J. COMPENSATION

1. Introduction and Background

Employees and others, such as independent contractors, who perform personal services for exempt organizations may be compensated in a variety of ways. The most common method of compensation is current salary or wages. Many employees also receive deferred compensation--the promise or expectation of receiving money in the future for services performed in the present. Deferred compensation may be in the form of a qualified employee plan, such as a pension or profit-sharing plan; an annuity; or a non-qualified deferred compensation plan. Compensation also takes non-cash forms, like employee health, death, or other welfare benefits. "Fringe benefits" may also include a personal vehicle, meals, or lodging; personal and family educational benefits; low-interest loans; payment of personal travel, entertainment, or other expenses; athletic or country club memberships; and personal use of the employer's property.

The proper tax treatment of compensation is an issue, directly or indirectly, in numerous contexts. This chapter will primarily address two such contexts:

(1) Is the benefit taxable compensation to the employee (on which the employee must pay tax)?

(2) Is the benefit subject to FICA, FUTA, and income tax withholding requirements?

In recent years, the tax treatment of compensation for personal services has changed dramatically. Provisions of the Code and regulations now specify the treatment of some forms of compensation previously handled by applying general principles, which continue to apply in other contexts.

This article discusses the tax treatment of compensation for personal services provided to exempt organizations. Part 2 discusses general principles relating to taxation of compensation. Part 3 begins the discussion of the treatment of specific items of compensation, and deals with current cash compensation. Part 4 discusses fringe benefits as an element of compensation, and Part 5 addresses deferred compensation.

2. Compensation - General Principles

A. General Rule of Inclusion - IRC 61(a)(1)

All forms of compensation are subject to income tax unless specifically excluded by the Code. This proposition is derived from IRC 61(a)(1), which defines "gross income" as including "all income from whatever source derived, including (but not limited to) . . . [c]ompensation for services, including fees, commissions, fringe benefits, and similar items . . . ." Thus, if a payment is "[c]ompensation for services," it is subject to tax unless an exclusion exists.

Occasionally, it is contended that an employer's payment to an employee is not "compensation for services," but instead a gift, excluded from gross income under IRC 102(a). IRC 102(c) (added by the Tax Reform Act of 1986), however, provides that the gift exclusion does not apply to "any amount transferred by or for an employer to, or for the benefit of, an employee." Benefits flowing from employer to employee are thus presumed to be compensatory.

This general rule of inclusion applies not only to payments of money, but also to other transfers by an employer to or for an employee's benefit, and codifies a position the Service had long sought to establish through litigation, with mixed success. A leading case is Chandler v. Commissioner, 119 F.2d 623 (3d Cir. 1941), aff'g 41 B.T.A. 165 (1940). There, the Third Circuit held an employee received compensation income both in his employer's providing property (a home) for his personal use, and paying his personal expenses (maintenance of the home). Both transfers discharged the employee's personal obligations, and were compensation.

Generally, whether an item of compensation, not specifically excluded, is currently taxable to an individual depends on three determinations. First, has the item been received, or constructively received? Second, is there something - money or property - to include? Third, in whose income should the item be included?

B. Receipt/Constructive Receipt Doctrine

Most individuals use the cash receipts and disbursements method of accounting. For them, when an item of income is included in gross income is governed by IRC 451 and regulations thereunder, which codify the doctrine of constructive receipt. IRC 451(a) provides generally that, for cash basis taxpayers, items of gross income are included for the taxable year in which received by the taxpayer. Reg. 1.451-2(a) further provides:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of his receipt is subject to substantial limitations or restrictions. . . .

The following simple examples illustrate the receipt/constructive receipt principle:

> **Example (1)**: A is to be paid $ 1,000 on the 15th and last days of each month, for work performed the previous bi-monthly period. A receives $1,000 on December 31, 1989, for work performed from December 16 through December 30. A receives $1,000 compensation in 1989; under IRC 451(a), $1,000 is included in gross income in the year received (1989).
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> **Example (2)**: B is to be paid $ 1,000 on the 1st and 15th days of each month, for work performed the previous bi-monthly period. B receives $1,000 on January 1, 1990, for work performed from December 16 through December 31, 1989. B includes $1,000 in gross income in 1990; the analysis is the same as in (1), and that the compensation is for services performed in 1989 is irrelevant.
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> **Example (3)**: Same as (2), except B's employer prepares the year's last paychecks a week early, making them available on December 24 rather than mailing them to employees' homes. B picks up his check on December 24. B includes $1,000 in gross income in 1989, again applying the same analysis. That some services are not performed until after the compensation is received is as irrelevant as that services were performed in a prior tax period.
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> **Example (4)**: Same as (3), except B does not pick up his check on December 24, but waits until January 1. B includes $1,000 in gross income in 1989. Here, inclusion is required by the doctrine of constructive receipt, as stated in Reg. 1.451-2(a). The $1,000 was "credited to [B's] account, set apart for him, or otherwise made available so that he [could] draw upon it . . . ." That B did not receive the income until 1990 results from his election or choice; as stated in Rev. Rul. 60-31, 1960-1 C.B. 174: "[A] taxpayer may not deliberately turn his back upon income and thereby select the year for which he will report it. . . ."

C. Economic Benefit Doctrine

Determining that there is "something" to tax is relatively simple with cash compensation - money is undoubtedly a taxable item. Similarly, 1984 amendments to IRC 61(a)(1) made clear that "fringe benefits" are also taxable. The treatment of

other non-cash forms of compensation may be less clear, however. Whether there is "something" to tax in such cases often depends on application of the economic benefit doctrine.

Under the economic benefit doctrine, an employee receives income from an economic or financial benefit received as compensation, even though it is not in cash form. Reg. 1.446-1(a)(3) reflects this doctrine:

> Items of gross income . . . which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. . . .

See also IRC 83, discussed pp. 175-180, below; Reg. 1.61-2(d)(1) (fair market value of property transferred in payment for services is compensation income); and Commissioner v. Smith, 324 U.S. 177, 181 (1945) (IRC 61(a) "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever form or mode by which it is effected").

A leading case is E.T. Sproull, 16 T.C. 244 (1951), aff'd, 194 F.2d 541 (6th Cir. 1952). In Sproull, an employer paid a trustee $10,500, in 1945, in recognition of services performed by an employee. The trustee was directed to invest the funds and pay the principal to the employee, half in 1946 and half in 1947; if the employee died, the amounts would be paid to his administrator, executor, or heirs. The Tax Court held the entire $10,500 was gross income to the employee in 1945, the year it was paid into the trust, because the employer's action in setting up the trust "conferred an economic or financial benefit . . . properly taxable to him in 1945." 16 T.C. at 247-48. The amount had been fully earned, and did not depend on any further action by the employee; it was set aside for his benefit, and no one else had any claim against or control over it; the employee's interest in the trust could be assigned or otherwise disposed of. In these circumstances, payment to the trust "was tantamount to paying over to him the cash . . . ." Id.

D. IRC 83

The economic benefit doctrine forms the basis of IRC 83, governing transfers of property in connection with performance of services. For exempt organizations, IRC 83 is significant primarily in the area of deferred compensation (although it may apply in other contexts).

Under IRC 83(a), property transferred in connection with performance of services is included in gross income of the person who performed the services ("employee") in the first taxable year in which the rights of the person having the beneficial interest in the property ("transferee") are transferable or not subject to a substantial risk of forfeiture. The amount included is the excess of the fair market value of the property over any amount paid for it. Fair market value is determined without regard to any restriction, other than a restriction that by its terms will never lapse, at the first time the transferee's rights are vested (i.e., are transferable or not subject to a substantial risk of forfeiture, whichever occurs first). If the transferee disposes of the property in an arm's length transaction before his rights are vested, the employee must at that time include in gross income the amount realized on the sale or disposition, less any amount paid for the property.

IRC 83 is a comprehensive section, governing not only the timing and amount of the employee's income, but also the employer's deduction, basis and holding period, and disposition of transferred property in various contexts. In most cases, however, its application requires consideration of two key elements: whether there is "property" subject to IRC 83, and whether that property is "transferable" or "subject to a substantial risk of forfeiture."

Meaning of "property": Reg. 1.83-3(e) defines "property" as including "real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future." In addition, "property" includes "a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account." Life insurance contracts are "property" only to the extent of their cash surrender value or fair market value.

In essence, this definition leaves the determination of whether there is "property," currently subject to tax, to the economic benefit and constructive receipt doctrines. By excluding "an unfunded and unsecured promise to pay money in the future," the regulation confirms the continuing vitality of the large body of precedents dealing with unfunded deferred compensation. Under these precedents, such a promise does not result in currently taxable compensation because it does not confer a current economic benefit on the promisee/employee.

The leading authority is Rev. Rul. 60-31, 1960-1 C.B. 174, modified, Rev. Rul. 64-279, 1964-2 C.B. 121, and modified, Rev. Rul. 70-435, 1970-2 C.B. 100. There, the Service considered several attempts to defer compensation; the first three involved unfunded and unsecured promises to pay money in the future:

> **Situation (1)**: As part of a 5-year employment contract, A is promised 10x dollars per year which will not be paid in the year earned. Instead, these amounts will be credited to a bookkeeping reserve account and paid, in annual installments of 1/5 the amount in the reserve, beginning the earliest of (a) A's termination of employment by the employer; (b) A's becoming a part-time employee; or (c) A's becoming partially or totally incapacitated. No trust is created; the employer is merely contractually obligated to make payments when due.
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> **Situation (2)**: B's employer maintains a deferred compensation plan under which a percentage of the employer's annual net earnings exceeding a stated amount is divided among plan participants in proportion to their salaries. These amounts are not paid currently; the employer credits them annually to a separate account for each participant. Annual distributions will be made beginning the earliest of (a) the date B reaches age 60; (b) B's terminating employment for any reason, including death; and (c) B's becoming totally disabled. No trust is created; the employer is merely contractually obligated to make payments when due.
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> **Situation (3)**: C, an author, executes an agreement granting a publisher the exclusive right to print, publish, and sell his book. The agreement provides that the publisher will pay C royalties based on sales, render to C semi-annual statements of sales, and pay amounts due with each statement. Under a separate agreement executed the same day, the publisher agrees to carry over to the next year annual amounts exceeding a certain limit. The publisher is not required to pay C interest on these amounts or segregate them in any manner.

In each case, the Service ruled no income was currently received, since the payor had "compensated" the service provider with "[a] mere promise to pay . . . ." Thus, there was nothing to include in current gross income. This distinguished the three situations from E.T. Sproull, 16 T.C. 244, discussed above, and from Situation (4) of the same ruling:

> **Situation (4)**: D, a football player, enters into a two-year standard player's contract. In addition to a specified salary, D will be paid a bonus, which he could have received when he signed the contract. Instead, at his suggestion, the contract is changed to provide for payment of the bonus to an escrow agent designated by D. The escrow agent agrees to pay the bonus, plus interest, to D over a 5-year period. The agent will hold the amount in an account in D's name, and if D dies, pay the balance to his estate.

In Situation (4), the situation was similar to that in Sproull, since an economic benefit was conferred on D by payment to an escrow agent acting on his behalf. IRC 83 would reach the same result, since D's interest in the escrow account is "property" under Reg. 1.83-3(e).

"Transferability" of property: Property transferred in connection with performance of services is included in gross income if the transferee's rights in the property are "transferable." Reg. 1.83-3(d) says the transferee's rights must be transferable to someone other than the transferor. Under the regulation, property is not transferable if transferred rights are subject to a substantial risk of forfeiture. That the transferee may designate a beneficiary to receive the property if he dies does not make the property "transferable."

"Substantial risk of forfeiture": Given the definition of "transferable," whether transferred property must be included in the employee's income will depend on whether it is subject to a "substantial risk of forfeiture." Once conditions imposing such a risk have expired or been removed, not only will the property no longer be "subject to a substantial risk of forfeiture," it will also be "transferable."

Reg. 1.83-3(c)(1) says a "risk of forfeiture" exists where rights in transferred property are conditioned, directly or indirectly, upon future performance (or refraining from performance) of substantial services by any person, or occurrence of a condition related to a purpose of the transfer. The risk of forfeiture is "substantial" if the possibility of forfeiture is substantial if the condition is not fulfilled.

A requirement that the employee continue working for the employer for a specified time is a substantial risk of forfeiture. See Reg. 1.83-3(c)(2). A covenant not to compete with the employer after terminating employment may be a substantial risk of forfeiture, depending on the facts and circumstances; relevant factors include the employee's age, the availability of competitive employment opportunities, the likelihood the employee will obtain competitive employment, the employee's skill and health, and the employer's practice of enforcing similar covenants. Similarly, a requirement that a retiring employee render consulting services upon request is a substantial risk of forfeiture if he is in fact expected to perform such services.

Reg. 1.83-3(c)(4), Example (2), describes an employer-established educational benefit trust under which employees' children who are full-time degree candidates at educational institutions receive an annual cash grant for each year completed, for up to 4 years. E, an employee, has an eligible child; E thus has a beneficial interest in the trust ("property" under IRC 83). The requirement that E's child complete a year of college to receive a grant is a "substantial risk of

forfeiture," however, and E need not include (under IRC 83) the value of his interest until the condition is satisfied.

If property is actually transferred, while subject to a substantial risk of forfeiture, different rules apply. See Reg. 1.83-1(b) (transfer in arm's length transaction), and Reg. 1.83-1(c) (transfer in non-arm's length transaction).

Applicability of rules: Under IRC 83(e), IRC 83 does not apply to:

(1) a transaction to which IRC 421 (qualified stock options) applies;

(2) a transfer to or from a trust described in IRC 401(a), or a transfer under an annuity plan which meets the requirements of IRC 404(a)(2) (qualified plans);

(3) the transfer of an option without a readily ascertainable fair market value;

(4) the transfer of property pursuant to exercise of an option with a readily ascertainable fair market value at the date of the grant; or

(5) group term life insurance to which IRC 79 applies.

The IRC 83 rules do apply to contributions to an employees' trust which is not exempt from tax under IRC 501(a), under IRC 402(b)(1). In such a case, the includable amount is the value of the employee's interest in the trust, rather than the fair market value of transferred property. For years beginning after December 31, 1988, if the trust is not exempt for reasons including that the related plan does not meet the participation requirements of IRC 401(a)(26) or the minimum coverage requirements of IRC 410(b), then highly compensated employees must include an amount equal to their vested accrued benefit (other than the amount reflecting their investment in the contract). The year of inclusion is the employee's taxable year with or within which the taxable year of the trust ends. IRC 402(b)(2)(A). In addition, if the trust is not exempt for the sole reason that the related plan does not meet those tests, it will be treated as exempt with respect to non-highly compensated employees (defined in IRC 414(q)). In addition, a stock bonus, pension, or profit-sharing trust which would be exempt if it were not created or organized outside the United States is treated as exempt for purposes of IRC 402(b), under IRC 402(c).

For years beginning after December 31, 1985, the IRC 83 rules also apply where an employer pays premiums for an annuity contract not subject to IRC

403(a) (annuity plan meeting the requirements of IRC 404(a)(2)), under IRC 403(c). The includable amount is the value of the annuity contract. This treatment does not apply to premiums excluded from gross income under IRC 403(b) (qualified tax-sheltered annuity plans, discussed below, pp. 215-217).

E. Examples

The following examples illustrate application of the doctrines of economic benefit and constructive receipt, and IRC 83(a); the examples do not consider possible application of IRC 457, discussed below, pp. 220-228; or IRC 402(b)(2), discussed above.

Example (1): As part of an employment agreement with A, Employer EO establishes an irrevocable, non-qualified trust into which it pays $10,000 annually, for each year A continues in EO's service, for the exclusive benefit of A. The trustee is required to use the funds each year to purchase an annuity contract for A. When A retires at age 65, payments on the annuity will begin, continuing until A's death. These facts are almost identical to those in E.T. Sproull, 16 T.C. 244. A receives an economic benefit each year payment is made to the trust, which is currently taxable. IRC 83(a) reaches the same result, since A's beneficial interest is vested property. (Additional facts might require applying IRC 402(b)(2)(A), discussed above.)

Example (2): Same as (1), except instead of funding payments through a trust, EO promises to make retirement payments to A from its general assets. This example is distinguishable from (1), since A receives only an unfunded, unsecured promise to pay retirement benefits. Thus, considering only the economic benefit doctrine, A receives no currently taxable benefit (and no "property" under IRC 83(a)). Thus, A's income is deferred until retirement payments begin.

Example (3): Same as (1), except EO purchases an annuity, in its own name, naming itself as beneficiary; once A retires, payments on the annuity will begin, giving EO the funds with which to pay A promised amounts. This example is essentially the same as (2), and also results in no current income. Although EO has, in a sense, "funded" its promise to A by purchasing the annuity, A has no beneficial interest in the annuity. Thus, A receives no current economic benefit or IRC 83(a) "property."

Example (4): Same as (1), except to receive payments, A must continue in EO's employ until age 65; A has not reached age 65. Here, A receives no current income, but only IRC 83 "property." The condition that A continue working for EO until age 65 is a "substantial risk of forfeiture"; thus, the value of A's interest

in the trust will not be included in his income until he fulfills the condition. (Additional facts might require applying IRC 402(b)(2)(A), discussed above.)

Example (5): Same as (2), except A may elect each year, on December 31, to receive the $10,000 currently or defer it. Here, the arrangement allows A to elect to defer receipt of income already earned. A could have received the income currently; under the doctrine of constructive receipt, he is currently taxed on it, even if he elects not to receive it.

F. Assignment of Income

Taxpayers may not avoid including compensation in income by assigning their right to receive it to third parties. This principle is frequently applied to prevent attempted assignment of income to charitable organizations. For example, a member of a religious order who has taken a vow of poverty may not avoid including compensation from outside employment in income by assigning it to the order. See, e.g., Rev. Rul. 77-290, 1977-2 C.B. 26, clarifying Rev. Rul. 76-323, 1976-2 C.B. 18, and amplified Rev. Rul. 79-132, 1979-1 C.B. 62, and amplified, Rev. Rul. 80-332, 1980-2 C.B. 34. (The employee may be entitled to a charitable contribution deduction under IRC 170, however. See, e.g., Rev. Rul. 76-323, supra.)

Where the individual performing services does so as an agent of the charitable organization, however, assignment of income principles do not apply; it is the organization that earns the income, not the individual. Thus, in Rev. Rul. 68-123, 1968-1 C.B. 35, clarified, Rev. Rul. 83-127, 1983-2 C.B. 25, a registered nurse remitted to her religious order amounts received for services performed in an associated religious hospital. Because of the relationship between the two organizations, the ruling concluded that the nurse performed services for the hospital as an agent of the religious order.

The assignment of income principle reflected in such cases underlies Reg. 1.61-2(c), which provides:

> The value of services is not includible in gross income when such services are rendered directly and gratuitously to an organization described in section 170(c). Where, however, pursuant to an agreement or understanding, services are rendered to a person for the benefit of an organization described in section 170(c) and an amount for such services is paid to such organization by the person to whom the services are rendered, the amount so paid constitutes income to the person performing the services.

Rulings clarify the assignment of income principle embodied in Reg. 1.61-2(c). In addition to "vow of poverty" cases, the regulation often determines the result in situations involving patient fees paid to institution-based physicians. Where fees are "earned" by a physician, they are included in is or her income, and attempts to assign them to the institution will be ineffective. Where, however, a physician acts as an institution's agent in performing services, the income is earned by the institution, and the physician need not include it.

In Rev. Rul. 58-220, 1958-1 C.B. 26, a hospital prohibited physician employees from receiving compensation from patients; occasionally, patients insisted on paying physicians directly, however. The hospital required physicians to turn these payments over to it. The ruling held that in accepting the fees, physicians acted as the hospital's agents, and therefore received no income. Similarly, in Rev. Rul. 69-274, 1969-1 C.B. 36, a university prohibited medical school faculty from accepting fees for work in hospitals; faculty sometimes received Medicaid payments, however, which they had to turn over to the university. Here, too, the physicians acted as agents and received no income. See also Rev. Rul. 76-479, 1976-2 C.B. 20 (physician-members of research and educational foundation did not have to include in income fees from "teaching cases," which employment contracts required them to assign to foundation).

In contrast, in Rev. Rul. 69-275, 1969-1 C.B. 36, amplified, Rev. Rul. 70-161, 1970-1 C.B. 15, physicians could elect whether to enter into agreements with a hospital to transfer fees; these physicians were in constructive receipt of income, and could not assign it to the hospital. Similarly, in Rev. Rul. 66-377, 1966-2 C.B. 21, amplified, Rev. Rul. 70-161, supra, medical school faculty could elect to be compensated by a salary, and remit patient fees to the university; or by receiving patient fees. Those who elected salary were required to include in income fees remitted to the university.

Thus, the determining factor is who controls the physician's actions in performing services, earning fees, and assigning fees to the institution. If the physician may elect to receive fees for services, those fees are income to the physician, even though they are assigned or remitted directly to the institution.

Assignment of income must be distinguished from transfer of income-producing property. In Rev. Rul. 71-33, 1971-1 C.B. 30, an individual transferred to a foundation all right, title, and interest in his memoirs. The ruling concluded he had transferred property, not assigned income, and was not subject to tax on income the foundation received from use or disposition of the memoirs. The result

would be different, however, if what had been assigned was the right to receive royalties.

3. Current Cash Compensation

Aside from assignment of income questions, the treatment of cash compensation currently received (or constructively received) presents few problems. Under IRC 61(a)(1), cash compensation is included in gross income, regardless of its form. Reg. 1.61-2(a)(1) specifies the following as includable items of current cash compensation: "Wages, salaries, commissions . . ., compensation for services on the basis of a percentage of profits, . . . bonuses (including Christmas bonuses), termination or severance pay, rewards, . . . [and] marriage fees and other contributions received by a clergyman for services . . . ."

Expense accounts and allowances: Generally, if an employer reimburses an employee's business-related expenses, reimbursement amounts are not compensation to the employee. But if reimbursement exceeds actual expenses, the employee receives income. Thus, in Rev. Rul. 67-30, 1967-1 C.B. 9, a retired executive who performed services for a charitable organization received income to the extent a per diem allowance exceeded actual travel expenses incurred on the organization's business. The allowance is also income if the employee is not required to account for it to his or her employer. See, e.g., Rev. Rul. 66-217, 1966-2 C.B. 107 (state judge who received allowance in lieu of reimbursement, for which he was not required to account, must include allowance amount in gross income).

For the most part, the treatment of expense accounts and allowances is now governed by the provisions of IRC 132 concerning "working condition fringes," discussed below, pp. 191-192.

Below-market-interest loans: Under IRC 7872(a)(1), an employee receives compensation income in the amount of foregone interest on "below-market loans." IRC 7872(e)(1) defines a below-market loan as (A) a demand loan (a loan payable upon demand from the lender) bearing interest of less than the applicable federal rate, or (B) a term loan, where the amount loaned exceeds the present value of payments due under the loan. The amount of income is determined under IRC 7872(e)(2). The same treatment applies to independent contractors who perform services for the person making the loan. See IRC 7872(c)(1)(B)(ii).

IRC 7872(c)(3) provides a de minimis exception, under which the general imputed income rule does not apply where the aggregate outstanding amount of loans between employee and employer is not over $10,000. The employee may still have income, however, if one of the principal purposes of the interest arrangement is avoiding federal tax.

4. Fringe Benefits

A. In General

Under IRC 61(a)(1), fringe benefits provided as compensation are included in the employee's income unless specifically excluded by the Code. Reg. 1.61-21(a)(3) says a fringe benefit is "compensation" if "provided in connection with the performance of services," including refraining from performing services. Fringe benefits are taxed to the employee (including an independent contractor, Reg. 1.61-21(a)(4)(ii)), regardless of to whom they are provided. Reg. 1.61-21(a)(4)(i). For example, where an employer provides a car for the personal use of an employee's spouse, the benefit is income to the employee.

Rules governing treatment of fringe benefits are found in numerous Code sections. Absent another Code section, IRC 61 and regulations thereunder (particularly Reg. 1.61-21) apply. (Reg. 1.61-2T provides rules similar to Reg. 1.61-21, and is effective from January 1, 1985, to December 31, 1988, for fringe benefits provided before January 1, 1989.) IRC 61 also applies to the extent requirements for exclusion under another Code section are not met. Thus, fringe benefits may be excluded from gross income if they do not exceed specified limits, or meet other requirements. If requirements for exclusion are not met, IRC 61's rules may apply, either to the entire benefit or the excess amount. Reg. 1.61-21(a)(2), (b)(3).

Rules for income taxation of specific fringe benefits are discussed in detail below, and summarized in Table I. Employment tax requirements, which generally parallel the income tax rules, are summarized in Table II. Announcement 85-113, 1985-31 I.R.B. 31 (Aug. 5, 1985), provides procedures for reporting of and withholding on taxable noncash fringe benefits.

Valuation of fringe benefits: In general, a fringe benefit results in income equal to the excess of its fair market value over the sum of any amount paid by the employee and any excludable amount. Reg. 1.61-21(b)(1). Fair market value is the amount an individual would have to pay for the benefit in an arm's length

transaction. Reg. 1.61-21(b)(2). If, however, a particular Code section excludes a benefit based on its cost, the employee need not include the difference between value and cost as income. Reg. 1.61-2(b)(3).

Special rules are provided for valuing employer-provided vehicles, Reg. 1.61-21(b)(4), Reg. 1.61-21(d)-(f); chauffeur services, Reg. 1.61-21(b)(5); flights on employer-provided aircraft (piloted, Reg. 1.61-21(b)(6), and not piloted, Reg. 1.61-21(b)(7); see also Reg. 1.61-21(g)); and meals at an employer-provided eating facility, Reg. 1.61-21(j). In addition, Notice 89-110, 1989-49 I.R.B. 17 (Dec. 4, 1989) provides employers who use the automobile lease valuation rule an additional safe harbor method for computing fair market value, for vehicles provided after December 31, 1988, which are leased by the employer. Notice 89-110 also provides other exceptions and special rules, governing valuation of employer-paid fuel; and the commuting valuation rule and certain control employees.

B. Welfare Benefits

Unless specifically excluded, employer-provided "welfare benefits," i.e., health, death, and similar benefits, whether self-funded or insured, are included in the employee's income as compensation, generally under IRC 61(a)(1). Rules for excluding certain benefits are discussed below, and summarized in Table 1.

Life insurance: The cost of up to $50,000 group term life insurance provided to an employee may be excluded under IRC 79(a). This exclusion extends only to term insurance which provides general death benefits, on the life of the employee; applicable non-discrimination rules must be satisfied. Under Reg. 1.79-3, the premium cost of group term life insurance exceeding $50,000 must be included in gross income; the includable amount is determined under Reg. 1.79-3(d)(2), Table I.

IRC 6052 requires employers to file special returns, and provide statements to employees, concerning group term life insurance includable in income under IRC 79(a).

The cost of group term life insurance on the life of an employee's spouse or child(ren) is generally includable in the employee's income. Before the effective date of the IRC 132 regulations, however, that cost need not be included if it is "merely incidental," i.e., for insurance not over $2,000. Reg. 1.61-2(d)(2)(ii)(b). Under Reg. 1.132-6(e)(2), such amounts are included for later years. The effective

date of this provision as it relates to such insurance has been postponed until further notice, however, and certain special rules provided to govern such insurance, in Notice 89-110, 1989-49 I.R.B. 17 (Dec. 4, 1989).

Employer-provided life insurance is otherwise generally includable, as a fringe benefit under IRC 61 and under Reg. 1.61-2(d)(2)(ii)(a); see also Reg. 1.83-1(a)(2). If ownership of the insurance contract is vested in the employee, its cash surrender value is subject to tax under IRC 83. With "split-dollar life insurance," however, the employee receives income equal to the excess of insurance value over premiums he pays. Under such an arrangement, the employer pays the premium to the extent of the periodic increase in cash value and the employee pays the rest; when benefits are paid, the employer receives the cash value out of the policy proceeds. See Rev. Rul. 64-328, 1964-2 C.B. 11, amplified, Rev. Rul. 66-110, 1966-1 C.B. 12, amplified, Rev. Rul. 78-420, 1978-2 C.B. 67.

Other welfare benefits: The Code excludes the following welfare benefits provided as fringe benefits, if applicable conditions are met:

(1) **Health benefits**: Under IRC 105(b), an employee may exclude amounts received through employer-provided accident or health insurance (including an employer's self-funded plan), if such amounts are to reimburse expenses deductible under IRC 213 and are paid, directly or indirectly, to the employee for his own or family medical care. Applicable non-discrimination rules must be satisfied. IRC 105(c) allows exclusion of accident or health insurance benefits that are payment for accidental dismemberment or disfigurement and are computed with reference to the nature of the injury, without regard to the employee's absence from work.

Benefits paid under other employer-provided accident or health insurance plans must be included, under IRC 105(a).

(2) **Health plan coverage**: Under IRC 106(a), an employee's gross income does not include employer-provided coverage under an accident or health plan. The exclusion extends to coverage for the employee, spouse, and dependents, under an insured or self-funded plan. Reg. 1.106-1.

(3) **Qualified scholarships and tuition reductions**: Discussed as educational benefits, pp. 210-213, below.

(4) **Qualified group legal service plans**: For taxable years specified in IRC 120(e), both an employer's contributions to, and the value of benefits received under, a qualified group legal services plan may be excluded from income, under IRC 120(a). The cut-off date in IRC 120(e) was extended by the

Omnibus Budget and Reconciliation Act of 1989, Section 7102. Under the new provision, the exclusion for employer-provided group legal services will expire for taxable years beginning after September 30, 1990. For taxable years beginning in 1990, the exclusion is limited to amounts paid for coverage provided on or before September 30, 1990.

(5) **Qualified transportation**: Discussed as transportation benefits, pp. 207-210, below.

(6) **Cafeteria plans**: Under IRC 125, an employee need not include in income employer contributions (including salary reduction amounts) to a qualifying cafeteria plan, solely because the plan offers a choice among otherwise excludable benefits, or between benefits and cash. In essence, IRC 125 precludes applying the doctrine of constructive receipt to tax non-taxable benefits, on the theory that the employee's election constitutes constructive receipt of income. IRC 6039D requires employers to file special information returns concerning IRC 125 plans.

(7) **Educational assistance programs**: Discussed as educational benefits, pp. 210-213, below.

(8) **Dependent care assistance programs**: Under IRC 129(a), an employee may exclude amounts paid or incurred by the employer for dependent care assistance furnished under a program satisfying the requirements of IRC 129(d). The amount of the exclusion is limited where benefits are paid to the employee (versus the employer providing care directly). Applicable non-discrimination rules must be satisfied.

IRC 129(d)(6) requires theemployer to provideemployees an annual written statement showing theamount of dependent care assistance provided. IRC6051(a)(9) requires a similar statement. Notice 89-111, 1989-49I.R.B. 19 (Dec. 4, 1989), provides guidance on complying withthese requirements.

C. IRC 132 - Excluded Fringe Benefits

IRC 132, added to the Code in 1984, excludes from gross income a variety of fringe benefits falling into four generic categories. The legislative history indicates Congress intended IRC 132 to deal comprehensively with fringe benefits, other than those specifically addressed by other Code sections. See, e.g., Conf. Rep. 98-861, 98th Cong., 2d Sess. 1166-67 (June 23, 1984). Thus, after IRC 132's enactment, the Code no longer allows for "nonstatutory fringe benefits" to exist.

Under IRC 132(a), gross income does not include any fringe benefit which is a:

(1) no additional cost service,
(2) qualified employee discount,
(3) working condition fringe, or
(4) de minimis fringe.

In addition, IRC 132(h)(5) excludes the value of certain employer-provided athletic facilities.

Each category of excluded benefit is discussed below.

If another Code section specifically provides for the tax treatment of a particular benefit, IRC 132 generally does not apply. Reg. 1.132-1(f)(1). For example, a university's tuition remission, not satisfying the requirements of IRC 117(d), may not be excluded as a no-additional-cost service or qualified employee discount. Where the other exclusion is limited based on cost, however, IRC 132 may apply to the excess amount. Reg. 1.132-1(f)(2).

In applying the rules below, all employees treated as employed by a single employer under IRC 414(b), (c), (m), or (o) are treated as employees of a single employer. Reg. 1.132-1(c).

On July 5, 1989, the Service issued regulations under IRC 132. The regulations (with an exception not relevant here) are effective as of January 1, 1989. Temporary regulations, similar to the final regulations, apply to benefits received from January 1, 1985, to December 31, 1988. See Reg. 1.132-1(g).

No additional cost service

IRC 132(b) defines a "no-additional- costservice," excluded under IRC 132(a)(1), as a service an employer provides an employee for the employee's use if:

(1) the service is offered for sale to customers in the ordinary course of the employer's line of business in which the employee performs services, and

(2) the employer incurs no substantial additional cost (including foregone revenue) in providing the service to the employee (determined without regard to any amount the employee pays for the service).

The "no-additional-cost" exclusion thus applies only where the employer has excess capacity, which would be unused if the employee did not receive the benefit, see Reg. 1.132-2(a)(2), and includes such services as accommodations, transportation, and utility services. Non-excess capacity services, such as an investment adviser providing brokerage services, are not covered. The exclusion applies whether the service is provided for free, at a reduced price, or by rebating all or part of the amount paid. Reg. 1.132-2(a)(3).

The benefit may be provided to spouses or dependents of employees; retired or disabled employees; or surviving spouses or dependents of employees or retired or disabled employees. See Reg. 1.132-1(b)(1). It may also be provided, under reciprocal agreements, to employees of other employers in the same line of business. IRC 132(g); see also Reg. 1.132-2(b), which provides detailed rules. "Line of business" requirements and non-discrimination rules, discussed below under **General requirements**, apply.

> **Example**: X is a 501(c)(3) organization that operates a historical site. The site contains a hotel where visitors can stay overnight. X allows employees who work at the hotel, and their families, to stay overnight at the hotel, on a space available basis. The value of the overnight accommodations may be excluded as a "no-additional-cost service".

Qualified employee discount

IRC 132(c)(1) defines a "qualified employee discount," excluded under IRC 132(a)(2), as an employee discount on qualified property or services, to the extent the discount does not exceed certain limits.

An "employee discount" is the amount by which the price the employee pays is less than the price at which property or services is offered to customers. IRC 132(c)(3). Reg. 1.132-3(b) provides rules for determining the amount of a discount. A discount may be provided by furnishing property or services at no charge, at a reduced price, or by rebating all or part of the amount paid. Reg. 1.132-3(a)(4). The employer may provide the discount directly, or through a third party (e.g., a retailer who distributes the employer's products). See Reg. 1.132-3(a)(5). Where an employee pays at least fair market value for damaged, distressed, or returned goods, the employee does not have income, see Reg. 1.132-3(b)(3).

A qualified discount may be offered only on "qualified property or services," defined in IRC 132(c)(4) as any property (other than real property or personal

property of a kind held for investment) or services, offered for sale to customers in the ordinary course of the line of business in which the employee works. See also Reg. 1.132-3(a)(2).

Under IRC 132(c)(1), a qualified discount may not exceed:

(A) For property, the "gross profit percentage" of the price at which the employer offers the property to customers, or

(B) For services, 20% of the price at which the employer offers the service to customers.

IRC 132(c)(2)(A) defines "gross profit percentage" as the percentage equal to the employer's aggregate profit margin (aggregate sales price to customers less aggregate cost, divided by aggregate sales price). Under IRC 132(c)(2)(B), gross profit percentage is determined for property offered customers in the ordinary course of the line of business in which the employee works, during a representative period. Reg. 1.132-3(c) provides rules for determining gross profit percentage.

Where an employer provides a discount exceeding the limits, only the excess discount must be included in income. Reg. 1.132-3(e).

A qualified employee discount may be available to spouses or dependents of employees; retired or disabled employees; or surviving spouses or dependents of employees or retired or disabled employees. See Reg. 1.132-1(b)(1). Reciprocal agreements among employers (to offer discounts to each other's employees) are not allowed. Reg. 1.132-3(a)(3). "Line of business" requirements and non-discrimination rules, discussed below under **General requirements**, apply.

> **Example**: Y, a hospital exempt under IRC 501(c)(3), allows hospital employees to purchase drugs at the hospital pharmacy at a 10% discount. Assuming Y's gross profit percentage at the pharmacy is at least 10%, employees may exclude the amount of the discount from gross income as a qualified employee discount.

Working condition fringe

IRC 132(d) defines a "working condition fringe," excluded under IRC 132(a)(3), as any property or services an employer provides an employee to the extent the employee, if he or she paid for the property or services, would be allowed a deduction under IRC 162 or167. Common working condition fringesare

business use of employer-provided vehicles (discussed below, pp. 207-210); on-the-job training; and required uniforms or safety equipment.

A working condition fringe may only be provided where the hypothetical deduction relates to the employee's trade or business of being an employee of the employer. See Reg. 1.132-5(a)(2)(i). Thus, where a hospital provides office space for a physician to see private patients, unrelated to hospital business, the exclusion would not apply. See Reg.1.132-5(a)(2)(ii), Example (1). Also, the hypothetical deduction must be under IRC 162 or 167; a deduction for expenses for the production of income (IRC 212) would not qualify the benefit for exclusion. See Reg.1.132-5(a)(1)(iii).

Substantiation requirements under IRC 162 or 167 apply in determining whether a working condition fringe exclusion is available for a particular benefit, Reg.1.132-5(a)(1)(ii); Reg. 1.132-5(c) provides detailed rules.

Under Reg. 1.132-5(a)(1)(v), a cash payment may qualify as a working condition fringe only if the employer requires the employee to:

(A) Use the payment for expenses related to a specific or pre-arranged activity for which a deduction is allowed under IRC 162 or 167;

(B) Verify the payment is used for such expenses; and

(C) Return to the employer any amount not so used.

Special rules are provided for excluding the use of consumer goods in an employer's product testing program, Reg. 1.132-5(n); and parking, IRC 132(h)(4) and Reg. 1.132-5(p), discussed pp. 209-210, below.

A working condition fringe may be provided to the employer's current employees and directors; and, except for parking or product testing programs, to independent contractors who perform services for the employer. Reg. 1.132-1(b)(2). Non-discrimination rules do not apply, except to product testing programs, in a limited way, see Reg. 1.132-5(n)(3). Reg. 1.132-5(q).

De minimis fringe

IRC 132(e) defines a "de minimis fringe," excluded under IRC 132(a)(4), as any property or service the value of which is so small as to make accounting for it unreasonable or administratively impracticable. Whether the value satisfies this

standard considers the frequency with which similar fringes are provided other employees. Benefits that may be excluded as de minimis fringes may include typing of personal letters, occasional personal use of an office copying machine, occasional supper money or taxi fare due to overtime work, and traditional holiday gifts of property with low fair market value. See Conf. Rep. No.98-861, 98th Cong., 2d Sess. 1168 (June 23, 1984).

Generally, in measuring how frequently similar benefits are provided, the focus is on the individual employee. Reg. 1.132-6(b)(1). For example, an employer could not pay for an employee's dinner every night as a de minimis fringe. Where, however, it would be administratively difficult to determine frequency with respect to individual employees, frequency is measured for the work force as a whole. For example, if an employer exercises sufficient control and imposes significant restrictions on personal use of an office copying machine, so at least 85% of the machine's use is for business purposes, personal use by particular employees is a de minimis fringe. Reg. 1.132-6(b)(2).

Benefits are excluded as de minimis fringes only where accounting for their value would be unreasonable or administratively impracticable. Thus, cash payments and cash equivalents (such as gift certificates or use of credit cards) are generally not excludable on this basis. Reg. 1.132-6(c). Where special rules in Reg. 1.132-6(d) allow cash or cash equivalents, however, this principle does not apply.

Where a benefit does not satisfy the requirements for exclusion as a de minimis fringe, no amount of the benefit may be excluded on this basis. Reg. 1.132-6(d)(4).

Reg. 1.132-6(d) provides special rules for transit passes (Reg. 1.132-6(d)(1)); cash reimbursement in lieu of transit passes (see Notice 89-110, 1989-49 I.R.B. 17 (Dec. 4, 1989)); and occasional meal money or local transportation fare (Reg. 1.132-6(d)(2)). Under these rules, benefits may be excluded even though they may not otherwise qualify as de minimis fringes. However, neither the special rules, nor the examples in Reg. 1.132-6(e) of includable and excludable benefits, may be used to establish general rules for other benefits. Reg. 1.132-6(d)(3).

A de minimis fringe may be provided to any person. Reg. 1.132-1(b)(4). Non-discrimination rules do not apply. Reg. 1.132-6(f).

On-premises athletic facilities

IRC 132(h)(5)(A) says gross income does not include the value of an on-premises athletic facility provided by an employer to employees. Under IRC 132(h)(5)(B), the facility must be a gym or other athletic facility(i) located on the employer's premises, (ii) operated by the employer, and (iii) substantially all the use of which is by "employees, "their spouses, and dependent children. Qualifying use includes use by retired or disabled employees, and by surviving spouses or dependents of employees or retired or disable employees. Reg. 1.132-1(b)(3). It also includes use by participants qualified with respect to other employers who together provide the facility. Reg. 1.132-1(e)(4).

A facility need not be on the employer's business premises; it must, however, be on premises owned or leased by the employer. Reg. 1.132-1(e)(2). A facility for residential use, such as a resort with accompanying athletic facilities, does not qualify, but one on premises of a voluntary employees' beneficiary association funded by the employer does.

The employer must also "operate" the facility; it may do so using its own employees or by contracting with a third party. Reg. 1.132-1(e)(4). A facility operated by more than one employer is deemed operated by each employer. Operation by a voluntary employees' beneficiary association funded by the employer also satisfies this requirement.

The exclusion does not apply to any athletic facility if the facility is available to the general public through memberships, rental, or similar arrangement. Reg. 1.132-1(e)(1). The exclusion also does not apply to membership in an athletic facility (including health clubs or country clubs) unless the facility itself qualifies. Reg. 1.132-1(e)(3).

Non-discrimination rules do not apply to this benefit. Reg. 1.132-1(e)(5). (Of course, where the benefit is provided through a voluntary employees' beneficiary association, non-discrimination rules do apply.)

General requirements

Line of business requirement: The exclusions for no-additional-cost services and qualified employee discounts are generally limited to services or discounts provided employees who work in the line of business of the employer with respect to which the service or discount is provided to customers. The purpose of this requirement is stated in Reg. 1.132-4(h):

> . . . The requirement is intended to ensure that employers do not offer, on a tax-free or reduced basis, property or services to employees that are not offered to the employer's customers . . . .

To satisfy the line of business requirement, an employee must perform substantial services in the same line of business in which the employer offers property or services to customers in the ordinary course of business. See Reg. 1.132-4(a)(1)(i). For this purpose, "customers" do not include employees. See Reg. 1.132-1(d). Thus, the exclusion is not available either where the employer does not provide the particular property or services to customers in the ordinary course of its business, Reg. 1.132-4(a)(1)(ii); or where the employee does not perform substantial services in the line of business in which the property or services are offered to customers. Benefits in more than one line of the employer's business may be provided where an employee performs substantial services in more than one line of business, Reg. 1.132-4(a)(1)(iii), or performs services that directly benefit more than one line of business, Reg. 1.132-4(a)(1)(iv).

Reg. 1.132-4(a)(2) defines "line of business" as a two-digit classification referred to in the Enterprise Standard Industrial Classification (ESIC) Manual, which is prepared by the Statistical Policy Division of the U.S. Office of Management and Budget. Reg. 1.132-4(a)(3) permits two-digit classifications to be aggregated in certain circumstances.

> **Example**: X operates a hospital, which includes a laundry service for hospital linens. X allows employees to use the laundry service for personal laundry, on a space available basis. Use of the laundry service may not be excluded as a no-additional-cost service (or qualified employee discount) because X does not provide laundry service to customers in the ordinary course of its hospital line of business.

Reg. 1.132-4(b) provides grandfather and other special rules relaxing the line of business requirements in circumstances not generally relevant to exempt organizations.

Non-discrimination rules: Non-discrimination rules, provided by Reg. 1.132-8, apply to no-additional-cost services and qualified employee discounts. For these benefits, Reg. 1.132-8(a)(1) requires generally that benefits be available on substantially the same terms either (1) to all the employer's employees, or (2) to a group of employees defined under a reasonable classification which does not discriminate in favor of highly compensated employees. Reg. 1.132-8(f) defines "highly compensated employees," generally tracking the definition in IRC 414(q).

If the non-discrimination rules are not satisfied, highly compensated employees must include in income the value of the entire benefit received, as well as benefits received under related fringe benefit programs. See Reg. 1.132-8(a)(2).

Under Reg. 1.132-8(d)(2), certain classifications are per se discriminatory: those that on their face make benefits available principally to highly compensated employees; and those based either on an amount or rate of compensation, if higher-compensated employees are favored. Classifications based on seniority, full-time status, or job description, are not per se discriminatory. Also, the benefit does not fail to be available on "substantially the same terms" merely because it is available on a "first come, first serve" basis, Reg. 1.132-8(c)(2)(i), or because priority is based on seniority if additional requirements are satisfied, Reg. 1.132-8(c)(2)(ii).

In testing for discrimination, employees of "related employers" (defined in Reg. 1.132-1(c)) are aggregated if they work in the same line of business. Reg. 1.132-8(b)(1). Former employees are tested separately, Reg. 1.132-8(d)(3).

D. Meals and Lodging

The value of living quarters and meals an employer provides an employee must be included in the employee's income unless specifically excluded. Reg. 1.61-2(d)(3). Excludable benefits are limited to the following, each discussed below:

(1) Meals or lodging furnished for convenience of employer: IRC 119

(2) Parsonage allowance: IRC 107

(3) Employer-operated eating facilities: IRC 132(e)(2)

Note, too, that occasional meal money may be excluded as a "de minimis fringe," discussed pp. 193-194, above, under the special rule in Reg. 1.132-6(d)(2).

IRC 119 - Meals or lodging furnished for convenience of employer

IRC 119(a) excludes from gross income the valueof meals or lodging furnished to an employee, spouse,or dependents by or on behalf of the employer for the employer'sconvenience, under certain circumstances. The exclusion extends only to meals and lodgingfurnished in kind, and not to a cash allowance for such items. Reg. 1.119-1(e).

If the requirements for exclusion are not met, the value of the benefit is subject to tax (unless another exclusion exists); absent contrary evidence, the Service may deem the amount paid to be the value of the item furnished. See Reg. 1.119-1(b). In addition, included benefits are "wages" for FICA, FUTA, and withholding purposes. See Rev. Rul. 81-222, 1981-2 C.B. 205.

Meals: The value of meals may be excluded only if furnished on the employer's business premises, generally the place the employee works, Reg. 1.119-1(c)(1). Meals must be furnished during working hours, or immediately after working hours if the employee's duties prevent obtaining a meal during working hours. Reg. 1.119-1(a)(2)(ii)(f). Meals furnished immediately before working hours may also be excluded in some circumstances. See Reg. 1.119-1(f), Example (1). Whether meals are furnished "for the convenience of" the employer depends on the facts and circumstances of each case; the terms of a statute or employment contract fixing terms of employment do not control. IRC 119(b)(1); Reg. 1.119-1(a)(1).

If meals are furnished without charge, they are "for the convenience of the employer" if furnished for a substantial noncompensatory business purpose of the employer. Reg. 1.119-1(a)(2)(i). For this purpose, employees are treated as a group; if the employer has a qualifying purpose for furnishing meals to substantially all its employees, the value of meals furnished other employees may also be excluded. Reg. 1.119-1(a)(2)(ii)(e).

The following examples illustrate substantial noncompensatory business purposes:

(1) Employee must be available for emergency call during meal period, Reg. 1.119-1(a)(2)(ii)(a). Thus, a hospital that provides its employees meals so they will be available for emergencies is furnishing the meals for a substantial noncompensatory business purpose, and employees may exclude the value of the meals. See Reg. 1.119-1(f), Example (9); Rev. Rul. 68-354, 1968-2 C.B. 60 (value of meals and lodging furnished state mental hospital employees who volunteer to reside at hospital and be available on 24-hour call for emergencies may be excluded).

(2) Employer's business requires restricting employee to short meal period, such as 30 or 45 minutes, and employee could not be expected to eat elsewhere during that period, Reg. 1.119-1(a)(2)(ii)(b).

(3) Employee could not otherwise secure proper meals within reasonable meal period (e.g., insufficient facilities in vicinity), Reg. 1.119-1(a)(2)(ii)(c).

Promoting employee morale or goodwill, or attracting prospective employees, is not a substantial noncompensatory business purpose. Reg. 1.119-1(a)(2)(iii).

Where employees are charged for meals, they are not furnished for the employer's convenience if employees may choose to purchase them or not, Reg. 1.119-1(a)(3)(i). Meals furnished for a charge the employee must pay (whether he accepts the meal or not) are treated as meals for which no charge is imposed, as discussed above. The fixed charge itself is excluded, see IRC 119(b)(2); Reg. 1.119-1(a)(3)(ii).

Lodging: Lodging furnished for the convenience of the employer may be excluded only if the employee must accept such lodging as a condition of employment. IRC 119(a)(2); Reg. 1.119-1(b)(3). The employee must be required to accept lodging to enable him properly to perform his duties, as where the employee must be available for duty at all times or could not perform required services unless lodging were furnished. Thus, if an employee of an institution may choose to reside at the institution free of charge, or reside elsewhere and receive a cash housing allowance, he must include the lodging's value in income because his residence is not required as a condition of employment. Reg. 1.119-1(f), Example (6). If the employee is charged a fixed amount (whether he accepts lodging or not), that amount is excluded from income, and exclusion of the value of the lodging is determined according to the rules discussed above.

Lodging must generally be furnished on the employer's business premises, IRC 119(a)(2); Reg. 1.119-1(b)(1), generally, where the employee works, Reg. 1.119-1(c)(1). For years beginning after December 31, 1981, lodging in certain camps in foreign countries is considered to be on the employer's business premises, IRC 119(c) and Reg. 1.119-1(c)(2). Qualifying camps are defined in Reg. 1.119-1(d).

The value of excluded lodging includes necessary utilities, unless the employee contracts for and purchases utilities directly. Rev. Rul. 68-579, 1968-2 C.B. 61.

IRC 119(d) provides special rules governing lodging furnished by educational institutions (defined in IRC170(b)(1)(A)(ii)).For years beginning after December 31, 1985, an employee may exclude the value of "qualified campus lodging". (For prior years, the legislative history indicates the Service is to apply

similar rules, see H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. II-545 (Sept. 18, 1986).) IRC 119(d)(3) defines "qualified campus lodging" as lodging, not excluded by IRC 119(a), which is (A) located on, or in the proximity of, a campus of the institution, and (B) furnished to the employee, spouse, or dependents, by or on behalf of the institution, for use as a residence. Where an employee pays rent less than the lodging's value, however, he may have to include a portion of the excess amount. See IRC 119(d)(2),for rules governing determination and inclusion of excess amounts.

Courts have generally agreed with the Service's interpretation of IRC 119. A good example is Bob Jones University v. United States, 670 F.2d 167 (Ct. Cl. 1982), modifying 47 A.F.T.R.2d 81-423 (Ct. Cl. Tr. Div. 1981), where the Claims Court held a university's employees could not exclude the value of employer-provided meals or lodging because they were not provided "for the convenience of the employer." Lodging could not be excluded for the additional reason that employees did not have to accept it as a condition of employment. The court's opinion throughout applies the tests in the regulations objectively, saying the employer's views concerning the relationship between meal and lodging benefits and the goals it seeks to achieve by providing them is irrelevant.

In the Bob Jones case, 70% of the university's employees, other than graduate students, received free housing on or near campus, and 85% received free meals on campus; other employees received cash allowances. The university argued providing housing and meals was for its "convenience"; it was necessary "to project an insulated Christian community and to promote informal contacts between [employees] and the students . . . ." The Claims Court, however, applied the "convenience" and "condition of employment" tests objectively, finding the benefits were not "integrally related" with achieving the employer's stated goals. There were minimal contacts between employees and students during employer-provided meals or in employer-provided housing, and employees who did not receive benefits had the same responsibilities as those who did. Thus, the court held, the university's non-compensatory reasons for providing the benefits were "tangential" to its compensatory purposes. Moreover, the university's off-campus housing was not on its business premises, as required by the Code and regulations.

IRC 107 - Parsonage Allowance

IRC 107 provides:

In the case of a minister of the gospel, gross income does not include—

(1) the rental value of a home furnished to him as part of his compensation; or

(2) the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home.

Where a cash allowance is paid, the minister may still deduct interest on a mortgage, or real property taxes on, a home acquired with the allowance. See IRC 265(a)(6)(B).

Several requirements must be met for the exclusion to apply:

Minister of the gospel: The taxpayer must be a "minister of the gospel." That an individual serves an organization with no formal ordination procedure is irrelevant if he or she provides qualifying services, Rev. Rul. 66-90, 1966-1 C.B. 27, modified, Rev. Rul. 78-301, 1978-2 C.B. 103. However, the exclusion is not allowed individuals in charge of church choir or youth programs who are not ministers. Rev. Rul. 59-270, 1959-2 C.B. 44. A Jewish rabbi who performs qualifying services is a "minister of the gospel." Rev. Rul. 58-221, 1958-1 C.B. 53.

Allowance as remuneration for ministerial services: The taxpayer must receive the home or allowance "as remuneration for services which are ordinarily the duties of a minister of the gospel." Reg. 1.107-1(a). Reg. 1.1402(c)-5, which applies in determining what services qualify, includes: performing sacerdotal functions, conducting religious worship, administering and maintaining religious organizations and their integral agencies, and performing teaching and administrative duties at theological seminaries.

The exclusion extends to an allowance furnished a retired minister in recognition for past services. Rev. Rul. 63-156, 1963-2 C.B. 79. No exclusion may be claimed for amounts paid a minister's surviving spouse, however. Rev. Rul. 72-249, 1972-1 C.B. 36.

The exclusion may be claimed by ordained ministers who teach or have other positions in parochial schools or colleges which are integral agencies of religious organizations. Rev. Rul. 62-171, 1962-2 C.B. 39; Rev. Rul. 70-549, 1970-2 C.B. 16; see Reg. 1.1402(c)-5(b)(2)(iv). But where a minister is employed by a school that is not an "integral agency," the exclusion does not apply. Rev. Rul. 63-90, 1963-1 C.B. 27. Similarly, a minister who is president of an exempt organization that furnishes financial advice to churches may not claim the

exclusion, where his employer is not affiliated with any church or religious organization. Rev. Rul. 78-172, 1978-1 C.B. 35; see also Rev. Rul. 68-68, 1968-1 C.B. 51 (value of apartment furnished minister could not be excluded where employer was not a religious organization nor integral agency); Rev. Rul. 72-606, 1972-2 C.B. 78 (minister employed by old age home that is affiliated with but not controlled by a church may not exclude rental allowance under IRC 107).

Rev. Rul. 72-606, supra, states criteria for determining if a church-related institution is an "integral agency" of a religious organization:

(1) Whether the religious organization incorporated the institution;

(2) Whether the institution's name indicates a church relationship;

(3) Whether the religious organization continuously controls, manages, and maintains the institution;

(4) Whether the institution's trustees or directors are appointed or must be approved by the religious organization;

(5) Whether trustees may be removed by the religious organization;

(6) Whether the institution must annually report finances and general operations to the organization;

(7) Whether the religious organization contributes to the institution's support; and

(8) Whether, if the institution were dissolved, its assets would be turned over to the organization.

Rev. Rul. 72-606 says these criteria should be applied as follows:

> The absence of one or more of these characteristics will not necessarily be determinative in a particular case. Generally, . . . when application of the above criteria does not clearly support an affirmative or negative answer, the appropriate organizational authorities are contacted for a statement, in light of the criteria, whether the particular institution is an integral agency, and their views are carefully considered.

Reg. 1.1402(c)-5(b)(2) says qualifying services must be performed "under the authority of a . . . church or church denomination." Under Reg. 1.1402(c)-5(b)(2)(v), this requirement is satisfied where a minister performs services for another organization (not itself a religious organization or integral agency), if

assigned or designated to do so by his church. In Lawrence D. Boyer, 69 T.C. 521 (1977), acq., 1978-2 C.B. 1, the Tax Court held the "assignment" must be directly related to accomplishing the church's purposes; more is required than ordained status and the church's perfunctory ratification of secular employment. Thus, a minister could not claim the exclusion where, after teaching at a secular college for a year, he had the college request his continued services and the church "assign" him to teach for the college.

"Home" provided: Where a minister receives an in-kind parsonage allowance, the exclusion extends to the "dwelling place (including furnishings), and the appurtenances thereto, such as a garage." Reg. 1.107-1(b). No additional authority explains what constitute "appurtenances." Authorities on what "used to provide a home" means, for purposes of the cash rental allowance exclusion, may assist in interpreting this term, however.

"Rental allowance" provided - designation requirement: Under Reg. 1.107-1(b), the employer must designate cash amounts as a rental allowance, before paying them, for the exclusion to be allowed. Designation may be in an employment contract, minutes, a resolution, or other appropriate instrument evidencing official action. The designation suffices if it permits a payment or part thereof to be identified as a rental allowance, as distinguished from salary or other remuneration. A national organization cannot designate on behalf of local congregations, Rev. Rul. 75-22, 1975-1 C.B. 49.

"Rental allowance" - "used to provide a home": Under IRC 107(2), the parsonage allowance exclusion extends to a cash allowance only to the extent "used . . . to rent or provide a home." Reg. 1.107-1(c) says an allowance is used to provide a home if expended (1) for rent of a home, (2) for purchase of a home, or (3) for expenses directly related to providing a home. Expenses for food and servants are not directly related to providing a home. And where a minister purchases a farm or other business property in addition to a home, the portion of the allowance expended in connection with that property is not excluded.

Thus, where a minister rents his home to a third party during a leave of absence, he may not exclude rental allowance received during the period of his absence. See Rev. Rul. 72-588, 1972-2 C.B. 77.

In Rev. Rul. 71-280, 1971-2 C.B. 92, the Service held a minister could not exclude his entire compensation as a parsonage allowance; instead, the exclusion is limited to the fair rental value of the home. The minister had purchased a home,

making a large down payment which, combined with annual payments on a mortgage, exceeded the minister's annual compensation. Immediately before purchasing the home, the minister's employer, at his request, had designated his entire annual compensation as rental allowance. This ruling should not be read as limiting a parsonage allowance to a "reasonable" or "fair" amount, however. Nor should it be interpreted as precluding a minister from excluding all or a substantial part of his annual compensation under IRC 107, when excluded amounts do not exceed the fair rental value of the minister's home.

The exclusion is limited to amounts actually paid to provide a home during a year. Thus, in a technical advice memorandum, the Service held an amount to amortize an advance payment for a retirement home could not be excluded as a "rental allowance" since it was not paid during the taxable year. P.L.R. 8039007 (June 20, 1980).

A minister may exclude rental allowances paid by several churches, to the extent used to maintain a permanent home. Rev. Rul. 64-326, 1964-2 C.B. 37 (minister performed evangelistic services at churches away from home). Apparently, however, the IRC 107 exclusion is allowed only for a single home. The language of the Code and regulations, referring to allowance "used . . . to . . . provide a home" (emphasis added) supports this interpretation.

Expenditures "to provide a home" (which may be excluded under IRC 107) may include utility services, Rev. Rul. 59-350, 1959-2 C.B. 45, and Rev. Rul. 71-280, 1971-2 C.B. 92; and capital expenditures to improve a minister's home, see Rev. Rul. 72-588, 1972-2 C.B. 77.

<u>"Rental allowance" - other requirements</u>: A rental allowance may not be excluded to the extent it exceeds reasonable compensation for services. Thus, in Rev. Rul. 78-448, 1978-2 C.B. 105, a minister was employed full-time outside a church and provided only occasional services for it. The church paid him a rental allowance exceeding reasonable compensation for the minimal services performed. The ruling held the minister could not exclude the amount by which the allowance exceeded reasonable compensation.

IRC 132(e)(2) - Employer-provided eating facilities

IRC 132(e)(2) allows an employee to exclude from income, as a form of "de minimis fringe" (discussed generally above, pp. 193-194), meals provided in certain employer-provided eating facilities. What is excluded is the excess of the

meal's value over any amount the employee pays, which would otherwise be included under IRC 61(a)(1). Thus, if requirements for exclusion are not satisfied, this is the amount that must be included in income. See Reg. 1.132-7(c). Reg. 1.61-21(j) provides special rules for valuing meals provided at employer-provided eating facilities; use of these rules is subject to the general limitations on use of special valuation rules, Reg. 1.61-21(c)(2)-(7).

To qualify for exclusion under IRC 132(e)(2), two requirements must be met:

Facility located on or near employer's business premises: The meal must be provided at a facility located on or near the employer's business premises. IRC 132(e)(2)(A). Reg. 1.132-7(a)(2) says this requirement is satisfied if (i) the employer owns or leases the facility; (ii) the employer operates the facility; (iii) the facility is located on or near the business premises of the employer; and (iv) meals are provided during, or immediately before or after, the employee's work day. An employer is deemed to operate the facility if it contracts with another to operate it, or operates it with other employers, Reg. 1.132-7(a)(3).

Revenue equal to or exceeding direct operating costs:

The second requirement for exclusion is that revenue from the facility must normally equal or exceed the facility's direct operating costs. IRC 132(e)(2)(B). Reg. 1.132-7(a)(1)(i) says this test must be met on an annual basis. If an employer can reasonably determine the number of meals excluded under IRC 119, all costs and revenues associated with those meals may be disregarded in determining if the direct operating cost test is satisfied. Reg. 1.132-7(a)(2). Also, if a hospital can reasonably determine the number of meals furnished, free or at a discount, to volunteers, costs and revenues associated with those meals may also be disregarded. Id.; see also Reg. 1.132-7(a)(4), Example (1). Note that the regulation's terms limit use of this special rule to hospitals. Note, too, that by excluding meals provided volunteers from direct operating cost calculations, the regulation implies such meals are not "compensation" to hospital volunteers, at least for purposes of IRC 61.

Reg. 1.132-7(b) provides detailed rules for determining direct operating costs.

Non-discrimination test for highly compensated employees: For the exclusion to be claimed by highly compensated employees, a non-discrimination

test must also be satisfied: Access to the facility must be available on substantially the same terms to each member of a group of employees defined under a reasonable classification which does not discriminate in favor of highly compensated employees. See Reg. 1.132-7(a)(1)(ii), which adopts the test in Reg. 1.132-8, discussed above, p. 196. Each dining room or cafeteria is treated as a separate eating facility.

"Highly compensated employees" are defined in Reg. 1.132-8(f)(1) (generally, IRC 414(q) definition). However, if access is available under a classification not satisfying the non-discrimination test, the classification will be deemed discriminatory only if the facility is used by "executive group employees" more than a de minimis amount. Reg. 1.132-8(d)(5)(i). An "executive group employee" is defined under Reg. 1.132-8(f)(1), but taking only the top 1% of employees (in terms of compensation), instead of 10%. Reg. 1.132-8(d)(5)(ii).

E. Transportation benefits (personal use of vehicles, commuting expenses, parking, etc.)

Under the general principle that transfers by an employer to or for the benefit of an employee are compensatory, an employee receives gross income when his or her employer provides a vehicle for personal use or pays personal commuting, parking, or similar expenses. There are few exclusions for such income.

IRC 124 - Qualified Transportation Provided by Employer

IRC 124(a) excludes from gross income the value of qualified transportation provided by an employer between an employee's residence and place of employment. The exclusion is available for qualified transportation provided in years beginning after December 31, 1978,and before January 1, 1986. IRC 124(e).

Under IRC 124(b), "qualified transportation" means transportation in a "commuter highway vehicle," defined in IRC 46(c)(6)(B) (without regard to clause (iii) or (iv)). Thus, the vehicle must have a seating capacity of at least 8 adults (excluding driver), and at least 80% of its mileage must reasonably be expected to be (I) for transporting employees between their residences and place(s) of employment, and (II) on trips during which employees make up at least 1/2 the seating capacity (excluding driver). IRC 124(c) requires that transportation be provided under a separate written plan of the employer which does not discriminate in favor of officers, shareholders, or highly compensated employees.

The plan must also provide that the value of transportation is in addition to (and not in lieu of) compensation otherwise payable.

Employer-provided vehicles - IRC 132(d)

Whether employee use of an employer-provided vehicle is included as personal use or excluded as business use is governed generally by IRC 132, in particular, IRC 132(d), which defines "working condition fringe" benefits, excluded under IRC 132(a)(3). IRC 132(d) is discussed generally above, pp. 191-192.

Allocation between business and personal use: Where the value of part of a vehicle's use may be excluded as a working condition fringe, Reg. 1.132-5(b) provides rules for allocating between the includable (personal) and excludable amounts, based on mileage. The value of the vehicle's use by the employee must first be determined, under Reg. 1.61-21(b)(4), or the special vehicle valuation rules in Reg. 1.61-21(d)-(f), if available. The employee may exclude the amount that would be allowable as a deduction under IRC 162 or 167, if he or she paid for the availability of the vehicle. Reg. 1.132-5(b)(1)(i). The excludable amount is determined by allocating, based on mileage, between excludable and includable use.

> **Example**: The value of an employer-provided vehicle for a full year is $ 2,000, without regard to any exclusion. During the year, the employee drives the vehicle 6,000 miles on the employer's business and 2,000 miles for other reasons. The includable amount is $ 500 (1/4 of total mileage for non-excludable use times $ 2,000 total use value).

If other employees drive the vehicle, their total mileage (includable and excludable) is included in total mileage (denominator), reducing the proportion of use which must be included by the employee. Special rules apply where substantially all the vehicle's use by other employees is limited to a certain period.

The includable amount is determined without reference to the value of the vehicle. Thus, where an employer provides an expensive vehicle for the employee's mixed personal and business use, that the vehicle is more expensive than the employee would have chosen is irrelevant, in determining income resulting from personal use of the vehicle. Reg. 1.132-5(b)(1)(iii).

Under Reg. 1.132-5(b)(2), the excludable amount is determined vehicle by vehicle. Thus, where an employer provides more than one vehicle for the employee's use, a separate allocation must be made for each.

Special Rules: Reg. 1.132-5(b)(3) and Reg. 1.61-21(b)(5) provide extensive rules governing employer-provided vehicles with chauffeurs. Reg. 1.132-5(m) provides special rules for determining the working condition fringe exclusion where an employer provides transportation for security reasons. Reg. 1.132-5(c) provides special substantiation rules where the vehicle provided is a "luxury automobile" subject to IRC 280F. See IRC 1.132-5(j). These rules apply even where the employer is an exempt organization not generally subject to the substantiation requirements of IRC 274(d). Reg. 1.132-5(c)(1).

Employer-provided aircraft

As with other vehicles, an employee may use an employer-provided aircraft for personal reasons (includable under IRC 61(a)(1)); or business reasons (excludable under IRC 132(a)(3) as working condition fringe). Reg. 1.132-5(k) provides rules for allocating total value between includable and excludable amounts. For example, where an employee's spouse or children are included in a particular flight, the value of their flights (determined under Reg. 1.61-21(g)), must be included in the employee's gross income, since the employee could not deduct those expenses if he or she paid for the flights.

Parking

IRC 132(h)(4) says "parking . . . on or near the business premises of the employer" is a working condition fringe, excludable under IRC 132(a)(3). In determining if the value of parking may be excluded, the special rules in Reg. 1.132-5(p) apply; if those requirements are satisfied, the value of parking is excludable regardless of whether the benefit would qualify under general rules for working condition fringes. See Reg. 1.132-5(p)(1). Discrimination rules do not apply, Reg. 1.132-5(q).

An employer may provide parking by owning or renting a parking facility or parking spaces. Reg. 1.132-5(p)(1). The employer may also reimburse the employee for ordinary and necessary expenses of renting a parking space on or near the employer's business premises if, but for the parking expense, the employee would not have been entitled to receive the reimbursed amount from the employer.

Reg. 1.132-5(p)(2). The employer may not, however, provide a general "transportation allowance" or similar benefit.

The exclusion also does not apply where parking is located on property the employee owns or leases for residential purposes. Reg. 1.132-5(p)(3). The exclusion is not available to independent contractors. See Reg. 1.132-1(b)(2). Thus, physicians who are independent contractors of a hospital may not exclude the value of free parking at the hospital as a working condition fringe.

F. Educational Benefits

Unless excluded, an employee must include in gross income the value of educational benefits provided by his or her employer, under IRC 61(a)(1). Benefits may be provided directly by the employer, by reimbursing amounts paid by the employee, or by paying a third party to provide education, to the employee or his or her family members. If payments are from a trust established and funded by the employer, IRC 83 determines the timing and amount of inclusion (see discussion of Reg. 1.83-3(c)(4), Example (2), above, p. 178).

A leading case is Richard T. Armantrout, 67 T.C. 996 (1977), aff'd, 570 F.2d 210 (7th Cir. 1978). In Armantrout, an employer paid college expenses for children of key employees, through a trust. The plan was established to relieve employees from concern about college costs, enabling them to better perform their duties, and because this was a benefit key employees desired. Benefits were available without regard to objective scholastic criteria or financial need. The court concluded amounts paid from the trust were income to the employees whose children benefited from the payments. In Wheeler v. United States, 768 F.2d 1333 (Fed. Cir. 1985), cert. denied, 474 U.S. 1080 (1986), the court affirmed a Claims Court decision upholding inclusion of benefits paid under a similar plan. The opinion in Wheeler contains a good discussion of the rationale for including benefits in employee income.

The following exclusions may be available:

(1) Qualified educational assistance programs: IRC 127

(2) Qualified scholarships: IRC 117(a)

(3) Qualified tuition reductions: IRC 117(d)

Note, too, that the value of job-related education provided an employee, directly or by reimbursing expenses, may be excluded as a working condition fringe, under the rules discussed above, pp. 191-192.

IRC 127 - Qualified educational assistance program

For taxable years specified in IRC 127(d), an employee may exclude amounts paid or expenses incurred by his or her employer under a qualified educational assistance program.IRC 127(a)(1). The cut-off date in IRC 120(e) was extended by the Omnibus Budget and Reconciliation Act of 1989, Section 7101. Under the new provision, the exclusion for employer-provided educational assistance will expire for taxable years beginning after September 30, 1990. For taxable years beginning in 1990, the exclusion is limited to amounts paid by the employer on or before September 30, 1990.

The program must meet the following requirements:

(1) "Educational assistance": The plan must provide "educational assistance," defined in IRC127(c)(1) as payingexpenses (including tuition, fees, books, supplies, and equipment), and providing courses of instruction (including books, supplies,and equipment). IRC 127(b)(1)(A). If benefits are paid by reimbursing employees, Reg.1.127-2(i) imposes substantiation requirements.

"Education" generally includes any form of instruction or training that improves or develops the individual's capabilities. Reg. 1.127-2(c)(4). Under IRC 127(c)(1)(B), "educational assistance" does not include providing tools or supplies the employee may retain after the course is over, see also Reg. 1.127-2(c)(3)(i), or meals, lodging, or transportation, see also Reg. 1.127-2(c)(3)(ii). Also excluded are graduate level courses normally taken by an individual pursuing a program leading to a law, business, medical, or other advanced academic or professional degree, IRC 127(c)(1); and education involving sports, games, or hobbies, IRC 127(c)(1)(B). The latter exclusion does not apply where such education (1) involves the employer's business, (2) is required as part of a degree program, or (3) instructs employees how to maintain and improve health (but not if athletic facilities or equipment are used or the "education" is recreational in nature). Reg. 1.127-2(c)(3)(iii).

(2) Written plan; non-discrimination rules: The plan must be a "separate written plan of an employer . . . to provide . . . employees with educational assistance, IRC 127(b)(1); and must satisfy non-discrimination rules in IRC 127(b)(2) (eligibility), and 127(b)(3) (aggregate benefits to principal shareholders and owners). See also Reg. 1.127-2(e)-(f). The "separate written plan" requirement means the program's terms must be set forth in a separate document or documents providing only educational assistance; this does not prevent educational

assistance from being part of a more comprehensive plan, however. Reg. 1.127-2(b).

(3) Notice to employees: Employees must receive reasonable notice of the terms and availability of the program. Reg. 1.127-2(g).

(4) No alternative benefits: The plan may not offer other benefits as an alternative to educational assistance. IRC 127(b)(4). (This parallels the prohibition on offering educational assistance benefits through a cafeteria plan, in IRC 125(e)(1).) Thus, a cash allowance, paid as salary or otherwise, may not be provided employees who do not use educational assistance benefits.

(5) Benefits for "employees": Benefits may be provided only to "employees," defined in Reg. 1.127-2(h)(1). Thus, a program that provides benefits to spouses or dependents is not a qualified program. Reg. 1.127-2(d).

(6) Maximum exclusion: The maximum exclusion is $ 5,250 per calendar year. IRC 127(a)(2).

IRC 6039D requires employers to file special information returns concerning IRC 127 programs.

IRC 117(a) - Qualified scholarships

Under IRC 117(a), gross income does not include amounts received as a "qualified scholarship" by a person who is a candidate for a degree at an educational institution (described in IRC 170(b)(1)(A)(ii)). In most cases, employer "scholarships" will be compensatory, and hence not excluded under IRC 117(a). See, e.g., Rev. Rul. 76-352, 1976-2 C.B. 37, amplified, Rev. Rul. 78-184, 1978-1 C.B. 304, which describes a compensatory program. But see Rev. Proc. 76-47, 1976-2 C.B. 670, which provides guidelines for determining whether employer-related grants are compensatory.

IRC 117(d) - Qualified tuition reduction

IRC 117(d), enacted in 1984, allows educational institutions to provide excludable compensatory educational benefits, to their own employees or those of other educational institutions. Under IRC 117(d)(1), gross income does not include any "qualified tuition reduction." To qualify, the benefit must satisfy the following requirements:

(1) Qualified organization: It must be provided by an educational organization described in IRC 170(b)(1)(A)(ii). IRC 117(d)(2).

(2) Qualified recipient: It must be for the education (below the graduate level), at the employing institution (or another IRC 170(b)(1)(A)(ii) organization), of (A) an employee, or (B) any person treated as an employee under IRC 132(f). IRC 117(d)(2). Thus, eligible individuals include employees, retired or disabled employees, and their spouses and dependent children (including surviving spouses and dependent children).

Where the person receiving the reduction is a graduate student at an educational organization, who engages in teaching or research activities for the organization, the restriction to undergraduate education does not apply. IRC 127(c)(8). Rev. Rul. 86-69, 1986-1 C.B. 78, holds that qualified tuition reductions excluded under IRC 117(d)(1), by reason of IRC 127(c)(8), are not subject to IRC 127(a)(2), which limits the amount excludable under a qualified educational assistance program. Note, however, that the special rule in IRC 127(c)(8) is subject to the cut-off date in IRC 127(d) (currently, years beginning before January 1, 1989).

(3) Non-discrimination rules: For benefits provided highly compensated employees (defined in IRC 414(q)), the exclusion applies only if the tuition reduction is available on substantially the same terms to members of a group of employees defined under a reasonable classification, which does not discriminate in favor highly compensated employees. IRC 117(d)(3). In testing for discrimination, employees excluded from consideration under IRC 89(h) may be excluded. IRC 117(d)(4).

In enacting IRC 117(d), Congress refused to specify that providing benefits only to faculty members is not discriminatory. See Conf. Rep. No. 98-861, 98th Cong., 2d Sess. 1172-73 (June 23, 1984). Thus, such plans may be discriminatory if the non-discrimination rules are not satisfied.

(4) Tuition reduction as payment for services: The exclusion does not cover any portion of an otherwise qualified tuition reduction which represents payment for teaching, research, or other services by the student required as a condition for receiving the benefit. IRC 117(c). Prop. Reg. 1.117-6(d)(2) (which is not final) interprets this requirement.

5. Deferred Compensation

A. In General

Deferred compensation programs of exempt organizations take various forms, summarized in Table III.

When an employee must include deferred compensation in income depends in part on the form the program takes. The timing of inclusion also depends on

when the program was established. It may also depend on whether the deferral is elective (at the option of the employee) or nonelective. Certain plans are excepted from IRC 457, which limits how much compensation employees of exempt organizations may defer.

Rules governing deferral, may be summarized as follows:

(1) Qualified plans: An employee receives no current income from his or her own or employer contributions to a qualified plan (p. 215). This treatment includes contributions to tax-sheltered annuity plans under IRC 403(b) (pp. 215-217).

(3) Deferral after income is earned: If an employee may elect to defer income after it is earned, he or she receives current income equal to the deferred amount, regardless of whether the plan is funded or unfunded, and regardless of whether it is subject to IRC 457 (p. 217).

(4) Non-qualified, funded deferred compensation plans: If the plan is funded, the employee receives income at the time his right to compensation vests, under IRC 83 and IRC 402(b) (pp. 217-218).

(5) Non-qualified, unfunded deferred compensation plans subject to IRC 457: If an unfunded plan is subject to IRC 457(a), the employee may defer income in accordance with that section's requirements and limits (pp. 220-228). If the plan is ineligible (i.e., does not meet IRC 457's requirements for deferral), deferrals are included in income once the employee's right to receive them is vested, under IRC 457(f) (p. 227).

(6) Non-qualified, unfunded, nonelective deferred compensation plans not subject to IRC 457: If an unfunded, nonelective plan is not subject to IRC 457, the employee does not receive income until amounts are actually distributed under the plan (pp. 218-220).

(7) Non-qualified, unfunded, elective deferred compensation plans not subject to IRC 457: If an unfunded, elective plan is not subject to IRC 457, the proper tax treatment is unclear (pp. 218-219).

B. Qualified Plans

Under IRC 402(a)(1), a beneficiary of a qualified employee trust is not taxed on contributions to the trust when they are made. Instead, the employee is taxed, as distributions are received, under IRC 72 (relating to annuities). At that time, income may include amounts that are compensation (ordinary income), non-taxable return of capital, or capital gain, depending on whether amounts are attributable to employer contributions, employee contributions, or appreciation.

This treatment extends to contributions to any trust described in IRC 401(a) and exempt under IRC 501(a). This includes all forms of qualified defined benefit and defined contribution plans, including qualified cash or deferred arrangements under IRC 401(k). Similar rules apply where benefits are paid under a qualified annuity contract, under IRC 403(a). Thus, income is taxed, not when contributions are made, but as distributions are received, generally under IRC 72.

C. IRC 403(b)

A beneficiary of a tax-sheltered annuity program meeting the requirements of IRC 403(b) is taxed in a manner similar to a beneficiary of a qualified annuity contract. Under IRC 403(b)(1), amounts an employer contributes for a qualified tax-sheltered annuity are excluded from an employee's gross income for the year made, within certain limits, and the employee is instead taxed as distributions are made under IRC 72.

This treatment extends to employee salary reduction elections, as well as actual employer contributions. See Reg. 1.403(b)-1(b)(3).

A tax-sheltered annuity plan must meet the following requirements:

(1) Eligible employer: It must be established by a qualified employer, either an organization exempt under IRC 501(c)(3), IRC 403(b)(1)(A)(i), or a public school, IRC 403(b)(1)(A)(ii). The Uniformed Services University of the Health Sciences is also a qualified employer, under Pub. L. No. 96-613, Section 1, 94 Stat. 3579 (Dec. 28, 1980).

(2) Eligible employees: It may be provided only to "employees" of an eligible employer. IRC 403(b)(1)(A). Thus, independent contractors, such as physicians who work in hospitals but are not hospital employees, are not eligible. See Rev. Rul. 66-274, 1966-2 C.B. 446 (radiologist was not an employee). Members of the civilian faculty or staff of the Uniformed Services University of the Health Sciences are eligible employees.

(3) Non-qualified plan: The annuity may not be subject to IRC 403(a); in other words, it may not be used to fund a qualified (401(a)) plan. IRC 403(b)(1)(B).

(4) Non-forfeitable: Employee rights under the contract must be non-forfeitable. IRC 403(b)(1)(C).

(5) Non-discrimination requirements: Except for a contract purchased by a church, the plan must meet the non-discrimination requirements of IRC

403(b)(10). IRC 403(b)(1)(D). These requirements are explained in detail in Notice 89-23, 1989-8 I.R.B. 25 (Feb. 21, 1989).

(6) Exclusion allowance: The exclusion may not exceed the "exclusion allowance" under IRC 403(b)(2). For each employee, the allowance is generally the excess of 20% of his or her "includible compensation" times years of service, over amounts the employer has contributed for excludable annuity contracts for prior years. IRC 403(b)(2)(A). Rules for calculating the exclusion allowance are explained in detail in Publication 571, Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations.

Excess contributions to a 403(b) plan are taxed under the rules in IRC 403(c). This section applies the rules of IRC 83 to the excess amounts (see above, p. 179). Thus, the employee's interest in annuity amounts are "property," included in income when the employee's interest vests, i.e., is not "subject to a substantial risk of forfeiture." The includable amount is the value of the contract.

D. Non-qualified deferred compensation plan - deferral after income earned

If an employee can elect to defer income that has been earned, he receives compensation, included in gross income under IRC 61(a)(1), when the amounts are available to him (when he can elect). This result is required by the doctrine of constructive receipt, discussed above, pp. 173-174. Because of this treatment, it is doubtful many deferred compensation plans are structured in this way, however.

An agreement to defer must be bona fide, i.e., it must substantially limit or restrict the employee's right to receive income. For example, if an employer makes available (or facilitates availability of) funds in lieu of deferred amounts (such as loans), the agreement may not be bona fide. An agreement to defer compensation for a brief time, to take advantage of scheduled reductions in individual tax rates, also may not be bona fide. See Announcement 87-3, 1987-2 I.R.B. 40 (Jan. 12, 1987).

E. Non-qualified, funded deferred compensation plans

If a non-qualified deferred compensation plan is "funded," an employee is taxed under the rules of IRC 83, pursuant to either IRC 402(b) (discussed above, p. 179) if the funding vehicle is a trust, or IRC 403(c) (discussed above, id.) if an annuity is used. A "funded" plan is, generally, one in which the beneficiary's payments are guaranteed in some way.

Non-qualified, funded plans thus do not achieve income deferral once a participant's rights are vested. In addition, funded plans are subject to most requirements imposed by the Employee Retirement Income Security Act. See, e.g., 29 U.S.C. Sections 1051(2) (participation and vesting), 1081(a)(3) (funding), 1101(a)(1) (fiduciary responsibility), and 1321(b)(6) (plan termination insurance), which exclude unfunded plans "maintained . . . primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." Consequently, plans to provide deferred compensation to executives are frequently unfunded.

What constitutes an "unfunded" plan, which may achieve income deferral, is discussed below.

F. Non-qualified, unfunded deferred compensation plans

Defined and General Treatment

Elective vs. nonelective plans: The proper treatment of a non-qualified, unfunded deferred compensation plan which is not subject to IRC 457, depends in part on whether deferral under the plan is elective. Prop. Reg. 1.61-16(a) takes the following position for elective plans: . . .

> [I]f under a plan or arrangement . . ., payment of an amount of a taxpayer's basic or regular compensation fixed by contract, statute, or otherwise (or supplements to such compensation, such as bonuses, or increases in such compensation) is, at the taxpayer's individual option, deferred to a taxable year later than that in which such amount would have been payable but for his exercise of such option, the amount shall be treated as received by the taxpayer in such earlier taxable year. For purposes of this paragraph, it is immaterial that the taxpayer's rights in the amount payment of which is so deferred become forfeitable by reason of his exercise of the option to defer payment.

Thus, under the proposed regulation, elective deferred compensation would be taxed when earned. The proposed regulation would except most qualified plans, as well as certain plans or arrangements in existence on February 3, 1978, when it was proposed.

It is unclear what principles apply in determining the year of inclusion for compensation under such elective deferred compensation plans, where the plan is one to which IRC 457 does not apply. Congress has effectively barred the Service

from applying the principles in Prop. Reg. 1.61-16 to governmental, non-exempt employers. See Revenue Act of 1978, P.L. 95-600, Section 132, 92 Stat. 2782 (Nov. 6, 1978). The Congressional prohibition does not apply, however, to plans of exempt organizations or governmental employers.

As discussed below, where IRC 457 applies, it is the exclusive means by which an unfunded plan may effectively defer compensation. This is true regardless of whether the plan is elective or non-elective, see Notice 87-13, Q&A 26, 1987-1 C.B. 432.

Non-elective plans which are not subject to IRC 457 are covered by the general principles discussed below; the principles in Prop. Reg. 1.61-16 do not apply where deferral is not at the individual's option. Whether the principles in the proposed regulation apply to elective plans of exempt organizations, or whether those plans are instead governed by the general principles discussed below, is not clear. The Service will not issue advance rulings in this area. See Rev. Proc. 89-3, Section 5.01, 1989-1 I.R.B. 29 (Jan. 3, 1989).

Meaning of "unfunded": Where a plan to pay deferred compensation is "unfunded" and not subject to IRC 457, discussed below, pp. 220-228, and the plan is non-elective, the participant can effectively defer income until amounts are actually received under the plan.

An "unfunded" deferred compensation plan is one in which the participant's interest is not "property" under IRC 83. In other words, the plan may not confer a current economic or financial benefit on the participant. This occurs when the agreement to pay deferred compensation is an "unfunded and unsecured promise to pay money or property in the future." Reg. 1.83-3(e). Nor can the participant have "a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account." Id.

Thus, the participant's right to receive deferred compensation cannot be guaranteed or secured by the employer. Understandably, however, participants often want assurance, beyond the employer's contractual promise, that funds will be available to pay agreed amounts. Various arrangements have been proposed, providing varying degrees of security, and with differing federal tax results. In general, if the employee has no present interest in the fund from which deferred compensation will be paid, deferral is effective. This will occur when the

employee's rights vis a vis the fund are no greater than rights of the employer's general creditors, if the employer becomes insolvent.

Funding other than in cash: Deferral is not achieved where an employer's promise to pay is funded by purchasing an annuity or insurance contract, if the employee has a present interest in the contract. Rev. Rul. 55-691, 1955-2 C.B. 21. Other forms of security, such as surety bonds, also result in current compensation. But deferral is effective where neither employee nor his or her beneficiary has any interest in the contract; the employer is the applicant, owner, and beneficiary of the contract; and the contract is subject to claims of the employer's general creditors. See Rev. Rul. 72-25, 1972-1 C.B. 127; Rev. Rul. 68-99, 1968-1 C.B. 193.

Funding or security by third party: A promise to pay deferred compensation may not be secured or funded by a third party. See Rev. Rul. 55-691, supra.

"Rabbi trust": An employer may also fund its promise using an irrevocable trust in which the employer's retained administrative powers cause the trust to be treated as a grantor trust under IRC 671-679. Although the trust is established for the employee's benefit, trust assets are assets of the employer in the event of insolvency. Thus, the employee has no greater rights than the employer's general creditors, and the plan is treated as unfunded, under IRC 83. Such an arrangement is known as a "rabbi trust" because the first Service ruling approving the arrangement involved a rabbi. See P.L.R. 8113107 (Dec. 31, 1980). The theory under which "rabbi trusts" effectively defer income is discussed in detail in G.C.M. 39230 (May 7, 1984); no published precedent approves them, however.

IRC 457

If a deferred compensation plan is subject to IRC 457, deferral may be achieved only within the rules and limits of that section. IRC 457 applies to deferred compensation plans of "eligible employers," defined in IRC 457(e)(1) as states, political subdivisions, their agencies and instrumentalities, and organizations exempt from tax under subtitle A of the Internal Revenue Code.

If a deferred compensation plan maintained by an "eligible employer" is excepted from IRC 457, however, its treatment depends on whether the plan is elective or nonelective. See discussion above, pp. 218-219, concerning Prop. Reg. 1.61-16.

The following are excepted from IRC 457:

(1) Pre-1987 plans of exempt organizations: The most significant exception is contained in section 1107(c)(3) of the Tax Reform Act of 1986 (TRA 1986), P.L. 99-514, 100 Stat. 2430 (Oct. 22, 1986), as amended by the Technical and Miscellaneous Revenue Act of 1988 (TMRA), P.L. 100-647, Section 1011(e)(6)-(7), 102 Stat. 3461 (Nov. 10, 1988). Under this provision, IRC 457 does not apply to amounts deferred under a deferred compensation plan established and maintained by an exempt organization, where the amounts:

(a) Were deferred from taxable years beginning before January 1, 1987, or

(b) Are deferred from taxable years beginning after December 31, 1986, pursuant to an agreement which was in writing on August 16, 1986, and on that date provided for deferral for each taxable year covered by the agreement of a fixed amount determined pursuant to a fixed formula. If the fixed amount or formula is modified after August 16, 1986, the exception ceases to apply. The exception applies only to individuals covered under the plan on August 16, 1986. In P.L.R. 8822052 (Mar. 4, 1988), the Service ruled that establishing a "rabbi trust" to fund the employer's obligation did not cause the exception to cease to apply, where the "fixed formula" was not modified.

The legislative history indicates the exception is to apply regardless of whether the organization maintaining the plan was exempt when the plan was established, if exemption is later obtained. See S. Rep. No. 100-445, 100th Cong., 1st Sess. 148 (Aug. 3, 1988).

(2) Nonelective collectively bargained plans: TMRA, Section 6064(d)(2), 102 Stat. 3701, excepts nonelective plans in existence on December 31, 1987, and maintained pursuant to collective bargaining agreements. For this purpose, a "nonelective" plan is one under which covered employees earn nonelective deferred compensation under a definite, fixed, and uniform benefit formula. The exception does not apply where the plan is materially modified after December 31, 1987. The legislative history indicates that in enacting this exception, Congress intended to codify the rules (except the cut-off date) in Notice 88-98, 1988-2 C.B. 421.

(3) Nonelective governmental plans: TMRA, Section 6064(d)(3), 102 Stat. 3701, excepts amounts deferred under nonelective plans maintained by governmental employers, if:

(a) Amounts were deferred from periods before July 14, 1988; or

(b) Amounts are deferred from periods on or after that date, under an agreement which on that date was in writing and provided for deferral for

each year covered by the agreement of a fixed amount or an amount determined by a fixed formula; and

(c) The individual with respect to whom the deferral is made was covered under the agreement on that date.

This exception does not apply to any year ending after the amount or formula set in the agreement is materially modified; a "material modification" is one which increases any benefit. Modifications before January 1, 1989, are permitted, however.

(4) Nonelective plans for non-employees: Under IRC 457(e)(12), IRC 457 does not apply to nonelective deferred compensation attributable to services not performed as an employee. For this purpose, deferred compensation is "nonelective" if all individuals (other than those not satisfying service requirements) with the same relationship to the payor are covered, with no individual variations or options.

(4) Church plans: IRC 457 does not apply to plans maintained by churches, for church employees, under IRC 457(e)(13). "Church" is defined under IRC 3121(w)(3)(A), and includes a qualified church-controlled organization as defined in IRC 3121(w)(3)(B).

(5) Bona fide vacation, sick leave, compensatory time, severance pay, disability pay, and death benefit plans are not considered deferred compensation plans, under IRC 457(e)(11).

(6) State judicial plans: IRC 457 does not apply to any qualified state judicial plan, defined in the Revenue Act of 1978, Section 131(c)(3)(B), P.L. 95-600, 92 Stat. 2782 (Nov. 6, 1978), as amended by the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, Section 252, 96 Stat. 532 (Sept. 3, 1982); see also TRA 1986, P.L. 99-514, Section 1107(c)(4), 100 Stat. 2431.

(7) Special rules: TRA 1986, P.L. 99-514, Section 1107(c) (5), 100 Stat. 2431, excepts deferrals under two specific plans.

Under IRC 457(a), amounts deferred under an "eligible deferred compensation plan" are not included in the participant's income until the year they are "paid or otherwise made available" to the participant (or his or her beneficiary). An "eligible deferred compensation plan" is a plan meeting the following requirements:

(1) Services for employer: Only individuals who perform services for the employer may participate. IRC 457(b)(1). Participants may include independent contractors. IRC 457(e)(2); Reg. 1.457-2(d).

(2) Eligible employer: The plan must be established and maintained by an eligible employer, IRC 457(b), as defined in IRC 457(e)(1). For years beginning after December 31, 1987, "eligible employers" include exempt organizations; for prior years, only governmental employers qualified.

"Instrumentalities" of governmental units may be exempt under IRC 501(c)(3), as discussed elsewhere in this text. In a technical advice memorandum, the Service has held such an employer (a hospital) is an "eligible employer" for years before 1988. P.L.R. 8228010 (Mar. 31, 1982).

(3) Deferral limits: Under IRC 457(b)(2), the plan must limit deferrals to the lesser of $ 7,500, or 33-1/3 percent of the participant's "includible compensation." The plan may provide for greater deferrals only in accordance with the "catch-up" election permitted by IRC 457(b)(3). Under IRC 457(b)(3), for 1 or more of the participant's last 3 taxable years ending before he or she achieves normal retirement age under the plan, the deferral limit is the lesser of $ 15,000, or the sum of the deferral ceiling for the year (determined under IRC 457(b)(2)) plus the 457(b)(2) ceiling for prior years which was not used.

The "catch-up" election may only include amounts the participant did not use in years beginning after December 31, 1978, provided the participant was eligible to participate during the prior year, and the plan in that year provided for a ceiling established under IRC 457(b)(2). Reg. 1.457-2(f)(1). The date used in this regulation relates to the effective date of IRC 457 for governmental plans; a later date may apply to plans of exempt organizations. Also, the election may not be made more than once; thus, where a participant rejoins the plan after retiring, if he or she used the catch-up election before retiring, it may not be used again. Reg. 1.457-2(f)(3).

In determining the deferral limit, amounts deferred under other 457 plans are aggregated, IRC 457(c)(1); this includes plans sponsored by different organizations, as well as multiple plans of the same organization. Also aggregated are amounts excluded from gross income under IRC 403(b), IRC 457(c)(2)(A); amounts excluded under IRC 402(a)(8) (qualified cash or deferred arrangements under IRC 401(k)), IRC 457(c)(2)(B)(i); amounts excluded under IRC 402(h)(1)(B) (employer-funded SEPs), IRC 457(c)(2)(B)(i); and amounts of contributions to 501(c)(18) organizations (certain employee-funded pension trusts), IRC 457(c)(2)(B)(ii). Also aggregated are amounts deferred under some non-qualified deferred compensation plans which are excepted from IRC 457 under the special rules described above. See TRA 1986, P.L. 99-514, Section 1107(c)(3), 100 Stat. 2431 (Oct. 22, 1986), as amended by TMRA, P.L. 100-647, Section 1011(e)(6)-(7), 102 Stat. 3461 (Nov. 10, 1988) (amounts received under excepted pre-1987 plans of exempt organizations are aggregated); and TMRA

Section 6064(d)(3), 102 Stat. 3702 (amounts received under excepted nonelective plans of governmental employers are aggregated). Amounts not subject to IRC 457, because deferred under plans sponsored by taxable employers, apparently are not aggregated, however.

IRC 457(e)(5) defines "includible compensation" as compensation for service performed for the employer which is currently includable in gross income. Deferred amounts (under IRC 457 or 403(b)) are not counted. This results in an effective ceiling of 25 percent of gross compensation, in most cases.

"Includible compensation" is determined without regard to community property laws. IRC 457(e)(7); Reg. 1.457-2(3)(2). The determination is based on the value of compensation in the year deferred, or vested (under the rules explained below). IRC 457(e)(6); Reg. 1.457-2(e)(3).

Example (1): A an employee of an eligible employer, receives a salary of $ 30,000. A may defer up to $ 7,500 (25% x total compensation of $ 30,000, or 33-1/3% x "includible compensation" of $ 22,500, reducing compensation by amount of deferral).

Example (2): Same as (1), except A excludes $ 3,000 from gross income under her employer's 403(b) plan. A may only defer $ 4,500 under the 457 plan.

(4) Deferral agreement: The plan must provide that compensation will be deferred for any calendar month only if an agreement providing for deferral is entered into before the beginning of the month. IRC 457(b)(4). For new employees, the agreement may be entered into during the month employment commences, if entered into on or before the first day of employment. Reg. 1.457-2(g).

(5) Distribution requirements: For years beginning after December 31, 1988, new distribution requirements, adopted by the Tax Reform Act of 1986, apply. For prior years, IRC 457(b)(5) requires that distribution not begin earlier than when the participant "separates from service" or is faced with an unforeseeable emergency (as defined in regulations). Additional pre-1989 distribution requirements are contained in Reg. 1.457-2(i).

IRC 457(b)(5) now requires that two distribution requirements, contained in IRC 457(d), be met. First, under IRC 457(d)(1)(A), amounts may not be "made available" under the plan earlier than (i) the year the participant reaches age 70-1/2; (ii) when the participant separates from service; or (iii) when the participant is faced with an unforeseeable emergency (as defined in regulations). The regulations define "separation from service," Reg. 1.457-2(h)(2)-(3), and "unforeseeable emergency," Reg. 1.457-2(h)(4). Second, IRC 457(d)(2) establishes minimum distribution requirements, which include the

requirements of IRC 401(a)(9) applicable to qualified plans, but require more rapid distribution.

Under the regulations, amounts are not "made available" if a participant or beneficiary may irrevocably elect, before amounts are payable, to defer payment to a fixed or determinable future time. Reg. 1.457-1(b)(1). However, if the participant may elect, after distributions begin, to receive any or all remaining amounts, the total amount is "made available" in the year the first payment is payable. See Reg. 1.457-1(b)(2), Example (2). If, on the other hand, the participant may make a similar election before payments are scheduled to begin, if he or she elects monthly payments in lieu of a lump sum, the total amount is not "made available" at the outset. See Reg. 1.457-1(b)(2), Examples (1)(ii)-(iii). Amounts are not "made available" solely because the participant can choose among various investment modes under the plan. Reg. 1.457-1(b)(1).

If the total amount payable to a participant under the plan is not over $ 3,500, and the participant may defer no additional amounts, the amount payable is not "made available" merely because the participant may elect to receive a lump sum after separation from service and within 60 days of the election. IRC 457(e)(9).

Transfers among 457 plans are permitted, without amounts being deemed "made available," IRC 457(e)(10). A participant may not "roll over" distributions into an individual retirement account, however. Rev. Rul. 86-103, 1986-2 C.B. 62.

(6) Unfunded: The plan must be unfunded; in other words, all deferred compensation, property and rights purchased with such amounts, and income attributable to such amounts must remain the property and rights of the employer, without being restricted to providing benefits under the plan, and must remain subject to claims of the employer's general creditors. IRC 457(b)(6).

Where a plan of an eligible employer is not an "eligible deferred compensation plan," deferred compensation is included in income for the first year the participant's (or beneficiary's) right to the amount is not subject to a "substantial risk of forfeiture." IRC 457(f)(1)(A). A "substantial risk of forfeiture" exists if rights to compensation are conditioned on future performance of substantial services by any individual. IRC 457(f)(3)(B). Distributions (i.e., amounts paid or "made available") are taxed under IRC 72, IRC 457(f)(1)(B); this treatment includes earnings credited on deferred amounts before they are paid, Reg. 1.457-3(a)(2).

Under IRC 457(f)(2), this treatment does not extend to:

(A) Any plan described in IRC 401(a) which includes a trust exempt under IRC 501(a) (qualified plans);

(B) Any annuity plan or contract described in IRC 403 (plans funded with annuities);

(C) That portion of any plan which consists of a trust to which IRC 402(b) applies (nonqualified employee trusts); or

(D) That portion of any plan which consists of a transfer of property described in IRC 83 (other funded plans);

In taxing deferred compensation when rights are vested, IRC 457 represents a dramatic change in its treatment. If a particular arrangement is subject to IRC 457, only $7,500 can be effectively deferred each year; in contrast, there may be no limit on how much compensation can be deferred if IRC 457 does not apply, at least under nonelective plans.

The total amount of compensation deferred must be reported on employees' Form W-2's. IRC 6051(a)(8)

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UPDATE

J. COMPENSATION

1. Introduction

Federal income tax treatment of compensation is in a state of flux, with new guidance continually being issued. The following discussion presents recent developments in the compensation area. (References are to pages in the 1990 CPE Text.)

2. Compensation - General Principles

Receipt/Constructive Receipt Doctrine (pp. 173-74)

In Rev. Rul. 90-29, 1990-15 I.R.B. 5 (Apr. 9, 1990), the Service considered the tax consequences of a "leave sharing" plan, under which employees could surrender leave to a "leave bank" for use by other employees who suffer "medical

emergencies." The Service held that leave surrendered under a "bona fide employer-sponsored leave-sharing arrangement" was income to the leave recipient, as additional compensation, but employees surrendering leave did not realize income.

The application of the constructive receipt doctrine is illustrated by two recent private letter rulings. In P.L.R. 9022059 (Mar. 6, 1990), the Service ruled that employees who can choose between an excludable benefit (health insurance) and cash are in constructive receipt of income. (The plan did not involve a cafeteria plan qualified under IRC 125.) Compare Rev. Rul. 61-146, 1961-2 C.B. 25 (income not constructively received where employer reimbursed employees for health insurance premiums, requiring proof of insurance in force and employees' payment of premiums), with Rev. Rul. 75-241, 1975-1 C.B. 316 (income constructively received where employer did not have contractual or legal obligation to provide health insurance and did not verify cash payments used to procure insurance). And in P.L.R. 9009052 (Dec. 6, 1989), the constructive receipt doctrine was applied in ruling that employees who could "cash in" unused leave received income, at the time the right to "cash in" accrued.

3. Current Cash Compensation

Expense accounts and allowances (p. 183): The Service has issued temporary (and proposed final) regulations concerning the taxation of and reporting and withholding on reimbursement and other employee expense allowance arrangements. See T.D. 8276, 1990-4 I.R.B. 4 (Jan. 22, 1990). The regulations provide different rules for years beginning before and after January 1, 1989. For years after 1988, three requirements apply for an expense allowance or reimbursement arrangement to be excludable as a "working condition fringe" under IRC 132(a)(3):

A. Business connection: The arrangement (including an employer-provided credit card) must provide an allowance for deductible business expenses incurred by the employee in performing services as an employee. Reg. 1.62-2T(d).

B. Substantiation: The arrangement must require that each expense be substantiated, as follows:

1. If the expense is subject to IRC 274 (travel, entertainment, use of auto, etc.), the employee must provide information sufficient

to satisfy the requirements of that section and the regulations thereunder. Reg. 1.62-2T(e)(2). Regulations under IRC 274 authorize the Commissioner to permit "simplified" substantiation procedures, such as for per diem and mileage reimbursement allowances. Reg. 1.274-5T(g). Guidance on such procedures was issued in Rev. Proc. 89-66, 1989-52 I.R.B. 13 (Dec. 26, 1989) (standard mileage rates), amplified, Rev. Proc. 90-34, 1990-26 I.R.B. 13 (June 25, 1990); and Rev. Proc. 89-67, 1989-52 I.R.B. 17 (Dec. 26, 1989) (per diem rates).

2. For other expenses, the employee must provide the employer information sufficient to allow the payor to identify the specific nature of the expense and to conclude the expense is attributable to the payor's business activities. Reg. 1.62-2T(e)(3).

C. Return of excess: The arrangement must require the employee to return any amount exceeding substantiated expenses. Reg. 1.62-2T(f).

On June 11, 1990, the Service held a public hearing on the regulations.

4. Fringe Benefits

Valuation of fringe benefits (p. 185): Pursuant to Reg. 1.61-21(g), the Service prescribes standard mileage and terminal charges for valuing use of employer-provided aircraft. See, e.g., Rev. Rul. 90-43, 1990-20 I.R.B. 5 (May 14, 1990) (charges for first six months of 1990).

Welfare Benefits

Life insurance (p. 186): Includable group term life insurance provided after December 31, 1988 must be valued in accordance with new Reg. 1.79-3T, which provides a uniform premium table.

Other welfare benefits (p. 186): IRC 6039D requires employers maintaining "specified fringe benefit plans" to file information returns and maintain records on such plans. For years beginning after December 31, 1988, the Tax Reform Act of 1986 added plans under IRC 79, 105, 106, and 129 to those covered by this provision. The required return is Form 5500.

Because Form 5500 and its instructions have not been changed to conform to the amendment to IRC 6039D, however, employers are not required to comply with the return-filing requirement until "further guidance." See Announcement 90-24, 1990-13 I.R.B. 17 (Mar. 26, 1990).

C. IRC 132 - Excluded Fringe Benefits (p. 188)

Liability insurance for foundation managers as "working condition fringe" (pp. 191-192): Whether the value of liability insurance coverage an exempt organization provides its volunteer directors or trustees is income to them is a current issue in the foundation community. Inclusion in income entails a host of reporting and other consequences of concern to foundation managers. For example, if the director is a government official, the foundation may be in violation of the prohibition against payments to such officials, see IRC 4941(d)(1)(F) and Reg. 53.4941(d)-2(g); and may be ineligible for special protections available under some state laws providing for limitations on liability of volunteer officers and directors.

Under Reg. 53.4941(d)-2(f)(3) and Rev. Rul. 82-223, 1982-2 C.B. 301, a foundation may, consistent with IRC 4941, pay premiums for coverage of a foundation manager's attorney's fees, expenses, and settlement, provided the amount of the premium does not result in excessive compensation. Under Reg. 1.61-21(a)(3) (see p. 184), a fringe benefit provided in connection with performance of services is compensation (income). The Service is currently studying whether an exclusion may be available for this income (value of the fringe benefit), as a working condition fringe. The issue is whether the exclusion is available where the director is not otherwise compensated, and thus has no income against which to allow a hypothetical deduction under IRC 162 (one of the requirements for a working condition fringe exclusion) (see p. 191).

Aggregation rules (p. 189): The aggregation rules under IRC 132 are derived from IRC 414(b), (c), (m), and (o). These same rules apply for purposes of IRC 79, 106, 117(d), 120, 125, 127, 129, 274(j), and 505. See IRC 414(t).

"Line of business" requirement (p. 195): The "line of business" requirement for exclusions for no-additional-cost services and qualified employee discounts is discussed in P.L.R. 9025068 (Mar. 27, 1990). This ruling permitted a corporation engaged in a vertically integrated auto manufacturing/financing business to combine its businesses, consisting of separate two-digit ESIC classifications, into a

single "line of business" in determining whether the qualified employee discount exclusion was available. The ruling was based on a determination that it is uncommon in the auto industry for any of the separate lines of business (auto manufacturing and financing) to be operated without the others - the standard required by Reg. 1.132-4(a)(3) for combining ESIC classifications. Thus, for example, employees who worked for the financing business could purchase automobiles under an otherwise qualified employee discount program.

D. Meals and Lodging (p. 197)

IRC 119 – Lodging (p. 199): IRC 119's requirement, for excluding the value of employer-provided lodging, that it be furnished on the employer's "business premises" was applied in P.L.R. 8938014 (June 23, 1989). In this ruling, a hospital furnished lodging to medical residents and allied health care professionals in a garden apartment complex separated from the hospital by a public road. Finding that no significant portion of the employees' duties were performed at the apartment complex, the ruling held that it did not constitute part of the hospital's "business premises." In addition, because housing was furnished to only some employees, based on a four-tiered priority list, the ruling held employees were not required to accept lodging as a condition of employment, as required by IRC 119(a)(2) and Reg. 1.119-1(b)(3).

IRC 107 (pp. 200-205): The Service is studying "whether amounts distributed to a retired minister from a pension plan should be excludable from the minister's gross income" under IRC107. See Rev. Proc. 89-54, 1989-37 I.R.B. 19 (Sept. 11, 1989).

5. Deferred Compensation (p. 214)

IRC 403(b) (p. 215)

In Rev. Rul. 90-24, 1990-11 I.R.B. 6 (Mar. 12, 1990), the Service ruled that a direct transfer between 403(b) investment vehicles is not an "actual distribution" under IRC 403(b)(1), which would result in current income to the employee. The ruling revokes Rev. Rul. 73-124, 1973-1 C.B. 200.

Non-qualified, unfunded deferred compensation plans (p. 218)

IRC 457(b)(6) - requirement that plan be "unfunded": In Q&A-25, Notice 87-13, 1987-1 C.B. 432, 444, the Service concluded that the 1986 amendments

extending IRC 457's coverage to exempt organizations did not amend Title I of the Employee Retirement Income Security Act. Thus, deferred compensation plans of exempt organizations are subject to applicable provisions of ERISA (unlike governmental plans, which are excluded from ERISA's coverage). In particular, Q&A-25 says:

> . . . In the case of a deferred compensation plan that is subject to Title I of ERISA, compliance with the exclusive purpose, trust, funding and certain other rules will cause the plan to fail to satisfy section 457(b)(6).

The implications of Q&A-25 are illustrated by P.L.R. 8950056 (Sept. 20, 1989), where an exempt organization proposed adopting an IRC 457 plan for all its employees. Title I of ERISA, however, excepts from certain requirements only unfunded plans "maintained . . . primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees" (see p. 218). Citing Department of Labor News Release 86-27 (Dec. 19, 1986), which concluded that plans covering all an exempt organization's employees are subject to Title I of ERISA, the Service held the proposed plan would not satisfy IRC 457(b)(6) (plan must be "unfunded", see p. 227).

"Grandfather" rule: The "grandfather" rule, excluding from IRC 457's coverage pre-1987 plans of exempt organizations (see p. 221), has provoked a host of ruling requests on what constitutes a "fixed amount or formula" in a pre-1987 deferred compensation agreement, modification of which renders the grandfather rule inapplicable and subjects the plan to IRC 457's limitations. In ruling on these requests, the Service has relied on Q&A-28, Notice 87-13, 1987-1 C.B. 432, 444, which says a deferral is "fixed" if:

(1) The written plan on August 16, 1986, provided for deferral determinable as a fixed dollar amount, a fixed percentage of a fixed base amount, or an amount to be determined under a fixed formula; or

(2) The plan on August 16, 1986, permitted deferral and the current deferral is the same as the deferral in effect on such date. For example, if a plan allowed an employee to elect to defer up to 5% of his or her salary and the employee on August 16, 1986, had a 5% election in effect, the employee may thereafter (e.g., in 1990) defer 5% of his or her salary. In other words, that the plan permits

the employee to elect a different deferral will not cause the deferral not to be "fixed," if a different election is not made.

Relying on Q&A-28, the Service has ruled:

(1) Where the employer's Executive Committee continued to set aside the same amount each year after 1986, pursuant to a provision in a deferred compensation agreement giving it discretion to determine the deferral amount, the agreement was within the grandfather provision. P.L.R. 9018052 (Feb. 6, 1990).

(2) Changing the combination of investment media used to measure benefits payable to a participant did not change the fixed percentage of salary deferred, and therefore did not vitiate application of the grandfather rule. P.L.R. 9016071 (Jan. 24, 1990).

(3) Renewal of a deferred compensation agreement for five years did not modify a deferral formula. P.L.R. 8945049 (Aug. 16, 1989).

(4) Modifying a deferred compensation plan to allow participants to designate and change death benefit beneficiaries did not modify the deferral formula. P.L.R. 9019031 (Feb. 9, 1990).

Treatment of distributions from IRC 457 plans: In Roy R. Rheal, T.C. Memo 1989-525, the Tax Court held that lump sum distributions from IRC 457 plans are not eligible for 10-year averaging under IRC 402(e)(4)(A), because they are not distributions from qualified plans.

6. Definition of "Qualified Church-Controlled Organization" - IRC 3121(w)(3) (new)

Churches and certain church-related organizations are excepted from many requirements imposed generally on employers with respect to the tax treatment of compensation paid employees. One of the basic definition sections which implements such exceptions is IRC 3121(w)(3), which defines classes of organizations entitled to special treatment for the following purposes:

(1) Election not to have services performed in their employ covered by FICA (IRC 3121(w));

(2) Exemption from non-discrimination requirements for 403(b) plans (IRC 403(b)(1)(D));

(3) Exception from mandatory application of IRC 457 (IRC 457(e)(13)); and

(4) Determination of "required beginning date" for distributions from qualified plans (IRC 401(a)(9)).

IRC 3121(w)(3) (which is in the jurisdiction of the Exempt Organizations function) divides qualified organizations into "churches" and "qualified church-controlled organizations." IRC 3121(w)(3)(A) defines "church" as a church, a convention or association of churches, or an elementary or secondary school controlled, operated, or principally supported by a church or convention or association of churches. IRC 3121(w)(3)(B) defines "qualified church-controlled organization" to mean any church-controlled tax-exempt organization described in IRC 501(c)(3), except an organization that both (i) offers (other than on an incidental basis) goods, services, or facilities for sale to the general public, other than goods, services, or facilities sold at a nominal charge which is substantially less than their cost; and (ii) normally receives more than 25% of its support from either (or both) (I) governmental sources, or (II) receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in activities which are not unrelated trades or businesses.

In rulings under IRC 3121(w)(3), the National Office has adopted the following approaches:

(1) A religious order is a "church" under IRC 3121(w)(3)(A).

(2) An organization is "controlled" by a "church" (i.e., it is "church-controlled") if there exists between it and a "church" a parent (church) and subsidiary (organization) relationship that would satisfy Reg. 1.502-1(b). In other words, the organization must be under the "control and close supervision" of the parent "church." See, e.g., Rev. Rul. 75-282, 1975-2 C.B. 201 (organization controlled by conference of churches); and Rev. Rul. 68-26, 1968-1 C.B. 272 (religious publishing organization).

(3) If an organization is "controlled" by a "church," and it satisfies the two-part test in IRC 3121(w)(3)(B) (relating to transactions with general public and sources of support), it is a "qualified church-controlled organization." There is no additional requirement that its activities be "religious" versus "secular." Thus, otherwise qualified hospital system "parents," which receive most of their support from management fees paid by members of the system but which do not provide services to the general public, may be "qualified church-controlled organizations."

TABLE I
FRINGE BENEFITS - INCOME TAXATION

Description of Benefit	Code	Treatment
Expenses accounts/allowances		
Working condition fringe	**32(a)(3)**	**Excluded**
Other	**1**	**Included**
Imputed interest on certain loans	**872**	**Included**
Life insurance		
Group term life insurance (less than or equal to $ 50,000)	**79**	**Excluded**
Group term life insurance (greater than $ 50,000)	**79**	**Included**
Spouse/dependent life insurance (less than or equal to $ 2,000)	**61**	[1]
Other employer-provided life insurance	**61, 83**	**Included**
Accident and health plans		
Benefits	**105(b)**	**Excluded**
Coverage (employer contributions)	**106**	**Excluded**
Qualified group legal service plans		
Benefits	**120(a)**	**Excluded**[2]
Coverage (employer contributions)	**120(a)**	**Excluded**[2]
Cafeteria plans		
Choice between benefits/cash	**125**	**Non-taxable**
Dependent care assistance		
Benefits	**129**	**Excluded**
IRC 132		
No-additional-cost service	**132(a)(1)**	**Excluded**

Qualified employee discount	**132(a)(2)**	**Excluded**
Working condition fringe	**132(a)(3)**	**Excluded**
De minimis fringe	**132(a)(4)**	**Excluded**
On-premises athletic facility	**132(h)(5)**	**Excluded**
Meals and lodging		
Provided for employer's convenience	**119**	**Excluded**
Parsonage allowance	**107**	**Excluded**
Employer eating facilities	**132(e)(2)**	**Excluded**
Other	**61**	**Included**
Transportation		
Qualified transportation	**124**	**Excluded[3]**
Commuting expenses (non-qualified)	**61**	**Included**
Business use of vehicles	**132(a)(3)**	**Excluded**
Personal use of vehicles	**61**	**Included**
Parking on or near business premises	**132(h)(4)**	**Excluded**
Education		
Qualified educational assistance	**127**	**Excluded[4]**
Qualified tuition reduction	**117(d)**	**Excluded**
Job-related education	**132(a)(3)**	**Excluded**
Other	**61, 83**	**Included**

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[1] See Notice 89-110, 1989-49 I.R.B. 17 (Dec. 4, 1989)
[2] Taxable years ending before 9/30/90.
[3] Taxable years beginning after 12/31/78 and before 1/1/86.
[4] Taxable years ending before 9/30/90.

[TABLE II and TABLE III are not shown]