Nontaxable Benefit Elections: Do They Trigger Taxable Income? More Confusion after *Express Oil Change*

Of all the creatures lurking in the IRS laboratory, one of the scariest is the "assignment of income" doctrine. Though barely past the protoplasm stage after many years of development, this theory yet remains a handy instrument of terror in the compensation world. Employers tempted to offer an employee-friendly array of flexible benefits must still worry that this theory may leap to life and successfully challenge an otherwise tempting compensation package.

The IRS recently let its theory out for a run in the employee benefits neighborhood in *Express Oil Change, Inc. v. United States*, 25 F.Supp. 2d 1313 (N.D. Ala. 1996), affirmed without opinion, __ F.3d __ (11th Cir. 1998). Fittingly enough, neither the district court nor the Eleventh Circuit made clear whether they think the theory is alive—nor did the Government's litigators explain what it would look like if it were.

Somewhat simplified, the facts of the case are these: The employer said to new employees before hire: We'll give you $300 per week. Or you can take $250 per week, and we'll pay premiums to an insurer for nontaxable health coverage. Fine, said some of the employees, also before hire. We'll take the health insurance. Not so fast, said the IRS to the employer. Any health insurance premiums you pay in this deal are taxable wages, subject to FICA, FUTA, and income withholding taxes. The employer paid the taxes, and sought a refund in district court.

The court agreed with the employer, and held that the health insurance premiums were not wages, either for FICA/FUTA or income tax withholding purposes.

In addition to deciding they were not "wages," the court also discussed the separate question of whether the premiums were "income." This is a separate issue, as the court realized, because for Internal Revenue Code purposes, "wages" and "income" are not always the same. Amounts paid as remuneration for services may be income under Code Section 61, even if not wages for withholding tax

purposes. (*Central Illinois Public Service Co. v. United States,* 435 U.S. 21 (1978).) If not wages under Code Section 3405, such amounts are not subject to income tax withholding by the employer under that section. But if income under Code Section 61 they might still be taxable to the recipient employee.

Having recognized it as a separate question, however, the court did not address the "income" issue entirely clearly. One reading of the opinion (ours): The IRS makes a pretty good argument that the amounts are taxable income under the assignment of income doctrine, but we do not have to reach this issue. Even if "income" to employees, the premiums are not "wages" subject to employer withholding, which is the only question we have to decide here.

Another possible reading of the opinion: The premiums are taxable income under the "assignment of income" doctrine. We agree with the district court, said the Eleventh Circuit, helpfully.

Neither court reached the second income theory advanced by the Government: The premiums were taxable income because offered in an elective arrangement outside of a qualified cafeteria plan under Code Section 125, which according to this argument is the exclusive way of providing such elections.

The case thus leaves unresolved the most fundamental question: When an employee agrees to reduce future cash compensation in return for otherwise excludable benefits (and assuming the benefit is not subject to cancellation), is the benefit taxable income or not? If it is income, employers' victory in this case is incomplete. The benefit is not included in "wages" for purposes of the employer's FICA, FUTA, and income tax withholding obligations. But the employer must report the benefit as income on the employee's W-2, and the employee is subject to income tax on it. (Rev. Proc. 80-53, 1980-2 C.B. 848.)

The implications of this issue go beyond the facts of *Express Oil Change* to include other flexible compensation arrangements provided outside of a cafeteria plan. It is not unusual, for example, for employers to negotiate individual benefit packages with senior level employees. In these packages, the employer might offer nontaxable benefits such as health insurance in return for reductions in otherwise available taxable compensation. Do these trades give rise to taxable income, even if not to withholdable wages? Does it matter if the benefit is insured or not?

History of the Assignment of Income Doctrine

The IRS has a number of long-standing doctrines for achieving taxation of flexible compensation deals. Under the doctrine of

"constructive receipt," an individual is in receipt of income for tax purposes in the taxable year it is credited to him or her, or made available to the individual. (Treas. Reg. Section 1.451-2(a).) However, the doctrine does not apply if the employee's election is made before the period in which the services for which the compensation is earned are performed. (Rev. Rul. 60-31, 1960-1 C.B. 174.) For this reason, the doctrine of constructive receipt does not result in current taxation of excludable benefits provided in return for taxable income, if the swap occurs in a prior period. (GCM 37014.)

The separate doctrine of economic benefit holds that a taxpayer must include in income amounts that would be income if paid directly to the taxpayer, that are irrevocably set aside for the taxpayer's benefit in a fund in which the taxpayer has a vested interest. (See, for example, *E.T. Sproull v. Commissioner*, 16 T.C. 244 (1951), affirmed per curiam, 194 F.2d 541 (6th Cir. 1952).) When an employee relinquishes cash for health insurance, however, the economic benefit doctrine does not result in current taxation. This is because any such benefit received by the employee is received in the form of employer-provided health coverage, which is specifically excluded from taxable income under Section 106 of the Code. For this reason, there is no taxation of this arrangement under *Sproull*. (See, for example, GCM 37014.)

The same reasoning suggests that there is no taxation of the arrangement under Code Section 83, which was enacted after *Sproull* was decided, and which codifies (or supplements—depending on your point of view) the economic benefit doctrine of that case.

In short, rather straightforward flexible benefit arrangements would appear to work under these various theories of income receipt.

In response, the IRS began to develop the assignment of income doctrine. Among other places, this theory was articulated in the employee benefits context by GCM 37014, written in 1977. Under the facts of this GCM, an employer allowed its employees to choose between various kinds of taxable and nontaxable insured benefits (for example, group term life insurance, automobile insurance, and household insurance, among others).The IRS reasoned that by directing the employer to purchase insurance for him or her with funds otherwise available as taxable income, the employee in this situation had enough "dominion and control" over this income to be in actual receipt of it—even when the employee elected an otherwise excludable benefit.

In support of this theory, the GCM cited a number of cases including *Lucas v. Earl*, 281 U.S. 111 (1930), and *Helvering v. Horst*, 311 U.S. 112 (1940). In *Lucas v. Earl*, a husband in a community

property state assigned half his future earnings to his wife. The Court held that, even though the contract was valid, the husband remained taxable on the income as an "anticipatory assignment" of income. In *Helvering v. Horst*, the owner of negotiable bonds detached the coupons before interest was payable, and gave them to his son. The Court held that under its decision in *Lucas v. Earl*, the donor/father was taxable on each interest payment when it was paid to his son.

Departing somewhat from its earlier reasoning, the Court explained that assignment of income by one party to another was income to the assignor, because the assignor enjoyed "control" and "power" over the money. "The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment and hence the realization of the income by him who exercises it."

A third case, not cited by GCM 37014, but usually included in later PLRs as part of a triptych, is *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). In *P.G. Lake*, the taxpayer assigned certain oil payment rights to a creditor as consideration for cancellation of indebtedness. The Court held that under *Helvering v. Horst*, the taxpayer/assignor was subject to taxation on each oil payment at the time it was paid to the creditor/assignee.

The assignment of income theory may result in taxation of an agreement when other theories do not, according to GCM 37014. In contrast with the constructive receipt doctrine, the assignment of income theory applies even if the agreement is entered into before amounts are earned. (*Lucas v. Earl* at 114.) In contrast with the economic benefit doctrine, assignment of income theory employs the notion that the employee is in actual receipt of any income he or she could have received when he directs that this income be paid to a third party. For example, under this doctrine any health care elected by the employee is not employer-provided. Rather, the employee is in actual receipt of taxable income at the time he directs his employer to pay the income to a third-party insurer as premiums for health insurance. (GCM 37014. See *Helvering v. Horst* at 118.) An employee's purchase of health insurance with his own funds is, of course, not excludable under Section 106 (although it might be deductible under Section 213).

The IRS has used this doctrine to disallow a number of arrangements that would allow employees to choose between various kinds of excludable employee benefits and deferred taxable compensation. For example, the IRS has issued unfavorable rulings where the employees could elect between employer contributions to a profit

sharing plan or to a health benefits account within the plan (PLR 9513027); between taxable compensation or health insurance, where the election was a one-time irrevocable election made before services commenced (PLR 9400602); and between contributions to a qualified retirement plan or insured medical coverage in the next year (PLR 9104050).The IRS disallowed tax-free treatment of all these arrangements as anticipatory assignments of income under *Helvering v. Horst*, *Lucas v. Earl*, and *P.G. Lake*.

Does the Theory Apply Outside of Third-Party Assignments?

Despite its long history, the assignment of income doctrine is less than fully formed. The most significant uncertainty in IRS thinking would appear to be whether it applies outside of the context of third-party arrangements. That is, does the IRS think the employee "assigns" income only when he directs the employer to transfer amounts to a third party such as an insurance company or a trust? Or does it apply when the employee elects that the employer pay him a benefit directly, with no third-party payor involved?

As a practical matter, the implications of this question are significant. If the theory applies only when the employee "assigns" income to a third party, it triggers income only if the employee elects a benefit paid from a trust, insurance company, or other separate person. The theory does not apply to elections for unfunded, uninsured benefits. But if the employee can be said somehow to "assign" income to himself, then the theory might trigger taxable income when he elects a benefit paid directly from the employer, with no third-party payor. In this case, the theory might apply even to elections for unfunded, uninsured benefits. (The IRS's statutory argument, based on Code Section 125, of course does not depend on whether the arrangement is insured or not, but that is not the topic of this piece.)

As a theoretical matter, this first uncertainty is sire to a litter of related ones. If the assignment of income doctrine applies only to third-party transactions, why is it different from the economic benefit doctrine? If different because of the "dominion and control" concept, why does not the doctrine also shift the timing of income to the moment of the exercise of dominion and control? Of course, the case law uniformly implies that the theory does *not* shift the timing of income receipt. (See, for example, *Helvering v. Horst* (income taxable to assignor at the time received by assignee); *P.G. Lake* (same).) So bringing us full circle, what does the "dominion and control" theory add to the economic benefit theory? And if it adds nothing, should it

even exist? Shouldn't Occam's razor apply to theories of income receipt as well as to any other theoretical question?

The IRS has historically tried to apply the doctrine in two-party situations. For example, in *Oates v. Commissioner,* the IRS argued that an election to delay receipt of income (after a prior election) was taxable under the theory of *Lucas v. Earl* and *Helvering v. Horst.* The Tax Court held, however, that the doctrine of these two cases does not apply outside the context of transfers to a third party. (18 T.C. 570 (1952), affirmed, 207 F.2d 711 (7th Cir. 1953).)

After its defeat in *Oates*, in its litigating posture and its PLRs, the IRS would appear to have confined the assignment of income theory only to third-party arrangements in which the welfare benefit is funded or insured. (See, for example, PLRs 9104050, 9400602, 9513027, 9227035, 9340054.) The IRS has won two cases arguing that an election between current and deferred cash is taxable under this doctrine, but both cases involved assignments to a third party in the form of a funded trust. (*United States v. Basye*, 410 U.S. 441 (1973); *Hicks v. United States*, 314 F.2d 180 (4th Cir. 1963).) Even *Express Oil Change*, as we have noted, involves insured benefits, and so involves "assignment" to a third-party insurer.

In short, it is unclear whether the IRS thinks its own assignment of income doctrine applies outside the third-party context. The dominion and control theory of GCM 37014 is drafted so broadly that it could arguably embrace two-party transactions. But in practice, the IRS has apparently applied the doctrine only in third-party arrangements.

Fruit or Tree?

One reason the scope of the doctrine is unclear may be that the case law itself is theoretically confused, or at any rate confusing. Unfortunately, in *Lucas v. Earl*, Justice Holmes chose to describe the doctrine by recourse to metaphor: Income tax may not be avoided, he held, by an "arrangement by which the fruits are attributed to a different tree from the one on which they grew."

Like many metaphors, the fruit-and-tree analogy gives the impression of clarity without the clarity. As used in *Lucas v. Earl*, the image suggests that the assignment of income doctrine applies only when income is assigned to a third party (the fruit is not taxed until transferred elsewhere). In *Helvering v. Horst*, the Court used the "fruit" metaphor to illustrate what had already become a slight

shift in the theory—that is, the idea that "control" over income is tantamount to actual receipt of that income: "The taxpayer has equally enjoyed the fruits of his labor or investment and obtain satisfaction of his desires," whether he disposes of it or collects it.

Further developing the "control" concept articulated in *Helvering v. Horst,* the Court in *P.G. Lake* used the doctrine to determine whether a taxpayer who disposes of income rights has exercised enough control over this "fruit" to be taxable on the disposition as ordinary income, rather than capital gain. After *P.G. Lake*, courts used the doctrine, and the fruit-and-tree image, to determine whether a taxpayer who disposes of an income right is in receipt of capital gain (the "tree") or ordinary income (the "fruit"). To take but one rather blowsy example: "We fail to see why the ripeness of the fruit matters so long as the entire tree is transplanted before the fruit is harvested." (*Caruth Corp. v. U.S.*, 865 F.2d 644 (5th Cir. 1989).)

It can be seen in these snippets that the doctrine first articulated in *Lucas v. Earl* has migrated. What started as a doctrine designed to identify which party should be taxed when income is disposed of ended up as a doctrine used to identify the character of income earned in a transaction.

This shift is hard to detect, maybe in part because of that tricky fruit-and-tree image, and in part because these two questions are in many cases the same. For example, when the taxpayer in *P.G. Lake* assigned oil payment in return for cancellation of indebtedness, the character of the taxpayer's income was oil income subject to depletion—rather than capital gain—for the reason that this taxpayer was identified as the proper recipient of that income in a third-party assignment.

But sometimes these two questions are not the same. A number of cases have involved the tax treatment of individuals with contractual rights to future income who relinquish these rights for cash. (*Holt v. Commissioner*, 35 T.C. 588 (1961), acq. 1961-2 C.B. 4, affirmed, 303 F.2d 687 (9th Cir. 1962); *Foote v. Commissioner*, 81 T.C. 930, 934 (1983); *Flower v. Commissioner,* 61 T.C. 140, 149 (1973), affirmed without opinion, 505 F. 2d 1302 (5th Cir. 1974). A typical example is the university professor who relinquishes tenure rights for a lump sum cash payment. (*Foote v. Commissioner.*) Citing *P.G. Lake*, the courts have held that the lump sum is ordinary income, rather than capital gain. That is, these cases invoke the assignment of income doctrine in a two-party transaction, where only the character of the income is at issue.

Does Section 125 Make This Discussion Moot?

Since enactment of Section 125, a second argument is available to the IRS. In PLR 9400602 the IRS considered the tax status of an arrangement similar to the one at issue in *Express Oil Change*. Under this arrangement, new hires were permitted, before commencing services, to elect between taxable cash salary or cash salary at a reduced amount, accompanied by nontaxable health benefits. The IRS held that amounts paid to the insurer were taxable at the time paid.

In addition to citing *Helvering v. Horst* and *Lucas v. Earl,* PLR 9400602 articulated a second theory as well. The PLR pointed to the enactment of the "cafeteria plan" provisions of Section 125, which permit employees to elect between taxable and nontaxable benefits under fairly rigidly defined rules. The PLR held that in enacting Section 125, Congress provided an exclusive way for employers to offer employees a choice between cash and excludable employer-provided benefits. Thus, according to PLR 9400602, whatever the status of the election before enactment of Section 125, it is no good after such enactment.

An alternative way of viewing Section 125 is as a safe harbor way of providing flexible benefit elections, rather than as the exclusive means permitted by Congress. The courts have not ruled on either view, however.

Express Oil Change

What does the IRS think, and what did the courts think of these issues in *Express Oil Change*?

District Court

Before the district court, the government argued that the amounts were earned by the employee under the assignment of income doctrine of *Lucas v. Earl* and *Basye*:

> The option to receive compensation as cash or health benefits is immaterial because the employee electing health coverage is merely assigning the future income (cash compensation) for consideration (health insurance). The result is the same as if the entire compensation for services had been paid directly to the employee and then a portion paid by the employee as his or her contribution to the premium. (Govt's Br. at 8-9.)

On the two-party versus three-party question, the Government is conservative; the brief expressly states that the transaction gives rise to income because of the transfer of premiums to the third-party insurer.

In addition, the Government argued (as had the IRS in PLR 9400602) that by enacting Section 125, Congress set forth the exclusive way of providing elections between taxable and nontaxable benefits. (Govt's Br. at 8-9.) Taxpayer's arrangement was not a qualified cafeteria plan, the Government argued, and thus gave rise to taxation when the employee elects otherwise excludable health insurance.

Most of the district court's opinion sets forth its reasons for holding that amounts paid to the health insurer are not "wages" for withholding purposes. On the prior question of whether the amounts are "income," the opinion is rather unclear. Here's what the court says:

> Defendant argues persuasively that because plaintiff's employees had the choice of accepting a salary reduction in exchange for health insurance coverage or a higher salary, they effectively assigned the amount of the salary reduction controlling their income...The question in this case, however, is not whether the salary reduction amounts constitute gross income to the employees, but rather whether they constitute "wages" for the purpose of income tax withholding.

We think the best reading of this is as a decision to forego a decision on the logically prior legal question—is it income?—because it is made moot by their decision on the ultimate legal question: Even if income, it isn't wages.

We admit our conclusion is clouded, however, by the fact that the court cites *Central Illinois* and Rev. Proc. 80-53, 1980-2 C.B. 848, in support. *Central Illinois* holds that certain fringe benefits provided as remuneration were income but not wages; Rev. Proc. 80-53 governs the employer's reporting obligations with respect to such remuneration. That is, it could be argued that by citing these authorities, the district court analyzes the issue in two separate but necessary steps: The amounts are (1) income but (2) not wages.

Eleventh Circuit

We are somewhat puzzled by the Government's litigating posture on appeal. As we have said, while not clear on this issue, the district court's opinion could arguably be construed as holding that the employer's payment of insurance premiums in this instance was

"income" to employees. In any event, the opinion unambiguously finds the Government's assignment of income argument "persuasive."

In the face of these kind words from the district court, the Government's appellate brief would appear to snatch defeat from the jaws of victory. The brief does not return to the assignment of income theory, or the cites to *Lucas v. Earl* and *Helvering v. Horst,* that the court below found "persuasive." Instead, on the issue of whether the amounts are income, the Government switches theories.

The Government argues, among other things, that those employees who elected health insurance were in "constructive receipt" of the premiums. Having constructively received those premiums, the argument continues, employees assigned those amounts to the employer for payment of health insurance premiums. (Govt's App. Br. at 34.)

It is hard to know what to make of this argument. The Government advances no explanation and no authority for its application of the constructive receipt doctrine. (It is conceivable that they apply the doctrine, for example, because of employees' apparent right to cancel the policies, mentioned for the first time in the Government's appellate brief. But without further explanation, this is only speculation.) If the argument represents evolution in the IRS's thinking, however, it is ominous. Under the theory, amounts once constructively received are taxable when "assigned" to the employer. That is, the theory would arguably extend the assignment of income doctrine to two-party situations.

On the other hand, the argument may not be a new theory at all, but only a rather lengthy expression of confusion on the part of its drafters.

Conclusion

After *Express Oil Change,* we know even less about the IRS's assignment of income theory than we did before. We do not know why the Government dropped the theory on appellate brief, having advanced it with some success below. We do not know why, to the extent the Government advanced anything like an "assignment" concept to the appeals court, it explained the transaction as an "assignment" of premiums to the employer following "constructive receipt" by the employee. We do not know if this new articulation is abandonment of the doctrine, repositioning for deployment against two-party situations, or simply confusion.

In light of this case, and given the weird and continued morphing of this creature after years of haphazard development, we might suggest that the IRS send its doctrine back to the laboratory for quick disposal in the biohazards bin. But more likely we must await the intrusion of its next incarnation in the employee compensation landscape. Stay tuned.

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