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INTRODUCTION

For years, employers have furnished meals to their employees as fringe benefits. Alternatively, some employers have provided cash reimbursements in lieu of meals in kind. These cash meal allowances have generated two major tax questions: whether these reimbursements should be includible in gross income and whether these meal allowances are wages subject to withholding for tax purposes.

The Supreme Court recently addressed both of these issues. Commissioner of Internal Revenue Service v. Kowalski dealt with the issue of includibility of meal reimbursements in gross income. Three months later, the Court in Central Illinois Public Service Co. v. United States considered whether these allowances constitute wages subject to withholding taxes.

This article will examine the taxability to employees of employers' meal reimbursements. The discussion will emphasize the effect of Kowalski and Central Illinois Public Service on the treatment of meal reimbursements as gross income and wages respectively. Finally, the article will explore the impact of these decisions on fringe benefits legislation currently under study by Congress.

THE INCLUSION OF MEAL REIMBURSEMENTS IN GROSS INCOME

Gross Income

The first step in determining whether meal reimbursements constitute gross income is to define gross income. Section 61 of the Internal Revenue Code defines gross income as all income from

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1. This situation is very common among state troopers. See text accompanying notes 13-24 infra.
4. The required employer-employee relationship was not questioned in the cases examined for this article. The issue of whether a person is an employee or an independent contractor is currently the source of much controversy. For discussions of this issue, see Brogan, Ruling Eases Independent Contractor Test for Owner-Drivers: What Are Implications, 46 J. Tax. 364 (1977); Frazer & Goldberg, Twenty-four Ways to Protect Independent Contractor Status of a Client's Workers, 20 TAX. FOR ACCOUNTANTS 260 (1978); Smith, "Independent Contractor" or "Employee"? That is the Question, 33 N.Y.U. ANN. INST. ON FED. TAX. 577 (1975).
5. At the present time both Congress and the Treasury Department have formed special task forces to study and make recommendations on the tax treatment of employee fringe benefits. See text accompanying notes 139-44 infra.
6. Section references are to the United States Internal Revenue Code.
whatever source derived, unless excluded by law. The concept is measured by the full extent of Congressional taxing powers. Accordingly, the definition has been held broad enough to include any economic or financial benefit from any source, conferred on an employee in any form.

Nonetheless, section 61 has an inherent defect. By defining gross income in terms of income, the provision fails to state what constitutes income. Thus, uncertainty arises in determining what benefits will trigger the operation of the statute.

**Meal Reimbursements before Kowalski**

Section 61 has been construed to include cash reimbursements for meals. Coactively, section 119 excludes from gross income the value of meals provided by an employer to an employee if two conditions are met. First, the meals must be furnished for the convenience of the employer. Additionally, they must be furnished on the employer’s business premises. The provision literally applies to meals furnished in kind. Courts have differed, however, on whether section 119 covers cash meal reimbursements.

*Kowalski* focused on the includibility in gross income of meal reimbursements paid to state troopers. Prior to *Kowalski*, five cases had addressed this issue under the 1954 Internal Revenue Code.

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7. I.R.C. § 61 provides in pertinent part:
   (a) Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
      (1) Compensation for services, including fees, commissions, and similar items;
12. I.R.C. § 119 provides:
   There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him . . . by . . . his employer for the convenience of the employer, but only if—
      (1) in the case of meals, the meals are furnished on the business premises of the employer, or
   *

13. *Accord*, Treas. Reg. § 1.119-1(a) (1964), “The value of meals furnished to an employee by his employer shall be excluded from the employee’s gross income if two tests are met: (i) The meals are furnished on the business premises of the employer, and (ii) the meals are furnished for the convenience of the employer.”
14. These five cases exclude the recent Supreme Court decision in Comm’r v. Kowalski.
Meal Reimbursements

Three held that meal allowances and reimbursements are excludable from gross income. Each court emphasized the convenience of the reimbursement system to the state. The other two cases ruled that meals must be furnished in kind to be excludable from gross income.

This apparent split may be explained by noting that the latter two cases were concluded after the Supreme Court decided United States v. Correll, while the former three were prior to Correll. The pre-Correll decisions reasoned that even if the reimbursement constituted gross income, the amount spent for meals was a deductible business expense under section 162. Hence, expedience compelled that these reimbursements not be considered gross income.

In Correll, however, the Court held that expenditures for meals cannot be deducted unless the employee is away from home overnight. Thus, by proscribing a deduction with respect to non-overnight meals, the Court eliminated the pre-Correll application of section 162 as a means of excluding the reimbursement. Wilson v. U.S. confirmed the foreclosure of this rationale by ruling that these meal expenditures are reimbursements for personal expenses. Consequently, they constitute income to the state trooper unless excluded by another statutory provision.

See notes 15-16 infra.

17. 389 U.S. 299 (1967). The court in Correll ruled that expenditures for meals cannot be deducted unless away from home overnight. Id. at 307.
18. United States v. Morelan, 356 F.2d at 208-09 (8th Cir. 1966); Hanson v. Comm'r, 298 F.2d 391, 394 (8th Cir. 1962).
19. I.R.C. § 162(a)(2) states, “There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . traveling expenses (including amounts expended for meals and lodging . . .) while away from home in the pursuit of a trade or business . . . .” A state trooper on patrol was held to be “away from home” within the meaning of this section whether or not his trips were overnight. Id. at 394. Thus, a trooper could report as gross income any meal reimbursements paid by the state without any net tax effect, since he could also deduct the cost of his on-duty meals.
20. See Wilson v. United States, 412 F.2d 694 (1st Cir. 1969). Technically, § 162 does not provide an exclusion at all, but allows deductions from gross income for business expenses. The net tax effect of an exclusion and of a deduction from gross income, though, is the same. Each lowers taxable income by the amount received or the amount paid respectively. See note 18 supra. Thus, when a taxpayer seeks to avoid tax on a reimbursement the two possible options might be to exclude the reimbursement, or to deduct the expense, from gross income.
22. 412 F.2d 694 (1st Cir. 1969).
section 162 as a means of exclusion, section 120(a), which allowed police to exclude up to five dollars a day in meal allowances from gross income, has been repealed. Therefore, the only remaining statutory provision which a state trooper can use in an attempt to exclude meal reimbursements from gross income is section 119.

Commissioner of Internal Revenue v. Kowalski

Background

Kowalski involved the applicability of section 119 to cash meal reimbursements paid a New Jersey state trooper. The Tax Court had held that section 119 applied only to meals furnished in kind. Accordingly, it followed that the trooper must include in gross income the meal allowance paid to him by the state. On appeal, the Third Circuit reversed, stating that the meal allowance was furnished for the convenience of the employer and was not intended to be compensatory. The Supreme Court, in reversing the Court of Appeals, held that section 119 is a comprehensive determinant of the excludability of meals provided to an employee, and it required this meal reimbursement to be included in gross income.

The major disagreement in Kowalski concerned whether the section 119 exclusion applies to both meals furnished in kind and meals furnished in cash. Treasury Regulation 1.119-1(c)(2) parrots the legislative history and attempts to settle this problem, but actually

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(a) GENERAL RULE—Gross income does not include any amount received as a statutory subsistence allowance by an individual who is employed as a police officer.
(b) LIMITATIONS—
(1) Amounts to which subsection (a) applies shall not exceed $5 per day.
26. New Jersey instituted the cash allowance for its state police officers in 1949. Prior to that time, troopers were provided with mid-shift meals in kind at various meal stations. This system proved unsatisfactory to the state, since it often required the troopers to leave their assigned patrol areas unguarded. The cash allowance system permitted troopers to remain on call in their assigned patrol areas during meal breaks. The meal allowance was paid biweekly in advance along with the trooper's salary.
28. There were six dissenting judges in the Tax Court who argued that the meal allowance should not be included in the trooper's gross income. 65 T.C. at 68.
29. 544 F.2d 686 (3d Cir. 1976). The Court of Appeals thus held that the meal allowance was excludable from gross income.
30. 434 U.S. at 92-94.
31. It is assumed in this analysis that the meal allowance is furnished on the business premises of Kowalski's employer.
Meal Reimbursements

confuses the issue further. The first line of the regulation states, “The exclusion provided by section 119 applies only to meals and lodging furnished in kind by an employer to his employee.” However, the last sentence reads “Cash allowances for meals or lodging received by an employee are includible in gross income to the extent that such allowances constitute compensation.” Thus, the regulation contains an inconsistency. It states that the exclusion applies only to meals in kind yet addresses the question of cash allowances.

Majority Decision

In requiring state trooper Kowalski to include the cash meal reimbursement in his gross income, the majority explained that section 119 was enacted to replace long standing judicial doctrine. This doctrine excluded employment related meal benefits merely by showing that they were conferred on an employee “for the convenience of the employer.” The Court found controlling the legislative history and Regulation 1.119-1(c)(2) which embodies it. The Senate report explicitly stated: “In enacting this section, the Congress was determined to end the confusion as to the tax status of meals and lodging furnished an employee by his employer. Section 119 applies only to meals or lodging furnished in kind.” Thus, the Court ruled that meals are excludable from gross income only if (1) furnished by an employer to an employee; (2) for the convenience of the employer; (3) on the employer’s business premises; (4) in-kind; and (5) for substantially noncompensatory reasons.

The fourth condition means that a cash reimbursement for meals will never fit within the section 119 exclusion. Cash expenditures fail to qualify despite language in the Senate Report and Regulation 1.119-1(c)(2) which includes cash meal allowances in gross income to the extent they constitute compensation. Hence, the implication is that all cash allowances constitute compensation and are

33. See the conflicting interpretations of this regulation in the Tax Court. 66 T.C. at 56, 68.
35. 434 U.S. at 92.
37. 434 U.S. at 84.
39. 434 U.S. at 84. The Court derived requirements one, two, and three from the language of section 119. Requirement five is delineated in Regulation 1.119-1(c)(2).
40. See note 32 supra. The Court noted that this sentence “was meant to indicate only that meal payments otherwise deductible under § 162(a)(2) of the 1954 Code were not affected by § 119.” 434 U.S. at 94-95.
includible in gross income.\textsuperscript{41}

However, this implication is inconsistent with other court decisions, Treasury Department rulings, and the explicit language of Regulation 1.119-1(c)(2). As early as 1925, the Court of Claims held that cash payments to army officers in commutation of quarters did not constitute gross income.\textsuperscript{42} Regulation 1.61-2(b) provides that subsistence allowances to members of the armed forces are excluded from gross income. Another exception arises from the IRS’s long standing position that “supper money” is excludable from gross income.\textsuperscript{43} In excluding cash supper expenditures, the Service’s position conflicts with the Court’s judgment that section 119 is comprehensive in character, and requires meals to be furnished in kind.\textsuperscript{44} Nevertheless, the Court merely stated that it will not presently determine whether notwithstanding section 119, the supper money position may be otherwise justified.\textsuperscript{45}

Minority Position

In response to judgments against taxpayer Kowalski, Judge Sterrett of the Tax Court and Justice Blackmun dissented. Both disagreed with the majority’s characterization of section 119 as comprehensive.\textsuperscript{46} They observed that Congress has long recognized that not all amounts paid by an employer result in inclusion under section 61.\textsuperscript{47} Further, the specific Internal Revenue Code exclusions are not intended to be exhaustive.\textsuperscript{48} Consequently, section 119 does not pro-

\textsuperscript{41} 434 U.S. at 92.
\textsuperscript{42} Jones v. United States, 60 Ct. Cl. 552 (1925).
\textsuperscript{43} 65 T.C. at 56. The convenience-of-the-employer doctrine has been extended to cash payments for “supper money,” which may be excluded from gross income. The term “supper money” means a payment by an employer to an employee who voluntarily performs extra labor after regular business hours. Such a payment, not considered additional compensation and not charged to the salary account, is viewed as a payment for the convenience of the employer. For that reason it does not represent taxable income to the employee. This “supper money” exclusion has not been eliminated by the Internal Revenue Service. 2 C.B. 90 (1920).
\textsuperscript{44} Overbeck, Fringe Benefits for the Rank and File Employees, 55 Taxes 820 (1977) [hereinafter cited as Overbeck].
\textsuperscript{45} 434 U.S. at 92 n.28.
\textsuperscript{46} See text accompanying note 30 supra.
\textsuperscript{47} 434 U.S. at 98; 65 T.C. at 65.

Other fringe benefits have traditionally not been taxed to employees. These include free
vide the only means for exclusion of these payments from gross income.

Judge Sterrett pointed out that as a matter of general tax law, meals provided by an employer, whether in kind or in cash, should be excluded from gross income when they are furnished for the employer's convenience and are not compensatory.\textsuperscript{49} Further, Justice Blackmun emphasized that a literal reading of section 119 draws no distinction between meals in kind and meals in cash.\textsuperscript{50} Viewing the language of section 119 against a background of the relevant legislative history and regulations demonstrates that the inclusion of cash payments in gross income is questionable.\textsuperscript{51}

The dissent's approach may substantially eliminate the restrictions that Congress imposed under section 119.\textsuperscript{52} The legislative history indicates that section 119 was intended as a replacement for prior law and as a comprehensive standard for determining exclusions from gross income.\textsuperscript{53} In addition, the first sentence of Regulation 1.119-1(c)(2) restricts the section 119 exclusion to meals furnished in kind. Hence, these authorities tend to negate the possibility of a class of cash meal payments which may be excluded from gross income.\textsuperscript{54}

\textbf{Alternative Approach to Meal Reimbursements}

In some situations meal reimbursements should be excludable under section 119. This conclusion is founded on final comments in

passes to airline employees, auto salesmen who have personal use of a demonstrator model, college professors whose children get free or reduced tuition, executive parking spaces and unusually generous medical benefits. Overbeck, \textit{supra} note 44.

The IRS attempts to tax nearly every form of economic benefit flowing to an employee by reason of the employment relationship except those specifically exempt by law. The Service claims there is a growing inclination among employees to seek untaxed fringe benefits instead of additional fully taxed pay increases. Therefore, the future taxability of these traditional benefits is uncertain.

\textsuperscript{49} 65 T.C. at 66. The employer's intent determines whether reimbursements are compensatory. Stubbs, Overbeck & Assocs., Inc. v. United States, 445 F.2d 1142, 1150 (5th Cir. 1971); Acacia Mut. Life Ins. Co. v. United States, 272 F. Supp. 188, 195 (D. Md. 1967); Humble Pipe Line Co. v. United States, 442 F.2d 1353, 1356 (Ct. Cl. 1971); Humble Oil & Refining Co. v. United States, 442 F.2d 1362, 1367 (Ct. Cl. 1971); Peoples Life Ins. Co. v. United States, 373 F.2d 924, 932 (Ct. Cl. 1967).

\textsuperscript{50} 434 U.S. at 97.

\textsuperscript{51} See S. Rep. No. 1622, \textit{supra} note 32, and Treas. Reg. § 1.119-1(c)(2) (1954). The minority also noted that there now exists an ironic difference in tax treatment accorded to the paramilitary New Jersey state trooper and federal military personnel, who may exclude subsistence allowances from gross income. 434 U.S. at 98; see Treas. Reg. § 1.61-2(b) (1954).

\textsuperscript{52} Overbeck, \textit{supra} note 44, at 823.

\textsuperscript{53} S. Rep. No. 1622, \textit{supra} note 32.

\textsuperscript{54} 434 U.S. at 92.
the majority opinion in *Kowalski*, the legislative history of section 119, and the last line of Treasury Regulation 1.119-1(c)(2). The key issue is whether the cash meal allowance represents compensation or is truly reimbursement of an expense incurred for the convenience of the employer. Accordingly, section 119 could be interpreted to mean that only cash allowances which compensate, rather than reimburse, must be included in gross income.

A five part test could be employed to determine whether a meal allowance to state troopers may be excluded from gross income under section 119.

1) There must be an employer-employee relationship.

2) The cash allowance must be for the convenience of the employer. The taxpayer should have to demonstrate that the meal allowance is necessary for the trooper to properly perform his duties. This condition could be satisfied by showing that the reimbursement would permit the officer to remain in his district and on duty to handle emergencies during meal periods.

3) The meal allowance must be considered an expense reimbursement and there must not be any evidence that the allowance is compensation. The program in *Kowalski* violated this guideline in several respects. The meal payments varied with the trooper's rank. During overtime each trooper received one and a half times the normal allowance. The state police brochure described the meal allowance as an additional item of salary. Further, the police union and the state negotiated over the amount of the allowance. To satisfy the third requirement, all troopers should receive the same reimbursement, which should not exceed amounts actually expended for meals on the job.

4) Substantiation of meal expenditures must be required. Pa-

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55. Justice Brennan, speaking for the majority, states:

In any case, to avoid the completely unwarranted result of creating a larger exclusion for cash than kind, the meal allowances here would have to be demonstrated to be necessary to allow respondent "properly to perform his duties." There is not even a suggestion on this record of any such necessity.

*Id.* at 95.


57. *Id.*

58. See note 66 infra.

59. See note 4 supra.

60. Treas. Reg. § 1.119-1(a)(2).

61. In Ghastin v. Comm'r, 60 T.C. 264, 267-68 (1973), the allowance varied based on the trooper's rank, and he received one and one half times the normal allowance during overtime. Thus, the Tax Court ruled that this cash allowance was gross income.

62. 434 U.S. at 80.
trolmen would be obligated to submit expense accounts showing the sums spent for meals so that no trooper receives an allowance in excess of the amount spent. In Kowalski no documentation of meal expenditures was required. Thus, the patrolmen did not even have to spend their cash allowance on meals.

5) The meals must be furnished on the business premises of the employer. Troopers would be required to eat their meals in public restaurants in their patrol area, thereby facilitating their availability to the public. If these five guidelines are followed by the state and the trooper, a cash meal allowance should be excludable from gross income under section 119.

63. Using this basic reimbursement system, each trooper would receive the same amount of money per meal regardless of rank. The trooper would then account to the state regarding how the meal allowance was spent. If the trooper did not spend the entire allowance, the balance would be returned to the state.

An alternative plan would be straight reimbursement to troopers for amounts spent on meals. The weakness in this system is the lack of an upper limit on the amount troopers could spend. Therefore, the basic reimbursement system is preferable.

64. The question of whether § 119 includes both meals in kind and cash reimbursements has been the subject of extensive litigation in a series of cases dealing with substantially similar fact situations. These cases concern state troopers who purchase meals while on duty and are reimbursed by the state.

In each case the Commissioner's principal argument was that § 119 applied only to meals furnished in kind and that, in any event, the meals were not furnished on the business premises of the employer. The courts' decisions have centered on whether the § 119 exclusion is limited to meals furnished in kind. In Kowalski, once the court determined that meals must be furnished in kind to be excludable under § 119, it found the consideration of other facts unnecessary. Therefore, the Kowalski court did not discuss the requirement that meals must be furnished on the business premises of the employer.

The court in United States v. Barrett, 321 F.2d 911 (5th Cir. 1963), ruled that meals to state troopers were furnished on the employer's business premises. It stated "The major business of this state law enforcement agency is obviously not confined to isolated station houses; rather it covers every road and highway in the state twenty-four hours a day every day." Id. at 912.

In Wilson v. United States, 412 F.2d 694 (1st Cir. 1969), the court took the opposite position, ruling that the state conducted no business in the public restaurant, where the officer was eating and he was not performing any business on behalf of the state while he was eating at the restaurant. Id. at 696.

65. See Treas. Reg. § 1.119-1(c)(1). "For purposes of this section, the term business premises of the employer generally means the place of employment of the employee." The state trooper's business premises should be interpreted to include restaurants in his patrol area. United States v. Morelan, 356 F.2d 198, 203 (8th Cir. 1966), aff'd 237 F. Supp. 879 (D. Minn. 1965). The convenience of the employer test is satisfied where an employee must accept his meals or lodging in order to properly perform his duties. Comm'r v. Kowalski, 434 U.S. at 93, citing S. REP. NO. 1622, supra note 32.

These two tests should be distinguished. For example, it may not be convenient to the state to have troopers eat at headquarters, usually because of the distance a trooper would have to travel to return there. Thus it is usually more convenient if the trooper takes his meals in or near his patrol area. If he is outside the patrol area, however, the meal would not be eaten on the business premises of the employer, although it could still be for the state's convenience.

66. While this analysis has emphasized state troopers, this five step approach can be
DO MEAL REIMBURSEMENTS CONSTITUTE WAGES SUBJECT TO WITHHOLDING

Overview

Under Kowalski, most meal reimbursements should be included in gross income. This holding magnifies the importance of determining whether these amounts are wages for the purpose of withholding taxes.\(^6\) Under the scheme of withholding taxes, an employer deducts sums calculated to approximate the employee’s ultimate tax liability at the end of the year.\(^6\) The concepts of income and wages, however, are not necessarily coterminus.\(^9\) Wages usually constitute income,\(^70\) yet many items qualify as income which are not wages.\(^71\) Nonetheless, to effectuate the purposes of withholding almost any income which an employee receives from his employer should be subject to withholding.

Central Illinois Public Service Co. v. United States\(^72\) addressed the issue of whether meal reimbursements to employees constitute wages. Internal Revenue Code section 3401(a) defines wages as “all remuneration for services performed by an employee for his employer.”\(^73\) Although this provision appears straightforward, it has been subject to conflicting interpretation.\(^74\)

The Treasury Department has linked the employer’s withholding obligation to whether the benefit conferred constitutes gross income to the employee.\(^75\) Several courts have upheld this broad interpreta-
tions of wages. For example, in S.S. Kresge Co. v. United States, the employer gave free lunches to employees who ate at the lunch counter and assisted during busy lunch periods. The Court held that the value of the free lunches was subject to withholding taxes.

Other cases, however, have distinguished between wages and employees’ income and have applied a much narrower concept of wages. In Royster Co. v. United States, the employer reimbursed

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(9) **Value of Meals and Lodging.** The value of meals and lodging furnished to an employee by his employer is not subject to withholding if the value of the meals and lodging is excluded from the gross income of the employee.

Treas. Reg. § 31.3401(a)-1(b)(2) provides:

(2) **Traveling and other expenses.** Amounts paid specifically—either as advances or reimbursements—for traveling or other bona fide ordinary and necessary expenses incurred in the business of the employer are not wages and are not subject to withholding.

These two regulations tie the employer’s withholding obligation to the employee’s tax result in different ways. The former delimits “wages” directly in terms of the employee’s gross income, while the latter excludes from withholding expenses which the employee may deduct from gross income. Although exclusions and deductions are not the same, they both reduce the net amount on which the employee pays taxes. See note 19 supra.

The IRS has followed these regulations in several revenue rulings. In Revenue Ruling 70-85, advice was requested whether withholding of income tax was required with respect to amounts paid to members of the state police as reimbursements for the cost of meals while on daily patrol duty and not in a travel status. The Treasury Department, relying on Regulation § 31.3401(a)-1(b)(9), and decisions that meal reimbursements are gross income, ruled that these reimbursements constituted wages subject to withholding for tax purposes. In Revenue Ruling 75-279, the Treasury Department stated amounts given to an employee as meal allowances are wages subject to withholding, if the employee is not away from home overnight and does not account to his employer for expenses.

76. Educational Fund of the Elec. Indus. v. United States, 305 F. Supp. 317 (S.D.N.Y. 1969), aff’d, 426 F.2d 1053 (2d Cir. 1970); Campbell Sash Works, Inc. v. United States, 217 F. Supp. 74 (N.D. Ohio 1963). The court in Campbell ruled that an expense paid vacation for employees was subject to withholding tax, even though the employees performed no services while on vacation. In Educational Fund, the fund made payments to electricians to attend a one week course in civics. The payments were part of a total benefit package negotiated by the union. Accordingly, they represented a portion of the agreed remuneration. The court found that these payments were wages within § 3401(a). 305 F. Supp. at 320. 77. 379 F.2d 309 (6th Cir. 1967).

78. Id. at 310. The value of these meals was not excludable from gross income because employees had the option of taking them. See Treas. Reg. § 1.119-1(d).

Kresge can be distinguished from Central Illinois Public Service. In Kresge, the employees were under a duty to perform services as called upon during their lunch hour. In contrast, the Central Illinois employees were not expected to and did not in fact perform services during their lunch hours. See note 89 infra and accompanying text.


In Stubbs, the court ruled that per diem payments given to employees as a living allowance were not wages. “In order to be wages, the payments must be made for services performed.”
salesmen for the cost of meals they purchased while on the road, even though the employees were not away from home overnight. The salesmen performed no duties for the employer during the meals. Hence, the Royster Court held that these reimbursements were not remuneration for services performed, and therefore were not wages.\textsuperscript{61}

Central Illinois Public Service presented the Supreme Court with its first opportunity to consider the relationship between the employer's withholding obligation and the employee's gross income. In granting certiorari, the Court recognized a conflict between the Royster decision in the Fourth Circuit and Central Illinois Public Service in the Seventh.\textsuperscript{62} The Court's decision, however, did not clearly resolve the conflict\textsuperscript{63} nor did it develop standards for determining what constitutes wages in the employment setting.\textsuperscript{64}

\textit{Central Illinois Public Service Co. v. United States}

\textbf{Factual Background}

In 1963, the Central Illinois Public Service Co. reimbursed employees for reasonable expenses incurred in non-overnight travel on company business. This allowance included payments for meals in an amount not to exceed one dollar and forty cents per meal. An employee was entitled to the allowance even if he brought his own lunch from home. Although the employee rendered no services to Central Illinois during his lunch period, the company considered the payment beneficial to its business interests.\textsuperscript{65} In an audit conducted

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\textsuperscript{60} 479 F.2d 387 (4th Cir. 1973).

\textsuperscript{61} 445 F.2d at 1149.

\textsuperscript{62} Id. at 392. Although wages subject to withholding may be narrower than gross income, anything which constitutes "wages" should be gross income to the employee. See note 99 \textit{infra}. The court in Royster noted that case law had rejected a theory of complete congruence between sections governing employees' tax liabilities, and those determining the employer's withholding obligations. Id. at 388-89. The government had contended, nonetheless, that nondeductibility of the expenses indicated that the reimbursements were wages subject to withholding. The court rejected that argument, however, and essentially denied the existence of any relation between the two concepts. Id. at 390.

\textsuperscript{63} Id. at 24.

\textsuperscript{64} See notes 108-114 \textit{infra} and accompanying text.

\textsuperscript{65} 435 U.S. at 29.

\textsuperscript{66} 435 U.S. at 23. This lunch payment arrangement saved the company employee time otherwise spent in traveling back and forth from work. It also saved the company travel expenses.
in 1971, the Internal Revenue Service took the position that the lunch reimbursements made in 1963 qualified as wages subject to withholding. Central Illinois paid the deficiency, and filed a claim for refund of the total amount paid.

The District Court and the Quid Pro Quo Test

The district court held that these meal reimbursements were not wages under section 3401(a), and therefore were not subject to withholding.\(^8\) The government argued that the definition of wages should include any payment attributable to the employment relationship. The court, however, explained that such a sweeping definition is too broad since wages is a narrower term than income.\(^7\) In the court's view, wages are only those payments which are received as a quid pro quo for particular services performed by an employee for his employer.\(^8\) Since the employees did not perform any services during their lunch hours, the reimbursements were not wages.\(^9\)

The quid pro quo approach seems inconsistent with the purposes of withholding.\(^6\) Congress designed withholding to collect, concurrently with the receipt of income, the tax which an employee would eventually owe on that income. Under Kowalski certain meal reimbursements must be included in gross income.\(^9\) Under the district court's opinion in Central Illinois Public Service, however, reimbursements which do not compensate for a specific service, are not subject to withholding. Thus, the quid pro quo approach results in employee income which is subject to taxation but not to withholding.\(^2\) Hence, this approach will cause a disparity to arise between total tax liability and tax already collected at the end of the year.\(^3\)

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87. 405 F. Supp. at 749.
88. Id.
89. Id. The court would have had to "[depart] from the realities of business life and [stretch the statute] to try to include the lunch payments as being for services rendered to the company." See also Note, Taxation—Employer Reimbursements not Subject to F.I.C.A., F.U.T.A., and Income Tax Withholding, 10 Wake Forest L. Rev. 651 (1974); Overbeck, supra note 44, at 824. Both articles affirm the proposition that since the employees did not perform and were not expected to perform any services while eating, the payments could not constitute wages as they were not made in return for services rendered.
92. Note, Withholding Tax on Wages, supra note 90 at 410.
93. Id. The quid pro quo approach aggravates the existing gap between an employee's
Seventh Circuit Decision

The Seventh Circuit reversed the district court and adopted an expansive definition of wages.\textsuperscript{64} The court ruled that the meal allowance constituted remuneration for services performed by Central Illinois employees. The treasury regulations support this expansive definition.\textsuperscript{65} They make clear that neither the name by which remuneration is designated, nor the manner in which it is paid, is a material factor in determining whether the payments constitute wages. The court evaluated the reimbursement policy in the context of the total relationship that Central Illinois maintained with its employees.\textsuperscript{66} The payments were viewed as part of a total package of remuneration given in exchange for the employees' services.\textsuperscript{67} Therefore, the reimbursements were wages subject to withholding for tax purposes.\textsuperscript{68}

The total package approach used by the Seventh Circuit causes all employee income arising from the employment relationship to be considered wages.\textsuperscript{69} This expansive definition of wages is supported by the legislative history of section 3401.\textsuperscript{100} In adopting withholding, Congress established a pay-as-you-go system of taxation.\textsuperscript{101} Under...
this system, the individual pays tax on a current basis and avoids the burden of making large tax payments at one time. The Treasury also benefits because the scheme provides greater assurance of collecting taxes from the employee. This collection feature suggests that wages subject to withholding should include all sums which will determine the employee’s ultimate tax liability. Further, the first withholding provisions required employers to withhold to the extent that wages were includible in the employee’s gross income. Thus, the purposes of withholding mandate congruence between wages and gross income derived from the employment relation.

The Supreme Court’s Decision

The Supreme Court focused on two major issues: (1) the relationship between income and wages; and (2) the potential retroactive effect of its decision. With respect to the first matter, the Court adopted neither the quid pro quo model of the district court, nor the totality approach of the Seventh Circuit. Rather, it reversed the Seventh Circuit, and held that “wages” is a narrower concept than gross income. The government argued the totality approach, and claimed that section 61(a)(1) and section 3401 have equivalent scopes. The Court rejected this as a “rather facile conclusion.”

The Court explained that an expansive definition of wages is inconsistent with the withholding system. Congress chose simplic-
ity, ease of administration, and circumscription of the wage concept as the standard for the withholding system.\textsuperscript{112} This standard was intentionally narrow and precise.\textsuperscript{113} Consequently, the employer's obligation to withhold should not be speculative as it was in this situation.\textsuperscript{114}

The possible retroactive effect of a determination adverse to the taxpayer was a significant factor in the Court's decision.\textsuperscript{115} Central Illinois provided the meal reimbursements in 1963. The Court observed that no employer at that time had reason to believe meal allowances were wages subject to withholding.\textsuperscript{116} In 1963, it was even questionable whether meal reimbursements were includible in the employee's gross income.\textsuperscript{117} Since the tax status of these meal reimbursements was uncertain, the Court refused to impose a withholding obligation on Central Illinois.\textsuperscript{118}

The Court's refusal to apply this retroactive liability had three bases. First, this application would have been contrary to congressional intent expressed in amendments to the withholding provisions.\textsuperscript{119} Adjustments in the withholding tax provisions have always been imposed prospectively as a matter of equity and custom.\textsuperscript{120} Second, retroactive assessments should be limited to cases where the Commissioner seeks to correct a mistake of law, not where the employer did not know and had no reason to know of the withholding obligation.\textsuperscript{121} Finally, if withholding taxes could be assessed ret-
Meal Reimbursements

proactively, employers would effectively be made guarantors of their employees' tax liabilities. The legislative history of the Internal Revenue Code reveals no such congressional intent. Therefore, the Court concluded that retroactive application of withholding taxes would be an abuse of discretion.

Observations on Central Illinois Public Service

The Supreme Court in Central Illinois Public Service held that in 1963 the applicable rules and regulations did not require income tax withholding on meal reimbursements. Although Central Illinois Public Service supports a narrower construction for wages than for income, it does not indicate which reimbursements constitute remuneration for services rendered. Thus, the impact of the decision on meal reimbursements is unclear. Certainly, the decision restricts the Treasury Department's liberal interpretation of "wages." The Court's emphasis on the effect of a retroactive imposition of withholding implies that an identical case arising today might be decided differently.

In 1963, courts ruled that taxpayers could either exclude meal reimbursements or deduct meal expenses from gross income. Without an indication that these reimbursements were income to the employee, no employer could possibly have foreseen that he should withhold taxes on them. Since 1963, however, notions of gross income and business deductions have changed. Under Correll and Kowalski meal expenses are not deductible and meal reimbursements are not excludable from gross income. Thus, between 1963 and the present, the concept of the ultimate basis of an employee's tax liability, his income, has expanded. By employing a narrow definition of wages, the Court in Central Illinois Public

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122. 435 U.S. at 34 (Brennan, J., concurring). The concurring opinion states further, "It is possible that the employer could sue each of his employees to recover the amount of withholding taxes retroactively assessed by the government. The chance that such a method of recovery would be either practical or cost effective is remote, however." Id. at 34 n.3.

123. Id. at 34.

124. Id. at 32 n.12, 34 (Brennan, J., concurring).

125. Kovey, supra note 93 at 278.


127. Hanson v. Comm'r, 298 F.2d 391 (8th Cir. 1962).

128. See note 19 supra.

129. See notes 115-124 supra and accompanying text.


Service implied that this change should have no effect on the withholding obligation.\textsuperscript{132}

This implication creates a conflict with certain treasury regulations which tie wages to the employee's income.\textsuperscript{133} The Court did not address this conflict since its decision was based primarily on the specificity of an employer's withholding obligation as it existed in 1963. To maintain consistency, the Court might find these regulations invalid because they conflict with the withholding statute as interpreted in Central Illinois Public Service. If the Court were to void these regulations, however, Congress could still expand the definition of wages to include meal reimbursements.\textsuperscript{134}

\textbf{IMPACT OF Kowalski AND Central Illinois Public Service ON FRINGE BENEFITS}

Considered together, Kowalski and Central Illinois Public Service will usually require that meal reimbursements be included in gross income, yet employers need not withhold taxes on these amounts. However, the decisions have a broader impact. Each case has affected the taxability of fringe benefits other than meal reimbursements.

After the Supreme Court's decision in Kowalski, the Internal Revenue Service intensified its efforts to tax fringe benefits.\textsuperscript{135} Although Kowalski involved a cash allowance, the Service used language in the decision to subject non-cash benefits to taxation.\textsuperscript{136} The majority opinion in Kowalski provides strong support for the view that the concept of gross income has a broad sweep and includes most types

\begin{itemize}
\item \textsuperscript{132} 435 U.S. at 39 (Stewart, J., concurring).
\item The so-called overnight rule of United States v. Correll has nothing whatever to do with the definition of . . . "wages." It is exclusively concerned with what deductions employees may take when they prepare their own tax returns.
\item . . . The importation of the Correll rule into this case can do nothing, therefore, but confuse the issues actually before us.
\item Id. (citations omitted).
\item See note 75 supra.
\item Congress may subject meal reimbursements to withholding by expanding the definition of wages, but it has not done so yet. 435 U.S. at 33.
\item Scharff, The Battle Over Taxing Fringe Benefits, \textit{MONEY}, Oct. 1978 [hereinafter cited as Scharff]. This is not to imply that the government was not interested in taxing fringe benefits before Kowalski, only that after Kowalski the IRS interest in taxing the receipt of fringe benefits became even more intense.
\item The IRS is attempting to use the Kowalski decision which involves cash benefits as a basis to increase its attack on the taxability of non-cash benefits. Overbeck, supra note 44 at 827-28. Examples of non-cash benefits are railroad and airline passes, free nursery care for children, auto salesmen who have personal use of a demonstrator model, executive dining rooms, and medical benefits.
\end{itemize}
of fringe benefits.\textsuperscript{137} The Service has indicated that most fringe benefits, whether in cash or in kind, should be taxed unless specifically excluded by statute.\textsuperscript{138}

Congress responded to the Internal Revenue Service's position by passing the Fringe Benefits Act.\textsuperscript{139} Section One of the Act prohibits the Treasury Department from proposing or issuing prior to 1980 regulations governing the includability of fringe benefits in gross income.\textsuperscript{140} Congress conceded that section 61 is broad enough to include in taxable income any economic or financial benefit conferred upon the employee as compensation.\textsuperscript{141} Nevertheless, Congress recognized that in actual practice this "economic benefit" test has not been broadly construed.\textsuperscript{142} Thus, the Fringe Benefits Act exhibits Congressional concern over the Internal Revenue Service's increased enforcement activity in the fringe benefits area.

The Act gives Congress time to study and construct specific guidelines for the taxability of fringe benefits. Congress and the Treasury Department have each formed committees to examine and make recommendations concerning the tax treatment of fringe benefits.\textsuperscript{143} Certainly, any new legislation on fringe benefits should define precisely which benefits are includible in gross income and which are not.\textsuperscript{144} The Treasury Department has warned that if Congress fails to act decisively, the Department will be ready to take tough measures in 1980.\textsuperscript{145}

The \textit{Central Illinois Public Service} decision, unlike \textit{Kowalski}, has hindered the Internal Revenue Service's enforcement activities in the fringe benefits area. \textit{Central Illinois Public Service} supports a

\textsuperscript{137} Stechel, \textit{Effect of Recent Supreme Court Decisions on Use of Meals and Lodging Exclusions}, 20 \textit{TAX. FOR ACCOUNTANTS} 216 (1978). The \textit{Kowalski} decision promotes an expansive interpretation of gross income. See text accompanying notes 35-41 \textit{supra}.

\textsuperscript{138} Scharff, \textit{supra} note 135.


\textsuperscript{140} \textit{Id}.

\textsuperscript{141} \textit{Id}.

\textsuperscript{142} \textit{Id}. As a result, there has been an inevitable lack of uniformity of treatment of taxpayers who receive different types of benefits even though the benefits may have approximately the same economic value.

\textsuperscript{143} Chairman Al Ullman of the House Ways and Means Committee has appointed a special task force to study the tax treatment of employee fringe benefits. In addition, Donald Lubick, Assistant Treasury Secretary for Tax Policy, initiated a joint Internal Revenue Service-Treasury Department study on fringe benefits. J. J. Pickle, Chairman of the House Ways and Means Committee Task Force on Fringe Benefits, has proposed safe harbor legislation which would allow most existing benefits that have gone untaxed to remain that way but preventing their proliferation. Scharff, \textit{supra} note 135.

\textsuperscript{144} Other problems facing Congress are which non-cash benefits provided to employees are wages subject to withholding taxes, and how to value benefits provided in-kind.

\textsuperscript{145} Scharff, \textit{supra} note 135.
definition of wages narrower than the concept of income. Under the decision, meal reimbursements as well as other fringe benefits includible in gross income, might not constitute wages subject to withholding. Thus, the decision blunts the Internal Revenue Service’s attempt to use the withholding system as the spearhead of its attack on fringe benefits.\textsuperscript{146} Congress may, however, reduce this obstacle to enforcement. The Report of the House Ways and Means Committee for the Fringe Benefits Act exhibits Congressional awareness of the need for guidelines providing uniformity in the wage area.

Finally, equitable considerations arising in \textit{Central Illinois Public Service} and \textit{Kowalski} suggest that limitations should be imposed on retroactive treatment in future fringe benefits legislation.\textsuperscript{147} A principle reason for the decision in \textit{Central Illinois Public Service} was the Court’s desire to relieve the employer from inadvertent retroactive liability.\textsuperscript{148} Congress has also registered its disapproval of retroactive tax liability. After \textit{Kowalski}, the Internal Revenue Service attempted to collect back-taxes from state troopers. In section three of the Fringe Benefits Act Congress prohibited the Service from retroactively applying \textit{Kowalski}.\textsuperscript{149} Similarly, any future fringe benefits legislation or rulings by the Treasury Department should be solely prospective.\textsuperscript{150}

**CONCLUSION**

\textit{Kowalski} held that cash meal reimbursements for non-overnight travel were includible in gross income. The decision provided a

\textsuperscript{146} Kovey, \textit{supra} note 93, at 276. There are several reasons why an expansive interpretation of withholding is preferable. The Treasury is assured of more revenue since it is guarded against deaths, disappearances, and insolvencies. When employers are required to withhold taxes, collection is more efficient because the IRS does not have to depend on each employee to report his taxable reimbursement on his return. An expansive interpretation is also favorable to an employee since it allows him to avoid the burden of making large tax payments at one time.

\textsuperscript{147} Kovey, \textit{supra} note 93, at 279.

\textsuperscript{148} 435 U.S. at 37 (Brennan, J., concurring). The Court reasoned, “that additional withholding taxes should not at least without good reason be assessed against employers who did not know of and who had no reason to know of increased withholding obligations at the time wages had to be withheld.” \textit{Id.} \textit{See} note 121 \textit{supra}.

\textsuperscript{149} The only reason given for this position is that Congress believes that the \textit{Kowalski} decision should not be applied on a retroactive basis. Fringe Benefits Act, Pub. L. No. 95-427, 92 Stat. 996 (1978). The Act excludes from gross income all statutory subsistence allowances received by state police officers, through 1977.

\textsuperscript{150} Kovey, \textit{supra} note 93 at 279; Smith, \textit{"Independent Contractor" or \textit{"Employee"}? That is the Question}, 33 N.Y.U. ANN. INST. ON FED. TAx. 577 (1975). \textit{See} Treas. Reg. § 301.7805-1(b) (1960) which states, “[T]he Secretary, may prescribe the extent, if any, to which any ruling or regulation of Treasury decision relating to the internal revenue laws shall be applied without retroactive effect.” Lenient use should be made of this regulation until precise guidelines are formed.
broad interpretation of income and construed the meal exclusion narrowly. In Central Illinois Public Service the Court ruled that similar meal allowances did not constitute wages subject to withholding. This results in confining the concept of wages to limits narrower than notions of gross income.

The effect of the two decisions is that meal reimbursements are generally taxable to the employee, yet his employer is not required to withhold taxes on them. This anomalous combination impedes enforcement and tends to place a greater tax burden on the employee at the end of the year. Further, the narrow concept of wages fails to effectuate the purposes of the withholding system and is symptomatic of a general lack of standards in the fringe benefits area.

To achieve clarity and equality in the taxation of fringe benefits, Congress should devise specific guidelines. Any new legislation should define which benefits constitute gross income and which do not. Then, Congress should expand the definition of wages to include those fringe benefits which also constitute gross income.\(^\text{151}\) If gross income is well defined, the simplest way to determine the employer’s withholding obligation will be to equate wages with employee gross income.

151. The Court notes the availability of this option at 435 U.S. at 33.

**Mark Resnik**