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Frequent Flyer Awards as Taxable Income: Time to Pay the Tax Man

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FREQUENT FLYER AWARDS AS TAXABLE INCOME: TIME TO PAY THE TAX MAN

INTRODUCTION

What began as marketing tools to attract and retain customers, frequent flyer[1] programs, have become part of the fabric of America—encouraging consumers to transform even the most mundane transactions into opportunities for free travel. The programs are simple to use. The program participant need only provide his membership number to the airline[2] to convert time on board an airplane into free transportation to exotic destinations such as Hawaii, Mexico, or Europe.[3] Today, most major air carriers offer their customers some sort of frequent flyer reward program.[4] The instant and continuing popularity of frequent flyer programs pays tribute to the marketing genius of their architects.

The Internal Revenue Service[5] has been uncharacteristically silent and appears to be following a "Don't Ask, Don't Tell" policy[6] with respect to the potential tax liabilities associated with frequent flyer benefits. The Service regards frequent flyer benefits as taxable income but has not insisted on taxpayer compliance.[7] The fiscal conse-

1. "Flyer" sometimes appears in publications as "Flier." This Comment uses the term, "Flyer."

2. *See* AMERICAN AIRLINES, INC., AADVANTAGE STEP-BY-STEP GUIDE TO WORLDWIDE TRAVEL AWARDS (1997) [hereinafter GUIDE].

3. *See* AMERICAN AIRLINES, INC., AADVANTAGE NEWSLETTER (August/September 1997) [hereinafter NEWSLETTER].

4. *See* Michael W. Gunn, Remarks at the Meeting of the American Airlines Marketing Association (January 14, 1988), at 2. Air carriers who have developed frequent flyer programs include United Airlines, Continental Airlines, Trans World Airlines, Delta Airlines and Southwest Airlines, to name just a few. The author wishes to thank Nancy A. Strong of Strong Travel Service in Dallas, Texas for her valuable assistance in providing details of program participation. Hereinafter, all references to personal interviews with Ms. Strong will be cited as "Strong."

5. The Internal Revenue Service will be referred to as the "Service."

6. *See* Ryan J. Donmoyer & Sheryl Stratton, *Don't Ask, Don't Tell: The IRS's Frequent Flier Policy*, TAX NOTES, Dec. 4, 1995, at 1159. The Service has always viewed frequent flyer credits as taxable fringe benefits, but problems with valuation, tracking, and timing of income have slowed efforts to enforce the Tax Code. *See id.* at 1161. "While the IRS has previously ignored informal travel policies which allow the personal use of frequent flier awards, don't invite an IRS challenge by maintaining a specific written policy which permits such personal use." *Id.* (quoting former IRS official, David R. Fuller).

7. *See* LISA FAGEN ET AL., MERTENS LAW OF FEDERAL INCOME TAXATION § 5A.05 (1997). "The Service and the courts have been reluctant to take a firm position on the treatment of frequent flyer miles earned for business travel but retained by the employee and used for personal purposes." *Id.* A recent attempt by the Service to assess tax on the value of mileage used for personal travel or sold for cash was met with shock in the travel trade press. *See* Richard D'Ambrosio, *IRS Taxing Frequent Flyer Benefits in Florida*, BUS. TRAVEL NEWS, April 5, 1993, at 1.

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quence of this inertia is the potential loss of considerable tax revenue.[8] Furthermore, the Service's unwillingness[9] to tax these accessions to wealth fosters a collective misconception among program beneficiaries that accumulated benefits are nothing more than gifts from the airlines or "perks" from their employers.[10] The Service's reluctance to collect any and all income taxes that flow from these accessions to wealth should not be misinterpreted.[11] Even a cursory reading of the current Internal Revenue Code[12] confirms, under certain circumstances, that the receipt and use of frequent flyer benefits represent income[13] to the beneficiary.[14]

A "Don't Ask, Don't Tell" policy, with respect to the collection of bona fide taxes, is a disservice both to the national treasury and to the taxpaying public. Income taxes are graduated; the tax rate increases as income rises.[15] "[T]he exemption is of greater value to a high-income taxpayer than to a low-income taxpayer."[16] Exempting qualified frequent flyer income from taxation leads to an unfair distribution of the tax burden, not only with regard to taxpayers in the same income group, but also to taxpayers at differing income levels. When frequent flyer income is excluded from taxable income, the value of the frequent flyer award becomes greater than cash compensation of equal face value. For example, a taxpayer in the highest tax bracket redeems mileage to acquire an airline ticket that would ordinarily have cost $500. That same traveler would have had to earn ap-

8. *See* Kathryn Symmes Hall, *Frequent Flyer Benefits: Substantive and Procedural Tax Consequences*, 20 IND. L. REV. 823 (1987) (suggesting that the potential tax revenue lost in 1985 alone would approximate 50 million dollars). A recent news story estimated 11 million round trip flights were awarded in 1994. *See Frequent Flyer Awards Return to IRS Scrutiny—If Only Briefly*, AIRLINE MARKETING NEWS, Dec. 6, 1995. According to one source, the taxation of frequent flyer benefits could result in "millions of dollars in new income." Richard Meyer, *Frequent Flyer Miles Pose Taxing Problem*, TRAVEL WEEKLY, Aug. 11, 1994, at 22.

9. *See* Donmoyer & Stratton, *supra* note 6, at 1161.

10. *See Miles to Go*, WALL ST. J., Dec. 1, 1995, at A14. "Things like company health benefits or frequent-flier miles are a way to get paid without getting taxed." *Id.*

11. *See* Terence Coppinger et al., *Frequent Flier Foolishness*, THE TAX ADVISOR, Mar. 1, 1996. "The Service has always maintained that frequent flier miles can result in taxable income." *Id.*

12. *See* Internal Revenue Code of 1986, 26 U.S.C. § 1 *et seq.* (1986). For convenience, the author will refer to the Internal Revenue Code simply as the "Code."

13. *See infra* Part II.A. *See also* Priv. Ltr. Rul. 93-40-007 (Oct. 8, 1993). "There are situations in which a passenger who received benefits under B's program will realize gross income." *Id.*

14. This Comment addresses only those circumstances where airline tickets are purchased by an individual for non-deductible reasons or purchased by an employer who does not receive the benefit of the frequent flyer award.

15. *See* I.R.C. § 1. The tax assessed on ordinary income ranges from 15% to 39.6%. *See id.*

16. *See* J. MICHAEL BURKE & MICHAEL K. FRIEL, TAXATION OF INDIVIDUAL INCOME 201 (4th ed. 1997).

proximately $825 to purchase that same ticket.[17] Employers and employees will be encouraged to factor in the value of business trips when negotiating compensation. This will result in salary inequities between traveling and non-traveling employees, with dissimilar wages being paid for similar labor. The effect of the Service's failure to tax consistently those items relating to frequent flyer compensation, contributes to a distortion in the labor market and a general distrust of the taxing authorities.[18]

This Comment will argue the Service's position should shift to aggressively collect all applicable taxes on frequent flyer benefits. Part I of this Comment provides a brief overview of the frequent flyer phenomena. Part II analyzes whether frequent flyer benefits are taxable income or excluded from income. Part III proposes a method both to value the benefits earned and to establish the timing of the event. The Conclusion calls for aggressive enforcement of the collection of income taxes on qualifying transactions.

I. THE FREQUENT FLYER PHENOMENA

In the early 1980s, the newly deregulated airline industry faced the ultimate marketing challenge—how to build brand loyalty and increase market share in a highly competitive marketplace.[19] In 1981, American Airlines inaugurated the AAdvantage program.[20] Frequent flyer programs are deceptively simple plans that reward an airline's best customers for their loyalty without affecting either product service levels or price.[21] AAdvantage was destined to become the "most successful marketing program" ever mounted by an airline and to change the visage of airline marketing forever.[22] According to a recent report, American's program alone has approximately 29 million members—a significant increase from the original 283,000 members.[23]

17. Assuming a 39.6% tax bracket. *See* I.R.C. § 1(a) (1986).

18. *See* BURKE & FRIEL, *supra* note 16, at 203.

19. *See* Gunn, *supra* note 4, at 2. "It is an exciting use of AAdvantage to hold on to or increase market share without depending solely on expensive mass media campaigns." *Id.* at 15. *See also* Susan Wooton, *Indirect Frequent-Flier Tax Slips in Under Public Radar: Travel Budget Provision Levies 7.5% Charge on Airlines' Sale of Miles—But Will Consumers Have to Pay the Freight?*, LOS ANGELES TIMES, Aug. 20, 1997, at D6 (estimating 8% of all airline passengers travel on tickets obtained with frequent flyer credits).

20. *See* Gunn, *supra* note 4, at 2. AAdvantage is a registered trademark of AMR Corporation.

21. *See id.* at 3. "What our frequent travelers really wanted was volume discount fares. But since we knew the financial pitfalls of discounting the inelastic portion of demand, we began searching for some other way to build brand loyalty among our regular travelers." *Id.*

22. *See id.*

23. *See AAdvantage Travel Awards Program*, AMR CORPORATE FACTS, June 1997 [hereinafter CORPORATE FACTS].

Program benefits have kept pace with the explosive membership growth, and today's frequent flyer programs afford their members opportunities to redeem awards in the form of free transportation, upgrades to premium classes of service, and vacation packages.[24] The opportunities to accumulate mileage have also increased to keep pace with the ever-increasing demand. A frequent flyer program participant may earn mileage when performing any of a myriad of mundane business or personal tasks including: making a long distance phone call,[25] parking the car,[26] buying a Christmas present,[27] reading a business newspaper,[28] or paying the mortgage.[29] Today's frequent flyer programs have grown to include even non-airline products.[30]

Frequent flyer programs[31] allow members to accumulate mileage by flying on the sponsoring airline, on any of a number of "partner" airlines, or using the services of other program participants.[32] To accumulate frequent flyer credits, a traveler simply provides a personal identification number[33] to the reservation agent at the time a ticket is purchased or any time prior to flight departure.[34] The frequent flyer number is printed on the boarding pass along with an estimate of the total miles accrued for that particular flight itinerary. The miles are tracked by the airline and periodic statements are sent to the traveler.[35] It is noteworthy that benefits are not extended to reward air

24. *See* NEWSLETTER, *supra* note 3.

25. *See* AMERICAN AIRLINES, INC., EARN AADVANTAGE MILES WITH YOUR PHONE CARD (1997) (offering members AAdvantage miles with the purchase of a MCI pre-paid calling card).

26. *See* AMERICAN AIRLINES, INC., RENT-TO-EARN. EARN 2750 AADVANTAGE MILES WHEN YOU PARK & RENT (1997) (offering members the opportunity to earn AAdvantage miles by parking their car at certain Thrifty car rental locations).

27. *See* AMERICAN AIRLINES, INC., GET 3000 BONUS MILES. AND START EARNING MILES ON ALL ONE'S PURCHASES (1997) (offering an affinity-type credit card through Citibank that allows the member to earn one AAdvantage mile for every dollar charged on the credit card).

28. *See* AMERICAN AIRLINES, INC., SUBSCRIBE NOW! RECEIVE FOUR WEEKS FREE AND EARN UP TO 2,000 AADVANTAGE MILES! (1997) (encouraging members to subscribe to the *Wall Street Journal* and receive a discounted rate, plus AAdvantage miles).

29. *See* AMERICAN AIRLINES, INC., EARN ONE AADVANTAGE MILE FOR EVERY DOLLAR OF MORTGAGE INTEREST YOU PAY (1997) (offering mileage in exchange for mortgage interest paid to Great Western Bank).

30. *See, e.g.*, Sheldon I. Banoff & Richard M. Lupton, *Secret Dining Rebates: Food for Thought*, 81 J. TAX'N 63 (July 1994) (discussing the newest affinity programs that encourage persons who eat out to choose a particular credit card and dining establishment to earn "mileage").

31. Most major frequent flyer programs operate in similar fashion. An exception is Southwest Airlines' program that allots free tickets on the basis of the number of flight segments flown—not miles accumulated. *See* Strong, *supra* note 4.

32. *See* CORPORATE FACTS, *supra* note 23.

33. *See* GUIDE, *supra* note 2, at 8.

34. *See id.* at 48. Program miles may not be credited retroactively; therefore, frequent flyer numbers must be entered into the airline's system prior to flight departure. *See id.*

35. *See* GUIDE, *supra* note 2, at 9; Gunn, *supra* note 5, at 10.

travel that uses certain types of tickets, such as employee, industry, negotiated, or deeply discounted tickets.[36] Moreover, benefits are awarded only to the traveler and not to the actual purchaser of the ticket.[37] Once the miles are credited to the traveler's personal account,[38] the traveler may redeem them for transportation vouchers or other program merchandise.[39]

Generally, flight reservations are not required to redeem miles.[40] The program member simply completes a redemption form, indicating the award redeemed and the beneficiary.[41] The airline forwards the flight certificates to the traveler from whose account the credits were deducted. The program participant then forwards the travel certificate to the actual traveler.[42] Flight certificates may be exchanged for airline tickets anytime within one year from date of original issue.[43] Program miles typically expire if not redeemed for flight certificates within three years after credit to the traveler's account.[44]

II. FREQUENT FLYER AWARDS AS TAXABLE INCOME

A. *What Is Income?*

To argue *sua sponte* that frequent flyer mileage awards are not taxable income is simplistic and fails to acknowledge either the full scope of the Sixteenth Amendment or the manifest congressional intent in passing that Amendment.[45] Before the value of an airline ticket purchased with mileage earned while traveling is determined to be taxable income, it is necessary first to define what is meant by income. An examination of the Constitutional Amendment that created the income tax is appropriate: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without ap-

36. *See* GUIDE, *supra* note 2, at 49. The reason for this policy is obvious when considering the reason for the advent of frequent flyer programs—increase both market share and revenue. *See* Gunn, *supra* note 4, at 3.

37. *See* GUIDE, *supra* note 2, at 48.

38. For example, the AAdvantage program's membership profile includes the member's name, address, business and home phone numbers, seating preference, and even their beverage preference. *See* Gunn, *supra* note 4, at 12.

39. *See* CORPORATE FACTS, *supra* note 23.

40. *See id.* at 13.

41. *See* AMERICAN AIRLINES, INC., MILEAGE SUMMARY (Aug. 1997).

42. *See id.*

43. *See id.*

44. *See id.*

45. *See* BURKE & FRIEL, *supra* note 16, at 4-5. The Sixteenth Amendment accomplished much more than simply providing a vehicle to supply revenue to the federal government. The federal income tax also serves as a tool of social and economic policy. *See id.*

portionment among the several states, and without regard to any census or enumeration."[46]

Following the Amendment's ratification, Congress passed the 1913 Tax Act ["Act"], which defined income to include all "gains, profits, and income derived from salaries, wages or compensation for personal services of whatever kind and in whatever form paid."[47] The Act's definition of income[48] was broad, and many taxpayers turned to the courts for clarification. The courts responded by affirming the Act's expansive definition of income. In *Eisner v. MacComber*,[49] the Supreme Court interpreted the new income tax laws defining income to include "gain derived from capital, from labor, or from both combined."[50] Twenty years later, the Court restated the broad interpretation of income and explained that such broad language was necessary to facilitate the "full use of [Congressional] taxing power."[51]

The courts and the Service followed the Supreme Court's expansive definition of income.[52] A review of the Court's decision in the landmark case of *Commissioner v. Glenshaw Glass*[53] further empha-

46. U.S. CONST. amend. XVI. *See also* United States v. Wells Fargo Bank, 485 U.S. 351 (1988) ("[E]xemptions from taxation are not to be implied; they must be unambiguously proved.").

47. *See* BURKE & FRIEL, *supra* note 16, at 24 (quoting Tax Law of October 3, 1913. H.R. 3321. II. sub.B.).

48. *See* I.R.C. § 22 (1913). Unless otherwise stated, all references to the Tax Code will refer to the 1986 Tax Code. The current Code defines income in Section 61. *See* I.R.C. § 61. Specifically, Section 61 provides the definition of income as all accessions to wealth "except as otherwise provided in the Code," leaving room for the various exceptions that are mandated by Congress. *Id.* As of the date of this publication, Congress has not provided for a "frequent flyer" exception, although such legislation has been proposed. *See infra* note 191.

49. 252 U.S. 189 (1920).

50. *Id.* at 206-07. In *Eisner*, the taxpayer received a 50% stock dividend from Standard Oil of California. The Court held that no gain (and, hence, no income) had been realized from the dividend, itself; therefore, the income could not be taxed until the stock was sold. *See id.*

51. Helvering v. Clifford, 309 U.S. 331, 334 (1940). In *Clifford*, the Court considered three factors relating to the disposition of the income from a trust: (1) the short duration of the trust; (2) the fact that the grantor's wife was the trust's beneficiary; and, (3) the fact that the grantor retained true control of the trust. *See id.* at 335. Therefore, the Court determined the trust income represented taxable income to the grantor. *See id.*

52. *See, e.g.*, James v. United States, 366 U.S. 213 (1961) (holding that embezzled funds are included in taxable income of an embezzler in the year in which they were misappropriated); Cesarini v. United States, 296 F. Supp. 3 (N.D. Ohio 1969) (holding that treasure trove is income); United States v. Kirby Lumber Co., 284 U.S. 1 (1931) (holding that a discharge of debt for less than face value constituted income to the corporation).

53. 348 U.S. 426 (1955). In *Glenshaw Glass*, the Court faced the issue of whether punitive damages awarded pursuant to an antitrust suit were income under Section 22 of the 1913 Code. After determining that there were "no constitutional barrier[s] to the imposition of a tax on punitive damages," the Court considered the definition of income. *See id.* at 429. *Glenshaw Glass* stands for the proposition that mere accessions to wealth, regardless of source, are income. The determination of whether an

sizes the broad scope of income. In *Glenshaw Glass*, the Court noted that the "definition of gross income has been simplified, but no effect upon its present broad scope was intended."[54] The Court continued, "[To hold otherwise] would do violence to the plain meaning of the statute and restrict a clear legislative attempt to bring the taxing power to bear upon all receipts . . . ."[55]

The definition of income continues to sweep broadly.[56] Courts consistently follow *Glenshaw Glass* and define income to encompass "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[57] Income includes not only wages, but also employer-provided college tuition,[58] prizes,[59] treasure trove,[60] and damage awards.[61] Income is recognized whether it is received in the form of money,[62] property,[63] or services,[64] unless specifically excluded by the Code.[65]

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individual has earned income is made without consideration of the income's source. *See id.* at 431.

54. *Id.* at 432 (noting that the change in the 1954 Code that moved the definition of income from Section 22(a) to Section 61(a) may have simplified the language but did not narrow the scope).

55. *Id.* at 432-33.

56. *See* I.R.C. § 61(a) (1986). "[G]ross income means *all* income *from whatever source derived.*" *Id.* (emphasis added).

57. *Glenshaw Glass*, 348 U.S. at 431. The issues of timing and control will be addressed *infra* Part III.C.1.

58. *See* Knapp v. Commissioner, 90 T.C. 430 (1988) (holding that payments made by taxpayer's employer, on behalf of taxpayer's children, directly to the educational institution they attended were not scholarships, but taxable income); Western Reserve Academy v. United States, 801 F.2d 250 (6th Cir. 1986) (holding that employer-provided tuition was income to the employee, but not wages subject to withholding).

59. *See* I.R.C. § 74 (1994). Gross income includes amounts received as prizes and awards with the exception of qualified scholarships (defined in Section 117) and certain low-cost employee achievement awards (defined in Section 74(c)). *See id. See also* McCoy v. Commissioner, 38 T.C. 841 (1962) (holding the fair market value of goods or services received as a prize is income).

60. *See* Cesarini v. United States, 296 F. Supp. 3 (N.D. Ohio 1969) (finding treasure trove to be income).

61. *See* Commissioner v. Schleier, 515 U.S. 294 (1995) (holding that a damage award from an Age Discrimination in Employment Act (ADEA) suit was income and taxable to the recipient).

62. *See* Treas. Reg. § 1.61-1(a) (1986). Compensation to be included when determining gross income includes: wages, tips, bonuses, termination or severance pay, rewards, jury fees, contributions received by a clergyman, and interest. *See* Treas. Reg. § 1.61-2(a)(1).

63. *See* Treas. Reg. § 1.61-2(d)(1). The fair market value of property taken in payment for services must be included in gross income. If the services either are exchanged for other services, or bartered, the fair market value of the services taken in must be included in gross income. *See id.*

64. *See* Rev. Rul. 79-24, 1979-1 C.B. 60 (holding that the barter of legal services for house painting services constituted income). "[I]f services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income." *Id.*

65. *See generally* I.R.C. §§ 101-38 (1986); United States v. Wells Fargo Bank, 485 U.S. 351 (1988) (holding exemptions from taxation are not to be implied; they must

To ascertain whether airline frequent flyer benefits are income, those accessions to wealth specifically excluded from income must first be examined. Congress has determined certain accessions to wealth are not income, including: certain types of gifts,[66] rebates or purchase price reductions,[67] and certain employee fringe benefits such as employer-provided meals[68] and lodging.[69] Therefore, to determine if mileage awards are exempt from recognition as income, this Comment examines each of the above.

B. *Frequent Flyer Awards As Gifts*

Many will argue that frequent flyer benefits are merely gifts, either from the airline to the traveler[70] or from an employer to an employee.[71] When considering whether to exempt a gift from taxation, the intent of the donor is controlling.[72] The Court addressed this in-

be unambiguously proved). Items excluded from income include: proceeds from life insurance policies, *see* Treas. Reg. § 1.101-1(a)(1) (1986); inheritances, *see* Treas. Reg. § 1.102-1(a); and damages received on account of personal physical injuries, *see* Treas. Reg. § 1.104-1(c).

66. *See* Commissioner v. Duberstein, 363 U.S. 278 (1960) (holding gifts are not income to recipient so long as given with "detached and disinterested generosity"). *But see* Olk v. United States, 536 F.2d 876 (1976) (holding that gratuities are not gifts, but income to recipient).

67. *See* Max Sobel Wholesale Liquors v. Commissioner, 69 T.C. 477 (1977) (holding that the cost of an additional bottle of liquor given to a customer as added value is not income to the customer, but a business deduction to the supplier); Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956) (holding that a purchase price reduction is excluded from the purchaser's gross income, but serves to reduce his cost); Pellar v. Commissioner, 25 T.C. 299 (1955) (holding purchase of property for less than its fair market value does not, of itself, give rise to the realization of taxable income). *But see* X-L Service, Inc. v. Commissioner, 32 T.C.M. (CCH) 701 (1973) (holding payment made to agent is not rebate, but income).

68. *See* First Nat'l Bank of Chicago v. United States, 964 F.2d 1137 (Fed. Cir. 1992) (opining that meals provided on employer's premises for employees are not income to employee if provided for the convenience of employer). *But see* Commissioner v. Kowalski, 434 U.S. 77 (1977) (holding meal allowances are not excluded from income).

69. *See* United States v. Gotcher, 401 F.2d 118 (5th Cir. 1961) (holding that the value of a business trip to Germany was not income to the employee who was present at the request of his employer, but that the value of the trip was income to the employee's wife who had no business reason to attend); Rudolph v. United States, 291 F.2d 841 (5th Cir. 1962) (holding trip sponsored by employer is income to employee and spouse as the reason for trip was not primarily for business). *See also* McCann v. United States, 696 F.2d 1386 (Fed. Cir. 1983) (holding fair market value of trips made by taxpayers to "sales seminars" that were primarily social in nature are included in gross income).

70. For example, to reward a traveler who purchases a ticket for travel that is unrelated to his employment.

71. For example, an employer who allows his employee to retain mileage earned from travel that is related to his employment.

72. Distinguishing a gift from compensation is a challenge that Congress addressed in 1962 with the enactment of Section 274(b), which disallows a deduction for gifts to individuals in excess of $25. *See* I.R.C. § 274(b)(1). Furthermore, Section

tent in *Commissioner v. Duberstein*.[73] In *Duberstein*, a taxpayer did not declare as income the value of a gifted car; however, the donor of the car deducted its value from his corporate return as a business expense. The Court opined that the donor's intention, as objectively manifested by the business deduction, was critical to the analysis and held that the gift of the Cadillac was not the product of "detached and disinterested generosity"[74] and, therefore, not a tax-free gift.

Observing the holding in *Duberstein*, one may exclude from income the value of a gift only if the gift is "a transfer of property from a legally competent person (the donor) to another (the donee or beneficiary) for which the donor gets nothing of economic value in return."[75] Furthermore, the transfer must be gratuitous. "If the donor receives or previously received any 'consideration' in exchange, the gift will fail."[76] Correlating the above to frequent flyer programs, the issue becomes whether: (1) the participating airline is acting with the intention to make a gift or from purely economic motives; or, (2) an employer may make a gift of frequent flyer credits on behalf of an employee.

To determine whether mileage awards are the product of the "detached and disinterested generosity" delineated by the Court in *Duberstein*,[77] one need only review the remarks of Michael W. Gunn, Senior Vice President of Marketing for American Airlines, Inc., in a speech delivered to the American Marketing Association. "[O]ne of the cornerstones of our aggressive marketing posture has been the development of the AAdvantage program."[78] It is axiomatic that mileage awards are the product of extensive marketing research and represent only one aspect of aggressive advertising campaigns. Frequent flyer mileage programs were developed to build brand loyalty among frequent travelers[79] and, therefore, do not represent the "detached and disinterested generosity" required by *Duberstein*. Frequent Flyer benefits are not openhearted gifts, but the by-product of marketing programs designed to increase market share and revenue.[80]

102(c)(1), enacted in 1986, disallows gifts from or for an employer to an employee. See I.R.C. § 102(c)(1).

73. 363 U.S. 278 (1960).

74. *Id.* at 285 (quoting Commissioner v. LoBue, 351 U.S. 243, 246 (1956)). In *LoBue*, the Court held that the employee realized immediate taxable gain when his employer, to provide an incentive to the taxpayer-employee, transferred to him options to buy stock at substantially less than market value. The Court found that the transfers bore "not the slightest indication of the kind of detached and disinterested generosity which might evidence a 'gift' in the statutory sense . . . [and] none of the earmarks of a gift." *LoBue*, 351 U.S. at 247.

75. 33A AM. JUR. 2D *Federal Taxation*, ¶ 13102 (1996).

76. *Id.*

77. 363 U.S. 278, 285 (1960).

78. Gunn, *supra* note 4, at 2.

79. *See id.*

80. As the Court in *Duberstein* pointed out, the intent of the "donor" is paramount. *See* Duberstein, 363 U.S. at 278. To determine if the airlines consider the

The recipient of the airlines' largess may not exclude these benefits from income.

Neither are frequent flyer awards tax-exempt employee gifts, as defined by the Code.[81] Generally, gifts from employers are taxable unless: (1) the gift constitutes an employee achievement award;[82] or, (2) the gift is considered a *de minimis* fringe benefit.[83] The Code specifically provides that amounts transferred by or for an employer to an employee are taxable income and not exempted under Section 102(c).[84] Therefore, even if frequent flyer benefits are termed employee gifts they are still taxable under the current code.

C. *Frequent Flyer Awards As Rebates or Purchase Price Reductions*

It is well established that rebates or purchase price reductions are excluded from income.[85] Many travelers regard frequent flyer benefits as an opportunity to purchase future transportation at a discounted rate and argue that any free or discounted transportation purchased with earned mileage represents a rebate or purchase price reduction and not taxable income. The successful classification of frequent flyer benefits as a purchase price reduction is dependent upon three factors: (1) the identity of the purchaser; (2) the relationship between the purchaser and the traveler; and, (3) the intended use for the qualifying tickets.[86]

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frequent flyer ticket as a gift, one need only look to how the airlines treat these tickets for accounting purposes. For example, Delta Airlines carries earned, but unredeemed, miles as a contingent liability. *See* DELTA AIRLINES, INC., ANNUAL REPORT PURSUANT TO § 13 OR § 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 (June 1996).

81. *See* I.R.C. § 102(c) (1986). In general, the taxpayer may not exclude from income "any amount transferred by or for an employer to, or for the benefit of, an employee." *Id.* An exception applies to "extraordinary transfers to the natural objects of an employer's bounty . . . if the employee can show that the *transfer was not made in recognition of the employee's employment.*" *See* Treas. Reg. § 1.102-1(f)(2) (as amended in 1989) (pertaining to related parties or a familial/employee relationship) (emphasis added).

82. An employee achievement award refers to an item of tangible personal property. *See* I.R.C. § 74(c). Gross income shall not include the value of an employee achievement award if the cost to the employer does not exceed $400 annually for all awards combined. *See* I.R.C. § 274(j)(2) (1986).

83. *See* discussion *infra* Part II.D.4.

84. In general, any amount transferred by or for an employer to, or for the benefit of an employee is not excluded from gross income. I.R.C. § 102(c) (1986).

85. *See* Rev. Rul. 76-96, 1976-1 C.B. 23 (amounts paid as rebates by an automobile manufacturer to induce qualifying retail customers to purchase its cars are treated as adjustments to the purchase price). *See also* Priv. Ltr. Rul. 97-46-048 (Aug. 14, 1997).

> It is well established that if, as part of a transaction involving a purchase of property, the purchaser receives other consideration, either from the seller of the property or from a third party, as an inducement to the purchase, the fair market value of the other consideration received is treated as a rebate that adjusts the purchase price of the property.

Id.

86. *See* Priv. Ltr. Rul. 93-40-007 (June 29, 1993).

A taxpayer will realize gross income upon the receipt and use of a mileage award unless the flights that entitled the traveler to receive the award were "*undertaken for personal, nondeductible purposes.*"[87] For example, an individual purchases airline tickets and neither deducts the face value of the tickets nor receives a face value reimbursement from a third party. The traveler, by participating in the frequent flyer program, is collecting credits that will contribute towards a price reduction on future travel. Should the traveler use the credits accumulated in this manner to secure an additional ticket for a non-deductible or non-reimbursable flight, no income is realized. Clearly, under these facts, any benefits earned as a result of the purchase are rebates or purchase price reductions.

The acquisition and redemption of frequent flyer mileage for personal use is a purchase price reduction that does not generate income to the recipient.[88] It is equally as certain that benefits earned as a consequence of traveling on a company-paid ticket are not a rebate so long as the purchaser of the ticket realizes a deduction from the transaction and the frequent flyer benefits are not returned to the purchaser.[89] If persons traveling for the above-mentioned reasons accumulate frequent traveler benefits, such benefits may constitute income.

As an example, let us examine the circumstances where an employee travels for company business and uses a ticket purchased by his employer, who intends to deduct the cost of the ticket as a business expense. The employee accumulates frequent flyer credits to his personal frequent flyer account. The employee then redeems the program credits for personal enrichment and does not return the accumulated benefits to his employer. The purchaser of the qualifying tickets, the employer, has not benefited from a purchase price reduction. It is the employee who reaps the benefits and the employee who receives income.[90]

87. *Id.* (emphasis added).

88. *See* 33A AM. JUR. 2D *Federal Taxation* ¶ 8206 (1996); Meade Emory et al., *Frequent Flyer Benefits Analyzed*, 80 J. TAX'N 61 (Jan. 1994). This conclusion is premised on the theory that a purchase price reduction simply serves to reduce the cost of the tickets. However, where the beneficiary of the price reduction is not the purchaser, the person benefiting from the reduction realizes income. *See id.*

89. *See USA: Frequent Flier Awards*, FIN. TIMES, LTD., Dec. 1, 1995, at 232. If an employee fails to return the rebate amount to the employer, the fair market value of the rebate is included in the employee's gross income and is subject to withholding. *See* Tech. Adv. Mem. 95-47-001 (July 11, 1995); Treas. Reg. § 1.62-2(c)(1)-(5) (as amended in 1996).

90. *See id.*

D. *Frequent Flyer Awards As an Employer-Provided Fringe Benefit*

Gross income includes any "economic or financial benefit conferred on the employee as compensation."[91] Fringe benefits are extra benefits received by an employee in connection with his employment.[92] Ask any traveler how she characterizes frequent flyer benefits realized from business travel and she is apt to answer—employee fringe benefit.[93] It is not surprising that many employees view frequent flyer benefits as additional compensation for time spent away from family on business trips. Employers commonly allow their employees to retain frequent flyer benefits for personal use[94] and regard these benefits as a no-cost method to compensate and pacify employees who must spend personal time traveling on company business.[95] The efforts to characterize frequent flyer benefits as a non-taxable benefit, received in lieu of salary have no basis in law. Unless specifically exempted by the Code, fringe benefits are taxable to the employee, regardless of the form they take.[96]

The Treasury Department has put forth regulations that detail the fringe benefits that are excluded from income.[97] Tax exempt fringe benefits include: (1) qualified transportation fringe benefits;[98] (2) qualified moving expense reimbursement;[99] (3) no-additional-cost service;[100] (4) qualified employee discounts;[101] (5) working condition

91. Commissioner v. Smith, 324 U.S. 177, 181 (1945) (affirming Tax Court's decision that the difference between the market value and the option price of stock given to employee by employer was taxable as income when option was exercised).

92. *See* 33A AM. JUR. 2D *Federal Taxation* ¶ 8200 (1996). Unless exempted by a specific provision of the Code, fringe benefits represent taxable income to the employee, regardless of what form the fringe benefit takes. *See id.*

93. *See Airlines Not Required to Report Issuance of Travel Bonus Awards,* 34 TAX MGMT. MEM. 369 (1993). An employer-provided free or discounted commercial airline ticket is a taxable fringe benefit; however, regulations have not been put forth to address the status of employer-provided frequent flyer miles. *See id.*

94. *See* Joseph C. Mandarino, *Taxation of Frequent Flyer Awards*, 43 LA. BUS. J. 494 (Feb. 1996) (discussing the ramifications of Technical Advice Memorandum 95-47-001 in light of the fact that most employers allow employees to retain earned frequent flyer miles); Donmoyer & Stratton, *supra* note 6, at 1160 (citing the administrative difficulties involved should the Service be forced to determine the value of frequent flyer miles retained for personal use).

95. *See Miles to Go*, WALL ST. J., Dec. 1, 1995, at A14. The airlines' fare structures usually require an over-the-weekend stay to qualify for the least expensive airfare. *See* Strong, *supra* note 4. Cost-conscious employers require employees to take advantage of these price reductions; the result is less time at home. *See id.*

96. *See* Treas. Reg. § 1.61-21(a)(1) (as amended in 1992).

97. 33A AM. JUR. 2D. *Federal Taxation* ¶ 8201 (1996).

98. *See* I.R.C. § 132(a)(5) (1986). This includes transportation on a commuter highway vehicle, transit passes, and qualified parking. *See* I.R.C. § 132(f)(1)(A)-(C).

99. *See* I.R.C. § 132 (a)(6). This includes any money received from an employer as payment (or reimbursement) for expenses otherwise deductible as a moving expense under Section 217. *See* I.R.C. § 132(g).

100. *See* I.R.C. § 132(a)(1). This benefit refers to any service provided by an employer to an employee if such service is offered for sale to customers in the ordinary

fringe benefits;[102] and (6) *de minimis* fringe benefits.[103] Neither the qualified transportation fringe benefit[104] nor the qualified moving expense reimbursement[105] pertains to frequent flyer benefits and, therefore, will not be addressed. This Comment considers the other benefits in turn.

1. No-Additional-Cost Service

Frequent flyer benefits are not a tax-exempt no-additional-cost service.[106] No-additional-cost services represent a discounted distribution of the employer's product to an employee.[107] To qualify as a no-additional-cost service: (1) the benefit must be provided by an employer to an employee;[108] (2) the benefit must be provided only for that employee's personal use;[109] (3) the provided service must be offered for sale by the employer to its customers in the ordinary course of business;[110] and, (4) the employer may not incur additional cost in providing the service to the employee.[111] Frequent flyer miles do not meet any of the above criteria. The exclusion from income of such no-additional-cost benefits clearly apply only to current, retired, or dis-

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course of business and the employer incurs no substantial additional cost in providing the service to the employee. *See* I.R.C. § 132(b)(1), (2).

101. *See* I.R.C. § 132(a)(2). The term refers to a discount given to an employee that consists of qualified property or services. *See generally* I.R.C. § 132(c).

102. *See* I.R.C. § 132 (a)(3). Working condition fringe benefits refer to property or services provided to an employee by an employer, such that would be deductible under Section 162 or Section 167. *See* I.R.C. § 132(d).

103. *See* I.R.C. § 132 (a)(4). This refers to any property or service, the value of which is so small so as to make accounting for it unreasonable. *See* I.R.C. § 132(e)(1).

104. *See supra* note 98 and accompanying text.

105. *See supra* note 99 and accompanying text.

106. *See* Charley v. Commissioner, 91 F.3d 72, 74 (9th Cir. 1996). The Court in *Charley* rejected the taxpayer's argument that frequent flyer miles were a "no additional cost service" and commented that "Truesdale [the employer] obviously did not offer frequent flyer miles to customers in the ordinary course of its business; thus, the travel credits at issue cannot be deemed an excludable no additional cost service." *Id.*

107. *See* McKean v. United States, 33 Fed. Cl. 535 (1995) (holding that the exclusion for no-additional-cost services extends only to those no-additional-cost services provided by an employer to a current, retired, or disabled employee).

108. *See* Treas. Reg. § 1.132-1(b)(1)(i)-(iii) (as amended in 1992).

109. The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) provided that a no-additional-cost service may be made available to an airline employee, the employee's spouse, the employee's child, and the employee's parents as well as to employees of airline-related companies (e.g. travel agencies). *See* 54 F.R. 28576-28579 (1989); Treas. Reg. § 1.132-1(b)(1) (as amended in 1992).

110. An employer's line of business is determined by reference to the Enterprise Standard Industrial Classification (ESIC) manual. *See* Treas. Reg. § 1.132-4(a)(2)(i) (as amended in 1989).

111. The term "cost" includes revenue that is foregone because the service is provided to an employee rather than a paying customer. *See* Treas. Reg. § 1.132-2(a)(5)(i) (as amended in 1989).

abled employees.[112] Inasmuch as frequent flyer program miles are not offered to the airlines' employees,[113] it follows that the benefit is not for the employees' personal use, as mandated by the statute.[114] Frequent flyer miles are distributed by the airlines to the airlines' customers and not airline employees; therefore, these benefits do not qualify as a non-taxable, no-additional-cost service.

2. Employee Discount

An employer will often make his product available for purchase by his employee at a discounted price.[115] The Code does not treat employee discounts as taxable income unless the discount relates to non-qualified property.[116] Qualified property is "any property or services that are offered for sale to customers in the ordinary course of the line of business of the employer in which the employee performs substantial services."[117] Under the above provisions, airline employees may certainly reap the benefit of free or reduced rate travel and characterize it as an employee discount.[118] Frequent flyer discounts do not represent an employee discount in the hands of the traveler, who is not an airline employee.[119]

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112. *See* McKean v. United States, 33 Fed. Cl. 535, 539 (1995) (holding that a damage award that included compensation for nontaxable employee fringe benefits was taxable as income).

113. *See* GUIDE, supra note 2, at 49. "[C]ertain airline tickets are not eligible for earning mileage credit . . . travel agency/industry reduced rate tickets . . . ." *Id.*

114. *See* 26 C.F.R. § 1.132-2(a)(1) (1994). When considering the character of the air travel benefit, the Service will ascertain whether inventory that would normally be available for sale to the airline's customers is compromised by an employee's exercise of the benefit. *See* 26 C.F.R. 1.132-2(c). The regulations cite the following example:

> Assume that a commercial airline permits its employees to take personal flights on the airline *at no charge* and receive *reserved* seating. Because the employer *forgoes potential revenue* by permitting the employees to reserve seats, employees receiving such free flights are not eligible for the no-additional-cost exclusion.

Id. (emphasis added).

115. A "qualified employee discount" is any employee discount with respect to qualified property or service provided by an employer to an employee for use by the employee to the extent that the discount does not exceed either: (1) the gross profit percentage multiplied by the discounted price offered to customers; or, (2) twenty percent off the discounted price offered to customers. *See* Treas. Reg. § 1.132-3(a)(i)-(ii) (1989).

116. *See id.* Qualified property does not include real property or personal property of a kind usually held for investment. *See* Treas. Reg. § 1.132-3(a)(2)(ii) (as amended in 1989).

117. Treas. Reg. § 1.132-3(a)(ii)(2) (as amended in 1989).

118. *See* Priv. Ltr. Rul. 91-31-054 (May 8, 1991).

119. The Service recognizes that an employee discount may apply to property that is provided indirectly through a third party. *See* 26 C.F.R. § 1.132-3(a)(5) (1994). One should not misinterpret this provision. The regulation cites, as an example, the situation where "an employee of an appliance manufacturer may receive a qualified employee discount on the manufacturer's appliances purchased at a retail store that offers such appliances for sale to customers." *Id.* Even if one would argue that an airline's customers may somehow qualify for such a discount, the regulation continues

3. Working Condition Fringe Benefit

The value of a "free" airline ticket is excluded from income as a working condition fringe benefit[120] only if that ticket is used by the employee[121] for the convenience of his employer.[122] Frequent flyer benefits may not be classified as a working condition fringe benefit. The traveler, who accumulates frequent flyer mileage while flying on behalf of his employer and exchanges the miles for a personal-use ticket has realized income.[123] The personal-use ticket does not represent a fringe benefit provided solely for the employer's convenience;[124] therefore, it represents income to the employee.

4. *De Minimis* Fringe Benefit

Any property or service provided to an employee will qualify as a non-taxable *de minimis* fringe benefit if the fair market value of the property or service is so small that accounting for the benefit would be unreasonable or impractical.[125] When determining if the benefit qualifies as a *de minimis* fringe benefit, the Service considers the frequency

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to clarify the value of such a discount, which value may not exceed 20%. *See* 26 C.F.R. § 1.132-3(e).

> Thus, if the price charged to customers for the flight taken is $300 (under restrictions comparable to those actually placed on travel associated with the employee airline ticket), $60 [representing 20% of $300] is excludible from gross income as a qualified employee discount and $240 is includible in gross income.

Id.

120. A working condition fringe benefit is any property or service provided to an employee by an employer to the extent that, if the employee had paid for the benefit, the amount paid would be allowable as a deduction under Section 162 (trade or business expenses) or Section 167 (depreciation). *See* Treas. Reg. § 1.132-5(a)(1) (as amended in 1996).

121. With respect to the working condition fringe benefit, the term, "employee" is defined as:

> (i) Any individual who is currently employed by the employer,
> (ii) Any partner who performs services for the partnership,
> (iii) Any director of the employer, and
> (iv) Any independent contractor who performs services for the employer.

26 C.F.R. § 1.132-1(b)(2).

122. *See* Tech. Adv. Mem. 95-47-001 (Nov. 24, 1995).

123. *See* 26 C.F.R. § 1.132-5(t). Insofar as travel for non-business reasons is not deductible under either Section 162 or Section 167 of the Code, the traveler must include in gross income the value of the benefit. *See id.*

124. *Compare* Peoples' Life Ins. Co. v. United States, 373 F.2d 924 (Ct. Cl. 1967) (holding that convention expenses paid by employer for an annual convention the company considered an important ingredient of its total effort to build a stable work force did not constitute income to those attending), *with* United States v. Gotcher, 401 F.2d 118 (5th Cir. 1968) (holding that an expense-paid trip to Germany for an employee and his spouse was not income to the employee, who attended at the request of his employer, but was income as to the portion of the cost to provide transportation and accommodations to his wife).

125. *See* Treas. Reg. § 1.132-6(a) (as amended in 1992).

with which the benefit is dispensed as well as the cost of the benefit.[126] *De minimis* fringe benefits include items of low fair market value such as employer-provided coffee, soft drinks, or newspapers.[127] The Service is adamant that cash or cash-equivalent gifts may not be excluded from income as a *de minimis* fringe benefit.[128] Therefore, a Christmas fruitcake may be considered a *de minimis* fringe benefit, but a Christmas gift certificate for the fruitcake store is not.[129]

To date, the Service has not issued specific regulations resolving the relationship between *de minimis* fringe benefits and frequent flyer benefits. Case law provides only faint guidance and addresses only those circumstances where frequent flyer benefits have been exchanged for cash. In *Charley v. Commissioner*,[130] the Service, presented with the circumstance of a sale of frequent flyer credits, argued that the proceeds from the sale represented taxable income from the sale of property or, in the alternative, a taxable fringe benefit to the employee.[131] The Tax Court declined to explore the Service's alternative argument and held that the taxpayer incurred income from the sale of property.[132]

At first glance, it appears that frequent flyer benefits could fall within the scope of the regulations describing *de minimis* fringe benefits. The cost to the employer to extend these benefits to the employee is minimal—after all, the employer does not control the

126. *See id.* For example, a benefit that is only extended to one employee is neither infrequent nor minimal with respect to that employee, even if it is with respect to the entire workforce. *See* Treas. Reg. § 1.132-6(b)(1).

127. *See* Treas. Reg. § 1.132-6(e)(1). Examples of fringe benefits that are not *de minimis* include: season tickets to sporting or theatrical events, employer-provided automobile, country club memberships, and employer-provided health insurance on persons other than the employee herself. *See* Treas. Reg. § 1.132-6(e)(2).

128. *See* Treas. Reg. § 1.132-6(c). For example, the provision of cash to an employee to enable the employee to purchase a theater ticket that would itself be excluded as a *de minimis* fringe, under Treasury Regulation § 1.132-6(e)(1), is not excludable. *See id.*

129. The value of any fringe benefit, the accounting of which would be neither unreasonable nor impractical, is included in gross income. Therefore, the provision of a cash fringe benefit is excludable from income only under very limited circumstances of meal money or bus fare. *See* Treas. Reg. § 1.132-6(c) (as amended in 1992); Treas. Reg. § 1.132-6(d)(2).

130. 66 T.C.M. (CCH) 1429 (1993), *aff'd in part and rev'd in part*, 91 F.3d 72 (9th Cir. 1996). In *Charley*, the taxpayer's company purchased first-class airline tickets for business travel and invoiced their client for the cost of the tickets. The taxpayer then "downgraded" the tickets to a lower airfare and used frequent flyer credits to "upgrade" back to first class. The taxpayer then pocketed the difference between the paid first class ticket and the "upgraded" first class ticket. *See id.*

131. The *Charley* court also opined that the travel account was neither a tax free gift nor a no-additional-cost service. *See Tax Turbulence for Frequent Flyer Mileage Cash-Out*, 25 TAX'N FOR LAW. 179 (1996).

132. *See id.* at 2. On appeal, the Ninth Circuit affirmed the decision of the Tax Court, did not speculate on the prospect of frequent flyer credits as fringe benefits, and held the taxpayer had received income from the sale of property. *See* Charley v. Commissioner, 91 F.3d 72 (9th Cir. 1996).

accumulation or distribution of the benefit.[133] Unresolved issues of timing and valuation have effectively stymied previous attempts by the Service to tax frequent flyer benefits that have not been exchanged for cash or some other compensation.[134] The value of these benefits should not be summarily dismissed. Frequent flyer benefits can be substantial and, therefore, not *de minimis*. The question naturally follows: What is the value of the benefit and at what point in time is that value determined?

III. VALUATION OF FREQUENT FLYER AWARDS

The Service is sending mixed messages to the traveling public. Although the Service has always maintained that the redemption and use of frequent flyer benefits may lead to gross income,[135] enforcement has been spotty and guidance restricted.[136] However, the Service has clearly spoken with respect to an analogous transaction whereby prize points were offered as a sales incentive.[137] In 1970, the Service considered the tax consequences of prize points awarded by a distributor to its dealers' employees that were redeemed for merchandise prizes listed in a catalogue of awards.[138] The Service ruled that the value of the prizes constituted gross income.[139] In so ruling, the Service reiterated the basic premise of Section 61(a) of the Internal Revenue Code defining gross income as "all income from whatever source derived, except as specifically excluded by other provisions of the Code."[140] The similarity between the "prize points" detailed

133. The traveler is responsible for providing her frequent flyer number to the airline. *See* GUIDE, *supra* note 2. Furthermore, the program member is the only person who may physically redeem the credits for transportation, even though she may transfer the benefit to another person. *See id.*

134. *See* Donmoyer & Stratton, *supra* note 6, at 1161. Even if the Service can sustain the position that frequent flier mileage constitutes income, taxpayers may still argue that the value of the mileage is minimal and the benefit simply a *de minimis* fringe. *See id.*

135. *See* Coppinger et al., *supra* note 11.

136. *See id.*

137. *See* Rev. Rul. 70-331, 1970-1 C.B. 14. The facts of this ruling are strikingly similar to those in a typical frequent flyer transaction. A distributor instituted a sales incentive program for the employees of the independent dealers handling his products. The dealer kept records of the individual employee's sales figures, forwarded these figures to the distributor, who awarded the appropriate number of "prize points." *See id.*

138. *See id.* The salesmen selected the desired prize from a catalogue of awards. The prize points were able to be redeemed only for gifts from the catalogue, and not for cash. *See id.*

139. *See id.* The Service cited Section 1.61-2(d)(1) in holding that if services are paid for other than in money, the *"fair market value of the property or services taken in payment* must be included in income." *Id.* (emphasis added). *See also* Rev. Rul. 80-52, 1980-1 C.B. 100 (holding that taxpayers received income in the form of a valuable right (as represented by barter credit units) to purchase goods).

140. *See* Rev. Rul. 70-331, 1970-1 C.B. 14. The fair market value of the prize points are included in gross income at the earlier of the time the prize points are paid or

above and frequent flyer credits cannot be discounted. Why has the Service not acted to tax these accessions to wealth?

According to Air Transport Association[141] President, Carol Hallett, "There is a long history of failure [of the Service] to announce any position with regard to the valuation, taxability, or reportability of income generated by frequent flyer miles."[142] The Service has consistently maintained that benefits earned from frequent flyer programs can result in gross income; however, "since the value of the benefit is not fixed or determinable, it is not reportable."[143] Although it is possible that the service would choose to shy away from the valuation question, such a reticence on the part of the Service is uncharacteristic, especially when one considers the plethora of cases,[144] rulings,[145] and memoranda[146] that address the issue of valuation. This Part presents three possible valuation methods for ascertaining the value of income earned when redeeming frequent flyer benefits: (1) fair market valuation; (2) airline valuation; and (3) a proposed valuation incorporating both fair market and airline tariff considerations.

A. *Fair Market Valuation*

In instances where the Service has taken a position on the taxability of frequent flyer benefits, the value of the benefit has been assessed at its fair market value.[147] In *Charley v. Commissioner*,[148] the taxpayer challenged an income tax deficiency resulting from the conversion of

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reduced to unfettered possession by the salesman. Furthermore, the Service held that the value of the prize points was not wages for Federal employment tax purposes. *See id.* It is interesting to note that the Service has ruled that, under Section 6041(a), airlines are exempted from the filing of informational returns with respect to frequent flyer benefits as well. *See* Priv. Ltr. Rul. 94-40-007 (June 29, 1993).

141. An industry watchdog group.

142. *Frequent Flyer Awards Return to IRS Scrutiny—If Only Briefly,* AIRLINE MARKETING NEWS, Dec. 6, 1995.

143. Coppinger et al., *supra* note 11.

144. *See, e.g.*, Alvary v. United States, 302 F.2d 790 (2d Cir. 1962) (holding that the small number of willing buyers does not preclude a finding that property has value); May v. McGowan, 194 F.2d 396 (2d Cir. 1956) (finding that stock in an insolvent corporation should have a fair market value of zero); Guggenheim v. Helvering, 117 F.2d 469 (2d Cir. 1941) (discussing the effect on estate and gift taxes of the determination that property has no value).

145. *See, e.g.*, Rev. Rul. 54-402, 1958-2 C.B. 15(i) (distinguishing between property that has no value and property that has unascertainable value); 29 T.C.M. (CCH) 528 (1970) (confirming that 700 pounds of suppositiories were found to have no value where the taxpayer was unable to find either a willing buyer or donee).

146. *See, e.g.*, 29 T.C.M. (CCH) 528 (1970).

147. Fair market value is defined as "the amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts." BLACKS LAW DICTIONARY 597 (6TH ED. 1990). *See, e.g.*, D'Ambrosio, *supra* note 7 (detailing assessment of tax based on coupon broker's rate of one and one-half cents per mile); Sheldon I. Banoff & Richard M. Lupton, *How Not To Deal With Frequent Flyer Miles for Tax Purposes*, 85 J. TAX'N 319 (Nov. 1996).

148. 91 F.3d 72 (9th Cir. 1996).

frequent flyer miles into cash. In affirming the Tax Court's decision that the taxpayer had earned unreported income, the Ninth Circuit acknowledged that the tax treatment of frequent flyer bonus programs is still under consideration.[149] The court determined the amount of cash received to be the value of the frequent flyer benefits sold.[150]

In *United States v. Armstrong*,[151] a National Basketball Association (NBA) referee was indicted on counts of making false statements concerning his income and obstructing the due administration of the Internal Revenue laws.[152] The indictment followed allegations that he purchased full-fare tickets, received appropriate reimbursement from his employer, and then "downgraded"[153] the tickets, pocketing the difference in price.[154] The court opined that the taxpayer's intent was to cause the NBA to under report his income and over report his travel expenses.[155] The taxpayer was assessed tax on the income realized, to the extent of the overcharge to the NBA.

Under different factual circumstances, the Service instructed six employees of a Florida-based marketing company to pay from $200 to $1,300 in back taxes owed as a result of the sale of frequent flyer miles.[156] The tax audit was triggered by an employee's tax return that indicated the employee received payments from his employer in exchange for frequent flyer miles.[157] After noting that other employees at the same company had also received payments, which they failed to report, the Service sent deficiency notices.[158] The frequent flyer benefits were valued using a "coupon-broker"[159] standard of 1.5 cents per mile, sparing the Service from having to respond directly to the question of the valuation of frequent flyer benefits.

In each of the above situations, the Service accepted as true the value placed upon frequent flyer benefits by program members. The value of the frequent flyer credits to the defendants in *Charley* and *Armstrong*, equaled the difference between a first class ticket and a coach, or discounted coach, ticket. The value of the frequent flyer credits to the employees who sold their miles back to their employer was assessed at a specific amount per mile. The Service willingly accepted these valuations.

149. *See id.* at 74.

150. *See id.*

151. 974 F. Supp. 528 (E.D. Va. 1997).

152. *Id.* at 530.

153. *See id.* at 528. Down grading is the process whereby high-priced airline tickets are exchanged for discounted fare tickets on the same flight. *See id.*

154. *See id.* at 530-31.

155. *Id.* at 531.

156. *See* D'Ambrosio, *supra* note 7, at 1.

157. *See id.*

158. *See id.*

159. *See id.*

B. *Airline Valuation*

The various airlines also attach value[160] to frequent flyer benefits, but the value varies with the circumstances of theft or redemption.[161] For example, in *United States v. Loney*,[162] the defendant appealed his conviction of wire fraud resulting from his participation in a scheme to defraud American Airlines through a bogus mileage scheme.[163] In upholding the conviction, the Fifth Circuit opined, "There is no question that a flight award coupon is something of value, for it can be used to obtain free flight tickets."[164] Later that year, in *United States v. Mullins*,[165] the Ninth Circuit addressed the value of stolen frequent flyer benefits. In *Mullins*, travel agents were convicted of mail and wire fraud resulting from the unauthorized electronic transfer of frequent flyer credits. The district court estimated the loss to American Airlines at between $500,000 and $1,000,000.[166]

In *Northwest Airlines, Inc. v. Ticket Exchange*,[167] an airline brought action against a ticket broker for damages resulting from the unauthorized sale of frequent flyer credits. Of particular note is the airline's measurement of damages. Northwest argued it was entitled to a full fare payment for every ticket sold.[168] Likewise, in *Transworld Airlines, Inc. v. American Coupon Exchange, Inc.*,[169] an airline sought damages resulting from the fraudulent sale of frequent flyer benefits. James Smith, Director of Business Marketing for Transworld Airlines, testified at the trial and assessed the lost revenue that directly resulted from the unauthorized sale of frequent flyer benefits as follows:

> American Coupon Exchange's activities are extremely damaging to TWA for a number of reasons. First, TWA is required to provide a free seat on its aircraft to a person who is not entitled to free transportation. . . . Fares on TWA for such transportation vary with the destination, but generally range between $3,000 and $5,000. Thus,

160. In *United States v. Schreier*, 908 F.2d 645, 647 (10th Cir. 1990), the court agreed that airline frequent flyer credits were the property of the airline and had value.

161. It is not within the scope of this Comment to address all instances of valuation of frequent flyer benefits by the sponsoring airlines. This Comment attempts only to recognize that these benefits indeed have an ascertainable taxable value.

162. 959 F.2d 1332 (5th Cir. 1992).

163. The defendant was convicted of twelve counts of wire fraud resulting from a scheme to add bogus mileage to AAdvantage accounts and to issue award coupons based upon that mileage. *See id.* at 1334.

164. *See id.* at 1336 (internal quotations omitted).

165. 992 F.2d 1472 (9th Cir. 1993).

166. *See id.* at 1475. According to American Airlines, 546 airline tickets were issued fraudulently. Airline employees, testifying at trial, estimated the value of the stolen tickets to be *more than 1.3 million dollars*. *See id.* at 1475 n.3 (emphasis added). The court gave no reason for the substantial reduction in their damage estimate. *See id.* at 1479.

167. 793 F. Supp. 976 (W.D. Wash. 1992).

168. *See id.* at 980.

169. 913 F.2d 676 (9th Cir. 1990).

> for every brokered certificate TWA is not able to detect and confiscate, there is a loss of revenue in that amount.[170]

Each of the airlines involved had established a fixed value for their frequent flyer product. It is interesting to note that the value set by American Airlines, Northwest Airlines, and Transworld Airlines directly correspond to the value of the product that could be "purchased" with the stolen benefits. Hence, the various airlines treat their frequent flyer credits as "dollars" to be spent purchasing a particular product.

C. *Proposed Method of Valuation and Timing*

1. Valuation

This Comment proposes a method of valuation that will provide a uniform method to calculate the income realized on the redemption and use of frequent flyer benefits.[171] Frequent flyer programs, regardless of sponsoring airline, offer similar benefits. Currently, one may redeem frequent flyer miles both for free airline tickets and free business or first class upgrades.[172] Pricing terms within the airline industry are uniform; airline tickets are classified as involving either restricted or unrestricted capacity airfares.[173] Airline upgrades are achieved either from restricted or unrestricted tickets to either business or first class tickets.[174]

The general practice is to allot fewer discount seats during peak periods than during slower travel periods.[175] The airline industry was one of the first to recognize that the difference between profit and loss turned on managing the perishable seat inventory to maximize revenue.[176] To accomplish this task, airlines have developed complex inventory control systems, known as "yield management systems."[177]

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170. *Id.* at 692.

171. This Comment suggests that frequent flyer benefits represent income only under the circumstances described in Part II. Frequent flyer miles earned (and spent) for personal, un-reimbursed, non-deductible travel do not constitute income to the traveler. *See* Priv. Ltr. Rul. 93-40-007 (June 29, 1993).

172. It is beyond the scope of this Comment to discuss other possible airline products. However, it is the author's contention that the analysis is applicable to all products.

173. *See* NEWSLETTER, *supra* note 3.

174. *See id.*

175. *See* Strong, *supra* note 4.

176. *See United Unveils "Deep Blue"-Powered Yield Management System*, AVIATION DAILY, Nov. 7, 1997, at 231. Paine Webber analyst, Sam Buttrick, has commented that airlines are unusual among industries in that they charge different rates to customers for a largely undifferentiated product. *See id.*

177. *See id.* United Airlines unveiled its yield management system that uses an IBM parallel processing system to manage seat inventory. "The Orion system will provide the company's inventory management department with much greater detail, enabling them to make the best possible decisions on how to allocate United's seat inventory to generate the greatest possible amount of revenue." *Id.* (quoting Bob Bongiorno, United's director of research and development).

These sophisticated computer programs assist managers whose job it is to determine exactly how many discounted seats to allow on each flight.[178]

Yield management systems permit airlines to manage the receipts earned on each flight and are updated continually to maximize revenue.[179] Variables, including the destination, time of travel, and historical utilization data, are programmed into the airline's system and determine whether airplane seats are to be made available, with or without restrictions, to discount flyers.[180] The physical allocation of airline seats to those passengers using frequent flyer credits is no different than the allocation of discounted seats to fare-paying passengers. For example, during certain peak travel times, such as the dates around major holidays, the airline may choose not to allot any seats for use by frequent flyers. Or, seats may be allotted only if a mileage "premium" is paid.[181]

From this system to allocate the numbers of seats available to frequent flyers, the airline may extrapolate the fair market value of the frequent flyer ticket "sold" by referencing the restricted or unrestricted "inventory" used to confirm the reservations. For example, a restricted capacity frequent flyer ticket should carry no more value than a similarly-restricted ticket that is available for purchase at the time the free transportation is confirmed. If, at the time of ticket issuance,[182] the least expensive airfare available for purchase was $250.00, then the value of the restricted frequent flyer ticket would be $250.00.[183] Similarly, frequent flyer credits redeemed for an unrestricted capacity frequent flyer ticket would be valued the same as an unrestricted capacity purchased ticket. This method of valuation will result in frequent flyer credits being valued at fair market value at the time of ticket issuance.[184]

178. United Airlines anticipates the installation of the Orion system will add between 50-100 million dollars to its annual revenue. *See id.*

179. American Airlines' yield management system, Sabre, houses one billion air fares and is capable of processing 5,450 transactions per second. *See United Unveils "Deep Blue"-Powered Yield Management System*, AVIATION DAILY, Nov. 7, 1997, at 231.

180. *See* GUIDE, *supra* note 2.

181. *See* NEWSLETTER, *supra* note 3. The miles required to confirm a reservation that is unrestricted are understandably significantly greater that those required to confirm a restricted availability ticket. *See* GUIDE, *supra* note 2 at 48.

182. As no ticket price is *guaranteed* until the ticket has been actually purchased, no valuation of a frequent flyer ticket would be ascertained until the actual ticket is issued. *See* Strong, *supra* note 4.

183. It is not economically efficient to suggest that a person who is using frequent flyer miles would value them more highly than the least expensive airfare, for if the miles were worth more than a purchased ticket, the traveler would simply save the miles for a later time and, instead, purchase and pay for a ticket.

184. *See* 33A AM. JUR. 2D *Federal Taxation* ¶ 8203 (1996). Fair market value is the amount that an individual would pay for the product in an arm's length transaction. *See* Treas. Reg. § 1.61-21(b)(1) (as amended in 1992).

Frequent flyer upgrade awards should be valued in much the same manner. Upgrades to business or first class from restricted capacity tickets should be valued at the actual difference between the airfare paid and the business or first class airfare. Upgrades from unrestricted capacity tickets should be valued at the actual difference between that airfare and the business or first class fare. Alternatively, the airlines may wish to designate a "special" airfare to be used by frequent flyer program participants to purchase an upgrade from an unrestricted ticket to first class.[185]

The paramount consideration, when determining the fair market value of free or upgraded tickets, is consistency. The technology is available to print the value on the ticket itself.[186] Taxpayers should be made aware of the extent of their potential tax liability at the time they make their decision to take advantage of frequent flyer benefits. Therefore, transportation "purchased" using frequent flyer credits should indicate a price on the face of the ticket. This receipt would assist the taxpayer with preparation and documentation.

The responsibility for determining the deductibility of these trips remains with the individual taxpayer. Under Section 6041 of the Internal Revenue Code,[187] airlines are currently exempt from the filing of information returns relating to frequent flyer awards, and there is no reason to change that policy. Ticket receipts and mileage statements provide the taxpayer with the information she needs to determine the value of any income earned as a result of the redemption of frequent flyer credits.

2. Timing

As with the determination of valuation, the question of timing directly affects frequent flyer benefits. When should the income be realized, at the time the credits are earned or at the time they are redeemed for airline tickets? This Comment proposes that frequent flyer benefits be valued at the time they are redeemed for airline tickets.[188] If valued at that time, only those miles actually redeemed will be included, any unused miles will remain in the traveler's account unvalued until redeemed—or they expire unused.

185. Delta Airlines offers a "FFY" fare—an upgrade from full coach to first class for a nominal charge. *See* Strong, *supra* note 4.

186. *See id.* Currently, frequent flyer tickets indicate either $0.00 or "award" in the price box.

187. *See* Priv. Ltr. Rul. 94-40-007 (June 29, 1993).

188. When the value of the property in question cannot be ascertained readily, valuation is postponed until a value may be determined. *See* Burnett v. Logan, 283 U.S. 404 (1931). *See also* Erwin v. United States, 580 F.2d 863 (5th Cir. 1978) (holding that an option to purchase property had no ascertainable value before it was exercised); Robinette v. Helvering, 318 U.S. 184 (1943) (holding that a highly contingent reversionary interest had unascertainable value).

Valuing miles at the time of redemption eliminates the virtual Pandora's box of problems that would arise if miles are valued at the time of receipt.[189] If the frequent flyer is taxed on the value of the miles only when redeemed, there is no potential loss to consider if the miles expire unused.[190] Furthermore, the mere acquisition of a large number of miles would not trigger estimated tax penalties for failure to make estimated tax payments.[191] Only the actual issuance of tickets would trigger a potential tax liability. Finally, if the program participant earns "points" from, for example, a hotel program, but converts them into credits in an airline's program, there is no realization event, and, therefore, no valuation until the points are redeemed for an actual product.[192]

CONCLUSION

Issues of valuation and timing are easily resolved. For many travelers, nothing more is needed than the maintenance of separate frequent flyer accounts for personal and business travel. Therefore, it is time for the Service to present and enforce a comprehensive plan to assess taxes on these accessions to wealth. To continue to turn a deaf ear, while retaining the right to selectively enforce the law, is predatory and unfair to taxpayers.

Today, tax managers and corporate executives cannot, with certainty, prepare for an audit; what would appear to be permission may actually be prohibition. The taxpayer becomes the victim. Unless Congress takes the steps to exempt frequent flyer awards from income,[193] it is time for the Service to step up—and enforce.

Sharon Alice Pouzar

189. *See* Banoff & Lupton, *supra* note 147, at 319.
190. *See id.*
191. *See id.*
192. *See* Rev. Rul. 70-331, 70-1 C.B. 14 (confirming that the fair market value of prize points awarded to a salesman is to be included as gross income at the time the prize is redeemed). *See also* Weigl v. Commissioner, 84 T.C. 1192 (1985) (holding the transfer to the shareholder of warrants constituted a dividend taxable to the shareholder at the time a fair market value for the warrants could be determined).
193. It is interesting to note that Rep. Barbara B. Kennelly, D-Conn., has twice introduced legislation to prohibit the taxation of frequent flyer benefits. *See* H.R. 3111, 104 Cong. § 2 (1996); H.R. 533, 105th Cong. § 2 (1997). To date, neither proposed bill has been acted upon.