the Armed Forces, also lost the right to deduct the right to deduct the expenses they incurred in moving to a new principal place of work. See P.L. 115-97. §11048I.R.C. § 217 (   ) (suspending deduction from 2018 through 2025); 2017 GENERAL EXPLANATION, supra note 19, at 77 (same).

[43] See P.L. 115-97, §11047 (suspending exclusion for bicycle commuting benefits from 2018 through 2025); IRS Publication 15-B, supra note 42, at 21 (same). Beginning in 2026, qualified bicycle commuting expenses will again be excludable from income, but employers will lose the right to deduct their costs. See P.L. 115-97, §11047.

[44] See I.R.C. §274(l)(2) (allowing deduction for employers' costs of providing qualified bicycle commuting reimbursement "for any amounts paid or incurred after December 31, 2017, and before January 1, 2026").

[45] See Julie A. Roin, Unmasking the "Matching Principle" in Tax Law, 79 Va. L. Rev. 813, 816 (1993) ("In business transactions, application of the matching principle requires that when one taxpayer takes a deduction, another must include the deducted amount in its income.").

section 132,[46] but section 274 now eliminates employers' deductions for some of the costs of providing such benefits.[47] Similar "exclusion but no deduction" treatment is accorded to "qualified transportation fringe benefits" more generally [48] as well as a small subset of employer-provided athletic facilities.[49] The only transportation benefit which must be included in the gross income of employees is the bicycle commuting fringe—a benefit which has always been a disfavored step-child in the category of "qualified transportation fringe"[50] The deduction for the expense of "directly related" and "associated" business entertainment,[51] previously capped at 50

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[46] See I.R.C. § 132(f)(C) (exclusion for "qualified parking"); IRS Publication 15-B, supra note 42, at 20 - 21 (describing exclusion for "[q]ualified parking").

[47] I.R.C. §§ 274(a)(4) ("No deduction shall be allowed under this chapter for the expense of any qualified transportation fringe (as defined in section 132(f)) provided to an employee of the taxpayer) & (l) (denying deduction for "any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence and place of employment…"). The General Explanation suggests that employer' deduction disallowance must include "the direct and other properly allocable costs that it incurs to maintain and provide the qualified parking to its employees," including "appropriate allocations of depreciation and other costs" for such facilities, even if such amounts exceed the value of the parking being provided. See 2017 GENERAL EXPLANATION, supra note 19, at 189 - 190 and note 962. Nonprofit employers must treat their costs of providing "qualified transportation fringe" benefits, including the costs of any parking facility "used in connection with qualified parking" as "unrelated business taxable income." I.R.C. §512(a)(7). This has the effect of levying a 21 percent excise tax on these amounts. Despite the language in the General Explanation, the "interim guidance" issued by the IRS provides that employers may claim depreciation disallowances for parking facilities that they own, and fails to require such employers to include anything like an imputed lease value for the underlying property. See Internal Revenue Service, Notice 2018-99, Parking Expenses for Qualified Transportation Fringes Under § 274(a)(4) and § 512(a)(7) of the Internal Revenue Code, pp. 7-8, at https://www.irs.gov/pub/irs-drop/n-18-99.pdf ("For purposes of this notice, "total parking expenses' include, but are not limited to, repairs, maintenance, utility costs, insurance, property taxes, interest, snow and ice removal, leaf removal, trash removal, cleaning, landscape costs, parking lot attendant expenses, security, and rent or lease payments…. A deduction for an allowance for depreciation on a parking structure owned by a taxpayer and used for parking by the taxpayer's employees is…not a parking expense for purposes of this notice."). As one commentator noted, this is "like estimating the cost of homeownership based on the utility bills but not the mortgage payment….[A] parking lot's land and construction costs range from 49 percent to 86 percent of total costs." Michael Anderson, Believe it or Not, Trump put a Huge Tax on Parking Lots – Maybe by Mistake, Streetsblog USA, Feb. 14, 2019, at https://usa.streetsblog.org/2019/02/14/believe-it-or-not-trump-put-a-huge-tax-on-parking-lots-maybe-by-mistake/. This rule obviously favors employer-owned parking facilities over employer-leased facilities—as well as parking benefits over other forms of qualified transportation benefits.

[48] See id. "Qualified transportation benefits" include vanpooling (such as the buses Apple provides to transport employees from their homes to its campus) and mass transit passes. 2017 GENERAL EXPLANATION, supra note 19, at 188 (describing qualified transportation fringes and deduction elimination).

[49] See §§ 274 & 512(a)(7). These disallowances/inclusions in UBIT apply only to the expenses of on-premises athletic facilities substantially all of whose use is by highly compensated employees and family members.

[50] Even before the TCJA, Congress limited the amount of "qualified transportation fringe benefits" excludable from employees' income under section 132(f). Employees could exclude up to $260 a month of vanpooling, mass transit and parking benefits in 2017, but only $20 per month of bicycle commuting benefits. See Employer transportation benefits in the United States, Wikipedia, at https://en.wikipedia.org/wiki/Employer_transportation_benefits_in_the_United_States (chart tracing exclusion amounts).

[51] Some business related meals are swept within the definition of entertainment. See 2017 GENERAL EXPLANATION, at 189 ("When a meal is included in an activity or event with a client that primarily constitutes entertainment, the provision disallows the deduction for for the entire activity or event, including the meal. For example, food or beverages consumed during a theatre or sporting event would be nondeductible….").

percent of the actual cost, was eliminated in its entirety.[52] However, reimbursements for such expenses continue to be excludable from employees' income as de minimus, or as working condition fringes under section 132, [53] or are allowed to be offset by the deduction provided under section 274 for reimbursed employee expenses.[54]

The TCJA also reduces the availability of employers' deductions for the cost of meals provided for the convenience of employers on their business premises. Prior to enactment of the TCJA, employers could deduct only one-half of the costs of providing many business meals, such as those provided employees traveling away from home on business, or those eaten in company with clients or customers.[55] However, this partial deduction disallowance did not extend to meals meeting the definition of "de minimis fringes" as described in of section 132(e) of the Code.[56] The definition of "de minimis fringes" was surprisingly capacious, including not only food provided at an employer-operated eating facility which charged its users fees sufficient to cover "the direct operating expenses of such facility,"[57] but also to all meals provided for free at such facilities for "the convenience of the employer" and excluded from the income of employees under section 119 of the Code.[58] The costs of providing both types of meals could be fully deducted by employers even as their value was excluded from the income of their recipients. This was a privilege widely exercised by technology and financial firms and even some law

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[52]I.R.C. § 274(a)(1)-(3) ("No deduction otherwise allowable under this chapter shall be allowed…."); 2017 GENERAL EXPLANATION, supra note 19, at 189 ("The provision provides that no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement, or recreation, (2) membership dues with respect to any club organized for business, pleasure, recreation, or other social purposes, or (3) a facility or portion thereof used in connection with any of the above items.").

[53] As discussed earlier, supra TAN 41, section 132(d) allows employees to exclude items, the payment of which would be allowed as a business deduction under sections 162 or 167. Section 274 deduction limitations thus would not affect the availability of such exclusions..

[54] Section 274(e)(3) specifically allows employees to deduct reimbursed employee business expenses (as long as the reimbursement occurs in the context of an "accountable" plan). Because these reimbursed expenses are allowed as an above the line deduction, taxpayers have long been allowed to simply exclude the reimbursements from income. See Treas. Reg. § 1.62-2(c)(4) ("Amounts treated as paid under an accountable plan are excluded from the employere's gross income…"); Internal Revenue Service, Publication 15 (Circular E), Employer's Tax Guide (2019), https://www.irs.gov/pub/irs-pdf/p15.pdf, at 15 ("Amounts paid under an accountable plan aren't wages and aren't subject to income, social security, Medicare and FUTA taxes."). Of course, the employee is not entitled to claim a deduction for the reimbursed expenses when taking advantage of this exclusion.

[55] See I.R.C. §274(n) (disallowing deduction of 50% of the cost of business meals).

[56] See I.R.C. § 274(n)(2)(B).

[57] See I.R.C. § 132(e)(2) ("de minimis" fringe includes meals obtained at an employer-operated "eating facility" located on or near the business premises of the employer, as long as the "revenue derived from such facility normally equals or exceeds the direct operating costs of such facility").

[58] See I.R.C. § 132(e)(2) ("an employee entitled under section 119 to exclude the value of a meal provided at such facility shall be treated as having paid an amount for such meal equal to the direct operating costs of the facility attributable to such meal."). This allowed employers and employees to treat meals received from, or eaten at, company dining rooms or cafeterias as "de minimis benefits" excludable from income under section 132(e). In a series of recent technical advice memoranda, the IRS has signaled that it is seeking to "enforce the requirements and interpretations of Code Section 119 rigorously," William Colgin & John Ludlum, IRS Attempts to Tighten Rules for Business Meal Exclusions, JD Supra, March 7, 2019, at https://www.jdsupra.com/legalnews/irs-attempts-to-tighten-rules-for-83867, and that practices that may have been unquestioned in the past may now come under scrutiny. See Internal Revenue Service, National Office Technical Advice Memorandum 201903017, January 18, 2019, at https://www.irs.gov/pub/irs-wd/201903017.pdf.

firms, often to the ire of politicians.[59] Not all employers found it easy to qualify for such favorable treatment; it did after all require the employer to maintain on on-business-premises "eating facility."[60] Absent such a facility, section 274(n)'s 50 percent deduction disallowance applied.

The TCJA changed the rules for meals provided for the convenience of the employer at on-premises eating facilities. Although the employee exclusion remains, Congress removed their exemption from the 50 percent disallowance rule contained in section 274(n). Employers can now deduct only 50 percent of the costs of providing such meals.[61] Moreover, beginning in taxable years starting after December 31, 2025, the employer's deduction will disappear entirely.[62] The more favorable 50 percent disallowance rule[63] will be limited to the costs of meals eaten while engaged in business travel,[64] customary business meals with clients or customers,[65] and perhaps—and only perhaps--snacks.[66]

Here, too, the TCJA seems to be moving the Code in the direction of a "single inclusion" or matching rule, this time by matching an exclusion with the loss of a deduction. But not all inclusions are the same because (among other things) employers and employees may pay tax at

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[59]Famously, Mountain View has enacted, and San Francisco has under consideration, ordinances which forbid employee cafeterias in new corporate construction "to force tech workers out of their subsidized cafeterias and into neighborhood restaurants." Nellie Bowles, San Francisco Measure Targets A Tech Staple: The Free Lunch, NYT, Section B, p. 2, July 31, 2018; Jay Barmann, Watered-Down Version Of SF's Tech Cafeteria Ban Returns to Supes' Agenda, July 22, 2019, at https://sfist.com/2019/07/22/watered-down-version-of-sfs-tech-cafeteria-ban-returns-to-supes-agenda/. Local politicians hope that forcing employees out of their offices at lunchtime will bring more jobs and investments to the neighborhoods, see Nellie Bowles, id, albeit at the expense of the jobs in those employer cafeterias.

[60]Disputes have arisen over the meaning of "eating facility.". See Office of Chief Counsel Memorandum 201151020, August 31, 2011 (in-flight meals provided to members of flight crew excludable from crew members' gross income under section 119 of the Code, not section 132, because a plane did not constitute an "eating facility"). Courts have been distinctly more generous in their definition of an employer-operated "eating facility" than the Internal Revenue Service, so it is unclear if that Chief Counsel's position would have been upheld in litigation. See Jacobs v. Cmmr, 148 T.C. No. 24, June 26, 2017 (holding that hotel dining rooms constituted employer operated eating facilities so that pre-game meals were "de minimis" fringe benefits and fully deductible expenses for the team owners).[need page cite]

[61] 2017 GENERAL EXPLANATION, supra note 19, at 190 ("[T]he provision reduces the deduction to 50 percent for expenses of the employer associated with providing food or beverages to employees through an eating facility that meets the requirements for *de minimis* fringes and for the convenience of the employer.")

[62] Id.; I.R.C. § 274(o).

[63] I.R.C. § 274(n).

[64] 2017 GENERAL EXPLANATION, supra note 19, at 189.

[65] Id; Internal Revenue Service, Notice 2018-76, 2018-42 I.R.B. 599 (2018). A number of commentators have suggested that allowing a partial deduction for customary business meals conflicts with "the plain language of the statute." Brett Bissonnette, Are Client Meals Deductible After the Tax Cuts and Jobs Act?, 161 Tax Notes 453, 453 (October 22, 2018); Gary R. McBride & Philip P. Storrer, Meals Deductible and Cohan Revived, but 'the Dog Didn't Bark', 161 Tax Notes, 591, 594 (October 29, 2018) ("the pre-TCJA legislative history and statutory language irrefutably declare that entertainment includes" meals with customers and clients).

[66] The language of section 274(o) suggests that expenditures for snack food (see Treas. Reg. § 1.132-6(e) (describing "coffee, doughnuts, and soft drinks" as de minimis fringe benefits) may escape its more draconian rule if provided outside of an employer-provided "eating facility." The question then becomes whether a snack room or snack closet constitutes an employer-operated eating facility. Whereas it is presently advantageous for taxpayers to expand the definition of "eating facility", it will soon become advantageous to argue for a more restrictive definition.

different rates. And as noted earlier, the TCJA does nothing to change the structure of section 274, which allows employers to shift their new tax burdens to their employees by treating the expenditures on the newly taxable (nondeductible) items as additional compensation to recipients, who may be in lower tax brackets than the employer.[67]

The most most notable rate discrepancy likely involves nonprofit employers, those exempt from income tax under section 501 of the Internal Revenue Code.[68] Although tax-exempt employers have to treat their costs of providing a few types of excludable fringe benefits as "unrelated business income," subjecting them to a 21 percent tax,[69] the expenses of providing employees with most types of excludable fringe benefits (including on-premises meals) fall outside this rule[70] and are never included in the income of either employers or employees.

As this snapshot of the changes wrought by the TCJA makes clear, the current rules for the taxation of employer-provided fringe benefits are inconsistent. The value of some benefits must be included in the income of their employee recipients, while others can be reflected in the form of higher income by either the employee or the employer, depending on whether the employer decides to treat the transfer as compensation for purposes of section 274 (in which case the employer would receive a full deduction) or as an excludable fringe benefit (in which case the employer's deduction would be limited or eliminated). It is far from apparent why bicycle commuting expenses should fall in the first category, while mass transit passes and parking provision should fall in the latter. Both sets of benefits defray costs associated with an employee's personal decision about where to live, and this suggests that all these benefits should be included in the income of employees. On the other hand, as discussed below, surrogate taxation—taxing (through non-deduction) the employer rather than the employee—has serious advantages as well as costs. It is a comparison of these benefits and costs that we turn to in Part III.

III. Surrogate Versus Direct Taxation

Many of the purported advantages of surrogate taxation stem from the fact that there are fewer employers than there are employees. Just as pollution is easier to battle in factories than at the consumer level, so too is it easier to track, audit, and collect from a smaller group of employers than the larger number of employees. But administrative ease should not be the only concern. Extracting the right amount of tax should also be a concern, as should the possibility of creating offsetting distortions in behavior. Finally, one arrangement might be more likely than another to reduce the use of noncash compensation in the first instance.

[67] Fewer opportunities will arise if the TCJA's corporate tax rate reduction remains in place. Not that many employees enjoy marginal income tax rates of less than 21 percent.

[68] Non-profit employers employ a non-trivial percentage of the nation's work force. See Brice McKeever & Marcus Gaddy, The Nonprofit Workforce: By the Numbers, NonProfit Quarterly, October 24, 2016, at https://nonprofitquarterly.org/nonprofit-workforce-numbers/ (as of 2013, "the more than 1.4 million registered nonprofit organizations…employed over 10 percent of the domestic workforce").

[69] See infra note 47 (parking expenses).

[70] See I.R.C. § 512(a)(7) ("disallowed fringe[s]" added to unrelated business taxable income include qualified transportation fringes, the cost of parking facilities used "in connection with" qualified parking, and certain on-premises athletic facilities).

A. Administrative Implications

1. **Record Keeping Advantages**.

From an administrative perspective, it is almost always easier to collect taxes levied on a smaller number of taxpayers than on a larger number of taxpayers. Even in an era of computerized returns and audit procedures, numbers matter. Absent some reason to expect employers to be less compliant than individual taxpayers, fewer audits—and hence less manpower managing those audits—would be required to examine the same (or even a larger) fraction of total fringe benefit situations. It is simply easier to look at one tax return than ten.[71] Business taxpayers are more sophisticated than individual taxpayers, and less likely to make inadvertent errors in accumulating and reporting transactions.

But on closer examination, the government's administrative advantages largely disappear in this context. If the amounts at issue were to be included in the income of the actual fringe benefit recipients, they would be includable in their income as additional wages, or, in the alternative, as non-wage income, either of which would be reported on those employees' W-2s. Amounts reported on W-2s are easily incorporated into tax returns, whether those returns are filled out by paid preparers, individual employees, or downloaded onto tax preparation software. Further, the IRS has access to electronic copies of all such W-2 forms, so that any failure to include reported amounts on the applicable individual returns would be picked up by the machine audits routinely performed by IRS computers. Such audits match amounts reported on individual returns to the underlying information returns and notify taxpayers (and the IRS) of any discrepancies.[72] It is worth noting that the two types of benefits made includable in employees' income by the TCJA, bicycle commuting benefits and moving expense benefits, are required to be reported as wages on employees' W-2 forms.[73] Tax withholding obligations also apply to those amounts.[74]

Serious auditing issues would remain if employees included benefits in income. The Internal Revenue Service would be interested in whether employers are treating the correct items—and the correct dollar amounts—as taxable fringe benefits. However, these issues would have to be investigated at the level of the employer no matter who is responsible for the income inclusion; if the employer made a mistake, it would be responsible for sending out amended W-2s, which again could be subject to computer matching and auditing. The additional costs posed by individual reporting would be small to nonexistent from the IRS's perspective.

This is not to suggest that there are no bookkeeping advantages from surrogate reporting, just that they are unlikely to redound to the benefit of the government. Individual reporting would

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[71] If one's goal is to examine the business bona fides of particular transactions, it is certainly easier to work with one central recordkeeper than many individuals. At the very least, there is less travel and organizational time involved.

[72] See Joy Taylor, Watch Out for Tax Audit Red Flags, Kiplinger's Retirement Report, May 3, 2019, at , https://www.kiplinger.com/article/retirement/T055-C000-S004-watch-out-for-tax-audit-red-flags.html ("The agency gets copies of all the 1099s and W-2s you receive. Its computer cross-checks the forms with income shown on your return, and if there is a mismatch it spits out a notice that the IRS will mail to you.").

[73] See Internal Revenue Service, Employer Update, June 28, 2019, https://www.irs.gov/newsroom/employer-update ("Employers must now include [moving expense reimbursements and payments and bicycle commuting benefits] in the employee's wages.").

[74]See Internal Revenue Service, Employer's Tax Guide to Fringe Benefits, Publication 15-B, supra note 42, at 29 (describing tax withholding and deposit requirements).

require employers to keep track of the benefits provided to each employee for reporting purposes. This would be relatively easy for some types of fringe benefits: those that are provided uniformly to all employees (perhaps premium support for medical insurance) or are provided relatively infrequently (such as moving expenses), or are already the subject of individual reimbursements arrangements (such as many business travel expenses). But many benefits are provided in kind, or in multiple small and varied increments, and for those, the bookkeeping costs may be substantial. Consider the difficulties encountered when an employer provides food at lunchtime (or breakfast or dinner) meetings. Not only would the employer have to keep careful attendance of those employees attending such meetings, but it would also have to keep track of which of those individuals actually availed themselves of the available food (and perhaps how much food).[75] This obligation would not be insuperable, but it would be a nuisance, particularly if employees were less than cooperative or diligent in complying with sign in requirements. Employers could face a significant bookkeeping burden as a result of such rules.

The fact that these bookkeeping advantages accrue to employers rather than the government is no reason to ignore them. Reducing costs for taxpayers is also regarded as a social benefit, at least if unaccompanied by offsetting costs. The next sections look at possibly offsetting costs.

2. Cost v. Value Received

Employers would face another problem if forced to reflect in-kind fringe benefits as additional wages income of employees: valuing those benefits. Beyond determining whether in-kind fringe were received by employees, the employer would have to assign a dollar value to such receipts. In some cases, that might not be difficult or controversial because the value of the fringe benefit would closely approximate, if not be identical to, the employer's cost of provision. It is hard for employees to dispute the value of, say, a mass transit pass. And other fringe benefits may be close enough to cash to for such an approach to be acceptable. It is worth noting that Congress has required employees to include in income the cost of providing some in-kind fringe benefits: the newly taxable bicycle commuting costs[76] and the previously taxable company cars.[77] However the correspondence between employer cost and employee value is not always so close or easily determinable.[78] In many cases, like the ones described in the introductory paragraph of this article,[79] individual taxpayers would complain mightily if employers added a pro-rated portion of the cost of providing many of these benefits to their W-2 wages. Such taxpayers would argue that they were being subjected to tax on phantom income, and hence overtaxed. It is

[75] One could, for example, encounter objections raised by a tee-totaling employee who is allocated his or her pro-rata share of the costs of a work dinner at which expensive bottles of wine were consumed.

[76]Internal Revenue Service, Employer Update, at https://www.irs.gov/newsroom/employer-update ("Employers must now include these [bicycle commuting] reimbursements in the employee's wages"). As these were, by definition, cash reimbursements, valuation poses no difficulties.

[77] See Internal Revenue Service, Employer's Tax Guide to Fringe Benefits 2019, Publication 15-B, supra note 42, at pp. 24 – 29 (outlining acceptable valuation methods).

[78] The reasons for such discrepancies, as well as a discussion of how concerned Congress should be over them, are explained in Part III.B.1, infra TAN .

[79] An employee might normally bring a peanut and jelly sandwich or a container of yogurt in for lunch on those days when the employer is not providing a free lunch. The family budget might not normally accommodate a hot meal at lunchtime. Or the employee might simply contend that, left to his or her own devices, it would have been possible to aquire the same benefit for less.

worth noting that both economists[80] and courts[81] agree that employees seldom value items that provided by their employers at full market value or cost. Their lack of personal input in the consumption choice degrades their value.[82] This has led many to conclude that "no businessperson would be comfortable…[with] increasing the salary dollar figure on the fact of each employee's Form W-2 by the amount of entertainment expenditures expended on behalf of such employee."[83]

Leaving employees out of the tax calculation—focusing the tax calculation on the employer—provides a way of avoiding this issue because it would seem so unnatural (not to mention un-administerable) to require businesses to forfeit deductions equal to the value of benefits received by employees. Restricting the deduction for the costs of providing benefits simply seems much more natural and more in keeping with how the system generally calculates income for tax purposes.

Further, such deduction limitations are eminently administerable. Business taxpayers are accustomed to keeping track of the costs of providing such benefits. They have always needed to substantiate those costs for purposes of deducting them. In many cases, although surrogate taxation will change the amount of tax paid by the employer, it will not require any material change in underlying bookkeeping practices. That will not always be the case; newly disallowed fringe benefit costs may not have previously been isolated or segregated from related (or similar) expenditures. On-premises meals might be accounted for together with client meals or business travel meals. But it is hard to believe that separating out the nondeductible portion of such expenses would present a more substantial burden than would devising (and applying) mechanisms for determining the value of benefits provided to employees.

From the standpoint of the tax authorities, it is relatively easy to audit the cost of providing benefits. Again, there may be some difficulties involved in disentangling fringe benefit costs from similar, fully (or partially) deductible ones. But cost can be substantiated in a much more straightforward way than can "value conferred."

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[80]As one academic explained, "[a]mong economic theorists, there is little doubt that taxpayers who receive in-kind benefits are much more likely to value them below the market-price level." Jay A. Soled, supra note 9, at 159. The classic example cited in Henry Simon's treatise on income taxation is of a Flugel Adjutant, or military attache, "who must accompany the emperor, as a condition of his position, to the theater and opera even though he (the Flugel Adjutant) detests both." Id. at 159-160. Although few would willingly opt into a job with such a dramatic mismatch between its duties and the employee's personal proclivities, "[a]s a practical reality….employees may engage in occupations that periodically or regularly cause them to consume goods that they perhaps slightly dislike or thoroughly disdain, signifying that they do not value the receipt of such goods at fair market value." Id. at 160. A partner might choose to invite a client to a baseball game knowing that the client loves attending such games, even though the partner prefers watching such games (if at all) from the comfort of home. What the actual game offers, that home entertainment does not, is the opportunity (during the many slow moments and commercial breaks) to convince the client to direct more business to the firm.

[81]See Turner v. Commissioner, T.C. Memo 1954-38 (1954) (Court discounted value of steamship tickets won in a lottery)

[82] This is similar to the value-destroying phenomenon of gift transfers. See Joel Waldfogel, The Deadweight Loss of Christmas, 83 Amer. Econ. Rev. 1328, 1328 (1993) (finding that "holiday gift-giving destroys between 10 percent and a third of the value of gifts") at. https://www.amherst.edu/media/view/104699/original/christmas.pdf

[83] See Jay A. Soled, supra note 9, at p.153.

But avoiding the valuation issue by shifting the tax focus away from employees onto employers only obscures, and does not solve, the underlying disconnect between the cost of providing some benefits and the corresponding value conferred on employees. More generally, the administratively simpler approach is not necessarily better than more complex alternatives. The tax system would be simpler if everyone was taxed on some hypothetical income amount randomly assigned to them by computer. The question discussed next is whether the advantages of simplicity in the fringe benefit contexst are outweighed by other considerations.

B. Substantive Goals

(Relative) simplicity is one goal of the tax system; another is reliance on a tax base that corresponds to economic income. A further concern is whether the tax being imposed on that base is levied at the correct rate. And it is with respect to these more substantive goals that surrogate taxation faces some challenges.

As detailed above, it is much easier for the tax authorities to focus on cost of provision than the value of the item or services being provided to employees. But in many cases, the employer's cost of provision bears little relationship to the value conferred on the receiving employee(s). Eliding this issue with substitute or surrogate taxation may camoflage this problem, but it does not necessarily ameliorate it. This section assesses the likely behavioral consequences of measuring taxable income by focusing on costs versus benefits conferred. Whether these consequences are positive or negative depends on whether the differential between cost and value is attributable to employers' attempts to achieve noncompensatory business goals or are a form of economic waste incurred in order to qualify for favorable tax treatment. But these pros and cons are identical whichever taxpayer—employer or employee—is directly affected by the use of the measure.

1. Defining the Tax Base: The Move from Benefit to Cost

The first point worth noting is that discrepancies between employers' cost of providing benefits may exceed or fall short of the value attached to those benefits by recipient employees. Though the former is probably more common, the latter should not be ignored.

There are two reasons employer costs may fall below the value of the benefit conferred. The first is the tax system's general failure to recognize an imputed profit margin on self-created property, understating the cost of creating such property.[84] Ignoring the foregone profit margin understates the cost of many employer-provided meals, but may be most monetarily substantial in context of the on-premises parking. A commercial parking operator would charge a fee that included a

[84] This is a general problem with the tax treatment of self-created assets. See Noel B. Cunningham & Deborah H. Schenk, How to Tax the House that Jack Built, 43 Tax L. Rev. 447, 450-451 (1988) (criticizing the failure to tax the economic income "generated as the self-constructor uses his capital on his own behalf"). But it also could apply to meals provided by an employer at an employer-operated eating facility. The cost of a meal purchased from a restaurant general includes not just the restaurant's food and labor costs, but also a profit margin. This foregone profit margin is omitted from the meal costs made (partially) nondeductible by the TCJA. This is the economic equivalent of providing employees with a "qualified employee discount" of the sort excluded from income under I.R.C. § 132(c)—only without necessarily meeting the requirements of that section.

return on its capital investment in land and any building costs. Current IRS valuation rules ignore the cost of those capital investments as well as any accompanying "imputed return" on them.[85]

Employers also may be able to take advantage of volume discounts unavailable to individual purchasers. Historically, the clearest example of that phenomenon has been health insurance. Large employers have traditionally been able to pay less, on a per employee basis, for health insurance than an employee would be charged in the individual marketplace.[86] But volume discounts may also be obtained from restaurants, hotels, and the like.

The more serious problem is that the employer's costs will exceed the value of the benefit conferred on employees (or others[87]). There are several reasons such discrepancies might exist. First, the arrangement might entail economic losses made rational only by the existence of tax benefits. Withdrawing the tax benefits from these arrangments could have the beneficial effect of discouraging their continuance and thereby eliminating this waste. Second, the arrangement might confer noncompensatory, as well as compensatory business advantages. In those cases, the consequences of withdrawing the tax advantages could be less salutary.

When an employer pays more to provide a benefit than the value attached to that benefit by its employee-recipient, and there is no reason for the transfer other than to provide the employee with compensation, from an economic perspective the arrangement wastes money. For example, it makes no economic sense for an employer to spend $50 to provide a meal to an employee who attaches a $40 value to that meal if the employer's only goal is to give the employee an addition to salary. It is equivalent to burning a $10 bill. The employer would be better off giving the employee $50 in cash. Both the employer and the employee would be better off if the employer gave the employee $45 in cash. However, once tax rules enter the picture, the economic calculation changes. If the employee's marginal tax bracket is 30 percent, cash salary is taxable and employer-provided meals are not, for example, providing the meal is a cost-minimizing move. The employer would have to increase the employee's cash salary by $57.14 to leave the employee with $40 of after-tax gain. A $50 meal is cheap by comparison. One reason for treating in-kind benefits such as employer-provided meals and parking more like cash salary is to eliminate the tax incentive to engage in economically inefficient transactions. Once the employer loses its deduction for the cost of providing the meal (or the employee becomes taxable on either the cost or the value of the meal), employers and employees will likely revert to cash transactions.[88]

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[85]The IRS's current definition of "total parking expenses" for purposes of implementing the new disallowance rules expressly exclude any "deduction for an allowance for depreciation on a parking structured owned by a taxpayer and used for parking by the taxpayer's employees" from the definition of a "parking expense for purposes of this notice." Internal Revenue Service, Notice 2018-99, supra note 47, at p. 8.

[86] The advent of Obamacare may have changed this calculation.

[87] Employees are not the only beneficiaries of business meals and entertainment. Often, the true focus (from the business perspective) is a client or customer, or prospective client or customer. Although the arguments for taxing the value of in-kind benefits conferred on non-employees are in some respects similar to those for taxing the value of in-kind benefits conferred on employees, there are enough differences between the two contexts to justify a separate discussion. See supra note 11.

[88] The exact content of those cash transactions, as discussed infra section III.B.2, is hard to predict.

But not all benefits are intended completely, or even primarily, to serve as a means of compensation. Employee discounts,[89] for example, may be offered to entice employees to utilize an employer's wares. Employee use can be a form of advertising. A salesperson can serve as a model for the goods offered for sale in the shop, whether those goods are clothing or cars. Further, the salesperson's personal experience with the goods may make them more knowledgeable about their qualities (or provide useful feedback on their deficits). This knowledge can redound to the benefit of potential customers as well as the owner of the shop. Similarly, the manager of a restaurant can glean much more information about the performance of particular employees as well as the overall quality of the restaurant's service and food if she regularly eats meals there.[90] Employers might gain from encouraging employees to eat together on its business premises, either because such behavior promotes more efficient use of the work day (i.e. shorter lunch breaks) or encourages employee interaction and learning experiences.[91] But given the discrepancy between the cost of home-prepared meals and restaurant meals, it is unlikely that employer-provided meals confer value commensurate with their cost on such employees. The discrepancy between cost and value may correspond to the value of the business purposes achieved as a result of the employee's eating on business premises. The additional money—the discrepancy between cost of provision and the value received by the employee—cannot be described as "wasteful" if it is spent to achieve a valid, noncompensatory business goal, such as better supervision of the overall business operation. A change in tax rules that makes such expenditures more expensive may lead to changes in business practices that are themselves inefficient, because the alternative methods of achieving those business goals may cost more on a pre-tax basis but less on a post-tax basis. For example, suppose (once again) that the employer pays $50 for a meal that the employee values at $40, but also receives $10 of noncompensatory business value from the expenditure. If the employer loses its deduction for the entire $50 cost of the meal (as it will beginning in 2026), it may decide to pay its employee $40 in cash, and spend $20 on some other mechanism to achieve its supervisory goals. All $60 of its costs would then be deductible. This change in business practice would increase its pre-tax costs by $10, but once the tax consequences are factored in, the employer would be left in a better economic position than had it continued its prior practice and lost the entirety of its $50 deduction. [92]

[89] The rules regarding the (nontaxability of) employee discounts are unaffected by the TCJA.

[90] Even the Joint Committee staff seems to believe this. Although at least somewhat at odds with the applicable statutory language, see supra note 65, the Joint Committee on Taxation's interpretation of the TCJA concludes that restaurants and caterers may continue to deduct 100 percent of the expenses of providing meals to their employees at their worksites. See Lisa Haffer, Employee Shift Meals Remain 100% Deductible for Tax Purposes, BDO Blog, January 9, 2019, at https://www.bdo.com/blogs/restaurants/january-2019/employee-shift-meals-remain-deductible-for-taxes ("In good news for the restaurant industry, the Blue Book contains language that confirms that employee shift meals are not subject to the 50-percent disallowance…and instead remain 100-percent deductible"); 2017 GENERAL EXPLANATION, supra note 19, at p. 188 n. 956.

[91] Whether the IRS or the courts will accept such business rationales is open to doubt after the release of a recent technical advice memorandum refusing to accept such rationales as sufficient justification for a § 119 exclusion. See Internal Revenue Service, Technical Advice Memorandum 201903017, supra note 58.

[92] If the employer is a corporation, continuing present practice would lead to a total out of pocket expense of $50. Given the new 21 percent corporate tax rate, a $60 deduction would reduce the employer's tax obligation by $12.60, leaving it with a net after-tax cost of only $47.40, which is lower than the $50 after-tax cost of providing the meal. Under the TCJA, the full cost of on-premises meals becomes nondeductible only in 2026. Prior to that date, employers are entitled to deduct half of the cost of such meals, and the employer would not find it profitable to change its business practices. The "right" rule, of course, would involve taxation (to the employee or the employer)

The example of the restaurant manager eating on-premises meals is just one example of a more common phenomenon, of where the exigencies of the job (the circumstances under which the meal must be eaten) increase the cost of the meals being provided beyond any conceivable concept of "value" conferred on the employee. For example, airline meals are (it seems) very costly to provide because of the specific requirements attendant on airplane travel.[93] The average flight attendant likely could obtain better meals for less money even if reduced to purchasing their meals at overpriced airport shops. However, particularly for long international flights, they may be unable to bring, or airline policy may prevent them from bringing, their own meals on board.[94] An even more extreme example would be that of astronauts. They obviously have to eat while in space—but it is hard to believe that the cost of NASA prepared meal kits bears any relationship to the consumption value of such food were it to be eaten on Earth. Though NASA, as a governmental entity, will not suffer any of the tax strictures introduced by the TCJA, the rise in private space enterprises means that in the not too distant future, private companies will feel the sting of tax rules that will disallow part or all of the costs of supplying astronauts with meals.

In other cases, the exigencies of the job dictate the expenditure altogether. The modern equivalent of the "Flugel Adjutant"[95] is the bodyguard. To serve their purpose, bodyguards must accompany their employers. If their employer attends a cultural or sporting event, the bodyguard must attend as well—and although they will need to have a ticket in order to attend the event, they should not spend much if any time actually enjoying it. They should instead be watching the audience and surroundings for possible threats.

In short, hiding overtaxation from ordinary taxpayers does not ameliorate its economic effects[96]—its effect on the after-tax cost of achieving non-compensatory business goals through mechanisms that have compensatory possibilities. Overtaxation is going to discourage the use of

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of $40, with both a deduction and an exclusion for the remaining $10. However, as noted earlier supra TAN 79 - 84, it is impossible as a practical matter to determine employees' subjective valuations of benefits such as meals.

[93] The average economy class meal costs $10.50 while business class meals cost $33. Kara Godfry, Flight secrets reveal how much your in-flight meal REALLY costs you, Express, Nov. 24, 2017, at https://www.express.co.uk/travel/articles/883867/flight-secrets-plane-inflight-meal-cost

[94] In fact, policies differ from airline to airline as well as between types of flights. Few if any airlines provide crew meals on short domestic flights. Some airlines provide flight attendants with per diems based on the hours worked, some provide special "crew meals" gratis on international flights, while others charge for such meals, and most seem to allow flight attendants to eat leftover passenger meals (if there are any). Pilots are provided business class meals—but each has to order a different entrée to ensure that both are not struck down by an inadvertent food poisoning event. Many flight attendants bring at least some of their meals on board. See Can flight attendants eat the airplane food or do they have to bring their own: Quora, September 8, 2018, at https://www.quora.com/Can-flight-attendants-eat-the-airplane-food-or-do-they-have-to-bring-their-own; Jet, Q&A: 26 Questions Answered by a Flight Attendant, These Gold Wings, https://www.thesegoldwings.com/questions-flight-attendants/; Yahoo Travel, Secrets of the Skies: Flight Attendants and Pilots Tell All, Yahoo Lifestyle, Arpil 21, 2015, at https://www.yahoo.com/lifestyle/secrets-of-the-skies-flight-attendants-and-pilots-116921298437.html.

[95] See supra note 80.

[96] At least, there is no amelioration unless employers are routinely taxed at lower tax rates than employees. As the discussion infra section III.B.3.b explains, this might be true given the recent decrease in corporate tax rates.Whether that rate differential is enough to get taxpayers and the government in "the right place" is open to dispute..

such mechanisms even if they would not result in any economically inefficient behavior.[97] And this discouragement effect is most profound for the least abusive situations, where very little compensation is enjoyed by "recipients" while substantial business goals are advanced. It may be that such discouragement is worthwhile, that the abuse possibilities are so extreme (or so prevalent) that the world would be a better place if the arrangements targeted by Congress in the TCJA were eliminated in their entirety. That is not outside the realm of possibility; perhaps Congress did a good job of identifying those situations with the greatest overlap between employer cost and employee benefit.

At some level, one could argue that many if not most of these situations are no different from the more general phenomenon encountered by businesses operating and taxpayers living in high cost jurisdictions. A person earning $100,000 in New York City has a much lower standard of living than a person earning the same amount in Peoria, Illinois. Yet their federal tax obligations are the same. As a practical matter, this probably works itself out through salary differentials—the person who is paid $60,000 in Peoria probably would not accept a job in New York City that paid less than $100,000. We are used to accepting that employers (and their employees) simply have to suffer financially if they choose to locate in a high-cost jurisdiction, or if their job entails the purchase of high priced clothes (think Brooks Brothers suits) when the employee's preference runs to denim and hoodies. One could make the same argument about employers which have chosen to incur expenditures with a compensatory component or employees who have chosen to work for employers making such transfers. They (or their employees) will be taxed on a certain amount of "phantom income" because alternative rules are no more accurate[98] and often risk the nontaxation of a far larger amount of real income.

That leaves open, of course, the question of in whose hands this possibly phantom income—income defined by cost of provision rather than value to the recipient--ought to be taxed. As explained in Part I, it is generally easier from an administrative standpoint to impose the additional tax on the employer. But as the next sections point out, the choice of taxpayer has substantive as well as administrative implications. It is to those that this paper turns to next.

2. Distributional Implications of the Employer/Employee Choice

In a world of perfect information and bargaining, it should not matter whether income taxes are imposed on employees through construction of a broader tax base or on employers through the loss of deductions. As long as employees and employers pay tax at equivalent rates, the government would collect approximately the same amount of revenue either way. Given that, by definition, employees and employers are in a contractual relationship with one another, the economic burden of the tax is easily reallocated among them. Someone has to bear the tax burden, but its initial allocation is no guarantee of whom that someone will be.

[97] Once one takes into account both the value of the compensation provided and of the independent business purpose served, no part of the cost is wasted or unappreciated.

[98] For example, the partial disallowance rule of § 274(n) applies regardless of the extent (if any) of the discrepancy between employer cost and employee value, and fails to differentiate between situations in which such discrepancies reflect deadweight losses or economic waste and those in which they result from efforts to achieve non-compensatory business objectives.

To take an extreme example, suppose the government changes its tax rules to completely eliminate the taxation of wage income at the individual level, while disallowing employers' deductions for wage expenses. Imagine two taxpayers, UniCorp and Sarah. Prior to this tax change, UniCorp's pre-tax and pre-Sarah's-salary income is $250,000, while Sarah's pre-tax salary is $50,000. And again, prior to this change, both UniCorp and Sarah are subject to tax at a 20 percent rate. Given Sarah's $50,000 salary, Sarah would pay $10,000 in income tax,[99] leaving her $40,000 in after tax income. UniCorp would pay $40,000 in tax,[100] leaving it with $160,000 of after-tax income. The government would collect a total of $50,000 in taxes. Now move to time two, when the tax rules change to make Sarah's salary non-taxable (to her), while UniCorp loses its ability to deduct that salary as a business expense. Now Susan would have $50,000 in after-tax salary, while UniCorp's post-tax income would decrease to $150,000.[101] The government would still collect $50,000 in taxes, but the entire sum would come out of UniCorp's pocket.

At least at first. It is hard to believe that an employer like UniCorp would continue to pay employees like Sarah the same cash salaries in the face of such a change in tax rules. Doing so would grant employees a huge effective pay increase which would be exactly matched by a huge decrease of the employer's after tax profits. One would expect to see (in time three) large reductions in the cash salaries offered employees, so that the employers' outlay for the combination of employee salaries and its new tax obligation closely replicated its pre-change outlay for employee salaries, and the employees' cash salaries closely approximated their (former) after tax salaries. UniCorp would reduce Sarah's salary to $40,000. Although UniCorp would still pay $50,000 in tax, its after-tax-and-salary income would rebound to $160,000, the same as it was in time one.

In the real world, nothing is that easy. Salaries may be set by contracts, even union contracts, that cannot be immediately renegotiated or amended. Decreases in cash salaries may have to take the form of gradual (or not so gradual) decreases in salary growth rather than the immediate diminution of current cash payments. Cash wages tend to be stickier than economists believe they ought to be.[102] In short, transactions costs often interfere with or delay theoretically expected adjustments. But it is unlikely that the long-term incidence of a tax burden will be affected by whether that burden is assigned to employers, through the loss of deductions, or employees, through the loss of exclusions from gross income.

There may well be short run differences, particularly in the fringe benefit context that is the subject of this article. In the UniCorp example, the same amount of income was subject to tax before and after the tax change; the change did not result in an overall increase in tax liability. Further, the arrangements, and the change in those arrangements, were fully transparent; only cash was involved. Neither is true of the (formerly) tax-free fringe benefit context. The TCJA

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[99] $50,000 x .20 = $10,000.
[100] $200,000 x .20 = $40,000.
[101] UniCorp's taxable income would now be $250,000, and its tax obligation would increase accordingly to $50,000. Since UniCorp would now have to pay Sarah's salary and $50,000 out of its $250,000 pre-salary-pre-tax income, it would be left with only $150,000 in cash.
[102] See Cut-price economics, The Economist, August 10, 2019, at 62 ("Wages are notoriously sticky, especially downwards.").

was meant to increase the amount of income subject to tax, and the total amount of tax collected from fringe benefit arrangements. Presumably this additional tax burden will end up being borne in some fashion (either by the payment of higher taxes or by changes in business practices) by the party that benefited from the original tax advantages. But it is usually far from clear who that beneficiary was, and the identity of the beneficiary likely differs from one employment relationship to another. The re-allocation of this additional tax burden is likely to be a fraught and lengthy process.

Although these non-taxable fringe benefit arrangements cost the government money, it unclear who benefited (and by how much) from these revenue losses. The government's losses could have been diverted either to employees (in the form of higher, after-tax wage and benefit packages) or to employers (in the form of lower compensation costs) or some combination of the two. The lack of clarity as to the true beneficiary of the original tax benefit means there is an equal lack of clarity as to who will (or should) suffer when the government decides to revoke the tax benefit. If the employees reaped the entire benefit of that tax favoritism—if they had essentially been paid above-market wages courtesy of the tax code—then one would expect that the tax change would lead to a reduction in that excess wage. However, if employers reaped the economic benefits of that tax favor, by reducing cash wages by an amount greater than the cost of the benefit provided, than one would expect that they would have to make their employees whole by increasing their cash wages to offset the new tax, or they would find it difficult to find new or retain old employees. The lack of transparency as to the original distribution of the tax benefit will make this unwinding process fraught, since neither employers nor employees will be eager to accept the economic loss caused by the withdrawal of the tax subsidy, and employers and employees may have quite different (though no doubt self-serving) interpretations of who benefited from the original subsidy. And the contentiousness of the unwinding process will undoubtedly be aggravated by general tensions regarding wage adjustments.[103] Even when the changes in tax treatment become salient bargaining issues, it may be difficult if not impossible to separate out the specific adjustments in pay packages attributable to the withdrawal of the previously allowed tax benefits from other economic factors affecting wage rates in the short term. The longer-term consequences are even harder to predict. Anything that increases labor costs will push employers in the direction of automation or other labor-saving production techniques. But how hard that push will be will depend on multiple factors, most of which are beyond not only the scope of this paper but also current predictive powers.

The important point is that the amount of additional tax that will be paid by employers and employees due to these tax rule changes will reveal little about the distribution of the additional tax burden that will be caused by the changes. The imposition of a tax, where none existed before, will decrease the joint income of employers and employees as a group. But which of the affected parties suffers how much of this income loss is difficult, if not impossible to discern.. This makes it difficult to evaluate the distributional aspects of the recent changes in the taxation of employer-provided fringe benefits.

[103] One might also fear that powerful, highly compensated executives will use the tax changes as another excuse to justify unreasonable wage demands, while less highly compensated employees are left behine. See Generic Script, The Economist, August 3, 2019, at 55 (noting Mylan's "offering to pay Robert Coury, its chairman, about $1m a year for not using a company plane").

But perhaps the distributional aspects are less important than the behavioral effects of these changes, and in particular, whether the changes will reduce the amount of noncash compensation provided to employees. The next section explores whether (ostensibly) assigning the burden of paying the additional taxes to employers or employees will affect the amount of such benefits provided in future years.

3. Behavioral Implication of the Employer/Employee Choice

Noncash fringe benefits are an impediment to the transparency and efficiency of the tax system. As previous sections showed, there is no administerable rule capable of ensuring that the tax system reflects the correct amount of compensation provided by such benefits in many such cases. Discrepancies in tax computation either inefficiently encourage the provision of in-kind rather than cash compensation, or they discourage efficient business practices that may be mistaken as attempts at tax-favored employee compensation. Inasmuch as there is no "perfect" tax rule on offer, the question becomes what rule is second-best. A good case can be made for using the cost of provision as such a second best rule on administrative grounds. But making this at least the default valuation rule does not, and should not, dictate the identity of the nominal taxpayer. Whether including this cost in the income of employees as additional wage income or in the income of employers through the disallowance of deductions is a separate policy choice. Although administrative simplicity should certainly be one consideration, others include revenue implications, and whether one configuration may reduce the frequency of problematic transactions. As the following section makes clear, the choice between including the value (or cost) of in-kind benefits on employees (by including costs of benefit provision in W-2 income) or on employers (by disallowing deductions for the costs of providing benefits) may well have an impact on those two fronts. The first is salience. The second is differences in relative tax rates.

a. Salience

The imposition of the additional tax burden on employers (rather than employees) has been defended precisely because it is less likely to lead to taxpayer rancor. Not only are employers "artificial entities that do not experience resentment,"[104] they allegedly are in a better position to eliminate deadweight losses inherent in the provision of wasteful in-kind benefits.[105] The contention is that imposing the additional tax burden on employers provides a relatively fast and painless route towards the elimination of wasteful in-kind benefits.

There is, however, some reason to be skeptical of this happy story. Eliminating in-kind benefits requires the acquiescence of employees. Employers cannot impose the terms of employment by fiat. And the elimination of fringe benefits—even wasteful ones--may generate employee resentment, as employees may see only the removal of the valuable benefits and not necessarily connect that removal with adjustments in their cash salaries. Indeed, it might actually be easier to eliminate wasteful fringe benefits precisely by making that waste salient to employees.

One way of sparking a conversation between employers and employees about the desirability of cash versus in-kind benefits would be to include the costs of such benefits in employee's income.

[104] See Jay Soled, supra note 9, at 188 ("surrogate taxation minimizes the sting of overtaxation….[E]mployers are often artificial entities that do not experience resentment in any meaningful way….").
[105] See id. at 153 ("surrogate taxation can serve as a useful tool to help eliminate or, at the very least, diminish deadwight losses to the economy").

If that cost exceeds the employee's valuation of that benefit—if, for example, the employee is deemed to receive the $50 cost of a meal that she only values at $40—her dismay at being taxed on the $10 of phantom income may lead her to lobby her employer to do something different.[106] One would also expect her to lobby the employer to change the form of her compensation package, away from in-kind benefits and in favor of cash. Indeed, an employee might lobby for such a change even if she currently believes that the benefit is worth as much as its cash cost. After all, that equivalence may not continue, and cash is can be used to buy anything—including the current benefit. The only situation, in fact, in which it would make sense for an employee to prefer a now-taxable benefit to its equivalent in cash compensation would be if the employee believed that the employer's cost of providing the benefit is lower than would be the employee's cost purchasing it.[107]

In the absence of a noncompensatory business purpose for the provision of an in kind benefit, it is hard to see why an employer would resist such entreaties. Employers' interests lie in making their employees happy at the lowest possible cost—and if providing cash in lieu of an equally expensive in-kind fringe benefit would make the employees happier, presumably they would be happy to do so. Other things being equal, one would expect a move away from the provision of in-kind benefits towards cash salary. This is particularly true if employees are a heterogeneous group, such that only a subgroup benefited from the in kind transfers to begin with.[108]

There could be exceptions. For example, an employer might have invested in the construction of a parking lot, or the purchase of buses or athletic facilities. Such investments might be stranded, made essentially valueless, by a switch to cash compensation, so that an employer might be willing to accept a higher overall expenditure on employee compensation as long as part of it is paid through a recoupment of those sunk costs. But over time, those assets will wear out, or the employer will find new uses for them (converting gym space to additional office space or building a new building on a parking lot) and the compensation packages would be adjusted accordingly.

The important point is that although employers have more information about the noncompensatory benefits of many fringe benefits, they actually have relatively little information about their compensatory benefits. They lack the information to know the extent of the dead-weight losses created by their compensation packages. Requiring employees to include the costs of providing such benefits in their own income would serve as an information-forcing device, which should lead to more socially efficient compensation packages, or to a better sorting of employees among employers.[109]

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[106]In the first instance, she is likely to try and obtain an offsetting pay increase from his or her employer, to restore her after-tax income to its pre-inclusion level. Whether the employee will be successful in that endeavor is uncertain, for the reasons discussed in the previous section.

[107] See the discussion of under-priced fringe benefits supra TAN 84 - 86. It is unclear whether this is a significant concern for the limited category of benefits affected by the TCJA..

[108] On the other hand, heterogeneity may make bargaining more difficult because employees will have different preferred outcomes..In some contexts, it may be possible for employers to offer individualized compensation packages to cater to their disparate tastes.

[109] As long as the benefits are included in the income of recipients, there is no social loss (and perhaps social gain) from having employees pick employers based on the content of their benefit packages.

Requiring employees to include in their own income their pro-rata share of their employer's cost of providing benefits creates problems as well as benefits. Even leaving aside the separate problem of how to treat third party diners,[110] the costs of engaging in customary business meals (with clients, customers, or suppliers) will increase. Suppose, for example, that the cost of a meal is $100, but the employee attaches a mere $35 value to it.[111] If the recipient's marginal tax rate is 35 percent, and the meal is treated as conferring value equal to cost, the recipient's tax obligation would be increased by $35—leaving him (or her) with no additional income and several fewer personal hours as a result of attending the meal. Effectively, such income would have been subject to tax at an effective rate of 100 percent. One would not expect to find many employees willing to partake of these meals under those circumstances. If the employer wants these meals to continue, it will have to reward participating employees with a side payment of cash. Increasing the cost of such meals will decrease their use.

Like a decline in the value of employer-provided meals generally, that outcome may be desirable. The fear is that many of these meals are meals that the attendees would have enjoyed together in any case because of preexisting social ties.[112] The meals are viewed by some as an excuse for self-dealing at the expense of the larger business enterprise, or even as a mechanism for the perpetuation of existing business relationships that often prove of most benefit to existing elites.[113]

But such meals can also make it easier for outsiders to penetrate otherwise closed business environments. It is all well and good to assume that businesses always opt for the lowest bidder, but in the real world, price is not everything. Reliability and trustworthiness count as well. Semi-social interactions such as the customary business meals provide occasions for building trust and familiarity that could encourage nonlitigious, nonconfrontational resolution of business problems as well as valuable exchanges of information.[114] Reducing the attractiveness of such occasions could make it difficult for newcomers—particularly those that lack other sources of connection such as attendance at the same schools or membership in the same clubs and organizations—to develop the sorts of relationships that might lead to experimentation with new suppliers and customers. Although the outsiders might try to overcome this barrier by offering to absorb the costs of such meals, their tax treatment effectively places an additional financial burden on such efforts.[115]

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[110] To be dealt with in a separate paper, see supra note 11.

[111] Of course, one might suggest that the existence of this discrepancy between cost and value is a deadwight loss, and a better resolution would be for the employer to find other restaurants serving food that is either cheaper or more to the liking of the recipients. However, that may not be possible if, for example, the different participants have wildly different food preferences, and the employer's first priority as to choice of attendee depends on business capabilities and not food compatibility.

[112] See Mortimer M. Caplin, The Travel and Entertainment Expense Problem, 39 Taxes, 947, 953 (1961) (revenue agent reports point out situations in which "the entertainment involves friends, and …the officers are in turn entertained by the same people whom they entertain when they pay the bill…").

[113]See Richard Schmalbeck & Jay A. Soled, supra note 22, at 762 ("[T]he benefits [of business meals and entertainment] are disproportionately enjoyed by those at the upper levels of the organization.").

[114] They also provide opportunities for less salubrious relationships. See id, at 762 ("At the opposite end of the goodwill generation spectrum lies a darker region of commercial bribery….[T]he similarities between commercial bribery and business entertainment expenses are striking.").

[115] Such concerns might underlie Congress' expressed desire (albeit in a single sentence of the TCJA's legislative history!) to allow taxpayers "to continue to deduct 50 percent of the food and beverage expenses associated with

Customary business meals are merely an example of the larger problem of dual purpose expenditures. Some expenditures can appear to generate dead weight losses when viewed from the recipient's perspective, but when viewed from the payor's perspective, the differential is compensated for by the benefit's achievement of an additional noncompensatory purpose. Suppose, for example, an employer supplies parking at a cost of $100 which it knows employees value only at $60. Such transactions appear to create inefficient dead weight loss. But perhaps the employer wants employees to have their personal automobiles available for business related trips during the day. Reimbursing employees for mileage while providing parking may be less expansive in terms of time or money than reimbursing employees for Uber or taxi fares. Once the TCJA forces employees to report the entire $100 parking cost in their income (and not just the $60), the employer's cost calculus may shift, and lead it to prefer the more expensive (before taxes are taken into account) alternative of having its employees rely on outside driving services. In such cases, the statutory change may actually increase economic inefficiency.[116]

Employers may provide on-premises meals to encourage co-workers to eat with each other and exchange ideas regarding on-going projects, turning lunch "breaks" into working sessions while avoiding the possibility of security breaches. Google may well want to limit the interaction between its employees and those of Amazon for fear of inadvertent disclosures of information. On-premises meals may also enable workers to spend less time away from their desks, an advantage for many time-sensitive activities.[117] On the other hand, perhaps both employer and employees would be better off if the employer provided less expensive meals, ones which more closely accorded with the valuations of the recipient employees.

In sum, bringing the cost of these now less-favored fringe benefits to the attention of employees by including those costs in their recipients' income holds both promise and peril. It will make it less difficult for employers and employees to negotiate alterations in arrangements which create economic waste, and should make overall compensation packages more transparent. But it may make it more expensive for employers to utilize dual purpose strategies—strategies that they undoubtedly over-used under prior law because the tax rules were too adventageous. Substitute or surrogate taxation, by hiding cost information from employees, merely reverses the problem. It makes it harder to eliminate or cut back on dead weight loss transactions, while preserving employers' ability to decide without employee interference whether to continue to spend money

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operating their trade or businesses," see H.R. Rep. No. 115-466, at 407 (2017) (Conf. Rep.). The IRS preserved a partial deduction for such meals in Notice 2018-76, supra note 65, despite the apparent conflict with the actual statutory language. See Gary McBride & Phillip P. Storrer, supra note 65, at 591 ("This surgical removal [in IRS Notice 2018-76] of CBMs from the definition of entertainment is at best awkward if not, as we argue, unsustainable.").

[116] Of course, the pre-TCJA rule which allowed the exclusion of a certain dollar amount of parking subsidies irrespective of their compensatory or noncompensatory justification was also imperfect. Given the difficulty of determining which discrepancies between the cost of provision and value to employees represent valid attempts to achieve noncompensatory business purposes versus attempts to game the tax system – or even to be certain when such discrepancies exist – one might plausibly applaud a decision to err in the direction of overtaxation. It depends on one's evaluation of the relative size of the inevitable errors.

[117]It is unclear whether either of these rationales would be sufficient to justify section 119 exclusions under the standards announced in its recent technical advice memoranda. See supra note 58 (discussing recent changes in IRS policy).

on dual-use purchases. Ultimately the relative merits of surrogate or direct taxation depend on ones instincts about the relative frequency—and magnitudes—of the two alternative scenarios.

This choice is not wholly within the hands of the government. Although in most situations, the TCJA seems to mandate the loss of employer deductions rather than employee inclusions,[118] employers can reverse this presumption by deciding on their own initiative to report what would have been nondeductible fringe benefits as additional employment income. If they do so, they should be entitled to deduct the entire costs of providing such benefits.[119] Whether employers would want to go this route, particularly before 2026, though, will be affected by another difference between direct and surrogate taxation: rate differentials. Unlike the assumptions of the Coasian model, the tax rates applicable to employers and employees may be quite different. As described in the next section, those rate differentials may affect the desirability (from taxpayers' perspectives) of employee inclusion versus employer loss of deduction.

b. Rate Differentials

Among the changes made by the TCJA was a dramatic lowering of corporate tax rates. Under the new rate structure, many, but not all, employers will face marginal tax rates far lower than those facing their employees. This rate discrepancy, together with the partial deduction that remains for some business meals, is likely to lead employers to favor the loss of deductions over employee inclusions, at least prior to the 2026 tax year, and indeed, to continue to use some of the impacted fringe benefit arrangements rather than switching to cash compensation. But that conclusion has to be qualified because different employers face quite different tax situations, and the situation will change in 2026 when section 274(o)[120] of the Code will come into play.

Individual taxpayers face marginal tax rates ranging from 10 percent to 37 percent. Although these rates generally rise with income, hidden discontinuities exist. For example, ostensibly lower bracket taxpayers can face much higher marginal rates of tax as their income rises due to the phaseout of the earned income credit.[121] Most corporate employers, by contrast, face a flat tax rate of 21 percent (assuming they are profitable[122]).[123] The tax rates facing other employers

[118] See supra TAN 46 – 54 (describing TCJA changes).
[119] The 50 percent disallowance rule for expenditures on business meals found in section 274(n) expressly excludes expenditures "treated as compensation." See I.R.C. §§274(e) & 274(n)(2)(A). The deduction disallowance contained in section 274(o), applicable to years after December 31, 2025, expressly applies to the costs of providing benefits treated as "de minimus fringes" under section 132(e)(1) and to meals provided under the auspices of section 119(a). Meals would have to be excluded from gross income to fall under either provision.
[120] Section 274(o) completely eliminates employer deductions for the costs of providing meals excluded under section 119(a) and section 132(e) in connection with employer-operated eating facilities.
[121] The phaseout range depends both on the status of the taxpayer (single, head of household, or married filing jointly) as well as the number of qualifying children in the household. Internal Revenue Service, 2019 EITC Income Limits, Maximum Credit Amounts and Tax Law Updates, at https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/eitc-income-limits-maximum-credit-amounts-next-year
[122] Unprofitable corporations pay no income tax, by definition.
[123] Corporate income is also taxed when it is distributed or otherwise received by shareholders. However, relatively few shareholders pay this second level of tax. See Steven M. Rosenthal, Only About One-Quarter of Corporate Stock is owned by Taxable Shareholders, Tax Vox Blog, May 16, 2016, at https://www.taxpolicycenter.org/taxvox/only-about-one-quarter-corporate-stock-owned-taxable-shareholders ("[T]hree-quarters of shares now are held in tax-exempt accounts such as IRAs or defined benefit/contribution plans, or by foreigners, nonprofits or others."). In addition, the shareholder level tax is imposed at a later time and formally

vary. Partners bear the tax burden for their respective shares of partnership income, so the applicable tax rate is the tax rate facing each partner (some of whom may be corporations).[124] Income generated by non-C corporations as well as unincorporated entities are also generally taxable at the marginal tax rates of their owners.[125] Some, but not all, of non-C corporation owners may be entitled to take advantage of the section 199A's 20 percent deduction for "qualified business income,"[126] effectively lowering their tax rate by one-fifth (i.e. to 29.6 percent for a 37 percent tax bracket taxpayer). Nonprofit institutions pay no tax aside from the UBIT. Though the TCJA provides that the cost of providing subsidized employee parking will be subject to the UBIT,[127] it does not provide comparable treatment for other fringe benefit expenditures disfavored in that act, such as entertainment expenses or expenditures on business meals (whether excluded under section 119 or otherwise). This diversity in marginal tax rates means that the reactions of taxpayers to the new tax rules applicable to in kind fringe benefits will differ in significant ways depending on what their tax status is.

Employers' tax status will be irrelevant when it comes to some fringe benefit arrangements. All employers will face the same economic incentives to continue (or not) those benefits Congress mandated be included in the income of the recipient employees. Bicycle commuting expenses are small in amount and their treatment will change after 2025 in any case. The more interesting case is moving expense reimbursements. Employers maintaining such programs have essentially three choices: continuing existing programs while reporting the reimbursement or direct payment amounts as income of the employees being moved; grossing up reimbursement payments (or adding a direct payment to employees to reimburse them in whole or in part for the additional tax burden they will face; or discontinuing their programs entirely (and perhaps providing all new hires with a taxable "transition bonus"). Which option a given employer chooses will reflect its economic circumstances—whether it feels it needs to recruit out-of-area employees, and what it has to pay them to come to a new jurisdiction. From an employers' standpoint, the costs of covering moving expenses is akin to the costs of hiring a headhunter: worth doing if the employees it attracts are worth enough more than the employees it would have had to hire locally to justify the extra expense. Because tying such amounts to actual moving costs no longer provides an associated tax benefit, though, employers might structure their programs differently, offering a flat cash amount rather than an amount tied to actual moving expenses. If so, that might eliminate some of the wasteful practices one sees when moving costs are fully reimbursed, such as paying more to move items than they would cost to replace at the new location.

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leveled on different taxpayers, so it is unlikely to enter into the calculations of how to structure fringe benefit transactions.

124 See Internal Revenue Service, Partnerships, at https://www.irs.gov/businesses/small-businesses-self-employed/partnerships ("A partnership...'paasses through' any profits or losses to its partners. Each partner includes his or her share of the partnership's income or loss on his or her tax return.").

125 Tax Policy Center, Briefing Book, Key Elements of the U.S. Tax System, at https://www.taxpolicycenter.org/briefing-book/what-are-pass-through-businesses ("Pass-through businesses include sole proprietorships, partnerships, and S corporations.").

126 See Internal Revenue Service, Tax Cuts and Jobes Act, Provision 11011 Section 199A – Qualified Business Income Deductions FAQs, at https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs (describing operation of §199A).

127 2017 GENERAL EXPLANATION, at p. 296.

But for most fringe benefits affected by the TCJA, the tax status of employers will matter. Take business entertainment expenses (aside from meal expenses), for example, for which deductions have been totally disallowed as a result of the TCJA. Tax is effectively imposed on these expenditures at the marginal tax rate of the payor. Employers can avoid paying this tax by treating the amounts expended entertainment as additional income of the participating employees.[128] Whether they will want to will depend on the relative tax rate of the employer versus that of the potentially affected employee. If the employee's tax rate is lower than the employer's tax rate, it should cost the employer less money to make the employee "whole" through an addition to cash salary that defraying the additional tax liability than it would to bear the tax liability itself.[129]

The question, of course, is whether there are many situations in which an employer's marginal tax rate would be substantially above that of the recipient employees'. It is unlikely that many situations would arise in the C corporation context. Individual taxpayers begin facing marginal tax rates of more than the corporate tax rate when their taxable income reaches $39,475.[130] Even taking the increased standard deduction into account, that is about the median household income in the United States. Further, many employees would also be subject to Social Security and Medicare taxes on those additions to wage income[131] further increasing their marginal tax rates.

Noncorporate employers, including large law and accounting firms, might well face a different calculus. The owners of their residual income may well be 37 percent tax bracket taxpayers, and because these businesses provide personal services,[132] the income derived from them would not qualify for the section 199A deduction.[133] Many of the employees at the receiving end of entertainment expenditures would face lower marginal tax rates.particularly if their income

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[128]See I.R.C. § 274(e)(2). If the entertainment is provided both to employees and non-employees (such as clients or customers), presumably the employer would only treat the portion attributable to the cost of entertaining the employee as part of his or her compensation, and would be forced to accept a partial loss of deductions for the remainder of the expense.

[129] It is often unclear whether the employer would have to make the employee entirely whole. See supra section III.B.2 (discussing incidence of tax increases mandated by the TCJA).

[130] See Rev. Proc. 2018-57, § 3.01, 2018- I.R.B. ____ (2018) (22 percent marginal tax rate begins at $39,475 for single individuals and $78,9500 for married taxpayers filing jointly) The tax table understates the income cut-offs since they reference taxable income. The standard deduction amounts for 2019 will be $12,200, $18,350, or $24,400, depending on filing status, so the 22 percent rate affects only taxpayers with gross incomes exceeding the cut off plus the appropriate standard deduction amount. For example, a single taxpayer would need gross income of at least $51,675 to pay tax at the 22 percent marginal rate. Some taxpayers with income below this amount, however, might face higher marginal rates of tax due to earned income tax credit phaseouts.

[131] It is uncertain whether Social Security taxes ought to be taken into account for these purposes, however, as the employees would receive an offsetting benefit—higher social security benefits after retirement—in return for those contributions. Those income-linked benefits may outweigh, on a present value basis, the cost of the additional taxes imposed.

[132]See I.R.C. § 199A(d)(2)(A) (trades or businesses "described in section 1202(e)(3)(A)" included in definition of "specified service trade or business" excluded from "qualified trade or business" eligible for deduction); I.R.C. § 1202(e)(3)(A) ("any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees").

[133] See I.R.C. § 199A(c) ("The term 'qualified business income means, for any taxable year, the net amount of qualified items of income…with respect to any qualified trade or business of the taxpayer.").

already exceeded the social security wage tax base.[134] The 37 percent marginal rate affects income in excess of $510,300 for single individuals and $612,350 for married couples filing jointly.[135] Highly-taxed employees would be no worse off if their share of any business entertainment expenses was reported as additional compensation income than if it were included as, say, additional partnership income (because the amount of such income was inflated due to the loss of the business expense deduction). [136]

In sum, over time, firms might well develop different patterns for dealing with fully disallowed fringe benefit expenses, such as entertainment expenses and, after 2025, section 119 meal expenses. Corporate employers and nonprofits will continue to offer such benefits on a "tax free" basis to their employees, while other types of businesses may begin treating such benefits as additional compensation. As described earlier,[137] that may lead to a reduction in the frequency and amount of such expenditures in those contexts. Whether the distinction in the pattern of in kind benefit provision will be politically sustainable is an open question.

Finally, it is worth noting that a significant fraction of in kind meal benefits remains somewhat tax-favored: meals eaten while on travel status, customary business meals, and, prior to 2026, section 119 "for the convenience of the employer" meals. The expenses of providing those meals remain 50 percent deductible, but only when paid for or provided by an employer or other non-employee.[138] Though the partial disallowance of deductions will impose differential costs on employers based on their tax status, it is unlikely that any employers would be able to reduce total tax payments by shifting the tax burden onto their employees by treating the benefits as compensation. Employees would be unable to deduct even the half of the expenses that remain deductible by the employers due to the suspension of the deduction for employee business expenses.[139] The effective tax rate on such expenditures in the hands of the employers would be about half of their normally effective tax rates. Relatively few if any employees would face marginal rates that low.

In sum, Congressional mandates of surrogate taxation are not actually mandates; in some situations, employers may opt instead to treat such benefits as additional compensation to employees. That in itself is not necessarily problematic. As explained in the prior section, including the cost of providing fringe benefits in the income of recipients is a better way of driving inefficient fringe benefit provisions out of existence. However, the distribution of the fringe benefits that remain may be troubling from a political standpoint. They will be tilted even further to employees of large corporations and non-profits, and to the most highly compensated employees of other organizations.

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[134]The social security wage base for 2019 is $132,900. See Social Security, Contribution and Benefit Base, at https://www.ssa.gov/OACT/COLA/cbb.html.
[135] See Rev. Proc. 2018-57, § 3.01, supra note 150.
[136]The allocation of the entertainment expenses/income might be different under the two reporting schemes, as partnership allocations would not necessarily correspond to actual receipts of entertainment and meal benefits.
[137]See supra section III.B.3.
[138] If the expenses were incurred by an employee and not reimbursed, they would be considered an "employee business expense," none of which may be deducted between 2018 and 2026.
[139] And even if those deductions had not been explicitly disallowed, the likelihood of their claiming any itemized deductions was radically reduced by the TCJA's increase in the standard deduction, and its cap on the deduction for state and local taxes.

IV. The Bottom Line

Surrogate taxation has been lauded as the "second best" mechanism for dealing with a perennial tax policy dilemma: how to tax in kind benefits provided by employers.[140] This analysis certainly seems to have been accepted by Congress; the TCJA's treatment of formerly tax-advantaged fringe benefits seems to adopt this approach whole heartedly. This article attempts to undercut some of the enthusiasm for this approach. In particular, it suggests that if the goal is to drive such benefits out of the system—to switch employers to move further in the direction of cash compensation, and to reduce the social inefficiencies of those benefits that remain, it may well be better to force employers to allocate the costs of providing those benefits to their employee recipients. Although this will impose a substantial recordkeeping burdens on employers, it will provide employers with the knowledge necessary to drive many of the current inefficiencies out of the system. Further, it will be much more neutral as between types of employers. Corporations and nonprofits will lose the favored treatment that the newly revised law leaves them with.

Nor is it clear that direct taxation would necessarily be less politically unpopular than surrogate taxation. At first glance, the political advantage accruing from imposing the additional tax burden on employers rather than employees seems obvious. There are fewer employers than there are employees—and employees (unlike artificial entities such as corporations) vote. Eliminating employer-level deductions, unlike eliminating exclusions from income, effectively hides the tax increase from those numerous voters, making political blowback less likely. On the other hand, numbers are not everything. Much recent political science literature makes clear that some votes and some voices are accorded greater weight in the political process than are others. Although employees would doubtless resent being held responsible for paying taxes on employer-provided benefits that were previously exempt from tax, employers as a group are almost certainly more financially sophisticated than most employees. They are probably more likely to notice—and understand the financial implications of—tax law changes, particularly those which increase their tax liabilities. And the absolute amount of the tax increase is greater for an employer than would be the tax cost to any given employee of his or her tax increase due to the loss of a benefit exclusion, given that most employers have more than one employee. Even if the tax increase attributable to the deduction disallowance is lower as a proportion of total taxes paid by for employers than it would be for employees, the absolute size of such tax increases are likely to make them salient to employers. Such salience, combined with the fact that many employers (unlike most employees) are already members of trade associations or other affinity groups regularly engaged in political and lobbying activities, leaves uncertain whether deduction disallowance at the employer level or the loss of an exclusion at the employee level is the more perilous political course.

It is worth noting that the inevitable side effect of disallowing deductions for costs aimed at achieving at non-compensatory business goals may not be a salubrious. Eliminating deductions for the costs attributable to achieving noncompensatory aims makes employing the affected methods of achieving such aims relatively more expensive than other methods (if they exist) of

[140] See Jay A Soled, supra note 9, at 192 ("it provides a practical respons to…how the Code should go about the taxation of in-kind benefits'). .

achieving them. But that may be precisely the point—such overtaxation may spur employers to come up with other, less suspicious-looking mechanisms for achieving those noncompensatory aims. Success in doing so would lead to the ultimate in administrative savings. Once stripped of noncompensatory purposes, there would be no point in providing employees with compensation in noncash form, and these suspicious looking transactions would not occur. Instead of receipts in kind, compensation would increasingly be paid in easily taxable cash. This assumes (perhaps counterfactually) that other mechanisms can be found to accomplish the noncompensatory aims of the targeted expenditures. Where it cannot, businesses will be hurt. But the inability to separate out these situations, coupled with the tax avoidance possibilities of doing nothing, may make this inevitable. Congress and or Treasury or the IRS could develop some sort of simplified regime for determining the inclusion amounts, as it has for other situations (like automobile expenses,[141] or expenses incurred while in travel status),[142] but there is no short term, obvious resolution for these issues.

[141] Taxpayers (other than employees) who use their automobiles for business purposes may choose between deducting actual expenses (subject to limits on depreciation) or claiming a "standard mileage rate" (currently 54.5 center per mile). Intgernal Revenue Service, Travel, Gift, and Car Expenses, Publication 463 (2018), at Chapter 4, https://www.irs.gov/publications/p463

[142] Taxpayers can use GSA-set per diem rates instead of itemizing their actual costs of lodging, meals and incidental expenses. See Internal Revenue Service, 2018-2019 Special Per Diem Rates, Notice 2018-77, at https://www.irs.gov/pub/irs-drop/n-18-77.pdf (setting out 2018 – 2019 rates).