TAXATION OF VALUE OF LODGING FURNISHED AN EMPLOYEE FOR HIS EMPLOYER'S CONVENIENCE: REQUIRED REIMBURSEMENTS

IN *J. Melvin Boykin*,[1] the Tax Court required petitioner to include in his taxable income amounts withheld from his salary representing the value of living quarters on his employer's premises,[2] even though the Commissioner conceded that the employee was required to live on the premises for the employer's convenience. The Tax Court based its decision on Treasury Regulation 1.119-1(c)(2),[3] which distinguishes between the value of lodging for which the employee is required to reimburse the employer and the value of lodging furnished by the employer for which the employee is not required to reimburse his employer,[4] including only the former in taxable income. Although

[1] P-H 1958 TAX CT. REP. & MEM. DEC. ¶ 29.88. As this issue went to press, the 8th Circuit Court of Appeals reversed the Tax Court's decision in the *Boykin* case, employing reasoning similar to that advocated in this note. CCH 1958 STAND. FED. TAX REP. ¶ 9900.

[2] Petitioner was a physician employed by the Veterans Administration during 1954 and 1955 and occupied personal living quarters on the grounds of the hospital. Quarters were owned and rented by the Veterans Administration. Petitioner was required to live on the hospital grounds in order to properly perform the duties of his employment. The Veterans Administration withheld $1147.46 in 1954 and $1188.86 in 1955 as rental charges for quarters occupied by petitioner based on fair rental value of quarters by local appraisers. See J. Melvin Boykin, P-H 1958 TAX CT. REP. & MEM. DEC. ¶ 29.88.

[3] "The exclusion provided by section 119 applies only to meals and lodging furnished in kind, without charge or cost to the employee. If the employee has an option to receive additional compensation in lieu of meals or lodging in kind, or is required to reimburse the employer for meals or lodging furnished in kind, the value of such meals and lodging is not excluded from gross income. . . . Cash allowances for meals or lodging received by an employee are includible in gross income to the extent that such allowances constitute compensation." Treas. Reg. § 1.119-1(c)(2) (1954).

[4] The following statement of the Tax Court indicates why it thinks the regulation was justified: "The legislative history of section 119 gives no indication that Congress gave any thought to the exclusion from income of the value of lodgings for which the employer charged the employee the fair rental value. . . . The legislative history of section 119 indicates rather clearly that Congress was thinking only about the exclusion from income of the value of meals and lodging furnished without charge to the employee by the employer." J. Melvin Boykin, P-H 1958 TAX CT. REP. & MEM. DEC. ¶ 29.88. This reasoning seems open to question, however. If Congress did not foresee a situation such as that which occurred in the *Boykin* case, the case should perhaps have been disposed of on the basis of the purpose for which section 119 of the Internal Revenue Code was enacted. Legislatures cannot forsee every problem that will arise under statutes, but this does not mean that every unforeseen circumstance is automatically beyond the preview of the statute. See 2 SUTHERLAND, STATUTORY CONSTRUCTION § 5102 (3d ed. 1943).

the regulation further provides that cash allowances[5] for meals and lodgings are includible in income to the extent that they constitute compensation, the deficiency letter which the Treasury wrote petitioner stated that the value of the lodging was being included in income because it was not paid for out of a cash allowance,[6] implying that cash allowances are not includible in income if they satisfy the requirements of section 119 of the Internal Revenue Code.[7] If this letter correctly states the Treasury's position, an anomalous situation has been created, for application of regulation 1.119-1(c)(2) may result in the levying of a tax upon gross economic benefit received in one instance and net economic benefit received in another instance, each determination hinging upon a simple matter of form rather than any substantive difference. By way of illustration:

> Employee *A* is employed by *X* hospital at a salary of $1250 per month. He is required to live on the hospital premises as a condition of employment. The value of his lodgings is $250 per month.

As the law now stands, there are three ways in which employee *A* might be paid:

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[5] A cash allowance may be defined as a form of remuneration in which the total cash received by the employee is apportioned between conventional salary and an allowance paid in cash to be used for a specific purpose, *e.g.* meals and lodging. The employer may require the employee to reimburse the employer to the extent of the amount denominated as cash allowance, or the employee may have an option to receive the allowance in lieu of meals or lodging. In the former case, the allowance would more than likely be excludible since the convenience of the employer test would be met. The latter, or option, form of cash allowance is obviously for the convenience of the employee and would thus be includible in income.

[6] "This amount represents the total payments that you made to your employer in order to pay him for a share of the lodging that he rented to you.

"We are disallowing this deduction because you did not make these payments to your employer out of a cash allowance that you specifically received for lodging." J. Melvin Boykin, P-H 1958 TAX CT. REP. & MEM. DEC. ¶ 29.88.

[7] Section 119 allows a taxpayer to exclude the value of meals and lodging from taxable income if it is for the convenience of the employer, on the business premises of the employer, and must be accepted by the employee as a condition of employment. Since all of these conditions were met in the *Boykin* case, the Treasury apparently felt that they could not include a cash allowance in taxable income under the statute.

An additional factor which may have influenced the Treasury to take this position as to cash allowances is the case of Saunders v. Comm., 215 F.2d 768 (3d cir. 1954), reversing, R. H. Saunders, 21 T.C. 630 (1954), where the court said: "Because the result in this case should not be dependent on whether meals are furnished in cash or in kind, we may refer to the principle of convenience of employer rule in deciding the classification of this cash allowance just as we may when meals are furnished." Saunders v. Comm., *supra* at 772.

I. Cash Compensation.

A. Required Reimbursement:

A may receive the value of lodgings as part of his salary and be required to reimburse his employer for the value of lodgings so received. Under this arrangement, *A* would receive $1250 a month and refund $250 to his employer.

For administrative expediency, *X* may simply withhold the value of lodgings from *A*'s salary, as in the *Boykin* case, leaving *A* with a take home pay of $1000 out of his $1250 salary. *A* would be taxed on $1250 in either situation.

B. Cash Allowance:

The taxpayer may receive the value of lodgings as a cash allowance. *A* would thus receive $1000 as salary and $250 as a cash allowance which he would have to pay *X* for the accommodations. This cash allowance is excludible, and *A* would be taxed on only $1000.

II. Compensation in Kind.

A may receive the net amount of his salary, $1000, in one payment. There would be neither a required reimbursement nor a cash allowance, but *A* would receive the same net take home pay and would be taxed on only $1000.

The problem thus presented has a controversial and somewhat confused background. Prior to the enactment of the 1954 Code, the Treasury wavered between an unadulterated economic benefit theory and the more liberal convenience of employer theory which was incorporated into the 1954 Code. Originally the Board of Tax Appeals, following Treasury Regulations, held that since a taxpayer was better off financially by receiving free meals and lodging, such economic benefits should be classified as additional compensation.[8] These holdings were modified in *Jones v. United States*,[9] where the Court of Claims drew a distinction between allowances and compensation, holding that the rental value of an army officer's quarters was a tax free allowance

[8] ". . . A was paid a regular salary of X and, in addition, his employer furnished him without charge the use of a house having a rental value for A's purposes of Y. It was recognized that A was better off financially for having received free lodging from his employer, and the fair rental value of such free lodging was regarded as additional compensation and included in his taxable income." J. Melvin Boykin, P-H 1958 TAX CT. REP. & MEM. DEC. ¶ 29.88. See also Charles A. Frueauff, 30 B.T.A. 449 (1934); Percy M. Chandler, 41 B.T.A. 165 (1940); Reynard Corp., 30 B.T.A. 451 (1934).

[9] 60 Ct. Cl. 552 (1925).

and not compensation. The decision was based on the court's conclusion that occupancy of government quarters by officers was requisite to the proper performance of their duties.[10]

Following the *Jones* decision, the Commissioner promulgated Treasury Regulation 118,[11] which stated that the value of free lodging was excludible from taxable income if the lodging was granted the employee primarily for the convenience of the employer, and not excludible if the lodging was granted as compensation for services.[12] This regulation was found to be very difficult to apply, and hence the cases are in hopeless conflict as to whether lodging is compensatory in nature, primarily for the convenience of the employer, or both.[13] This confusion made it necessary to modify regulation 118.

In 1950 the Treasury promulgated the much criticized Mimeograph 6472,[14] which relegated the convenience of the employer test to a mere

[10] The *Jones* decision marked the advent of the exclusion of cash allowances for lodgiug. For subsequent applications of the *Jones* case see CCH 1958 STAN. FED. TAX REP. ¶ 1191.0711-.0714.

[11] "If a person receives as compensation for services rendered a salary and in addition thereto living quarters or meals, the value to such person of the quarters and meals so furnished contitutes income subject to tax. If, however, living quarters or meals are furnished to employees for the convenience of the employer, the value thereof need not be computed and added to the compensation otherwise received by the employees." McDermott, *Meals and Lodging Under the 1954 Code*, 53 MICH. L. REV. 871, 872 (1955).

[12] ". . . [T]he value of meals and lodging are includible in the employee's income . . . if there is an indication that the meals and lodging were taken into consideration in establishing the salary paid." Erbacher, *Meals or Lodging Furnished for Convenience of Employer*, 32 TAXES 826, 827 (1954).

[13] Several cases which illustrate the confusion under Regulation 118 are: R. D. Bartilson, 13 TCM 1117 (1949). "Radio operator . . . elected to have food furnished by his employer, who also furnished taxpayer's lodging, instead of receiving $40 per month to buy his own food. The value of the food and lodging was taxable as compensation, since there was no conclusive evidence that they were furnished for the convenience of the employer." CCH 1958 STAN. FED. TAX REP. ¶ 1191.04.

Henry M. Lees, 12 TCM 472 (1949). "The value of housing furnished a construction supervisor who was required to be near the construction was not compensation includible in income since it was for convenience of employer." CCH 1958 STAN. FED. TAX REP. ¶ 1191.0585.

Chandler v. Comm. 119 F.2d 623 (3d Cir. 1941). "Rental value of lodge, occupied rent-free by taxpayer and his family, . . . represent taxable compensation." CCH 1958 STAN. FED. TAX REP. ¶ 1191.0665. See also Hazel M. Carmichael, 7 TCM 278 (1948).

[14] "The convenience of the employer rule is simply an administrative test to be applied only in cases in which the compensatory character of such benefits is not otherwise determinable. It follows that the rule should not be applied in any case in which it is evident from other circumstances involved that the receipt of quarters or meals by the employee represents compensation for services rendered." Mim. 6472, 1950-1 CUM.

administrative gauge to be applied only when the compensatory character of the benefits could not be determined from all the surrounding circumstances. In effect, the economic benefit test had been reinstated.[15] The situation was confused again, however, when the Second Circuit refused to recognize Mimeograph 6472.[16]

Section 119 of the 1954 Code overruled Mimeograph 6472 and effectively restored the convenience of the employer test. Under section 119, three requirements must be satisfied before a taxpayer may exclude the value of lodging from his taxable income: lodging must be furnished for the convenience of the employer;[17] lodging must be on the business premises of the employer;[18] and the employee must be required to accept such lodging as a condition of employment.[19] The Senate Finance Committee Report stated that the basic test for exclusion

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BULL. 15. See also McDermott, *Meals and Lodging Under the 1954 Code*, 53 MICH. L. REV. 871 (1955).

[15] "In 1950 the Treasury definitely espoused the economic-benefit theory as applied to employee fringe benefits, despite its accompanying denial that it did not renounce the convenience-of-the-employer-rule. The special rulings that it rendered in 1950 (6472) and thereafter leave no doubt that the Treasury has at least seriously curtailed, if it has not completely renounced, the convenience-of-the-employer-test. Meals and lodging for hotel employees, . . . living quarters, and meals for hospital employees had become taxable to employees to the extent that their economic value to them was measurable, even though the applicability of the convenience-of-employer-rule was obvious." Landman, *The Taxability of Fringe Benefits*, 33 TAXES 173, 178 (1955).

[16] "The policy outlined in Mimeograph 6472 was followed by the Tax Court in Joseph L. Doran, 21 T.C. 374 (1953). However, it was rejected by the Second Circuit Court last year in Diamond v. Sturr 221 F.2d 264 (2d cir. 1955), the court taking the position that treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially re-enacted statutes, are deemed to have received Congressional approval and have the effect of law." Rapp, *Some Recent Developments in the Concept of Taxable Income*, 11 TAX L. REV. 329, 346 (1956). See also Gordon v. United States, 152 F.Supp. 427 (D.C.N.J. 1957), following the Diamond v. Sturr, *supra*, decision.

[17] Prior to the 1954 Code, the Bureau of Internal Revenue defined for the convenience of the employer as follows: "As a general rule, the test of 'convenience of the employer' is satisfied if living quarters or meals are furnished to an employee who is required to accept such quarters and meals in order to perform properly his duties." Mim. 5023, 1940-1 Cum. Bul. 14. See also 53 MICH. L. REV. 871 (1955).

[18] The House version of section 119 used the words, "furnished at the place of employment." The Senate version which ultimately prevailed used the words, "on the business premises of his employer." No substantive difference seems to have been intended as a result of the slight change in wording. See McDermott, *Meals and Lodging Under the 1954 Code*, 53 MICH. L. REV. 871, 874, 875 (1955).

[19] "The phrase 'required as a condition of employment' means required in order for the employee to perform properly the duties of his employment." Treas. Reg. 1.119-1(b) (1954).

was convenience of the employer.[20] At this point, it seems evident that the result in the *Boykin* case does not comport with the basic considerations which motivated Congress to enact section 119.

The congressional committee reports[21] discussing section 119 indicate that it was designed to provide an exclusion for any employee required to eat or live on the business premises for his employer's convenience. Treasury Regulation 1.119-1(c)(2) modified the intended result, however, by distinguishing between meals and lodging involving no reimbursement to the employer and those for which the employee must reimburse his employer. This regulation may have sprung from an erroneous interpretation of the following example, found in committee reports from both the House[22] and Senate,[23] part of which was adopted verbatim into that portion of Regulation 1.119-1(c)(2) dealing with cash allowances:

> This section applies only to meals or lodging furnished in kind. Therefore, any cash allowances for meals or lodging received by an employee will continue to be includible as under existing law to the extent that such allowances constitute compensation. . . .
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> Example 2—An employee of an institution is given the choice of residing at the institution free of charge or of residing elsewhere and receiving an allowance of $30 per month in addition to regular salary. If he elects to reside at the institution, the value to the employee of the lodging furnished by the employer will be includible in gross income because his residence at the institution is not required as a condition of his employment.

This example ostensibly was intended only to illustrate the difference between situations in which the employee is required to live on the premises for the employer's convenience, and those situations in which the employee has an option of either living on the premises or receiving a cash allowance and living elsewhere, the latter arrangement obviously being for the employee's convenience. The Treasury, however, may

[20] "Your committee has provided that the basic test of exclusion is to be whether the meals or lodging are furnished primarily for the convenience of the employer (and thus excludible) or whether they are primarily for the convenience of the employee (and therefore taxable)." S. REP. No. 1622, 83rd Cong., 2d Sess. 19 (1954).

[21] See 100 CONG. REC. 3423 (1954); H.R. REP. No. 1337, 83rd Cong., 2d Sess. 18 (1954); S. REP. No. 1622, 83rd Cong., 2d Sess. 19 (1954).

[22] S. REP. No. 1622, 83rd Cong., 2d Sess. 190 (1954).

[23] H.R. REP. No. 1337, 83rd Cong., 2d Sess. A38 (1954).

have interpreted the words "free of charge" to mean that the convenience of the employer test should not be applied in situations where the employee is charged by the employer for meals and lodging. In view of the context in which the words "free of charge" were used, this negative inference is unwarranted. The crucial factor in the example is the presence or absence of an option on the part of the employee, not whether accommodations are furnished free of charge. Since it is probable that a situation such as that which existed in the *Boykin* case was not contemplated by the drafters of this example, there is no justification for disposing of the *Boykin* case on this basis.

Both the Senate[24] and House[25] Reports have championed the convenience of employer test as codified under section 119; the *Boykin* case seems to indicate that the Treasury has adopted this test as to cash allowances. Nevertheless, as the law now stands, an employee who is required to reimburse his employer for food and lodging out of his regular salary is being penalized because of the way his employer keeps his books. Since any distinction between required reimbursements, accommodations involving no reimbursement, or cash allowances depends entirely upon routine accounting entries, there appears to be no overriding reason why the convenience of employer test should not be applied to required reimbursements.

[24] See note 22 *supra.*

[25] See note 23 *supra.*