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UP IN THE AIR OVER TAXING FREQUENT FLYER BENEFITS:

THE AMERICAN, CANADIAN, AND AUSTRALIAN EXPERIENCES

Introduction

Since frequent flyer programs first appeared in the early 1980s, the agencies charged with the administration of their nations' income tax laws have struggled with the question of whether–and if so how–to tax employees who earn frequent flyer points (or "miles") on employer-paid business trips, and who eventually redeem those points for personal travel rewards (or other personal consumption services or goods). This article describes and evaluates the ways in which three agencies–the Internal Revenue Service (IRS) in the United States, the Canada Revenue Agency (CRA), and the Australian Taxation Office (ATO)–have responded to the tax administration challenge presented by frequent flyer programs. The rather disheartening end of the story (in all three countries) is that no significant amount of tax is being collected on frequent flyer benefits, even though the benefits are clearly taxable in theory (at least in the United States and Canada; the legal analysis in Australia is more complicated).

Back-of-the-envelope calculations suggest that the foregone tax revenue is significant. One industry expert has estimated that United States travelers alone earn as many as three trillion frequent flyer points each year.[1] If the points are valued at one cent per mile,[2] three trillion points are worth $30 billion. Even in theory, not all points are taxable. Points generated by personal consumption expenditures–most significantly, by personal travel and by charging personal expenses (of any sort) on a credit card awarding points based on dollars charged to the card–are not includible in gross income.[3] If roughly half of all points are earned by air travel,[4] and if about 40 percent of air travel is for business,[5] then the taxable points generated by air travel of United States travelers should be roughly 600 billion annually, with a value of about $6 billion. Assuming that value would be taxed, on average, at the rate of 25 percent, the annual federal income tax revenue lost by the failure of the IRS to enforce the taxation of frequent flyer benefits is in the neighborhood of $1.5 billion. The revenue significance of the *de facto* tax-exempt status of frequent flyer benefits is similar to that of a number of well-known legislatively authorized tax expenditures, including the deferral of gain on like-kind exchanges, the exclusion of damages received on account of personal physical injuries or sickness, and the exclusion of

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[1]Inside Air Travel, AirGuideOnline.com & AirGuideBusiness.com, March 6, 2013 (available in LexisNexis "News" file) (citing Randy Petersen, the editor of *InsideFlyer* magazine).

[2]For the evidence supporting a valuation of approximately that amount, see infra text accompanying notes 78-92.

[3]This is explained infra text accompanying notes 11-12.

[4]Press Room–Frequent Flyer Facts, http://www.frequentflyerservices.com/press_room/facts_and_stats/frequent_flyer_facts.php (last visited May 13, 2014) (estimating that only 46 percent of points are earned by ways other than flying).

[5]United States Department of Transportation, Percentage of Air Travel for Business vs. Other Purposes, https://ntl.custhelp.com/app/answers/detail/a_id/252/~/percentage-of-air-travel-for-business-vs-other-purposes (last visited May 13, 2014) (estimating, based on 2001 survey data, that 40.6 percent of air travel was for business)..

meals and lodging furnished on an employer's business premises for the convenience of the employer.[6]

Part I of this article recounts, in some detail, the adventures and misadventures of the IRS, the CRA, and the ATO as those agencies struggled with the question of what–if anything–to do about frequent flyer benefits. After more than three decades, the results could hardly be more discouraging. Virtually no tax on frequent flyer benefits is collected anywhere, and respect for the rule of law (on the part of both taxpayers and the agencies themselves) has been eroded. Part II analyzes what features of frequent flyer programs are responsible for the tax agencies' difficulties, and explains that taxing benefits involves serious problems of timing, valuation, enforcement, and public acceptance. Part III considers how, in light of those problems, an agency (or legislature) could go about designing an effective system for taxing frequent flyer benefits. The task is not easy, but it is also not impossible.

I. Three Case Studies

A. United States

Section 61(a) of the Internal Revenue Code provides that "gross income" includes "all income from whatever source derived." In *Commissioner v. Glenshaw Glass Co.*, arguably the leading judicial opinion interpreting this definition, the Supreme Court noted that "Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their

[6]Staff of the Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017, tbl. 1, at 34 (like-kind exchanges, $2.0 billion in 2013), 37 (meals and lodging, $1.7 billion in 2013), 39 (personal injury damages, $1.6 billion in 2013).

nature."[7] When an employer pays for an employee's business travel, the employee receives frequent flyer points from an airline on account of that travel, and the employee eventually redeems those points for nonbusiness personal travel (or for some other personal consumption award), it is beyond dispute that the employee has realized income under section 61(a) as interpreted by *Glenshaw Glass.* There is some room for argument as to whether the taxable event is the earning of the points or the later redeeming of the points for a reward, there is some room for argument as to whether the benefits are received from employers as compensation for services or from airlines as kickbacks, and there is much room for argument concerning the fair market value of the points or reward (as the case may be), but there is no serious case to be made against the conclusion that the employee realizes gross income at some time and in some amount in connection with her participation in the frequent flyer program.

In the more than three decades since the first frequent flyer program appeared in 1981, commentators have been nearly unanimous on the bottom-line issue of taxability, despite considerable disagreement on the questions of timing and valuation.[8] A few lonely voices have

[7] 348 U.S. 426, 429-30 (1955).

[8] See, e.g., Jonathan Barry Forman, Income Tax Consequences of Frequent Flyer Programs, 26 Tax Notes 742 (1985) (concluding that frequent flyer benefits are taxable at the time an employee receives an award, rather than when the points are earned); M. Bernard Aidinoff, Frequent Flyer Bonuses: A Tax Compliance Dilemma, 31 Tax Notes 1345 (1986) (same); Lee S. Garsson, Frequent Flyer Bonus Programs: To Tax or Not to Tax–Is This the Only Question?, 52 J. Of Air Law & Comm. 973 (1987) (same); George Guttman, IRS Moves Slowly on Frequent Flyer Issue, 38 Tax Notes 1309 (1988) (noting that "most tax experts agree that frequent flyer passes earned on employer-paid business travel are income to the employee if used for personal travel"); Joseph M. Dodge, How to Tax Frequent Flyer Bonuses, 48 Tax Notes 1301 (1990) (concluding that, by application of the tax benefit rule, an employee realizes income when he uses employment-generated points for personal travel); Lee A. Sheppard, News Analysis: Collecting the Tax on Frequent Flyer Benefits, 59 Tax Notes 1140 (1993) (concluding that under current law there is no clear answer as to whether accrual or redemption of points is

suggested that frequent flyer benefits might escape taxation under the section 132(a)(4) exclusion for de minimis fringe benefits,[9] but the case for the applicability of that exclusion is very weak. The statute defines a "de minimis fringe" as "property or service the value of which is . . . so small as to make accounting for it unreasonable or administratively impractical."[10] Accounting for frequent flyer benefits is undeniably challenging, but the challenge has nothing to do with the benefits being "so small," as required by the exclusion provision; in the case of many employees the benefits are worth well over $1,000 annually.

Although frequent flyer benefits arising out of employment and used for personal travel (or other forms of personal consumption) are clearly within the scope of the statutory definition of gross income, some other forms of frequent flyer benefits are not. If an employee earns frequent flyer points on work-related travel, but the employer permits the employee to redeem

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the taxable event); Sharon Alice Pouzar, Frequent Flyer Awards as Taxable Income: Time to Pay the Tax Man, 5 Tex. Wesleyan L. Rev. 55 (1998) (concluding that the redemption of points for tickets should be treated as the taxable event); Jennifer A. Cunningham, Are Frequent Flyer Benefits Really Benefits? An Analysis of the Frequent Flyer Tax Debate and a New Theory of Taxability for Frequent Flyer Benefits, 47 Clev. St. L. Rev. 281 (1999) (concluding that frequent benefits are not taxable as fringe benefits of employment, because they are not received by an employee from her employer, but that they are taxable as prizes or awards under section 74 of the Code); Gene Steuerle, Frequent Flier Miles: Cheating Employers is the Issue, 69 Tax Notes 1539 (1995) (concluding that "free trips represent a form of [taxable] compensation"); Dominic Daher, The Proposed Federal Taxation of Frequent Flyer Miles Received from Employers: Good Tax Policy But Bad Politics, 16 Akron Tax J. 1 (2001) (concluding that frequent flyer benefits are taxable fringe benefits of employment, and that the taxable event is the redemption of the points); Darrell L. Oliveira, The Taxability of Frequent Flyer Credits Earned by Employees: Why the IRS has Remained Silent on the Issue, 4 U. Pa. J. Lab. & Emp. L. 643 (2002) (concluding that taxation at the time of redemption is theoretically correct under current law, but that problems of valuation, timing, and enforcement justify the IRS's don't-ask-don't-tell policy).

[9]Kathy Krawczyk & Lorraine Wright, How Should Frequent Flyer Miles Be Taxed?, 79 Tax Notes 1029 (1998) ("Exclusion as a de minimis fringe benefit seems reasonable . . . ").

[10]IRC sec. 132(e)(1).

those points only for other employment-related travel, then the employee has not received any taxable benefit.[11] And if a taxpayer pays for her personal travel with after-tax (that is, non-deductible) dollars, receives frequent flyer points as a result, and eventually redeems those points for personal travel, the taxpayer has not realized gross income. In effect, the taxpayer has received a volume discount on a consumer purchase. Getting a good deal on an arms'-length consumer purchase–whether by buying a product when it is on sale, or by receiving frequent flyer benefits–never results in a gross income inclusion.[12] The same principle applies in the case of frequent flyer points generated by other non-deductible consumer purchases, such as points awarded by hotel chains, car rental companies, and credit card issuers.

When frequent flyer programs emerged in the early 1980s,[13] the IRS made no pronouncements as to the federal income tax implications of the programs, and made no discernible effort to enforce the taxation of employment-generated points redeemed for personal consumption. Other than insisting on the taxability of the conversion of points to cash,[14] the IRS

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[11]As a technical matter, in that case the frequent flyer benefits would qualify as excludable "working condition fringes," which the statute defines as "any property or services provided to an employee . . . to the extent that, if the employee paid for such property or services, such payment would be allowable as a [business expense] deduction." IRC secs. 132(a)(3), (d).

[12]See, e.g., Rev. Rul. 76-96, 1976-1 C.B. 23 (retail purchasers of automobiles were not required to include in their gross income cash rebates received from automobile manufacturers).

[13]See, e.g., Paul Grimes, Practical Traveler: Coupons and Other Bonuses for the Airborne, New York Times, October 11, 1981, sec. 10, p. 3 (describing "bonus incentive plans based on the number of trips you take or miles you fly," recently introduced by several airlines).

[14]The IRS's position on this point was upheld in Charley v. Commissioner, 91 F3d 72 (9th Cir. 1996). Dr. Charley was employed by a closely-held corporation which he controlled. When he traveled for his employer, he would (1) purchase a coach-class ticket, (2) use his frequent flyer miles to upgrade the ticket to first class, and (3) cause the employer to "reimburse" him for the price of a first-class ticket. In effect, he sold his frequent flyer miles–largely generated by

did almost nothing about the taxation of frequent flier benefits. In 1985, in connection with a wide-ranging regulations project on miscellaneous fringe benefits, the IRS did ask the public for comments on the taxation of frequent flyer programs–specifically on “the need for special rules relating to the valuation of the benefits, the administrability of either withholding on or reporting the value of such benefits, and the appropriate party to charge with reporting.”[15] However, the request led to no regulations, or even proposed regulations.

In the absence of IRS pronouncements or enforcement activities, neither employers nor airlines treated frequent flyer benefits as subject to income tax information reporting, and in the absence of information reporting only the most hyper-scrupulous employees (if any) reported the value of their frequent flyer benefits on their individual income tax returns. As this state of affairs persisted into the 1990s, well-traveled employees came to view the tax-free status of frequent flyer benefits as an established fact–in most cases, one suspects, without knowing that the exclusion was only a *de facto* exclusion based on IRS inaction, rather than a statutory exclusion blessed by Congress.

Things changed suddenly–but as it turned out, only briefly–in 1995, when Technical Advice Memorandum (TAM) 9547001 emerged from the depths of the IRS’s Office of Chief

previous employer-financed business trips–to his employer for cash. The Ninth Circuit readily concluded that the cash received by Dr. Charley was includible in his gross income, either as additional compensation for services or as the amount realized on the sale of assets in which he had a basis of zero. The court emphasized, however, that the case was only about the taxability of cash: “The Charleys argue that this case raises the question of whether, in the abstract, frequent flyer miles constitute gross income. We disagree and do not reach that issue.” 91 F3d at 74.

[15] 50 Fed. Reg. 52,333, 52,334 (December 23, 1985).

Counsel.[16] A TAM is a rather modest sort of administrative pronouncement, issued without high-level review within the agency, and addressed only to the situation of the taxpayer described in the TAM. TAMs are, however, made available to the public in redacted form. This particular TAM implied that frequent flyer points were includible in the gross income of employees who were allowed to retain their employment-generated points for personal use. A reporter from the *Wall Street Journal* got wind of the TAM (several months after it had been issued) and wrote a story describing both the TAM itself and the "storm of protest . . . gathering in an attempt to persuade the IRS to change its mind."[17] Having been alerted to the existence of the TAM by the *Journal*, the higher levels of the IRS wasted no time in disavowing the TAM. On the same day the story appeared in the *Journal*, IRS spokesperson Frank Keith reassured a worried public, "We have no particular compliance activities geared toward the taxation of frequent flier miles and we don't anticipate any," and that the IRS was "reconsidering the analysis in the technical advice memorandum."[18]

All was quiet on the frequent flyer tax front until 2002, when the IRS issued Announcement 2002-18,[19] confirming what Frank Keith had told reporters seven years earlier. Explaining that "[t]here are numerous technical and administrative issues relating to these benefits on which no official guidance has been provided, including issues relating to the timing

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[16]Technical Advice Memorandum 9547001 (July 11, 1995).

[17]Tom Herman, Frequent-Flier Miles May Become IRS Target, Wall Street Journal, November 28, 1995, at A3.

[18]Robert D. Hershey, I.R.S. Backs Down on Frequent-Flier Miles, New York Times, November 28, 1995, at B14.

[19]Announcment 2002-18, 2002-10 I.R.B. 621.

and valuation of income inclusions and the basis for identifying personal use benefits attributable to business . . . expenditures versus those attributable to personal expenditures," the Announcement confirmed that "the IRS will not assert that any taxpayer has understated his federal tax liability by reason of the receipt or personal use of frequent flyer miles . . . attributable to the taxpayer's business . . . travel." The Announcement cautioned, however, that the IRS's don't-ask-don't-tell policy did not extend to "travel or other promotional benefits that are converted to cash."

Nothing in the Announcement expressed any doubt on the part of the IRS that employee-retained frequent flyer benefits were, in fact, taxable under the terms of the Internal Revenue Code. At the same time, the Announcement made it clear that the IRS had no intention of enforcing the taxability of frequent flyer benefits, and that it did not expect taxpayers to report such benefits as part of their gross income. The Announcement was a prominent example of a phenomenon that is surprisingly common in the IRS's administration of the federal income tax–what might be called "customary deviations" from the tax law on-the-books, always in a taxpayer-favorable direction.[20] The main objection to such deviations is not that they breed disrespect for the law on the part of taxpayers; most affected taxpayers probably assume that the IRS's position is based on an interpretation of the law, rather than on a disregarding of it. Rather, such deviations erode the rule of law in the minds of the tax administrators themselves, leading the administrators to believe they can deviate from the dictates of the statute (but only in a pro-taxpayer direction) whenever they decide that policy considerations strongly favor a

[20]For much more on the phenomenon of customary deviations on the part of the IRS, see Lawrence Zelenak, Custom and the Rule of Law in the Administration of the Income Tax, 62 Duke L. J. 829 (2012).

deviation.[21]

If the IRS was hoping that Announcement 2002-18 would spare its spokespersons from ever again having to discuss frequent flyer miles, it was to be disappointed. In 2012 the *Los Angeles Times* reported that Citibank had issued Forms 1099-MISC to persons who had received frequent flier points from Citibank as rewards for opening accounts with the bank.[22] A Form 1009-MISC is an information return, reporting to the IRS cash or in-kind payments made by the filer of the form and includible in the gross income of the recipient of the cash or in-kind payment. The Citibank depositors who received their copies of the Forms 1099-MISC, and who had not anticipated any tax liability from their receipt of points, were understandably unhappy.

Apparently Citibank had concluded that the don't-ask-don't-tell policy of Announcement 2002-18 did not cover the bank's situation, and that points received as a reward for opening an account were within the statutory definition of gross income. Both conclusions would have been entirely reasonable. By its express terms, Announcement 2002-18 applied only to frequent flyer benefits attributable to travel. As for the gross income inclusion, a benefit received for opening an account is either interest or closely analogous to interest, and the statute expressly states that interest is includible in gross income.[23] Citibank was undoubtedly aware that the penalty for failing to file required Forms 1099-MISC is $100 per form, subject to a $1.5 million ceiling on total failure-to-file penalties imposed on any one non-filer for any one calendar year.[24] It may

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[21]Id. at 854.

[22]David Lazarus, Tax Man Leaves Fliers Up in the Air, Los Angeles Times, January 24, 2012, at B1.

[23]IRC sec. 61(a)(4).

[24]IRC sec. 6721(a).

not have been a coincidence that Citibank issued the Forms 1099-MISC shortly after Congress had increased the per-form penalty from $50 to $100 and the total-penalty ceiling from $250,000 to $1.5 million.[25] Faced with an unappealing choice between potential penalties of as much as $1.5 million and incurring the wrath of owners of recently-opened accounts, Citibank chose to incur the wrath. It may not have been a wise decision, given the absence of any indication that the IRS was poised to assert penalties if Citibank had not issued the Forms 1099-MISC. (There are no media accounts of any other banks having issued Forms 1099-MISC in similar circumstances, or of the IRS having asserted penalties against any other banks for having failed to do so.) It was not, however, an incomprehensible decision.

Forced by events to comment on the issue, IRS spokesperson Michelle Eldridge supported Citibank's view of the substantive issue: "When frequent-flier miles are provided as a premium for opening a financial account, it can be a taxable situation subject to reporting under current law."[26] Ms. Eldridge's remarks were consistent with the IRS's position in its taxpayer's guide to the taxation of investment income, which states that "non-cash goods or services" received for making bank deposits or opening an account are taxable as interest income (although the guide makes no specific mention of frequent flyer points).[27] Senator Sherrod Brown (D, Ohio) expressed his outrage at Citibank (and his disagreement with the IRS's position) by sending a letter to Vikram Pandit, CEO of Citibank, strongly urging the bank to

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[25]Creating Small Business Jobs Act of 2010, Pub. L. No. 111-240, sec. 2102(a)(1), 124 Stat. 2504, 2561-62.

[26]David Lazarus, Taxing Airline Miles Flies in the Face of Reason, Los Angeles Times, January 31, 2012, at B1.

[27]IRS Publication 550, Investment Income and Expenses (Including Capital Gains and Losses) (January 7, 2014) at 6.

change its ways. "The last thing Citibank should be doing," wrote Brown, "is creating baseless fear in middle class families, or placing a nonexistent tax burden on the backs of families who are already struggling to make ends meet."[28]

After a brief flurry of 2012 media coverage of the Citibank Forms 1099-MISC, the question of the taxability of frequent flyer points for opening bank accounts has disappeared from the national discourse. There are no indications that any other banks have followed Citibank's lead in issuing Forms 1099-MISC, or that even Citibank itself has issued such forms in more recent years. To the contrary, the *Boston Globe* reported that Citibank was *not* planning to issue Forms 1099-MISC for frequent flyer points it awarded in 2012: "Citibank said it is not required to make similar IRS filings this year because the details of the current offer are different."[29] The *Globe* did not explain what differences in details made the 2012 points nontaxable, and no solution to the puzzle suggests itself. In all likelihood, Citibank had grown confident that the IRS would look the other way if it did not issue Forms 1099-MISC, and so had decided not to enrage its depositors a second time. Now that the Citibank dust has settled, the situation with respect to bank-issued frequent flyer points appears to be the same as the situation with respect to travel-generated points between the 1995 TAM crisis and the 2002 Announcement. The issue has had its Warholian fifteen minutes of fame, and the IRS has not formally announced a don't-ask-don't-tell policy, but all indications are that the IRS is doing absolutely nothing to enforce the law.

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[28]Id.

[29]Todd Wollack, Interest and Rates Can't Entice, Banks Offer Bonuses in Bid to Win Customers, Boston Globe, December 23, 2012, at G1.

Of course, the IRS is not the only authority that could have addressed the federal income tax treatment of frequent flyer benefits. Congress might have legislated to resolve the discrepancy between the *de jure* taxability of (some) frequent flyer benefits and their *de facto* tax-free status. It might, for example, have provided an explicit statutory exclusion for frequent flyer benefits received under specified circumstances. Or it might have resolved the discrepancy in the other direction, by explicitly stating that frequent flyer benefits are taxable, and by providing rules to make taxation workable (for example, by clarifying whether the taxable event is the accrual of points or their redemption, by providing easy-to-apply valuations rules, and by clarifying the information reporting obligations of employers, airlines, banks, and other issuers of points).

There would have been a close precedent for the explicit exclusion approach. Beginning with the early years of the income tax and extending over many decades, the IRS developed a practice of not asserting the taxability of a wide range of fringe benefits of employment, despite the absence of any statutory authority for their exclusion from gross income.[30] Examples included employer-provided free parking at work, employee discounts on goods and services sold by an employer to the public, and free stand-by flights for employees of airlines. Unhappy with the proliferation of *de facto* exclusions and the resulting gap between the law-on-the-books and the law-as-enforced, in 1978 IRS Commissioner Jerome Kurtz warned Congress that unless it provided a statutory basis for the *de facto* exclusions Kurtz would direct the IRS to begin enforcing the taxation of forty types of then-untaxed fringe benefits.[31] The initial legislative

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[30]For a brief recounting of this history, see Zelenak, supra note 20, at 841-44.

[31]Taxing Perks–If Congress Won't, IRS' Kurtz Will, Forbes, July 24, 1978, at 20.

response was to impose a moratorium on any administrative action to upset the *de facto* nontaxation of fringe benefits.[32] Six years later, however, Congress finally enacted new section 132, which provided a clear statutory foundation for most of the established *de facto* exclusions.[33] The 1984 legislation also added an express mention of "fringe benefits" in the section 61 definition of gross income, thus suggesting that there were to be no more *de facto* administrative exclusions[34]–a suggestion which the IRS has ignored in the case of frequent flyer benefits.

Given that frequent flyer programs had existed for three years by the time Congress passed the 1984 fringe benefit legislation, Congress *could* have addressed the taxation of those benefits–by expressly providing either for exclusion or inclusion–in that legislation. In fact, however, as one congressional aide told *Tax Notes,* "The issue [of the taxation of frequent flyer benefits] was never forced. To the extent that the [1984] tax-writing committees were ever asked about it, the committees ducked the issue."[35] In 1984 frequent flyer benefits were too recent a phenomenon for their *de facto* exclusion to have become well established; thus they escaped legislative attention. If frequent flyer programs had developed a few years earlier, or if Congress had gotten around to enacting fringe benefit tax rules a few years later, there would probably now be an explicit statutory treatment–whether complete inclusion, complete exclusion, or something in-between–of frequent flyer benefits. But the timing was not quite

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[32]Act of October 7, 1978, Pub. L. No. 95-427, sec. 1, 92 Stat. 996, 996.

[33]Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 531(a), 98 Stat. 494, 877.

[34]Id, sec. 531(c), 98 Stat. At 884.

[35]Forman, supra note 8, at 743.

right for resolution of the issue in 1984, and it appears that Congress can bestir itself to clean up messes of this sort only once or twice in a century.

Interestingly, despite its unwillingness to clarify the income tax treatment of frequent flyer benefits, Congress has managed to enact other legislation relating to the taxation of frequent flyer programs. Section 4621(a) of the Internal Revenue Code imposes a 7.5 percent excise tax on amounts paid for taxable air transportation. In 1997 Congress added section 4261(e)(3), which states that the excise tax applies to amounts paid to an air carrier for the right to provide frequent flyer points to others.[36] If a car rental company or a hotel chain pays an airline for the right to award frequent flyer points to its customers, the excise tax applies. There are two reasons (at least) why the enactment of this provision did not encounter the resistance that would inevitably accompany any legislative attempt to enforce the income taxation of frequent flyer benefits. First, the excise tax is imposed on cash purchases of the right to award points, thus avoiding the standard objections (based on valuation, liquidity, and public incomprehension) to taxes on non-cash transactions. Second, the excise tax is imposed on a business-to-business transaction, making the tax nearly invisible to the flying public. This near invisibility could not be more different from the in-your-face quality of the taxation of in-kind benefits under the income tax.

B. Canada

In contrast with the head-in-the-sand approach of the Internal Revenue Service, the Canada Revenue Agency (CRA) early on asserted the income taxability of frequent flyer benefits received in connection with employer-paid business travel. The Tax Court of Canada upheld the

[36]Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1031(c)(2), 111 Stat. 788, 931.

CRA's position in its 1995 decision in *Mommersteeg and Giffen v. The Queen* (*Giffen*).[37] Interpreting section 6(1)(a) of the Income Tax Act, which included in the income of an individual "the value of board, lodging and other benefits of any kind whatever received or enjoyed . . . in respect of, in the course of, or by virtue of an office or employment," the Tax Court agreed with the CRA's position that the taxpayers were taxable on the fair market value of the plane tickets received in redemption of their frequent flyer points. The Court explained that the accrual of points was not itself a taxable event because "[p]oints are not themselves offered or portrayed as rewards. They serve only to measure the amount of qualifying activity necessary to earn a reward."[38] Rejecting the taxpayers' arguments that the free flights were also not taxable, because the taxpayers did not receive the flights "in respect of, in the course of, or by virtue of . . . employment," the Court endorsed the CRA's position that "it is not necessary that the benefit be conferred by the employer; all that is required is a connection between the receipt of the benefit and the employment."[39] In the view of the Court, "Where a benefit is received by reason of employment it is of no consequence that some other condition unconnected with employment must also be met."[40] The Court described the proper valuation standard as "the price which the employee would have been obligated to pay for a revenue ticket entitling him to travel on the same flight in the same class of service and subject to the same restrictions as are applicable to reward tickets," and directed the CRA to reassess the taxpayers pursuant to that

[37]96 D.T.C. 1011 (1995).

[38]Id. At 1015.

[39]Id.

[40]Id.

standard.[41] The standard is easier to state than to apply, given the fact (acknowledged by the Court) that there typically are no revenue tickets subject to restrictions identical to those imposed on reward tickets.

Despite the CRA's judicial victory, there is no indication that the CRA is making any meaningful attempt to enforce the taxability of frequent flyer rewards. The CRA does not require an employer to include frequent flyer rewards in an employee's wages reported by the employer to the CRA[42]–nor could the employer do so without the employee's cooperation, because the employer will not know when the employee has redeemed her points. Instead, the CRA relies on the employee "to determine and include in income the fair market value of any benefits received or enjoyed."[43]

Writing in 2004, Kim Brooks observed that "there has been very little discussion of the taxation of frequent flyer points in Canada since the release of *Giffen* and the short flurry of activity afterwards. One might assume this is because the Revenue Agency does little to enforce the law in this area."[44] The CRA's approach–of insisting that employees must report as income frequent flyer rewards attributable to employer-paid travel, but doing almost nothing to enforce the law–provides an interesting contrast to the IRS's approach of telling the public that frequent flyer benefits are taxable in theory, but that the tax administrator neither wants nor expects anyone to report their benefits as income. In terms of breeding disrespect for the law, it is a

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[41]Id. At 1016.

[42]IT-470R, para. 14 (October 12, 1999).

[43]Id.

[44]Kim Brooks, Determining the Concept of Income: The Taxation of In-Kind Benefits, 49 McGill L.J. 255, 298, n. 101.

close call which of these approaches is worse. Is it the IRS's approach, because the tax administrator arrogates to itself the power to rewrite the tax laws, or is it the CRA's approach because the insistence on an unpopular, non-intuitive and unenforceable income inclusion will inevitably lead to virtually every business traveler cheating on his taxes? The IRS's approach largely avoids the nation-of-tax-cheats problem (and the accompanying special tax on the heroically honest) inherent in the CRA's approach, but at the cost of turning the tax administrator itself into a scofflaw. The one certainty is that no significant amount of tax is being paid on employment-related frequent flyer benefits in either country, despite the apparent taxable status of those benefits under the income tax laws of each.

The CRA has also opined on another frequent flyer tax issue–one which has generated no discussion in the United States. Frequent flyer points can be earned not only by travel, but also by making credit card purchases (of anything). What if an employer allows an employee to charge business-related expenses (whether for air travel or anything else) on the employee's personal credit card, with the employer later reimbursing the expense and the employee keeping the frequent flyer points for her personal use? The CRA's initial position was that the rewards generated by those points were taxable (under the *Giffen* rationale), and that it was "the responsibility of the employee to determine and include in income the fair market value of any benefits received or enjoyed."[45] In 2009, however, recognizing that "employees often face significant difficulties with respect to the valuation of these benefits as well as tracking and identifying the benefits attributable to points accumulated by way of employment versus

[45]Income Tax Technical News No. 40 (June 11, 2009) (describing the prior position being abandoned by the CRA).

personal use of the credit cards," the CRA announced that it would no longer consider these benefits to be taxable (unless the points were converted to cash, or the employer facilitated an employee's maximizing his credit card points–for example, by allowing an employee to use his personal credit card to pay the travel expenses of other employees).[46]

Despite the 2009 never-mind pronouncement concerning credit card-generated points, the CRA's 1999 pronoucement insisting on the taxation of travel-generated points remains in force.[47] Thus the CRA's current position seems to be that employees must report as income frequent flyer rewards attributable to employer-paid air travel, but need not report as income frequent flyer awards attributable to charging employer-reimbursed expenses on the employee's personal credit card.

The CRA's position on credit card points reflects the same basic approach–a *de facto* administrative exclusion from gross income–adopted by the IRS in the case of points generated by air travel. So the CRA now follows both its original unsatisfactory approach (in the case of travel-generated points) and the IRS's more-or-less equally unsatisfactory approach (in the case of credit card-generated points). The CRA's embrace of both approaches is puzzling, given that its stated rationale for the don't-ask-don't-tell treatment of credit card-generated points (based on

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[46]Id.

[47]IT-470R, supra note 42, para. 14. The crucial language is as follows:

> Under this [frequent flyer] program, which usually is sponsored by an airline, a frequent air traveller can accumulate credits which may be exchanged for additional air travel or other benefits. Where an employee accumulates such credits while travelling on employer-paid business trips and uses them to obtain air travel or other benefits for the personal use of the employee or the employee's family, the fair market value of such air travel or other benefits must be included in the employee's income.

the difficulty of determining the value of rewards and the difficulty of keeping track of points generated in the employment context versus points generated by personal expenditures) applies with equal force to travel-generated points. One suspects that the CRA may have come around to the view that don't-ask-don't-tell is the less bad alternative on the merits (thus explaining its adoption in the credit card context), but that it also believed that it should not abandon its victory in *Giffen* (thus explaining the persistence of the unenforceable hardline position in the air travel context).

C. Australia

Like the CRA (and unlike the IRS), the ATO began by insisting on the taxability of frequent flyer rewards attributable to employer-paid air travel. The issue was litigated in the 1996 case of *Payne v. Federal Commissioner of Taxation.*[48] The general definition of income in section 25(1) of the Australian income tax statute has long been interpreted to include non-cash benefits only if the benefits are convertible to cash. This interpretation–which is sharply at odds with both the standard theoretical definition of income[49] and the approach taken by the federal income tax of the United States[50]–originated with an 1892 case from the United Kingdom,

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[48](1996) 32 A.T.R. 516.

[49]Henry Simons, Personal Income Taxation 50, 61-62, 206 (1938) (defining income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question").

[50]For example, Treas. Reg. sec. 1.61-21(b)(2) states that the fair market value of a taxable fringe benefit is "the amount that an individual would have to pay for the particular fringe benefit in an arm's-length transaction," without regard to whether (or for how much) the individual could sell the benefit.

Tennant v. Smith.[51] Concluding that the frequent flyer reward in question was not convertible to cash, the Federal Court of Australia ruled that the reward was not taxable under section 25(1). That was not the end of the matter, however, because another section of the income tax statute (section 26(e)) provided for the taxability of “the value to the taxpayer of all allowances, gratuities, compensations, benefits, bonuses and premiums allowed, given or granted to him in respect of, or for or in relation directly or indirectly to, any employment of or services rendered by him,” and the convertibility-to-cash requirement did *not* apply for purposes of this provision. But the ATO fared no better under section 26(e) than it had under section 25(1). The court interpreted section 26(e) to apply only if the taxpayer’s employment was “wholly or partly the reason for the donor or granter [i.e., the airline] making the gift or grant.”[52] Because the airline had provided the frequent flyer reward with no reference to the taxpayer’s employment status, the court concluded that the value of the flight was not within the scope of the income-from-employment provision.

In response to the ATO’s argument that the Tax Court of Canada had recently decided (in *Giffen*) that frequent flyer rewards received under similar circumstances constituted income from employment under the Canadian income tax statute, the Australian court explained that the difference in result was compelled by the different wording of the Canadian and Australian statutes. The Canadian provision applied to benefits “received or enjoyed” by the taxpayer, whereas the Australian provision applied to benefits “given or granted to him.” To be charitable, it is less than self-evident that the difference in language made *Giffen* clearly distinguishable

[51](1892) A.C. 150.

[52]32 A.T.R. at __.

from *Payne* (as claimed by the Australian court).[53]

Although the result in *Payne* was dubious (at best) as a matter of statutory interpretation, the ATO *might* have taken it as a blessing in diguise. Supplied with a judicial ruling that frequent flyer benefits were not taxable, the ATO could have accepted its defeat gracefully. Because of *Payne*, the ATO did not have to choose between the unpalatable alternatives of (1) announcing that it was going to ignore the law and broadly hinting that taxpayers should follow its lead (as in the case of the IRS), or (2) insisting on a taxability it had no means of enforcing (as in the case of the CRA). Instead of taking the easy way out, however, the ATO soldiered on. Although the ATO accepted the result in *Payne* in the employment context, in 1999 it issued a ruling indicating that *Payne* did not apply to self-employed taxpayers; a self-employed person who used business-generated frequent flyer points for personal travel could be taxed under a statutory rule that "a non-cash business benefit that is not convertible to cash shall be treated as if it were convertible to cash."[54]

The income tax was not the only Australian tax with potential application to frequent flyer benefits. Australian employers are subject to an excise tax on noncash benefits provided to their employees. Until 2004 the ATO took the position that frequent flyer rewards were not subject to the employer excise tax because the rewards did not satisfy the statutory requirement of having been furnished to the employee by the employer, or by a third party pursuant to an

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[53]As one commentator has noted, "The difference in language between the Australian and Canadian statutes does not seem to justify a different outcome in the cases in each jurisdiction." Kevin Holmes, The Concept of Income: A Multi-Disciplinary Analysis 512 (2001).

[54]TR 1999/6 (quoting section 21A of the Income Tax Assessment Act of 1936).

arrangement with the employer.[55] In 2004, however, the ATO issued a new pronouncement indicating that frequent flyer rewards are subject to the fringe benefit excise tax "where the facts demonstrate that there is an arrangement between the employee and employer so that the provision of the reward has a sufficient and material connection to employment."[56]

Writing in 2013, Jonathan Teoh and Richard Krever offered an educated guess that the ATO is doing little or nothing to enforce either the income taxation of frequent flyer benefits of self-employed persons or the taxation of frequent flyer benefits under the employer excise tax:

> While there have been minor amendments of the 1999 ruling since [2004], there have been no other public statements issued by the ATO and no reported cases. It is thus doubtful that the ATO has attempted to assess loyalty program benefits under the income tax or fringe benefits tax regime even with its assertion 14 years ago that it could do so.[57]

Despite the opposite results in *Giffen* and in *Payne*, Australia seems to have ended up in roughly the same situation as Canada with respect to the taxation of frequent flyer benefits. In each country the tax administrator insists that frequent flyer benefits are taxable (at least under certain circumstances), but makes no visible effort to enforce its interpretation of the law.

II. Why Is This So Difficult?

Why have tax administrators had so much trouble figuring out what to do about frequent flyer benefits? At least in the United States (where the tax laws are free of the pernicious influence of *Tennant v. Smith*) and Canada (where *Giffen* seems to have settled the issue), the

[55]TR 1993/2.

[56]PS LA 2004/4, para. 19.

[57]Jonathan Teoh & Richard Krever, The Continuing Saga of Australian Taxation of Frequent Flyer Points, 69 Tax Notes International 1137 (2013).

theoretical taxability of frequent flyer benefits arising from employment is clear-cut. Why, then, is non-enforcement the norm?

There is no denying that any serious enforcement attempt would encounter significant valuation difficulties. Taxing non-cash benefits often raises valuation problems, and the challenges in the case of frequent flyer benefits are particularly acute. If the accrual of points is considered the taxable event, how are the points to be valued? If the employer purchased the points separately from the employee's air travel, and then allowed the employee to keep the points, the amount the employer paid for the points would be strong evidence of the value of the points to the employee.[58] The problem, of course, is that the employer pays a bundled price for the employee's ticket and the frequent flyer points, and there is no easy way of unbundling that price into its two components.[59] Nor can the points be valued at the amount for which the employee can sell them, because the terms of the frequent flyer programs do not permit such sales.[60] There *are* legal sales of points by airlines, in bulk to businesses (such as banks, car rental companies, and hotel chains) that want to provide points to their customers, and in some cases to program participants who need points to reach a desired reward level.[61] The prices at

[58]At least in the United States, however, the cost to the employer would not be conclusive on the question of the value received by the employee. See Treas. Reg. sec. 1.61-21(b)(2), stating that the cost incurred by the employer for a taxable fringe benefit is not "determinative of its fair market value" when received by the employee.

[59]Teoh & Krever, supra note 57, emphasize this aspect of the valuation problem.

[60]Some sales may nevertheless occur, but such sales do not help with the valuation problem, both because a sale in the shadow of official nontransferability will likely be at a sharp discount, and because the tax administrator will not be able to determine reliably the price at which points are changing hands in black or grey markets.

[61]For more on the prices at which airlines sell points, and how those prices might be used by tax administrators, see infra text accompanying notes 86-92.

which points sell in these transactions is some evidence of the fair market value of points received for business travel, but because of the differing circumstances those prices are not conclusive of the value of employees' points. If the redeeming of points for rewards is considered the taxable event, the valuation task does not get any easier. In fact, in the case of the prototypical award of free air travel, it is harder to value the rewards than it would be to value the points themselves. The *Giffen* court's approach to valuation of free flights–the cost of a revenue ticket on the same flight and subject to the same restrictions–is both clearly theoretically correct and clearly practically unworkable (because of the usual absence of revenue tickets featuring identical restrictions).

As discussed below,[62] the valuation problems are not insuperable, at least if the focus is on the accrual of points rather than on their redemption. It is easy, however, to appreciate how, at the dawn of the frequent flyer program era, tax administrators might have been inclined to ignore the problem in the hope that it would somehow go away. Taxing in-kind benefits is never an easy sell with the taxpaying public. It would have been an especially difficult sell in the case of frequent flyer benefits, given the confluence of unusually severe valuation problems, popular resistance to what would have been perceived as a new tax, and the absence of legislation explicitly imposing a tax on frequent flyer benefits. By the time it became clear that, far from going away, frequent flyer programs had grown to massive proportions and were here to stay, traveling employees had become accustomed to the *de facto* tax-free status of their benefits. They would have objected strenuously if the tax administrator (or the legislature) had taken away their *de facto* exemption at that point.

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[62]Infra text accompanying notes 77-92.

Although it is easy to be critical of the IRS's head-in-the-sand approach, and to bemoan the results thereof, it is only fair to note that the situations in Canada and Australia today are not very different from the situation in the United States, despite the fact that both the CRA and the ATO began by asserting the taxability of frequent flyer benefits. A judicial opinion supporting taxability (as in Canada) is useless without a workable valuation method and an effective enforcement mechanism–neither of which has emerged in Canada.

At this late date, it may be the better part of valor to accept the political inevitability of the continued *de facto* tax-free status of frequent flyer benefits (in all three countries). If so, the legislatures should make the gross income exclusions explicit, thereby eliminating the scofflaw status of the tax administrator itself (in the care of the United States) or of large numbers of taxpayers (in the cases of Canada and Australia). But there is also a case for getting serious about taxing frequent flyer benefits. The potential tax revenue is substantial, and from a distributional standpoint it is difficult to defend an exclusion the benefits of which are enjoyed disproportionately by upper-middle class taxpayers. In the not-very-likely event that either a tax administrator or a legislature decides to get serious about taxing frequent flyer benefits, the following section offers some thoughts on how that might be done.

III. How to Tax Frequent Flyer Benefits (If You Want To)

The focus of this section is on taxing frequent flyer benefits under the federal income tax of the United States. Much of the analysis, however, should readily transfer to the income tax systems of other countries.

A. In Theory: Timing

The first question is about timing. If frequent flyer benefits are to be taxed, should the taxable event be the accrual of points or the redemption of points for rewards?[63] As explained earlier, both the CRA and the ATO asserted that the later event was the taxable moment, and in *Giffen* the Tax Court of Canada agreed. Among American commentators who have opined on the timing issue, the overwhelming majority have favored waiting until the points are redeemed to impose the tax.[64] I disagree with this almost-consensus, for both theoretical and practical reasons.

At least under United States income tax principles, the receipt of points seems fairly clearly to qualify as a taxable event. The points themselves have value, as indicated by the fact that points are regularly bought and sold (legally, in many cases).[65] The receipt of points should qualify, then, as a realized accession to wealth–and thus as a taxable event under the section 61 definition of gross income as interpreted by *Glenshaw Glass.* Although it is true that there is no personal consumption until the points are redeemed for travel (or some other reward), and that that would be reason enough to defer taxation until redemption under a consumption tax, it is not a reason to defer taxation under an income tax. For whatever it may be worth, the IRS pronouncement most nearly on-point is consistent with this view. In a 1970 revenue ruling, the IRS considered the taxability of “prize points,” redeemable for merchandise, awarded by a

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[63]If the later point is chosen as the taxable event, a further tax timing choice must be made among the receipt of an award voucher, the exchange of a voucher for a ticket, and the actual taking of the trip.

[64]See, e.g., Aidinoff, supra note 8, at 1352; Guttman, supra note 8, at 1313; Dodge, supra note 8, at 1302: Pouzar, supra note 8, at 76: Daher, supra note 8, at 18: Oliveira, supra note 8, at 660-61.

[65]For some details on the legal buying and selling of points, see infra text accompanying notes 86-92.

distributor to the salespersons-employees of dealers carrying the distributor's products.[66] The ruling gave no indication that there was any way for the salespersons to convert their prize points directly to cash (although they could, of course, attempt to sell the merchandise for which they redeemed their points). The ruling concluded that "the fair market value of the prize points awarded to a salesman . . . is includible in his gross income at the time the prize points are paid or otherwise made available to him, whichever is earlier." Also, although it obviously does not carry a great deal of weight, recall that Citibank assumed that the awarding of points was the taxable event when it issued its notorious Forms 1099-MISC.

Although most of the commentators favoring taxation at redemption offer little explanation of their timing preference, the arguments of two of the commentators merit some discussion. According to M. Bernard Aidinoff,

> A participant in a frequent flyer program does not realize income merely because he earns bonus miles. A participant is not entitled to draw upon a benefit until he has accumulated enough bonus miles to earn an award. Nor does a participant realize income merely because he earns enough bonus miles to entitle him to an award. No tangible benefit is made available to him on that account such as would constitute an "accession to wealth" within the meaning of *Glenshaw Glass.*[67]

Aidinoff's second claim (about the participant who has accrued enough points to qualify for an award) seems clearly wrong. The same reasoning would indicate that the receipt of cash is not a taxable event, because no "tangible benefit is made available" to the recipient of cash until he spends the cash on personal consumption. But, of course, the receipt of cash as compensation *is* taxable under an income tax. Aidinoff's second claim would make sense under a consumption

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[66]Rev. Rul. 1970-331, 1970-1 C.B. 14.

[67]Aidinoff, supra note 8, at 1352.

tax, but not under an income tax.[68] Aidinoff's first claim (about a participant who has not accrued the number of points required to earn the lowest-point award) is more defensible. However, its implication is that the tax system must treat identically a taxpayer who has accumulated 24,999 points when the lowest-point award requires 25,000 points, and a taxpayer who has accumulated zero points. There is a real difference in wealth between the two taxpayers even though neither is yet presented with a consumption opportunity, and there is no reason why an income tax (in contrast with a consumption tax) must ignore that difference. In any event, Aidinoff's first claim is of limited practical significance, given that most business travelers will have accrued far more points than the minimum required to qualify for a reward.

The second argument comes from Joseph M. Dodge.[69] In Dodge's view, the key to the taxation of frequent flyer benefits is the tax benefit rule, under which a taxpayer has income in year two if he claims a deduction (or exclusion) in year one, and in year two some event occurs which is fundamentally inconsistent with the assumption on which the earlier deduction (or exclusion) was based.[70] Suppose an employee takes an employer-paid business trip in year one, and excludes the cost of air travel from his gross income based on the assumption that the entire amount paid by the employer was for business travel.[71] If, in year two, the employee redeems for

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[68]In addition to the problem pointed out in the text, Aidinoff's second claim disregards the doctrine of constructive receipt, under which "a taxpayer may not deliberately turn his back upon income and thus select the year for which he will report it." Hamilton National Bank of Chattanooga v. Commssioner, B.T.A. 63, 67 (1933). A taxpayer who could redeem points for an award at any time, but chooses not to do so, is arguably in constructive receipt of the award.

[69]Dodge, supra note 8, at 1302.

[70]Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983).

[71]The technical basis for the exclusion is section 132(a)(3), which provides that "working condition" fringe benefits are excluded from gross income.

personal travel the frequent flyer points generated by the year-one business trip, Dodge would apply the tax benefit rule against the taxpayer at that point, but not before: “Tax-benefit-rule doctrine . . . dictates that the award should be includible in the year used for pleasure . . . , not as and when one becomes eligible for an award. There is no event inconsistent with the prior deduction until the award is actually committed to, or used for, pleasure travel.”[72] The problem with Dodge’s analysis is that his view of the facts does not comport with the standard workplace treatment of frequent flier points, at least not as of 2014. Dodge assumes that until the points are redeemed for personal travel, it is entirely possible that the employee will use his points to save his employer money on some future business trip. In fact, however, the standard–nearly universal–practice is that the points are firmly committed to an employee’s personal consumption as soon as they accrue, with the result that the fundamentally inconsistent event triggering taxation under Dodge’s tax-benefit-rule analysis should be the accrual of the points, not their later redemption. Dodge’s analysis would be correct in the case of an employee whose employer initially mandated that employees use their frequent flyer points only on business travel, but later permitted an employee to put his miles to personal use. That situation, however, is vanishingly rare.

There is one other theoretical argument against treating the accrual of points as the taxable event, although to my knowledge it has not previously appeared in the (surprisingly extensive) literature on the taxation of frequent flyer points. If one reads the fine print of the terms and conditions of a typical frequent flyer program, one discovers that the airline does not actually commit itself to very much, if anything. Under American Airlines’ AAdvantage

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[72]Dodge, supra note 8, at 1302..

program, for example, American "may, in its discretion change the AAdvantage program rules, regulations, travel awards and special offers at any time with or without notice. This means that the accumulation of mileage credit does not entitle members to any vested rights with respect to such mileage credits, awards or program benefits."[73] Moreover, "American Airlines reserves the right to end the AAdvantage program with six months' notice." Other airlines' programs have similar terms.

These provisions are so disadvantageous to program participants as to suggest the possibility that there is only an illusory contract between an airline and one of its frequent flyers. If a frequent flyer actually has no legal rights because the airline has the power at any moment to strip accrued points of all value, under either the right-to-change clause or the right-to-terminate clause, then the points themselves are legal nullities that cannot serve as the trigger for a gross income inclusion. In that case, the redemption of points for an award would be the only possible taxable event, despite the considerable practical advantages (discussed below) of taxing points rather than awards.

But *are* particpants rights' under frequent flyer programs merely illusory? Two decisions of the United States Supreme Court–one of them very recent–are relevant here. In the 1995 case of American Airlines v. Wolens,[74] a program participant sued American Airlines for having reduced the value of his accrued points by imposing "blackout dates" and by reducing the number of seats per flight made available as frequent flyer awards. The Court ruled that the

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[73]Terms and Conditions, http://www.aa.com/i18n/AAdvantage/programInformation/termsConditions.jsp, last visited April 28, 2014.

[74]513 U.S. 219 (1995).

plaintiff's claim under the Illinois Consumer Fraud Act was preempted by the Airline Deregulation Act o 1978 (ADA),[75] but also noted in dictum that the plaintiff still had the possibility of prevailing on a claim based solely on the interpretation of the contract terms (which claim was not preempted by the ADA). Recently, in the 2014 case of Northwest, Inc. v. Ginsberg,[76] the Court considered the claims of a participant in Northwest's frequent flyer program arising out of Northwest's decision to cancel his membership pursuant to a contract provision stating that Northwest could terminate an account based on a member's "improper conduct as determined by [Northwest] in its sole judgment." The Court held that the plaintiff's claim based on the Minnesota common law duty of good faith and fair dealing was preempted by the ADA–but only because Minnesota law did not allow contracting parties to opt out of the common law duty. The Court indicated that the result would have been different in a state which implied the duty when a contract was silent on the point, but which permitted the parties to specify that the duty did not apply.

How all this affects the tax analysis is far from clear. A right-to-change clause *may* render frequent flyer rights illusory, but only if a court interprets the clause to permit program-gutting changes, and even then only if the contract is governed by the law of a state either lacking an implied duty of good faith and fair dealing or imposing a duty of the sort preempted by the ADA under the *Ginsberg* analysis. A right-to-terminate clause clearly does not make a program participant's rights wholly illusory, but the possibility of having to redeem all one's points in just six months (if at all) undeniably depresses their value.

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[75]Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705.

[76]No. 12-462, April 2, 2014.

In short, there is some risk (based primarily on right-to-change clauses) that a court could determine that apparent rights associated with frequent flyer points were wholly illusory, and thus not within the statutory definition of gross income. Just how much risk depends on the precise wording of a particular program's terms and conditions, and on the governing state contract laws. On balance, however, the risk seems small enough, and the advantages of taxing points rather than rewards seems great enough, to justify the pursuit of points-based taxation–assuming, of course, that frequent flyer benefit are to be taxed at all.

B. In Practice: Valuation

If employee-retained frequent flyer points are to be taxed effectively, there must be an information reporting obligation imposed on either airlines or employers. And for an information reporting regime to be workable, there must be easy-to-apply valuation rules for the reporting party (arline or employer, as the case may be) to follow. It would be much easier to develop appropriate valuation guidelines for points than for rewards. The problem with valuing rewards has been discribed above, in connection with the discussion of *Giffen.* The identically-restricted revenue ticket required for proper valuation will almost never exist. More workable formula-based valuations are possible, and might be politically acceptable if they consistently produced valuations on the low side of actual fair market value. There is a model of sorts in the current fringe benefit regulations, which state that a taxable standby flight, provided by an airline to a relative of an employee, is to be valued (and taxed to the employee) at "25 percent of the actual carrier's highest unrestricted coach fare in effect for the particular flight taken."[77] But even this approach puts heavy information demands on airlines; if applied to frequent flier

[77]Treas. Reg. sec. 1.61-21(h)(1).

awards it would require referencing the highest unrestricted coach fares for thousands upon thousands of flights. The 25 percent rule in the current regulations, by contrast, applies to a minuscule number of flights. Moreover, other mechanical valuation rules would be needed for the wide variety of frequent flyer rewards other than air travel.

There is also the problem of developing workable allocation rules to deal with the situation of the taxpayer who redeems points for a reward when he has in his account both points generated by business travel (the redemption of which would be taxable) and points generated by personal travel (the redemption of which would be tax-free). This allocation problem disappears if the accrual of points, rather than their redemption, is the taxable event; in that case the points awarded for any given trip would be either fully taxable or fully tax-free.

But the bigger practical advantage of taxing points rather than rewards is with respect to valuation. Compared to the morass of reward valuation, point valuation could be a model of simplicity–as long as the government is content with a tax valuation clearly lower than actual fair market value. According to media reports, when Citibank issued Forms 1099-MISC to its depositors, it used a valuation of "about 2.5 cents" per point.[78] In addition to being upset that Citibank had reported the points to the IRS at all, many depositors thought that the reported value was far too high.[79] Given the inevitable room for argument about valuation of points, the goal for information reporting purposes should be to set the value low enough that the reported value is at or modestly below the lowest plausible value. The value should be high enough to make the exercise worthwhile in terms of revenue (and in terms of restoring respect for the rule

[78]Lazarus, supra note 22.

[79]Wollack, supra note 29.

of law in this context), but low enough that no one would have a valid complaint of being overtaxed.[80] This approach is similar to the approach Congress has taken with respect to information reporting by restaurants of the tip income of their employees. Restaurants are generally required to allocate among employees, and to report to the IRS, tip income equal to 8 percent of gross receipts.[81] The 8 percent figure is high enough to raise significant revenue, but low enough that very few tipped employees can credibly complain that the allocation is higher than their actual tips. However, the

proposal here differs from the tip allocation rules in one important respect. Whereas a restaurant employee is supposed to report all his tips as gross income, whether or not reflected on the information return filed by the employer, the IRS would accept the information reporting value of frequent flyer points as the taxable value.

So what is an appropriate per-point value, for purposes of both information reporting and employees' tax returns? There is no reason to suppose that the per-point value is the same for all frequent flyer programs. Informed observers believe values differ significantly across programs. In 2013 blogger "Lucky" of boardingarea.com offered his "subjective valuations based on what I typically redeem my miles for," for the frequent flyer points of fourteen programs.[82] Lucky's estimates ranged from a low of 0.8 cents per mile for Virgin Atlantic Flying Club to 1.8 cents per

[80]Anyone with a remarkably low subjective valuation of frequent flyer points, or with an obsessive concern about being taxed on points he may never get around to redeeming, could avoid taxation simply by not signing up for any frequent flyer programs. See Rev. Rul. 57-374, 1957-2 C.B. 69 (holding that a winner of an in-kind prize on a game show may avoid being taxed on the value of the prize by refusing to accept it).

[81]IRC sec. 6053.

[82]What Miles & Points are Worth: Airline Miles, www.boardingarea.com, posted March 14, 2013 (last visited May 14, 2014).

mile for American's AAdvantage and United's Mileage Plus. Obviously, Lucky's subjective valuations cannot serve as the foundation for the tax valuation of frequent flyer points, but Lucky's analysis does make the make the point that frequent flyer points from different programs may have very different values.

In a 2012 article (inspired by the episode of the Citibank Forms 1099-MISC), Sheldon Banoff and Richard Lipton described four different approaches that might be used to value frequent flyer points.[83] Under one approach, which they call the "highest and best use" method, the value of any given number of points "might be the cost savings one could obtain by using miles instead of cash to purchase the most expensive flight to the most expensive location one could think of."[84] As the authors note, this approach is patently unworkable as a standard for information reporting. It is also, of course, designed to produce high-end estimates of value rather than low-end estimates, and so would surely encounter fierce resistance from affected taxpayers.

Another method, which Banoff and Lipton call the "in the ballpark" approach, is broadly consistent with Lucky's analysis. The idea is to estimate the average per-point value based on the value of the rewards for which points are typically redeemed. The authors offer a back-of-the-envelope estimate for the typical program of 1.4 cents per point using this method.[85]

Airlines frequently make time-limited offers to sell frequent flyer points to program participants. A third method, the "cash-sales" price approach, would value the points at the price

[83] Sheldon I. Banoff & Richard M. Lipton, Taxing Your Miles Won't Bring Smiles: What Value is Reportable?, 116 Journal of Taxation 173 (March 2012).

[84] Id. at 174.

[85] Id. at 176.

at which an airline offers to sell points to participants.[86] In April 2014, for example, American Airlines offered to sell as few as 1000 points (for $29.50, or 2.95 cents per point) or as many as 106,000 points (for $2,200, or 2.08 cents per point).[87] At the same time, Delta was also selling points at the fixed price (no volume discounts) of 3.5 cents per point.[88] The price differences among airlines, the volume discounts (in some cases), and price differences over time all create major problems for this approach if the goal is a close approximation of actual value.

The fourth method considered by Banoff and Lipton looks to the per-point price an airline charges other businesses (for example, banks, car rental companies, and hotels) that want to offer points as loyalty rewards to their customers.[89] *Tax Notes* reported in 2012 that the price in this context is "generally no more than $0.01 per mile, depending on how many miles a bank buys."[90] As *Tax Notes* pointed out, IRS Publication 550, "Investment Income and Expenses (Including Capital Gains and Losses)," states that non-cash "gifts" for opening a bank account or making a deposit are taxable as interest, and that cost to the bank is the taxable value to the bank's customer.[91] As a technical matter, this valuation method is flatly wrong. The amount of a gross income inclusion is determined by the fair market value of what the taxpayer receives,

[86]Id. at 174.

[87]www.aa.com/purchasemiles (last visited April 28, 2014).

[88]https://www.delta.com/buygftxfer/displayBuyMiles.action (last visited April 28, 2014).

[89]Banoff & Lipton, supra note 83, at 176.

[90]Marie Sapirie, What Is a Frequent Flyer Mile Worth?, 134 Tax Notes 619 (2012).

[91]IRS Publication 550, supra note 27, at 6.

not by the cost to the transferor.[92] On the other hand, the lowest volume-discount price at which airlines sell points to other businesses does furnish a lower bound on valuation. If that lower bound happens to be, say 0.8 cents per point, no taxpayer would have a valid complaint if an information return reported his points at that value. An information reporting value of one cent per point would also be defensible, on the grounds that (1) volume discounts provided to extremely high-volume commercial purchasers are irrelevant at the point volumes of individual taxpayers, and (2) as long as one cent per mile is close to the correct low-end value, the tidiness and memorability of that figure is simply too attractive to pass up.

C, In Practice: Information Reporting and (Maybe) Withholding

If one is persuaded that points (rather than rewards) should be taxed, that the tax value of the points should be fixed (by regulation or other administrative notice) at some value in the range of 0.8 cents to one cent per point, and that points should be subject to information reporting, the final question is whether the information reporting obligation should be placed on employers or on airlines. This discussion will focus on the options that appear to be open to the IRS under current United States federal tax legislation, but the discussion of policy considerations in choosing between the options should be relevant in other countries as well.

There is authority under current law for the Treasury to promulgate regulations requiring employers to withhold tax on the value of employees' frequent flyer miles and to include that value on their employees' Forms W-2 (information reporting for wages). Sec. 3501(b) of the Internal Revenue Code authorizes regulations imposing employer withholding obligations with

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[92]See, e.g., Treas. Reg. sec. 1.61-21(b)(2) (specifically stating, in the case of taxable fringe benefits of employment, that the cost incurred by an employer to provide a fringe benefit is not determinative of its fair market value).

respect to taxable "non-cash fringe benefits," and sec. 6501(a) requires employers subject to wage withholding obligations also to file information returns reporting wages paid, "including the cash value of such remuneration paid in any medium other than cash." It might be objected that employees do not receive frequent flyer points from their employers–as would be necessary for the withholding and information reporting obligations to apply–given that the terms of frequent flyer programs stipulate that points are credited only to the account of the person who takes the trip (and not to the account of the payer, if the payer is not also the traveler).[93] Thus, the argument would go, if the employer never possessed either the points or the right to the points, it could not have transferred the points to the employee.

The argument would be, however, clearly wrong. The employer pays for the ticket the purchase of which gives rise to the employee's frequent flyer points. And although the employer does not have the power to have the points credited to its own account, it does have the power either to require employees to use their points only on business travel or to prohibit employees from seeking to receive points for employer- paid travel.[94] The employer pays for the points, and the employer chooses to allow the employees to receive personal consumption benefits from the points. That is all that is needed to establish that employees have received the points as fringe

[93]See, .e.g., AAdvantage terms and conditions, supra note 73 ("Mileage will be credited only to the account of the AAdvantage member who flies, rents a care, stays at a hotel or earns mileage utilizing other participating companies").

[94]Selecting the latter option–under which nobody gets the benefit of the frequent flyer points the airline would have been willing to credit–would not necessarily be dog-in-the-manger behavior on the part of an employer. The practice of allowing employees to retain frequent flyer points for personal use encourages employees to seek to maximize the points generated by their business travel, even at the cost to the employer of more expensive tickets or less time-efficient travel arrangements. See Gene Steuerle, Frequent Flier Miles: Cheating Employers is the Issue, 69 Tax Notes 1539 (1995).

benefits from their employers.

The real problem with putting withholding and reporting obligations on employers is that employers will not know how many frequent flyer points employees have accrued on business travel, unless the employees tell them.[95] The obvious solution is to require employers to ask their employees for the necessary information. There is precedent for a duty of inquiry in the current regulations concerning withholding on taxable fringe benefits provided to an employee of one employer by another business, pursuant to a reciprocal arrangement between the employer and the other business. According to the regulations, "The employer must take the steps necessary to obtain the relevant information from the provider of the benefits in order to enable the employer to satisfy" its withholding obligations.[96] In the existing regulations the employer's duty is to inquire of another business. In the frequent flyer situation, by contrast, it would be much more workable to impose on employers a duty to inquire of their employees, rather than of the airlines issuing the points.[97] The existing regulations are sufficient, however, to establish the principle that withholding and information reporting obligations may be imposed even when an employer can satisfy those obligations only by seeking out information not initially in its possession.

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[95]If the employer knows the number of points, under the approach proposed here there would *not* be a further problem with the valuation of those points. The points would simply be valued at the amount set by regulation as the taxable per-point valuation–probably something in the range of 0.8 cents to one.cent per mile.

[96]Treas. Reg. sec. 31.3501(a)-1T, Q&A-6.

[97]If an employee initially pays for travel with his personal credit card and seeks reimbursement, the employer will not know from which airline to seek points information until it is informed by the employee. Given the necessary involvement of the employee even if the employer eventually inquires of the airline, it would be more practical simply to require the employer to seek the points information (as well as the identity of the airline) from the employee.

There are two major advantages to imposing withholding and reporting obligations on employers, rather than opting for the alternative (discussed below) of imposing information reporting obligations on airlines (and other issuers of points). First, it would mean that the only points subject to information reporting would be points which are, in fact, taxable. Employees would not be required to inform their employers of points earned on personal travel, and the value of such points would not be reflected on Forms W-2. Second, collection of the tax due on the value of the points would be facilitated by withholding. On the other hand, this approach would impose a rather burdensome duty of inquiry on employers, and–probably worse–the system would be at the mercy employees' decisions whether or not to furnish accurate information to their employers. If sizeable numbers of employees falsely told their employers that they earned no points (for example, because they decided not to sign up for frequent flyer programs rather than to pay tax on points), the employer-based reporting system would fail. Ordinarily the point of third-party information reporting is to avoid having tax compliance depend solely on the honesty of taxpayers themselves; but employer-based information reporting of frequent flyer points would ultimately rest on the honesty of the taxpayer-employees. Although this is a serious objection, it may not be quite as conclusive here as it would be in most other contexts. Perhaps a substantial majority of employees would not risk telling lies–and rather implausible lies at that--to their employers in order trim (typically) a few hundred dollars off their income tax bills.

The policy alternative would be to put the information reporting burden (to file Forms 1099-MISC) on airlines and other issuers of points. Section 6041(a) requires businesses making various sorts of payments to file Forms 1099 reporting those payments to the IRS, whenever the payments made to a person during a year total $600 or more. If this were applied to airlines issuing frequent flyer points, if a traveler earned 100,000 points in a particular airline's program during the year, and if the tax value of points were set at one cent per point, then the airline would be required to issue a Form 1099-MISC reporting a $1,000 payment to that traveler.

It is not clear whether current law authorizes the imposition of this obligation on the airline. In a 1993 private letter ruling, the IRS Chief Counsel's Office opined that an airline could not be required file information returns on frequent flyer rewards (cash rebates and free flights) under the authority of section 6041(a).[98] The statutory language imposes reporting obligations in the case of "fixed or determinable gains, profits, and income." The ruling noted that an airline would not know whether a particular reward would or would not be taxable. If an employee earned a reward on an employer-paid business trip and retained the reward for personal use it would be taxable, but a reward earned by personal travel would not be taxable. The ruling concluded that the uncertain taxability (from the airline's perspective) of the reward meant that the reward did not constitute "fixed or determinable . . . income," with the result that section 6041(a) did not apply. The ruling's conclusion is highly questionable. According to the relevant regulation, "Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained."[99] Under the regulation, frequent flyer points would seem to be determinable. The regulation refers only to the determinability of the "amount to be paid"; it says nothing about the determinability of the tax status of that amount.

Moreover, one of the most widespread payment types subject to Form 1099 reporting has

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[98]PLR 9340007 (June 29, 1993).

[99]Treas. Reg. sec. 1.6041-1(c).

a similarly ambiguous tax status (from the payer's perspective). Under the authority of section 6050E(a), the IRS requires state and local governments to report state and local tax refunds on Forms 1099-G.[100] Oversimplifying slightly, such refunds are taxable if the taxpayer itemized his federal income tax deductions in the tax year to which the refund relates, and are not taxable if the taxpayer claimed the standard deduction on his federal income tax return for that year.[101] Rather than sorting out taxability at the information reporting stage, state and local governments report all refunds (of $10 or more), and taxpayers sort out the taxability when they prepare their Forms 1040. It is true that information reporting for tax refunds is pursuant to section 6050E(a) rather than section 6041(a), but the tax refund reporting rules nevertheless establish a precedent for information reporting of amounts of uncertain taxability, and the language of section 6041(a) and the regulations thereunder does not foreclose the same approach in the case of frequent flyer points.

On the assumption that section 6041(a) would authorize the imposition of an information-reporting requirement on airlines, would that be preferable to imposing the reporting requirement on employers? On the plus side, the reporting burden would be much lighter for airlines than for employers, because airlines would possess all the information needed to comply. On the minus side, there will be no withholding if the burden is placed on airlines rather than on employers. The lack of withholding should not be a major issue, however, as long as the frequent-flyer income not subject to withholding is only a small percentage of the wage income

[100]See Form 1099-G, Box 2, "State or local income tax refunds, credits, or offsets."

[101]Richard Schmalbeck & Lawrence Zelenak, Federal Income Taxation 79-81 (3d. ed. 2011).

subject to withholding–as would almost always be the case.

The more serious problem is the mismatch, in both directions, between the value of points reported by airlines on Forms 1099 and taxable amounts. Given the statutory reporting threshold of $600, and assuming a tax valuation of one cent per point, a taxpayer could earn up to 59,999 points in any one program in a single year without triggering the information reporting requirement. A taxpayer participating in four programs and carefully spreading her point among programs could earn almost 240,000 points without information reporting. The obvious response to this concern would be to lower the reporting threshold to some amount substantially lower than $600, but this would require legislation.

The mismatch in the other direction is that some points subject to information reporting would have been earned on personal travel, and thus not includible in gross income. This is troubling for two reasons. First, some taxpayers who receive Forms 1099-MISC for taxable points may feel they can with impunity omit the reported amounts from their tax returns, because the IRS will have no way of knowing–short of a full-scale audit–that the points were, in fact, earned on employer-paid travel. Second, other taxpayers who receive Forms 1099-MISC for wholly or partly non-taxable points may overreport their income, either because they do not realize that not all points are taxable or because their recordkeeping is inadequate to determine the amount of their non-taxable points.

Of course, information reporting for state and local tax refunds raises the same sorts of concerns about information reporting of non-taxable amounts. Despite those theoretical concerns, information reporting for tax refunds is longstanding, noncontroversial, and apparently satisfactory in its operation. True, the situations are not perfectly parallel. Perhaps taxpayers are afraid to disregard taxable state and local tax refunds reported on Forms 1099-G because they realize that the IRS possesses the information needed to determine whether a particular refund is taxable (that is, the taxpayer's prior-year federal income tax return), but they would be willing to disregard taxable frequent flyer points reported on Forms 1099-MISC because they realize the IRS does *not* possess the information needed to make the taxability determination (that is., whether points were generated by business or personal travel). But this may be overthinking what taxpayers are thinking. Compliance may be quite high when points are subject to information reporting, even though the information returns explain that the points may or may not be taxable depending on how they were earned, and even though the information needed to determine the taxability of particular points is not readily available to the IRS. It may at least be worth the experiment.

All in all, it is a close call whether it would be better to put the reporting burden on employers or on airlines and other issuers of points. Perhaps the better approach would be to start by imposing the burden on airlines and other issuers, both to minimize the number of businesses required to report and to avoid requiring employers to solicit point information from their employees. If experience with that system proved unsatisfactory, it would always be possible to shift to employer-based reporting.

Conclusion

One is tempted to say, with respect to the tax treatment of frequent flyer benefits in all three countries, that the status quo is intolerable. Given how long the current situations have persisted, however, that must not be right. But if the situations are not quite intolerable, they are borderline scandalous. The current approaches of the three agencies make scofflaws of the agencies themselves, of taxpayers, or of both. The approaches also forego the collection of a significant amount of tax, most of which would be paid by at least moderately affluent taxpayers.

The first-best solution would be for a government to get serious about taxing frequent flyer benefits, by designing and implementing effective compliance and enforcement mechanisms. As this article has attempted to show, in the United States the IRS could probably do this at any time under existing statutory authority–although new legislation, covering issues such as timing, valuation, and information reporting would eliminate any doubts about authority and would shelter the IRS from the political fallout that would surely result if it acted in the absence of additional legislation.[102] If, in a particular country, neither the tax agency nor the legislature is willing to get serious about the taxation of frequent flyer benefits, the second-best approach would be for the legislature to solve the scofflaw problem by turning the *de facto* administrative exclusion into an explicit legislative exclusion.

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[102]In Australia, legislation might be needed to reverse the result in *Payne.*