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Surrogate Taxation and the Second-Best Answer to the In-Kind Benefit Valuation Riddle

Jay A. Soled[*]

For well over a century, theorists have debated how the receipt of in-kind benefits, such as meals and lodging furnished for the convenience of an employer and business entertainment opportunities, should be taxed. While debate participants have generally agreed that the receipt of such in-kind benefits constitutes income, the question has remained about whether to value such benefits at fair market value or at the recipient's subjective value or to use some other metric. Because of administrative considerations in determining the tax base, the Internal Revenue Code (Code) historically used a binary approach: either include the in-kind benefit at its fair market value or exclude it entirely.

This analysis explores an intermediate approach known as surrogate taxation, a process by which one taxpayer bears another taxpayer's tax burden. Over the past several decades, surrogate taxation has evolved and grown in prominence. It is now commonly used to tax the receipt of in-kind benefits (and other forms of income) in ways that produce outcomes that are more administrable, equitable, and efficient than the Code's binary approach. While this analysis concludes that direct taxation is preferable to surrogate taxation, administrative concerns sometimes dictate that surrogate taxation is often a necessary substitute.

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I. INTRODUCTION

Problems associated with taxing the value of items received in kind rather than in cash have historically bedeviled and baffled both income tax theorists and administrators. Simply put, the problem is as follows: When taxpayers receive cash payments, such as salary emoluments, they have unlimited consumption opportunities, signaling that a tax on the amounts they received is appropriate. Conversely, when taxpayers receive in-kind benefits, such as business gifts, their consumption choices are typically constrained, signaling that a tax on the fair market value of the items they received is inappropriate. Nevertheless, in the latter case, there is little doubt

that the taxpayer has experienced a taxable accretion to wealth. But a riddle emerges: how much?

In his foundational treatise, *Personal Income Taxation*, Henry C. Simons devoted an entire chapter to addressing this issue and attempting to solve the valuation riddle.[1] Indeed, he tailored the precise terms of his famous definition of income partially to account for the receipt of in-kind benefits. Income, he asserted, consisted of the "market value of rights exercised in consumption" plus the change in wealth over the accounting period.[2] Simons's definition not only indicates that the value of things received beyond cash must be included in income, it also conveys Simons's strong sense that the receipt of goods and services likewise constitutes income, and the appropriate metric for including services in income is their fair market value.

The Internal Revenue Code (Code) generally adheres to Simons's *income* definition. First, the Code defines the term *income* without any limitation,[3] and the Treasury Regulations affirm that "[g]ross income . . . includes income realized in any form, whether in money, property, or services."[4] Second, in the context of taxable transactions, the Treasury Regulations specifically declare that the

1. HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 110–25 (1st ed. 1938). In chapter 5, Simons addresses the difficulties of resolving this problem. However, Simons's discussion of this problem is not confined to chapter 5 alone; it is also featured prominently in chapter 2, which explains the famous Haig-Simons income definition. *See id.* at 61–62. Other tax commentators have dwelled on this issue as well. *See, e.g.*, Daniel I. Halperin, *Business Deduction for Personal Living Expenses: A Uniform Approach to an Unsolved Problem*, 122 U. PA. L. REV. 859, 880–85 (discussing "psychic benefits," such as those of the theater critic who enjoys plays, the teacher who likes to teach, or the lawyer who enjoys arguing cases).

Aside from Henry Simons, other theorists have posited definitions of income. *See* Richard B. Goode, *The Economic Definition of Income*, *in* COMPREHENSIVE INCOME TAXATION (Joseph A. Pechman ed., 1977) (offering an economic definition of the term income); Stanley A. Koppelman, *Personal Deductions Under an Ideal Income Tax*, 43 TAX L. REV. 679 (1988) (defining the term income based upon individual welfare); J.B. McCombs, *An Historical Review and Analysis of Early United States Tax Policy Scholarship: Definition of Income and Progressive Rates*, 64 ST. JOHN'S L. REV. 471 (1990) (offering a historical overview of several definitions of the term income and the role such definitions have played in shaping the Internal Revenue Code); Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45 (1990) (describing how the term income should be defined by principles of equity); Alvin C. Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081 (1980) (advocating a social product theory of the term income).

2. SIMONS, *supra* note 1, at 50.

3. I.R.C. § 61 (2006).

4. Treas. Reg. § 1.61-1(a) (2010).

fair market value of what is received is the background valuation standard.[5]

However, the Code sometimes departs from including income received in kind. For example, the tax rules do not require hotel managers to include in their gross income the value of lodging that hotels might provide to them to ensure their availability during off-duty hours, nor do the rules require airline employees to include the value of in-flight meals that they are allowed to eat free of charge.[6] Relief from taxation on the full fair market value of the services and meals in these two cases appears justified because the in-kind benefit recipients (i.e., hotel managers and airline employees) likely derive less than full economic utility from such constrained consumption. Put somewhat differently, there often exists a palpable disparity between the fair market value of these items and the recipient's subjective evaluation of these items' economic worth.

Returning to the riddle of how in-kind benefits should be taxed, it appears that the Code has historically adopted a binary approach. In some instances, if the in-kind benefit is remunerative in nature, the Code taxes it to the recipient at its full fair market value;[7] in other instances, the Code does not tax the receipt of the in-kind benefit at all (as evidenced by the discussion in the prior paragraph).

Upon closer inspection, however, Congress has adopted on many occasions a middle approach known as surrogate taxation. A surrogate tax is a process by which one taxpayer nominally bears tax as a proxy for another taxpayer's receipt of income.[8] Surrogate taxes come in a variety of forms, including deduction denials, excise taxes, and withholding taxes.[9] At first glance, surrogate taxation seems all but unsatisfactory because it appears to be targeted at the wrong taxpayer (i.e., the one whose income is *not* increasing). However,

5. *Id.* § 1.61-2(d)(1).

6. *See, e.g.*, Benaglia v. Comm'r, 36 B.T.A. 838 (1937) (ruling that a hotel manager does not have to include as income the fair market value of his meals and lodging he receives while on the job). *See generally* I.R.C. § 119 (excluding the value of meals and lodging from employee's income when such meals and lodging are provided for the convenience of the employer).

7. *See* Treas. Reg. §§ 1.61-1(a), 1.61-2(d)(1).

8. *See, e.g.*, Eric M. Zolt, *Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343, 349 n.26 (1989) (describing one form of "surrogate taxation" as follows: "Imposing severe dollar restrictions on a donor's deductions reduces the necessity of requiring a donee to include the value of business gifts in income.").

9. *See infra* Part IV.

upon closer inspection, surrogate taxation has proven to be an effective tool for taxing income that might otherwise escape taxation, for minimizing deadweight losses to the economy, and for preserving the tax base.[10] Despite its importance, surrogate taxation is a fairly ubiquitous Code practice that has basically been unexplored—at least until now.[11]

This Article argues that Congress should employ surrogate taxation whenever (1) the taxpayer has experienced an accretion to wealth, (2) the application of a direct tax is not logistically feasible, and (3) the failure to tax would result in a serious misallocation of economic resources.[12] In contrast, when all three of these conditions have not been met, Congress should refrain from imposing a surrogate tax.[13] Once the decision to apply a surrogate tax is made, choosing the appropriate surrogate tax rate is the next challenge. In those instances when Congress believes that the in-kind benefit is likely to equal or approach the item's fair market value in the employee's hands,[14] the surrogate tax rate generally should be set high on the marginal rate scale.[15] Conversely, in those instances

10. *See infra* Part III.

11. Surrogate taxation has drawn academic attention and analytical rigor only in the sphere of issues as to the time value of money. *See* Charlotte Crane, *More on Accounting for the Assumption of Contingent Liabilities on the Sale of a Business*, 3 FLA. TAX REV. 615 (1997); Mary Louise Fellows, *Future Costs Reconsidered: A Reevaluation of IRC Section 461(h)*, 44 TAX NOTES 1531 (1989); Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506 (1986); *see also* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 74–75 (4th ed. 2008) (discussing the ambiguity surrounding who actually bears tax burdens).

12. For example, see *infra* Part III for a detailed analysis of how these conditions are all met when it comes to business entertainment expenses, which has led Congress to enact I.R.C. § 274(n) (2006).

13. For example, I.R.C. § 132(e) excludes the receipt of de minimis fringe benefits, such as employer-supplied coffee, from income. To date, Congress has not felt it necessary to employ surrogate taxation to capture this accretion to wealth in the employee's hands. This hesitancy to tax is probably because the misallocation of economic resources is fairly insignificant (employers are generally not substituting free coffee in lieu of taxable wages) and the inequities, if any, are probably fairly minimal (perhaps the boss gets a better grade of java than the rank-and-file employees).

14. Put somewhat differently, while on the job, many employees receive goods and services that in some form or fashion cause an accession to personal wealth. The question is whether this accession to wealth should be taxed. If so, should the tax be direct or indirect (i.e., in the form of a surrogate tax)?

15. For example, I.R.C § 274(d), which is a form of surrogate taxation, denies a deduction for all business gifts (although this section permits a small de minimis deduction up to $25). This deduction disallowance will generally produce a surrogate tax equal to the donor's highest marginal tax rate. To illustrate, suppose a donor provides a $1000 business gift

when Congress believes that the in-kind benefit is likely to be less than fair market value—but not negligible—the surrogate tax rate generally should be set low on the marginal rate scale.[16]

In the Parts that follow, this Article will investigate the largely uncharted territory of surrogate taxation and its role in taxing in-kind benefits and other forms of income that are not directly taxed in the hands of the recipient. Part II explores why a binary approach (i.e., tax versus no-tax) to taxing the receipt of in-kind benefits fails to produce equitable and efficient outcomes. Part III uses the business entertainment deduction limitation as a case study and then discusses surrogate taxation and its underlying rationales. Part IV surveys three different modes of surrogate taxation and their significance. Part V explains how surrogate taxation bolsters the Code's equity, efficiency, and administrability in the varied circumstances in which Congress has used it. Finally, Part VI concludes.

II. THE VALUATION RIDDLE OF TAXING IN-KIND BENEFITS

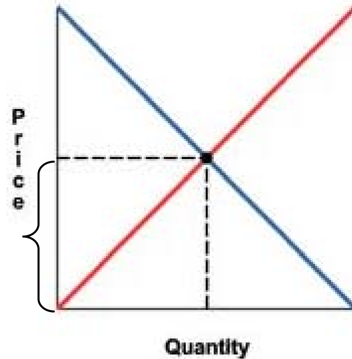
As pointed out previously, the receipt of in-kind benefits is profoundly difficult to value.[17] By way of comparison, consider when income is received in cash. In those instances, the taxpayer has complete control over the use of the funds and presumably will exchange those funds only for goods and services that yield as much utility (or more) as she would enjoy from keeping the cash or spending it on something else. Spelled out in terms of supply-and-demand curves, a taxpayer's preferences for the goods and services she actually consumes can be mapped on the portion of the demand curve that lies above the point at which the demand curve intersects

to a good referral source. Under I.R.C. § 274(d), the donor cannot deduct the value of this gift. If the donor's income were subject to tax at a thirty-five percent marginal tax rate, the donor (but not the business gift recipient) would bear an additional $350 of tax as a result of this deduction disallowance.

16. For example, I.R.C. § 274(n), which is a form of surrogate taxation, denies a fifty percent deduction for business entertainment expenses. This deduction limitation will produce an effective surrogate-tax rate generally equal to one-half of the provider's highest marginal tax rate. To illustrate, suppose an employer provides a $1000 front-row concert ticket to an employee to use in taking a prospective client. Under I.R.C. § 274(n), the employer cannot deduct one-half of the ticket's price. If the employer's income were subject to tax at a thirty-five percent marginal tax rate, the employer (but not the employee) would bear an additional $175 of tax as a result of this partial deduction disallowance.

17. *See supra* Part I.

the supply curve, signaling that the economic utility derived equals or exceeds the market price.[18]



Next, consider the situation when a taxpayer receives in-kind goods or services (in the employment context, the taxpayer has no choice in the matter). There is no way to be sure where the taxpayer's preferences lie, and thus there is no certain way to map them on the demand curve. On the one hand, his preferences may be above the market-price level. That is, the taxpayer's preferences are for goods or services that he would have purchased with his cash earnings had someone else not provided them in kind (see diagram above). On the other hand, his preferences may be below the market-price level. That is, due to the timing, social company, and other factors associated with the receipt of these in-kind benefits, they do not constitute goods or services of the recipient's choice. In the latter scenario, preferences for these goods and services can be mapped on the portion of the demand curve that lies below the point at which the demand curve intersects the supply curve, signaling that the economic utility derived equals or is less than the market price.

Among economic theorists, there is little doubt that taxpayers who receive in-kind benefits are much more likely to value them below the market-price level. Indeed, much of Henry Simons's treatise is devoted to a discussion of "Kleinwacher's conundrums,"[19] the most famous of which involves a Flugel Adjutant, or military

18. *Supply and Demand*, WIKIPEDIA (Jan. 19, 2012), http://bit.ly/wGCt3q (giving a basic exposition of supply and demand curves).

19. Friedrich Kleinwacher, *Das Einkommen und seine Verteilung*, LEIPZIG 1–16 (1896) (*cited in* SIMONS, *supra* note 1, at 43, 53).

attaché,[20] who must accompany the emperor, as a condition of his position, to the theater and opera even though he (the Flugel Adjutant) detests both.[21] In determining the taxability of the Flugel Adjutant's attendance at either form of entertainment, Simons labels this problem as "clearly hopeless."[22] In practice, however, the problem does not require much hope because it is unlikely to arise with any frequency, or at least not in dollar amounts of any significance. In a free market, taxpayers ordinarily would not choose to engage in occupations that force them to consume goods or services that they abhor. For example, taxpayers who dread flying are not ordinarily attracted to the airline industry, and those taxpayers who do not have a propensity for the thespian world are not likely to be lured into being theater ushers. As a practical reality, however, employees may engage in occupations that periodically or regularly cause them to consume goods that they perhaps slightly dislike or thoroughly disdain, signifying that they do not value the receipt of such goods at fair market value. But the fact that recipients do not necessarily value such benefits at fair market value does not mean that they attach no value at all to such items. And therein lies the crux of the problem: How should tax apply in situations when the taxpayer's demand curve is below fair market value yet still above zero?

Congress and the Treasury Department have sensibly eschewed the option of making individual assessments of subjective valuation of goods and services received in kind, if only because the administrative burdens of such assessments make that option inconceivable.[23] Instead, the choice has historically been made

20. The modern counterpart would be a military attaché who accompanies the President carrying the "football" containing nuclear launch codes. This is mentioned in Ronald Reagan's memoirs. *See* RONALD REAGAN, AN AMERICAN LIFE 257 (1990).

21. SIMONS, *supra* note 1, at 53.

22. *Id.*

23. Several commentators have noted that the theoretically correct answer—albeit one that is administratively impossible—is for employees to be taxed on the subjective value of in-kind benefit. Halperin, *supra* note 1; William A. Klein, *The Deductibility of Transportation Expenses of a Combination Business and Pleasure Trip—A Conceptual Analysis*, 18 STAN. L. REV. 1099 (1966). *But see* Kim Brooks, *Delimiting the Concept of Income: The Taxation of In-Kind Benefits*, 49 MCGILL L.J. 255 (2004) (explaining why the fair market value of the in-kind benefit is the appropriate metric for income tax purposes).

In rare instances, individual valuation determinations under the Code are not unheard of. Consider the case of *Turner v. Comm'r*, 13 T.C.M. 462 (1954), in which the taxpayer won luxury cruise tickets with a retail value of $2200. In *Turner*, the tax court made the following

between one of two administrable rules: either full inclusion at fair market value (the background assumption under which Code § 61 and treasury regulations were promulgated) or complete exclusion (as is the case of meals and lodging provided for the convenience of the employee).[24]

While justifiable on administrative grounds, the full-inclusion versus full-exclusion response to the problem of receipts of in-kind benefits is clearly wrong, but in different ways. In those instances when such goods and services are included at fair market value, there is an overstatement of income, which both overtaxes the recipient and discourages what may be economically efficient transactions. Conversely, in those instances when such goods and services are excluded from income, there is an understatement of income, which under-taxes the recipient and functions as a powerful lure to employers to exploit economically inefficient transactions.

An example helps to illustrate the issues with overstatement and understatement of income as articulated in the prior paragraph. Suppose a bakery generally sells nine baguettes each day at one dollar apiece. The bakery chooses to bake ten baguettes each day. This ceiling on baguette production is because the marginal cost of baking the tenth is twenty cents. Plus, usually one day in each five-day workweek a customer purchases the tenth baguette. (Thus, the marginal cost of producing the tenth baguette is equal to its marginal revenue.)[25] Every day, if the baguette is unsold at the time the bakery closes for the day, the bakery allows the store manager to take home the tenth baguette. Assume that there is no market for day-old baguettes. And assume further that the manager values the

observation: "The winning of the tickets did not provide [the taxpayers] with something which they needed in the ordinary course of their lives and for which they would have made an expenditure in any event, but merely gave them an opportunity to enjoy a luxury otherwise beyond their means." *Id.* at 463. In light of this observation, the taxpayers were allowed to take a smaller amount into income based, in part, on the subjective value the taxpayers put on the luxury cruise tickets.

24. In some instances, Congress has chosen an approach that offers a compromise between the two rules, though not one that involves individual valuation determinations. This analysis refers to this compromise as surrogate taxation, a topic that this Article explores in much greater depth in the sections that follow.

25. The figures in this example suggest that the bakery would be indifferent about the tenth baguette. But a reasonable additional assumption is that there is some intangible goodwill generated by not disappointing the tenth customer on those days when she shows up hoping to buy a baguette.

standby baguette, which is at the far edge of its use-by date, at thirty cents.

Under these circumstances, consider two possible tax options: including the baguette in the store manager's income at its full fair market value or, alternatively, excluding it from his income.

If the baguette were included in the manger's gross income, the manager would be taxed on the receipt of one dollar—the fair market value of the baguette. Taxing the manager in this fashion will result in over-taxation. He would have preferred as little as thirty-one cents of after-tax cash compensation to the baguette, but under this scenario he will be taxed on one dollar. If the manager's marginal tax rate exceeds thirty percent, he will rationally decline the opportunity to take the baguette. This is because the tax cost associated with taking the baguette would be greater than the value he would receive from consuming it.[26] The manager's decision to decline the baguette will also occasion a deadweight loss to the economy since the tax system will have foiled an arrangement in which goods that cost only twenty cents would have passed to someone who attached a thirty-cent value to them. And while equity and efficiency are typically viewed as competing goals in a good tax system,[27] taxing the recipient on the item's full, fair market value simultaneously thwarts both goals.

Unfortunately, not taxing the standby baguette at all poses the risk of different—yet essentially symmetrical—errors. It would allow the manager to enjoy goods that he values at thirty cents without imposition of any tax, which is clearly unfair to other taxpayers who receive wages exclusively in cash. The absence of a tax being levied encourages employers to uncover and exploit opportunities to pass income to their employees in this tax-favored way. For example, strange as it might initially seem under a tax-free regime, the bakery might bake still another baguette every day, at its marginal cost of

26. Even if the bakery manager's marginal tax rate were less than thirty percent, he would probably continue to take the bread but would have a stinging sense that it is barely worth it in light of a tax cost that approaches the subjective value of the bread. Depending upon the marginal tax rate imposed upon his income, the manager would face an effective tax rate that may approach 100 percent, even if it does not exceed that level. For example, if the manager's marginal tax rate were twenty-five percent, he would pay a twenty-five-cent tax on a baguette that he values at thirty cents—the equivalent of imposing an eighty-three percent effective tax rate on the true value of what he perceived that he received.

27. *See generally* ARTHUR M. OKUN, EFFICIENCY AND EQUITY: THE BIG TRADE-OFF (1975).

twenty cents, to give to another employee who might attach only an eighteen-cent value to that baguette. This outcome begins to make sense, however, if that employee is also exposed to a marginal tax rate of thirty-five percent. More specifically, the bakery would have had to pay her nearly twenty-seven cents in cash to yield the eighteen cents of after-tax value produced by the baguette $(0.27 - (0.27 \times 0.30))$. That being the case, the bakery can save on labor costs by spending twenty cents (instead of twenty-seven cents) to produce an item that is valued at only eighteen cents by its recipient. Just like market-value inclusion, complete exclusion also produces an outcome that is both inequitable and inefficient.

Between the binary worlds of full inclusion and full exclusion there exists a third alternative known as surrogate taxation—commonplace when a recipient's value of the in-kind benefit is unknown and a direct tax is impractical. By utilizing surrogate taxation, Congress can produce outcomes that are more equitable and efficient than a binary approach and function as a second-best alternative to using the taxpayer's subjective value of in-kind benefits as an income metric.

In terms of particulars, Congress could use one of the specified forms of surrogate tax detailed in this Article (i.e., denying a deduction, imposing an excise tax, or enforcing a withholding rule)[28] to impose a tax cost on the employer (e.g., in the prior example, the bakery) in lieu of taxing the recipient taxpayer (e.g., in the prior example, the bakery employee) who consumes the in-kind good or service. While surrogate taxes, because they are not calibrated to take into account the recipient taxpayer's ability to pay tax,[29] are less ideal than direct taxes, they nevertheless help curb inequities and inefficiencies and generally make the Code more administrable.[30]

28. *See infra* Part IV.

29. This principle was long ago expressed by Adam Smith when he made the following assertion: "The subjects of every state ought to contribute towards the support of the government, as nearly as possible in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state." 2 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 414–15 (London, MacMillan & Co. 1869), *available at* http://bit.ly/yF9801. A majority of the nation's taxpayers still generally subscribe to this same sentiment. *See* U.S. TREASURY DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 13, 14 (1984) ("Most Americans probably agree that those with high incomes should pay a greater percentage of their income in tax than those with intermediate levels of income.").

30. *See infra* Part V.A.

III. SURROGATE TAXATION AND ITS UNDERLYING RATIONALES

Surrogate taxes are not a historical novelty to the Code. Over the past several decades, Congress has imposed several varieties of such taxes.[31] This part of the Article uses Code § 274(n) as a case study to illustrate the mechanics of how a surrogate tax operates and its underlying rationales. Code § 274(n) denies a deduction equal to fifty percent of a business-entertainment expense incurred. This surrogate tax was enacted in lieu of directly taxing the benefactors of business-entertainment expenditures.[32] Instead, by denying a portion of an otherwise allowable expense, the taxpayer making the expenditure and the taxpayer receiving the benefit are each indirectly taxed; far from clear, however, is how these two parties share this tax burden.

Consider a simple numerical example of how Code § 274(n) operates. Suppose Company *X* employs two equally qualified middle managers: Taxpayer *A* in technical support and Taxpayer *B* in sales. Company *X* periodically sends Taxpayer *B* to entertain prospective clients. Most recently, Company *X* gave Taxpayer *B* and Taxpayer *C*, a prospective client, courtside seats at a professional basketball game. The seats cost $100 apiece. Before the enactment of Code § 274(n), Company *X* could deduct the entire ticket purchase price of $200 (2 × $100) under the general business expense category.[33] After the enactment of Code § 274(n)[34] and its subsequent amendments,[35] Company *X* can deduct only $100 ($200 (cost of tickets) × 0.50), rather than $200. Assuming that the income Company *X* earns is subject to a thirty-five percent marginal tax rate, this deduction

31. *See infra* Part IV.

32. *See* H.R. REP. NO. 111, at 645 (1993) ("[S]ome portion of business meal and entertainment expenses represent personal consumption (even if the expenses serve a legitimate business purpose).").

33. For early examples of how the courts approached the deductibility of business entertainment expenses, see *Appeal of McQuade*, 4 B.T.A. 837, 840 (1926) ("In the light of the evidence, we are of the opinion that the amount spent in the purchase of such [entertainment] tickets constituted an ordinary and necessary expense of the taxpayer in the conduct of his liquor business and as such was deductible from gross income."), and *Appeal of Blitzer*, 3 B.T.A. 696, 696 (1926) (holding that considerable entertainment expenses were deductible because such expenses were deemed to constitute "ordinary and necessary business expenses").

34. Tax Reform Act of 1986, Pub. L. No. 99-514, § 142, 100 Stat. 2085, 2117, 2120.

35. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13209(a), 107 Stat. 468, 469 (codified as amended in scattered sections of 26 U.S.C.).

limitation produces an additional thirty-five dollar tax burden on the $100 that was disallowed as a deduction.

There are two essential reasons for Code § 274(n)'s enactment. On the one hand, for reasons previously discussed,[36] it would be inequitable and inadministrable to tax the recipients on the fair market value of business entertainment events. The subjective value of business entertainment is typically less than its fair market value, making taxation on the basis of the latter metric fundamentally unfair.[37] Furthermore, in terms of administrative practicalities, no businessperson would be comfortable issuing a Form 1099 to each prospective or existing client in attendance at an entertainment event. Businesses would also likely be just as uncomfortable with the prospect of increasing the salary dollar figure on the face of each employee's Form W-2 by the amount of entertainment expenditures expended on behalf of such employee. A more detailed explication of the direct taxation of the receipt of in-kind benefits at their fair market value would therefore prove unproductive.

On the other hand, not taxing the value of these entertainment tickets at all is intolerable for the following three reasons: (1) income in the form of entertainment events (i.e., consumption) would otherwise go untaxed; (2) left unchecked, exempting business entertainment from the tax base generates a significant deadweight loss to the economy; and (3) employers would substitute tax-free remuneration for taxable remuneration, significantly narrowing the tax base. In the three subsections that follow, this analysis explores the merits of each of these rationales and how each contributed to the emergence of surrogate taxation.

A. Mechanism to Tax Income

When a businessperson and a guest attend an entertainment event, akin to paying attendees at the same event, each participates in an act of consumption. Nevertheless, neither the businessperson nor the guest is directly taxed.[38] Considering the context in which business entertainment typically transpires, does this failure to tax make any sense? Certainly, it is not in an employer's interest to shower its employees with costly goods and services that the

36. *See supra* Part II.
37. *See supra* Part II.
38. I.R.C. § 132(d) (2006).

employees do not substantially value. Similarly, it is not in the interest of a seller of goods or a provider of services to shower potential customers or clients (as well as its own employees) with entertainment opportunities that are not substantially valued by the recipients of those benefits.

Consider the fact that the taxpayer who sponsors the business entertainment event can choose the events that it expects its employees and potential clients and customers will prefer. If, for example, the firm thinks its managers, rank-and-file employees, and customers are football fans, it will purchase box seats for a football game rather than for another kind of sporting event. By the same token, clients can be selective in the entertainment events they choose to attend, declining those events in which they have no interest and avoiding the social company of those whom they may dislike or abhor. In light of their ability to select those entertainment events that they are apt to find pleasurable, most taxpayers who attend an entertainment event in the context of "doing business" probably derive economic utility somewhat close to the full ticket value, on par with attendees who are at the event for a non-business purpose.

Concluding that businesspeople and their guests should bear some tax on the consumption associated with entertainment events is the easy part; the hard part is figuring out how to go about doing so. Rather than allow the income associated with such business entertainment expenditures to escape taxation completely, Congress chose to utilize surrogate taxation. More specifically, in 1986, in recognition of the personal consumption (a.k.a. income) inuring to the parties attending business entertainment events, Congress grafted subsection (n) to Code § 274, partially denying the host's deduction of business entertainment expenses.[39] As amended in 1993, this provision now denies a deduction of fifty percent of the expenditure.[40] This feature in the Code permits the indirect taxation of in-kind benefits such as business entertainment expenditures that would otherwise escape taxation in the recipient's hands. Put differently, every dollar of deduction denied yields the same revenue as including the identical dollar benefit in income, assuming that the

39. *See* Tax Reform Act § 142.

40. *See* Omnibus Budget Reconciliation Act § 13209(a).

taxpayer denied the deduction is taxed at the same effective tax rate as the taxpayer receiving the benefit.

B. Mechanism to Minimize Deadweight Loss to the Economy

As a general matter, any time the Code permits the tax-free receipt of income, a distortion is likely to occur in the form of a deadweight loss to the economy.[41] This is because taxpayers will exploit benefits that are tax-exempt in nature even though the marginal utility that such benefits yield is lower than their concomitant costs. The tax-free receipt of business entertainment expenditures illustrates this point.

Consider our earlier fact pattern in which Company *X* has two equally qualified middle managers, Taxpayer *A* in technical support and Taxpayer *B* in sales. Suppose that Taxpayer *B*'s weekly pay is $1000 plus $100 in the form of a tax-free in-kind benefit: a courtside basketball seat when he, at the behest of Company *X*, hosts a business entertainment event involving Taxpayer *C*, a potential customer. Assuming that business entertainment expenses are fully deductible (i.e., Code § 274(n) was not enacted), Company *X* is indifferent if it pays Taxpayer *B* $100 in the form of a (i) deductible cash payment or (ii) courtside basketball seat.[42] But Taxpayer *B* is not so indifferent. Relative to the receipt of a cash payment in which Taxpayer *B* nets only sixty-five dollars after tax, the courtside basketball seat produces $100 worth of value. In light of this sixty-five dollars versus $100 differential, Taxpayer *B* will be driven to negotiate with Company *X* to get more courtside seats or other tax-free benefits in lieu of receiving taxable cash.

This negotiation process for tax-free benefits between Taxpayer *B* and Company *X* will not, however, continue unabated. Unlike a cash payment that can be used to meet any of the taxpayer's consumption needs,[43] tax-free in-kind benefits do not offer such

41. For general discussions of the meaning of deadweight loss and its implications to the economy, see generally KARL E. CASE & RAY C. FAIR, PRINCIPLES OF ECONOMICS 442 (James Boyd ed., 5th ed. 1999); RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 277–95 (Scott D. Stratford ed., 5th ed. 1989); HARVEY S. ROSEN, PUBLIC FINANCE 283–305 (Paul Shensa ed., 7th ed. 2005); HARVEY S. ROSEN & TED GAYER, PUBLIC FINANCE 331 (Doug Hughes ed., 8th ed. 2008); David F. Bradford & Harvey S. Rosen, *The Optimal Taxation of Commodities and Income*, 66 AM. ECON. REV. 94 (1976).

42. Company *X* may not be indifferent if the labor market is truly efficient and Company *X* is in a position to exploit this efficiency. *See infra* Part III.C.

43. Calvin Johnson, *An Employer-Level Proxy Tax on Fringe Benefits*, 123 TAX NOTES

limitless choices. Thus, whereas the first courtside basketball seat may yield $100 of economic utility to Taxpayer *B*, each additional courtside ticket will produce progressively less economic utility. By the hundredth basketball game, the thrill of being seated courtside may begin to wear thin. Salary negotiations between Company *X* and Taxpayer *B* will likely strike an equilibrium point where Taxpayer *B*'s nth courtside seat produces economic utility equal to or slightly greater than sixty-five dollars, the amount of economic utility that an equivalent after-tax cash payment would yield.

This equilibrium point is demonstrative. It pinpoints the exact deadweight loss that the economy suffers as a result of this income tax exemption. For virtually every dollar of in-kind benefit that Company *X* expends on behalf of Taxpayer *B* and that goes untaxed, the latter reaps less than one dollar of economic utility. At the extreme, driven by the apparent vacuum in the tax system that enables business entertainment income to escape taxation, the cost to the economic system is horrific: at some point along the expenditure cycle, for every dollar expended, an amount equal to or a little less than the marginal tax rate, here assumed to be thirty-five percent, is wasted. In terms of actual dollars, consider that at the nth basketball game, Taxpayer *B* derives only $65.01 of value by sitting courtside even though Company *X* has to spend $100 to purchase the ticket, signifying a $34.99 deadweight loss to the economy. Not only is this cost a net loss to the economy, but the government suffers as well: instead of collecting thirty-five dollars of tax related to the $100 remuneration that Company *X* pays Taxpayer *B* in the form of a courtside seat, it collects nothing.

If properly instituted, surrogate taxation can eliminate the aforementioned deadweight loss to the economy. In the situation just described, the employer was indifferent if it paid Taxpayer *B* with cash or secured courtside basketball seats on Taxpayer *B*'s behalf (i.e., for income tax purposes, both were deductible). Were business entertainment expense deductions eliminated or such expenditures subject to an excise or withholding tax,[44] Company *X* would shed this indifference. Instead, Company *X* would basically have two choices. Specifically, in lieu of using courtside seats as a form of remuneration, it would compensate Taxpayer *B* in the form

483, 485 (2009) ("Cash allows each employee to maximize preferences.").

44. *See infra* Part IV (describing various modes of surrogate taxation).

of deductible salary payments; alternatively, if it continued to use courtside seats as a form of remuneration, depending upon the elasticity of the labor market, Company *X* would likely reduce Taxpayer *B*'s overall compensation to recapture part of the additional tax cost it incurred in making the ticket purchase.

C. Mechanism to Preserve the Tax Base

Aside from taxing another's income by proxy and curbing economic deadweight losses, surrogate taxation sometimes serves another role: it can be used to impose a tax on taxpayers who are in a position to exploit the receipt of tax-exempt income by another taxpayer.

To demonstrate this point, the analysis returns to its prior example where Company *X* employs two equally qualified middle managers, Taxpayer *A* in technical support and Taxpayer *B* in sales. For purposes of this example, suppose that Taxpayer *A*'s weekly compensation is $1,100. Assuming a flat thirty-five percent tax rate,[45] Taxpayer *A* will enjoy an after-tax benefit of $715 ($1100 × 0.65). Suppose further that Taxpayer B's weekly pay is $1000 plus $100 in the form of a tax-free in-kind benefit, such as a courtside basketball seat when he, at the behest of Company *X*, hosts a business entertainment event for Taxpayer *C*, a potential customer.[46] In this latter situation, assuming that Taxpayer *B* values the in-kind benefit at its fair market value, Taxpayer *B* will enjoy after-tax income of $750 (($1000 × 0.65) plus $100).

The wage differential between Taxpayer *A* and Taxpayer *B* ($715 versus $750) seems to call for a solution that is targeted at the employee level (e.g., levying a tax on Taxpayer *B*'s receipt of the in-kind benefit). However, the outcome just described ignores the efficient labor market theory and the tendency of markets to seek

45. Of course, the federal income tax is imposed at graduated rates, so this assumption oversimplifies how the Code applies in practice. For heuristic reasons, this analysis assumes that Taxpayer *A*'s income was large enough that this $1100 weekly compensation payment was the taxpayer's last income increment and, as such, was fully taxable within the thirty-five percent tax bracket.

46. This analysis assumes that all of these professional sporting events are offered to Taxpayer *B* as legitimate, business-entertainment expenditures and that he and a guest discussed or engaged in business before, during, or after the game. *See* Treas. Reg. § 1.274-2 (2011) (distinguishing the nature of deductible business entertainment expenses from those that are nondeductible).

equilibrium.[47] More specifically, a situation in which two equally qualified employees enjoy significantly different after-tax wages is inherently unstable. Over time, what we would expect to happen is that the after-tax wages of the two equally qualified individuals would ultimately be the same. In this particular instance, the point of equilibrium could be achieved by reducing Taxpayer *B*'s taxable income to $946, resulting in $715 of after-tax income (($946 × 0.65) plus $100 of tax-free income). The economic disparities between Taxpayers *A* and *B* would thus disappear (i.e., both Taxpayer *A* and Taxpayer *B* would have after-tax income of $715).

Notice, however, that it is the employer, not the employee, who captures the tax benefit associated with the deductibility of this in-kind benefit that is tax-exempt to its recipient. More specifically, the employer's cost of compensating Taxpayer *A* remains at $715 ($1100 salary less $385 ($1100 x 0.35) of tax savings), again assuming that the employer is taxed at a flat thirty-five percent rate; conversely, with respect to compensating Taxpayer *B*, the employer will incur a net cost of only $680 ($946 salary plus the $100 perk, less $366 ($1046 × 0.35) of tax savings). Viewed from the prism of the efficient labor market theory, Company *X* reaps a thirty-five dollar benefit ($715 less $680) because of Taxpayer *B*'s tax-free receipt of income in the form of courtside basketball tickets.

Instead, consider the consequences if the Code were to deny Company *X*'s deduction for the $100 in-kind benefit that inured to Taxpayer *B*. The net cost of compensating Taxpayer *B* would accordingly be $715 ($946 salary plus $100 in-kind benefit, less $331 ($946 x 0.35) of tax savings).[48] This is precisely the same tax outcome that befell Company *X* when it remunerated Taxpayer *A* with cash equivalent to the in-kind benefit, thereby suggesting its

47. PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION & MANAGEMENT 250–52 (1992) (describing the "efficient wage" model); Boris I. Bittker, *Equity, Efficiency and Income Tax Theory: Do Misallocations Drive Out Inequalities?*, 16 SAN DIEGO L. REV. 735 (1979) (discussing how much and to what extent taxpayers can shift nominal tax burdens); *see also* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 292–306 (1980) (describing the efficient labor market as it pertains to corporate managers). S*ee generally* Charles T. Clotfelter, *Equity, Efficiency, and the Tax Treatment of In-Kind Compensation*, 32 NAT'L TAX J. 51, 52 (1979) (pointing out that employees who receive tax-free benefits will generally be paid less than those employees who receive only taxable wages).

48. Were Congress to deny a deduction, only the $946 salary would be deductible, yielding $331 ($946 x .35) of tax savings; because the $100 expenditure to purchase the $100 perk would not be deductible, it would not produce any tax savings to Company *X*.

appropriateness. Simply put, denying a deduction in a case such as this would remove any incentive for an employer to find ways to compensate employees in nontaxable forms and garner the tax savings for itself. In the context of an efficient labor market, surrogate taxation is thus more equitable than allowing such in-kind benefits to go untaxed since it targets a potential beneficiary associated with the receipt of tax-free income, namely, the employer.[49]

* * *

Central to the viability of any income tax system is accurately measuring accretions to wealth,[50] minimizing deadweight losses to the economy,[51] and preserving the tax base.[52] As evidenced by the foregoing discussion, surrogate taxation helps the Code achieve all three of these objectives. Not all surrogate taxes are designed in the same manner, however. In the next Part, this Article explores the salient characteristics of different forms of surrogate taxation.

IV. DIFFERENT FORMS OF SURROGATE TAXES AND THEIR SALIENT CHARACTERISTICS

Having explored the rationales that led to the emergence of surrogate taxation, the next issue is implementation. Although there are several possibilities, the three most viable methods of instituting

49. Admittedly, due to variations across the economic spectrum, the efficient labor model may not be universally applicable. For example, if there are opportunities to provide compensation in tax-free forms in some industries but not in others, then the entire wage structure of the perk-intensive industry will be lower and more lightly taxed. In the long run, this will attract additional capital to these industries until after-tax rates of return are equilibrated across the market. Assuming that capital markets are so fluid, the effect of permitting tax-free perks is unpredictable. If the demand curve for the goods and services offered in a perk-intensive industry is relatively elastic, consumers may find that they, rather than the employers, reap the benefits of tax rules that allow compensation to be paid in tax-free forms.

50. *See, e.g.*, INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 84 (1992) ("Through provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.") (citations omitted).

51. *See generally* David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627 (1999).

52. *See, e.g.*, Abbott Labs. v. United States, 84 Fed. Cl. 96, 98 (2008) ("Congress, as early [as] 1917, sought to preserve the tax base of the United States.").

surrogate taxation involve (A) the denial of an otherwise allowable deduction, (B) the imposition of an excise tax on the party making the expenditure, and (C) the placement of a withholding tax on the remunerating party. The three subsections below elaborate the salient characteristics of each form of surrogate taxation and highlight their concomitant advantages and disadvantages. Business entertainment expenditures are again used for explication purposes.

A. Denial of Otherwise Allowable Deductions

By way of background, expenditures that businesses incur that are "ordinary and necessary" in nature, subject to certain limitations,[53] are usually deductible.[54] The reason that such expenditures are deductible is that the amount expended constitutes a decline in income (i.e. the expended amount can no longer be consumed or result in the accretion of wealth).[55] For example, if Company *X* were to purchase supplies (e.g., paper for its photocopying machine), the amount paid for such supplies would be deductible.[56]e

On the surface, it seems that business entertainment expenses should share in the classification of being fully deductible because such expenditures fall with the purview of being ordinary and necessary in nature. Indeed, many businesspeople would argue that business entertainment is pivotal to the success of their businesses—to wit, the incurrence of these expenses helps build bridges of trust and forge mutual understandings that are central to the formation of goodwill. And for many decades, consistent with the notion that business entertainment expenses are similar in nature to other business expenses, such expenditures were held to be fully deductible.[57]

But there is something fundamentally different about the nature of business entertainment expenses that distinguishes them from

53. I.R.C. § 274 (2006).

54. *Id.* § 162(a).

55. In general, deductions for business expenses are predicated upon the principle that taxpayers who incur expenses to produce income should be taxed on a net, rather than a gross, basis. *See, e.g.*, Hantzis v. Comm'r, 638 F.2d 248, 249 (1st Cir. 1981) ("[A] fundamental principle of taxation [is] that a person's taxable income should not include the cost of producing that income.").

56. I.R.C. § 162(a).

57. *See supra* note 33 and accompanying text.

other business expenses. Business expenses normally give rise to taxable income in the hands of the party or parties benefiting from such expenditures (e.g., in our prior example, the purveyor of photocopying paper experiences taxable income upon the sale of its inventory);[58] in stark contrast, business entertainment expenses do not generate income to the most immediate benefactors of such expenditures, namely, the hosts and guests of such business entertainment events.[59]

Admittedly, not every deduction sanctioned under the Code gives rise to taxable income to another taxpayer. Indeed, sometimes there are overarching policy objectives that justify asymmetrical income/deduction outcomes. For example, employers often make deductible contributions to retirement accounts;[60] these contributions are exempt from taxation in the hands of employees.[61] The reason for such asymmetrical tax treatment is to promote employee solvency during retirement.[62] However, when it comes to business entertainment expenses, no such overarching policy grounds exist to justify an exemption from income in the recipients' hands. To the contrary, as previously pointed out,[63] there exist strong theoretical justifications for taxing both the host and guest who attend business entertainment events. Administrative impracticalities such as issuing Form 1099s to guests and capturing entertainment ticket values on Form W-2s for employees, however, make the "direct tax" approach a political nonstarter. Instead of simply allowing the income that inures to the host and guest to escape taxation, however, Congress has opted to employ a form of surrogate taxation whereby an otherwise legitimate deduction is curtailed or denied.[64]

58. I.R.C. § 1001(a).

59. *Id.* § 132(d). Another way to conceptualize the situation is as follows: the employer gives to the host and guests cash that is equal to the fair market value of the entertainment expense, and the host and guests then use that cash to make their purchases.

60. *Id.* § 402(a); *see* Treas. Reg. § 1.402(a)-1(a)(1)(i) (2011) ("If an employer makes a contribution for the benefit of an employee to a trust described in section 401(a) . . . the employee is not required to include such contribution in his income except for the year or years in which such contribution is distributed or made available to him.").

61. I.R.C. § 404(a)(1).

62. *See generally* Jay A. Soled & Bruce A. Wolk, *The Minimum Distribution Rules and Their Critical Role in Controlling the Floodgates of Qualified Plan Wealth*, 2000 BYU L. REV. 587.

63. *See supra* Part II.

64. *See supra* notes 34–35 and accompanying text.

At least with respect to business entertainment expenses, there are several reasons why Congress selected this mode of surrogate taxation. Specifically, one of the major attractions of this surrogate tax form is its administrative ease. A deduction limitation centralizes the point of taxation on the host rather than upon each attendee at a particular business entertainment event.[65] By centralizing the point of taxation, Congress has made it easier for the IRS to fulfill its oversight mission: the IRS can review the tax return of the taxpayer making these entertainment expenditures and gauge the legitimacy of the business nature of such expenses. This relieves the agency of the painstaking task of reviewing each and every tax return of the hosts and guests to determine if each included its value in income. In a similar vein, the IRS has a much greater financial incentive to conduct audits regarding the bona fides of business entertainment deductions incurred by a hosting taxpayer: if an audit reveals deduction improprieties (e.g., the business entertainment events in question served no legitimate business purpose), the resulting revenue would be much greater than the resulting revenue of case-by-case audits of hosts or guests attending a single entertainment event.

Another feature of deduction denials that make them politically attractive is their deep historical roots. Consider that for many decades before the institution of Code § 274(n), Congress, along with the Treasury Department, had instituted rules providing that business travel expenses that are primarily personal in nature are not deductible.[66] For example, assume that a New York-based company sends one of its employees to a one-day business meeting in Florida and the employee, in order to soak up the sunshine, extends his stay for a week. The Code and pertinent Treasury regulations deny a deduction to the company for the cost of such travel expenses;[67]

65. *See, e.g.*, IRS News Release IR-2007-184 (Nov. 6, 2007) (presenting a uniform and centralized means for federal and state employment officials to exchange information for purposes of employment tax audits).

66. I.R.C. § 162(a)(2); *see* Treas. Reg. § 1.162-2(b)(1) (2011). If a taxpayer travels to a destination and then engages in both business and personal activities, traveling expenses to and from the destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at the destination.

67. *See, e.g.*, Robinson v. Comm'r, 22 T.C.M. (CCH) 1043 (T.C. Aug. 6, 1963) (concluding that although the taxpayer had a meeting that resulted in an item of business, the taxpayer's trip was made primarily for sightseeing and other personal reasons and thus was not

neither the Code nor regulations, however, require the employee to include the company's travel expenditures made on his behalf as income. This deduction denial coupled with the income exclusion is one of the earliest incarnations of surrogate taxation in the Code, setting forth a model for other Code sections and Treasury regulations to follow.

A final factor that has made surrogate taxation politically attractive is that it is consistent with congressional attempts to keep marginal tax rates low. More specifically, in the last quarter-century, Congress has generally been more comfortable with denying deductions (and thereby broadening the tax base) as a mechanism to raise revenue than with increasing marginal tax rates.[68] Evidence for the foregoing proposition is readily found in two Code sections that are emblematic of this congressional stance. Code § 67(a) denies deductions for "miscellaneous itemized deductions" except to the extent that they exceed two percent of the taxpayer's adjusted gross income,[69] and Code § 68(a) reduces taxpayers' otherwise allowable itemized deductions by certain specified percentages.[70] There is no theoretical logic that underlies either of these Code sections. Instead, these Code sections and others like them signify legislators' apprehension about raising marginal tax rates. Surrogate taxes in the form of deduction denials are likewise consistent with this approach.

B. Imposition of an Excise Tax on the Party Making the Expenditure

The imposition of an excise tax on expenditures made by one party on behalf of another party represents a different form of surrogate taxation.[71] That is, in lieu of directly taxing business entertainment benefactors (i.e., hosts and guests) or indirectly taxing them by denying the deductibility of such expenditures, Congress

deductible).

68. *See generally* Brian Galle, *Hidden Taxes*, 87 WASH. U. L. REV. 59 (2009).

69. Tax Reform Act of 1986, Pub. L. No. 99-514, § 132(a), 100 Stat. 2113, 2113.

70. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11103(a), 104 Stat. 1388, 1406.

71. For a detailed exposition of using this form of surrogate tax, see Johnson, *supra* note 43. In his analysis, to create parity between taxpayers who receive cash and taxpayers who receive tax-free, in-kind benefits, Professor Johnson considers the appropriate excise tax rate to be fifty percent (rather than the thirty-five percent posited in this analysis). Professor Johnson's proposed excise tax rate takes into account the fact that when a taxpayer bears another taxpayer's tax liability, the tax payment itself constitutes an additional accretion to wealth that itself should be subject to tax.

could instead impose an excise tax (say, thirty-five percent) upon a party making such expenditures.[72] In our prior example, if Company *X* were to purchase a $100 courtside basketball seat for Taxpayer *B*, Congress could impose a business entertainment excise tax of thirty-five dollars ($\$100 \times 0.35$).

Congress has not extensively used excise taxes as a form of surrogate taxation. However, on occasion, Congress has employed this method, reflecting its potential viability. Consider the little-known excise tax found under Code § 4977(a). By way of background, under current law, employees who receive fringe benefits are taxed on the value of such benefits,[73] unless certain exemptions enumerated under Code § 132 apply. Included within the scope of these exemptions are no-additional-cost services and qualified employee discounts.[74] To qualify for either of these exemptions, however, an employee must work in the employer's same line of business as such benefits are offered.[75] By imposing this restriction, Congress apparently sought to ensure that employees employed in large conglomerates did not have an unfair advantage relative to employees who work in smaller business enterprises. When an employer operates a conglomerate and offers no-additional-cost services and qualified employee discounts, some of its employees may fail to meet the "same line of business" test and risk income inclusion. In lieu of including the value of such benefits in the employee's gross income, an employer may elect to pay an excise tax equal to thirty percent on the fair market value of the benefit inuring to such employees.[76]

In comparison to the direct taxation of in-kind benefits, which is fraught with valuation problems,[77] liquidity concerns,[78] and a host of

72. *Id.*

73. Treas. Reg. § 1.61-21(a) (2010).

74. I.R.C. §§ 132(b)–(c) (2006).

75. Treas. Reg. § 1.132-4(a)(1)(i) ("[A]n employee who does not perform substantial services in a particular line of business of the employer may not exclude from income under section 132(a)(1) or (a)(2) the value of services or employee discounts received on property or services in that line of business.").

76. I.R.C. § 4977(a).

77. For example, what income-inclusion value should be attributable to attendance at an employer-sponsored, weekly cocktail party? An annual holiday party? Should the amount of taxation depend upon how much a particular employee eats or drinks at the event? The inability to answer these and other questions suggests that direct taxation is sometimes a logistic impossibility.

78. Historically, Congress has been sensitive to liquidity concerns. *See, e.g.*, I.R.C. § 453

compliance problems,[79] an excise tax has several potential advantages. First, imposition of an excise tax moots valuation issues. For example, if Company *X* purchases a $100 courtside seat on behalf of Employee *B*, Company *X* apparently believes that this expenditure is worth the ticket's face value. Second, imposition of an excise tax obliterates liquidity concerns. This is because the party to be taxed controls the purse strings, making it ideally situated to balance the expenditures it chooses to make with the excise tax that it knows would ultimately be imposed upon it. Finally, imposition of an excise tax facilitates IRS oversight as it centralizes the point of taxation to one purchaser rather than to multiple benefactors.

Excise tax imposition also has a distinct advantage relative to the mode of surrogate taxation that engenders the denial of otherwise allowable deductions. Surrogate taxation involves taxing a proxy in

(stating that Congress permits taxpayers to use installment reporting); S. REP. NO. 69-52, at 19 (1926) (explaining that when Congress enacted the predecessor to I.R.C. § 453 as part of the Revenue Act of 1926, it sought to relieve taxpayers who sold property on an installment basis from having to pay an income tax in the year of sale based on the full amount of anticipated profits when in fact they had received in cash only a small portion of the sale price). But liquidity sensitivities have never extended to the receipt of in-kind benefits. Therefore, if taxpayers were obligated to pay tax on the receipt of in-kind benefits, including those that they either do not utilize (e.g., an employer-provided gym) or do not negotiate to obtain (e.g., a courtside basketball ticket while hosting a business entertainment event), they would likely consider themselves overtaxed.

79. When it comes to accurate tax reporting, third-party information returns are critical to ensure taxpayer compliance. OFFICE OF TAX POLICY, U.S. DEP'T OF TREASURY, A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP 13 (2006), *available at* http://www.treasury.gov/press-center/press-releases/Documents/otptaxgapstrategy%20final.pdf. *See generally* JAMES M. BICKLEY, CONG. RESEARCH SERV., RL 34464, TAX GAP: ADMINISTRATION PROPOSAL TO REQUIRE INFORMATION REPORTING ON MERCHANT PAYMENT CARD REIMBURSEMENTS (2008), *available at* http://www.policyarchive.org/handle/10207/bitstreams/19300.pdf; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-266, COSTS AND USES OF THIRD-PARTY INFORMATION RETURNS (2007), *available at* http://www.gao.gov/new.items/d08266.pdf.

In the absence of third-party information return issuance, tax compliance has historically been abysmal. *See* Leandra Lederman, *Statutory Speed Bumps: The Role Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 731 n.202 (2007) ("Collaborated evasion . . . may not only operate in small enterprises with fairly homogeneous employees. It may also be relevant to certain groups of workers in large enterprises . . . where tax avoidance, in the form of paying part of the total compensation in non-taxable fringe benefits, is a very common practice. Avoidance and evasion are closely related decisions . . . ." (quoting Gideon Yaniv, *Collaborated Employee-Employer Tax Evasion*, 47 PUB. FIN. 312, 313 (1992) (internal quotation marks omitted))). Accordingly, if the receipt of an in-kind benefit, such as attendance at a business-entertainment event, were not to entail the issuance of an information return (i.e., Form 1099), it is easy to anticipate that taxpayer compliance with reporting such income would likely be anemic.

lieu of the taxpayer who is in actual receipt of income. If the proxy, however, happens to have tax-exempt status under the Code or, alternatively, because of operating losses, has no immediate income tax exposure, denying a deduction to the proxy falls short of achieving effective surrogate taxation. By way of example, suppose the president of Duke University, a tax-exempt educational institution, invites potential donees to attend a Blue Devils' game. If the Code denies the university a deduction, it is a nonevent from an income tax perspective: first, it fails to tax directly or indirectly the university's president and prospective donees on the value of the courtside tickets that they received and from which they benefited; and second, due to its tax-exempt status, unless the university has unrelated business income,[80] the tax deduction denial is nothing more than a mere book entry.

A significant percentage of the U.S. economy is comprised of tax-exempt entities.[81] Couple this fact with the reality that many companies have net operating losses that, at least on a temporary basis, effectively insulate them from tax. Deduction denials therefore have little or no impact on either sort of enterprise.[82] In contrast, the imposition of an excise tax would still achieve the objective of indirectly taxing otherwise tax-free accretions to wealth, notwithstanding the tax status of the party making the expenditure (i.e., exempt or experiencing net operating losses). This makes excise tax imposition an attractive choice for some, but not all, surrogate tax purposes.[83]

80. *See* I.R.C. §§ 511–514.

81. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-561T, GOVERNANCE, TRANSPARENCY, AND OVERSIGHT ARE CRITICAL FOR MAINTAINING PUBLIC TRUST 3–4 (2005), *available at* http://www.gao.gov/new.items/d05561t.pdf ("[T]he tax-exempt sector comprises a significant part of the nation's economy and workforce.").

82. Some tax-exempt entities that earn unrelated business income are subject to tax on that income. I.R.C. § 511(a)(1). In such situations, denying a tax deduction may correspondingly increase the amount of unrelated business income that the tax-exempt entity must pay tax upon. *See id.* § 512(a)(1). Apart from tax-exempt entities, denying a tax deduction reduces the amount of loss that a taxpayer experiences, resulting in a smaller, net operating loss carryback or carryforward. *Id.* § 172(a).

83. The application of universal excise taxes raises some difficult political questions. For example, would a cancer ward center for children be subject to an excise tax if it hosted a birthday party for one of its patients?

C. Placement of a Withholding Tax on the Remunerating Party

A third possible mode of surrogate taxation is the institution of a withholding tax. In other words, the Code could require that taxpayers be obligated to withhold a certain percentage (say, thirty percent) of any remuneration paid to or on behalf of another taxpayer and to remit the withheld amount to the government. For example, when it comes to non-U.S. persons[84] and those taxpayers who do not supply correct identification numbers,[85] withholding taxes of the sort just described are quite common.[86]

From an administrative perspective, withholding on cash remuneration is relatively easy. For example, on a $100 dividend payment, thirty dollars of tax may be withheld, netting the intended dividend recipient seventy dollars. However, the same ease of administration does not extend to withholding on the receipt of in-kind benefits. For example, if an employer supplies a $100 courtside ticket to one of its employees, it should withhold thirty dollars. Obviously unable to withhold from the actual basketball ticket itself, the employer must contribute its own thirty dollars to meet this withholding tax obligation, triggering an additional nine-dollar ($30 × 0.30) withholding tax obligation on the initial thirty-dollar withholding obligation, which will itself result in another thirty percent withholding tax on the additional nine-dollar of out-of-pocket expenses it incurred, and so on.

When a withholding tax does apply, a flat tax rate is commonplace. Consider, too, that there is a built-in mechanism to bolster withholding tax compliance. A withholding agent must be compliant lest its derelictions are discovered and it is held financially responsible for the taxes that it failed to withhold.[87] Not surprisingly,

84. *See* I.R.C. § 7701(a)(30) (defining "United States person").

85. *Id.* § 3406(a).

86. In the sphere of foreign investment in the United States, the Code has developed an elaborate withholding-tax system on so-called FDAP (fixed, determinable, annual, or periodical) income. *See id.* §§ 871(a), 881(a), 1441(a). The Code has also developed an elaborate, backup withholding-tax system applicable to those taxpayers (1) who fail to provide a tax identification number, (2) who furnish an incorrect taxpayer identification number, (3) who are notified that backup holding applies, or (4) to whom the payee does not certify that it is not subject to backup withholding tax. *See generally id.* § 3406(a) (setting forth the statutory framework of the Code's backup withholding-tax system).

87. Treas. Reg. § 1.1441-7(c)(4) (2011); *see also* Lederman, *supra* note 79. In contrast, taxpayers have a financial incentive to cheat when it comes to direct taxation: if they are not caught, they are enriched by their malfeasance.

tax compliance is usually high in those instances when the Code utilizes withholding taxes as a mode of surrogate taxation.[88]

The main disadvantage of using a withholding tax in lieu of a direct tax is a problem associated with the imposition of all surrogate taxes; namely, the fact that such taxes are not calibrated to the ability of any particular taxpayer to pay. What this means is that, in some instances, too little tax is withheld, and in other instances, too much tax is withheld. For example, a thirty percent withholding rate may be too low (e.g., if the taxpayer's actual effective tax rate is thirty-five percent); alternatively, the thirty percent withholding rate may be too high (e.g., the taxpayer's actual effective tax rate is twenty-five percent). In both cases, the thirty percent withholding tax misses its intended mark of substituting for a direct tax.[89]

* * *

This analysis illustrates the operation of the three most common forms of surrogate taxation, namely, the denial of allowable deductions, the imposition of an excise tax, and the institution of a withholding tax. There are advantages and disadvantages associated with the use of each form of surrogate taxation. For largely practical, historical, and political reasons, Congress has predominantly used deduction denials in the sphere of domestic taxation and withholding taxes in the sphere of foreign taxation, as modes of imposing surrogate taxation. Other countries (e.g., Australia) have favored excise taxes.[90]

88. *See, e.g.*, STAFF OF JOINT COMM. ON TAXATION, JCS-02-05, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 6 (2005), *available at* http://www.jct.gov/publications.html?func=startdown&id=1524 (noting that in cases where a system of tax withholding is in place, estimates are that tax compliance among taxpayers is approximately ninety-nine percent); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-100T, TAX COMPLIANCE OPPORTUNITIES EXIST TO REDUCE THE TAX GAP USING A VARIETY OF APPROACHES 10 (2006), *available at* http://www.gao.gov/new.items/d061000t.pdf (same).

89. Sometimes Congress recognizes the legitimacy of this concern and, depending on the circumstances, requires taxpayers to file an income tax return remitting the balance of any tax due or providing taxpayers with the opportunity to seek a refund. I.R.C. § 31(a)(1). Other times, Congress considers a withholding tax the final tax. *See* Treas. Reg. § 1.6012-1(b)(2)(i) (stating that on FDAP income, *see supra* note 86, a foreign investor is relieved of filing a tax return unless that taxpayer is engaged in a trade or business in the United States).

90. For a general overview of the Australian Fringe Benefits Tax, see JOHN WALKER, BUSINESS OPERATIONS IN AUSTRALIA 19 (Tax Mgmt. Portfolio 951-3d ed. 2006) (2000).

In the next Part, this Article examines how surrogate taxation makes the Code more functional and elaborates upon its varied uses.

V. THE IMPORTANCE OF SURROGATE TAXATION AND ITS VARIED USES

This Article has thus far examined the nuts and bolts of surrogate taxation, the rationales that underlie its imposition, and the three kinds of surrogate taxation that Congress has employed to date. This Article is now in a position to examine how surrogate taxation (A) fosters a good tax system and (B) can be used in a variety of contexts.

A. Surrogate Taxation and Its Role in Fostering a Good Tax System

While there are many ways to evaluate the efficacy of a tax system, the three most common criteria are whether such a system is equitable, efficient, and administrable.[91] Surrogate taxation plays an important role in promoting each of these qualities under the Code.

1. Surrogate tax's role in promoting equity under the code

Although the word *equity* connotes many meanings and is admittedly abstract in nature, in the tax context, it is often defined in terms of horizontal equity—namely, similarly situated taxpayers should bear the same tax burden[92]—and vertical equity—namely, those taxpayers who earn more income than other taxpayers (i.e., possess a greater ability to pay tax) should bear a larger proportion of tax.[93] In other words, if two taxpayers, *A* and *B*, each earn $1000,

91. Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAX L. REV. 1, 1 (2006) (stating that the traditional grounds for evaluating tax policy are efficiency, equity, and administrability); Anthony C. Infanti, *Tax Equity*, 55 BUFF. L. REV. 1191 (2008) (same).

92. *See* David Elkins, *Horizontal Equity as a Principle of Tax Policy*, 24 YALE L. & POL'Y REV. 43, 43 (2006); Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139 (1989); Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607 (1993); Richard A. Musgrave, *Horizontal Equity: A Further Note*, 1 FLA. TAX REV. 354 (1993). The concept of horizontal equity has a long, historical lineage, dating back several centuries. *See* THOMAS HOBBES, LEVIATHAN 235 (Richard Tuck ed., Cambridge Univ. Press 1996) (1651) ("To equal Justice, appertaineth also the equal imposition of taxes."); JOHN STUART MILL, PRINCIPLES OF THE POLITICAL ECONOMY: WITH SOME OF THEIR APPLICATIONS TO SOCIAL PHILOSOPHY 155 (Donald Winch ed., 1970) (1848) ("For what reason ought equality to be the rule in matters of taxation? For the reason, that it ought to be so in all affairs of government.").

93. Boris I. Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive*

under the principle of horizontal equity, each should bear an equal tax burden, and if *A* earns $1,500 and *B* earns $1000, under the principle of vertical equity, *A* should pay proportionately more tax than *B*.

Congress has generally sought to use surrogate taxation as a means to make the Code more equitable. Return again to our business entertainment example in which a host and guest each receive courtside tickets worth $100. Under the Code, neither the host nor the guest is taxed on the receipt of his ticket.[94] Compare this result to one in which in lieu of $100 cash compensation, an employee is paid with a $100 courtside basketball ticket. In the latter case, the employee would be fully taxed on the ticket's fair market value.[95] While there is some justification for not taxing the ticket's recipient in one situation and taxing him in the other,[96] surrogate taxation helps close the gap between these disparate outcomes.

Assuming that the sponsor of the business entertainment event is subject to the same effective tax rate as the host and guest, employment of a surrogate tax can help foster a more equitable outcome. For example, if the business entertainment sponsor, the host, and the guest are all subject to an effective thirty-five percent tax rate and the Code were to deny a deduction for the entire $200 business entertainment expense (2 tickets × $100), an additional seventy dollars ($200 × 0.35) tax burden would befall the sponsor. This $70 tax burden is equivalent to the tax burden that would have arisen had the host and guest each been taxed on the receipt of his $100 ticket ((2 × $100) × .35).[97] If the host and guest were to each bear a pro rata share of this tax (i.e., the host's salary was correspondingly reduced by seventy dollars to cover this additional expense and the guest, who subsequently played host at the next business entertainment event, shouldered an equivalent tax burden),

Out Inequities?, 16 SAN DIEGO L. REV. 735 (1979), *reprinted in* THE ECONOMICS OF TAXATION 3, 13–18 (Henry J. Aaron & Michael J. Boskin eds., 1980).

94. *See* I.R.C. § 132(d).

95. Treas. Reg. § 1.61-21(a) (2010).

96. *See supra* Part III (explaining the reasons why a host and a guest may enjoy a lesser amount of economic utility in the business rather than the nonbusiness context).

97. Depending on the elasticity of the labor market and other factors (e.g., if the sponsor and guest reciprocate in offering one another business-entertainment events), the host and guest ultimately may each bear the burden associated with the imposition of the surrogate tax.

then surrogate tax would have produced an appropriate and equitable solution to the in-kind benefit problem.

When it comes to promoting equity under the Code, there are several reasons why surrogate taxation does not always operate with complete perfection. First, taxpayers are not all taxed at the same flat rate. Unlike the outcome portrayed by the example in the prior paragraph, depending upon each party's different effective tax rate, the imposition of a surrogate tax may result in the parties being taxed too heavily or too lightly.[98] Second, sometimes the taxpayer burdened by the surrogate tax (e.g., the sponsor in the prior example) may be in a position to shift the tax burden to the taxpayers actually experiencing the accretion to wealth (e.g., the host and guest in the prior example); other times, the burdened taxpayer will be able to shift the surrogate tax to other taxpayers whose income had not been increased.[99]

2. Surrogate tax's role in promoting efficiency under the code

As it pertains to the Code, the word *efficiency* defies a ready definition. The classic definition of an efficient tax system is one that is neutral as to its effect on the free market.[100] Other commentators disagree with this classic definition and argue that an efficient tax system is one that regulates and directs the free market.[101] This Article has chosen to use a more generic, less politically charged,

98. *See supra* Part II.

99. Consider the result if the sponsor in the prior example were a publicly traded, corporate entity. The surrogate tax's additional burden might be borne by the corporation's shareholders, the corporation's other employees, or the consumers of the corporation's products instead of by the event's host and guest. *See* George R. Zodrow, *Incidence of Taxes: The Analysis and Measurement of Who Bears the Final Burden of a Tax*, *in* THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 169 (Joseph J. Cordes et al. eds., 1999); Richard A. Musgrave, Karl E. Case & Herman Leonard, *The Distribution of Fiscal Burdens and Benefits*, 2 PUB. FIN. Q. 259, 261 tbl.1 (1974); Joseph A. Pechman & Mark J. Mazur, *The Rich, the Poor, and the Taxes They Pay: An Update*, 77 PUB. INT. 28, 31 tbl.1 (1984); Herwig J. Schlunk, *I Come Not to Praise the Corporate Income Tax, But to Save It*, 56 TAX L. REV. 329, 354 n.54 (2003) ("Although the corporate income tax nominally falls (indirectly) on shareholders, the tax burden almost surely shifts, in part or in whole, from shareholders to employees, customers, and nonequity capital providers. Thus, its actual incidence is uncertain.").

100. *See, e.g.*, Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 849 (2005) ("Tax policy typically invokes neutrality in a specifically economic sense. Economic efficiency is obtained when tax systems are neutral relative to a hypothetical no-tax world.").

101. *See, e.g.*, JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY (1964).

definition of the word *efficiency*, i.e., a tax system that produces as little deadweight loss to the economy as is possible.[102] As defined by Professor Terrance O'Reilly, "[d]eadweight loss (also known as excess burden) measures, in monetary terms, the costs imposed by taxation beyond the amount of revenue raised. By raising the cost of certain resources, a tax can alter behavior, causing taxpayers to purchase less of some goods and more of others."[103]

In an earlier essay,[104] Professor Calvin Johnson offers an excellent exposition of how the combination of deductions for business meals and other expenses of similar nature and the failure to tax as income the receipt of such business meals and other consumption items produces tremendous (and inexcusable) deadweight losses to the economy. To make his case, Professor Johnson contrasts two situations: one where an employer supplies an employee with a $100 cash payment that is taxable and another where the same employer supplies the same employee with a $100 meal that is not taxable.[105] Because the $100 cash payment, on an after-tax basis (assuming a thirty-five percent tax rate), enables the employee to utilize only sixty-five dollars, the employee will generally prefer the receipt of the $100 tax-free meal, at least initially.[106] Because of diminishing marginal utility, as the employee gradually receives more tax-free meals, an equilibrium point will be reached where the value of the *n*th additional meal will equal sixty-five dollars even though it will have a $100 price tag associated with its purchase.[107] The thirty-five dollar delta in the foregoing example is a graphic illustration of the deadweight loss to the economy that some ill-conceived tax provisions are capable of generating.[108]

Deadweight loss is a profound problem for the economy. Succinctly put by Professor Johnson, human happiness, measured in economic terms, could be as much as fifty-four percent higher were

102. *See* Alan J. Auerbach, *The Theory of Excess Burden and Optimal Taxation*, *in* 1 HANDBOOK OF PUBLIC ECONOMICS 61, 67 (Alan J. Auerbach & Martin Feldstein eds., 1985); CHARLES L. BALLARD, DON FULLERTON, JOHN B. SHOVEN & JOHN WHALLEY, A GENERAL EQUILIBRIUM MODEL FOR TAX POLICY EVALUATION 8–9 (1985).

103. Terrance O'Reilly, *Principles of Efficient Tax Law: Apocrypha*, 27 VA. TAX REV. 583, 585 (2008).

104. Johnson, *supra* note 43.

105. *Id.* at 485–86.

106. *Id.*

107. *Id.*

108. *Id.*

this deadweight loss to the economy eliminated.[109] In numeric terms, instead of a spent dollar producing sixty-five cents' worth of utility, the spent dollar would produce a dollar's worth of utility; the thirty-five cents (one dollar less sixty-five cents) of additional utility accounts for the fifty-four percent (thirty-five cents/sixty-five cents) increase in the taxpayer's overall utility. Another compounding deadweight loss problem is that its presence constitutes a major revenue drain on the government, which is particularly distressing at a time of a hemorrhaging national deficit.

When properly employed, surrogate taxation can serve as a useful tool to help eliminate or, at the very least, diminish deadweight losses to the economy. Assuming that a particular situation does not lend itself to the imposition of a direct tax,[110] Congress can circumvent this problem by using some form of surrogate taxation to protect against deadweight economic losses. Surrogate taxation, when properly deployed, thus has the ability to function as a proxy for a direct taxation system, minimizing deadweight losses to the economy.[111]

3. Surrogate tax's role in promoting administrability under the code

In order for a tax system to be administrable, at least two important conditions should be met: the costs to taxpayers in terms of time, money, and energy in fulfilling their tax compliance obligations should be manageable;[112] and, in light of the amount of revenue raised, the government's costs to administer the tax system and monitor tax compliance should be reasonable.[113]

109. *Id*. at 485.

110. *See supra* Part III.

111. *See supra* Part III.B.

112. *See* Nina Olsen, National Taxpayer Advocate, The Tax Gap, Hearing Before Subcommittee on Taxation and IRS Oversight, Senate Committee on Finance (July 26, 2006), *available at* http://www.irs.gov/pub/irs-utl/ntatestimonysfctax_gap072606.pdf ("For taxpayers who generally will go to great lengths to comply [with the tax law], the likely source of noncompliance is the complexity of the tax code. . . . For taxpayers who will comply if doing so is easy enough, our main emphasis should . . . be [on] simpler laws and procedures . . . .").

113. *See* Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 572–74 (1965) (referring to this particular criterion as one of practicality). *See generally* THE CRISIS IN TAX ADMINISTRATION (Henry J. Aaron & Joel Slemrod eds., 2004) (discussing general issues of tax administration that the Government encounters).

Employment taxes are representative of an administrable tax.[114] Taxpayers and the IRS alike ordinarily find compliance and oversight of such taxes to be straightforward. Employment taxes are withheld from taxpayers' wages by their employers,[115] and the withheld taxes are then paid by the employers to the government.[116] The IRS can easily monitor employment tax compliance because the imposition of such taxes involves the issuance of information returns,[117] and the point of compliance is centralized in the hands of employers rather than with each individual employee.

By way of contrast, an example of a much more difficult tax to administer is the state use tax. Such taxes are designed to complement state sales taxes.[118] When a taxpayer purchases an out-of-state item and is a resident of a state with a sales tax, the taxpayer is supposed to pay a use tax on the difference between sales tax in the state in which the item is being consumed and the sales tax (if any) that the taxpayer actually paid.[119] The challenge for state tax authorities is to identify those items that taxpayers purchased out-of-state. Because of registration issues, some items purchased out-of-state are easy to identify (e.g., automobiles); the vast majority of other items purchased out-of-state, however, are far less easy to identify. As a result of this administrative shortcoming, compliance with respect to such taxes is virtually nonexistent.[120]

Sensitive to resulting administrative burdens, Congress has decided that taxing some categories of income is not cost-justified. Consider the case of de minimis fringe benefits. Such benefits undoubtedly constitute income;[121] nevertheless, Congress exempts such income from tax.[122] Why? Congress does not want to force

114. I.R.C. § 3101(a)–(b) (2006).

115. *Id.* § 3102(a).

116. *Id.* §§ 3401(a), 6302(a).

117. *Id.* § 6501(a).

118. JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION II: SALES AND USE, PERSONAL INCOME, AND DEATH AND GIFT TAXES AND INTERGOVERNMENTAL IMMUNITIES ¶ 16.02 (3d ed. 2001).

119. *Id.*

120. *See, e.g.*, Brian S. Masterson, *Collecting Sales and Use Tax on Electronic Commerce: E-Confusion or E-Collection*, 79 N.C. L. REV. 203, 206 (2000) ("Absent substantive reform in the collection of use tax on interstate commerce, the states will continue to lose use tax revenue that buyers clearly owe under existing laws.").

121. Treas. Reg. § 1.61-21(d) (1991).

122. I.R.C. § 132(e).

taxpayers to keep track at work of every personal photocopy they make, every cup of coffee they drink, and every holiday office party they attend. The administrative nightmare of keeping track of all of these items, coupled with the IRS's inability to readily monitor compliance, does not justify whatever might be the resulting revenue associated with taxing such de minimis fringe benefits.

In other instances, despite administrative apprehensions, Congress has decided to tap alternative means to impose a tax. In these instances, Congress has resorted to applying surrogate taxes to alleviate the administrative burdens that direct taxation would otherwise engender.[123] Put differently, the proxy who bears a surrogate tax, yet whose income is not increasing, is presumably in a much better position, relative to the income recipient, to handle a deduction denial, bear the imposition of an excise tax, or endure a withholding tax. Furthermore, a serendipitous feature of surrogate taxation is that the point of taxation is usually centralized in the

123. Although they are generally designed to ameliorate administrative compliance issues, surrogate taxes admittedly generate their own set of administrative concerns. One particular concern relates to the inability of surrogate taxes to capture income that does not immediately vest in the hands of a particular taxpayer. To demonstrate, consider the tax consequences to an employer that spends $70,000 refurbishing an existing building wing into an on-premises gym for its employees. If the employer built a new building wing and added a gym, it would have cost $500,000. Suppose the gym costs the employer $30,000 a year to operate, its employees pay nothing to use its amenities, and normal membership in a gym of this quality would be $1000 annually. Under the deduction denial mode of surrogate taxation, the employer would be precluded from deducting the $30,000 of annual expenses it incurs in maintaining the gym. Under the excise tax mode of surrogate taxation, the employer bears a $300 annual excise tax ($1000 x .30) on a per-employee basis. Under the withholding mode of surrogate taxation, the employer should remit $1538 ($1000 / 1 − 0.35) on a per-employee basis to the government to account for the $1000 benefit inuring to the employee plus the tax gross-up. Yet, it remains unclear under all these modes of surrogate taxation how the $70,000 conversion expense or the $500,000 cost of constructing a new gym would fit into the surrogate tax regime.

Another administration problem is that taxpayers are not likely to respond passively to surrogate taxes. To the contrary, crafty taxpayers will be inclined to reclassify nondeductible expenses—expenses that might give rise to an excise tax and expenditures that result in the imposition of a withholding tax—into a deductible form of expense—an expense that does not give rise to an excise tax—or a form of income that does not give rise to a withholding tax. For example, in the case of business-entertainment expenses, some taxpayers would likely reclassify the expenses as advertising/promotional expenses that would be fully deductible. I.R.C. § 162(a). The IRS can monitor taxpayers' expense (mis)classifications, but such monitoring is likely to be a labor-intensive endeavor, subverting one of the underlying goals of the surrogate tax—namely, to foster administrative ease.

hands of a single taxpayer rather than widespread over numerous individual taxpayers, thereby facilitating IRS oversight.[124]

* * *

As evidenced by this Part of the Article, surrogate taxation is designed to supplement direct taxation, not supplant it. Despite its shortcomings, on the whole, surrogate taxation makes several important contributions to the Code, enhancing its equity, efficiency, and administrability. Most importantly, it imposes costs—and, hence, incentives to minimize those costs—on the party who has the greater control over the manner in which the transaction is structured. For example, the provider/supplier of the in-kind benefits should know its own costs and should have some sense as well of how this benefit might be viewed by its recipients. The provider/supplier can also factor its own overtaxation into its negotiations in the future with the in-kind recipients over the amount of their cash wages, thereby recouping all or much of the tax cost imposed on the provider/supplier in the first instance. Furthermore, the surrogate approach minimizes the costs of collection because in most situations of this sort, there will be far fewer payers than payees.

Finally, surrogate taxation minimizes the sting of overtaxation. The employee who faces an effective marginal tax rate approaching or exceeding one-hundred percent will deeply resent the rule that dictates that result and the tax system that imposes it. As a group, employers are fewer in number than employees, they are often artificial entities that do not experience resentment in any meaningful way, and they may even be staffed by executives who are sophisticated enough to appreciate the virtues of the surrogate tax mechanism, which would predictably diminish any resentment that a particular form of surrogate tax engenders.

As is apparent by the material in the next Part of this Article, the virtues of surrogate taxation make it a commonplace phenomenon under the Code.

124. *See* Lederman, *supra* note 79.

B. Congressional Employment of Surrogate Taxation

Because of its versatility and utility, Congress has sought to assign a wide array of duties to surrogate taxation. Thus far, this Article has examined its use primarily from the vantage point of business entertainment expenses. In the subsections that follow, this Article discusses several other representative surrogate taxes, highlighting the utility of this tool.[125]

1. Code § 274(c): a deduction denial

Domestic business travel expenses are deductible if the nature of the trip is primarily business, rather than personal, in nature.[126] Code § 274(c) limits the application of this rule in the case of foreign travel.[127] That is, if the trip has both business and personal components, only the business-related portion of the travel expenses is deductible. For example, assume that an employee must travel from New York to Montreal for a six-day business meeting and the round-trip flight costs $900. Assume further that the employee stays in Montreal visiting friends for an extra three days. Since the trip is primarily business in nature, the cost of airfare is deductible—to an extent:[128] Code § 274(c) limits the amount of the deduction relating to the trip's airfare to $600 ($900 × 6/9), i.e., that proportion of the trip that was business-related.[129] Rather than deem the employee taxable on $300 (the portion of the travel expenses related to the

125. While this analysis does not necessarily agree, at least some commentators have argued that the entire gift and estate tax regime is a surrogate tax. These commentators assert that transfer taxes are designed to tax unrealized gain that would otherwise escape taxation because of the "basis equals fair market value" rule enunciated under I.R.C. § 1014(a). *See, e.g.*, Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 VA. L. REV. 1183, 1191 ("With a seriously eroded income tax base, a transfer tax is needed to ensure that each taxpayer eventually bears a fair share of the tax burden.").

126. Treas. Reg. § 1.162-2(b)(1).

127. I.R.C. § 274(c)(1) ("In the case of any individual who travels outside the United States . . . in pursuit of trade or business . . . no deduction shall be allowed under section 162. . . ."); I.R.C. § 274(c)(2) ("Paragraph (1) shall not apply to the expense of any travel outside the United States . . . if such travel does not exceed one week, or the portion of the time of travel outside the United States . . . not attributable to the pursuit of the taxpayer's trade or business . . . is less than 25 percent of the total time on such travel.").

128. I.R.C. § 162(a)(2).

129. *See* Treas. Reg. § 1.274-4(g)(Example (7)).

trip's personal component), Congress has chosen to deny the employer a deduction of an equivalent dollar amount.

Emerging from this deduction denial are several important observations. One pertains to administrability: Congress apparently did not feel it practical to tax the employee on the portion of travel expenses that she was able to exploit for her personal use (i.e., $300). Another observation pertains to efficiency: if Congress did not limit the deductibility of this expense, employers might otherwise use such expenditures as a tax-free perk to employees, injecting a deadweight loss into the economy.[130] A final observation pertains to equity: depending upon the elasticity of the labor market, the employee who enjoys this benefit/accretion to wealth will bear part of the surrogate tax burden in the form of lower wages or a reduction of other benefits.[131]

2. Code § 4972: an excise tax

Code § 4972 imposes a ten percent excise tax on nondeductible contributions made to certain qualified retirement plans.[132] Rather than impose a tax on the additional benefits that were to inure to employees via these excess contributions, Congress chose to impose an excise tax upon the plan sponsor. The reason for this excise tax is that tax-exempt plans generally preclude easy participant access to funds,[133] putting the ability to rectify funding problems out of reach of plan participants. Surrogate taxation in the form of an excise tax obviates this problem: the plan sponsor has the liquidity to bear this excise tax (lest it would not have made the excess contribution in the first place) and is also in a position to take remedial action and recoup the excess payment.[134]

130. *See supra* Part III.B.

131. *See supra* Part III.C.

132. These are plans qualified under I.R.C. §§ 401(a), 403(a), 408(k), 408(p). I.R.C. § 4972(d)(1)(A). While highly technical in nature, nondeductible contributions are essentially the sum of (i) the excess of the employer's contribution for the tax year over the amount allowed as a deduction under I.R.C. § 404 and (ii) the nondeductible contributions for the preceding tax year reduced by amounts returned to the employer or applied as deductible contributions in the current year. I.R.C. § 4972(c).

133. *Id.* § 72(t)(1).

134. *Id.* § 4972(c)(3).

3. Code § 1441: a withholding tax

Code § 1441 imposes a thirty percent withholding tax on so-called FDAP (fixed, determinable, annual, or periodic in nature) income (e.g., interest, dividends, and royalties) earned by foreign investors, coupled with a withholding duty on the payer.[135] The reason Congress chose to impose this indirect tax is that from an administrative perspective, the IRS otherwise would have little or no recourse to collect taxes owed in courts of foreign jurisdictions had the recipients of such income not fulfilled their tax paying obligations to the United States.[136] In those instances when nonresident alien taxpayers are subject to this withholding tax, they need not file an income tax return[137] because the withholding tax is deemed to represent the full amount of tax due.

* * *

While surrogate taxes produce salutary effects, they have their limitations. Therefore, Congress should restrict their use to when collection obstacles necessitate taxation of the surrogate in lieu of an unreachable income recipient (e.g., nonresident aliens). Direct taxes on the income recipient remain the method of first choice because direct taxes can be tailored to address the circumstances of the individual taxpayer.[138]

VI. Conclusion

When and where possible, Congress prefers direct rather than indirect taxation of income. The reasons for this preference are obvious: direct taxation is apt to be more exacting, and the

135. *Id.* § 1441(a)(1).

136. *See, e.g.*, European Cmty. v. RJR Nabisco, 424 F.3d 175, 179 (2d Cir. 2005) ("Under the long-standing common law doctrine known as the 'revenue rule,' the courts of one nation will not enforce final tax judgments or unadjudicated tax claims of other nations.").

137. Treas. Reg. §§ 1.6012-1(b)(2)(i), -2(g)(2)(i) (2006).

138. Payers, for example, do not usually know how many mouths a payee may have to feed or what other sources of income the payee may be able to call upon in discharging her support obligations and in meeting her own consumption needs. Payers likewise do not necessarily know how much a particular payee may contribute to charity or pay to others in the form of alimony or state and local taxes. The appeal of a direct tax is that each taxpayer possesses unique knowledge of his own circumstances, enabling him to assess his personal tax burden on the basis of these self-reported circumstances.

compliance burden falls squarely on the appropriate party (i.e., the party experiencing an accretion to wealth). Prompted largely by administrative concerns, however, direct taxation is not always logistically possible. In these situations, surrogate taxation takes front-and-center stage.

In the appropriate circumstances, surrogate taxation produces equitable, efficient, and administrable outcomes. The limitation on the deductibility of business entertainment expenses demonstrates this point, illustrating that surrogate taxation has a number of venerable characteristics that can assist in augmenting the functionality of the Code.[139]

For years, the receipt of in-kind benefits has confused and confounded tax theorists, particularly regarding the vexing issue of valuation.[140] In the past, these tax theorists have primarily focused their attention on the in-kind benefit recipient. This analysis instead focuses attention on the provider of such in-kind benefits, highlighting the important role that surrogate taxation has thus far played in the Code's development and other roles that it may play in the future. And while admittedly the application of surrogate taxation may not supply the "right" answer to the in-kind benefit valuation riddle—indeed, because there may not be one—it nonetheless provides a practical response to the question itself, namely, how the Code should go about the taxation of in-kind benefits (and other forms of income) that, due to administrative reasons, would otherwise go untaxed.

139. Richard Schmalbeck & Jay A. Soled, *Elimination of the Deduction for Business Entertainment Expenses*, 123 TAX NOTES 757 (2009).

140. *See supra* note 1.