I.R.C. SECTION 274(b) AND DUBERSTEIN RESURFACE: THE EMPEROR STILL HAS NO CLOTHES*

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Scenario: Employer "gives" to employee, at year end, a $400 television set because of the employee's "years of service." Or, in a more egregious case, employer annually "gives" $400 in merchandise to all employees because of their "productivity." Employer then deducts his costs per Internal Revenue Code section 162, without limit by section 274(b), and under the auspices of his "Qualified Award Plan" approved by his attorney and accountant. Of course, employer reports nothing to the Internal Revenue Service (except the deduction), withholds nothing from employees' salaries, and, most importantly, the employees do not include any amount in their gross income as a result of the "gifts."

Shocking? Not permissible under Revenue Ruling 59-58?[1] Not possible in the system that enacted Internal Revenue Code section 83(a)[2] and

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* As in the fabled children's story in which no one dared be so irreverent as to notice the emperor's nakedness, today too many jurists assume not only that Congress and the Court make sense but also that they have a duty to discover that sense and to proclaim it. As an innocent young boy in a mythical place once announced, we hereby let it be known: the emperor had no clothes in 1962 and still has none.

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1. In a famous ruling, Rev. Rul. 59-58, 1959-1 C.B. 17, the Internal Revenue Service counseled that the value of a Christmas "turkey, ham, or other item of merchandise of a similar nominal value," while deductible by the employer, was subject neither to withholding nor to taxation in the hands of the recipient. 1959-1 C.B. at 18. The Service restricted its advice to nominal distributions "at Christmas, or a comparable holiday, as part of a general distribution to employees engaged in the business of the employer as a means of promoting their good will . . . ." *Id.* The ruling excluded "distributions of cash, gift certificates, and similar items of readily convertible cash value, regardless of the amount involved." *Id.*

2. Section 83(a) essentially provides that the fair market value of property transferred in connection with the performance of services shall be included in the gross income of the recipient. I.R.C. § 83 (1983).

fathered the *Duberstein*[3] "detached and disinterested generosity" definition for gifts? Surely no reasonable practitioner could approve such an exclusion with a straight face? Surprisingly, the suggested scenario can be effected under the present tax laws.

While no person—other than one who is perhaps congenitally gullible[4]—could ever be surprised at the illogic[5] of the United States tax system, could anyone reasonably believe that Congress contemplated such large productivity awards[6] escaping taxation? Whether it did (and whether anyone believes it) is explored below. To start, the history and mechanics of section 274(b)[7]—the strange statute which serves as the basis

3. Commissioner v. Duberstein, 363 U.S. 278 (1960).

4. Whether such a person actually exists is unclear; reference to him, however, has been made at least twice before. 1 STANSBURY'S NORTH CAROLINA EVIDENCE, 222 (Brandis Rev. 1973) (terming a strange rule "a monumental legal asininity, impossible to explain to any layman not congenitally gullible"); Robertson, *Reason Versus Rule in Louisiana Tort Law: Dialogues on Hill v. Lundin & Associates, Inc.*, 34 LA. L. REV. 1, 4 (basing an entire article on a hypothetical legal explanation made to an intelligent layman "not congenitally gullible").

5. In United States v. Henderson Clay Prods., 324 F.2d 7 (5th Cir. 1963), *cert. denied*, 377 U.S. 917 (1964), the court maintained that "there is an area of permissible illogic in tax law." 324 F.2d at 12. Despite the court's position, the permissibility of this pervasive illogic is questionable. *Cf.*, Willis OF [IM]PERMISSIBLE ILLOGIC AND SECTION 1031, 34 U. FLA. L. REV. 72 (1981).

6. The Code restricts the deductibility of employer to employee awards in section 274(b), but excludes from the restriction "an item of tangible personal property which is awarded to an employee by reason of *length of service*, *productivity*, or safety achievement . . ." I.R.C. § 274(b)(1)(C) (1983) (emphasis added). The significance of this exclusion is explored *infra* in the text accompanying notes 97 through 98.

7. I.R.C. § 274(b) (1983) provides:

(b) GIFTS.—

(1) LIMITATION.—No deduction shall be allowed under section 162 or section 212 for any expense for gifts made directly or indirectly to any individual to the extent that such expense, when added to prior expenses of the taxpayer for gifts made to such individual during the same taxable year, exceeds $25. For purposes of this section, the term "gift" means any item excludable from gross income of the recipient under section 102 which is not excludable from his gross income under any other provision of this chapter, but such term does not include—

(A) an item having a cost to the taxpayer not in excess of $4.00 on which the name of the taxpayer is clearly and permanently imprinted and which is one of a number of identical items distributed generally by the taxpayer,

(B) a sign, display rack, or other promotional material to be used on the business premises of the recipient, or

(C) an item of tangible personal property which is awarded to an employee by reason of length of service, productivity, or safety achievement, but only to the extent that—

(i) the cost of such item to the taxpayer does not exceed $400, or

(ii) such item is a qualified plan award.

(2) SPECIAL RULES.—

(A) In the case of a gift by a partnership, the limitation contained in paragraph (1) shall apply to the partnership as well as to each member thereof.

(B) For purposes of paragraph (1), a husband and wife shall be treated as one taxpayer.

(3) QUALIFIED PLAN AWARD.—For purposes of this subsection—

(A) In General.—The term "qualified plan award" means an item which is awarded as part of a permanent, written plan or program of the taxpayer which does not discriminate in favor of officers, shareholders, or highly compensated employees as to eligibility or benefits.

(B) Average amount of awards. — An item shall not be treated as a qualified plan award for any taxable year if the average cost of all items awarded under all plans described in subparagraph (A) of the taxpayer during the taxable year exceeds $400.

(C) Maximum amount per item. — An item shall not be treated as a qualified plan award under this paragraph to the extent that the cost of such item exceeds $1,600.

for the above scenario—will be covered, with a concentration on changes made by the Economic Recovery Tax Act of 1981,[8] which created Qualified Award Plans.[9] The scant judicial,[10] executive,[11] and scholarly[12] opinion in the area will then be reviewed, along with the definitions of gift and compensation. This review leads to the conclusion that the famed *Duberstein* test is an inappropriate standard for distinguishing gifts from compensation. In light of this conclusion, the following central questions will be considered:

1. Can a transfer from employer to employee for productivity or service be a *gift* rather than *compensation*, under traditional tax theories?
2. Did Congress intend, with the enactment or expansion of section 274(b), a fundamental theoretical shift in the definitions of gift and compensation?

The answer to both of these questions is no. As a result, this Article will contemplate the consequences to counsel and taxpayers who engage in schemes such as the one posited above. Finally, a new method to handle the problems which prompted the subsection will be suggested.

I. AN EXAMINATION OF SECTION 274(b)

A. *History and Purpose of Section 274(b)*

Alarmed by billions of dollars in business gifts, travel, entertainment, and kickbacks, Congress enacted section 274 in 1962.[13] This legislation

8. Pub. L. No. 97-34, § 265, 95 Stat. 172, 265 (1981).

9. I.R.C. § 274(b)(3) (1983).

10. Few cases involve the operation of § 274(b) as it relates to employer-employee giving; those that do typically involve the narrow area of widows' payments. Bank of Palm Beach & Trust Company v. United States, 476 F.2d 1343 (Ct. Cl. 1973). No reported cases contribute practically or pedagogically to an understanding of the subsection.

11. In 1963, the Treasury issued regulations which essentially paraphrase the subsection except for the significant comment that § 274 does not affect the inclusion of awards in the gross income of the recipient. Treas. Reg. § 1.274-3(b)(2) (1963). On December 16, 1982, the Treasury issued additional proposed regulations in response to the 1981 amendments to § 274(b). Again, the proposals do little more than paraphrase the statute. Treas. Reg. § 1.274-3 (Prop.), 47-242 Fed. Reg. 56, 367-69 (1982). In addition, the Service has issued a news release, Internal Revenue News Release IR-81-138, STAND. FED. TAX REP. (CCH) ¶ 6258 (Dec. 21, 1981), an announcement, Announcement 82-7, 1982-3 I.R.B. 48 (Jan. 1982), and several private letter rulings concerning the subsection. *Cf.*, Let. Rul. 8228112 I.R.S. LETTER RULINGS (CCH) (April 19, 1982) (dealing with a recipient's inclusion under § 61 of an award arguably transferred under § 274(b)).

12. *See* Reid, *Effects of Business Gifts on Payor and Payee*, 12 TUL. TAX. INST. 624 (1963). For the most part, Reid analyzes business "gifts" outside the employment context.

13. Revenue Act of 1962, Pub. L. No. 87-834, § 4, *reprinted in* 1962-3 C.B. 111, 123. Congress responded to reports detailing abuses of the tax system described as "widespread," 108 CONG. REC. 14,116 (1962) (remarks of Senator Gore, citing President Kennedy's Tax Message of April 20, 1961), and "orgiastic," U.S. TREAS. DEPT., STUDY ON ENTERTAINMENT EXPENSES, PART FOUR, *Compilation of Current Comments in Newspapers and Periodicals Relating to Expense Accounts and Business Gifts* (1962) (citing an article in DUN'S REVIEW Aug. 1960 at 39-41), *reprinted in Hearings on H.R. 10650 Before the Senate Comm. on Finance*, 87th Cong., 2d Sess. 327, 329 (April 2, 1962) (testimony of Secretary Dillon, Exhibit V). *Accord*, H.R. REP. NO. 1447, 87th Cong., 2d Sess. 19 (1962), *reprinted in* 1962-3 C.B. 405, 423; S. REP. NO. 1881, 87th Cong., 2d Sess. 24-25 (1962), *reprinted in* 1962-3 C.B. 707, 730. In addition to considering the reports from the President and the Secretary of the Treasury, Congress also considered and listed dozens of magazine and newspaper articles discussing the problem. 108 CONG. REC. at 17,795, citing THE REPORTER, December 25, 1958, at 20-21.

was prompted by two motivations: outrage over flagrant deductions with no matching inclusions[14] and the fear of a business climate fraught with blackmail.[15] Realizing that forcing recipients to include gifts and entertainment in gross income would create administrative difficulties,[16] Congress chose instead to restrict the deductions allowed to the "donors."[17] Section 274(a) therefore limits deductions allowed for entertainment, amusement, and recreation expenses. With extensive exceptions, section 274(b)—the subject of this Article—limits deductible donative business transfers to any individual to $25.

Significantly, the section 274(b) limitation does not apply merely to gifts given to customers and clients, the subjects of alarming stories told by the Secretary of the Treasury,[18] but to all individuals,[19] including employees. Also significantly, the Senate amended the House version of section 274(b)[20] by excluding employee safety and service awards under $100.[21] A

14. *See* 108 CONG. REC. 17,786, 17793-94, (1962) (remarks of Senator Douglas, Exhibit V, quoting an article in CHALLENGE, Nov. 1960 at 10-12); U.S. TREAS. DEPT. STUDY ON ENTERTAINMENT EXPENSES, PART TWO, *Report by the Commissioner of Internal Revenue on Administrative Problems Under Present Law Relating to Deduction of Travel and Entertainment Expenses reprinted in Hearings on H.R. 10650 supra* note 13 at 279, 284, stating:

> The Service also has difficulties with respect to so-called business gifts. Frequently, taxpayers cannot prove that they made the expenditure at all. Furthermore, many taxpayers who can prove that they purchased gift items cannot or [sic] refuse to give examining officers the names of the donees. In some cases this is done to protect the donee from possible imposition of an income tax on the value of the gift.

(comment of Commissioner Mortimer Caplin).

15. *See* 108 CONG. REC. 17,786, 17,795 (remarks of Senator Douglas, Exhibit V, quoting several articles using such terms as "bribe" and "payola"); STUDY ON ENTERTAINMENT EXPENSES, *reprinted in Hearings on H.R. 10650 supra* note 13 at 346 ("a racket"), 348 ("parasitic expenses").

16. *See generally*, STUDY ON ENTERTAINMENT EXPENSES, PART TWO, *reprinted in Hearings on H.R. 10650 supra* note 13, at 284.

17. Congress rejected the President's recommendation that deductions for business entertainment and entertainment facilities be disallowed in full, but adopted his proposal to restrict deductibility of business gifts and travel expenses. H.R. REP. NO. 1447, *supra* note 13 at 19, 1962-3 C.B. at 423; S. REP. NO. 1881, *supra* note 13, at 25, 1962-3 C.B. at 731.

18. *Hearings on H.R. 10650 Before the Senate Comm. on Finance*, 87th Cong., 2d Sess. 89 (April 2, 1962) (testimony of Secretary Dillon); *see generally*, STUDY ON ENTERTAINMENT EXPENSES, PART FOUR, *reprinted in Hearings on H.R. 10650, supra* note 13. Both the House Committee on Ways and Means and the Senate Committee on Finance referred to these reports in their respective reports, H.R. REP. NO. 1447, *supra* note 13, at 19; S. REP. NO. 1881, *supra* note 13, at 24. The Senate also discussed the Secretary's remarks. *See* 108 CONG. REC. 14,116 (1962) (remarks of Sen. Gore).

19. I.R.C. § 274(b)(1) (1983).

20. Senate Amendment No. 32, adopted in full by the House, CONF. REP. NO. 2508, 87th Cong., 2d Sess., at 17 (1962), 1962-3 C.B. at 1145; S. REP. NO. 1881, *supra* note 13, at 33-34, 1962-3 C.B. at 739-40.

21. Section 274(b)(1), as originally enacted, read:

> (b) GIFTS.—
>
> (1) LIMITATIONS.—No deduction shall be allowed under section 162 or section 212 for any expense for gifts made directly or indirectly to any individual to the extent that such expense, when added to prior expenses of the taxpayer for gifts made to such individual during the same taxable year, exceeds $25. For purposes of this section, the term "gift" means any item excludable from gross income of the recipient under section 102 which is not excludable from his gross income under any other provision of this chapter, but such term does not include—
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> (A) an item having a cost to the taxpayer not in excess of $4.00 on which the name of the taxpayer is clearly and permanently imprinted and which is one of a number of identical items distributed generally by the taxpayer.

1981 amendment[22] increased the permissible awards to $400, added productivity as a motivator, and created Qualified Award Plans.[23]

Clearly, the Senate's motivations for the 1962 addendum and 1981 amendment were not the horror stories of kickbacks and lavish entertainment, for those tales revolved around *non-employees*. While Congress never adequately articulated its motives behind the *employee* gift exception,[24] an awareness of two problems must have motivated it. First, employees received and excluded items which had been fully deducted by their donors, as did non-employees.[25] Second, to the extent that these items were de minimus (valued under $100), forcing their inclusion in employees' income might be administratively burdensome and politically unwise: burdensome because of the numerous small amounts involved,[26] and unwise because Congress did not want to offend industries which manufactured items commonly given.[27] Despite Congress' attempt to alleviate abusive outside giving,[28] the problem of "inside" or employer to employee giving, which has been debated furiously under the name of "nontaxable

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(B) a sign, display rack, or other promotional material to be used on the business premises of the recipient, or

(C) an item of tangible personal property having a cost to the taxpayer not in excess of $100 which is awarded to an employee by reason of length of service or for safety achievement.

I.R.C. § 274(b) (1962).

22. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 265, 95 Stat. 172, 265 (1981).

23. An example of a Qualified Award Plan is reproduced in the Appendix immediately following this article.

24. The 1962 addendum arose at a late stage in the legislative process: it resulted from Senate Amendment number 32 and was adopted in full by the House of Representatives, without discussion, in the Conference Committee. CONF. REP. No. 2508, 87th Cong., 2d Sess., at 17 (1962), 1962-3 C.B. at 1145. The Senate Committee on Finance, which did discuss the amendment, noted:

> It is a common practice of many employers to give such items as pins or watches to employees upon their completion of a specified number of years of satisfactory employment or in recognition of some safety achievement. Your committee felt that gifts for these purposes which serve to strengthen the relationship between business and its employees should not be discouraged by the tax law.

S. REP. No. 1881, *supra* note 13, at 34, 1962-3 C.B. at 740. Of course, recognizing the value of such gifts and piously remarking that they "should not be discouraged" does not articulate a need for legislation. Disappointingly, Congress never explained how the law discouraged the transfers, nor how the new section encourages them.

25. Congress thus chose to limit a deduction rather than to enforce inclusion. As is discussed later, this was an inappropriate solution. *See infra* text accompanying notes 118-23. The limitation applied to expenditures which, in the employment context, are deductible anyway, regardless of the purported limitation or disallowance. *See infra* text accompanying notes 97-99.

26. Forcing inclusion on employees should not be an administrative burden since employers are required to report remuneration to employees by section 6051(d) and to withhold tax on "wages" by section 3402(a).

27. The Senate Committee on Finance heard testimony from several representatives of interested industries. *See Hearings on H.R. 10650 Before the Senate Committee on Finance*, 87th Cong., 2d Sess. 1098-1165 (1962). One witness, the President of Hamilton Watch Company, was particularly instructive: he claimed that sales for length-of service awards have "become a very substantial part of the total sale of watches by watch companies whose brand names are associated with quality. In the case of some companies these sales are about 25 percent of total watch sales . . . [D]iscontinuance of this custom would be . . . a very serious financial blow to many jeweled watch companies." *Id.* at 1132.

28. Whether Congress successfully solved the problem of abusive "outside" giving is beyond the scope of this Article.

fringe benefits,"[29] was only exacerbated by the revision of section 274(b).

B. *Mechanics of Section 274(b) and Its Application to Factual Situations*

Subsection (b) limits a taxpayer's section 162 and section 212 deductions for gifts to any individual to $25 per recipient per year.[30] While this paraphrase of the Code appears clear, precise, and easy to understand, it actually raises several significant questions, only some of which are answerable. Because a proper reading of the Code results in the subsection never being triggered in the employment context and thus having no effect, not all the apparent questions need be addressed; instead, some will be answered, others pondered, and many merely mentioned.

Initially, we begin with a list of four key phrases in the statute; later, we will expand upon this list. First, the purported limitation restricts the allowability of deductions only under "section 162 or section 212." Transfers deductible under other Code sections are not affected. Second, the statute applies only to transfers made to "individuals," rather than to all "persons" or corporations or to any other type of recipient. Third, the dollar limitation applies to a total of transfers made "directly or indirectly" to an individual; Congress apparently wished to restrict transfers made to related parties.[31] Last, the limitation applies only to "gifts."

The statute also defines, for purposes of subsection 274(b), the term "gift" as "any item excludable from gross income of the recipient under section 102 which is not excludable from his gross income under any otherprovision of this chapter. . . ."[32] Specifically, Congress excluded three types of expenditures from the "gift" category:

1. items which cost the taxpayer not more than $4.00 and on which the taxpayer's name is imprinted,[33]
2. advertising or promotional material to be used on the recipient's

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29. *See infra* note 143.

30. I.R.C. 274(b)(1) (1983). A proposed amendment, introduced by House Ways and Means Committee Chairman Rostenkowski, would increase the $25 limit to $100. H.R. 4271, 98th Cong., 1st Sess. (1983); [Weekly Alert] FED. TAX COORDINATOR 2D 337 (Nov. 10, 1983). The Treasury supports the proposal. Treas. News Release R-2402 (Nov. 3, 1983).

31. The House Committee on Ways and Means stated in its Technical Explanation of the Bill that, "[t]he reference to 'indirect' gifts in this subsection includes situations where the gift is intended for the eventual use or benefit of an individual but is made initially to his corporation or to some member of his family." H.R. REP. No. 1447, *supra* note 13, at A31, 1962-3 C.B. at 529. The Senate's Committee on Finance uses the same language in its technical explanation. S. REP. No. 1881, *supra* note 13, at 170, 1962-3 C.B. at 874.

32. A curious discrepancy appears between the House and Senate technical explanation of § 274(b). The House explanation states that "[t]he term 'gift', for purposes of section 274, has the *same* meaning as it does under section 102 of the Code (relating to the exclusion of gifts and inheritances from gross income)." H.R. REP. No. 1447 *supra* note 13, at A31, 1962-3 C.B. at 529 (emphasis added). The Senate explanation, which was written after the House report, states that "[t]he term 'gift' for purposes of section 274, has, *in general*, the same meaning as it does under section 102 of the Code . . ." S. REP. No. 1881 *supra* note 13, at 170, 1962-3 C.B. at 874 (emphasis added). The author of the Senate version gives no explanation for this departure. The Treasury, in background material accompanying the proposed amendments to the section 274 regulations, used the Senate phraseology as well. 47 Fed. Reg. 56,367, 56,368 (1982). The Senate's position seems either unintended or incorrect; the House interpretation, therefore, should be viewed as the appropriate expression of legislative intent.

33. I.R.C. § 274(b)(1)(A) (1983). For a brief discussion of the provision and the motives which prompted it, see S. REP. No. 1881, *supra* note 13, at 33-34, 1962-3 C.B. at 739.

business premises,[34] and

3. "an item of tangible personal property which is awarded to an employee by reason of length of service, productivity, or safety achievement, but only to the extent that—
   (i) the cost of such item to the taxpayer does not exceed $400, or
   (ii) such item is a qualified plan award."[35]

The immediate result of the exclusions is that an item falling within one of the three categories is not affected by the $25 limitation; thus, the recipients can receive the excluded items plus $25 in other "gifts" before the section is triggered.

The third exclusion, employee gifts, is a major focus of this Article. Eight restrictions or nuances appear within the exclusion. While these details are apparent on the face of the statute, they deserve specific attention:

1. The thing transferred (or, as the Code required, "awarded") must be *property*. As a result, cash will not qualify.[36]
2. The property must be "personal,' as opposed to real or immovable.
3. The property must be "tangible"; consequently, stocks, bonds, options, and similar intangibles will not qualify.
4. The recipient must be an "employee."[37]
5. The reason for the award must be "length of service, productivity, or safety achievement." In the original act, service and safety were the only qualifiers.[38] The 1981 act added "productivity" to the list. Obviously, many questions arise from the association of the two concepts of "gift" and "award for productivity."
6. The exclusion applies only to a *portion* of the item: the extent to which its cost did not exceed $400 or the extent to which it is a "qualified plan award."[39]
7. Cost, not fair market value, is the measure for the $400 limitation.[40]

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34. I.R.C. § 274(b)(1)(B) (1983). S. REP. No. 1881, *supra* note 13, at 33-34, 1962-3 C.B. at 739.

35. I.R.C. § 274(b)(1)(C) (1983).

36. In proposed regulations, the Treasury states that the term "tangible personal property" does not include cash, any gift certificate, or any award of a right to choose among five or more different items. Treas. Reg. § 1.274-3(b)(2)(iv) (Prop.), 47 Fed. Reg. 56,367-69 (1982). *Cf.* Rev. Rul. 59-58, 1959-1 C.B. 17, 18 (ruling that small holiday gifts, other than cash and gift certificates—such as hams and turkeys—are excludable from the recipient's gross income); *but cf. Hallmark Cards, Inc. v. United States* 200 F. Supp. 847, 850 (W.D. Mo. 1961) (holding that gift certificates are not the same as cash and thus do fall within the auspices of Revenue Ruling 59-58).

37. Section 274(b) neither defines the term "employee" nor incorporates definitions of the term found in other Code sections. Presumably, those other sections are nevertheless relevant. *See* I.R.C. §§ 3121(d); 3231(b).

38. For the text of this statute, enacted in 1962, see *supra* note 21.

39. For example, if an employer transferred $1000 in merchandise to an employee, the transfer would be excluded from the definition of gift to the extent of $400 or to the extent it was "qualified." It would thus, to the applicable extent, escape the limitation on deductibility.

40. "Cost," or more accurately "tax cost," is the appropriate measure when dealing with deductibility. Surely no employer should be allowed to deduct more than cost, whatever the value transferred. Cost as a measure of includability, however, would be both inequitable and nontraditional. *See* I.R.C. §§ 83; 1001 (1983). For example, a furniture industry employee who receives $1000 of merchandise costing $250 should not be treated differently from a grocery employee who receives $1000 of food costing $950. The choice of cost as a measure in section 274(b) reinforces

8. Qualified Plan Awards (QPAs), a detailed definition of which appears in the act[41] and below, also fit the exclusion if the restrictions listed in items one through five above are met.

1. *Qualified Plan Awards*

Qualified Plan Awards (QPA's) were the children of Senator Garn, who proposed the plans as part of a floor amendment[42] to the Economic Recovery Tax Act of 1981.[43] The plans accomplish two things: 1) they formalize the process of employer to employee giving, and 2) they permit gifts larger than $400 to some employees conditioned upon broader coverage of the gift programs.

The statute defines a QPA as an item awarded under a qualified award plan. To qualify, a plan must be permanent, written, and nondiscriminatory.[44] Although the statute contemplates multiple plans,[45] the average cost of all awards under all plans of a single taxpayer must not exceed $400 during a single taxable year. The violation of this average cost restriction disqualifies *all* awards under all plans from being QPA's; of course, to the extent the cost of any single award does not exceed $400, it still could qualify under the general provision.[46] An additional restriction applies to specific items under a qualified plan and limits deductibility of such items to the extent their cost does not exceed $1600.[47] Violation of this additional restriction results in the disqualification of the excessive portion (thus subjecting it to the $25 per individual/per year limit) and does not automatically affect the eligibility of any other award or the qualification of the plan. The excessive portion, however, may[48] affect the average of all awards.

2. *The Ultimate Plan*

An initial reading of section 274(b) results in the shocking observation that employees can receive an average of $400 each, or up to $1600 individually, in exchange for productivity, without limitation of the deduction and with the widely held inference[49] that the recipients are not taxed on

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Congress' intention not to affect the *includability* of awards under section 61. *See infra* note 105. If Congress had intended to affect includability, it surely would have written a separate Code section detailing which awards are includable, using fair market value as the measure.

41. I.R.C. § 274(b)(3)(A) (1983).

42. 127 CONG. REC. S8640 (daily ed. July 28, 1981). The unprinted amendment, No. 325, was proposed by Senator Garn, and agreed to by the Senate, on July 28, 1981. In the process, Senators Hatch and Chafee were added as co-sponsers. Both Senators Garn and Dole discussed the increased cost limitation from $100 to $400 in section 274(b)(1)(C)(i), which was part of the amendment. *Id.* Curiously, no reported floor discussion addressed that portion of the amendment dealing with Qualified Award Plans.

43. Pub. L. 97-34, § 265, 95 Stat. 172, 265 (1981).

44. I.R.C. § 274(b)(3)(A) (1983).

45. I.R.C. § 274(b)(3)(B) refers to "all plans . . . of the taxpayer . . . ." I.R.C. § 274(b)(3)(B) (1983).

46. I.R.C. § 274(b)(1)(C)(i) (1983).

47. I.R.C. § 274(b)(3)(C) (1983).

48. Ambiguity exists because the Code requires an average to be taken of all "items" awarded under all plans, but never defines the term "item." *See infra* text accompanying note 55.

49. *See infra* text accompanying notes 112-13.

the "gifts." A technical reading results in an even more amazing revelation: the per individual/per year limitation found in section 274(b)(1) applies only to gifts. Because QPA's, described in section 274(b)(3), are excluded from the definition of gift, and because subsection (b)(3) contains no per individual/per year restriction, an employee could conceivably receive a $1600 QPA from each of several qualified plans of a single employer. An employee might even receive multiple $1600 QPA's from a single plan as long as each QPA was a separate item. For example, an employer could establish an "Employee-of-the-Month Qualified Award Plan" under which a particular employee could be honored twelve times in a single year![50]

C. *Examples*

The following two examples demonstrate the operation of the statute and pose some ambiguities that arise from the attempt to apply the statutory provisions.

1. *Example I*

Employer established a "Length of Service Award Plan" under which each employee annually receives $50 of tangible personal property per year of service. Employer has ten employees, who have the following service records and who receive the following awards:

Employee	Years of Service	Cost of Award	QPA Potential
A	40	$2000	$1600
B	20	1000	1000
C	5	250	250
D	5	250	250
E	3	150	150
F	3	150	150
G	3	150	150
H	1	50	50
I	1	50	50
J	1	50	50
TOTAL		$4100	$3700
	DIVIDED BY 10 EMPLOYEES		
		$ 410	$ 370

An analysis of this plan raises two serious questions: whether the plan is discriminatory and thus disqualified under section 274(b)(3)(A),[51] and

50. Because the statute requires that the average of all awards from a single taxpayer not exceed $1400, any such ultimate plan could only benefit some employees to the ultimate of multiple $1600 awards. A sufficient number of small awards would be necessary to lower the average of all awards to $400.

51. Section 274(b)(3)(A) provides: "The term 'qualified plan award' means an item which is awarded as part of a permanent, written plan or program of the taxpayer which does not discriminate in favor of officers, shareholders, or highly compensated employees as to eligibility or benefits." I.R.C. § 274(b)(3)(A) (1983).

whether the plan violates the $400 average per item maximum and thus is disqualified under section 274(b)(3)(B).[52] Neither question is easy to resolve; in fact, the only easy thing about the plan is that A's $2000 award cannot qualify in full.[53]

a. *Does the Plan Discriminate?*

Awards will not qualify as QPA's if the plan itself discriminates in favor of officers, shareholders, or highly compensated employees as to eligibility or benefits.[54] Section 274 provides no additional guidance regarding what constitutes discrimination. The language of section 274(b)(3)(A), however, is comparable to two other Code sections: section 401(a)(4),[55] which sets forth qualification requirements for pension and profit-sharing plans of employers, and section 105(h),[56] which restricts benefits under discriminatory medical expense reimbursement plans. Presumably, Congress intended that the concepts set forth in those areas should apply to QPA's. Whether Congress desired that the detailed eligibility and benefit provisions of sections 105 and 401 apply to QPA's is not known, but such an interpretation would not be unwarranted.[57]

In the example above, some employees benefit more than others. If those employees are members of the prohibitive group, the plan may discriminate in operation, in which case no awards would be QPA's.[58]

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52. Section 274(b)(3)(B) provides: "An item shall not be treated as a qualified plan award . . . if the average cost of all items awarded under all plans . . . exceeds $400." I.R.C. § 274(b)(3)(A) (1983).

53. As discussed earlier, at most $1600 will qualify. *See supra* text accompanying note 47.

54. I.R.C. § 274(b)(3)(A) (1983).

55. Section 401(a)(4) provides that pension, profit-sharing, and stock bonus plans shall be qualified if, among other restrictions, "the contributions or benefits provided under the plan do not discriminate in favor of employees who are—

(A) officers,

(B) shareholders, or

(C) highly compensated." I.R.C. § 401(a)(4) (1983).

56. Section 105(h)(2) provides that a self-insured medical reimbursement plan can qualify only if: "(A) the plan does not discriminate in favor of highly compensated individuals as to eligibility to participate; and (B) the benefits provided under the plan do not discriminate in favor of participants who are highly compensated individuals." I.R.C. § 274(b)(3)(A) (1983). Section 105(h)(5) defines "highly compensated individuals," generally, as the highest paid twenty-five percent of all employees, excluding those under age twenty-five and with fewer than three years of service, plus the top five officers and all major shareholders. I.R.C. 105(h)(5) (1983).

57. *See generally* I.R.C. § 410 (1983) (setting forth participation and eligibility restrictions); I.R.C. § 416(c) (1983) (requiring minimum benefits for certain "top heavy" plans); I.R.C. § 105(h)(3) (1983) (setting forth eligibility requirements); I.R.C. § 105(h)(7) (1983) (detailing benefit restrictions).

58. The plan will probably qualify, however, because 1) all employees of the employer are eligible and are in fact participating, and 2) the basis for the awards is "years of service," which is both easily ascertainable and lacking a facially discriminatory element. This issue is raised to point out a significant administrative problem and is not fully developed herein. A myriad of unanswered questions nevertheless exist in the area. For instance, can employees with less than one completed year of service be excluded from participation? *Cf.* I.R.C. § 410(a)(1)(A)(ii) (1983). What about employees with fewer than three years service? *Cf.* I.R.C. § 105(h)(3)(B)(i) (1983). Also, plans based on productivity will be particularly vulnerable to charges of discrimination, since productivity may depend on arbitrary judgments. *See infra* Example II at p. 917.

b. *Is the Average Too High?*

For purposes of section 274(b)(3)(B), the average cost of all awards depends upon whether the term "all items awarded" under the plan includes the excess over $1600 of a particular award. In the facts of Example I, inclusion of the excess results in an average of $410; exclusion, in an average of $370. The difference is crucial because the larger average results in a disqualified plan while the smaller does not. Disqualification in turn results in a maximum "gift" exclusion of $400 per recipient;[59] all amounts in excess of $400 would in fact be "gifts" for purposes of section 274(b) and would thus exceed the $25 per individual/per year deduction limitation. Qualification of the plan, however, results in a maximum "gift" exclusion of $1600 per recipient; again, additional amounts would be "gifts" and thus limited to a $25 per person deduction. In short, inclusion of the excess means the employer's deduction is $2950, while exclusion results in a deduction of $3725. The Treasury, in proposed regulations, chooses the inclusion method. It takes the position that the average cost of the items is computed by dividing 1) the sum of the cost for all items (including amounts in excess of the $1600 limitation) by 2) the total number of items.[60]

2. *Example II*

Employer establishes a plan based upon employees' productivity. Difficulties are immediately apparent: aside from the strangeness of associating productivity with gifts, the employer should ponder how to measure productivity, particularly when various classes of employees exist. Because the plan must not discriminate in favor of certain employees, it must be a single plan that encompasses all eligible employees. Precisely how is the plan administrator to compare productivity or productivity increases of secretaries with those of factory workers or executive vice presidents? Separate plans for separate classes of employees might be easier to administer but would be inherently suspect as discriminatory.

II. DEFINITIONS—"GIFT" AND "COMPENSATION"

As explained earlier, application of section 274(b) hinges upon a transfer first being denominated as a section 102 gift; consequently, before the ultimate validity of the statute is considered, the definition of the term "gift" must be explored. The term "compensation" must be considered concurrently because the types of transfers detailed within section 274(b)(1)(C) are necessarily based upon an employee's service, productivity, or safety achievement and therefore appear inherently compensatory. The next logical step, of course, will be to question whether gifts are ever compatible with the employment relationship as the Code apparently contemplates.

59. I.R.C. § 274(b)(1)(C)(i) (1983).
60. Treas. Reg. § 1.274-3(d)(2) (Prop.), 47-242 Fed. Reg. 56,367, 56,369 (1982).

A. *Gift vs. Compensation*

Although many income tax sections of the Code refer to the term "gift,"[61] none ever define the concept. Consequently, practitioners and jurists, faced with transfers which are arguably but not obviously gifts, have attempted, often contradictorily, to fill the void left by Congress. The United States Supreme Court, in two landmark cases—*Bogardus v. Commissioner*[62] and *Commissioner v. Duberstein*[63]—helped both to clarify and then to confuse the issue.

The *Bogardus* Court helped by distinguishing the terms "gift" and "compensation" and by explaining that "[t]he two terms are, and were meant to be, mutually exclusive [since] . . . a bestowal of money cannot, under the statute, be both a gift and a payment of compensation."[64] The Court then oddly applied an "all or nothing" (rather than apportionment) test to separate the concepts with regard to specific facts. It explained that the "sum of money" involved was either a gift or compensation, in total rather than cent by cent.[65]

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61. *See* I.R.C. §§ 41(c)(1) (1983); 162(b); 170(c); 271(b)(2); 273; 356(f); 425(c); 502(b)(3); 508(d); 509(d).

62. Bogardus v. Commissioner, 302 U.S. 34 (1937). In *Bogardus*, the Court held that transfers of money by a corporation to employees of a predecessor corporation were gifts within the meaning of section 102 (at that time section 22) and thus were excludable by the recipients. Both the government and the taxpayers stipulated that the payments were not made, or intended to be made, for any services rendered or to be rendered by the recipients, or for any consideration given or to be given. 302 U.S. at 37-38, 42. Also, the corporation claimed no deduction for the payments. *Id.* at 38. Thus, the Court concluded that "[t]here is entirely lacking the constraining force of any moral or legal duty as well as the incentive of anticipated benefit of any kind beyond the satisfaction which flows from the performance of a generous act." *Id.* at 41.

63. Commissioner v. Duberstein, 363 U.S. 278 (1960). In *Duberstein*, the Court required the recipient of a Cadillac automobile to include its value in his gross income. The transferor was a business acquaintance of the recipient and had transferred the automobile in appreciation of the recipient's providing lists of potential customers.

64. 302 U.S. at 39.

65. *Id.* at 40. The Court's error is one of mechanics rather than theory. To understand, consider the lower court's error. The circuit court concluded that an amount could be both a gift and compensation when prompted by mixed motives. 302 U.S. at 39; Bogardus v. Helvering, 88 F.2d 646, 647 (2d Cir. 1937). As explained below, *see infra* text accompanying notes 93-96, such an understanding is wrong: although gift and compensation motives can coexist, and distinct transfers prompted by separate but coexisting motives can be made to appear as a single transfer (*e.g.*, a watch or a "sum of money"), nevertheless, the motives remain distinguishable and the transfer or transfers remain serverable for tax purposes. Thus, the watch or sum *can* be both gift and compensation in a sense, *but only if* viewed as a whole, which would be the wrong perspective. Viewed correctly, the transfer is allocated between the categories and becomes part gift and part compensation.

In *Bogardus*, the Supreme Court saw part of the difficulty missed by the lower court: that gift and compensation motives are incompatible and thus a "sum" cannot be both. Unfortunately, the Court did not take the next logical step in analyzing what it means by a "sum." The Court instead made the common error of thinking in terms of transactional wholes rather than severable parts, a particularly easy pitfall when the thing transferred is both tangible and nondivisible, such as a watch. The Court should have imagined the dividing of the indivisible—mentally chopping up the retirement watch. Such an approach, which we call the apportionment test, see *infra*, text accompanying notes 87-91, would be consistent with the Court's theory that the concepts of gift and compensation are incompatible. It would also transcend the mechanical difficulty posed by multi-motivated, indivisible transfers: the objects of mixed motives would no longer need to be classified in an all-or-nothing manner as either gifts or compensation; instead, they could be properly classified with only a bit of mental slicing.

The *Bogardus* Court also confused the situation because it chose an inadequate vehicle in which to distinguish the terms: the *Bogardus* facts—a transfer prompted solely by gift motives—

The *Duberstein* Court in turn misunderstood *Bogardus*. The Court properly referred to *Bogardus* when it spoke of "moral or legal duty" and "the incentive of anticipated benefit" as indications of compensation; however, the Court incorrectly relied upon *Bogardus* as saying that payments proceeding "primarily" from those motives are not gifts.[66] *Bogardus* did not say that; neither did the case imply it. Instead, it did imply that *any* such motive, however slight, would indicate compensation—a far cry from a "primary" test. This criticism of the *Duberstein* Court, while technical, is important because the case so sternly applies a primary or dominant motive test. While the application of such a test—or any test—is helpful in the sense that it at least clarifies what the test is, it is harmful in the sense that it falsely relies upon *Bogardus* for authority instead of announcing that its test is new.

Also confusing is the *Duberstein* Court's description of the appropriate test. The theme of the opinion appears to be that dominant or primary motives control.[67] However, in the same paragraph in which it applies the primary motive test, the Court also asserts that a gift must proceed from "detached and disinterested generosity."[68] Unfortunately, the case is typically read as applying both concepts,[69] which appear inherently inconsistent: 1) that gifts must be *de*tached and *dis*interested, and 2) that a gift may involve some compensatory motives as long as those motives are less than primary. The problem arises because the phrases "primary or domi-

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were inappropriate for illustrating a test to describe multi-motivated transfers. The majority stressed three times that moral or legal duty was "*entirely* lacking," 302 U.S. at 41 (emphasis added); that the "*slightest* notion" of compensation was not present, *id.* at 42 (emphasis added); and that no moral obligation of the donor existed, "however *slight*," *id.* at 42 (emphasis added). The Court also continually stressed that these "facts" were stipulated, and, in the process, implied considerable disbelief in their veracity. *Id.* at 41, 42. Disappointingly, and despite professing to clarify lower courts' conflicting views on the issue of gift versus compensation, 302 U.S. at 35, the Court never explained how its test applied when mixed motives exist. It says what to do when compensation motives are "entirely lacking"—but who wouldn't know that—and it implies strongly that it would reach a different result if compensation motives were at least "slight"; nevertheless, it never explained how much is "slight" and what it would do differently if "slight" compensation motives existed. Would it adopt an apportionment test instead? We are never told.

Remarkably, both the minority in *Bogardus*—Brandeis, Stone, Cardozo, and Black—and the majority in *Duberstein*, twenty-three years later, were confused about the *Bogardus* majority's position; they also interpreted the opinion differently. The *Bogardus* minority accused the majority of saying that "every payment which in any aspect is a *gift* is perforce not compensation. . . ." *Id.* at 44 (emphasis added). The prevailing opinion, of course, implied quite the opposite; that is, that every payment which in any aspect is *compensation* is perforce not a gift. Whether the quoted language from the dissent is a misprint or a misreading is unclear.

66. 363 U.S. at 285.

67. *Id.* at 285-86.

68. *Id.* at 285.

69. Perhaps the Court is articulating a two-step judicial process. First, the judge must assign the various motives for a transfer to either gift or compensation categories. Then, he must determine which category is dominant or primary. In such a process, the phrase "detached and disinterested generosity" merely describes the gift category: i.e., for a motive to join the category, it must proceed from detached and disinterested generosity; otherwise, the motive indicates compensation. Critically, the transfer itself need not be "detached and disinterested" in order to be classified as a gift; instead, the dominant category of reasons for the transfer must proceed from detached and disinterested generosity. If the Court intended its opinion to reflect the above explanation, it would be helpful. Unfortunately, however, the case is not typically read as we suggest it should be.

nant" and "detached and disinterested" are inherently incompatible.[70]

Over the years, lower courts,[71] the Internal Revenue Service,[72] and academicians[73] have applied additional gloss, at times explaining the Court's positions and at times departing on their own. This tradition continues in the following analysis.

Gift classification requires both factual and legal determinations.[74] The factual determination examines, lists, and weighs the various reasons for which the transfer was made. The factual reasons[75] for a particular transfer are then grouped into two legal classifications:[76] 1) reasons which indicate gift[77] motivation, and 2) reasons which indicate compensation[78] motivation. Next, a mechanical test is applied to the two categories to determine the tax consequences of the transfer.[79] The *Duberstein* Court ex-

70. The words "detached" and "disinterested" are extremes—the "de" and "dis" imply a zero interest or business association. In contrast, the term "primary or dominant" indicates the existence of mixed motives and admits that non-gift motives behind a gift might be greater than zero so long as they are less than primary.

Because the Court leaves room for confusion, subsequent authorities have tended to blur the distinction between categorizing motives and applying a primary motive test to the categories. Stating that a transfer should be taxed as a gift because it stems from detached and disinterested generosity is to ignore the necessity of analyzing all motives behind the transfer—those which are detached and those which are not. *Compare* the Tax Court opinion in Estate of Pierpont, 35 T.C. 65 (1960) *with* the Fourth Circuit reversal, *sub nom.* Poynor v. Commissioner 301 F.2d 287 (4th Cir. 1962). *See* Jensen v. United States 511 F.2d 265, 269 (5th Cir. 1975) (citing *Duberstein* as establishing that a gift occurs if a transfer is made with detached and disinterested generosity, failing however to note the "primary" test of *Duberstein*).

71. *Compare* Estate of Carter v. Commissioner, 453 F.2d 61 (2d Cir. 1971) (holding that payments by an employer to the widow of an employee were gifts excludable by the widow and citing *Duberstein* as authority) *with* Bank of Palm Beach & Trust Co. v. United States, 476 F.2d 1343 (Ct. Cl. 1973) (holding that the payments identical to those made in *Carter* were not gifts and were deductible in full by the employer).

72. *See* Rev. Rul. 76-516, 1976-2 C.B. 24 (discussing the application of *Duberstein* to length of service payments from a municipal employer to retired firefighters and holding such payments to be gross income to the recipients); Rev. Rul. 64-40, 1964-1 C.B. 68 (applying concepts in *Bogardus* and *Duberstein* to Christmas payments to employees and holding the payments to be compensation).

73. *See* Reid, *Effects of Business Gifts on Payor and Payee*, 12 TUL. TAX. INST. 624 (1963) (discussing taxation of business gifts in light of *Duberstein* and *Bogardus*); Comment, *Voluntary Payments to Widows of Corporate Executives: Gift or Income?*, 62 MICH. L. REV. 1216 (1964) (discussing the interpretation of *Duberstein* and *Bogardus* by various courts and offering alternative methods of dealing with taxation of payments to widows).

74. *Bogardus*, 302 U.S. at 38-39; *Poyner*, 301 F.2d at 289-90.

75. Factual reasons for transfers in the employment context might include payment for past or future service, affection, emotional attachment, or reward for charitable deeds or for particular job performance.

76. Although the Court in *Duberstein* refused to group the factual reasons existing in the case into gift and compensation categories, and thus refused to clarify the specific legal definition, it did provide some guidance. Later courts have had little difficulty with the groupings. *Duberstein*, 363 U.S. at 289-90. *See* Olk v. United States, 536 F.2d 876, 878 (9th Cir. 1976) (the determination of whether tokens given to casino dealers are the result of detached and disinterested generosity on the part of the patrons is a question of law as applied to the factual determinations).

77. The *Duberstein* Court said that, generally, gifts arise from detached and disinterested generosity and proceed out of affection, respect, admiration, charity or like impulses. 363 U.S. at 285. The Court borrowed the "detached and disinterested generosity" language from Commissioner v. LoBue, 351 U.S. 243, 246 (1956), and the "out of affection, respect, admiration, charity or like impulses" language from Robertson v. United States, 343 U.S. 711, 714 (1952).

78. Compensation carries with it the anticipation of a derivative economic benefit and arises from the constraining force of some moral or legal duty. *Duberstein*, 363 U.S. at 285.

79. This procedure of making factual determinations, applying legal concepts and then using a mechanical test is the logical interpretation of the language of *Duberstein*. *See supra* note 69.

plained the test succinctly: the dominant or primary category of motives controls the characterization of the transfer.[80]

Contrary to widespread academic commentary,[81] the *Duberstein* test is very clear: the majority motives control. It is also at times harsh because it relies upon an "all-or-nothing" approach: regardless of the combination of motives and their relative weights, the test results in a transfer being labeled either all gift or all compensation. Because of such extreme results, the test is also inequitable in close cases;[82] consequently, it should be replaced.

Admittedly though, the *Duberstein* test sometimes produces a just result. For example, the process of assigning factual issues to legal groups is typically noncontroversial, since most triers can easily distinguish between gift and compensation *motives*[83] once they have established the facts. If all the reasons for a transfer fall entirely within either the gift or compensation grouping,[84] detection of the dominant category is uncomplicated. Characterization of transfers prompted by substantial mixed motives, however, continues to be difficult for lower courts which have trouble applying the *Duberstein* test consistently to similar facts.[85]

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80. *Duberstein*, 363 U.S. at 285-86.

81. *See* Klein, *An Enigma in the Federal Income Tax: The Meaning of the Word "Gift,"* 48 MINN. L. REV. 215, 216 (1963) ("[t]he precise holding of the Court was not entirely clear"); Reid, *Effects of Business Gifts on Payor and Payee*, 12 TUL. TAX INST. 624, 630 (1963) ("the Court seemed to go out of its way to avoid laying down any hard-and-fast rules of law for governing cases in this area"); Griswold, *The Supreme Court 1959 Term—Foreword*, 74 HARV. L. REV. 81, 88-89 (1960) (the author chastises the Court for not developing some guides and standards, claiming that the Court leaves "gift" determination as purely a factual inquiry, ignoring, however, that the Court did establish certain legal tenets which must be applied in the determination process). The Supreme Court admits that its conclusions "may not satisfy an academic desire for tidiness, symmetry and precision in this area, any more than a system based on the determinations of various fact-finders ordinarily does." *Duberstein*, 363 U.S. at 290.

82. For example, Judge A, faced with a transfer prompted by mixed motives, might conclude that compensation reasons dominated. Judge B, faced with identical facts, might be more concerned with the harshness of labeling a transfer as all-compensation and thus might "find" the gift motives as dominant in order to insure what he perceives as a more equitable result. Of course, such an approach is itself inequitable because it ignores the interests of litigants who desire the opposite determination, and it is inconsistent with decisions of less "concerned" judges. Admittedly, our argument assumes that some judges will claim to follow the Supreme Court's test while at the same time arranging the facts to achieve the desired answer. Evidence of this proposition is empirical: so many cases have resulted in inconsistent and result-oriented determinations that some such re-arranging of facts must be occurring. *See, e.g.*, Estate of Carter v. Commissioner, 453 F.2d 61, 68, nn.12-13 (2d Cir. 1971) (listing numerous cases with similar facts but different results); *cf.* Bank of Palm Beach & Trust Co. v. United States, 476 F.2d 1343 (Ct. Cl. 1973) (reaching an opposite result from *Carter* on the same facts, different litigants). Even if such rearranging does not occur and all judges are being forthright in their pronouncements, the *Duberstein* test remains harsh because of its "all-or-nothing" nature. It is also indefensible in its widely divergent treatment of a 51% compensation-motivated transfer as compared to one which is only 49% compensation-motivated. Because the test could so easily be replaced by an apportionment test, retention of it is ill-advised.

83. Both *Bogardus* and *Duberstein* speak of "intent" in describing the reason for a donor's conduct. The Court in *Duberstein*, though, states that the difference between the words "intent" and "motive" is of little practical consequence. 363 U.S. at 286. The terms, therefore, are used interchangeably in this Article. *But see*, Note, *Payments to Widows of Corporate Executives and Employees—Gifts or Income?* 49 VIR. L. REV. 74, 95 (1963).

84. This was the situation the *Bogardus* court faced (obviously without the benefit of *Duberstein's* analysis). In *Bogardus*, the Court stated that moral or legal duty was "entirely lacking," 302 U.S. at 41, and that the "slightest notion" of compensation was not present. *Id.* at 42.

85. *See supra* note 82.

Why does the difficulty continue? Some commentators believe the answer lies in the ambiguity of the dominant category test: they claim that it leaves too much discretion to a trial judge.[86] A contrary, but more believable explanation is that the problem arises because of too little discretion; the test allows only two choices, all gift or all compensation, and commands that characterization of a transfer follow the majority motives. This results in a failure to recognize that a substantial motive contrary to the majority deserves to determine the characterization of at least a portion of the transfer. As a result, judges faced with similar facts reach different conclusions in attempts to alleviate the arbitrary "all-or-nothing" nature of the *Duberstein* test.

B. *The Apportionment Test*

The more logical approach involves division of the value transferred between the gift and compensation categories. Thus, to the extent a transfer arose from detached generosity, its value would be a gift; to the extent it arose because of anticipated benefit, it would be compensation. This apportionment method is intuitively the most acceptable approach,[87] particularly in its pure form, which would require that each penny transferred from an employer to an employee, throughout the year, be evaluated to determine whether it is a gift or compensation. Both the *Duberstein* test and section 274(b),[88] in contrast, isolate "items" or "transfers" in the employment context and label them as wholly gift or wholly compensation.

In applying these rules, courts lose sight of the multifaceted nature of the employment relation. For example, an employer pays a salary of $48,000 to an employee worth $50,000. At year-end, the employer "gives" the employee a $5,000 gold watch to compensate him for his additional productivity and to evidence the employer's affection for the employee. Under the all-or-nothing balancing test, the giving of the watch would be a "transfer" by the employer prompted by mixed motives.[89] A court would conclude that the dominant purpose for the "transfer" was the making of a gift and thus that the entire "transfer" is a gift. The apportionment test

86. *See* Griswold, *supra* note 81, at 88-89; Klein, *supra* note 81, at 217-20.

87. This type of analysis is applied in determining the tax consequences of transfers which are part gift/part sale, wherein a portion of the transfer is denominated as a sale and the balance as a gift. *See* Treas. Reg. §§ 1.1015-4; 1.1001-1(e) (1972) (detailing treatment of these transfers outside the charitable contribution area); I.R.C. § 1011(b) (1983) and Treas. Reg. § 1.1011-2(c) (1980) (for part-gift/part-sales in the charitable context). Although valuing services in the context of employment transfers may be more difficult than valuing property in a part gift/part-sale, the task is certainly manageable. A similar valuation exercise is required to establish the reasonableness of compensation for the purpose of section 162. *See* Harolds Club v. Commissioner 340 F.2d 861 (9th Cir. 1965). Although research has revealed no reported decisions explicitly applying this apportionment standard in the context of mixed motive employment transfers, we hesitate to claim the approach as an original thought, fully realizing that "there is nothing new under the sun." *Ecclesiastes* 1:9.

88. I.R.C. § 274(b) (1983) applies to "items" which are gifts rather than items to the extent they are gifts, using the term "item" eleven times. The language suggests an all-or-nothing approach. The term "item" creates confusion in other areas, as well. *Cf.* I.R.C. § 1314(a) (discussing the meaning of "item" in relation to mitigation of the statute of limitations).

89. The employer is motivated partially by the employee's additional productivity and partially by affection.

would instead divide the watch "transfer" into $2,000 of compensation and a $3,000 gift.[90]

Such a division would be neither original in the area of gifts nor unique in the field of tax law.[91] Instead, it is consistent with normal tax procedures: although some issues, such as character, realization, and recognition depend upon events, transactions, and "transfers," the bottom line income tax is imposed upon an annual rather than transactional basis. Section 274(b), however, mistakenly contemplates the denomination of some amounts transferred for compensatory reasons as gifts merely because those amounts were transferred in conjunction with larger gifts.

Thus, in analyzing the above employee's receipts for the year, a court or practitioner should classify every penny—including the $48,000 in salary. The ease by which the salary is classified does not lessen the importance of the process. To single out a portion of the receipts, as does section 274(b), simply because that portion—the watch—is tangible and thus easily visualized as a "transfer," and to classify that lump sum as a whole, rather than penny by penny, is to misapply fundamental tax principles. Regardless of appearance and ease of classification, mixed-motive transfers have mixed motives and thus should have mixed effects—just as do part-sale/part-gift transactions. To allow an employer to deliberately lump compensation and gifts into one tangible item is to allow the tax result to be determined by visual misdirection or sleight of hand.

III. GIFTS IN THE EMPLOYMENT CONTEXT

To apply the above definitions of gift and compensation to section 274(b), and thus to tranfers in the employment context, four issues must be resolved. First, under traditional tax theories, is the concept of a gift ever compatible with the employment relationship, or, in other words, can an employer ever, for any reason, make a gift to a person who happens to be his employee? Second, assuming arguendo that the concepts are at least sometimes compatible, can transfers based upon length of service or productivity, as envisioned by section 274(b),[92] ever qualify as gifts? Third, how is the employee affected by this analysis? Finally, did Congress, through the enactment or amendment of section 274(b), intend to alter the traditional theories of gift and compensation?

A. *Is "Gift" Compatible with "Employment?"*

No, it is not, but the concepts "gift" and "employment" can coexist: a person can wear separate hats, those of employer and of friend.[93] While wearing the "employer hat," a person necessarily proceeds from employ-

90. As is discussed later, the "affection" motivation is inconsistent with the employment relationship, making gift classification of such transfers inherently suspect. *See infra* text accompanying notes 93-96.

91. *See supra* note 87.

92. I.R.C. § 274(b)(1)(C) (1983).

93. The distinction between an employer acting as employer and an employer acting as friend is most difficult to discern in the area of widows' payments. An employer may have several motives for these transfers, including compassion, affection, and desire to make up for earlier

ment-type motivations, and hence, cannot make a gift because he inherently acts with other than detached and disinterested generosity. In contrast, while wearing the "friend hat," a person acts due to feelings of affection or admiration;[94] thus, any transfers he makes are indeed gifts. Of course, a person might wear both hats at once. In such a case, any transfer proceeds from mixed motives and should be apportioned between the two categories.

Essentially, the prior paragraph states the obvious: while "gifts" can be made to employees,[95] the transfers, *because they are gifts*, are inherently non-employment related.[96] If the transfers are motivated by personal affection and are consequently non-employment, non-business related, they are not deductible as ordinary and necessary business expenses under section 162. Consequently, the purported limitation on their deductibility, under section 274(b), is superfluous. The section is triggered by deductible gifts; gifts, however, by their nature, are nondeductible. Therefore, the trigger is non-triggerable.

Such a conclusion about a Code section—that it is based upon a non-sequitur and thus has no application—normally would end an analysis, there being nothing left to analyze. Nevertheless, we continue pedagogically, as if some gifts might somehow be business-related and thus deductible.[97] Statutorily, employment-related awards based upon length of

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undercompensation. Because multiple motives may exist, the apportionment test is a particularly appropriate method to use in determining tax consequences.

In widows' payment cases, which usually involve mixed motives, an additional complication exists. Widows' payments are made not to the employee, but rather to his survivor. Courts have struggled with the problems of deductibility and includability of such transfers, but no clear consensus has evolved. *See* Estate of Carter v. Commissioner, 453 F.2d at 66-68 (summarizing and listing the various cases treating widows' payments as gifts or as compensation and noting the dichotomy); Comment, *supra* note 73, at 1225-26.

94. An interesting question involves whether a corporation may have such feelings. The Supreme Court in *Duberstein* found no basis in section 102 for precluding deductible gifts by corporations. 363 U.S. at 287-88. *Accord* United States v. Kasynski, 284 F.2d 143, (10th Cir. 1960). *See* Pomerance v. United States, 348 F. Supp. 861, 866 (E.D.N.Y. 1972) ("the corporate mind here consisted in the minds of the [stockholders]").

95. The Supreme Court in *Duberstein* discussed the frequency of such gifts, stating that "it doubtless is, statistically speaking, the exceptional payment by an employer to an employee that amounts to a gift." 363 U.S. at 287.

96. The Court of Appeals for the Sixth Circuit states that "[a]n employer may make a gift to an employee without rendering it taxable whether made before, during or after the termination of service. However, a payment of an additional sum by an employer to an employee carries a strong presumption that such payment is for services rendered." Willkie v. Commissioner, 127 F.2d 953, 955 (6th Cir. 1942). The Second Circuit says, "There is in fact a so-called 'presumption' that an employer gives . . . to a present employee for service rendered and not out of altruism." Carragan v. Commissioner, 197 F.2d 246, 249 (2d Cir. 1952).

97. While we reject the proposition as illogical, others have clothed it with varying degrees of respectability. For example, the Supreme Court in *Duberstein* implied that it lukewarmly accepted the proposition by rejecting the converse argument of the Service:

> The major corollary to the Government's suggested "test" is that, as an ordinary matter, a payment by a corporation cannot be a gift, and, more specifically, there can be no such thing as a "gift" made by a corporation which would allow it to take a deduction for an ordinary and necessary business expense. As we have said, we find no basis for such a conclusion in the statute . . . .

363 U.S. at 288.

The Congress, in contrast, by adopting section 274(b), accepted the proposition with open arms: the section affects only transfers which are both business deductions and gifts. Because we conclude that such transfers cannot occur, we also conclude that the statute has no effect.

service or productivity—to a maximum of $1600—are not considered "gifts" and thus cannot trigger the section 274(b) limitation; thus, they are fully deductible. The immediate and puzzling question is: why would *productivity* and *services* awards be considered gifts in the first place, such that the statutory exclusion might be needed? The inquiry is brief.

B. Can Gifts Be Based on Productivity and Service?

While laymen might be forgiven for imagining that gold watches "awarded" for "productivity" or "service" might be gifts rather than compensation, could a trained legal mind ever be so deluded? Assuming arguendo that *some* business-related transfers exist which are at the same time gifts, transfers based upon productivity or service[98] are inherently and quintessentially compensatory; they are the antithesis of detached and disinterested generosity. As a result, such awards, by their nature, are business-related, ordinary and necessary, and thus fully deductible under section 162. The section 274(b)(1)(C) statement that such awards are not gifts for purposes of the section, and thus are fully deductible, is again superfluous: they are not gifts for purposes of *any* section. Certainly a new statute was not needed to state this obvious conclusion. In summary, section 274(b) contains an exclusion for items which need not be excluded and has a trigger which cannot be triggered.

C. The Effect upon the Employee

Bluntly put, section 274(b) has no effect upon the employee. The section explicitly limits only the *deductibility* of "gifts" made by employers to employees. Employers may properly deduct such transfers, to the extent compensatory, under section 162; alternatively, employers might label such transfers wholly as "gifts" and incorrectly deduct them as section 162 expenses within the limitations of section 274(b). Naturally, to the extent of the limitation, employers are indifferent with regard to the two alternatives: either results in a deduction. Employees, however, do care which characterization the transfers receive because compensation results in tax, while gifts do not.

98. The discussion hereinafter is limited to awards based upon productivity or length of service. Although section 274(b) also contemplates awards based upon safety achievement, we feel that such awards might generate different tax consequences, as follows. A safety award could be motivated by an employee's long record of accident-free work. Such an award would be employment-related and compensatory because the employer would be rewarding his employee for something done in his work; thus, the award would be deserving of the same analysis as awards based upon productivity or service. But a safety award might instead be motivated by a single heroic event. In such a case, the award might be excludable from the employee's gross income under section 74(b), as being an award based upon a civic or charitable achievement. For a discussion regarding the wide breadth in the meaning of the word "charitable," *see* B. Hopkins, The Law of Tax-Exempt Organizations 41-51 (3d ed. 1979). An "heroic event" award, however, could be ordinary and necessary to the employer's business and thus deductible under section 162 because it is, in a sense, compensatory and it builds good-will in the community and with other employees. It would not, however, be limited in deductibility by section 274(b) because it would not be an "item excludable from gross income of the recipient under section 102 which is not excludable from his gross income under any other provision of this chapter . . ." I.R.C. § 274(b)(1) (1983).

Taxation of the employee/recipient, is governed by sections 61, 74,[99] and 102.[100] Section 274(b) does not purport to, and does not in fact, deal with *inclusion* issues.[101] Curiously, as discussed earlier,[102] a relationship exists between section 102 and section 274(b); critically, only section 274(b) is affected by the interplay. Labeling an ordinary and necessary business expense as a gift *for purposes of section 274(b)* does not make the transfer a gift *for purposes of exclusion* by the recipient.[103] As was pointed out earlier,[104] transfers in the employment context, particularly those motivated by service or productivity, can never be "gifts"; likewise, bona fide gifts to employees can never be deductible. Thus, because of the interplay between sections 102 and 274(b), the latter section is meaningless—unless Congress intended to alter the fundamental concept of a gift by enacting section 274(b).

D. Does Section 274(b) Fundamentally Alter the Definitions of Gift and Compensation?

The legislative history of the Revenue Act of 1962 clearly confirms that no alteration of the definition of gift was intended by the enactment of section 274(b). The House Committee on Ways and Means stated that the section "does not affect the question of includability or excludability of an item in income of any individual."[105] In Senate Finance Committee hear-

99. Section 74(a) reinforces the broad inclusion provision of section 61, stating that "gross income includes amounts received as prizes and awards." I.R.C. § 74(a) (1983). Section 74(b) lists exceptions to the general rule, none of which encompasses employer to employee transfers made for productivity or service. In fact, the regulations provide that "any prizes and awards from employer to an employee in recognition of some achievement in connection with his employment" are includable in the employee's gross income. Treas. Reg. 1.74-1(a)(1) (1955). The 1954 Committee Reports, describing section 74, similarly provide: "Subsection (b) is not intended to exclude prizes or awards from an employer to an employee in recognition of some achievement in connection with his employment, such as having the largest sales record or best production record during a certain period." S. Rep. No. 1622, 83d Cong., 2d Sess. 179 (1954). *Accord* H.R. Rep. No. 1337, 83d Cong., 2d Sess. A27 (1954). See *supra* note 98 for a discussion of section 74's relationship to § 274(b)(1)(c) "safety achievement" awards.

100. The fact that an employer takes no deduction for a payment to an employee has no bearing on the issue of inclusion, "especially . . . where the corporation earned no taxable profits in the year in which the payment was made . . ." Carragan v. Commissioner, 197 F.2d 246, 249 (2d Cir. 1952). However, some courts conclude that "evidence of [a] deduction is of weight in deciding the question of whether or not the payment was a gift . . ." Willkie v. Commissioner, 127 F.2d 953, 956 (6th Cir. 1942) (holding that severance payment to an employee was not excludable from gross income as a gift and that the corporation, by claiming a deduction, manifested an intent to pay compensation rather than to make a gift).

101. The Court of Claims states that,

> I.R.C. § 274(b) bars the deduction as a business expense of gifts of more than $25 per individual per year. Payments to an employee will be treated as income and not as gifts excludable from the employee's gross income under I.R.C. § 102 even in the absence of any obligation on the employer if, at bottom, they are a recompense for past services or an inducement of further services in the future.

Neely v. United States 613 F.2d 802, 804 n.2 (Ct. Cl. 1980).

102. *See supra* text accompanying note 32.

103. The House and Senate Committee reports clearly state that § 274(a) has no bearing on the issue of recipient inclusion. *See infra* notes 105 and 108.

104. *See supra* text accompanying notes 93-96.

105. The Committee's full statement is as follows:

> The only purpose of this section is to disallow deduction in certain cases and therefore this bill does not affect the question of the includability or excludability of an item in income of any individual. The rules presently applicable under present law will con-

ings based upon the House Bill, a representative of the watch industry testified that the House Committee's position would establish that employer awards "are not gifts."[106] He argued that, as a result, employees would likely be taxed on the awards and that employers would consequently discontinue the practice.[107] The Senate Committee, aware of the ramifications of its actions, nevertheless incorporated language identical to that in the House Report.[108] The Treasury has reiterated Congress' position in 1963 Regulations,[109] in a 1981 press release,[110] and in a 1982 announcement.[111]

Despite these pronouncements, some observers maintain that such a shift did occur,[112] although others, fearful that it did not, have suggested

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tinue to govern in this respect. Thus, for example, while pins or watches presented to an employee upon his retirement will not be regarded as gifts under this provision, this bill will have no effect in determining whether the recipient of the pin or watch will be taxed on their value.

H.R. REP. No. 1447, *supra* note 13, at 19-20, 1962-3 C.B. at 423-24.

106. *Hearings on H.R. 10650 Before the Senate Committee on Finance*, 87th Cong., 2d Sess. 1132 (1962).

107. *Id.*

108. The report of the Senate Committee on Finance states that "this section does not affect the question of the includability or excludability of an item in income of any individual." S. REP. No. 1881, *supra* note 13, at 27 (1962), 1962-3 C.B. at 733. The Committee's technical explanation of the bill concurs, stating that section 274(b)(1)(c) "relates only to deductibility by the employer" and that the subsection "is not intended to have any effect in determining whether the employee who receives the award is to be taxed on its value." *Id.* at 171, 1962-3 C.B. at 875.

109. Referring to various employer to employee transfers allowed by section 274(b)(1)(C) without limitation, the regulations provide: "The fact that such items are excepted from the applicability of this section has no effect in determining whether the value of such items in includable in the gross income of the recipient." Treas. Reg. 1.274-3(b)(2) (1963).

110. Internal Revenue News Release IR 81-138, STAND. FED. TAX REP. (CCH) ¶ 6258 (Dec. 21, 1981).

111. Whether an award is additional compensation to the employee or a gift from the employer depends on the specific facts in each case. Unless it can be shown that the award was given because of the employer's detached generosity and in no way represented compensation for services rendered, the value of the award must be included in the employee's income.

A number of newspaper stories commenting on this change in the law have erroneously concluded that all such awards are tax free to the employees.

Announcement 82-7, 1982-3 I.R.B. 48 (1982). Interestingly, the Treasury restricts its comments to awards which "in no way" represent compensation, implying that a different rule might prevail for awards which are partially compensatory. Such an implication conflicts with the *Duberstein* test, which denominates as compensation only transfers which are *primarily* compensatory. 363 U.S. at 285. *See supra* text accompanying notes 80-85. *See* Rankin, *A Tax Assist For Merit Gifts*, N.Y. Times, Nov. 28, 1981, at 30 (discussing the excludability of awards prior to the news release or announcement); Wall St. J., Dec. 30, 1981, at 1, col. 5 (discussing the excludability of awards, following the news release but prior to the announcement).

112. The N.Y. Times cites Senators Garn and Chafee, the original proponents of the 1981 amendment, as maintaining the "Congressional intent . . . was that the awards be tax-free to employees." N.Y. Times, *supra* note 111. The article also quotes Larry Batdorf, an I.R.S. spokesman, as saying that "some people here [at the I.R.S.] think [the awards are non-taxable.]" *Id.* That statement, of course, preceeded the Service's December 21, 1981 news release to the contrary. Of interest to practitioners, the *Times* quotes a tax partner with Arthur Anderson & Company as claiming the awards are "a way to make a nice Christmas gesture." Whether the partner meant to imply that the awards are non-taxable is unclear; the *Times*, however, infers as much. Finally, the *Times* quotes an attorney and editor with the Research Institute of America as predicting that the Service might rule that the gifts are taxable, but maintaining "that is not necessarily the ultimate answer." *Id.*

Following the Treasury news release claiming that such awards are taxable, the *Wall Street Journal* quoted Robert McCahill, a partner with the accounting firm of Peat, Marwick, Mitchell &

amendments to section 74 to explicitly alter the definitions.[113] Meanwhile, Congress inhibited the ability of the Treasury to deal with the problem by restricting promulgation of fringe benefit regulations;[114] the Service understandably views Qualified Plan Awards as, in essence, fringe benefits.[115] Each aspect of this controversy is discussed below.

The basic purpose of section 274(b) was to limit the abusive entertainment of, and gifts to, business clients and customers—activities which appeared to be, and might have been, kickbacks and bribes.[116] Significantly, the abuses did not involve transfers to employees.[117] To alleviate the abuses, Congress faced two logical alternatives: to eliminate the deductions and permit exclusion by the recipients *or* to allow the deductions but enforce inclusion.[118] Congress chose neither, but instead adopted a middle ground of partial deduction coupled with a specific statement that inclusion was still expected.[119] Some might call it compromise; others might call it having-your-cake-and-eating-it-too. Whichever it is called, the forced inclusion option was rejected for an administrative reason: discovering the recipients of business gifts and entertainment is too burdensome[120] (although in the employment context, such identification poses no difficulty).[121] Congress rejected the other option, total elimination of de-

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Co., C.P.A.'s, who argued that the news release was "an overly restrictive interpretation" of the law. Wall St. J., *supra* note 111.

113. Such amendments have apparently been offered by lobbyists of the watch and jewelry industries in hopes of encouraging such awards. Telephone interview of an I.R.S. spokesman, off-the-record (February 11, 1983).

114. The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 801 (1981) provides that no fringe benefit regulation shall be issued in final form before December 31, 1983. The act defines "fringe benefit regulation" as "a regulation providing for the inclusion of any fringe benefit in gross income by reason of section 61 of the Internal Revenue Code of 1954." I.R.C. § 801 (1981).

115. That employee awards are fringe benefits and thus that employee-award regulations are prevented by the general proscription of fringe benefit regulation is self-evident: if employer to employee awards are not fringe benefits, what are? Clearly the Service views such awards as fringe benefits. *See supra* note 113.

116. *See supra* text accompanying notes 13-18.

117. Abuses cited by Congress centered on "gifts" to persons outside the donor's employment such as clients, customers, and business associates. *See generally* 108 CONG. REC. 17,794-95 (1962); 107 CONG. REC. 9,127-28 (1961).

118. President Kennedy proposed complete disallowance of deductions for business entertainment and gifts, but the House and Senate concluded that this approach was not "the proper solution to the problem." H.R. REP. No. 1447, *supra* note 13, at 19, 1962-3 C.B. at 423; S. REP. No. 1881, *supra* note 13, at 25 (1962), 1962-3 C.B. at 731. The Senate Committee on Finance explained:

> Rather, your committee is convinced that expenses incurred for valid business purposes should not be discouraged since such expenses serve to increase business income, which in turn produces additional tax revenue for the Treasury. If valid business expenses were to be disallowed as a deduction (particularly expenses associated with selling functions), there might be a substantial loss of revenue where business transactions are discouraged, or where they fail to be consummated. Moreover, the entertainment industry employs large numbers of service personnel, most of whom are unskilled workers who would find it difficult to obtain new employment in other fields if the disallowance of entertainment expenses created considerable unemployment in the entertainment industry. In such cases, taxes now paid by these workers would be lost to the Treasury. S. REP. No. 1881, *supra* note 13, at 25 (1962); 1962-3 C.B. at 731.

119. *See supra* notes 105 and 108.

120. STUDY ON ENTERTAINMENT EXPENSES, PART TWO, *reprinted in Hearings on H.R. 10650, supra* note 137, at 284, and *Part Four, reprinted in Hearings on H.R. 10650 supra* note 13, at 329.

121. Employers already notify the service of the names and social security numbers of all

ductions, with brief discussion.[122] Also, despite the very limited deduction permitted and the expectation of continued inclusion, Congress failed to give the Service any additional enforcement tools. In fact, Congress' restriction of new fringe benefit regulations significantly hampered the Service's enforcement posture.

Congress' compromise approach has prompted unnecessary controversy. For example, despite the clear 1962 committee reports and the regulation statement that inclusion was not affected, in 1981 Senators Garn and Chafee publicly maintained[123] that Congress intended the awards to be tax-free to employees. These Senators, the initial Congressional proponents of Qualified Plan Awards,[124] apparently relied upon a "clarification" of Congressional intent from Senators Long and Dole. This remarkable "clarification" consisted of the following:

> Mr. DOLE: When Section 274(b)(1)(C) was originally added to the code in 1962, the Senate made it clear that:
>
> Gifts for these purposes . . . serve to strengthen the relationship between business and its employees (and) should not be discouraged by the tax laws. (S. Rep. 87-1881, at 34).
>
> Our action today reaffirms that intention. Furthermore, the amendment is consistent with the overall purpose of the Economic Recovery Tax Act of 1981
>
> Mr. GARN: Does the distinguished minority floor manager of the measure share this understanding?
>
> Mr. LONG: Yes, I do.[125]

Most distressing is not that Senators misunderstood each other, but rather that practitioners have inferred a fundamental shift in the definitions of gift and compensation and have in fact treated the awards as tax-free to the recipients.[126] Both the *New York Times* and the *Wall Street Journal* have quoted "experts" who maintain that the awards can be excluded.[127] Support for these assertions stems from the Long and Dole statements[128] and from the naive expectation that Congress passes logical laws.

Also, since 1961, confusion has persisted both in the judiciary and in the Treasury. For example, Judge Duncan of the Western District of Missouri concluded in 1961 that Christmas gift certificates given to employees for past service were gifts rather than compensation.[129] In mistakenly

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employees on a W-2 form. Requiring them to add amounts of "awards" to the reports would be a minor inconvenience. Businesses do not file such reports with respect to non-employee recipients unless payments are $600 or more. *See* I.R.C. § 6041 (1983).

122. *See supra* S. REP. No. 1881, reproduced in pertinent part at note 118.

123. *See supra* news reports at note 112.

124. *See supra* text accompanying note 42.

125. 127 CONG. REC. § 9194 (daily ed. Aug. 3, 1981).

126. *See supra* notes 111-12.

127. *Id.*

128. *See supra N.Y. Times*, note 111.

129. Hallmark Cards, Inc. v. United States, 200 F. Supp. 847 (W.D. Mo. 1961). In this case, an employer presented to each of its regular employees with more than one year of service a gift certificate for $25 which was redeemable in merchandise at any store in the country that handled or sold the employer's products. 200 F. Supp. at 848.

characterizing the transfers as gifts,[130] the judge gave lip service to *Duberstein*[131] and relied on a twisted application of Revenue Ruling 59-58.[132] The ruling permits employers to exclude from withholding, and employees to exclude from gross income, the value of holiday turkeys, hams, and other items of "similar nominal value." It specifically does not apply to "distributions of cash, gift certificates, and similar items of readily convertible cash value, regardless of amount involved."[133]

In order to reach the conclusion he deemed equitable, Judge Duncan ignored the prescription concerning gift certificates.[134] He determined that the Treasury, the author of the ruling, must have meant to exclude only gift certificates that are cash equivalents, which, of course, in the judge's opinion the certificates in question were not.[135] Revenue Ruling 59-58 evinces Treasury confusion when it reasons that excludability is warranted "[i]n view of the small amounts involved, and since it may reasonably be contended in many cases that such items constitute excludable gifts. . . ."[136] The ruling prompts several unanswered questions, which in turn prompt the present confusion. Understandably, administrative reasons exist for *treating* such items, in small amounts, as gifts; but the ruling does much more: it says that such small items, in many cases, might actually *be* gifts. How? Are they not compensatory despite their nominal value? Also, if employer to employee gift motives can exist, as the ruling implies, what distinguishes a turkey from cash or a gift certificate? Does the Treasury mean to say that cash is inherently compensatory? Of course, Congress seems to imply as much in section 274(b) when it restricts Qualified Plan Awards to non-cash items.[137]

Since the eruption of the most recent controversy, lobbyists have attempted to cultivate congressional interest in further action to settle the issues. Probably because of their lack of success in 1962, the watch and jewelry industries are again encouraging amendments specifying that qualified awards are indeed gifts and thus are not subject to tax. Thus far, such proposals have gained little attention.[138]

Also, the Treasury attempted to defuse the situation with its December 1981 press release which claimed that awards for productivity and service are very much includable.[139] Significantly, however, the Treasury has not gone further with new and specific regulations dealing with the controversy or with a new ruling detailing permitted awards; instead, in February 1983, it merely issued proposed regulations that do little but

130. The certificates were given to *all* employees (except salesmen) and for past services, both factors strongly indicating compensation motives. *Id.* at 848.

131. 200 F. Supp. at 850.

132. *Id.* at 849-50; Rev. Rul. 59-58, 1959-1 C.B. 17.

133. Rev. Rul. 59-58, 1959-1 C.B. 17.

134. 200 F. Supp. at 849-50.

135. *Id.*

136. 1959-1 C.B. 17.

137. I.R.C. § 274(b)(1)(C) applies only to "an item of tangible personal property . . . ." I.R.C. § 274(b)(1)(C) (1983).

138. *See supra* note 113.

139. *See supra* note 110.

paraphrase the statute.[140] Apparently, the Treasury feared Congress' repeated[141] prohibition of fringe benefit rules; after all, awards to employees are the consummate fringe benefit.

IV. CONSEQUENCES TO COUNSEL AND PARTICIPANTS

The Appendix to this Article contains a sample Qualified Award Plan. While the plan is a suggested implementation of section 274(b), caution should accompany its use. Because a correct reading of the Code renders section 274(b) meaningless, the plan, in light of such a reading, accomplishes nothing. Nevertheless, taxpayers and tax planners who disagree with the conclusions stated herein regarding section 274(b) may wish to use such a plan or one like it. They should, before proceeding, contemplate the disclosure and withholding requirements of the Code as well as the civil, criminal, and ethical constraints upon them.

Section 3402[142] is a good place to begin. It requires an employer to withhold a portion of "wages" paid to employees. "Wages" in turn is defined by section 3401(a) as "all remuneration . . . for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash."[143] Similarly, sections 3102[144] and 3301[145] require, with respect to "wages," FICA withholding and the payment of FUTA taxes. Both sections define wages in the same manner as does section 3401,[146] with one notable exception: payments made on

140. Treas. Reg. 1.274-3(d)(2) (Prop.), 47 Fed. Reg. 56,367-69 (1982).

141. In 1978 Congress prohibited the issuance of final fringe benefits regulations before January 1, 1980. Pub. L. No. 95-427, § 1, 92 Stat. 996 (1978). In 1979, Congress extended the prohibition to June 1, 1981, Pub. L. No. 96-167, § 1, 93 Stat. 1275 (1979), and in 1981, it further extended the prohibition to January 1, 1984, Pub. L. No. 97-34, § 801 (1981). On October 5, 1983, the House Committee on Ways and Means approved the Permanent Tax Treatment of Fringe Benefits Act of 1983, H.R. 3525, 98th Cong., 1st Sess. (1983). The Act, as proposed, would solve many of the existing problems associated with the taxation of employee fringe benefits by defining which benefits are taxable and which are excludable; it would not, however, directly affect the operation of § 274(b). *See* Press Release, Subcommittee on Select Revenue Measures, House Committee on Ways and Means, September 30, 1983; 129 CONG. REC. H5056 (daily ed. July 12, 1983) (technical explanation of H.R. 3525); JOINT COMMITTEE ON TAXATION, DESCRIPTION OF HR 3525, 98th Cong., 1st Sess. (1983). The Act may indirectly affect section 274(b) by ending the moratorium on fringe benefit regulations, and consequently the Treasury's apparent fear of issuing more stringent regulations dealing with section 274(b). Whether the Treasury would, upon passage of the proposal, issue new proposed regulations under section 274(b) is, of course, conjecture.

142. I.R.C. § 3402(a) (1983).

143. I.R.C. § 3401(a) (1983).

144. I.R.C. § 3102 requires the deduction of FICA taxes from an employee's "wages." I.R.C. § 3121(a) (1983) and Treas. Reg. § 31.3121(a)-1, in turn, define the term "wages" for FICA purposes.

145. I.R.C. § 3301 (1983) requires the payments by employers of unemployment taxes on "wages" paid to employees. I.R.C. § 3306(b) (1983) and Treas. Reg. § 31.3306(b)-1 in turn define the term "wages" for FUTA purposes.

146. Not only is the language of the various provisions nearly identical, but the Supreme Court also held in 1981 that their reach is coextensive. Rowan Companies, Inc. v. United States, 452 U.S. 247 (1981). In so holding, the Court invalidated portions of the FICA and FUTA regulations which attempted to reach further than the income tax withholding regulation. 452 U.S. at 263. Three dissents to *Rowan* agreed with the Court of Appeals for the Fifth Circuit in arguing that FICA and FUTA are broader than withholding for income taxes. 452 U.S. at 263 (White, J., joined by Brennan and Marshall, J.J., dissenting); Rowan Companies, Inc. v. United States, 624 F.2d 701, 704-06 (5th Cir. 1980).

account of an employee's retirement are not wages.[147] In addition, sections 6041[148] and 6051[149] require disclosure to the Service and to the employee of wages paid.

Under a strict reading of these statutes, awards to employees for productivity or service fit within the definition of wages. They therefore are subject to withholding for income taxes, FICA, and FUTA.[150] Failure to so withhold and report the amounts could produce the dire consequences discussed below. Nevertheless, the Service, recognizing that disclosure and withholding on "fringe benefits" rarely occurs and that employers seem little impressed by the threatened consequences, has attempted at least to

147. I.R.C. §§ 3121(a)(5), 3306(b)(5) (1983). I.R.C. § 3401 (1983), defining wages for income tax withholding, has no such provision.

148. Section 6041 (1954) provides:

> All persons engaged in a trade or business and making payment in the course of such trade or business to another person, of . . . salaries, wages . . . compensations, remunerations . . . or other fixed or determinable gains, profits, and income . . . of $600 or more in any taxable year . . . shall render a true and accurate return to the Secretary . . . setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payments.

I.R.C. § 6041 (1983).

149. Section 6051(a) provides for W-2 forms by stating that,

> Every person required to deduct and withhold from an employee a tax under section 3101 [FICA] or 3402 [income tax withholding] . . . or every employer engaged in a trade or business who pays remuneration for services performed by an employee, including the cash value of such remuneration paid in any medium other than cash, shall furnish to each such employee in respect of the remuneration paid by such person to such employee during the calendar year, . . . a written statement . . .

I.R.C. § 6051(a) (1983). Section 6051(d) requires that a duplicate of any such statement be furnished to the Secretary in accordance with the regulations. I.R.C. § 6051(d) (1983).

150. To fit within the definition of "wages," awards need only qualify as "remuneration." *Cf.* Hotel Conquistador, Inc. v. United States 597 F.2d 1348, 1353 (Ct. Cl. 1979) (holding that the term "wages" does not include certain meals provided to employees, thus that such payments are not subject to FICA and FUTA provisions, and that 'remuneration' is the test of what 'wages' include.") Nevertheless, the term " 'remuneration' does not include all non-cash benefits the employer confers." *Id.*

The regulations provide some guidance regarding the term "remuneration." Treasury Regulation section 31.3121(a)-1 explains that "the name by which the remuneration for employment is designated is immaterial . . ." and that "the medium in which the remuneration is paid is also immaterial." Treas. Reg. 31.3121(a)-1(c), (e) (1975). For similar language, *see* Treas. Reg. 31.3306(b)-1 (c), (e) (1975). In explaining which non-cash benefits do not fit the definition, the regulations provide:

> (f) Ordinarily, facilities or privileges (such as entertainment, medical services, so-called "courtesy" discounts on purchases), furnished or offered by an employer to his employees generally, are not considered as remuneration for employment if such facilities or privileges are of relatively small value and are offered or furnished by the employer merely as a means of promoting the health, good will, contentment, or efficiency of his employees.

Treas. Reg. 31.3121(a)-1(f); 31.3306(b)-1(f) (1975).

Although no cases expressly hold that productivity and service awards are remunerative, the proposition seems self-evident, especially after a reading of the above regulations. Typically, cases excluding non-cash benefits from withholding requirements involve meals, lodging, and travel expenses. *Cf. Hotel Conquistador* 597 F.2d at 1354 (meals); Rowan Companies, Inc. v. United States, 452 U.S. 247 (1981) (meals and lodging); Central Illinois Public Service Co. v. United States, 435 U.S. 21 (1978) (lunch expense reimbursement); Oscar Mayer & Co., Inc. v. United States, 623 F.2d 1223 (7th Cir. 1980) (unreimbursed value of use of company cars). In fact, the regulations dealing with income tax withholding specifically exclude the value of meals or lodging from wages if the employee excludes the value from his gross income. Treas. Reg. 31.3401(a)-1(b)(9) (1980). Provisions in the FICA and FUTA regulations specifically including as wages the value of meals or lodging were invalidated by the Supreme Court in *Rowan*, 452 U.S. at 253, 263 (1981).

demand information. Revenue Procedure 80-53[151] discussed the persistent noncompliance with the income tax withholding provision as applied to fringe benefits.[152] The Treasury insists upon W-2 disclosure of such benefits even if the transfer may not be subjected to withholding.[153] Admittedly, the apparently weak stance was due to Congress' proscription of any new rules governing fringe benefits.[154] It is not, however, a surrender to the notion that withholding provisions do not apply—after all, they clearly apply on their face. The ruling, instead, seems to be a first attack, a way of saying, "at least follow the law this much . . . we'll deal with enforcing other sections, later."

Employers who fail to comply with the withholding and disclosure requirements are subjected to a variety of statutory penalties. Both civil and criminal penalties exist for 1) failure to disclose wages to the Service,[155] 2) failure to disclose wages to the employees,[156] 3) failure to withhold taxes and to pay them over,[157] 4) failure to pay the employer's share of FICA and FUTA,[158] and 5) failure to tell the truth about the transaction.[159] In addition, the broad scope of section 7201,[160] which covers will-

151. 1980-2 C.B. 848.

152. The ruling was in response to the Supreme Court's decision in Central Illinois Public Service Co. v. United States, 435 U.S. 21 (1978), which exacerbated the problem of noncompliance. In holding that the requirement to withold tax is narrower than the requirement to include receipts in gross income, the Court permitted exclusion from the term "wages," and from withholding, of some fringe benefits. *Id.* at 922-23 (cash reimbursements for lunch expenses of employees on overnight travel).

Fearful that this decision would open the floodgates, the Service acknowledged the Court's position but attempted to limit the exclusion to payments which are "not the type of benefit treated as wages under the statute, a regulation, a revenue ruling, a revenue procedure, or a court decision" and to require a "reasonable basis for the belief that such benefit should not be considered as remuneration for services." 1980-2 C.B. at 848.

153. The ruling states that includable fringe benefits which are not wages "must be reported by employers as other compensation on a Form W-2 prepared for each employee if the total of such compensation paid to the employee and the amount of the employee's wages to be reported on Form W-2 aggregates $600 or more in a calendar year." Rev. Proc. 80-53, 1980-2 C.B. at 848.

154. The ruling itself recites the history of Congress' prohibition of fringe benefit rulings and regulations. *Id.*

155. I.R.C. § 6652(a)(1)(A)(i), (vi) (1983) ($50 per incident civil penalty with a maximum of $50,000 per year for failure to file an information return required by section 6041 or to furnish the Secretary with a copy of a W-2; § 6672(a) (1983) (civil penalty equal to the amount of any tax not truthfully accounted for by a person required to collect or account for the tax); § 7203 (1983) (misdemeanor with a $25,000 fine or one year imprisonment for willful failure to file a return or supply information).

156. I.R.C. § 6674 (1983) ($50 civil penalty for willful failure to timely furnish a W-2 Form to an employee); I.R.C. § 7204 (1983) (misdemeanor with a $1000 fine and one year imprisonment for willful failure to supply information required on a W-2).

157. I.R.C. § 6672 (1983) (civil penalty equal to the amount of any tax not truthfully accounted for by a person required to collect or account for the tax); I.R.C. § 7202 (1983) (felony with a $10,000 fine and five year imprisonment for willful failure to collect or truthfully account for and pay over any tax required to be collected, accounted for, and paid over).

158. I.R.C. § 6653(b) (1983) (civil penalty equal to 50% of any underpayment of tax if any part of the underpayment is due to fraud); I.R.C. § 7201 (1983) (felony with a $100,000 fine and five years imprisonment for the willful attempt in any manner to evade or defeat any tax); I.R.C. § 7203 (1983) (misdemeanor with a $25,000 fine and one year imprisonment for the willful failure to pay any tax).

159. I.R.C. § 6653(b) (1983) (civil penalty equal to 50% of any underpayment of tax if any part of the underpayment is due to fraud); I.R.C. § 6674 (1983) ($50 civil penalty for willfully furnishing a false or fraudulent statement to an employee); I.R.C. § 7206 (1983) (felony with a $100,000 fine and three year imprisonment for perjury); I.R.C. § 7207 (1983) (misdemeanor with a $10,000

ful attempts to evade tax, could potentially reach any person, either employer or tax adviser, who aided an employee-recipient in not including an award.[161] Such an attempt might amount to nothing more than, "I won't tell them, so you don't report it, and they'll never know."

Tax planners should also direct their attention to the ethical implications of advising clients on the tax consequences of award plans. Transfers in the employment context are inherently compensatory and thus must be included in the employee's gross income. Practitioners advising otherwise do violence to the fundamental principles of section 102, even if their advice is based upon inferences derived from section 274(b) ambiguities. Dubious inferences such as these are a major cause of the well-documented decline of the integrity of the tax system.[162]

V. SUGGESTED REFORM

Congress should start by eliminating those portions of section 274(b) which deal with transfers in the employment context and should amend subsection (b)(1) to apply only to individuals who are not employees. Sections 274(b)(1)(C) and (b)(3) should be repealed. The middle ground approach adopted in 1962 should be abandoned.[163] Compensatory transfers should be fully deductible, subject to the section 162 strictures of ordinary, necessary, and reasonable. Recipients should include receipts in gross income.

This proposal would return the Code to its pre-1962 status, but no

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fine and one year imprisonment for willful disclosure of false or fraudulent information to the Secretary).

160. Section 7201 provides:

> Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.

I.R.C. § 7201 (1983).

161. In addition to noting the broad reach of section 7201, any practitioner or employer contemplating an award plan under which they advise recipients not to include awards in gross income should also consider section 7206(2), which provides:

> Any person who—
>
> * * *
>
> Willfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document . . . shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.

I.R.C. § 7206(2) (1983).

162. *See* Kurtz, *The State of Our Federal Tax System*, 1980 S. CAL. TAX. INST. 17 (1980). In this article, Kurtz, who was at the time Commissioner of the Internal Revenue Service, estimates that for the 1976 tax year, individuals failed to report between $75 billion and $180 billion in income from legal activities. *Id.* at 17-2. Compliance with reporting requirements was estimated to be approximately 98% in the case of wages subject to withholding, 85-90% for items subject to information reporting but not withholding and 60% for income subject to neither information reporting nor withholding. *Id.* at 17-3. News reports have also publicized the system's decline. *See* TIME, March 28, 1983, at 26 (cover story).

163. *See supra* text accompanying note 122.

detriment will result because the dilemma Congress then faced—administrative difficulty in enforcing inclusion—did not, and still does not, apply to employee recipients.[164]

Additionally, Congress should quit dodging the responsibility for drafting fringe benefit guidelines, a task which it emphatically removed from the Treasury.[165] Congress should tell us which benefits and what dollar amounts are excludable by recipients and, likewise, explain which ones are deductible by payors. To a limited extent, Congress has begun: for example, section 125 provides for a variety of excludable yet deductible benefits.[166] Also, it has implicitly promised more comprehensive legislation by its persistent[167] proscription of new regulations. In fact, the House Committee on Ways and Means approved a 1983 bill[168] which would have at least solved some of the problems unrelated to section 274(b). The full House, however, failed to consider the measure under the original rule developed by the Rules Committee.[169] The need for such a new statute is obvious: too much uncertainty exists with regard to the deductibility and includability of such things as airline passes, employee discounts, qualified plan awards, and free tuition.[170] A piecemeal approach of dealing with the problem, as now exists, tends to confuse, especially when regulations are forbidden. A statute which makes no sense and has no application—such as section 274(b)—is even worse.

164. *See supra* note 25.
165. *See supra* note 141.
166. I.R.C. § 125 (1983).
167. *See supra* note 141.
168. H.R. 4170, 98th Cong., 1st Sess. (1983).
169. 21 Tax Notes 735 (Nov. 21, 1983). Whether the measure will arise under a new rule is questionable. Some observers predict a revival while others consider the proposals dead. *Id.*
170. *See generally*, Weaver, *The Fringe Benefit Turmoil*, 38 N.Y.U. INSTITUTE ON FEDERAL TAXATION 7-1 (1980, Erisa Supp.); Note, *Federal Income Taxation of Employee Fringe Benefits*, 89 HARV. L. REV. 1141 (1976).

APPENDIX
QUALIFIED AWARD PLAN FOR EMPLOYEES OF _____, INC.

_____, Inc. (the "Corporation"), a corporation organized under the laws of the State of _____, hereby establishes this Qualified Award Plan (the Plan), effective as of _____. This Plan is designed to reward employees of the Corporation for productivity and length of service to the Corporation through gifts of tangible personal property.

I. ELIGIBILITY AND PARTICIPATION

Any employee of the Corporation who has completed at least 1000 hours of service during the Corporation's current fiscal year shall be eligible to participate under this Plan.

II. BENEFITS

The Corporation may, on an annual basis, determine that gifts to its employees are appropriate to reward employees for special productivity and length of service to the Corporation. Gifts to employees shall be based on uniform criteria and shall not discriminate in favor of officers, shareholders, or highly compensated employees. The criteria to be considered are the special or unusual productivity of an employee and the employee's length of service to the Corporation, the latter to be measured by the number of fiscal years of the Corporation during which the employee has been employed by the Corporation and has rendered at least 1000 hours of service.

Gifts to employees shall be in the form of tangible personal property. The average cost of all gifts made to employees under this Plan for any fiscal year of the Corporation shall not exceed $400.00. No individual gift to any employee in any fiscal year of the Corporation shall exceed $1,600.00.

In the event that an employee dies during a fiscal year in which the Corporation determines to make gifts under this Plan, the gift that would otherwise have been made to the deceased employee shall be made to his estate or successor.

III. ADMINISTRATION

The Board of Directors of the Corporation shall administer this Plan and shall keep necessary records of the productivity and length of service of all employees so that the Plan can be properly implemented.

IV. AMENDMENT AND TERMINATION

The Corporation shall have the right at any time, and from time to time, to amend, in whole or in part, any or all of the provisions of this Plan, or to terminate this Plan. However, no such amendment or termina-

tion shall be permitted which operates to discriminate in favor of officers, shareholders, or highly compensated employees.

IN WITNESS WHEREOF, the Corporation has caused this Plan to be executed by its duly appointed officers and the corporate seal to be hereunto affixed this _____ day of _____.

Signed, sealed and delivered
in our presence as witnesses: _____, Inc.
_____ By: _____
_____