

AN ANALYSIS OF THE DICHOTOMOUS  
FEDERAL INCOME TAX TREATMENT OF  
THE INCOME-PRODUCING EXPENSES  
OF INDIVIDUALS

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THE INCOME-PRODUCING EXPENSES OF INDIVIDUALS

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## ABSTRACT

### AN ANALYSIS OF THE DICHOTOMOUS FEDERAL INCOME TAX TREATMENT OF THE INCOME-PRODUCING EXPENSES OF INDIVIDUALS

By

Kevin Mark Misiewicz

The income-producing expenses of individuals have been subject to a dichotomous treatment for the past 30 years. Some expenses are deductible for adjusted gross income while others may only be deducted from adjusted gross income by taxpayers who itemized deductions. The purpose of this research was to determine the appropriateness of the present dichotomous Federal income tax treatment of the income-producing expenses of individuals. The main criteria applied were horizontal and vertical equity achievement.

The explicit reasons advanced for making some expenses deductible for adjusted gross income have been inconsistent and conflicting. Justifications have ranged from "directly incurred in a trade or business" or "administrative simplicity" to "substantial relative to income" or "similar to business expenses and likely to be relatively large."

An analysis of individual expense categories derived a few distinctions between income-producing expenses deductible for adjusted gross income and those which must be itemized. Two

deductions for adjusted gross income have maximum time and minimum location constraints while itemized income-producing expenses do not. No other consistent differences existed between these two expense groups in regard to length of acceptance, amount constraints, minimum time constraints, maximum location limits, personal versus business allocation, motivation determining criteria, substantiation requirements, implications of employer requests or income-producing status.

An analysis of court cases concerning income-producing expenses from 1969 through 1974 identified only one consideration which differed greatly without explanation between these two deduction groups. Deductions for adjusted gross income had a larger proportion of cases decided in Courts of Appeals and a smaller proportion of cases decided in the Tax Court than did cases concerning itemized income-producing expenses. Differences in frequency of occurrence between groups of expenses of other considerations were largely explained by the nature of one expense within a group. There was only a slight tendency for amounts of expense or tax in dispute to be higher in cases involving deductions for adjusted gross income.

These groups did not significantly differ in regard to average numbers of government and taxpayer lawyers and frequency of reference to Section 262, the meanings of ordinary and necessary, the meaning of a trade or business, poor substantiation and whether the expense was reasonable.

The impact of the present dichotomous treatment is contrary to the principles of horizontal and vertical equity. Taxpayers may have to pay more tax than others in equal economic circumstances because

Kevin Mark Misiewicz

of differences in occupations, types of income-producing expenses incurred, the existence of direct reimbursement, revenue patterns or incidence of home ownership. Vertical inequity is present to the extent that lower income taxpayers itemize less often because they, consequently, are less often able to deduct many income-producing expenses. The impact is also vertically inequitable because low-income taxpayers are discouraged from deducting income-producing expenses for adjusted gross income by the structure of Form 1040A. Non-itemizers apparently deduct income-producing expenses less frequently and in smaller amounts for adjusted gross income than do itemizers, who tend to have larger incomes, also probably because they keep poorer records and are less knowledgeable concerning what is deductible since so few of their expenses are presently deductible.

Two most probable alternatives would provide more horizontal and vertical equity for the treatment of income-producing expenses. Each choice, however, leads to an increase in some administrative costs and to a loss in tax revenues unless tax rates are changed.

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## CHAPTER I

### INTRODUCTION

#### Background

The basic structure of our income tax law has stayed intact since its modern adoption in 1913. However, over time it has assumed a growing role in federal revenues and concurrently it has probably become one of the most complicated tax statutes ever devised by man. These developments have led to difficulty in assessing its ramifications, but also to an increase in the importance of this assessment.

An analysis of any tax or tax system is complicated by its interrelated objectives. Objectives such as allocation, stabilization, revenue collection, and redistribution, which appear to be among the principal aims of federal tax policy, are often in conflict with each other.

The principle of equity is a common function of these differing objectives. Equity is defined as "the quality of being fair or impartial."<sup>1</sup> From this definition come the concepts of vertical equity and horizontal equity.

Vertical equity "describes the treatment of taxpayers who are unequal with the appropriate degree of inequality."<sup>2</sup> Judgments about the exact appropriate degree of unequal treatment depend on economic measurements of equal sacrifice, equal marginal utility, and other measurement criteria. However, this research will deal

with vertical equity to the extent that present law or alternatives appear to favor one income group over another.

"Perhaps the most widely accepted principle of equity in taxation is that people in equal positions should be treated equally."<sup>3</sup> This is horizontal equity. "Without such equity, taxes may as well be assessed at random."<sup>4</sup> The two problems with achieving this ideal are determining the index of equality to be used and then defining it. Income has become the main 20th century index for measuring equality. "There is widespread agreement that the basic principle of equity underlying individual income taxation is that equal amounts of income should bear equal tax liabilities."<sup>5</sup> Income's definition for tax purposes has been the subject of much debate and legislation.

Tax policy objectives are basically achieved through directives (a) determining which gross revenues are taxable, (b) determining what can be deducted from taxable gross revenues to obtain taxable income, (c) specifying where in the computation process these items should be subtracted, and (d) prescribing at what rates the taxable income is to be taxed. This research will confine itself to the middle 2 areas insofar as they apply to the horizontally and vertically equitable treatment of expenses incurred by individuals to produce gross income.

#### Present Law

Basically, the structure of the computation of an individual's taxable income is as follows:

|                                               |
|-----------------------------------------------|
| Gross Revenues                                |
| - <u>Exclusions</u>                           |
| Gross Income                                  |
| - <u>Deductions for Adjusted Gross Income</u> |
| Adjusted Gross Income                         |

- Personal Exemptions
  - Largest of 
    - Itemized Deductions
    - Percentage Standard Deduction
    - Low-income Allowance
- 
- Taxable Income

The main deductions for adjusted gross income are:

1. moving expenses,
2. travel expenses,
3. local transportation expenses,
4. outside salesmen expenses,
5. other reimbursed expenses incurred in connection with employment where the reimbursement is included in gross income.
6. trade or business expenses of self-employed individuals,
7. expenses attributable to rents or royalties,
8. payments by a self-employed person to a retirement plan,
9. losses from sale or exchange of property,
10. long-term capital gains deduction, and
11. losses from nonbusiness bad debts.

The main itemized deductions from adjusted gross income are:

1. medical expenses,
2. tax expenses,
3. charitable contributions,
4. interest expenses,
5. personal casualty losses,
6. alimony payments,
7. tax counseling and assistance fees,
8. miscellaneous deductions related to the production of income:
  - a) entertainment expenses,
  - b) education expenses,
  - c) work clothes and uniforms (including upkeep),
  - d) union dues,
  - e) protective clothing,
  - f) residence expenses related to employment,
  - g) fees paid in seeking or obtaining employment,
  - h) small tools and supplies,
  - i) subscriptions to professional journals,
  - j) membership dues in professional societies,
  - k) surety bond premiums,
  - l) certain household and dependent care services,
  - m) cost of physical exams paid by the taxpayer and required by the employer,
  - n) cost of business gifts,
  - o) telephone expenses,
  - p) expenses of planning and maintaining investments, and
  - q) gambling losses to the extent of gambling gains.

Sections 62, 162, 212, 214, and 217 of the Internal Revenue Code of 1954, as amended, cover the income-producing expenses of individuals. Sections 162, 212, 214, and 217 cover deductible expenses. Section 162 allows as a deduction all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Sections 214 and 217 allow the deduction of certain household and dependent care services and moving expenses, respectively. The deduction of expenses incurred in the production or collection of nontrade or nonbusiness income is allowed by Section 212. Section 62 limits the deduction for adjusted gross income of these expenses to:

1. trade and business expenses of self-employed persons in trade, business, or profession,
2. travel, local transportation, outside salesmen, moving, and reimbursed expenses (where the reimbursement is included in gross income) of employees, and
3. expenses attributable to the production of rents or royalties.

#### Statement of the Problem

Expenses incurred by individuals to produce income as they are presently defined by Sections 162, 212, 214, and 217 of the Internal Revenue Code of 1954, as amended, are deductible in either of two different places for some taxpayers and some cannot be deducted at all by other taxpayers because they do not itemize deductions.

The present structure of the law means that many expenses which individuals incur to produce income are deductible only if they itemize deductions. Taxpayers only find it beneficial to itemize when their itemized deductions exceed the \$1,300 low-income allowance and the percentage standard deduction which is 15 per cent of their

adjusted gross income with a \$2,000 maximum. If either of the latter is largest, the taxpayer does not itemize and therefore gets no deduction for some of his income-producing expenses. In 1971, the most recent year for which statistics are available, only 41 per cent of all individual returns contained itemized deductions. For returns with adjusted gross income less than \$5,000, 10 per cent of returns contained itemized deductions. Returns with an adjusted gross income greater than \$15,000 contained itemized deductions 87 per cent of the time.<sup>6</sup> Thus only a minority of all taxpayers itemize deductions and only one-tenth of the lowest income taxpayers itemize. These expenses which non-itemizers are not allowed to deduct amount to \$3 to \$4 billion.<sup>7</sup> On the other hand, for those non-itemizers who have a percentage standard deduction between \$1,300 and \$2,000, their percentage standard deduction is higher than it would have been if they had been able to deduct all of their income-producing expenses for adjusted gross income. This somewhat offsets their inability to deduct some income-producing expenses.

Both itemizers and non-itemizers are affected by this dichotomous treatment of income-producing expenses in some states and localities which use federal adjusted gross income as a base for their income taxes. Some of these, such as Michigan and Illinois, do not then allow a deduction for income-producing expenses which would have been itemized deductions on a federal income tax return. Thus, the inability to deduct some of his expenses incurred to produce income for adjusted gross income on the federal return can result in higher state and city income tax bills for the taxpayer. However, this impact is lessened for federal itemizers since these increased state and local income

taxes can be deducted on their federal income tax return.

Even if the taxpayer itemizes, other parts of his computation of tax process are affected by the present dichotomous treatment of income-producing expenses:

1. Basically, only medicine and drugs in excess of 1 per cent of adjusted gross income and total medical expenses in excess of 3 per cent of adjusted gross income may be deducted.
2. Charitable contributions can only be deducted to the extent they do not exceed a percentage of adjusted gross income.
3. The maximum tax on earned income is based on gross income from wages, etc., less any deductions for adjusted gross income which are connected with this earned income.
4. The maximum allowable deduction for certain household and dependent care services is reduced by \$1 for every \$2 of adjusted gross income in excess of \$18,000.
5. Adjusted gross income is used as a base to obtain the deductible state and local sales tax from tables provided by the Internal Revenue Service.

This dichotomous treatment also discriminates in favor of self-employed taxpayers and certain groups of employees and investors.

1. Reimbursed employee expenses may be deducted for adjusted gross income where the reimbursement is included in gross income even though they otherwise would be deductible only if the taxpayer itemized deductions. This treatment favors the employees who have expense allowances over the employee who receives the same total compensation but in the form of a larger salary with no expense allowance.
2. The self-employed person and the employee who is an outside salesman may deduct all of their income-producing expenses for adjusted gross income. Employees, other than outside salesmen, may deduct many of their income-producing expenses only if they itemize deductions.
3. Dealers in income-producing property are considered to be in a trade or business so all of their expenses are deductions for adjusted gross income. Investors in income-producing property, except for property producing rent or royalties, can only deduct their Section 212

expenses if they itemize deductions.

4. Expenses attributable to the production of rent or royalties are deductions for adjusted gross income. Expenses to produce other types of investment income can only be deducted by itemizers. Thus, the expenses of direct investment in real estate are favored over expenses of indirect investment in real estate, such as through stock.

#### Objectives of the Study

1. determine whether and how the present federal income tax treatment of income-producing expenses of individuals is horizontally equitable.
2. determine the attainment of other tax policy or administrative objectives, other than horizontal equity, and analyze their combined attainment.
3. provide an analysis of the impact of present law concerning individual income-producing expenses and of alternatives which would bring the law more in accord with principles of equity.

#### Methodology

1. research the tax treatment of income-producing expenses of individuals up to the present to accomplish the first objective.
  - a) determine the development of the dichotomous treatment of income-producing expenses.
  - b) examine the specific development of income-producing expenses which are deductions for adjusted gross income and those which are itemized deductions to ascertain any systematic differences in deduction criteria.
2. investigate possible achievement of other objectives which could balance a lack of horizontal equity to accomplish the second objective.
  - a) analyze for factors which are systematically different in recent court cases concerning income-producing expenses of individuals which are deductions for adjusted gross income and those which are itemized deductions.
  - b) determine the non-horizontal equity impacts of present law on taxpayers using published tax data.

3. achieve the third objective by comparing the present law with alternatives and their probable impacts using tax data and other information available from the U.S. Treasury Department.

### Limitations of the Study

This research will have a number of specific limitations such as the following:

1. Income-producing expenses of individuals will be limited to those as indicated by Sections 62, 162, 212, 214, and 217 of the Internal Revenue Code of 1954, as amended. A further step would be to look beyond the Congressionally dictated definition to the determination of the appropriate definition of what should be a deductible income-producing expense of an individual and what should be personal and not deductible. However, this study should be a useful input in that definitional process.
2. Only expenses of individuals to produce gross income will be considered here. Section 265 of the Internal Revenue Code of 1954, as amended, only allows the deduction of expenses related to tax-exempt income for business expenses to produce tax-exempt interest. All other expenses to produce tax-exempt income are not deductible. This research will confine itself to expenses incurred to produce income which is taxable.
3. Section 183 of the Internal Revenue Code of 1954, as amended, limits the deduction of income-producing expenses in the case of a hobby, which is an activity deemed not to be carried on for profit. Only profit-seeking expenses are considered here, notwithstanding the definitional problem of where a tax shelter becomes a hobby.<sup>8</sup>
4. This study will not consider the deductibility of income-producing expenses which frustrate public policy, such as bribes and penalties, as determined by the courts.
5. Only costs whose value is used up in the present year are covered in this work. Section 263 of the Internal Revenue Code of 1954, as amended, determines when these expenses are incurred. The line between capital expenditures and expenses is important but not to the results determined here.
6. Some areas of individual income-producing expenses, such as employee lobbying expenses and repayment of insider profits, are not mentioned further due to their insignificant specific impact on taxpayers.

7. Although an earned-income credit existed in various forms in most years from 1924 to 1943 supposedly to counter the discrimination of the tax law against earned income, it had no relation to actual income-producing expenses incurred, so this research will not cover its computation and effects.

Other more specific limitations will be pointed out in the subsequent chapters.

### Summary

Horizontal equity is desirable and it does not appear to be attained in the present tax treatment of the income-producing expenses of individuals. The research discussed in subsequent chapters will determine the degree to which horizontal equity exists, why it does not exist in some areas, and the implications of the present treatment contrasted with that of various alternative treatments.

## FOOTNOTES--CHAPTER I

1. The American College Dictionary (New York: Random House, Inc., 1963), p. 406.
2. Allan, Charles M., The Theory of Taxation (Manchester: C. Nicholls & Co., Ltd., 1971), p. 36.
3. Musgrave, Richard A., The Theory of Public Finance (New York: McGraw-Hill, 1959), p. 160.
4. Musgrave, Richard A., A Comprehensive Income Tax Base?, (Branford: Federal Tax Press, 1968), p. 114.
5. Ture, Norman B., "The Federal Revenue System: Facts and Problems 1959," Hearings of the Joint Economic Committee, 86th Congress, 1st Session, p. 12.
6. U.S. Treasury Department, Internal Revenue Service, Statistics of Income - 1971, Individual Income Tax Returns (Washington: U.S. Government Printing Office, 1973), p. 78.
7. Ibid., p. 332.
8. Surrey, Stanley S., Pathways to Tax Reform (Cambridge: Harvard University Press, 1973), p. 312.

## CHAPTER II

### BACKGROUND OF DICHOTOMOUS TREATMENT

Before looking at the specifics of the deductions for income-producing expenses, it is important to look at the basis for their deduction. A subsequent tracing of the development of our present dichotomous treatment of these expenses provides possible reasons for the present tax law structure.

#### Basis for the Deduction

From the first U.S. income tax legislation in 1861, only the word income has been mentioned as the base for this tax. It is important to know whether the law is referring to gross income, net income, or some base between these two. The term net income implies that expenses incurred to produce that income are deductible. Unfortunately, the determination of the appropriate base is not easily discerned.

In drafting our first two income tax laws in 1861 and 1862, members of Congress were not sure whether gross or net income was what should be taxed. They were afraid to say net income for fear that taxpayers would take too many personal expenses.<sup>1</sup> Senator Clark referred to the ambiguity in the amendment because of the failure to explain whether income meant gross or net income, but Simmons stated that the desire of the committee was simply to give the government

the power to levy the tax, but that all the details should be worked out by the Secretary of the Treasury.<sup>2</sup> These statements, inconclusive as they are, are important because much of the phraseology of the Civil War laws was carried over into the laws written after the adoption of the Sixteenth Amendment.<sup>3</sup>

Even in the 20th century, arguments continue concerning the appropriate base of our income tax law. Lutz stated that even though the word income was used in the Sixteenth Amendment without defining it, it was assumed, from the start that the only proper way of applying the amendment was to levy upon some vague but emotionally satisfactory base called net income.<sup>4</sup> However, the Supreme Court has said that the authority conferred upon Congress by Section 8 of Article I of the Constitution to lay and collect taxes is exhaustive, embraces every conceivable power of taxation, and that this authority is not limited by the 16th Amendment.<sup>5</sup> The Tax Court has ruled that "regardless of theory, gross income as we are here concerned with it is gross income according to the statute. . .deductions from gross income are matters of legislative grace and are allowable only where the conditions which have been prescribed by Congress have been met and satisfied."<sup>6</sup> Some people concluded that so far as the Constitution is concerned, the income tax could be levied on gross income.<sup>7</sup> Others, such as Seligman,<sup>8</sup> Rice,<sup>9</sup> Haden,<sup>10</sup> Pechman,<sup>11</sup> Surrey,<sup>12</sup> Griswold,<sup>13</sup> and the American Institute of Accountants<sup>14</sup> concluded that a constitutional right exists to deduct expenses incurred to produce income. However, their arguments appear to be based on the expressed intentions of Congress rather than on the inherent power which the Constitution gives our lawmakers should they choose to use it.

Although the number of vocal advocates favors the constitutional right argument, the controversy is not at present resolved. It, therefore, can only be assumed that individual expenses to produce income are deductible only insofar as and wherever Congress allows them to be deducted. Any other conclusion at this late stage would leave open the possibility of attributing modern meanings to those words which they did not possess at the time they were written.<sup>15</sup>

#### Dichotomous Deduction Evolution

Concluding that these income-producing expenses are deductible only insofar as and wherever Congress deems, necessitates the determination of the evolution of the present treatment by law of these expenses. This will produce a general historical perspective and, more importantly, it will divulge the express and some of the implied reasons for the structure of our income tax concerning this area.

The first U.S. income tax was passed by Congress in 1861, although it was never implemented. Subsequent acts were passed and put into effect from 1862 through 1871. These first attempts to tax income failed to define income precisely and they allowed for very few deductions other than taxes and rent paid. It was left to the Secretary of the Treasury to determine what should be deducted.<sup>16</sup> Apparently, he allowed the deduction of ordinary and necessary business expenses.<sup>17</sup> Tax rates during this period were low and compliance was increasingly lax. The Act of 1894 made the same sketchy reference to income-producing expenses. This law was determined to be unconstitutional before it was put into force.

Our modern U.S. income tax was authorized with the ratification

of the 16th Amendment. Section 2(B) of the subsequent Revenue Act of 1913 allowed the deduction of ordinary and necessary expenses incurred in carrying on any trade or business. The Revenue Acts of 1916 and 1918 retained that language in their Sections 5(a)(1) and 214(a)(1), respectively. Subtracting deductible expenses from the total of revenues, which was called gross income, resulted in net income. Tax due was computed by multiplying tax rates by net income. Article 291, concerning office-in-home expenses, and Article 292, concerning travel expenses, of Regulations 45 issued by what is now the Internal Revenue Service, were initial attempts to interpret the tax legislation concerning income-producing expenses. The increasing tax rates and lower exemptions made this interpretation important for larger groups of taxpayers.

Subsequent revenue acts, regulations, rulings, and court decisions developed and refined the basic deductibility criteria of ordinary, necessary and reasonable which are now applied to individual income-producing expenses. These sources indicate an increasing number of expenses which were felt to exist in conformance with these criteria. Allowing the deduction of all of these income-producing expenses was accepted as horizontally equitable. An occasional voice advocated their limitation, but even then the dissents were conditioned upon a decrease in tax rates and the achievement of simplification.<sup>18</sup>

The Revenue Act of 1941 initiated the concept of deducting a given amount or a percentage of income rather than actual expenses which were otherwise deductible. This amounted to a 10 per cent tax reduction in lieu of deductions for those with incomes of \$3,000 or less derived from salaries, wages, dividends, interest and rent.

The purpose of this alternate tax computation was to simplify compliance for the added millions of people paying income tax due to the law changes initiated to help finance World War II.<sup>19</sup>

In 1942, Congress added Section 23(a)(2) to the Internal Revenue Code of 1939. It, like its successor, Section 212 of the Internal Revenue Code of 1954, extended the deductibility of income-producing expenses to activities not involving a trade or business.

The Individual Income Tax Act of 1944 modified the 1941 tax reduction option by defining a new term, adjusted gross income, and by allowing either itemized actual expenses or 10 per cent of adjusted gross income to be deducted from adjusted gross income. This standard deduction was introduced to reduce the complexity of the income tax for the vast majority of taxpayers.<sup>20</sup> Taxable income was computed by determining gross income, subtracting certain actual expenses to obtain adjusted gross income, and then subtracting personal exemptions plus the larger of the standard deduction or certain other actual expenses. This basic structure remains intact today.

Reports of the House of Representatives' Ways and Means Committee and the Senate Finance Committee provide the best insight into the formulation of adjusted gross income. Concerning income-producing expenses, House Report No. 1365 and Senate Report No. 885 said that Section 22(n) provided for adjusted gross income to be gross income less trade or business expenses of self-employed people, employee travel or reimbursed expenses, and investor expenses to produce rents or royalties.<sup>21</sup> Section 22(n) amended the Internal Revenue Code of 1939 and corresponds to Section 62 of the Internal Revenue Code of 1954. Both reports indicated that these expenses are those which

are necessary to make as nearly equivalent as practicable the concept of adjusted gross income, when that concept is applied to different types of taxpayers deriving their incomes from various sources. The committee felt that such equivalence is necessary for equitable application of a mechanical tax table or a standard deduction which does not depend on the source of income. The committee reports gave the example of a store proprietor needing to reduce his gross income by his business expenses before his income becomes comparable, for the purposes of a tax table or standard deduction, to the salary of an employee in the usual case. Their other example stated that expenses to produce rents or royalties are deductions for adjusted gross income while expenses to produce interest or dividends are not, so the resulting adjusted gross incomes will be on a parity. No further explanation indicates in what manner the deduction for adjusted gross income of all self-employed expenses but only travel and reimbursed expenses of employees produces comparability. They also do not explain how allowing taxpayers the deduction for adjusted gross income of rent or royalty producing expenses puts them on a parity with taxpayers whose expenses attributable to other types of investment income can only be deducted if they itemize deductions.

The reports justify this dichotomous treatment by indicating that income-producing expenses deductible for adjusted gross income are those directly incurred in the carrying on of a trade or business. They do not indicate why, for instance, office-in-home expenses of a self-employed person are inherently more directly related to his income-producing activities than the same expenses of an employee. Section 23(a)(1)(A) of the Internal Revenue Code of 1939 and its

successor, Section 162 of the 1954 Code, authorized the deduction of expenses incurred in a trade or business and considered an employee to be in a trade or business insofar as allowing the deduction of income-producing expenses is concerned. No explanation is directly given concerning the decision to allow self-employed taxpayers to deduct all of their trade or business expenses for adjusted gross income while some employee trade or business expenses could only be deducted as itemized deductions.

It is also unclear why at that time employee income-producing expenses, other than travel, were made deductible for adjusted gross income only if they were reimbursed. An inference can be made that if an employer pays an employee for an expense he incurred, it is more likely to fit the criteria for tax deduction. It is probable that the employer could be viewed as an initial auditor, also, so that the Internal Revenue Service doesn't have to worry so much about auditing reimbursed employee expenses. The reports shed no further light on these matters.

The only other information concerning Section 22(n) in this Congress was provided by Representative Doughton on the floor of the House of Representatives. Unfortunately, his statement merely described how the bill allowed taxpayers to deduct certain business expenses separately before taking the standard deduction without saying more about why the deduction for all income-producing expenses wasn't allowed before taking the standard deduction.<sup>22</sup>

Subsequent I.R.S. rulings and court decisions from 1945 to 1954 upheld and reinforced this dichotomous treatment. Outside salesmen had to deduct entertainment, transportation, and commissions to other

salesmen as itemized deductions.<sup>23</sup> That also applied to the cost of army officer insignias<sup>24</sup> and nonreimbursed employee transportation expenses.<sup>25</sup> The courts held that employee transportation<sup>26</sup> and miscellaneous<sup>27</sup> expenses had to be deducted from adjusted gross income. One case held that Section 22(n) prohibited the itemized deduction of expenses which it states are to be deducted for adjusted gross income.<sup>28</sup> These judicial decisions referred only to the language used by the 1944 committee reports to justify the dichotomous treatment of income-producing expenses.

In 1953, a number of people recommended at Congressional hearings that the law be changed.

It is difficult to see what, if any, basis exists in logic or equity for this distinction and for the preferential treatment which it affords to one group of taxpayers as distinguished from another.<sup>29</sup>

The employee should be treated as an earning entity, and the expenses he incurs in earning his salary income should be allowed to him to the same extent as the business expenses allowed to his self-employed neighbor.<sup>30</sup>

Sec. 23 of the IRC should be modified so that deductions from gross income will be divided into two separate and basic categories: namely, (1) those attributable to gainful activity and the production of income and (2) personal deductions. Many disputes have arisen as to which deductions are allowable in addition to the optional standard deduction. A division of the deductions permitted by the Code into two separate and distinct categories would be an improvement over the present arrangement.<sup>31</sup>

The hearings reflected no testimony in favor of the status quo.

However, the 1954 Congress only made employee transportation and outside salesman expenses additionally deductible for adjusted gross income. Their reasoning was that these expenses, when incurred, usually are substantial, regarding transportation,<sup>32</sup> or substantial relative to their incomes, regarding outside salesmen.<sup>33</sup> Both

committee reports used this wording.

The 1954 Code also added a new income-producing expense deduction, Section 214, for the costs of child care incurred to allow the taxpayer to be gainfully employed. The deduction can only be taken by taxpayers not using the standard deduction.<sup>34</sup> Testimony at the 1953 hearings was in favor of deducting child care expenses for adjusted gross income because they are "directly related to the production of income."<sup>35</sup> No reason was stated for the tax writing committees' acting in conflict with that testimony.

From 1955 to 1963, I.R.S. rulings and court decisions reflected the wording and reasoning of the 1944 and 1953 Congressional committee reports. They indicated that Section 62 does not create any new deductions,<sup>36</sup> nor does it impose additional requirements for the deduction of the business expenses of employees.<sup>37</sup> The I.R.S. emphasized that education expenses were deductible for adjusted gross income only for self-employed individuals.<sup>38</sup> This language was cited in the case where the judiciary held that a taxpayer can still deduct the standard deduction even though he mistakenly deducted for adjusted gross income some income-producing expenses which could only be subtracted as itemized deductions.<sup>39</sup>

Other sources indicate misunderstanding of or lack of agreement with this treatment during this period. One knowledgeable tax lawyer stated that the standard deduction "is in lieu of the deductions without a source of gain connection."<sup>40</sup> This is not true for investors or employees. An expert economist had an incorrect idea of the effect of this provision, thus:

Adjusted gross income is a statutory concept which is intended to approximate net income after allowing for expenses incurred in earning such income. For administrative reasons, expenses incurred in earning non-business incomes (i.e. wages and salaries, interest, and dividends) are generally not allowed as deductions in arriving at adjusted gross income. This deficiency is corrected by permitting taxpayers to deduct such expenses in arriving at taxable income.<sup>41</sup>

The rationale of administrative reasons does not agree with the committee reports previously cited and this deficiency is not made up for people who do not itemize deductions. Another economist recommended a change in the law.

Those deductions that may be regarded as reducing income taxpaying capacity as charges against income that are designed to refine the income concept, it seems to me, ought, in any event, whatever else the committee may do, be removed from the personal expense deduction and be made expenses for adjusted gross income.<sup>42</sup>

Another tax expert's view was that the present treatment negates that an employee is in a trade or business except as to the four specific categories of travel, transportation, outside salesman, and reimbursed expenses.<sup>43</sup>

In 1964, Section 217 was added to the 1954 Code. It allowed a deduction for moving expenses of employees. These expenses were made deductible for adjusted gross income by amending Section 62. The Congressional committee reports show that this treatment was due to a determination that these expenses are substantially similar to business expenses and because, when they are incurred, they are likely to be relatively large.<sup>44</sup> The committees felt that it would be undesirable to, in effect, make taxpayers choose between taking this deduction and the standard deduction in lieu of itemized personal deductions.<sup>45</sup>

In 1967, Bittker, who views the tax law as resisting any

underlying theory base other than being the result of conflicting pressures, expressed the feeling that the costs of earning a living should be deductible despite the definitional and allocative problems caused by the personal benefits these costs inextricably confer.<sup>46</sup> He did not include Section 62 in his list of sections which he deemed were the only operative provisions needed for an ideal computation of taxable income.<sup>47</sup>

The 1969 Tax Reform Act modified the moving expense and household and dependent care expense deductions. It also initiated the low-income allowance to provide a floor, currently \$1,300, so that this amount can be deducted when it exceeds a taxpayer's itemized deductions and percentage standard deduction. Its purpose was to ensure that persons below the poverty level would not be subject to Federal income tax.<sup>48</sup>

### Summary

It can be reasonably concluded that income-producing expenses are deductible for federal income tax purposes wherever and to whatever degree is specified by current law. This law specifies that these expenses be treated in a dichotomous manner. The reasons for this structure are varied and conflicting. Lawmakers have justified making only some income-producing expenses deductions for adjusted gross income because they either were directly incurred in a trade or business, reimbursed, substantial when incurred, substantial relative to income when incurred, or similar to business expenses and likely to be relatively large when incurred. These explicit justifications do not appear to exhibit a cohesive differentiation from those other

income-producing expenses which an individual can deduct only if he itemizes deductions, especially in the light of the cited arguments of tax experts advocating a more unified approach in this area. The reasons cited also do not appear to justify the effects, which were cited in the previous chapter, of this two-fold treatment of income-producing expenses. Thus, a tracing of our law to the present does not provide a consistent and substantive justification for the apparent lack of horizontal equity in the treatment of income-producing expenses of individuals.

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## CHAPTER III

### DEDUCTIONS FOR ADJUSTED GROSS INCOME

A tracing of the history of the dichotomous treatment of income-producing expenses led to several conflicting reasons which did not account for the apparent horizontal inequity of our present law. A possible alternative justification for Section 62 might be derived by a look at the development of the expenses which make up individual income-producing expenses. Any consistent differences in the criteria used by lawmakers in formulating the extent to which these expenses are deductible or distinctions in their separate histories may justify the different classification of these groups. This chapter will review the present group of income-producing expenses which are deductions for adjusted gross income and determine if they possess any common characteristics which might distinguish them from the group of income-producing expenses which must be taken as itemized deductions which are discussed in Chapter IV.

#### Self-Employed Expenses

All of the income-producing expenses of self-employed taxpayers, except child care expenses, have always been deductible for adjusted gross income. The criteria used to determine the deductibility of these expenses have been the same as the criteria applied to the similar expenses of employees and investors. Thus, this portion of

the research cannot answer the question of why all expenses of self-employed individuals, but only some expenses of employees and investors, are deductions for adjusted gross income. However, it can shed light on further possible reasons for the present split of the income-producing expenses of employees and investors. If expenses in these two groups have consistently different histories or deductibility criteria, then those distinctions may be able to supplement previously cited sources in explaining the apparent horizontal inequity of our present law.

#### Employee Expenses

Currently, the income-producing expenses of employees related to travel, transportation, moving, activities of outside salesmen, and other expenses which were reimbursed directly by employers are deducted for adjusted gross income. Each of these will be researched in depth in the chronological order of its inclusion in the Code as a deduction for adjusted gross income in order to supply a further perspective of the process which brought us to the present.

Travel. The revenue acts of the 19th Century and the first revenue acts after the Sixteenth Amendment was ratified were very general in their reference towards the deduction of income-producing expenses. During periods when income was being taxed, a new revenue act was passed about every two years, but this legislation retained a general reference to allowing as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.<sup>1</sup> The Commissioner of Internal Revenue was left with the task of interpreting the application of this part of the law

to individual taxpayer facts and circumstances.

Until 1918, his pronouncements tended to be informal and not widely disseminated. Because the income tax started to have a direct impact on many more citizens, the Commissioner found it necessary to issue many formal regulations interpreting the law. Regulations 45 was formulated to apply to the Revenue Act of 1918. Article 292 of Regulations 45 applied specifically to travel expenses. It allowed the deduction of railroad fares on business trips but not the costs of meals and lodging except to the extent they were in excess of the taxpayer's expenses while living at home.<sup>2</sup>

The Revenue Act of 1921 modified Section 214(a) to explicitly allow the deduction of the entire amount expended for meals and lodging while away from home in the pursuit of a trade or business. Despite its logical appeal, the previous regulation had proved so difficult to administer that the Treasury Department had asked Congress to grant a deduction for the entire amount of such lodging and meal expenditures.<sup>3</sup> At least one contemporary tax expert feared that even the new provision would have administrative difficulties outweighing any gains in equal treatment of taxpayers.<sup>4</sup> However, this treatment has been contained in every Revenue Act or in the Code since 1921. After losing numerous court cases, the Commissioner gave up the contention that a salaried person was not entitled to the deduction of all his food and lodging expenses while in a business travel status.<sup>5</sup>

Subsequently, much disagreement between taxpayers and the Internal Revenue Service has resulted from the problem of allocation of expenses on trips which are not completely business related.

Article 292 of Regulations 45 had allowed the deduction of travel expenses if the trip was on business. Article 101(a) of Regulations 62, interpreting the Revenue Act of 1921, allowed a deduction for travel expenses only when the trip was solely on business. All subsequent regulations have used this basic wording but they have not interpreted it literally. The deduction for all travel fares was allowed through 1962, if the trips were primarily, not solely, business related.<sup>6</sup> However, in 1962 Congress reacted to the problem of taxpayers taking deductions for business trips which had a substantial vacation element by adding Section 274(d) to the Internal Revenue Code. It directed that for all business trips with personal elements, expenses must be allocated between business and personal purposes for trips exceeding one week in duration or where more than 25 per cent of the trip was time spent on personal activities. In 1964, Congress amended Section 274(d), retroactive to 1962, to repeal the allocation rule for expenses incurred for a combined business and pleasure trip within the United States. At present the law allows a deduction for the full amount of transport expenses, such as airplane tickets, incurred on trips which are primarily for business reasons. On trips which are primarily personal, only the expenses directly related to income-producing activities are deductible. The relative generosity of this allocation criterion is reflected by a noticeable lack of litigation. To a great extent the problem has been compromised in the Internal Revenue Service audit process because there was no substantial business purpose for the trip or there was an inability to substantiate expenses.

A great deal of taxpayer and Internal Revenue Service disagreement

has been due to differing interpretations of when a trip is primarily for the purpose of producing income. The usual criterion used by the Internal Revenue Service in such cases is to determine the relative amounts of time spent on personal and business activities during the trip and to ascribe as the primary purpose the activity to which the taxpayer has devoted the greatest length of time. This approach allows slightly differing facts to significantly change the deductible amounts on a trip which has business and personal aspects. Many early Internal Revenue Service decisions narrowly construed the range of a taxpayer's income-producing activities but they were universally overturned by subsequent rulings.<sup>7</sup> Court decisions also developed a broad view of when travel expenses were incurred primarily to produce income<sup>8</sup> but their concept was not without limits.<sup>9</sup> Thus a conclusion about the primary reason of a taxpayer for his travel can be either subjective, such as a determination of motivation, or objective, such as a measure of relative time spent. The burden of proof in each case rests with the taxpayer to show that these criteria, when applied to the facts and circumstances, will indicate a primary income-producing purpose.

The most frequent problem with the travel expense deduction is the decision about whether or not a person is away from home. If not away from home, then at most only transport costs are deductible. The definition of what comprises the tax home of a taxpayer is inextricably bound up with the motivation of Congress in allowing the deduction of travel expenses. The law was meant to compensate for the duplication of living expenses while away from home and to make allowance for the excessive cost of food and lodging while traveling.<sup>10</sup> The definition

of tax home has developed with these objectives in mind to prevent the tax deduction of expenses incurred due to personal needs and considerations. Home was originally viewed as the residence maintained for the purpose of carrying on the business in connection with which the deduction for travel expenses was claimed.<sup>11</sup> Thus Congressmen could not deduct their Washington, D.C., living expenses as travel.<sup>12</sup> If taxpayers could not show that they had a tax home, then they could not deduct the cost of meals and lodging on business trips.<sup>13</sup> Many subsequent court cases interpreted home to mean the principal place of employment.<sup>14</sup> The Supreme Court has failed to resolve this controversy,<sup>15</sup> although the thrust of its deliberations has been subsequently relied on.<sup>16</sup> However, there is agreement that duplication of living expenses is important and that the existence of a principal place of employment or a regular place of abode is necessary for the deduction of travel expenses.<sup>17</sup> Congress somewhat solved this problem for its members by passing a law which allows them to consider their residences in their home states as their homes for travel purposes to the extent of the first \$3,000 of Washington, D.C., living expenses.<sup>18</sup>

In some situations, minimum and maximum time constraints have been applied to the allowable deduction of business travel expenses. Originally, a subjective evaluation was applied to the facts and circumstances of each taxpayer claiming travel expenses to determine that a sufficient amount of expense duplication had occurred, yet the travel was not of such a duration to justify the switching of the place designated as his principal place of business and the moving of his principal residence. The Internal Revenue Service had decided that the minimum time criterion was satisfied if the taxpayer was away from

home long enough to necessitate resting before returning.<sup>19</sup> This test developed into the present away overnight test which has been supported by the courts as being a rather arbitrary distinction avoiding the inequity of benefitting a person just because he covers more miles in a business day.<sup>20</sup> Recommendations for a broader duty area test, which would allow the deduction of expenses as travel outside of a geographical range, have not been implemented.<sup>21</sup>

The maximum duration criterion for travel expenses was necessary to distinguish between situations where a change of employment location was temporary and those where the taxpayer could reasonably have been expected to move his residence to the vicinity of his new place of employment. It is only since 1944 that the concept of traveling expenses has been applied to temporary employment situations, yet a large amount of litigation in the last 30 years has concerned this determination.<sup>22</sup> The Internal Revenue Service developed explicit concepts of the difference between temporary and indefinite employment.<sup>23</sup> The courts have been more willing to use subjective judgments of taxpayer intent at the time a position was acquired to ascertain if it was contemplated to be temporary at the time it was accepted.<sup>24</sup>

There have been more taxpayer disputes concerning the substantiation of expenses in the area of travel expenses than in any other income-producing expense area with the possible exception of entertainment expenses. The problem of providing written documentation has existed since the onset of the income tax.<sup>25</sup> Originally, bare estimates were not sufficient evidence to prove the allowable deduction of travel expenses.<sup>26</sup> This requirement was modified in 1930 by a court decision pertaining to circumstances where the evidence indicates that

the taxpayer has incurred a deductible expense but its exact amount can not be determined. The court concluded that the lower court could not disallow the deduction entirely but that it must make as close an approximation as it could, bearing heavily upon the taxpayer whose inexactitude was of his own making.<sup>27</sup> Just an oral statement of expenditures was still not sufficient, however.<sup>28</sup> The courts still looked skeptically at cases where records were lacking due to the actions of the taxpayer.<sup>29</sup> The Cohan doctrine gave rise to such extensive expense account abuses that Congress used the Revenue Act of 1962 to add Section 274 to the Internal Revenue Code.<sup>30</sup> This section expressly rejected Cohan and held taxpayers to more rigid substantiation requirements for business travel.<sup>31</sup> The Commissioner issued many pronouncements to further develop the requirements of Section 274.<sup>32</sup> Regulation Section 1.274-1 emphasized that the Section 274 substantiation requirements were in addition to those of Sections 162 and 212. Therefore, as of now, the Cohan rule may not be applied to travel expenses.

The Revenue Act of 1962 also placed a maximum on the amounts which may be deducted as travel expenses by amending Section 162(a)(2). Thus, meals and lodging related to business travel are only deductible to the extent they are not lavish or extravagant under the circumstances.<sup>33</sup> This limitation does not apply to other income-producing expenses. However, this research was unable to discover any subsequent litigation or Internal Revenue Service indications that this new wording had led to a different treatment of maximum deductible travel expenses.

The law does not distinguish for deductibility purposes, whether

the travel expense is incurred at the option of the employee or at the insistence of the employer.<sup>34</sup>

An employee must also be in a trade or business before he can deduct travel expenses.<sup>35</sup>

In conclusion, travel for business purposes has been tax deductible throughout the history of the U.S. income tax, is not subject to any minimum or, in practice, maximum amounts, and is seldom subject to allocation when primarily for business, but limited when primarily for personal reasons. Both subjective and objective criteria are used to determine purpose. Minimum and maximum time constraints are applied. The tax home for travel purposes of a taxpayer is usually his principal place of business. Substantiation requirements are especially rigid and explicit. Travel costs may be incurred voluntarily or at the insistence of the employer and they must be incurred by a taxpayer already in a trade or business.

Reimbursed. The receipt by employees of amounts directly from employers to partially or completely offset some of the costs of their income-producing activities in the name of the employer has often received special treatment in the application of our income tax laws. There are four options in regard to reimbursing the income-producing expenses of employees. One is to have the employee charge the bill to the employer so that the employer pays it directly. Another is to have the employee pay the bill, present the receipt to the employer, and get direct reimbursement. A third would give the employee a specified expense allowance to use for income-producing expenses. Lastly, a larger salary can be used to allow for the income-producing

expenses of the employee without any direct reference to the necessity of his incurring certain types of expenses.

Article 292 of Regulations 45 demonstrated in 1918 the preferential treatment to be accorded to certain methods of reimbursing employee expenses.<sup>36</sup> In 1921, Article 101(a) of Regulation 62 brought these reimbursement methods somewhat closer together in their tax treatment in that reimbursement for actual expenses had to be included in gross income and the actual expenses had to be deducted on the tax return. Also, expenses in excess of an expense allowance could also be deducted. This treatment lasted until 1942 when the standard deduction and 1040A tax return were initiated. The Internal Revenue Service ruled that employees with gross income of less than \$3,000 and using the 1040A must include reimbursements in income, but that they could not deduct their income-producing expenses since they deducted a standard deduction instead.<sup>37</sup> Howls of protest led to quick revocation, thus reinstituting the 1918 treatment of directly reimbursed employee business expenses,<sup>38</sup> which excluded both the reimbursement and the expense deduction.

The Individual Income Tax Act of 1944 changed the law to indicate the appropriate treatment of reimbursed expenses whereas the previous treatment had only been mentioned in Internal Revenue Service interpretations. However, the rules themselves remained the same.<sup>39</sup> Thus, expenses directly paid by the employer or directly reimbursed if the employee paid them, never entered into the tax return of the employee. When compensation in addition to salary was paid to the employee as an allowance to offset his income-producing expenses without regard to their actual amounts, the allowance was

included in gross income and the actual expenses were deducted for adjusted gross income. In 1944, only the travel expenses of employees could be deducted for adjusted gross income if they were not reimbursed. All other unreimbursed income-producing expenses of employees could be deducted only if the taxpayer itemized deductions.

Some tax experts were concerned that these provisions might encourage the reimbursement by a business of the personal expenses of business executives or favored employees since these amounts are not taxable to the individual and are preferable to an increase in taxable compensation. It was deemed likely that these expenditures do not receive the same close scrutiny as other expenses for value received by the business.<sup>40</sup> Congress considered Treasury Department suggestions to tighten up this area as early as 1952, but it failed to take any action.<sup>41</sup>

The Internal Revenue Code of 1954 added transportation and outside salesman expenses to those which could be deducted for adjusted gross income even if they were not reimbursed. This did not greatly affect employees with expense allowances since they could and still can deduct all of their reimbursed income-producing expenses for adjusted gross income. Neither did it affect directly reimbursed employees since they can keep the expenses and their offsetting reimbursements out of their tax computation entirely.

In November, 1957, the Internal Revenue Service tried to enforce the reporting on individual tax returns of all reimbursed employee expenses to enable the Service to give attention to apparently disproportionate claims and thus aid in the detection of abuses that had arisen in the area.<sup>42</sup> There was a large volume of protests

because many reimbursed employees did not retain copies of bills and receipts and because of the additional accounting burden that would be imposed on employers if detailed records had to be supplied. The Commissioner decided to postpone application until the 1958 tax year.<sup>43</sup> However, Regulation 1.162-17, which became final in August, 1958, stated that an employee who accounted to his employer for his business expenses would not need to report them on his tax return, but merely state that the reimbursement he received from his employer either did not exceed his ordinary and necessary expenses or any excess had been included in income.<sup>44</sup> It was estimated that this lenient treatment of reimbursed expenses results in an annual tax loss to the federal government of one to two billion dollars.<sup>45</sup>

A limited study conducted by the Internal Revenue Service in 1959 found a large number of employers who did not use acceptable business practices in requiring an accounting of business expenses by their employees. Audits of their employees resulted in almost 50 per cent owing additional taxes as a result of erroneous treatment of amounts received from their employers as expense account allowances or reimbursements.<sup>46</sup> The Service had been forced to further define the procedures that qualify as accounting to an employer for expenses.<sup>47</sup>

Although Section 274 added by the Revenue Act of 1962 provided greater substantiation requirements for some income-producing expenses, Section 274(e)(4) provides, generally, that when they are incurred by an employee in the performance of services for his employer and he directly accounts for them to the employer under a reimbursement arrangement, he is not subject to the harsher requirements of Section 274(a).

In 1964, Congress added the newly available moving expense deduction to those which are deductible for adjusted gross income even if they are not reimbursed.

In 1965, the Internal Revenue Service issued rulings indicating that direct accounting to employers was not necessary for travel and transportation expenses as long as the reimbursement did not exceed given per mile or per day allowances. The reimbursement was not included in gross income nor did the actual expenses appear on the tax return unless the actual expenses exceeded reimbursements.<sup>48</sup> However, when actual expenses exceed reimbursements, all amounts received must be reported as gross income and then actual expenses deducted.<sup>49</sup> Reimbursed expenses would be deductible for adjusted gross income but the appropriate place for the deduction of the excess would depend on the identity of the expenses. To the extent that reimbursement up to these given amounts exceeds actual expenses, it constitutes tax-free income to the employee with travel or transportation expenses because the I.R.S. does not enforce reporting of the excess.

Employees can not assume the income-producing expenses of their employers by not claiming reimbursement when they are eligible for it. It is still the expense of the employer so the employee can not deduct it on his tax return.<sup>50</sup>

Thus, the treatment of reimbursed employee income-producing expenses appears to have been motivated to a great extent by a striving for administrative simplicity in the application of our income tax laws. Study by the Internal Revenue Service has shown that special treatment of reimbursed expenses appears to allow

amounts of employee compensation to go untaxed since nondeductible expenses are directly reimbursed by employers, thus both the expense and the reimbursement do not appear on the tax return of the employee.

The Section 62 treatment of reimbursed expenses favors employees with designated expense allowances or direct reimbursement arrangements over employees with their compensation only designated as wages or salary. Of the main income-producing expenses which can only be deducted as itemized deductions unless reimbursed, entertainment appears to be the only one conducive to the use of an expense allowance. Household and dependent care, job-seeking, and, probably, education expenses would not be reimbursed through an expense allowance arrangement in the vast majority of employment situations. Thus, the Section 62 reimbursed expenses statement is generally only applicable to the entertainment expenses of employees with expense allowances and to partially reimbursed employee expenses.

It also appears that, as a group, the deductions for adjusted gross income are more likely to be directly paid or reimbursed by employers than are those expenses which are itemized deductions. Travel, moving, and transportation are especially likely to be reimbursed while household and dependent care expenses are seldom reimbursed. Employment seeking or securing expenses, education, and entertainment are increasingly likely to be reimbursed, respectively.

Transportation. The allowance of a deduction for transport costs incurred to produce income has existed as long as our income tax laws. Its treatment by the law and Internal Revenue Service statements has been less explicit than that of travel expenses. The problems of

this deduction have mainly been differentiating between income-producing and personal expenses and enforcing a reasonable amount of substantiation.

Under the first interpretation given our income tax laws, an individual could deduct the cost of daily transportation between his residence and his place of business.<sup>51</sup> By 1920, however, the Internal Revenue Service adopted a stricter interpretation of what constituted an ordinary and necessary business expense and reversed the earlier ruling so that commuting from home to work was not a deductible expense.<sup>52</sup> The reasoning was that the costs of commuting are not incurred to produce gain because an employee does not start to work until he reaches his place of employment.<sup>53</sup> In general, subsequent court cases have upheld this interpretation of the law concerning the nondeductibility of commuting expenses.<sup>54</sup>

In 1954, the nondeductibility of commuting expenses was reinforced by a statement to that effect in the new Code despite much testimony in the hearings in 1953 which had advocated deductibility. Congress explicitly decided that commuting is not a business expense.<sup>55</sup> The nondeductibility of commuting was interpreted as applying even where a large distance existed between the principal place of employment and the nearest habitable community<sup>56</sup> although commuting is deductible when incurred while in a travel status.<sup>57</sup> Even physically handicapped taxpayers have not been able to deduct their commuting expenses.<sup>58</sup> Attempts to change the law have been unsuccessful.<sup>59</sup> Some taxpayers have been able to deduct commuting costs fully or partially when transporting bulky or heavy tools, musical instruments, etc., to their places of employment, but with decreasing success.<sup>60</sup>

However, nothing prevents the deduction of expenses in excess of ordinary commuting expenses which can be shown to have been incurred in transporting job-required tools and materials to or from the work site.<sup>61</sup>

Many attempts to deduct transportation expenses have been limited by incomplete substantiation although the Cohan rule has been applied when approximation is appropriate.<sup>62</sup> To alleviate some of the substantiation problem, the Internal Revenue Service initiated a mileage allowance which a taxpayer could claim for each income-producing mile in lieu of allocating actual operating costs incurred.<sup>63</sup>

The problem of allocating transportation costs between business and personal purposes is interrelated with the substantiation of these expenses. The use of the mileage allowance for business miles driven has simplified this allocation for most taxpayers. For those taxpayers who deduct actual expenses, the percentage of total miles driven incurred to produce income is multiplied by each actual expense to obtain deductible transportation costs.<sup>64</sup> No primary purpose criterion needs to be applied to car usage for the year in this allocation process.

It was established early that employees could not voluntarily assume the expenses of their employers by incurring transportation expenses and not claiming reimbursement to which they were entitled.<sup>65</sup>

Court decisions, especially, established the interpretation that, once an employee arrived at the place of employment, the employee was in an income-producing status until leaving for a residence or for some other personal purpose. Not only does using a car in the services of the first employer result in deductible transportation

expenses, but so does the act of going from the first to a second place of employment.<sup>66</sup> Attempts by employees with offices in their homes to use this interpretation to overcome the commuting expense deduction prohibition have been unsuccessful.<sup>67</sup>

Thus, transportation expenses, except commuting, have a long history of deductibility, location constraints and no special substantiation requirements. They receive preferential substantiation treatment when reimbursed by means of a mileage allowance and are always subject to business versus personal allocation. Criteria used to evaluate motivation may be subjective or objective. Concerning transportation expenses, an employee is not considered to be incurring income-producing expenses until he reaches his place of employment.

Outside Salesmen. As of 1954, outside salesmen are a class of employees which receives preferential tax treatment allowing the deduction of all income-producing expenses for adjusted gross income like self-employed taxpayers. Outside salesmen are employees engaged principally in the solicitation of business at places other than the places of business of the employers.<sup>68</sup> Some litigation has involved employees seeking the benefits of outside salesmen status so they could deduct all of their income-producing expenses for adjusted gross income.<sup>69</sup> Other employee groups have sought to change the law so that it would include them as outside salesmen.<sup>70</sup> The deductibility criteria applied to the income-producing expenses of outside salesmen are the same as those applied to other employees.

Moving. Prior to 1964, there was no mention of moving expenses in the tax laws, so the area developed from administrative rulings and court decisions. Moving expenses were not deductible under any circumstances before 1964.<sup>71</sup> However, reimbursement of direct moving expenses was not taxed for transferred old employees<sup>72</sup> due to an apparent disregard of Section 61 pertaining to gross income.<sup>73</sup> Direct moving costs are those of transporting household goods and personal effects and of the actual trip to the new place of employment. New employees<sup>74</sup> and indirect moving expenses<sup>75</sup> did not receive this beneficial treatment since they could not prove that their respective expenses were ordinary and necessary business expenses within the meaning of Section 162.<sup>76</sup> The result was a difference in tax treatment based on whether or not the salary of the employee had been established in contemplation that he would pay his moving costs to the new job. Employees were not considered to be in a trade or business when moving to the location of an initial job or while in the act of changing employers.

In 1964, Congress added Section 217 to the Internal Revenue Code.<sup>77</sup> Section 217 allowed the deduction of direct moving expenses for new and transferred employees within certain constraints. The new place of work had to be at least 20 miles further from his former residence than was his former principal place of work. The employee also had to be employed full-time for at least 39 weeks of the year after the move at the new location in order to claim the deduction. Reimbursed employees still received preferential treatment because this subsequent full-time employment test did not apply to the extent that direct moving expenses were reimbursed.<sup>78</sup> Reimbursed expenses,

which were otherwise deductible, and their reimbursement were not included in the tax computation. Also, non-direct reimbursed moving expenses of transferred employees were allowed to offset reimbursements and to be excluded from the tax return to the extent that the courts found them to fulfill the criteria of Section 162.<sup>79</sup> Suggestions for a more explicit interpretation of deductible indirect moving expenses were not implemented.<sup>80</sup>

Subsequent court decisions and Internal Revenue Service rulings clarified the meaning of household goods and personal effects and developed a line of reasoning pertaining to the treatment of reimbursed indirect moving expenses of transferred employees. Household pets are household goods<sup>81</sup> whereas yachts<sup>82</sup> and furniture purchased while enroute<sup>83</sup> are not. Reimbursed home selling expenses,<sup>84</sup> house-hunting and temporary living expenses,<sup>85</sup> and the loss on the sale of a home<sup>86</sup> were determined not to fit under the criteria of Section 162.

The 1969 Tax Reform Act<sup>87</sup> widened deductible moving expenses to increase labor mobility and to provide for more equitable treatment of employees whose moving expenses are not reimbursed and of self-employed taxpayers. Deductible indirect moving expenses were delineated, but they are only deductible up to \$2,500. Indirect moving expenses of househunting and up to 30 days temporary living were subjected to an additional maximum constraint of \$1,000. Certain costs of buying and selling residences and lease settling expenses are the other deductible indirect moving expenses. Self-employed taxpayers became eligible to deduct moving expenses, but their subsequent full-time work test at the new location is twice that of employees, that is, 78 weeks out of the subsequent 2 years. All

reimbursements of moving expenses were required to be included in gross income in following years, thus equalizing the tax treatment of the moving expenses of reimbursed and nonreimbursed employees and of self-employed taxpayers. Also the change of location test was lengthened from 20 miles to 50 miles.<sup>88</sup>

In 1971, the Internal Revenue Service decided that a mileage allowance could be deducted for auto usage during the move although it was only 50 per cent of the mileage allowance allowed for transportation and travel expenses.<sup>89</sup>

The deductibility of moving expenses is relatively recent. Indirect moving expenses have maximum dollar limits. Allocation of income-producing and personal expenses is seldom necessary. The criteria used to evaluate income-producing motivation are objective and explicitly stated. A minimum time constraint applies to the full-time employment motivation criterion while a maximum time constraint only applies to the indirect moving expenses of temporary living at the new location. Substantiation requirements are those normally applied to income-producing expenses, except that reimbursement does not remove the need to justify these expenses on the tax return and that a mileage allowance can be claimed for auto usage. Whether the move is voluntary or employer required is irrelevant to deductibility. New employees and self-employed individuals changing locations may deduct moving expenses although they are not currently in a trade or business.

Investor Expenses

Income-producing expenses not incurred in a trade or business were not mentioned explicitly in revenue acts nor in regulations until 1942. The only basis for their deduction was the sections of the successive revenue acts which allowed the deduction of all the ordinary and necessary expenses incurred in carrying on any trade or business. Neither the statutes nor the regulations defined carrying on a trade or business. This failure to explicitly allow for the deduction of income-producing expenses not incurred in a trade or business was noted and proposals for modification were submitted in the early days of the modern income tax.<sup>90</sup> However, no changes were made since the Treasury Department had construed the language of the old law so broadly as to permit the deduction of expenses of investments and managing property.<sup>91</sup> Subsequent Bureau of Internal Revenue statements reflected this liberal interpretation.<sup>92</sup> Generally, court decisions used a more narrow understanding of the meaning of a trade or business.<sup>93</sup>

Purchasing a house for renting, listing it for rent, and showing it to prospective tenants but failing to rent it were determined to be deductible trade or business expenses.<sup>94</sup> The expenses incurred while offering a house acquired as a gift for rent although never rented, were not trade or business expenses.<sup>95</sup>

Apparently, the announced policy of the Bureau of Internal Revenue was not consistently applied because a conflict appeared among the Circuit Courts of Appeals concerning whether expenses for the management of securities were deductible as trade or business expenses.<sup>96</sup> A 1941 Supreme Court case settled this controversy.<sup>97</sup> This decision

held that security investment expenses were not made while carrying on a trade or business but that the expense of renting buildings was. The distinction apparently was made based on the source of gain in the one case being real property, incapable of producing gain without management, while in the other case the source of gain was invested capital, capable of producing dividends or interest without management, except to look after the gain once it was realized.<sup>98</sup> The Board of Tax Appeals had held that an investor is in a business where there is an active association with enterprises in which there is a financial interest or where a large part of time is devoted to handling investments.<sup>99</sup> Now the Supreme Court ruled in the Higgins case that these were not deductible. Previous court decisions and Bureau interpretations in the favor of taxpayer expense deduction were overruled and rescinded.<sup>100</sup>

The Treasury Department<sup>101</sup> and tax experts<sup>102</sup> subsequently recommended corrective legislation and Congress enacted their basic proposals to correct this inequitable situation in the form of Section 23(a)(2) which was effective retroactively for all years in order to reinstate and ratify the previous interpretations of deductible income-producing expenses of individuals.<sup>103</sup>

The effect of Section 23(a)(2) was to provide for a class of non-business deductions coextensive with the business deductions allowed by Section 23(a)(1), except for the fact that, since they were not incurred in connection with a business, the section made it necessary that they be incurred for the production of income or in the management or conservation of property held for the production of income.<sup>104</sup>

There are no implicit limitations in Section 23(a)(2), now Section 212, other than the ordinary and necessary criteria which are also

found in Section 23(a)(1)(A), now Section 162.<sup>105</sup> The Treasury Regulations were amended by T.D. 5196 to conform to the 1942 Act by the addition of Section 19.23(a)-15 to Regulations 103.<sup>106</sup> The subsequent emphasis in cases concerning the income-producing expenses of individuals was on the objective of the expenses rather than on whether they were incurred in a trade or business.

The Individual Income Tax Act of 1944 added Section 22(n) to the Internal Revenue Code of 1939. It affected the location of the deduction of Section 23(a)(2) expenses but it did not change any of the criteria for the deduction of either group. Expenses directly incurred in the rental of property or in the production of royalties were made deductible for adjusted gross income. All other non-trade or non-business expenses could only be deducted by individuals who itemized deductions. The special treatment of expenses producing rental income may have its basis in previous court decisions which concluded that they were incurred in a trade or business.<sup>107</sup>

The special treatment of expenses producing royalty income has a less firm basis for those not in a trade or business since royalty income may be the proceeds of a sale based upon, for instance, the amount of minerals produced or number of books sold, where, after the sale, little management effort is possible by the seller. Perhaps, the Senate Finance and House Ways and Means Committees were well represented by Congressmen from oil-producing states at this time.

Subsequent litigation concerning expenses attributable to the production of rents or royalties has been sparse. Some cases explored the deductible extent of expenses of residences used for personal purposes and to produce rents.<sup>108</sup> The main criterion applied was

to determine if the use of the property was of such a nature that in good faith the taxpayer genuinely expected or intended to make a profit. Substantial personal usage during the peak rental periods indicates that the primary purpose for which the property is held is not to produce income.<sup>109</sup> A ruling indicated that a gross income tax on the portion of an individual's income from the extraction of minerals was a deductible royalty-producing expense.<sup>110</sup>

### Summary

The historical development of income-producing expenses of individuals deductible for adjusted gross income and factors in their deductibility have been analyzed in this chapter. Table 3.1 indicates a basic summary of the main considerations in the deduction of some of these expenses. Expenses of self-employed individuals and outside salesmen have the same criteria applied to determine their deductibility as are applied to the like categories of employee expenses with minor exceptions. Self-employed taxpayers have a longer full-time employment test than do employees in the qualification for the deduction of moving expenses. Self-employed taxpayers also miss the benefits accruing to employees with actual expenses less than employer reimbursements for car usage or per diem allowances where the employees do not have to report the difference as income. It is difficult to define factors, other than a required primary income-producing purpose, which are significant in the test of deductibility of expenses incurred to produce rents or royalties. Table 3.1 does not indicate a large degree of consistency in the application of these criteria to determine the deductibility of each expense as analyzed based on

a study of the law, Internal Revenue Service statements, the statements contained within court decisions, and other sources of information. A comparison with the criteria applied to the deductibility of income-producing expenses which are only deductible as itemized deductions, except when reimbursed, is needed next for a comprehensive evaluation.

Table 3.1 Factors Pertaining to the Deduction for Adjusted Gross Income of Certain Income-Producing Expenses of Individuals

| Expense Category | History           | Amount Constraints |                               | Time Constraints                          |                                                        | Location Constraints                         |                            |
|------------------|-------------------|--------------------|-------------------------------|-------------------------------------------|--------------------------------------------------------|----------------------------------------------|----------------------------|
|                  |                   | Minimum            | Maximum                       | Minimum                                   | Maximum                                                | Minimum                                      | Maximum                    |
| Travel           | Well Accepted     |                    | Not Extravagant               | Overnight or Requiring Rest Before Return | One Year or Sooner if Temporary Job Becomes Indefinite | Must Have "Tax Home"                         |                            |
| Reimbursed       | Well Accepted     |                    | Reimbursement in Gross Income | See each Expense                          | See each Expense                                       | See each Expense                             | See each Expense           |
| Transportation   | Well Accepted     |                    |                               |                                           |                                                        | Have at Least Arrived at Place of Employment | Not Commuting to Residence |
| Moving           | Recently Accepted |                    | On In-direct Expenses         | Employed 75% of Subsequent Year           | 30 Days on Temporary Living Expenses                   | Move at Least 50 Miles                       |                            |

Table 3.1 (Continued)

| Expense Category | Income-Producing v. Personal Allocation                                    | Criteria to Determine Income-Producing Motivation | Substantiation                                                                                                                                | Employer Requested or Voluntary | Already Producing Income           |
|------------------|----------------------------------------------------------------------------|---------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------|------------------------------------|
| Travel           | Not For transport Expenses but Allocate Other Expenses                     | Objective or Subjective                           | Special Requirements (No application of Cohan rule)                                                                                           | Either                          | Required                           |
| Reimbursed       | See Each Expense                                                           | See Each Expense                                  | Easy When Directly Account to Employer or When Receive Mileage or Per Diem Allowance--Except For Reimbursed Moving or For Child Care Expenses | See Each Expense                | See Each Expense                   |
| Transportation   | Always                                                                     | Objective or Subjective                           | Normal Requirements (12¢ per mile)                                                                                                            | Either                          | Required                           |
| Moving           | None, Except When Deduct Actual Auto Expenses Instead of Mileage Allowance | Objective                                         | Normal Requirements (12¢ per mile)                                                                                                            | Either                          | Not Necessary for First or New Job |

## FOOTNOTES—CHAPTER III

1. Section 49, Act of 1861, 12 Stat. 292; Section 91, Act of 1862, 12 Stat. 432, and Act of 1863, 12 Stat. 713; Section 117, Act of 1864, 13 Stat. 223, Act of 1865, 13 Stat. 469, and Act of 1867, 14 Stat. 471; Section 9, Act of 1870, 16 Stat. 256; Section 28, Act of 1894, 28 Stat. 509; Section II(B), Act of 1913, 38 Stat. 114; Section 5(a)(1st), Revenue Act of 1916, 39 Stat. 756; Section 214(a)(1), Revenue Act of 1918, 40 Stat. 1057.
2. Kohler, Eric L., Accounting Principles Underlying Federal Income Taxes, (Chicago: A. W. Shaw Co., 1925), p. 186.
3. Statement of T. S. Adams representing the U.S. Treasury Department, Hearings on H.R. 8245 Before the Senate Committee on Finance, 67th Congress, First Session, (Washington: U.S. Government Printing Office, 1921), pp. 234-5.
4. Satterlee, Hugh, "Some Suggestions for the Simplification of Federal Taxation," Proceedings of the 13th Annual Conference of the National Tax Association, (New York: National Tax Association, 1921), p. 145.
5. Dendy, Thomas H., "New Cases on What You Can Deduct from Salary Income," Proceedings of the New York University 7th Annual Institute on Federal Taxation, (Albany: Mathew Bender & Co., 1949), p. 1002-3.
6. Rev. Rul. 56-168, 1956-1 Cum. Bull. 93.
7. A 1922 ruling prevented the deduction of travel expenses incurred to teach during the summer at another school I.T. 1238, I-1 Cum. Bull. 140; revoked in 1932 by I.T. 2640, XI-2 Cum. Bull. 246. A 1922 ruling did not allow the deduction of the travel expenses of a doctor to attend a medical convention I.T. 1369, I-1 Cum. Bull. 369; revoked in 1931 by I.T. 2602, X-2 Cum. Bull. 130. A 1922 ruling disallowed the deduction of the travel expenses of a teacher to a convention I.T. 1520, I-2 Cum. Bull. 625; revoked in 1933 by I.T. 2688, XII-1 Cum. Bull. 251.
8. A lawyer was allowed to deduct the cost of attending ABA meetings *Ellis v. Comm.* 15 BTA 1075, aff'd 50 F.2d 343 (CA 1, 1931). Also see *Marlin v. Comm.* 54 TC 560 (1970).
9. Especially *Comm. v. Flowers* 326 U.S. 465 (1946), *Barnhill v. Comm.* 148 F.2d 913 (CA 4, 1945), *Reed v. Comm.* 35 TC 199 (1960); and *Mazzotta v. Comm.* 57 TC 43, aff'd (CA 2, 1972), 72-2 USTC 9709, which emphasized that the travel is deductible only if the exigencies of business rather than the personal conveniences and necessities of the taxpayer are the motivating factors.
10. *James v. U.S.* 308 F.2d 204 (CA 9, 1962).

11. O.D. 1021, 5 Cum. Bull. 1803 (1921).
12. O.D. 864, 4 Cum. Bull. 1549 (1920) and *Lindsay v. Comm.* 34 BTA 840 (1936).
13. O.D. 905, 4 Cum. Bull. 1621 (1920); I.T. 1490, I-2 Cum. Bull. 580 (1922); *Martin v. Comm.* 44 BTA 185 (1941); *Mitnick v. Comm.* 13 TC (1949).
14. *Schurer v. Comm.* 3 TC 544 (1944); *Albert v. Comm.* 13 TC (1949); *Kroll v. Comm.* 49 TC 557 (1968).
15. *Comm. v. Stidger* 386 U.S. 287 (1967). The court held that the military man's permanent duty station was his home for tax purposes but it stressed the special status of the military taxpayer and expressly avoided a comprehensive endorsement of the principal place of employment rule. Three dissents had concluded that home for tax purposes means residence.
16. F.J. Markey, T.C. Memo 1972-154; rev'd 74 AFTR 2d 403, (CA 6, 1974).
17. *Griesemer v. Comm.* 10 BTA 386 (1928); *Gustafson v. Comm.* 3 TC 998 (1944) stated that duplication was not necessary; S. Waggener 63,524 P-H Memo TC; *Hicks v. Comm.* 47 TC 71 (1961) stated that must have substantial and duplicitous expenses; Rev. Rul. 71-247, 1971-1 Cum. Bull. 54; Rev. Rul. 73-529, 1973-2 Cum. Bull. 49 stated objective factors for determining whether a taxpayer has a regular place of abode.
18. Legislative Branch Appropriation Act, Public Law 471, 82nd Congress, Second Session, (Washington: U.S. Government Printing Office, 1953) and now a provision of Section 162(a).
19. I.T. 3395, 1940-2 Cum. Bull. 64 and Rev. Rul. 61-221, 1961-2 Cum. Bull. 34.
20. *United States v. Correll* 389 U.S. 299 (1967) and *Barry v. Comm.* 435 F.2d 1290 (CA 1, 1970).
21. Recommendations of the American Institute of Certified Public Accountants and American Bar Association, Public Hearings Before the Committee on Ways and Means, House of Representatives, 93rd Congress, First Session, on the Subject of General Tax Reform, (Washington: U.S. Government Printing Office, 1973), pp. 1034 and 1173.
22. *Schurer v. Comm.* 3 TC 544 (1944); *Leach v. Comm.* 12 TC 20 (1949); *Peurifoy v. Comm.* 27 TC 149 (1956); modified 254 F.2d 483 (1957); aff'd 358 U.S. 59 (1958); *Harvey v. Comm.* 32 TC 1368 (1959); rev'd 283 F.2d 491 (1960) and many others.

23. Rev. Rul. 60-314, 1960-2 Cum. Bull. 48 stated that test periods of employment constitute indefinite employment; Rev. Rul. 60-189, 1960-1 Cum. Bull. 60 established the criterion that employment change of location for longer than one year strongly implied that the change was for an indefinite period.
24. *Dilley v. Comm.* 58 TC 27 (1972).
25. A.R.R. 719, I-1 Cum. Bull. 19 (1922).
26. *Weiss v. Comm.* 3 BTA 228 (1925) and *Coleman v. Comm.* 8 BTA 1126 (1927).
27. *Cohan v. Comm.* 11 BTA 743 (1928); rev'd 39 F.2d 540 (CA 2, 1930).
28. *Miller v. Comm.* 47 BTA 68 (1942).
29. *Finley v. Comm.* 27 TC 413 (1956); aff'd 255 F.2d 128 (CA 10, 1958).
30. Revenue Act of 1962, Public Law 87-834, pp. 123-126. No deduction is allowed unless the taxpayer substantiates by adequate records or sufficient evidence corroborating his own statement the amount of the expense, time and place of travel, and business purpose.
31. House Report No. 1447, 87th Congress, Second Session, (Washington: U.S. Government Printing Office, 1962), pp. 427-8. Also Senate Report No. 1881, pp. 740-742.
32. Rev. Proc. 63-4, 1963-1 Cum. Bull. 219; Rev. Rul. 63-144, 1963-2 Cum. Bull. 129; Rev. Proc. 63-3, 1963-1 Cum. Bull. 258.
33. Revenue Act of 1962, p. 126.
34. *Whitaker v. Comm.* 24 TC 750 (1955); *Stricker v. Comm.* 54 TC 355 (1970).
35. *Tucker v. Comm.* 55 TC 783 (1971).
36. If an employee received a salary as full compensation for his services, without reimbursement of traveling expenses, his expenses were deductible. If the employee received a salary and expense allowance, any excess of expenses over the allowance was not deductible, but any excess of the allowance over the actual expenses was taxable income. For employees receiving a salary and repayment of his actual expenses, no part of the expenses was deductible nor was any of the repayment returnable as income.
37. I.T. 3547, 1942-1 Cum. Bull. 138.

38. Mim. 5397, 1942-2 Cum. Bull. 152.
39. House Report No. 1365, p. 19.
40. Elridge, Douglas H., "Expense Accounts," Proceedings of the 54th Annual Conference of the National Tax Association (Harrisburg: National Tax Association, 1962), p. 218.
41. U.S. Treasury Department, "Proposals for Strengthening Tax Administration," Hearings Before a Subcommittee of the Committee on Ways and Means, House of Representatives, 82nd Congress, Second Session, (Washington: U.S. Government Printing Office, 1952), pp. 98-100. One provision would have required information from businesses concerning payments and perquisites of more than \$200 annually furnished any employee, partner, or shareholder.
42. Treasury Department, Internal Revenue Service, Release IR-204, November 11, 1957.
43. Treasury Department, Internal Revenue Service, Release IR-206, November 25, 1957.
44. T.D. 6306, filed August 27, 1958.
45. Rothschild, V. Henry and Sobernheim, Rudolph, "Expense Accounts for Executives," Yale Law Journal, Volume 67, Number 8 (July, 1958), p. 163.
46. Treasury Department, Internal Revenue Service, 1960 Audit Report on Entertainment, Travel, and Similar Expenses (Washington: U.S. Government Printing Office, 1961), p. 24.
47. Rev. Rul. 59-410, 1959-2 Cum. Bull. 64, stating that using a car leased by the employer and charging other expenses to the employer by the use of credit cards did not constitute accounting to him for the expenses.
48. Rev. Rul. 67-29, 1967-1 Cum. Bull. 42; Rev. Rul. 65-212, 1965-2 Cum. Bull. 84, superseded by Rev. Rul. 71-412, 1971-37 Int. Rev. Bull. 71-412, which provided relaxed substantiation for per diem up to \$36 per day and mileage up to 15¢ per mile.
49. Rev. Rul. 73-191, 1973-1 Cum. Bull. 17.
50. I.T. 1706, II-2 Cum. Bull. 960 (1923); *Podems v. Comm.*, 24 TC 21 (1955); Rev. Rul. 57-502, 1957-2 Cum. Bull. 118; *Stolk v. Comm.*, 40 TC 345; *aff'd* 326 F.2d 760 (CA 2, 1971); *Fountain v. Comm.*, 59 TC 69 (1973).
51. 1 Cum. Bull. No. 1, p. 159 (1919).
52. 1 Cum. Bull. No. 3, p. 191 (1920).

53. Haden, Harry H., op. cit., pp. 38-39.
54. *Steinhort v. Comm.*, 335 F.2d 496 (CA 5, 1964), stated that "Deeply ingrained in the whole tax structure, memorialized by literally hundreds of tax rulings, Tax and other Court decisions, is the basic proposition that the cost of going to and from home and an established place of business is a nondeductible personal expenditure. At times the pursuit of this approach brings about illogical and near absurd conceptual situations. But its predominant redeeming grace is a sort of rough equality among all the millions of tax-paying, income-earning Americans who go to and from their homes and their place of work. A lesser virtue is administrative uniformity."
55. House Report No. 1337, Report of the Committee on Ways and Means, Internal Revenue Code of 1954, 83rd Congress, Second Session (Washington: U.S. Government Printing Office, 1954), p. 9. Senate Report No. 9 used identical language.
56. *U.S. v. Tauferner*, 407 F.2d 243 (CA 10, 1969); cert. den. 396 U.S. 824 (1969), indicated that the argument of the taxpayer was appealing from an equitable and logical standpoint, but that it could not prevail when considered in the light of the statutes, regulations, and case law. The court concluded that the nature of the work engaged in, the distance traveled, the mode of transportation, and the degree of necessity are unsatisfactory guides with any degree of consistency and certainty.
57. Rev. Rul. 63-145, 1963-2 Cum. Bull. 86.
58. *Bruton v. Comm.*, 9 TC 882 (1947); Rev. Rul. 66-80, 1966-1 Cum. Bull. 57.
59. H.R. 424 and S. 1069 introduced in 1969 would have permitted blind and disabled taxpayers to deduct up to \$600 for transportation expenses incurred in going to and from work.
60. See especially *Fausner v. Comm.*, 472 F.2d 561 (1973); aff'd 93 U.S. 2820 (1973), which concluded that no rational basis exists for allocation between the nondeductible commuting component and the deductible business component of the total expense. The deduction was disallowed so that a common burden not be negated for a particular taxpayer by the happenstance that he must carry incidentals of his occupation with him.
61. Rev. Rul. 63-100, 1963-1 Cum. Bull. 34.
62. *Waldheim v. Comm.*, 244 F.2d 1 (CA 7, 1957) and *Marcello v. Comm.*, 43 TC 168 (1964) among others.
63. Rev. Proc. 64-10, 1964-1 (Part 1) Cum. Bull. 667; superseded by Rev. Proc. 66-10, 1966-1 Cum. Bull. 622; superseded by Rev.

Proc. 70-25, 1970-1 Cum. Bull. 59.

64. Leonhart v. Comm., 414 F.2d 749 (CA 4, 1969) and many other cases.
65. I.T. 1903, III-1 Cum. Bull. 1298 and Podems v. Comm., 24 TC 21 (1955).
66. Chandler v. Comm., 226 F.2d 467 (CA 1, 1955), Rev. Rul. 55-109, 1955-1 Cum. Bull. 261, and Kistler v. Comm., 40 TC 657 (1963).
67. Sheldon v. Comm., 50 TC 24 (1968) and Green v. Comm., 59 TC 44 (1973).
68. House Report No. 1337, loc. cit., Reg. 1.62-1(h) and Rev. Rul. 62-85, 1962-1 Cum. Bull. 13, provide further refinements of this definition.
69. Novak v. Comm., 51 TC 7 (1968).
70. Statement of John P. Meehan, Hearings Before the Committee on Ways and Means on Tax Reform, 91st Congress, First Session (Washington: U.S. Government Printing Office, 1969), p. 4552.
71. O.D. 451, 2 Cum. Bull. 848; Appeal of Leland D. Webb, 1 BTA 759 (1924); Nichols v. Comm., 13 TC 916 (1949); Rev. Rul. 54-429, 1954-2 Cum. Bull. 53; United States v. Woodall, 255 F.2d 370 (CA 10, 1958); Wilson v. Comm. 412 F.2d 314 (CA 6, 1969), where the move was involuntary; and others.
72. Schairer v. Comm., 9 TC 549 (1947); Rev. Rul. 55-140, 1955-1 Cum. Bull. 317; Cavanagh v. Comm., 36 TC 300 (1961); and others.
73. Mason, John C., "New Deductions for Individuals," Proceedings of the New York University 23rd Annual Institute on Federal Taxation (Albany: Mathew Bender & Co., 1965), p. 68.
74. Bradley v. Comm., 39 TC 652 (1963).
75. Ferebee v. Comm., 39 TC 801 (1963).
76. Comm. v. Mendel, 351 F.2d 580 (CA 4, 1965).
77. Public Law 88-272, 1964-1 (Part 2) Cum. Bull. 6.
78. Section 217(d)(1).
79. House Report No. 749, op. cit., p. 182.
80. Statement of Syd Herlong, Hearings Before the Committee on Ways and Means on the President's 1963 Tax Message, 88th Congress, Second Session (Washington: U.S. Government Printing Office, 1964), p. 1281.

81. Rev. Rul. 66-305, 1966-2 Cum. Bull. 102.
82. *Aksomitas v. Comm.*, 50 TC 79 (1968).
83. Rev. Rul. 70-625, 1970-2 Cum. Bull. 67.
84. *Pederson v. Comm.*, 46 TC 155 (1966).
85. *McLellan v. Comm.*, 51 TC 462 (1968), and *Lull v. Comm.*, 51 TC 841 (1969).
86. *Ritter v. United States*, 393 F.2d 823 (Ct. cls., 1968); cert. denied 393 F.2d U.S. 844.
87. Section 231, Public Law 91-172, 1969-3 Cum. Bull. 61.
88. Ibid.
89. Rev. Proc. 71-2, 1971-1 Cum. Bull. 659, allowed the deduction of \$.06 per mile in lieu of computing actual auto expenses.
90. Committee on the Federal Income Tax, "Report of the Committee on the Federal Income Tax," Proceedings of the 9th Annual Conference of the National Tax Association (Ithaca, New York: National Tax Association, 1915), p. 296. They concluded that it would be easy to make this matter clear so that the expenses of managing property held for investment would be treated like business expense.
91. Committee on the Federal Income Tax, "A Statement of the Provisions of the Income Tax Law of September 8, 1916, Conforming to the Committee's Recommendations and of Other Changes Made by the Said Act," Proceedings of the 10th Annual Conference of the National Tax Association (New Haven, Connecticut: National Tax Association, 1917), p. 189.
92. O.D. 877, 4 Cum. Bull. 1576, allowed the deduction of expenses to produce income from stocks and bonds; O.D. 1134, 5 Cum. Bull. 1972, allowed the deduction of expenses to produce rental income; I.T. 2103, III-2 Cum. Bull. 1862, allowed the deduction of expenses for investment advisory services; I.T. 2579, X-2 Cum. Bull. 129, allowed the deduction of the rent for safety deposit boxes used primarily for income-producing securities; I.T. 2751, XIII-1 Cum. Bull. 43, allowed the deduction of expenses incurred with regard to the management, protection, and conservation of properties producing taxable income.
93. *Potter v. Comm.*, 18 BTA 549 (1929) allowed the deduction of travel expenses to inspect investments which afforded the main source of income of the taxpayer; *Hoover v. Comm.*, 42 BTA 461 (1940) disallowed investment counsel fees not incurred in a trade or business; *Roebbling v. Comm.*, 37 BTA 82 (1938) also looked at whether the taxpayer was in a trade or business based

on a stricter interpretation.

94. Jephson v. Comm., 37 BTA 1117 (1938).
95. Montgomery v. Comm., 37 BTA 232 (1938).
96. Brodsky, Samuel, and McKibben, David, "Deduction of Non-Trade or Non-Business Expenses," Tax Law Review, Volume 2 (February, 1946), p. 41.
97. Higgins v. Comm., 312 U.S. 212 (1941).
98. Haden, Harry H., op. cit., p. 35.
99. Smith, J. Duke, "An Investor's Deductions from Gross Income," Taxes, Vol. 19 (March, 1941), p. 138.
100. I.T. 3452, 1941-1 Cum. Bull. 205, revoked I.T. 2751, I.T. 2579, and O.D. 877. See Footnote 92.
101. Statement of the Department of the Treasury, Hearings Before the Committee on Ways and Means on Revenue Revision, 77th Congress, Second Session (Washington: U.S. Government Printing Office, 1942), p. 88.
102. Paul, Randolph E., "Suggested Income Tax Revisions," Proceedings of the 34th Annual Conference of the National Tax Association (Washington: National Tax Association, 1941), p. 387.
103. Revenue Act of 1942, Section 121, 56 Stat. 798, 819.
104. Trust of Bingham v. Comm., 325 U.S. 365 (1945).
105. Schwanbeck, W.J., "Non-Trade and Non-Business Deductions," Taxes, Vol. 22 (October, 1944), p. 467, stated that the intention of Congress was to allow the individual taxpayer such non-trade or non-business expenses as safety deposit box rent, office rent, clerical salaries, custodian expenses, etc., but not to allow the individual non-trade or non-business expenses which would not be deductible as trade or business expenses to an individual engaged in business.
106. Brodsky, Samuel, op. cit., p. 44.
107. See Footnotes 94, 97, and 98.
108. Jones v. Comm., 22 TC 407; rev'd 222 F.2d 891 (CA 7, 1955); allowed the deduction of maintenance expenses of a residence listed for rent but unoccupied until a subsequent year; Coors v. Comm., 60 TC 44 (1973), allowed the deduction of expenses of a condominium only occupied by the owner for 5 per cent of the year and held out for rent for the rest of the year.

109. Carkhuff v. Comm., 425 F.2d 1400 (CA 6, 1970); Rand v. Comm., 34 TC 1146 (1960).
110. Rev. Rul. 55-237, 1955-1 Cum. Bull. 317.

## CHAPTER IV

### DEDUCTIONS FROM ADJUSTED GROSS INCOME

The deductible income-producing expenses of individuals which were not covered in the previous chapter may only be deducted by taxpayers who itemize deductions. This group of expenses comprises household and dependent care services for all taxpayers, other trade or business expenses of employees which are not reimbursed, and non-business expenses not attributable to the production of rents or royalties.

The analysis in this chapter will determine the factors significant to the deduction of the expenses in this group and study the consistency of their application within the group. Then, these factors will be compared with the factors important to the deduction of income-producing expenses which are deductible for adjusted gross income to ascertain whether consistent inter-group differences can justify the present dichotomous treatment of income-producing expenses.

#### Household and Dependent Care Expenses

Early attempts to deduct the costs of care for children to allow the parent to work were determined not to fall within the ordinary and necessary criteria applied to the income-producing expenses of individuals. Both the courts and the Bureau of Internal Revenue had concluded that these costs were primarily personal in

nature.<sup>1</sup>

Testimony at Congressional hearings in 1953 indicated that a large number of people felt that some of these expenses should be deductible.

It is my belief that if as many mothers, for instance, had been working at the time that regulations were shaping the meaning of ordinary and necessary business expenses as there are now, the Treasury Department would have permitted deductions for wages paid housekeepers, nursemaids, and expenses of nursery care.<sup>2</sup>

Other testimony advocated deduction of these expenses for adjusted gross income.

Section 22(n) should be amended to provide that this expense be deductible in computing adjusted gross income. It is an expense directly related to the production of income and should be deducted on the same basis as travel and other similar expenses.<sup>3</sup>

Subsequently, a number of bills were submitted concerning these expenses and the new Internal Revenue Code of 1954 contained Section 214 which allowed the limited deduction of what were termed child care expenses. The law followed the proposals of the Senate Finance Committee which were more liberal than those of the House Ways and Means Committee.<sup>4</sup> The deduction was allowed to a working woman or widower for the expenses paid for the care of a dependent who was mentally or physically incapable of self-care or who was the child of the taxpayer under twelve years of age. The child care expense deduction could not exceed \$600, nor were payments to dependents deductible. The allowable deduction was reduced for working wives by the amount by which the adjusted gross income of the taxpayer and her spouse exceeded \$4,500. Because of the construction of Section 62, these expenses could only be deducted from adjusted gross income.<sup>5</sup>

It was subsequently established that this deduction also applied to self-employed taxpayers<sup>6</sup> and that these expenses must have been incurred to allow the taxpayer to produce income.<sup>7</sup>

The provision for the deduction of these expenses was amended in 1964 because it was too restrictive.<sup>8</sup> The maximum deduction became \$900 for two or more dependents and the care expenses of children under 13 were made deductible. The allowable deduction was reduced by adjusted gross income in excess of \$6,000.<sup>9</sup>

The law was held not to violate due process even though it did not allow the deduction to a man who had never been married since all members of the class of unmarried men were treated equally.<sup>10</sup> Nor does it violate the Fifth Amendment although one class, women with children, are discriminated against depending on their income while other income-producing expenses are not dependent upon level of income for a determination of the amount which is deductible.<sup>11</sup>

In 1971, this area was changed again. Reasons for revision were to encourage the use of domestic help to allow full-time employment and to support the care of dependents in the home.<sup>12</sup> The level of the maximum allowable annual deduction was raised to \$4,800 because the previous level was deemed inadequate. Coverage was extended to the care expenses of children 14 years of age and under.

The allowable deduction decreased \$1 for every \$2 of adjusted gross income in excess of \$18,000, based on a Conference Committee change.<sup>13</sup> The original Senate amendment had mandated phase-out over a \$12,000 adjusted gross income because it was assumed that \$12,000 would be the median income for families in the subsequent year.<sup>14</sup> Median income was chosen as the phase-out point because the spouses

with earnings below this figure are felt to be working to maintain minimum living standards.<sup>15</sup> The Conference Committee raised this figure to encourage middle class as well as low income families to pay for high quality child care and household assistance without worrying about unduly shrinking their total income.<sup>16</sup> The Senate voted 59 to 24 in favor of this change.<sup>17</sup>

The Senate also debated whether these expenses should be deductible for adjusted gross income. One argument in favor of this change was that it was estimated that almost 70 percent of taxpayers with adjusted gross incomes less than \$10,000 would not itemize deductions.<sup>18</sup> However, the Treasury estimated that this change would cost an additional \$110 million in tax revenues.<sup>19</sup> Thus, the discussion revolved around the probable loss in tax revenue and the availability to low-income taxpayers rather than whether these expenses were primarily income-producing or personal in nature. The Senate vote was 74 to 1 in favor of the change,<sup>20</sup> yet the Conference Committee rejected this amendment without explanation but accepted the \$18,000 phase-out amendment which passed the Senate by a much smaller margin.<sup>21</sup> After 1971, indirect child care costs, such as for cleaning childrens' rooms and preparing meals for them, became deductible.<sup>22</sup>

It has been theorized that much of the force behind the position that child care is a real business expense derives from the view of womens' groups that the expense of child care is generally offset against the probable earnings of the working wife to see how much net income she would add to the family by working.<sup>23</sup> Consequently:

Under these mores, the child care deduction assists her in obtaining a freedom of decision on a parity with the husband. In this view, it would seem that if decisions as to who works outside the home were made regardless of sex, there would be no basis for the child care deduction. If so, as a matter of tax structure it is hard to see why the expense is really a business expense and not a personal expense.<sup>24</sup>

Thus, the opinions of Congress, the Treasury Department, and tax experts are divided concerning whether the expenses of household and dependent care services are primarily income-producing expenses of individuals. These expenses have only been deductible for the last 20 years. There are no special substantiation requirements. Deductible amounts have a maximum which is \$4,800 for adjusted gross incomes up to \$18,000. Between adjusted gross incomes of \$18,000 and \$27,600 this maximum decreases. No child care expenses are deductible on tax returns with an adjusted gross income of at least \$27,600. The criteria applied to determine motivation are objective insofar as the expenses must be incurred to allow full-time employment, which is an explicitly defined time constraint, and a joint return must be filed. Allocation of these expenses is necessary to the extent that services are provided without a reasonably direct relationship to the care of dependents of the taxpayer. Location is only important to the deduction of these expenses when they are incurred outside of the home of the taxpayer where the maximum deduction depends upon the number of dependents being cared for.

#### Employee Expenses

All income-producing expenses of employees other than travel, transportation, moving, outside salesmen, and reimbursed expenses

are deductible only by employees who itemize deductions from adjusted gross income. Except for child care expenses, the deductibility of these expenses has basically been established by the interpretation of the Internal Revenue Service and the courts of the section of the law which allows the deduction of ordinary and necessary trade or business expenses.<sup>25</sup> Although there are many of these expenses,<sup>26</sup> only entertainment, education, office-in-home, and employment seeking or securing expenses will be investigated because of their relatively large size when incurred or greater frequency of occurrence.

Entertainment. Entertainment expenses of individuals to produce income were not mentioned by the law or the regulations until 1958. Prior to that time, the only basis for deductibility was Revenue Service and court interpretation of what constituted an ordinary and necessary business expense. However, entertainment expense deductions were allowed in many cases for employees<sup>27</sup> and self-employed taxpayers.<sup>28</sup>

Substantiation of entertainment expenses has probably caused more problems than any other area of individual income-producing expenses. Originally, estimates of expenses were of no help in establishing deductible amounts.<sup>29</sup> However, the Cohan case established the principle that estimates could be used to determine deductible entertainment expenses, although the lack of records would weigh against the taxpayer in the decision of the court as to what amount was deductible.<sup>30</sup> The Cohan rule was applied in subsequent court cases.<sup>31</sup> It resulted in uncertain enforcement by

the Internal Revenue Service.<sup>32</sup> Proposals to modify the Cohan rule's effect on entertainment expenses were frequently made by the executive branch<sup>33</sup> and by tax experts.<sup>34</sup> The Internal Revenue Service attempted to maintain a strict enforcement attitude towards the deduction of entertainment expenses.<sup>35</sup> The Treasury felt that many taxpayers, who incurred a nominal amount of entertainment expenses, were consistently taking advantage of the Cohan rule by making generous estimates of entertainment expenses.<sup>36</sup>

Section 274 was added to the Code in 1962 to curb these abuses and to relieve some administrative uncertainty.<sup>37</sup> It requires the taxpayer to keep and maintain certain records for entertainment expenses in excess of \$25. A transition period was allowed to implement this change in the keeping of entertainment expense records.<sup>38</sup> Numerous subsequent cases continue to involve the problem of which records provide adequate substantiation of entertainment expenses.

Determining when entertainment expense has been incurred primarily to produce income has had an elusive solution because of the highly personal nature of these expenses. To delineate between deductible and nondeductible entertainment expenses has required some necessarily arbitrary decisions by the Internal Revenue Service, the courts, and, more recently, Congress.

The original criterion applied to measure the motivation of the taxpayer in incurring the entertainment expense was a determination of whether a direct relationship existed between the expense and the business of the taxpayer. Failure to prove this direct relationship resulted in disallowance of the deduction.<sup>39</sup> However, the Service and the courts were liberal in the determination of where this

connection existed.<sup>40</sup> Because of this problem, the President recommended that the deduction of most previously deductible entertainment expenses be disallowed.<sup>41</sup> He proposed that some of the remaining deductible entertainment expenses be subject to daily maxima.<sup>42</sup> Congress did not agree that almost complete disallowance was a proper solution to the problem.<sup>43</sup> In 1962, an explicit test was added to the Code to limit the abuse and ambiguity in this area.<sup>44</sup> Deductible entertainment expenses must subsequently be directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion, associated with, the active conduct of the trade or business of the taxpayer.<sup>45</sup> Objective standards were made to apply where there must be apportionment between the expenses which meet this test and those which do not.<sup>46</sup> These standards are not clear<sup>47</sup> nor objective.

The critical point to note is that Section 274 was designed to assist, by objective tests, the administration of the tax laws. Yet what could be more subjective than a query whether circumstances and surroundings were conducive to a business discussion, or whether a substantial business discussion did not occur because of reasons beyond the taxpayer's control. The administration of the tax laws has not been helped by the enactment of Section 274. The Regulations have liberalized Section 274 but have not clarified the basic rules either for the taxpayers or the revenue agents.<sup>48</sup>

The end result for the majority of taxpayers who incur entertainment expenses was not significantly changed by Section 274 because of subsequent broad interpretations of its wording and intent.<sup>49</sup> Thus, the criteria used to measure the income-producing motivation of entertainment expenses are objective according to Congress, but subjective in their practical application to the circumstances of

each taxpayer.

The type and degree of relationship between the taxpayer and the person being entertained are very important to the ultimate deductibility of the entertainment. The closer the social relationship and the more remote the business relationship, the harder it is to incur deductible entertainment expenses.<sup>50</sup>

At one time, employees could only deduct entertainment expenses when they could prove that their wages had been fixed in an amount to cover such expenses.<sup>51</sup> Some subsequent decisions have indicated that explicit employee-employer agreement as to entertainment responsibilities is still important,<sup>52</sup> while others have decided that it is not important.<sup>53</sup> Another case concluded that, despite an agreement, an employee entertaining extensively to further customer relations could not deduct the expenses because as a corporate officer he was just fulfilling civic and social obligations which were personal.<sup>54</sup> It seems reasonable to conclude, however, that, generally, employer-acknowledged entertainment responsibilities are helpful to the deduction of the entertainment expenses of employees, although not sufficient nor necessary for their deductibility.

Another consideration in the determination of deductible entertainment expenses concerns whether or not the expenses of the entertainer are deductible. A number of decisions have concluded that only the excess of expenses for oneself over what would have been spent normally for one's meal is deductible.<sup>55</sup> This situation arises only in the case of entertainment expenses because other income-producing expense areas explicitly allow the deduction of the full amount of otherwise personal costs, not just abnormal costs.

Examples are meals and lodging when in a travel status or when moving and temporary living costs incurred in connection with moving. Some knowledgeable sources take the court decisions at face value.

The entertainment expense deduction for taking a client to lunch includes only that portion of the check representing the client. What the host spent on his own meal, it was assumed, was personal; he would have had to eat lunch even if he had been alone.<sup>56</sup>

However, other sources indicate that the Sutter rule will only be applied by the Internal Revenue Service where it finds an abuse situation.<sup>57</sup> Apparently, the taxpayer's normal personal expenses, which are incurred in an entertainment situation where the costs of the person being entertained are deductible, are not deductible, although the auditing agent may allow their deduction if he does not find that the taxpayer is claiming a substantial amount of entertainment expenses which includes personal living expenses.<sup>58</sup>

Thus, entertainment expenses incurred to produce income have been deductible for many years, although this deductibility has been based on interpretation of Section 162 and its predecessors, rather than on explicit statements in the Code. Section 274 requires special record-keeping for entertainment expenses and disallows the application of the Cohan rule to estimate expenses incurred when records are inadequate. Allocation must be made for portions of entertainment expenses for the taxpayer, in general, and for guests without an income-producing relationship with the taxpayer. The criteria applied to determine motive, such as directly related to or associated with, are basically subjective. Deductibility does not depend on employer requirement or awareness of the employee's entertaining expenses, but it does depend upon the taxpayer already being in the position

of producing income.

Education. It was not until 1950 that a broader interpretation of what constituted ordinary and necessary business expenses resulted in the subsequent deductibility of many education expenses incurred to produce income. Previously, costs of summer school attendance,<sup>59</sup> post-graduate medical courses,<sup>60</sup> professional books,<sup>61</sup> research assistance for a scholar writing articles,<sup>62</sup> and engineering night school courses for a mechanic<sup>63</sup> were not deductible.

In 1950, *Hill v. Comm.* concluded that summer school expenses of a teacher were deductible by applying more liberal criteria than those used in the past.<sup>64</sup> Before this time, the criteria used had been whether the expenses had been required by the employer, whether they were principally to enable the continuance of a present career, and whether they would lead directly to profit. The effect of this case was to eliminate much of the dichotomy between the reasoning in education and non-education cases so that the costs of obtaining income-producing knowledge directly in a formal educational setting, especially, would be as deductible as other means of obtaining revenue. *Hill v. Comm.* developed criteria to ascertain the deductibility of these expenses, such as, whether the expenses were incurred to maintain a present position or to attain a new position, to preserve or to expand and increase, and to carry on or to commence.<sup>65</sup> The Internal Revenue Service subsequently promulgated a statement to the same general effect.<sup>66</sup> Education expenses incurred in connection with advancement within a profession<sup>67</sup> or to obtain a new position<sup>68</sup> were not deductible.

In 1958, the Service issued formal regulations which applied a more extended approach for deductible education expenses.<sup>69</sup> Subsequent deduction depended upon education expenses having had a primary purpose of maintaining or improving needed skills or of meeting the express requirements of the employer.<sup>70</sup> This primary purpose test allowed the deduction of costs incurred in obtaining a Ph.D. in the subject area of the job of the employee,<sup>71</sup> but it disallowed the expense deduction when the original education motivation was not primarily related to retention of the present job held.<sup>72</sup> Employer requirement of the education enabled the deduction of expenses which otherwise would be considered to be training for a new trade or business.<sup>73</sup>

As a result of increased uncertainty and lack of uniformity in the application of the primary purpose test,<sup>74</sup> a new regulation concerning the deduction of education expenses was issued in 1967.<sup>75</sup> Subsequently, education costs are not deductible if they are part of a program which will lead to qualifying the taxpayer in a new trade or business even though their primary purpose is to maintain or improve present job skills or to meet employment retention conditions of the employer.<sup>76</sup> This requirement has resulted in numerous cases where education expenses were incurred in programs leading to formal college degrees, especially law degrees, and their deduction was disallowed. This more objective test has resulted in many fewer cases requiring court decisions and being decided in the favor of the taxpayer.

One problem has been whether a taxpayer is in an income-producing status and thus is able to deduct education expenses if the present

job is left to pursue education on a full-time basis. A teacher who resigned her position, took graduate courses for one year, and then took a different teaching position was held to be in the same trade or business continuously.<sup>77</sup> However, studying for four years with no employment relationship and no attempt to obtain a teaching position,<sup>78</sup> and having a job in a different profession before obtaining education related to the old profession and returning to the old profession,<sup>79</sup> were indicative of ceasing to be in the same trade or business and, therefore, the education expenses were not deductible.

Although other types of income-producing investment costs are allowed to be amortized over their useful lives, that treatment has never been allowed for the basic education expenses of individuals incurred to meet the minimum standards of their subsequent employment.<sup>80</sup> Many tax experts have advocated amortization of these human capital costs,<sup>81</sup> but the Regulations have continually maintained that they are personal, despite the fact that moving costs to a first or a new job are deductible income-producing expenses.

Thus, education expenses incurred to produce income are deductible only after entering a trade or business and they can not be part of a program leading to qualification in a new trade or business. Their deductibility has been recently established, but only through Regulations, rulings and court decisions. There must always be allocation between personal and income-producing education expenses and the criteria for this allocation are mainly subjective. The incurring of these expenses can be either on a voluntary basis or as a result of an employer requirement for keeping a job.

Education expenses have no special substantiation requirements.

Office-in-Home. References were made to the deductibility of the allocated expenses of a home used to produce income as early as 1918<sup>82</sup> and similar language has been used by all subsequent regulations to the present time.<sup>83</sup> The revenue acts and Codes have never mentioned this expense explicitly.

Early litigation determined that the taxpayer had to be in a trade or business to deduct these expenses.<sup>84</sup> Also, allocation had to be made between the income-producing expenses of the office and the personal expenses of the rest of the residence.<sup>85</sup> The courts seemed to interpret the regulations as preventing the deduction of office-in-home expenses of an employee.<sup>86</sup> Subsequent litigation recognized that employees could be eligible to deduct this income-producing expense, but only when the home office was required by the employer.<sup>87</sup> Guidelines issued by the I.R.S. in that same year allowed the deduction of these expenses only when the home office was required by the employer and when it was regularly used.<sup>88</sup>

Subsequently, expenses for a home office were deductible where space limitations existed at the office furnished by the employer,<sup>89</sup> but they continued to be deductible only for a taxpayer actively engaged in a trade or business.<sup>90</sup> In 1963, the Service ruled that expenses of research were deductible even though they might have only an indirect income-producing effect for teachers.<sup>91</sup> As a result of this ruling, home office costs for research are more likely to be deductible than office costs for ordinary teaching activities.<sup>92</sup> Revenue Ruling 64-272<sup>93</sup> expanded upon Revenue Ruling

63-275, but its deductibility criteria were that the expense was deductible if the college expected faculty research but did not provide adequate facilities and that the portion of the home be used regularly. These are, basically, an extension of Revenue Ruling 62-180 criteria.

The courts have recently modified these criteria insofar as employer requirement is considered a necessity for deduction of office-in-home expenses. In 1966, the Tax Court held that to be deductible as an ordinary and necessary business expense it is sufficient that the expenditure be appropriate and helpful to the conduct of the business; it need not be required.<sup>94</sup> In 1970, the courts further emphasized that Revenue Ruling 62-180 is not controlling but is merely helpful and that each case is to be decided upon the weight of the facts presented.<sup>95</sup>

Two Tax Court cases decided in 1973 further applied this test of appropriate and helpful. In one, the court stated that this test, rather than employer requirement, should be applied here just as it is to other business expenses.<sup>96</sup> As a condition of employment was interpreted to mean required to perform properly the duties of employment, rather than the more limited Service interpretation. Strong dissents saw an analogy to Fausner<sup>97</sup> and would have disallowed the deduction unless the taxpayer had been able to show that he would have rented a smaller apartment or bought a smaller house, except for his need of an office in his home to produce income. The other Tax Court decision also disagreed with Revenue Ruling 62-180, especially regarding how much office-in-home expenses were incurred to produce income.<sup>98</sup>

Thus, office-in-home expenses are subject to normal substantiation requirements and they always must be allocated between personal and income-producing purposes. To result in deductible expenses, the office must be used regularly by a person already in a trade or business. It is reasonable to assume that use of the office need only be appropriate and helpful to the performance of employment duties rather than required by the employer as the Internal Revenue Service contends.

Employment Seeking or Securing. The costs of looking for or actually finding a job have never been explicitly mentioned in our income tax laws. However, the Internal Revenue Service generally has interpreted the sections of the law allowing the deduction of ordinary and necessary trade or business expenses to apply to fees incurred to successfully find employment.<sup>99</sup> Fees paid to seek employment unsuccessfully were held to be nondeductible.<sup>100</sup> Subsequent court decisions relied on that distinction.<sup>101</sup> The Service tried to carry this rationale even further by reasoning that the obligation to pay employment agency fees in the event of employment is incurred in seeking employment and, therefore, not deductible even if employment is secured through the agency.<sup>102</sup> Very strong protests to this ruling caused the I.R.S. to reconsider and revoke Revenue Ruling 60-158 so that employment agency fees continued to be deductible if they resulted in a new job.<sup>103</sup>

A 1970 court case established a two-part test for the deductibility of employment agency fees.<sup>104</sup> To be deductible, the fees must have led to securing a new job and the new job must have duties similar to those of the present job of the taxpayer. Another decision in that

same year allowed the deduction of employment agency fees where the agency secured a new job for the employee although he stayed with the same employer.<sup>105</sup> However, the I.R.S. and another court continued to draw a line between job-seeking and job-securing expenses,<sup>106</sup> although the Service indicated acceptance of the Primuth decision.<sup>107</sup> In 1972, the Tax Court completely eliminated the distinction between seeking and securing.<sup>108</sup> The new tests for deductibility appear to be that the employment must be sought in good faith and in a similar occupation,<sup>109</sup> although the Service has not explicitly indicated agreement with Cremona. Such criteria abandon the clear-cut test of the securing and seeking distinction for a test in which each case must be decided on its own facts.<sup>110</sup> A recent decision disallows a deduction if the origin of the expense is personal even though incurring it may make a present job more secure.<sup>111</sup> The Service removed job seeking expenses from its list of tax issues that it will not compromise on.<sup>112</sup> This implies its acceptance of the thrust of these latest court decisions which are in accord with previous suggestions of some tax experts.<sup>113</sup>

One criterion which has been applied consistently to job seeking expenses is that they must be for employment in a new position with similar duties.<sup>114</sup>

It has also been consistently held that a taxpayer may not deduct employment seeking or securing expenses if he is unemployed<sup>115</sup> even though some other types of income-producing expenses have been held to be deductible by temporarily unemployed taxpayers.<sup>116</sup>

Thus, employment securing expenses have long been deductible, while mere employment seeking expenses have only recently become

deductible. Normal substantiation requirements apply to these expenses. These expenses are not deductible when incurred either by an unemployed taxpayer or to obtain a position in a different trade or business. Employment seeking or securing expenses are either fully deductible or not deductible, so no allocation between deductible and personal portions is necessary. The criteria applied to determine whether a primary income-producing motive exists are very subjective.

### Investor Expenses

A great variety exists in the types of income-producing expenses which are not incurred in a trade or business nor attributable to the production of rents or royalties. Expenses incurred to produce income from securities or alimony income are the most frequent subjects of litigation.

The criteria for deductibility are basically the same as those applied to expenses incurred to produce rents or royalties which were covered in pages 46 to 49. They must bear a proximate relation to the activities carried on. The expenses are not deductible if they arise from personal activities, notwithstanding the fact that failure to incur these expenses may result in the attachment, sale, or use of the income-producing property of the taxpayer in order to settle a liability.<sup>118</sup> The key question is the intention of the taxpayer in the light of all the facts and circumstances.<sup>119</sup> The use of the property should be of such a nature that the taxpayer in good faith genuinely expected or intended to make a profit.<sup>120</sup>

Thus, the main criterion for deductibility of these expenses

appears to be that the primary motive of the taxpayer was to produce income.

### Summary

This chapter has analyzed the historical development and factors in the deduction of the income-producing expenses of individuals which are deducted from adjusted gross income. Table 4.1 indicates a basic summary of the main considerations impacting on most of these deductible expenses. The same basic criteria for deductibility of each type of expense are applied to self-employed taxpayers, employees and investors. Table 4.1 indicates some internal consistency in the use of mostly subjective deductibility criteria and the requirement that all be incurred while in a trade or business, although a temporarily unemployed person is not considered to be in a trade or business for the purpose of deducting job seeking or securing expenses, whereas he would be for the purpose of deducting some other income-producing expenses.<sup>121</sup>

The purpose of Chapters 3 and 4 was to determine whether any consistent differences exist in the criteria promulgated by lawmakers to indicate the extent to which the two groups of income-producing expenses are and have been deductible. The presence of consistent differences may account for the lack of horizontal equity perceived in Chapter I which was not explained by the Chapter II tracing of the chronological development of the dichotomous treatment of income-producing expenses. A scrutiny of the pertinent factors in the deduction of each expense as summarized in Table 4.2 fails to find even internal consistency in their application. Both

Table 4.1 Factors Pertaining to the Deduction from Adjusted Gross Income of Certain Income-Producing Expenses of Individuals

| Expense Category               | History                                                  | Amount Constraints |                                               | Time Constraints   |                       | Location Constraints |                                                         |
|--------------------------------|----------------------------------------------------------|--------------------|-----------------------------------------------|--------------------|-----------------------|----------------------|---------------------------------------------------------|
|                                |                                                          | Minimum            | Maximum                                       | Minimum            | Maximum               | Minimum              | Maximum                                                 |
| Child Care                     | Recently Accepted                                        |                    | Based on Income and Where Child Care Provided | Employed Full-time |                       |                      |                                                         |
| Entertainment                  | Well Accepted                                            |                    |                                               |                    |                       |                      |                                                         |
| Education                      | Recently Accepted                                        |                    |                                               |                    |                       |                      | Can Not Lead to Qualification for New Trade or Business |
| Office-in-Home                 | Recently Accepted                                        |                    |                                               |                    | Office Regularly Used |                      |                                                         |
| Employment Seeking or Securing | Securing-Well Accepted<br>Seeking-Very Recently Accepted |                    |                                               |                    |                       |                      | For Position With Similar Duties                        |

Table 4.1 (Continued)

| Expense Category               | Income-Producing v. Personal Allocation | Criteria to Determine Income-Producing Motivation | Substantiation                                      | Employer Requested or Voluntary                           | Already Producing Income |
|--------------------------------|-----------------------------------------|---------------------------------------------------|-----------------------------------------------------|-----------------------------------------------------------|--------------------------|
| Child Care                     | Possibly For Care in Home               | Objective                                         | Normal Requirements                                 | Not Applicable                                            | Required                 |
| Entertainment                  | Usually                                 | Subjective                                        | Special Requirements (No application of Cohan rule) | Either                                                    | Required                 |
| Education                      | Always                                  | Mainly Subjective                                 | Normal Requirements                                 | Either                                                    | Required                 |
| Office-in-Home                 | Always                                  | Subjective                                        | Normal Requirements                                 | Courts-Appropriate and Helpful IRS - Required by Employer | Required                 |
| Employment Seeking or Securing | Never                                   | Subjective                                        | Normal Requirements                                 | Either                                                    | Required                 |

Table 4.2 A Summary of the Occurrence of Factors Pertaining to the Deduction of Certain Income-Producing Expenses of Individuals

| Expense Category               | History                  | Amount |      |      |      | Constraints |      |      |          | Allocation Necessary | Motivation Measures | Substantiation | Already Producing Income |
|--------------------------------|--------------------------|--------|------|------|------|-------------|------|------|----------|----------------------|---------------------|----------------|--------------------------|
|                                |                          | Min.   | Max. | Min. | Max. | Time        | Min. | Max. | Location |                      |                     |                |                          |
|                                |                          |        |      |      |      |             |      |      | Min.     | Max.                 |                     |                |                          |
| For A.G.I.                     |                          |        |      |      |      |             |      |      |          |                      |                     |                |                          |
| Travel                         | Long                     |        | X    |      | X    |             |      | X    |          |                      | Obj.+Sub.           | Special        | Yes                      |
| Reimbursed                     | Long                     |        | X    |      |      |             |      |      |          |                      |                     | Relaxed        |                          |
| Transportation                 | Long                     |        |      |      |      |             |      |      | X        | X                    | Obj.+Sub.           | Normal         | Yes                      |
| Moving                         | Recent                   |        | X    |      | X    |             | X    | X    |          |                      | Objective           | Normal         | Not Necessary            |
| From A.G.I.                    |                          |        |      |      |      |             |      |      |          |                      |                     |                |                          |
| Child Care                     | Recent                   |        | X    |      |      |             | X    |      |          |                      | Objective           | Normal         | Yes                      |
| Entertainment                  | Long                     |        |      |      |      |             |      |      |          | Yes                  | Subjective          | Special        | Yes                      |
| Education                      | Recent                   |        |      |      |      |             |      |      | X        | Yes                  | Mainly Subjective   | Normal         | Yes                      |
| Office-in-Home                 | Recent                   |        |      |      |      |             | X    |      |          | Yes                  | Subjective          | Normal         | Yes                      |
| Employment Seeking or Securing | Part-Long<br>Part-Recent |        |      |      |      |             |      |      | X        | No                   | Subjective          | Normal         | Yes                      |

deductions for and from adjusted gross income have expense categories with a long history of acceptance and others with a short history of deductibility. Deductions for adjusted gross income have maximum time and minimum location constraints unlike deductions from adjusted gross income, but both groups have maximum amount, maximum location, and minimum time constraints. Neither group has any minimum amount constraints. The application of other factors appears to be similarly distributed within each group, except for the moving expense deduction which is allowed for individuals before they start producing income or before they enter a trade or business. This analysis of deductibility criteria does not, therefore, lead to any consistent substantive distinctions which would justify the current dichotomous treatment of the income-producing expenses of individuals.

## FOOTNOTES--CHAPTER IV

1. I. T. 1767, II-2 Cum. Bull. 1071; *Smith v. Comm.*, 40 BTA 1038; *aff'd* 113 F.2d 114 (CA 2, 1940); *O'Connor v. Comm.* 6 TC 323 (1946).
2. Statement of Aime J. Forand at the Hearings Before the Committee on Ways and Means on General Revenue Revision, 83rd Congress, First Session, Part 1 (Washington: U.S. Government Printing Office, 1953), p. 30.
3. Statement of Julia Thompson, loc. cit.
4. House Report No. 1337, op. cit., p. 30; Senate Report No. 1622, op. cit., p. 35; House Report No. 2543, Internal Revenue Code of 1954, 83rd Congress, Second Session (Washington: U.S. Government Printing Office, 1954), p. 31-32.
5. Section 62 allows the deduction for adjusted gross income of trade and business expenses allowed by the income tax chapter concerning normal taxes and surtaxes, Chapter 1, except for those expenses allowed within Part VII of Subchapter B which indicates deductible itemized deductions for individuals. Section 214 is contained within Part VII of Subchapter V so it is the exception to the rule that the income-producing expenses of self-employed individuals are deductible for adjusted gross income. Although moving expenses are made deductible by Section 217, which also is contained within Part VII of Subchapter V, their deduction for adjusted gross income is independently authorized by Paragraph 8 of Section 62.
6. T. D. 6184, 1956-2 Cum. Bull. 157.
7. Rev. Rul. 56-169, 1956-1 Cum. Bull. 135, and *Lustig v. Comm.* 30 TC 926 (1958); *aff'd* 274 F. 2d 448 (CA 9, 1960).
8. House Report No. 749, loc. cit., pp. 181-182.
9. Section 212, Public Law 88-272, 1964-1 (Part 2) Cum. Bull. 6.
10. *Moritz v. Comm.*, 55 TC 113 (1970), stated that the taxpayer could only avail himself of the deduction if he fitted within the terms of the statute. It also concluded that if Congress sees fit to establish classes of persons who shall or shall not benefit from a deduction, there is no offense to the Constitution, if all members of one class are treated alike.
11. *Nammack v. Comm.*, 56 TC 1379 (1971); *aff'd* 459 F. 2d 1045 (CA 2, 1972); cert. den. 409 U.S. 991 (1972). This decision concluded that these expenses are business and personal in nature and that Congress was free to classify such expenses

in either category. The fact that it chose to allow the deduction only in the case of the less affluent family does not constitute a violation of the rights of the petitioner under the Fifth Amendment. A different conclusion is not called for simply because the nondeductibility of certain child care expenses might impose a particular burden on working women. The court said that the presumption of constitutionality of an act of Congress is particularly strong in the case of a revenue measure.

12. Senate Rept. No. 437, Report of the Committee on Finance on the Revenue Act of 1971, 92nd Congress, First Session (Washington: U.S. Government Printing Office, 1971), p. 60.
13. Ibid., p. 61.
14. Ibid., p. 60.
15. Ibid., p. 59.
16. Congressional Record, 92nd Congress, First Session, Vol. 117, Part 31, p. 41255.
17. Ibid., p. 41256.
18. Ibid., p. 40934.
19. Ibid.
20. Ibid., p. 50935.
21. Senate Conference Report No. 553, Conference Report on the Revenue Act of 1971, 92nd Congress, First Session (Washington: U.S. Government Printing Office, 1971), p. 42.
22. *Smail v. Comm.*, 60 TC 76 (1973).
23. *Surrey*, Stanley S., p. 357.
24. Ibid.
25. Section 162 of the Internal Revenue Code of 1954 and Section 23(a)(1)(A) of the 1939 Code.
26. See p. 3.
27. *Lickumovitz v. Comm.*, 4 BTA 1181 (1926); *Pollack v. Comm.*, 10 BTA 1297 (1928); *Wayburn v. Comm.*, 32 BTA 813 (1935).
28. *Appeal of Parish-Watson*, 3 BTA 840 (1926); *King v. Comm.*, 9 BTA 502 (1927); *May v. Comm.*, 39 BTA 946 (1939).
29. *Friend v. Comm.*, 8 BTA 712 (1927).

30. Cohan v. Comm., op. cit.
31. Kahn v. Comm., 38 BTA 1417 (1938); aff'd 108 F. 2d 748 (CA 2, 1940); Boverman v. Comm., 10 TC 476 (1948).
32. Eldridge, Douglas H., "Expense Accounts," Proceedings of the 54th Annual Conference of the National Tax Association (Harrisburg, Pennsylvania: National Tax Association, 1962), p. 216.
33. Department of the Treasury, "Proposals for Strengthening Tax Administration," Hearings Before a Subcommittee of the Committee on Ways and Means, 82nd Congress, Second Session (Washington: U.S. Government Printing Office, 1952), pp. 98-100; "The President's Recommendations Contained in his Message on Taxation," Hearings Before the Committee on Ways and Means, 87th Congress, First Session (Washington: U.S. Government Printing Office, 1961), pp. 39-40.
34. Smith, Henry Cassorte, "General Business Expense (But with Particular Reference to Entertainment, Gift and Travel Expenses)," Tax Revision Compendium of the Committee on Ways and Means, 86th Congress, First Session (Washington: U.S. Government Printing Office, 1959), p. 1085.
35. Rev. Rul. 54-195, 1954-1 Cum. Bull. 47, directed internal revenue officers to closely scrutinize the deduction of business expenses.
36. Internal Revenue Service, Department of the Treasury, 1960 Audit Report on Entertainment, Travel and Similar Expenses (Washington: U.S. Government Printing Office, 1961), p. 23.
37. Revenue Act of 1962, loc. cit.
38. Rev. Proc. 63-3, 1963-1 Cum. Bull. 258; Rev. Proc. 63-18, 1963-1 Cum. Bull. 506.
39. G.C.M. 5533, VIII-1 Cum. Bull. 4062; Denny v. Comm., 33 BTA 738 (1935); Schulz v. Comm., 16 TC 401 (1951).
40. Senate Report No. 1881, op. cit., p. 731.
41. "The President's Recommendations Contained in his Message on Taxation," op. cit., p. 39.
42. Ibid., p. 40.
43. House Report No. 1447, op. cit., p. 423; Senate Report No. 1881, loc. cit. The Senate report indicated that entertainment expenses should remain deductible to some degree because they increase business income which in turn produces additional tax revenues for the Treasury.

44. Revenue Act of 1962, loc. cit.
45. Ibid.
46. House Report No. 1447, op. cit., p. 425; Senate Report No. 1881, op. cit., p. 735.
47. Bittker, Boris I., Panel Discussions Before the Committee on Ways and Means, 93rd Congress, Second Session, Part 1 (Washington: U.S. Government Printing Office, 1973), p. 126. He felt that Section 274 overloads both taxpayer capacity to comply and I.R.S. capacity to enforce because of its many fine distinctions.
48. Rich, Dixon R., "A Wife's Tax Value: Tax Aspects of a Wife's Attending Conventions, Sales Meetings, Etc.," Proceedings of the New York University 22nd Annual Institute on Federal Taxation (Albany: Matthew Bender & Co., 1964), pp. 918-919.
49. Laforce v. Comm., 53 TC 41 (1969), allowed a doctor to deduct allotted country club dues because the club was used primarily to further his medical practice at quiet business meals; Bussabarger v. Comm., 52 TC 819 (1969), allowed the deduction of party expenses for employees of hospital where practiced medicine.
50. Mill v. Comm., 5 TC 691 (1945), where drinks and cigars for lodge members was not shown to be beneficial to the taxpayer's business; Chapman v. Comm., 48 TC 358 (1967), where court decided that primary motivation for garden party for students and fellow faculty members was social; Ryman v. Comm., 51 TC 799 (1969), where law professor had faculty over after passing bar exam was held to be personal due to inviting wives, serving alcohol and dinner, holding on a Saturday night, and having small expectation of business benefit.
51. Appeal of McGill, 4 BTA 272 (1926).
52. Jergens v. Comm., 17 TC 806 (1951); Rev. Rul. 55-201, 1955-1 Cum. Bull. 269.
53. Abraham v. Comm., 9 TC 222 (1947).
54. Noland v. Comm., 269 F. 2d 108 (CA, 4); cert. den. 361 U.S. 885 (1959).
55. Sutter v. Comm., 21 TC 170 (1953); Smith v. Comm., 33 TC 861 (1960); Teeling v. Comm., 42 TC 671 (1964).
56. Holzman, Robert S., Federal Income Taxation (New York: The Ronald Press Co., 1960), p. 9.25.
57. Rev. Rul. 63-144, 1963-2 Cum. Bull. 129.

58. J. K. Lasser Tax Institute, J. K. Lasser's Your Income Tax, Bernard Greisman ed. (New York: Simon and Schuster, 1970), p. 27.
59. O. D. 892, 4 Cum. Bull. 1595 (1920).
60. O. D. 984, 5 Cum. Bull. 1755 (1921).
61. King v. Comm., 9 BTA 502 (1927).
62. Osborn v. Comm., 3 TC 603 (1944).
63. Larson v. Comm., 15 TC 956 (1950).
64. Hill v. Comm., 13 TC 291 (1949); rev'd 181 F. 2d 906 (CA 4, 1950).
65. Ibid.
66. I. T. 4044, 1951-1 Cum. Bull. 16 (1951), which also modified O.D. 892 (See footnote 59).
67. Namrow v. Comm., 33 TC 419 (1959); aff'd 288 F. 2d 648 (CA 4, 1961); cert. den. 368 U.S. 914 (1962).
68. Booth v. Comm., 35 TC 1144 (1961).
69. T. D. 6291, 1958-1 Cum. Bull. 63, and later Rev. Rul. 60-97, 1960-1 Cum. Bull. 69.
70. Ibid.
71. Carlucci v. Comm., 37 TC 695 (1962).
72. Lamb v. Comm., 46 TC 539 (1966).
73. Lund v. Comm., 46 TC 321 (1966), where the employer required his flight engineers to obtain pilots' licenses to retain their status as flight crew members.
74. Greenberg v. Comm., 45 TC 480 (1966), is a good example because there were many dissents who found it difficult to reconcile the ordinary and necessary criteria of Section 162 with the primary purpose test of the 1958 Regulations.
75. T. D. 6918, 1967-1 Cum. Bull. 36.
76. Ibid.
77. Furner v. Comm., 47 TC 165 (1966); rev'd 393 F. 2d 292 (CA 7, 1968).
78. Corbett v. Comm., 55 TC 884 (1971).

79. Wyatt v. Comm., 56 TC 517 (1971).
80. Denman v. Comm., 48 TC 439 (1967), tried to amortize the costs of an engineering degree over the years to age 65.
81. Statement of Elizabeth L. Brady at the Hearings Before the Committee on Ways and Means on General Revenue Revision, op. cit., p. 188; Kahn, Harry C., "The Scope for Tax Reform In Personal Deductions and Exemptions," Proceedings of the 55th Annual Conference of the National Tax Association (Harrisburg, Pennsylvania: National Tax Association, 1963), p. 69; Goode, Richard, The Individual Income Tax (Washington: The Brookings Institution, 1964), p. 92, where he stated that he knew of no evidence that the consumption component is greater than the cost element, therefore, good social policy would be to resolve the doubts about deductibility in favor of the taxpayer; Goode, Richard, Proceedings of the 58th Annual Conference of the National Tax Association (Harrisburg, Pennsylvania: National Tax Association, 1966), p. 659, where he stated that the problem of distinguishing between income-producing educational expenses and cultural expenditures would not be basically different from that already being drawn in connection with travel and entertainment and many expenses of self-employed persons that may involve personal as well as business elements.
82. Article 291, Regulations 45, stated that if a professional man used part of his house for his office, such portion of the rent as was properly attributable to such office was deductible.
83. Regulation Section 1.162-6 states that a professional man may deduct the cost of rent paid for office rooms and the cost of the fuel, light, water, telephone, etc., used in such offices.
84. Walker v. Comm., 20 BTA 937 (1930); aff'd 63 F. 2d 351 (CA 3, 1933); cert. den. 289 U.S. 746 (1933).
85. I. T. 3929, 1948-2 Cum. Bull. 29.
86. Hand v. Comm., 16 TC 1410 (1951), where a teacher could not deduct the costs of using a home office for teaching activities primarily because he was not an independent contractor engaged in business.
87. Davis v. Comm., 38 TC 175 (1962).
88. Rev. Rul. 62-180, 1962-2 Cum. Bull. 52.
89. Peiss v. Comm., 40 TC 78 (1963).
90. Knowles v. Comm., 40 TC 578 (1963).

91. Rev. Rul. 63-275, 1963-2 Cum. Bull. 85.
92. Lewis, Charles D., "IRS and courts adopting more liberal views toward professors' home office expenses," The Journal of Taxation, Volume 24, Number 10 (April, 1966), p. 232.
93. Rev. Rul. 64-272, 1964-2 Cum. Bull. 55.
94. Bischoff v. Comm., T. C. Memo 1966-25, 66 AFTR 102.
95. Newl v. Comm., 432 F. 2d 998, 70-2 USTC 9669 (CA 2, 1970).
96. Bodzin v. Comm., 60 TC 86 (1973).
97. See Footnote 60, Chapter 3.
98. Gino v. Comm., 60 TC 304 (1973), which stated that allocations of this type are necessarily imprecise, but they are required if justice is to be served.
99. O.D. 579, 3 Cum. Bull. 1055 (1919).
100. I.T. 1397, I-2 Cum. Bull. 428 (1921).
101. McDonald v. Comm., 323 U.S. 57 (1944), disallowed a judge's campaign expenses; Frank v. Comm., 20 TC 511 (1953).
102. Rev. Rul. 60-158, 1960-1 Cum. Bull. 140, revoked O.D. 579.
103. Rev. Rul. 60-223, 1960-1 Cum. Bull. 57, revoked Rev. Rul. 60-158 and reinstated O.D. 579.
104. Primuth v. Comm., 54 TC 374 (1970).
105. Kenfield v. Comm., 54 TC 1197 (1970).
106. Rev. Rul. 70-396, 1970-2 Cum. Bull. 68, disallowed the deduction of amounts expended in traveling to find employment and superseded I.T. 1397; Morris v. Comm., 423 F. 2d 611 (CA 9, 1970).
107. Rev. Rul. 71-308, 1971-2 Cum. Bull. 167, to the effect that fees paid to an executive placement service were deductible even though payable regardless of whether the service found the taxpayer a job.
108. Cremona v. Comm. 58 TC 20 (1972), where a fee to assist obtaining a better job was held deductible even though no employment offers resulted and the taxpayer kept his old job.
109. Malloy, John M., "Employment Agency Fees: An Area of Continued Litigation?," Taxes, Volume 52, Number 2 (February, 1974), p. 104.

110. Ibid.
111. Walker v. Comm., T. C. Memo 1973-144, 32 TCM 690, where the taxpayer indirectly paid his creditors to escape bankruptcy which would have led to being discharged from his job.
112. "Job-Seeking Costs Removed from 'Prime Issue' List," The Practical Accountant, Volume 7, Number 1 (January/February, 1974), p. 34.
113. Bittker, Boris I., "The Individual as Wage Earner," Proceedings of the New York University 11th Annual Institute on Federal Taxation (Albany: Matthew Bender & Co., 1953), p. 1167. Recommendation of the American Institute of Certified Public Accountants, Hearings Before the Committee on Ways and Means on Tax Reform, 93rd Congress, First Session (Washington: U.S. Government Printing Office, 1969), p. 4391.
114. Carter v. Comm., 51 TC 932 (1969); Black v. Comm., 60 TC 13 (1973); and previously cited cases where the primary issue had been whether employment seeking expenses were deductible.
115. Morris v. Comm., 423 F. 2d 611 (CA 9, 1970); Miller v. Comm., 73-2 USTC 9681 (DC Tenn.).
116. Haft v. Comm., 40 TC 2 (1963), where the court concluded that the entertainment expenses of the unemployed salesman were incurred during a period of transition while seeking a job in which he could serve his old customers; Furner v. Comm., 393 F. 2d 292 (CA 7, 1968), where a teacher could deduct education expenses for attending one year of college while temporarily unemployed because the employer did not grant leaves.
117. Bingham's Trust v. Comm., 325 U.S. 365 (1945); Rev. Rul. 64-236, 1964-2 Cum. Bull. 64.
118. Franklin v. Comm., 39 TC 192 (1962).
119. Newcombe v. Comm., 54 TC 1298 (1970).
120. Coors v. Comm., 60 TC 44 (1973).
121. See Footnote 116, Chapter 4.

## CHAPTER V

### ANALYSIS OF CONSIDERATIONS IN COURT DECISIONS INVOLVING INCOME-PRODUCING EXPENSES

A tracing of the history of the dichotomous treatment of the income-producing expenses of individuals and an analysis of the explicit deductibility criteria used for each main expense led to no consistent substantive justification for the apparent lack of vertical and horizontal equity in this area.

The purpose of this chapter is to analyze the most recent court cases in this area to identify any basic distinctions between objectively determinable considerations in cases in which the income-producing expense was allowed, and those where it was denied. The purpose of this procedure is to determine if there are consistently different factors operating in the two deductibility classifications. The frequencies of occurrence of factors within each classification will then be aggregated and compared for possible distinctions.

This analysis will be accomplished in three steps. The first will identify objectively determinable considerations present in court cases where the deduction of an income-producing expense of an individual has been substantially disallowed. These cases will be grouped based on whether the expense category of concern is deductible for or from adjusted gross income. The considerations

present in the cases in these two groups will then be compared to determine whether different characteristics are present in each group which might justify their present separate treatment. The second step will apply a similar methodology to cases where the income-producing expense was substantially allowed. A third step will compare total frequencies of considerations in each deduction classification.

There are a number of important considerations involved in this analysis. The first concerns the existence of previous research utilizing this technique. A number of previous studies have applied this methodology to varying degrees in widely diverse tax areas. One study analyzed the eighteen Federal tax cases concerned with the valuing of fractional interests in property where the allowance of a discount was an issue.<sup>1</sup> The objective of this analysis was to arrive at some basic distinctions between the cases in which the discount was allowed and those where it was denied.<sup>2</sup> Although some factors favorable to each side were identified and compared, the conclusion was that it was impossible to arrive at any formula which establishes exactly the circumstances which will, or will not, give rise to a discount because the facts can vary so greatly between any two cases.<sup>3</sup> Another research effort has identified the criteria involved and the final outcome of cases concerning unreasonable compensation.<sup>4</sup> This study attempted to highlight the relative frequency with which the various criteria were applied in resolving disputes over the reasonableness of compensation.<sup>5</sup> A third source has identified the factors important in court decisions concerning the accumulation of earnings.<sup>6</sup> The last two sources attempted only

a descriptive matrix summarization of factors important in court decisions without any analysis of, for instance, cases where a deduction was allowed compared with those where it was denied. However, all of these studies concluded that factors identified in court cases in a given area can provide a useful pattern of information, although different combinations and different weightings prevent reliable predictability for a specific set of facts and circumstances.

A second concern is the number of cases selected for examination. Cases will be chosen concerning expenses deductible for adjusted gross income and those which would have been itemized deductions. The actual number chosen will depend on the length of the period chosen. The cases chosen will cover the same period, but cases where deductions were substantially allowed will be smaller in number than those denied because the I.R.S. wins the bulk of court decisions.

The period of selection of cases is a third important consideration. Selection will commence using the topical indexes of the Prentice-Hall and Commerce Clearing House federal tax case publications<sup>7</sup> covering November, 1969, to July, 1974. This period was chosen because explicit deductibility criteria have gone through few changes during the period covered by these cases. Also, these cases detail the most recent considerations applied to determine the deductibility of these expenses.

Cases chosen, a fourth consideration, will be all of the decisions during the period chosen of the District Courts, the Tax Court, the Circuit Courts of Appeals, the Court of Claims and the

Supreme Court pertaining to the Federal income tax deduction of the income-producing expenses of individuals which were studied in Chapters III and IV. District Court cases are included although the available information about their decisions tends to be confined to instructions to the jury. These instructions usually supply most of the facts and relevant considerations available in texts of the decisions of other courts. Tax Court Memorandum decisions are not covered because they consist largely of the establishment of fact situations within previously settled legal principles and, therefore, have little precedential value.

A fifth important concern is the determination of which considerations to look for in each case. Previous research indicates that these considerations only become apparent, to a great extent, after a reading of some of the cases. The considerations must be objectively determined from the text of each case. This constraint is necessary so that replication by another researcher would provide similar results. One portion of objectively determinable considerations will involve quantifiable facts which are generally provided in the texts of court decisions. An example would be the annual income of the taxpayer during the year in dispute, if that information is usually provided. Only the frequency of occurrence of other objectively determinable considerations can be observed, such as, whether or not the decision included a determination of the "reasonableness" of the expense. Since the analysis of consistency will depend on average amounts or relative frequencies there is no need to determine the relationship of these considerations to the court's decision. Such a determination would be

highly subjective. An additional criterion used to determine relevant considerations is mentioning in more than just a couple of cases. Also, a consideration must have some possible impact on the decision concerning deductibility. For example, the number of commas within the decision would not be a relevant consideration. Occurrence is recognized for each consideration when the court's terminology mentions the factor, thus indicating that it had an impact on the deductibility decision.

A last consideration concerns the analysis and conclusions. The choice of the most recent cases from all main courts deciding on federal tax matters and the subsequent analysis of objectively determinable considerations in each case provides a relevant pattern of information. Consistency and frequency of occurrence of these factors are compared between the two deduction classifications of income-producing expenses of individuals. Lack of consistency in the frequency and degree of application of these considerations between deductions for adjusted gross income and deductions from adjusted gross income would provide a rationale for the present dichotomy.

#### Deduction Substantially Disallowed

This step will identify objectively determinable considerations present in court cases where the deduction of income-producing expenses of individuals was substantially disallowed. These factors are organized in a matrix format in Tables 5.1 and 5.2 and compared based on respective deduction classifications.

The identification of important considerations resulted from an

Table 5.1 Significant Considerations in Court Decisions from November, 1969, through July, 1974, Which Substantially Disallowed the Deduction for Adjusted Gross Income of Income-Producing Expenses of Individuals

| Case                       | Expense Category | Annual Amounts in Dispute Tax Expense | Years of Returns | Lawyers |          | Court | Factors Analyzed in Decision |             |             |            |
|----------------------------|------------------|---------------------------------------|------------------|---------|----------|-------|------------------------------|-------------|-------------|------------|
|                            |                  |                                       |                  | Govt.   | Taxpayer |       | Sec. 262                     | Ord. & Nec. | Tr. or Bus. | Reasonable |
| Wirth 61.89 P-H TC         | Travel           | \$2,105                               | 1968             | 1       | 0        | TC    |                              |             |             |            |
| Mathews 61.3 P-H TC        | Enter.           | 2,925                                 | 1964             | 1       | 1        | TC    |                              |             |             | X          |
| (self-employed)            |                  | 2,251                                 | 1965             |         |          |       |                              |             |             |            |
| DeMichele 74-1 USTC 9222   | Trans.           | 84                                    | 1966             | 1       | 1        | CA    |                              |             |             |            |
| Markey 74-1 USTC 9192      | Travel           |                                       | 1967             | 4       | 0        | CA    | X                            |             |             |            |
| Goldman 74-1 USTC 9469     | Moving           | 151                                   | 1968             | 6       | 0        | CA    |                              | X           |             |            |
| Sheehan 74-1 USTC 9535     | Trans.           | 287                                   | 1967             | 1       | 1        | CA    |                              |             |             |            |
| Boone 73-2 USTC 9577       | Trans.           | 494                                   | 1966             | 7       | 0        | CA    | X                            |             |             |            |
| Imeson 73-2 USTC 9775      | Trans.           | 112                                   | 1965             | 11      | 0        | CA    |                              |             |             |            |
| Coker 73-2 USTC 9757       | Trans.           | 287                                   | 1966             | 3       | 1        | CA    | X                            |             |             | X          |
| Block 73-2 USTC 9596       | Trans.           |                                       | 1961             | 4       | 0        | CA    |                              |             |             | X          |
| Faustner 73-2 USTC 9515    | Trans.           | 1,425                                 | 1966             | 4       | 1        | SC    | X                            |             |             | X          |
| Emberton 73-2 USTC 9575    | Trans.           | 775                                   | 1967             | 2       | 2        | DC    | X                            |             |             |            |
| Conv. Chem. 73-1 USTC 9356 | Travel           |                                       | 1970             | 1       | 1        | DC    |                              | X           |             |            |
| Levie 73-1 USTC 9104       | Travel           |                                       | 1964             | 2       | 0        | DC    |                              | X           |             | X          |
| Kanter 73-1 USTC 9311      | Rent. Prod.      |                                       | 1969             | 1       | 1        | DC    |                              |             |             |            |
| Anderson 60.88 P-H TC      | Trans.           | 220                                   | 1969             | 1       | 1        | TC    |                              |             |             |            |
| Gino 60.37 P-H TC          | Travel           | 1,447                                 | 1966             | 1       | 1        | TC    |                              |             |             | X          |
| Fountain 59.69 P-H TC      | Travel           |                                       | 1967             | 1       | 1        | TC    |                              |             |             |            |
| Mazzotta 72-2 USTC 9709    | Travel           | 164                                   | 1965             | 4       | 2        | CA    |                              |             |             |            |
|                            |                  | 263                                   | 1966             |         |          |       |                              |             |             |            |
|                            |                  | 234                                   | 1967             |         |          |       |                              |             |             |            |
| Edmerson 72-2 USTC 9702    | Trans.           |                                       | 1962             | 4       | 1        | CA    |                              |             |             |            |
| Burnett 72-2 USTC 9635     | Trans.           | 291                                   | 1965             | 1       | 1        | DC    | X                            |             |             |            |
| Green 59.44 P-H TC         | Trans.           | 300                                   | 1966             | 1       | 1        | TC    |                              |             |             |            |
| Halls 72-2 USTC 9531       | Enter.           | 406                                   | 1967             | 1       | 4        | CA    | X                            |             |             | X          |
| (self-employed)            |                  |                                       | 1964             | 8       |          |       |                              |             |             |            |
| Masline 72-2 USTC 9524     | Travel           | 777                                   | 1965             | 4       | 0        | CA    | X                            |             |             |            |
|                            |                  | 1,163                                 | 1966             |         |          |       |                              |             |             |            |
|                            |                  | 934                                   | 1967             |         |          |       |                              |             |             |            |
| Phillips 72-1 USTC 9358    | Rent. Prod.      |                                       | 1967             | 1       | 2        | DC    |                              | X           |             |            |
| Kasey 72-1 USTC 9307       | Travel           |                                       | 1963             | 2       | 0        | CA    |                              |             |             | X          |
|                            |                  | 5,000                                 | 1964             |         |          |       |                              |             |             |            |
|                            |                  | 1,376                                 | 1965             |         |          |       |                              |             |             |            |
|                            |                  | 978                                   | 1964             |         |          |       |                              |             |             |            |
| Henson 72-1 USTC 9196      | Travel           |                                       | 1965             | 5       | 1        | DC    | X                            |             |             |            |
| Piorentino 72-1 USTC 9160  | Enter.           |                                       | 1967             | 1       | 1        | CA    |                              |             |             | X          |
| (self-employed)            |                  | 1,764                                 | 1965             |         |          |       |                              |             |             |            |
| Schumaker 72-1 USTC 9153   | Trans.           | 1,817                                 | 1963             | 4       | 0        | CA    |                              |             |             | X          |
| Memish 72-1 USTC 9135      | Travel           |                                       | 1967             | 6       | 0        | CA    |                              |             | X           |            |
|                            |                  | 504                                   | 1964             |         |          |       |                              |             |             |            |
| Kennedy 72-1 USTC 9142     | Travel           |                                       | 1965             | 1       | 0        | CA    | X                            |             |             |            |
| Dilley 5827 P-H TC         | Travel           | 1,276                                 | 1966             | 1       | 2        | TC    |                              |             |             |            |
| Cavender 71-2 USTC 9723    | Trans.           | 1,110                                 | 1968             | 1       | 2        | DC    |                              |             |             | X          |
| Griner 71-2 USTC 9714      | Trans.           |                                       | 1962             | 1       | 1        | DC    |                              |             |             | X          |
|                            |                  |                                       | 1966             |         |          |       |                              |             |             |            |

Table 5.1 (Continued)

| Case                      | Expense Category | Annual Amounts<br>in Dispute<br>Tax Expense | Years<br>of<br>Returns | Lawyers |          | Court | Factors Analyzed in Decision |                |                | Reason-<br>able |
|---------------------------|------------------|---------------------------------------------|------------------------|---------|----------|-------|------------------------------|----------------|----------------|-----------------|
|                           |                  |                                             |                        | Govt.   | Taxpayer |       | Sec. 262                     | Ord. &<br>Nec. | Tr. or<br>Bus. |                 |
| Curtis 71-2 USTC 9666     | Travel           | \$ 370                                      | 1965                   | 7       | 1        | CA    |                              |                |                |                 |
|                           |                  | 327                                         | 1966                   |         |          |       |                              |                |                |                 |
|                           |                  | 336                                         | 1967                   |         |          |       |                              |                |                |                 |
| Brown 71-2 USTC 9574      | Travel           | 7,318                                       | 1962                   | 1       | 1        | CA    |                              | X              | X              |                 |
|                           |                  | 8,928                                       | 1963                   |         |          |       |                              |                |                |                 |
|                           |                  | 2,546                                       | 1964                   |         |          |       |                              |                |                |                 |
| Hess 71-1 USTC 9431       | Trans.           |                                             | 1964                   | 3       | 1        | DC    |                              |                |                |                 |
| Jones 71-1 USTC 9461      | Travel           | 824                                         | 1963                   | 6       | 1        | CA    |                              | X              |                |                 |
|                           |                  | 984                                         | 1964                   |         |          |       |                              |                |                |                 |
|                           |                  | 955                                         | 1965                   |         |          |       |                              |                |                |                 |
|                           |                  | 1,111                                       | 1966                   |         |          |       |                              |                |                |                 |
| Egan 71-1 USTC 9420       | Travel           |                                             | 1963                   | 2       | 3        | DC    |                              | X              |                |                 |
| Rosenspan 71-1 USTC 9241  | Travel           | 1,210                                       | 1962                   | 5       | 2        | CA    |                              |                |                |                 |
|                           |                  | 796                                         | 1964                   |         |          |       |                              |                |                |                 |
| Stricker 71-1 USTC 9237   | Travel           | 403                                         | 1967                   | 4       | 1        | CA    |                              |                |                |                 |
| Barry 71-1 USTC 9126      | Travel           | 301                                         | 1966                   | 2       | 0        | CA    |                              | X              |                |                 |
| Steel 71-1 USTC 9164      | Enter.           |                                             | 1964                   | 4       | 0        | CA    |                              |                |                | X               |
|                           |                  | 4,850                                       |                        |         |          |       |                              |                |                |                 |
| Brightwell 71-1 USTC 9157 | Travel           | 348                                         | 1965                   | 3       | 1        | DC    |                              | X              |                |                 |
| Chimento 71-1 USTC 9224   | Travel           | 1,015                                       | 1965                   | 4       | 0        | CA    |                              |                |                |                 |
| Blatnick 56.105 P-H TC    | Travel           | 677                                         | 1967                   | 1       | 0        | TC    |                              |                |                |                 |
| Rendall 56.67 P-H TC      | Enter.           | 569                                         | 1965                   | 1       | 0        | TC    |                              | X              |                | X               |
|                           |                  |                                             |                        |         |          |       |                              |                |                |                 |
| Turner 56.3 P-H TC        | Trans.           |                                             | 1966                   | 1       | 0        | TC    |                              | X              |                |                 |
| Tucker 55.82 P-H TC       | Travel           | 364                                         | 1967                   | 1       | 0        | TC    |                              | X              |                |                 |
| Anderson 55.79 P-H TC     | Trans.           |                                             | 1965                   | 2       | 1        | TC    |                              |                | X              |                 |
| Hitt 55.63 P-H TC         | Trans.           | 117                                         | 1967                   | 1       | 0        | TC    |                              | X              |                |                 |
| Gilberg 55.61 P-H TC      | Trans.           | 120                                         | 1965                   | 1       | 0        | TC    |                              | X              |                |                 |
| McMullen 70-2 USTC 9709   | Travel           | 1,178                                       | 1963                   | 2       | 1        | DC    |                              |                |                |                 |
|                           |                  | 890                                         | 1964                   |         |          |       |                              |                |                | X               |
| Schmidt 70-2 USTC 9617    | Enter.           |                                             | 1964                   | 5       | 0        | CA    |                              | X              |                | X               |
|                           |                  | 2,430                                       |                        |         |          |       |                              |                |                |                 |
| Bunavith 70-1 USTC 9414   | Trans.           | 175                                         | 1965                   | 1       | 0        | CA    |                              |                |                |                 |
| Carthuff 70-1 USTC 9387   | Rent Prod.       | 3,130                                       | 1962                   | 5       | 3        | CA    |                              | X              |                |                 |
|                           |                  | 319                                         | 1963                   |         |          |       |                              |                |                |                 |
|                           |                  | 5,719                                       | 1964                   |         |          |       |                              |                |                |                 |
| Davis 70-1 USTC 9297      | Enter.           |                                             | 1962                   | 4       | 0        | CA    |                              |                |                | X               |
|                           |                  | 2,624                                       |                        |         |          |       |                              |                |                |                 |
|                           |                  | 2,000                                       | 1963                   |         |          |       |                              |                |                |                 |
|                           |                  | 2,435                                       | 1964                   |         |          |       |                              |                |                |                 |
|                           |                  | 2,837                                       | 1965                   |         |          |       |                              |                |                |                 |
| Andress 70-1 USTC 9273    | Enter.           | 1,615                                       | 1964                   | 9       | 1        | CA    |                              |                |                | X               |
|                           |                  | 727                                         | 1965                   |         |          |       |                              |                |                |                 |
| Barton 70-1 USTC 9257     | Trans.           | 1,267                                       | 1965                   | 4       | 0        | CA    |                              |                |                |                 |
| Call 70-1 USTC 9194       | Travel           | 1,181                                       | 1961                   | 2       | 2        | DC    |                              |                |                |                 |
| Jenkins 70-1 USTC 9135    | Travel           | 2,006                                       | 1958                   | 4       | 1        | CA    |                              |                |                |                 |
|                           |                  | 1,560                                       | 1959                   |         |          |       |                              |                |                |                 |
|                           |                  | 2,081                                       | 1960                   |         |          |       |                              |                |                |                 |
| Newcombe 54.123 P-H TC    | Rent Prod.       | 2,060                                       | 1966                   | 2       | 1        | TC    |                              |                |                |                 |
| O'Hare 54.84 P-H TC       | Trans.           | 153                                         | 1966                   | 1       | 0        | TC    |                              |                | X              |                 |

Table 5.2 Significant Considerations in Court Decisions from November, 1969, through July, 1974, Which Substantially Disallowed the Itemized Deduction of Income-Producing Expenses of Individuals

| Case                     | Expense Category | Annual Amounts |                 | Years of Returns | Lawyers |          | Court | Factors Analyzed in Decision |             |                     | Reasonable |
|--------------------------|------------------|----------------|-----------------|------------------|---------|----------|-------|------------------------------|-------------|---------------------|------------|
|                          |                  | Expense        | in Disputes Tax |                  | Govt.   | Taxpayer |       | Sec. 262                     | Ord. & Nec. | Tr. or Bus. Records |            |
| Glenn 62.32 P-H TC       | Educ.            | \$ 225         | \$ 978          | 1970             | 1       | 1        | TC    |                              |             | X                   |            |
| Krist 73-2 USTC 9664     | Educ.            | 613            |                 | 1967             | 5       | 1        | CA    | X                            |             | X                   |            |
| Weissmann 73-2 USTC 9633 | Educ.            | 359            |                 | 1966             | 4       | 0        | CA    |                              |             | X                   |            |
| Meinik 73-2 USTC 9521    | Educ.            |                | 764             | 1969             | 4       | 1        | DC    | X                            |             | X                   |            |
| Ruddy 73-1 USTC 9307     | Educ.            | 257            |                 | 1968             | 1       | 0        | CA    | X                            |             | X                   |            |
| Miller 73-2 USTC 9681    | Emp.-Seek.       | 4,495          |                 | 1967             | 2       | 1        | DC    |                              |             | X                   |            |
|                          |                  | 1,674          |                 | 1968             |         |          |       |                              |             |                     |            |
| Shioesaki 73-1 USTC 9310 | Sec. 212         | 394            |                 | 1967             | 5       | 0        | CA    | X                            |             |                     | X          |
| Burroughs 73-1 USTC 9131 | Sec. 212         | 275            |                 | 1966             | 3       | 1        | DC    | X                            |             |                     |            |
| Taubman 60.85 P-H TC     | Educ.            | 161            |                 | 1969             | 1       | 0        | TC    |                              |             | X                   |            |
| Small 60.76 P-H TC       | Ch. Care         |                | 600             | 1968             | 1       | 1        | TC    |                              |             |                     |            |
| Nichols 60.28 P-H TC     | Sec. 212         | 610            |                 | 1968             | 1       | 0        | TC    |                              |             | X                   |            |
| Kellner 72-2 USTC 9741   | Educ.            |                | 300             | 1965             | 4       | 0        | CA    |                              |             | X                   |            |
| Carey 72-1 USTC 9425     | Sec. 212         | 3,820          |                 | 1965             | 4       | 2        | CA    |                              |             | X                   |            |
| Kennally 72-1 USTC 9348  | Enter.           |                | 2,460           | 1965             | 1       | 1        | CA    |                              |             | X                   |            |
|                          |                  |                | 1,797           | 1966             |         |          |       |                              |             |                     |            |
| Brooks 72-1 USTC 9288    | Sec. 212         |                | 13,372          | 1966             | 4       | 1        | CA    |                              |             |                     |            |
|                          |                  |                | 10,450          | 1967             |         |          |       |                              |             |                     |            |
| O'Connell 72-1 USTC 9312 | Ch. Care         |                | 103             | 1967             | 2       | 0        | DC    | X                            |             |                     |            |
| Paurowski 72-1 USTC 9229 | Ch. Care         |                | 600             | 1962             | 1       | 3        | DC    |                              |             |                     | X          |
| Hughes 72-1 USTC 9122    | Enter.           |                | 1,911           | 1963             | 4       | 1        | CA    |                              |             |                     | X          |
|                          |                  |                | 2,150           | 1964             |         |          |       |                              |             |                     |            |
| Fielding 57.80 P-H TC    | Educ.            |                |                 | 1965             | 1       | 1        | TC    |                              |             |                     |            |
| Gallery 57.25 P-H TC     | Educ.            | 176            |                 | 1967             | 1       | 0        | TC    | X                            |             | X                   |            |
| Johnson 71-1 USTC 9347   | Educ.            | 333            |                 | 1966             | 3       | 0        | DC    |                              |             | X                   |            |
| Weissmann 71-1 USTC 9312 | Educ.            | 310            |                 | 1965             | 5       | 0        | CA    | X                            |             | X                   |            |
| Rombach 71-1 USTC 9285   | Educ.            |                |                 | 1964             | 4       | 1        | CC    | X                            |             | X                   |            |
| Ramsburg 71-1 USTC 9253  | Sec. 212         |                | 31,209          | 1960             | 5       | 1        | CA    |                              |             | X                   |            |
|                          |                  |                | 57,759          | 1961             |         |          |       |                              |             |                     |            |
| Bakken 71-1 USTC 9188    | Educ.            | 349            |                 | 1965             | 3       | 0        | CA    |                              |             |                     |            |
|                          |                  | 394            |                 | 1966             |         |          |       |                              |             |                     |            |
| Mammack 56.110 P-H TC    | Ch. Care         | 661            |                 | 1965             | 1       | 2        | TC    | X                            |             |                     | X          |
| Bodley 56.107 P-H TC     | Educ.            |                | 1,112           | 1968             | 1       | 0        | TC    | X                            |             |                     |            |
| Mitsky 56.54 P-H TC      | Sec. 212         |                | 1,000           | 1964             | 1       | 1        | TC    |                              |             | X                   |            |
| Wyatt 56.40 P-H TC       | Educ.            | 77             |                 | 1967             | 1       | 0        | TC    |                              |             | X                   |            |
| Corbett 55.89 P-H TC     | Educ.            | 401            |                 | 1967             | 1       | 0        | TC    | X                            |             | X                   |            |
| Perret 55.72 P-H TC      | Sec. 212         |                | 1,375           | 1965             | 1       | 1        | TC    |                              |             |                     |            |
|                          |                  |                | 6,141           | 1966             |         |          |       |                              |             |                     |            |
| Jungreis 55.58 P-H TC    | Educ.            | 65             |                 | 1967             | 1       | 1        | TC    | X                            |             | X                   |            |
| Moritz 55.14 P-H TC      | Ch. Care         |                | 600             | 1968             | 1       | 0        | TC    |                              |             | X                   |            |
| Morris 70-1 USTC 9296    | Emp.-Seek.       |                | 1,099           | 1962             | 2       | 1        | CA    | X                            |             | X                   |            |
|                          |                  |                | 1,071           | 1963             |         |          |       |                              |             |                     |            |
| Weinstein 70-1 USTC 9190 | Sec. 212         |                |                 | 1967             | 4       | 1        | CC    |                              |             |                     |            |
| Weiler 54.38 P-H TC      | Educ.            | 227            |                 | 1968             | 1       | 0        | TC    |                              |             | X                   |            |
| Horodysky 54.45 P-H TC   | Educ.            | 134            |                 | 1965             | 1       | 0        | TC    |                              |             | X                   |            |
|                          |                  | 167            |                 | 1966             |         |          |       |                              |             |                     |            |
| Bradley 54.19 P-H TC     | Educ.            | 309            |                 | 1966             | 1       | 0        | TC    |                              |             | X                   |            |

extensive and detailed reading of these cases. Quantifiable facts generally observed were (1) annual amounts in dispute and (2) numbers of lawyers. Other factors were (3) the particular court, (4) the analyzing of the appropriateness of the deduction based on the criteria of Sec. 262, which pertains to the nondeductibility of personal expenses, (5) the meanings of "ordinary and necessary," (6) the determination of what constitutes a "trade or business," (7) the meaning of a "reasonable" expense and (8) the presence of inadequate substantiation. Another possible consideration, taxpayer income, was not included because it was available in few cases and, where available, it was stated in many differing forms. Infrequency of mention or unlikelihood of impact on the deductibility decision excluded other possible considerations from this analysis.

During this period, 64 decisions disallowed the deduction of income-producing expenses which would have been deductible for adjusted gross income and 37 disallowed the itemized deduction of income-producing expenses. The mean amounts in dispute and the mean number of lawyers categories appear to have different treatments. These differences will be explained in the third step where deductions allowed and disallowed are aggregated within the two groups of deductions because they appear in the aggregate figures also.

Two areas which have very different frequencies of occurrence are the analysis of the meaning of a trade or business and the existence of poor substantiation. Cases concerning deductions for adjusted gross income mention these items 6 and 17 times, respectively, whereas cases concerning expenses which should be itemized

mention them 20 and 4 times, respectively. Only 9 per cent of cases concerning deductions for adjusted gross income analyze the meaning of a trade or business while it is done by 54 per cent of cases concerning itemized deductions. This divergence is largely explained by the heavy emphasis placed on this consideration in cases involving the deduction of education expenses. Deleting them from the population of itemized deduction cases results in only 3 cases analyzing the meaning of a trade or business. This is 18 per cent of the remaining cases. Poor substantiation is mentioned in 11 per cent of cases involving itemized deductions and in 27 per cent of other cases where the deduction of the income-producing expense was substantially disallowed. This difference is largely due to the presence of 8 cases concerning the deduction of entertainment expenses for adjusted gross income by self-employed persons while only 2 itemized deduction cases concerned entertainment expenses. All disallowed entertainment expense cases had poor records. Deletion of entertainment expense cases leaves 16 per cent of cases concerning deductions for adjusted gross income mentioning poor substantiation, while it is a concern in 6 per cent of cases involving itemized deductions. Thus, for the period studied, income-producing expense cases resulting in substantial disallowance reflect a slightly greater frequency of mention of the meaning of a trade or business for itemized deductions, but a less frequent occurrence of inadequate substantiation. These consistent differences in emphasis could provide a weak partial justification for the present treatment of the income-producing expenses of individuals. They provide a reason for the different

treatments based on inherent distinctions between the expenses in each group.

#### Deduction Substantially Allowed

Tables 5.3 and 5.4 identify considerations present in court cases where the deduction of income-producing expenses of individuals was substantially allowed. During this period, 12 decisions allowed the deduction of income-producing expenses for adjusted gross income and 13 allowed the itemized deduction of income-producing expenses. There are no consistent differences in considerations present in these cases nor in the frequency of their occurrence other than for the mean amount of expense in dispute which will be covered for all groups of cases in the third step.

#### Aggregate Analysis of Case Factors

This step combines the considerations enumerated in Table 5.1 with those in Table 5.3 and those in Table 5.2 with those in Table 5.4. This aggregation leads to the construction of Table 5.5 which displays these considerations and their frequencies clustered by deduction location. Reasonableness and proportion of taxpayers without lawyers are mentioned here also, although their occurrence was not significant enough to mention in the tables previously presented.

Analysis reveals that a much larger proportion of cases involving itemized income-producing expenses are decided in the Tax Court. The average amount of tax in dispute in cases involving deductions for adjusted gross income appears to be much higher than the mean tax for itemized deductions. However, deleting 2 of

Table 5.3 Significant Considerations in Court Decisions from November, 1969, through July, 1974, Which Substantially Allowed the Deduction for Adjusted Gross Income of Income-Producing Expenses of Individuals

| Case                       | Expense Category | Annual Amounts in Dispute |         | Years of Returns | Lawyers |          | Court | Factors Analyzed in Decision |             |             | Reasonable |
|----------------------------|------------------|---------------------------|---------|------------------|---------|----------|-------|------------------------------|-------------|-------------|------------|
|                            |                  | Tax                       | Expense |                  | Govt.   | Taxpayer |       | Sec. 262                     | Ord. & Nec. | Tr. or Bus. |            |
| Ford 73-2 USTC 9798        | Travel           | \$ 274                    | \$      | 1967             | 2       | 1        | CA    |                              |             | X           |            |
| Coors 60.44 P-H TC         | Rent. Prod.      |                           | 2,492   | 1966             | 1       | 1        | TC    |                              |             |             |            |
| Wilkins 72-2 USTC 9707     | Travel           | 927                       |         | 1965             | 1       | 1        | DC    | X                            | X           |             |            |
|                            |                  | 813                       |         | 1966             |         |          |       |                              |             |             |            |
| Jordan 72-2 USTC 9501      | Travel           |                           |         | 1969             | 1       | 1        | DC    |                              | X           |             |            |
| Newton 57.23 P-H TC        | Trans.           |                           | 600     | 1968             | 1       | 0        | TC    |                              |             |             | X          |
| Cornwall 71-2 USTC 9630    | Travel           |                           |         | 1963             | 3       | 1        | CA    | X                            |             | X           |            |
| Puckett 56.83 P-H TC       | Travel           |                           | 798     | 1967             | 1       | 0        | TC    | X                            |             | X           |            |
| LaForge 70-2 USTC 9694     | Enter.           |                           | 931     | 1964             | 4       | 1        | CA    |                              |             |             |            |
| (self-employed)            |                  |                           | 1,045   | 1965             |         |          |       |                              |             |             |            |
| Newl 70-2 USTC 9669        | Off.-Home        |                           | 1,055   | 1964             | 4       | 1        | CA    | X                            | X           |             |            |
| (Outside Salesman)         |                  |                           |         |                  |         |          |       |                              |             |             |            |
| Schweighardt 54.119 P-H TC | Travel           | 390                       |         | 1964             | 1       | 0        | TC    |                              |             |             |            |
|                            |                  | 313                       |         | 1965             |         |          |       |                              |             |             |            |
| Dean 54.62 P-H TC          | Travel           | 194                       | 1,183   | 1965             | 1       | 0        | TC    |                              |             |             |            |
| Michaels 53.28 P-H TC      | Travel           |                           | 2,066   | 1964             | 1       | 0        | TC    |                              |             |             |            |

Table 5.4 Significant Considerations in Court Decisions from November, 1969, through July, 1974, Which Substantially Allowed the Itemized Deduction of Income-Producing Expenses of Individuals

| Case                   | Expense Category | Annual Amounts in Dispute |         | Years of Returns | Lawyers |          | Court | Factors Analyzed in Decision |             |             | Reasonable |
|------------------------|------------------|---------------------------|---------|------------------|---------|----------|-------|------------------------------|-------------|-------------|------------|
|                        |                  | Tax                       | Expense |                  | Govt.   | Taxpayer |       | Sec. 262                     | Ord. & Nec. | Tr. or Bus. |            |
| Glasgow 73-2 USTC 9773 | Educ.            | \$ 389                    | \$      | 1967             | 4       | 0        | CA    |                              |             | X           |            |
| Bodzin 60.86 P-H TC    | Off.-Home        | 88                        |         | 1967             | 2       | 1        | TC    | X                            | X           |             |            |
| Dowell 74-1 USTC 9243  | Enter.           |                           |         | 1967             | 3       | 2        | DC    |                              |             |             |            |
| Hesse 60.72 P-H TC     | Sec. 212         |                           | 10,000  | 1967             | 1       | 1        | TC    |                              |             |             |            |
|                        |                  |                           | 5,000   | 1968             |         |          |       |                              |             |             |            |
|                        |                  |                           | 5,000   | 1969             |         |          |       |                              |             |             |            |
| Gino 60.37 P-H TC      | Off.-Home        |                           | 500     | 1966             | 1       | 1        | TC    |                              |             |             |            |
|                        |                  |                           | 630     | 1967             |         |          |       |                              |             |             |            |
|                        |                  |                           | 1,000   | 1968             |         |          |       |                              |             |             |            |
| Black 60.13 P-H TC     | Emp.-Seek.       |                           | 1,875   | 1968             | 1       | 0        | TC    |                              |             |             |            |
| Cremona 58.20 P-H TC   | Emp.-Seek.       | 573                       |         | 1968             | 1       | 0        | TC    |                              |             | X           |            |
| Ford 56.102 P-H TC     | Educ.            | 274                       |         | 1967             | 1       | 0        | TC    |                              | X           | X           |            |
| Holland 70-1 USTC 9303 | Enter.           |                           | 1,600   | 1960             | 3       | 2        | DC    |                              | X           |             |            |
|                        |                  |                           | 1,284   | 1961             |         |          |       |                              |             |             |            |
|                        |                  |                           | 173     | 1962             |         |          |       |                              |             |             |            |
| Kenfield 54.113 P-H TC | Emp.-Seek.       | 392                       | 1,782   | 1966             | 1       | 0        | TC    |                              |             | X           |            |
| Motto 54.48 P-H TC     | Emp.-Seek.       | 599                       | 2,722   | 1967             | 2       | 0        | TC    |                              |             |             |            |
| Primuth 54.36 P-H TC   | Emp.-Seek.       | 754                       | 3,016   | 1966             | 1       | 1        | TC    |                              |             | X           |            |
| Marlin 54.49 P-H TC    | Educ.            |                           | 1,100   | 1966             | 1       | 0        | TC    |                              |             |             |            |

Table 5.5 Significant Considerations in Court Decisions from November, 1969, through July, 1974,  
Concerning the Deduction of the Income-Producing Expenses of Individuals

| Factor                                    | Deduction for A.G.I. |       |       |       |       | Itemized Deduction |       |        |       |       |
|-------------------------------------------|----------------------|-------|-------|-------|-------|--------------------|-------|--------|-------|-------|
|                                           | DC                   | TC    | CA    | Other | All   | DC                 | TC    | CA     | Other | All   |
| Number of Cases                           | 16                   | 22    | 37    | 1     | 76    | 8                  | 27    | 13     | 2     | 50    |
| Percentage of Total Cases                 | 21                   | 29    | 49    | 1     | 100   | 16                 | 54    | 26     | 4     | 100   |
| Mean Amount<br>in Dispute                 | 744                  | 684   | 1,304 | 0     | 1,080 | 753                | 327   | 765    | 0     | 630   |
| ( $\$$ )                                  | 3,460                | 1,820 | 2,550 | 2,562 | 2,378 | 1,694              | 2,230 | 11,234 | 0     | 4,543 |
| Percentage of Taxpayers<br>With No Lawyer | 6                    | 59    | 46    | 0     | 41    | 25                 | 59    | 54     | 0     | 50    |
| Mean Number<br>of Lawyers                 | 1.8                  | 1.1   | 4.1   | 4.0   | 2.8   | 2.6                | 1.1   | 3.5    | 4.0   | 2.1   |
|                                           | Taxpayer             | .4    | .7    | 1.0   | .8    | 1.3                | .4    | .5     | 1.0   | .6    |
| Relative<br>Frequency<br>of               | Sec. 262             |       | 30    |       |       |                    |       | 30     |       |       |
|                                           | Ord. & Nec.          |       | 20    |       |       |                    |       | 26     |       |       |
| Occurrence                                | Tr. or Bus.          |       | 12    |       |       |                    |       | 50     |       |       |
| of                                        | Poor Records         |       | 24    |       |       |                    |       | 8      |       |       |
| Considerations                            | Reason-              |       | 4     |       |       |                    |       | 4      |       |       |
| (%)                                       | ableness             |       |       |       |       |                    |       |        |       |       |

DC = District Courts  
TC = Tax Court  
CA = Circuit Courts of Appeals  
Other = Court of Claims and Supreme Court

the 76 cases, Brown and Carkhuff, results in an average tax in dispute in cases involving deductions for adjusted gross income of \$697 which is very close to the \$630 for itemized deduction cases. The average amount of expense in dispute in itemized deduction cases appears to be relatively higher, but deleting 1 of the 50 cases, Brooks, results in an average expense in dispute for itemized income-producing expenses of \$1,849 which is slightly below the \$2,378 average for deductions for adjusted gross income.

The overall mean numbers of lawyers appear to be lower in cases involving itemized deductions but this is a result of the case mix for each area. If the mean number of lawyers for the government and the taxpayer in cases concerned with deductions for adjusted gross income are multiplied in each court separately times the number of itemized deduction cases decided in that court, the overall means become 2.1 and .6, respectively. So this apparent difference reflects the fact that a greater proportion of itemized deduction cases were decided in the Tax Court which has the lowest average number of lawyers for either side. Other considerations observed, other than trade or business definition and poor records which were covered in the first step, do not display different frequencies of occurrence between the two deduction classifications.

### Summary

This chapter involved the analysis of the most recent court cases concerning the deduction of income-producing expenses by individuals in order to identify any basic distinctions in considerations or in their frequency of occurrence within decisions concerning

deductions for adjusted gross income and decisions concerning itemized deductions. Although no observably different factors occurred in these groups of cases, some differences in their frequency of occurrence were observed. However, these distinctions were basically due to different case mixes, to one or two cases with extremely high amounts of tax or expense in dispute, or to the basic nature of one of the expense categories, such as education, within a deduction group. Deductions for adjusted gross income had a larger proportion of cases decided in Courts of Appeals and a smaller proportion of cases decided in the Tax Court than did cases concerning itemized income-producing expenses. This distinction does not appear to be a reasonable explanation for the present dichotomous treatment because tax law distinctions should not be based on differing frequencies of courts resolving disputes in the area. Slight differences in the frequency of occurrence of 2 considerations and the slight tendency for amounts in dispute for deductions for adjusted gross income to be higher provide weak partial justification for the present dichotomous treatment of the income-producing expenses of individuals. It is possible that the present dichotomy is justified because the meaning of a trade or business is a more frequent consideration, inadequate substantiation is a less frequent consideration and larger amounts are in dispute for deductions for adjusted gross income. However, these differences are so small that they provide a minor justification for the inequities of the present law.

## FOOTNOTES--CHAPTER V

1. Fowler, Anna C., Analysis of Valuation of Undivided Interests in Property for Federal Tax Purposes, M.B.A. Thesis, The University of Texas at Austin, Graduate School of Business, 1970. The factors identified and compared were evidence of comparable sales, subsequent sales, expert witness presented, actual appraisals conducted, nature of the property, income status of the property, situs of the property, owners of the other interests, presence of diverse parties, size of the interest, court, and date of decision.
2. Ibid., p. 62.
3. Ibid., pp. 106-7.
4. Halsey, Crawford C. and Peloubet, Maurice E., Federal Taxation and Unreasonable Compensation (New York: The Ronald Press Company, 1964), p. 20. This study identified 21 different factors.
5. Ibid.
6. Prentice-Hall Federal Taxes - 1974, Vol. 3 (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1974), pp. 21,326-21,356-D. Identification of 12 items and their effects was accomplished.
7. Tax Court Reported Decisions, Volumes 53 thru 62, (Englewood Cliffs, New Jersey: Prentice-Hall, Inc.), and U.S. Tax Cases, Volumes 70-1 thru 74-2 (New York: Commerce Clearing House, Inc.)

## CHAPTER VI

### THE IMPACT AND ALTERNATIVES OF THE DICHOTOMOUS TREATMENT PROBLEM

The preceding chapters have developed a conflicting basis for the present dichotomous treatment of the income-producing expenses of individuals. The purpose of this chapter is to determine the impact of the present law, to examine or consider possible alternatives based on the results of Chapters II through V, and to ascertain the probable effects of these alternatives.

#### The Impacts of the Present Dichotomous Treatment

Pages 5 through 8 of Chapter I detailed many of the ramifications of the present dichotomous treatment concerning the numbers of people not itemizing deductions. The amount of standard deduction or low-income allowance which they can deduct is the same for identical adjusted gross incomes even though they have different amounts of income-producing expenses which can not be deducted for adjusted gross income. The consequences of this treatment for non-federal income taxes, for other parts of the tax computation process, and for various types of tax-payers were also detailed.

This portion of the present chapter will analyze the effects of the present law on taxpayers with various types and levels of income. The basic source of data for this analysis is Statistics of Income-Individual Income Tax Returns,<sup>1</sup> which is published annually by the

Internal Revenue Service about three years after a given tax year. It summarizes the statistics of returns filed for that given year.

Table 6.1 shows the proportion of individual taxpayers in recent years who itemized deductions each year. They are divided into adjusted gross income classes.

Table 6.1

## Percentage of Individuals Itemizing Deductions

| AGI (\$)    | 1966 | 1967 | 1969 | 1970 | 1971 |
|-------------|------|------|------|------|------|
| < 5,000     | 17   | 17   | 18   | 16   | 10   |
| 5 - 10,000  | 53   | 53   | 53   | 52   | 42   |
| 10 - 15,000 | 71   | 72   | 74   | 75   | 64   |
| 15,000+     | 87   | 88   | 90   | 91   | 87   |
| All         | 41   | 42   | 46   | 48   | 41   |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

The 1969 Tax Reform Act and the Revenue Act of 1971 reversed a trend towards more people itemizing. In 1971, only 41 per cent of all taxpayers and only 10 per cent of taxpayers with an adjusted gross income less than \$5,000, itemized deductions. Preliminary figures indicate that only 35 per cent of taxpayers itemized in 1972.<sup>2</sup> To the extent that itemizers are favored by the present treatment of income-producing expenses, the law is vertically inequitable because there is a direct correlation between itemization frequency and level of income.

A study of the I.R.S. data pertaining to the sources of income

of itemizers and non-itemizers provides a further perspective of the taxpayer groups who are unable to deduct some of their income-producing expenses. Not only do itemizers tend to have larger absolute amounts of certain types of revenue, but they also have a different revenue mix and, in some cases, they claim certain types of revenue more often than do non-itemizers. These conclusions are based on a study of the data available for three years which segmented revenue sources for itemizers and non-itemizers. Table 6.2 was derived by dividing the amount claimed as wage and salary revenue by the number of taxpayers claiming it in each deduction classification.

Table 6.2

## Average Amounts Claimed as Wage and Salary Revenue

| AGI (\$)    | 1967    |         | 1970    |         | 1971    |         |
|-------------|---------|---------|---------|---------|---------|---------|
|             | Item.   | N-item. | Item.   | N-item. | Item.   | N-item. |
| < 5,000     | \$3,262 | \$2,087 | \$3,589 | \$2,131 | \$3,623 | \$2,233 |
| 5 - 10,000  | 7,307   | 6,872   | 7,530   | 7,023   | 7,501   | 7,014   |
| 10 - 15,000 | 11,532  | 10,967  | 11,910  | 11,258  | 12,031  | 11,401  |
| 15,000+     | 18,880  | 14,654  | 16,698  | 15,851  | 20,197  | 16,058  |
| All         | 9,530   | 4,253   | 11,530  | 4,694   | 12,881  | 5,305   |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

However, these absolute numbers are not realistically comparable because, even within income brackets, itemizers tend to have higher average incomes. To facilitate comparison, it is necessary to determine in Table 6.3 the average gross income for each taxpayer group.

Table 6.3

## Average Gross Income

| AGI (\$)    | 1967    |         | 1970    |         | 1971    |         |
|-------------|---------|---------|---------|---------|---------|---------|
|             | Item.   | N-item. | Item.   | N-item. | Item.   | N-item. |
| < 5,000     | \$3,392 | \$2,136 | \$3,786 | \$2,202 | \$3,833 | \$2,331 |
| 5 - 10,000  | 7,624   | 7,171   | 7,758   | 7,257   | 7,875   | 7,273   |
| 10 - 15,000 | 12,176  | 11,848  | 12,452  | 11,929  | 12,536  | 12,071  |
| 15,000+     | 27,424  | 20,249  | 24,698  | 19,422  | 24,980  | 19,265  |
| All         | 10,953  | 4,453   | 12,840  | 4,863   | 14,490  | 5,532   |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

Dividing the average amount claimed for a certain type of revenue by the appropriate average gross income indicates in Table 6.4 the relative impact of that type of revenue after adjusting for differences in average gross incomes.

Table 6.4

## Percentage of Revenue Derived From Wages and Salaries

| AGI (\$)    | 1967  |         | 1970  |         | 1971  |         |
|-------------|-------|---------|-------|---------|-------|---------|
|             | Item. | N-item. | Item. | N-item. | Item. | N-item. |
| < 5,000     | 96    | 98      | 95    | 97      | 95    | 96      |
| 5 - 10,000  | 96    | 96      | 95    | 97      | 95    | 96      |
| 10 - 15,000 | 95    | 93      | 96    | 94      | 96    | 94      |
| 15,000 +    | 69    | 72      | 80    | 82      | 81    | 83      |
| All         | 87    | 96      | 90    | 97      | 89    | 96      |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

There probably is an overall tendency for non-itemizers having wages and salaries to have a larger proportion of their revenue in this form than do itemizers. Unfortunately, the structure of the basic I.R.S. data prevents testing these figures statistically to determine if they are significantly different.

A similar technique can be applied to determine the frequency of the claiming of a type of revenue for itemizers and non-itemizers. Table 6.5 indicates that overall frequencies of claiming wage and salary revenue are quite close, but they, apparently, are more frequently claimed in low income groups by non-itemizers.

Table 6.5

## Percentage of Returns Claiming Wages and Salaries

| AGI (\$)    | 1967  |         | 1970  |         | 1971  |         |
|-------------|-------|---------|-------|---------|-------|---------|
|             | Item. | N-item. | Item. | N-item. | Item. | N-item. |
| < 5,000     | 71    | 89      | 71    | 90      | 66    | 88      |
| 5 - 10,000  | 90    | 95      | 91    | 95      | 89    | 94      |
| 10 - 15,000 | 95    | 93      | 96    | 95      | 96    | 95      |
| 15,000 +    | 85    | 80      | 91    | 86      | 92    | 88      |
| All         | 89    | 91      | 90    | 91      | 90    | 90      |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

This method of analysis was applied to the other 21 sources of revenue listed in Statistics of Income-Individual Income Tax Returns for all 3 years. A number of them displayed patterns of consistent differences which imply differences between itemizers and non-itemizers.

Tables 6.6 and 6.7 indicate that itemizers consistently incur net gains and net losses from self-employment more frequently than non-itemizers.

Table 6.6

## Percentage of Returns With Self-Employment Net Income

| AGI (\$)    | 1967  |         | 1970  |         | 1971  |         |
|-------------|-------|---------|-------|---------|-------|---------|
|             | Item. | N-item. | Item. | N-item. | Item. | N-item. |
| < 5,000     | 11    | 4       | 10    | 4       | 11    | 4       |
| 5 - 10,000  | 9     | 5       | 9     | 4       | 9     | 4       |
| 10 - 15,000 | 8     | 7       | 7     | 3       | 7     | 6       |
| 15,000+     | 17    | 18      | 12    | 12      | 11    | 11      |
| All         | 10    | 5       | 9     | 4       | 10    | 5       |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

Table 6.7

## Percentage of Returns With Self-Employment Net Loss

| AGI (\$)    | 1967  |         | 1970  |         | 1971  |         |
|-------------|-------|---------|-------|---------|-------|---------|
|             | Item. | N-item. | Item. | N-item. | Item. | N-item. |
| < 5,000     | 2     | .6      | 3     | .7      | 4     | .8      |
| 5 - 10,000  | 2     | .7      | 3     | .8      | 3     | 1       |
| 10 - 15,000 | 2     | 1       | 2     | 1       | 3     | 1       |
| 15,000+     | 2     | 1       | 3     | 1       | 3     | 1       |
| All         | 2     | .7      | 2     | .8      | 3     | .9      |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

For returns with net income from farm operations, taxpayers itemizing deductions claim much smaller average amounts for farming revenue than non-itemizers. They also claim farming revenue relatively less frequently. Tables 6.8 and 6.9 demonstrate these patterns. Farms with net losses do not display any consistent amount or frequency differences though.

Table 6.8

## Percentage of Revenue from Farming Net Income

| AGI (\$)    | 1967  |         | 1970  |         | 1971  |         |
|-------------|-------|---------|-------|---------|-------|---------|
|             | Item. | N-item. | Item. | N-item. | Item. | N-item. |
| < 5,000     | 49    | 67      | 47    | 49      | 56    | 64      |
| 5 - 10,000  | 36    | 51      | 38    | 45      | 44    | 51      |
| 10 - 15,000 | 33    | 51      | 28    | 47      | 30    | 47      |
| 15,000+     | 33    | 62      | 31    | 57      | 32    | 60      |
| All         | 31    | 62      | 30    | 58      | 32    | 61      |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

Table 6.9

## Percentage of Returns Having Farm Net Income

| AGI (\$)    | 1967  |         | 1970  |         | 1971  |         |
|-------------|-------|---------|-------|---------|-------|---------|
|             | Item. | N-item. | Item. | N-item. | Item. | N-item. |
| < 5,000     | 3     | 3       | 3     | 3       | 2     | 2       |
| 5 - 10,000  | 2     | 3       | 2     | 3       | 2     | 2       |
| 10 - 15,000 | 1     | 4       | 1     | 4       | .9    | 3       |
| 15,000+     | 2     | 7       | 2     | 7       | 1     | 5       |
| All         | 2     | 3       | 2     | 3       | 1     | 3       |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

Itemizers have net income from rent more frequently than non-itemizers, but net rent income tends to comprise a smaller proportion of the total revenues of itemizers. Tables 6.10 and 6.11 show these tendencies.

Table 6.10

## Percentage of Returns Having Rental Net Income

| AGI (\$)    | 1967  |         | 1970  |         | 1971  |         |
|-------------|-------|---------|-------|---------|-------|---------|
|             | Item. | N-item. | Item. | N-item. | Item. | N-item. |
| < 5,000     | 12    | 3       | 10    | 3       | 12    | 3       |
| 5 - 10,000  | 7     | 3       | 6     | 2       | 7     | 3       |
| 10 - 15,000 | 7     | 6       | 5     | 4       | 5     | 5       |
| 15,000+     | 12    | 14      | 9     | 10      | 9     | 8       |
| All         | 8     | 4       | 7     | 3       | 7     | 3       |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

Table 6.11

## Percentage of Revenue from Rental Net Income

| AGI (\$)    | 1967  |         | 1970  |         | 1971  |         |
|-------------|-------|---------|-------|---------|-------|---------|
|             | Item. | N-item. | Item. | N-item. | Item. | N-item. |
| < 5,000     | 24    | 36      | 27    | 37      | 26    | 37      |
| 5 - 10,000  | 10    | 12      | 14    | 16      | 14    | 13      |
| 10 - 15,000 | 7     | 9       | 7     | 9       | 8     | 8       |
| 15,000+     | 10    | 11      | 10    | 11      | 10    | 12      |
| All         | 11    | 21      | 12    | 21      | 11    | 18      |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

Although the figures for amounts of net rental loss are comparable for both deduction classifications, itemizers still tend to claim it more often as is shown in Table 6.12.

Table 6.12

## Percentage of Returns Having Rental Net Loss

| AGI (\$)    | 1967  |         | 1970  |         | 1971  |         |
|-------------|-------|---------|-------|---------|-------|---------|
|             | Item. | N-item. | Item. | N-item. | Item. | N-item. |
| < 5,000     | 5     | .8      | 5     | .8      | 6     | 1       |
| 5 - 10,000  | 6     | 2       | 5     | 1       | 5     | 1       |
| 10 - 15,000 | 6     | 3       | 5     | 2       | 6     | 3       |
| 15,000+     | 8     | 5       | 7     | 4       | 7     | 5       |
| All         | 6     | 1       | 6     | 1       | 6     | 1       |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

Table 6.13 shows that non-itemizers tend to have a greater proportion of their income in the form of pensions and annuities, especially in the lowest income bracket.

Table 6.13

## Percentage of Revenue from Pensions and Annuities

| AGI (\$)    | 1967  |         | 1970  |         | 1971  |         |
|-------------|-------|---------|-------|---------|-------|---------|
|             | Item. | N-item. | Item. | N-item. | Item. | N-item. |
| < 5,000     | 51    | 70      | 52    | 70      | 56    | 73      |
| 5 - 10,000  | 32    | 33      | 36    | 35      | 35    | 40      |
| 10 - 15,000 | 19    | 21      | 23    | 25      | 26    | 25      |
| 15,000+     | 13    | 14      | 16    | 17      | 17    | 20      |
| All         | 21    | 39      | 21    | 40      | 21    | 42      |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

Although dividends reported do not vary much between deduction classifications as a proportion of gross income, Table 6.14 implies that they are claimed more frequently in all brackets by itemizers.

Table 6.14

## Percentage of Returns Having Dividend Income

| AGI (\$)    | 1967  |         | 1970  |         | 1971  |         |
|-------------|-------|---------|-------|---------|-------|---------|
|             | Item. | N-item. | Item. | N-item. | Item. | N-item. |
| < 5,000     | 14    | 3       | 15    | 4       | 18    | 4       |
| 5 - 10,000  | 8     | 6       | 10    | 6       | 10    | 5       |
| 10 - 15,000 | 12    | 13      | 11    | 11      | 10    | 10      |
| 15,000+     | 40    | 35      | 30    | 26      | 27    | 22      |
| All         | 15    | 5       | 16    | 5       | 16    | 6       |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

Concerning proceeds from the sales of capital assets, itemizers claim net losses and net gains more frequently, especially in the lowest income bracket. Tables 6.15 and 6.16 provide the basis for this tentative conclusion.

Table 6.15

## Percentage of Returns Having Net Gain from Sale of Capital Assets

| AGI (\$)    | 1967  |         | 1970  |         | 1971  |         |
|-------------|-------|---------|-------|---------|-------|---------|
|             | Item. | N-item. | Item. | N-item. | Item. | N-item. |
| < 5,000     | 12    | 4       | 10    | 3       | 12    | 3       |
| 5 - 10,000  | 9     | 7       | 8     | 4       | 8     | 5       |
| 10 - 15,000 | 14    | 15      | 8     | 8       | 8     | 8       |
| 15,000+     | 38    | 36      | 18    | 18      | 19    | 19      |
| All         | 15    | 6       | 11    | 4       | 12    | 5       |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

Table 6.16

## Percentage of Returns Having Net Loss from Sale of Capital Assets

| AGI (\$)    | 1967  |         | 1970  |         | 1971  |         |
|-------------|-------|---------|-------|---------|-------|---------|
|             | Item. | N-item. | Item. | N-item. | Item. | N-item. |
| < 5,000     | 3     | .5      | 3     | .7      | 4     | .6      |
| 5 - 10,000  | 3     | .8      | 3     | 1       | 3     | .8      |
| 10 - 15,000 | 3     | 2       | 4     | 2       | 4     | 2       |
| 15,000+     | 9     | 5       | 12    | 6       | 10    | 5       |
| All         | 4     | .8      | 6     | 1       | 5     | 1       |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

Table 6.17 indicates the inclination of returns not itemizing to report interest revenue more often than returns itemizing deductions.

Table 6.17

## Percentage of Returns Having Interest Revenue

| AGI (\$)    | 1967  |         | 1970  |         | 1971  |         |
|-------------|-------|---------|-------|---------|-------|---------|
|             | Item. | N-item. | Item. | N-item. | Item. | N-item. |
| < 5,000     | 53    | 23      | 54    | 25      | 57    | 27      |
| 5 - 10,000  | 46    | 38      | 46    | 34      | 47    | 36      |
| 10 - 15,000 | 61    | 60      | 57    | 54      | 57    | 56      |
| 15,000+     | 82    | 81      | 78    | 75      | 78    | 76      |
| All         | 56    | 31      | 58    | 31      | 61    | 35      |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

This analysis indicates that there are some probable distinctions in the sources of revenue and the frequency with which they are claimed between taxpayers who itemize and those who do not, even when differences in average gross income are adjusted for. Itemizers are more likely to have relatively larger amounts of dividends, interest, and gains and losses from the sale of capital assets in their computation of gross income. Non-itemizers are more likely to have relatively larger amounts of wages and salaries, farm net income, rental net income, and pensions and annuities in their gross income. Items of revenue which apparently occur more frequently in the gross income of itemizers are self-employment net income, self-employment net loss, rental net income, rental net loss, dividends, net gain from the sale of capital assets, net loss from the sale of capital assets, and interest. Non-itemizers claim wage and salary revenue more often in the lowest two adjusted gross income brackets and farm net income more often at all levels of income.

Thus, to the extent the present dichotomous treatment of income-producing expenses favors itemizers over non-itemizers, the law is benefitting taxpayers with apparently distinct revenue patterns. This implicit favoritism of taxpayers with certain revenue patterns is contrary to the general objective of horizontal equity. If taxpayers with certain revenue patterns are more likely to itemize, these revenue patterns predominate at higher income levels, and the present dichotomous treatment favors itemizers, then the law is vertically inequitable to a further degree. This would be beyond the inequity due to the direct relationship of income level and frequency of itemization.

A second consideration of the effects of the present law involves the actual deduction of income-producing expenses which are deducted for adjusted gross income by all individual taxpayers. Scrutiny of further Statistics of Income-Individual Income Tax Returns data reveals that itemizers consistently claim some of these expenses relatively more frequently and in relatively larger amounts than non-itemizers. Tables 6.18 and 6.19 demonstrate these patterns for years whose sufficient categorized information allows the comparison for moving expenses and for employee business expenses which are defined as travel, transportation, reimbursed and outside salesmen expenses.

Undoubtedly, some of the intra-bracket differences in frequency or amount are caused by itemizers having higher average intra-bracket income. However, at lower income levels especially, the spreads appear too wide to be explained by this factor alone. The differences in Tables 6.18 and 6.19 can not be statistically tested,

Table 6.18 A Comparison of Frequency of Itemization With Frequencies of Moving Expenses and Employee Business Expenses Claims on Returns Itemizing Deductions

| AGI (\$)    | Year | Percentage of Returns Itemizing | Percentage of Total Returns Claiming Moving Expenses Which Also Itemized | Percentage of Total Returns Claiming Employee Business Expenses Which Also Itemized |
|-------------|------|---------------------------------|--------------------------------------------------------------------------|-------------------------------------------------------------------------------------|
| < 5,000     | 1966 | 17                              | 62                                                                       | 49                                                                                  |
|             | 1967 | 17                              | 62                                                                       | 52                                                                                  |
|             | 1970 | 16                              | 45                                                                       | 47                                                                                  |
|             | 1971 | 10                              | 30                                                                       | 32                                                                                  |
| 5 - 10,000  | 1966 | 53                              | 66                                                                       | 72                                                                                  |
|             | 1967 | 53                              | 66                                                                       | 71                                                                                  |
|             | 1970 | 52                              | 61                                                                       | 72                                                                                  |
|             | 1971 | 42                              | 47                                                                       | 63                                                                                  |
| 10 - 15,000 | 1966 | 71                              | 71                                                                       | 80                                                                                  |
|             | 1967 | 72                              | 71                                                                       | 81                                                                                  |
|             | 1970 | 75                              | 74                                                                       | 84                                                                                  |
|             | 1971 | 64                              | 60                                                                       | 75                                                                                  |
| 15,000+     | 1966 | 87                              | 90                                                                       | 92                                                                                  |
|             | 1967 | 88                              | 90                                                                       | 92                                                                                  |
|             | 1970 | 91                              | 91                                                                       | 95                                                                                  |
|             | 1971 | 87                              | 86                                                                       | 91                                                                                  |
| All         | 1966 | 41                              | 68                                                                       | 73                                                                                  |
|             | 1967 | 42                              | 69                                                                       | 75                                                                                  |
|             | 1970 | 48                              | 67                                                                       | 79                                                                                  |
|             | 1971 | 41                              | 56                                                                       | 73                                                                                  |

Source: Statistics of Income-Individual Income Tax Returns, Internal Revenue Service.

Table 6.19 A Comparison of Frequency of Itemization With the Percentage of Total Moving Expenses and Total Employee Business Expenses Claimed on Returns Itemizing Deductions

| AGI (\$)    | Year | Percentage of Returns Itemizing | Percentage of Total Moving Expenses Which Were Claimed on Itemized Returns | Percentage of Total Employee Business Expenses Which Were Claimed on Itemized Returns |
|-------------|------|---------------------------------|----------------------------------------------------------------------------|---------------------------------------------------------------------------------------|
| < 5,000     | 1966 | 17                              | 57                                                                         | 54                                                                                    |
|             | 1967 | 17                              | 51                                                                         | 54                                                                                    |
|             | 1970 | 16                              | 47                                                                         | 54                                                                                    |
|             | 1971 | 10                              | 37                                                                         | 35                                                                                    |
| 5 - 10,000  | 1966 | 53                              | 65                                                                         | 71                                                                                    |
|             | 1967 | 53                              | 67                                                                         | 72                                                                                    |
|             | 1970 | 52                              | 68                                                                         | 75                                                                                    |
|             | 1971 | 42                              | 57                                                                         | 68                                                                                    |
| 10 - 15,000 | 1966 | 71                              | 74                                                                         | 79                                                                                    |
|             | 1967 | 72                              | 80                                                                         | 88                                                                                    |
|             | 1970 | 75                              | 82                                                                         | 95                                                                                    |
|             | 1971 | 64                              | 73                                                                         | 77                                                                                    |
| 15,000+     | 1966 | 87                              | 92                                                                         | 92                                                                                    |
|             | 1967 | 88                              | 93                                                                         | 93                                                                                    |
|             | 1970 | 91                              | 96                                                                         | 95                                                                                    |
|             | 1971 | 87                              | 92                                                                         | 93                                                                                    |
| All         | 1966 | 41                              | 71                                                                         | 75                                                                                    |
|             | 1967 | 42                              | 70                                                                         | 77                                                                                    |
|             | 1970 | 48                              | 80                                                                         | 83                                                                                    |
|             | 1971 | 41                              | 74                                                                         | 76                                                                                    |

Source: Statistics of Income-Individual Income Tax Returns, Internal Revenue Service.

but the stability of their patterns over time is a strong argument for their validity. Thus, taxpayers who itemize deductions also have a greater tendency to deduct some income-producing expenses which are deductible for adjusted gross income and to deduct them in larger amounts.

The problem is to determine whether itemizers incur these expenses more frequently and in greater amounts or whether they are more careful about deducting the expenses they incur. The probable answer to the first part of the question can be derived by a determination of the expense factors which lead directly to a taxpayer's itemizing deductions.

Approximately 74 per cent of 1970 itemizers were homeowners. The mortgage interest and real property tax that they are able to include as itemized deductions are the most important factors in their decision to itemize. Table 6.20 shows for 1970 the number of itemizers claiming these homeowner expenses, the average amounts claimed for each, their average totals and the figures which they could alternatively claim in 1974 if they did not itemize, that is, \$1,300 or 15 per cent of average adjusted gross income with a \$2,000 maximum. Thus, home ownership plays a predominant part in the decision to itemize especially when 1974 interest and tax figures are compared to the 1974 alternatives.

Table 6.20 Impact of Homeowner Expenses on the 1970 Decision to Itemize Compared With the 1974 Alternative Deduction

| AGI (\$)    | Percentage of Itemized Returns Claiming |           | Average Amount Claimed |           | Total  | 1974 Deduction Alternative to Itemizing |
|-------------|-----------------------------------------|-----------|------------------------|-----------|--------|-----------------------------------------|
|             | Mort. Int.                              | Prop. Tax | Mort. Int.             | Prop. Tax |        |                                         |
| < 5,000     | 23                                      | 53        | \$461                  | \$341     | \$ 802 | \$1,300                                 |
| 5 - 10,000  | 46                                      | 65        | 549                    | 326       | 875    | 1,300                                   |
| 10 - 15,000 | 65                                      | 81        | 670                    | 407       | 1,077  | 1,845                                   |
| 15,000+     | 66                                      | 87        | 919                    | 697       | 1,616  | 2,000                                   |
| All         | 54                                      | 74        | 700                    | 462       | 1,162  |                                         |

Source: Statistics of Income-Individual Income Tax Returns, Internal Revenue Service.

Itemizers tend to be homeowners and homeowners usually incur higher average moving costs than non-homeowners, so there is some positive correlation between the amounts of deductions for adjusted gross income and the amounts of itemized deductions reported by taxpayers. However, the relative frequencies and average amounts claimed are even more disproportionate for the employee business expenses of itemizers than for their moving expenses.

Alternative hypotheses for this relationship concern the degree to which expenses incurred are deducted. One possibility is that taxpayers who itemize tend to be more knowledgeable concerning deductible expenses. Another is that itemizers are more likely to keep receipts and other records for their income-producing expenses because they already are keeping them for the personal expenses which are itemized deductions. A third explanation concerning the non-claiming of income-producing expenses is that many taxpayers not itemizing deductions use Form 1040A, which is a short form that does not allow the deduction of any income-producing expenses. However, the disproportionate relationships detailed in Tables 6.18 and 6.19 continued to prevail in 1970 and 1971, years in which all taxpayers had to use Form 1040. It is possible that non-itemizers had been conditioned by the use in past years of Form 1040A so that they did not even deduct these expenses on the Form 1040 when they could have. Form 1040A has been reinstated and millions of taxpayers will use it in 1974 and subsequent years.

It appears likely that the present dichotomous treatment of income-producing expenses and the way that the present law is administered have a negative impact even on the frequency and amounts

of income-producing expenses deducted for adjusted gross income by taxpayers not itemizing deductions. Allowing more income-producing expenses to be deducted for adjusted gross income would encourage more non-itemizers to become aware of their deductibility and to keep better records. To the extent that the present law leads to unequal tax treatment of individuals in similar economic circumstances because one is consequently less likely to deduct income-producing expenses, the law is horizontally inequitable. Vertical inequity is apparent to the extent that non-itemizers tend to be discouraged from deducting income-producing expenses for adjusted gross income by the structure of Form 1040A because these taxpayers are predominately in the lowest income groups.

Another element of consideration in this area concerns the amounts and incidence of income-producing expenses which may not be deducted by non-itemizers. Pertinent data is sketchy concerning these expenses because the I.R.S. only analyzes itemized deductions every even numbered year and, even then, it usually groups these expenses with others in varying general categories such as "Miscellaneous Deductions" or "Type not Specified."

The most complete information is available for household and dependent care expenses which are sometimes separately totalled. Table 6.21 indicates the number of itemized returns claiming this expense and the average amounts they claimed.

Table 6.21

## Household and Dependent Care Expenses

| AGI (\$)    | Number of Returns |         | Average Amount Deducted |       | Percentage of Itemizers Claiming These Expenses |      |
|-------------|-------------------|---------|-------------------------|-------|-------------------------------------------------|------|
|             | 1966              | 1970    | 1966                    | 1970  | 1966                                            | 1970 |
| < 5,000     | 99,451            | 136,886 | \$484                   | \$360 | 2                                               | 3    |
| 5 - 10,000  | 135,767           | 281,604 | 535                     | 455   | 1                                               | 2    |
| 10 - 15,000 | 14,453            | 91,625  | 516                     | 357   | .2                                              | .9   |
| 15,000+     | 4,752             | 54,628  | 567                     | 199   | .1                                              | .6   |
| All         | 254,423           | 564,743 | 515                     | 391   | .9                                              | 2    |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

The only other specifically identified and separately aggregated expense was education in 1966. Table 6.22 shows the impact of its deduction.

Table 6.22

## Education Expenses Deducted in 1966

| AGI (\$)    | Number of Returns | Percentage of Itemizers Claiming Education Expenses | Average Deduction |
|-------------|-------------------|-----------------------------------------------------|-------------------|
| < 5,000     | 100,966           | 2                                                   | \$100             |
| 5 - 10,000  | 291,276           | 2                                                   | 189               |
| 10 - 15,000 | 240,887           | 4                                                   | 195               |
| 15,000+     | 125,563           | 3                                                   | 195               |
| All         | 758,692           | 3                                                   | 180               |

Source: Statistics of Income-Individual Income Tax Returns,  
Internal Revenue Service.

Since it seems reasonable to conclude that to a great extent similar expenses are incurred by non-itemizers, it appears that many of them are not able to deduct some income-producing expenses which average hundreds of dollars. Thus, economically identical taxpayers pay different tax bills because one has larger amounts of deductible personal expenses. Non-itemizers with the same adjusted gross income deduct the identical standard deduction or low-income allowance although they have varying amounts of income-producing expenses which can not be deducted. The income-producing expenses detailed in Tables 6.21 and 6.22 are largest in relation to income at lowest income levels. Lowest income taxpayers itemize least often, so they frequently are unable to deduct large amounts of these expenses. Recent proposals and statements indicate that the House Ways and Means Committee is seriously considering provisions which would further limit the deduction of income-producing expenses. These suggestions would only allow the deduction of itemized income-producing expenses to the extent they exceed a given amount each year. If these proposals are accepted, previously observed inequities would be worsened.

#### Possible Justification for the Present Dichotomous Treatment

There are a number of possible reasons, beyond those developed in Chapters II through V, for retaining the present law despite its observed inequities. The decision concerning whether they outweigh the negative aspects of the present law is basically a value judgment.

It can be said that non-itemizers benefit under the present treatment because they are able to deduct the larger of the low-income

allowance or the percentage standard deduction. This deductible amount is larger than the sum of their income-producing expenses, which must be itemized, and some specified personal expenses. A number of conflicts arise, however, even if this justification is accepted.

The objective of the low-income allowance is to ensure that persons below the poverty level are not subject to Federal income tax.<sup>3</sup> Since a poverty level income is computed by measuring minimum physical needs for a given family size, the low-income allowance figure derived is meant to cover income derived after subtracting income-producing expenses from gross revenues. Thus, the low-income allowance is only meant to protect from tax income available for spending on personal needs.

The percentage standard deduction alternative might have more merit since its purpose is administrative simplicity.<sup>4</sup> Allowing some taxpayers to deduct a given amount rather than forcing them to keep records of expenses, fill out more forms, and invite more arithmetic mistakes and conceptual disagreements, has a lot of appeal, especially when those expenses are personal. When some of those expenses are explicitly income-producing, this alternative loses a great deal of appeal because the basic focus of our income tax has always been on a measure of net income. This excuse for the present law becomes even more suspect in regard to horizontal equity because the identity of the income-producing expense can determine deductibility. An example would be two taxpayers where both had the same gross income but one had travel expenses of \$100 while the other had \$100 of unreimbursed education expenses. The first



taxpayer would pay a smaller amount of tax even though the two were in the same economic position.

A practical argument for the present dichotomous structure concerns the tax revenues which would not be collected if more or all income-producing expenses were made deductible for adjusted gross income. Previously mentioned factors, such as the structure of Form 1040A, historical conditioning and the tendency to keep fewer records, would inhibit the expanded deduction of these expenses by non-itemizers but surely some increase in total deductions would result.

Thus, a number of arguments in addition to those developed in Chapters II through V support the retention of the present dichotomous treatment of income-producing expenses.

#### Alternative Treatments for Income-Producing Expenses

Three basic alternatives to the present treatment of the income-producing expenses of individuals are (1) not allowing their deduction, (2) allowing different groups of these expenses to be deducted for or from adjusted gross income or (3) allowing all of them to be deducted for adjusted gross income. Because the federal income tax has always sought to tax net income rather than gross income, the first possibility does not appear very desirable.

Based on the elements identified in Chapters II through V, a different group of income-producing expenses could be made deductible for adjusted gross income with the rest deductible only by itemizers. This option has attraction because it would result in smaller revenue loss than full deductibility for adjusted gross income and it would

retain relative administrative simplicity.

One possible grouping would make moving expenses and household and dependent care expenses available only to itemizers on the grounds that they are primarily personal expenses which have full-time employment tests only to objectively determine deductibility. Section 62 would have to be modified to allow the deduction for adjusted gross income of all Section 162 and 212 expenses while deleting Subsection 8 concerning moving expenses. These expenses have been explicitly determined as not being ordinary and necessary business expenses.<sup>5</sup> Their deductibility was established only through special sections of the Code just like personal itemized deductions. Other income-producing expenses are deductible whether incurred in connection with part or full-time income-producing activities. Indirect moving expenses and household and dependent care expenses are subject to deductible maxima unlike other income-producing expenses. The thrust of our income tax laws has always been to allow the complete deduction of expenses directly incurred to produce income. The treatment of indirect moving expenses and household and dependent care expenses closely approaches the treatment of medical expenses and charitable contributions regarding the relationship of their deductible amounts to income and to maximum deductible amounts. However, inequities previously detailed would not be resolved under this alternative treatment to the extent that these expenses are primarily incurred to produce income.

A third alternative would allow all of these expenses, including moving and household and dependent care expenses, to be deducted for adjusted gross income. Section 62 would have to be modified to allow

the deduction of all Section 162, 212, 214, and 217 expenses for adjusted gross income. Horizontal and vertical equity would be more closely achieved between types of taxpayers and different taxpayer income groups, respectively. Taxpayer compliance might increase due to increased understandability of the tax computation structure. Administration and compliance would be more efficient to the extent that resources are presently expended in attempts to deduct for adjusted gross income expenses which must presently be itemized. This clear distinction between the treatment of income-producing and personal expenses would facilitate further discussion concerning which presently and/or possibly deductible expenses should be in each group. A stronger excuse would also exist for the modification of Form 1040A to allow deductions for adjusted gross income to attain greater horizontal and vertical equity. Undoubtedly, tax collections would decrease and tax administration would be more difficult with more taxpayers claiming the deduction of income-producing expenses. The quantification of these negative aspects would require information only available at the Department of the Treasury to the extent pertinent data is available at all.

Table 6.23 compares the comprehensive deduction for adjusted gross income of all income-producing expenses, the present law, and the alternative partial treatment where only moving and household and dependent care expenses would be itemized. Under the partial treatment alternative, all Section 162 and 212 income-producing expenses would be deductible for adjusted gross income. Section 214 and 217 expenses could only be deducted by itemizers. The comprehensive treatment alternative would allow all of these

expenses to be deducted for adjusted gross income.

Table 6.23

## Income-Producing Expenses Deductible For Adjusted Gross Income

| Code<br>Section | Present Law                                                                 | Alternatives |               |
|-----------------|-----------------------------------------------------------------------------|--------------|---------------|
|                 |                                                                             | Partial      | Comprehensive |
| 162             | Travel<br>Transportation<br>Reimbursed<br>Outside Salesmen<br>Self-employed | All          | All           |
| 212             | To Produce Rent<br>or Royalty                                               | All          | All           |
| 214*            | None                                                                        | None         | All           |
| 217**           | All                                                                         | None         | All           |

\*Household and Dependent Care

\*\*Moving

Summary

The present dichotomous treatment of the income-producing expenses of individuals has many vertically and horizontally inequitable impacts. Non-itemizers, who tend to be in lower income groups, have different revenue patterns than itemizers. The law presently tends to favor taxpayers with higher incomes and those with specific revenue patterns. The present law and its administration appear to encourage non-itemizers to deduct income-producing expenses for adjusted gross income relatively less frequently and in relatively smaller amounts than itemizers. Only itemizers, who also tend to be homeowners, are able to deduct a large number and quantity of income-producing expenses, although self-employed taxpayers and

outside salesmen can deduct all but household and dependents care expenses. However, the present treatment most likely results in the collection of more tax revenue and certain probably smaller administrative costs than the two most likely general alternatives previously developed. These alternatives would reduce inequities but they probably would result in some increased administrative costs and some decrease in tax revenues because more taxpayers would be deducting these expenses.

## FOOTNOTES--CHAPTER VI

1. Department of the Treasury, Internal Revenue Service, Statistics of Income-Individual Income Tax Returns, Publication 79 (Washington: U.S. Government Printing Office, annually).
2. Department of the Treasury, Internal Revenue Service, Preliminary Report, Statistics of Income - 1972, Individual Income Tax Returns (Washington: U.S. Government Printing Office, 1974).
3. Staff of the Joint Committee on Internal Revenue Taxation, op. cit., p. 218.
4. Ibid., p. 216.
5. See p. 43 and p. 62.

## CHAPTER VII

### SUMMARY, CONCLUSIONS, RECOMMENDATIONS AND SUGGESTIONS FOR FUTURE RESEARCH

#### Brief Summary of Purpose and Methodology

The purpose of this research was to determine the appropriateness of the present dichotomous Federal income tax treatment of the income-producing expenses of individuals. The main criteria applied were horizontal and vertical equity achievement.

To accomplish this objective, the basis for deductions within the income tax was sought. The chronological development of the present law concerning the locations for the deduction of income-producing expenses was determined. Expense categories were analyzed to determine the consistency with which deductibility factors were applied by the present law within and between the two present groups of income-producing expenses. Court decisions were analyzed to determine distinctions between considerations significant to the deductibility and to the nondeductibility of income-producing expenses deductible for and from adjusted gross income. A final step sought to delineate the impact of the present law, formulate possible alternatives, and compare the aspects of the present law with those of the alternatives.

Summary of Findings

Constitutional Federal income tax deductions are basically whatever Congress deems them to be, although the base for taxation has always been some concept of net income.

The income-producing expenses of individuals have been subject to a dichotomous treatment for the past 30 years. Some expenses are deductible for adjusted gross income while others may only be deducted from adjusted gross income by taxpayers who itemized deductions. The explicit reasons advanced for making some expenses deductible for adjusted gross income have been inconsistent and conflicting. Justifications have ranged from "directly incurred in a trade or business" or "administrative simplicity" to "substantial relative to income" or "similar to business expenses and likely to be relatively large."

An analysis of individual expense categories derived a few distinctions between income-producing expenses deductible for adjusted gross income and those which must be itemized. Two deductions for adjusted gross income have maximum time and minimum location constraints while itemized income-producing expenses do not. No other consistent differences existed between these two expense groups in regard to length of acceptance, amount constraints, minimum time constraints, maximum location limits, personal versus business allocation, motivation determining criteria, substantiation requirements, implications of employer requests or income-producing status.

An analysis of court cases concerning income-producing expenses from 1969 through 1974 identified only one consideration which

differed greatly without explanation between these two deduction groups. Deductions for adjusted gross income had a larger proportion of cases decided in Courts of Appeals and a smaller proportion of cases decided in the Tax Court than did cases concerning itemized income-producing expenses. Differences in frequency of occurrence between groups of expenses of other considerations were largely explained by the nature of one expense within a group. There was only a slight tendency for amounts of expense or tax in dispute to be higher in cases involving deductions for adjusted gross income.

These groups did not significantly differ in regard to average numbers of government and taxpayer lawyers and frequency of reference to Section 262, the meanings of ordinary and necessary, the meaning of a trade or business, poor substantiation and whether the expense was reasonable.

The impact of the present dichotomous treatment is contrary to the principles of horizontal and vertical equity. Taxpayers may have to pay more tax than others in equal economic circumstances because of differences in occupations, types of income-producing expenses incurred, the existence of direct reimbursement, revenue patterns or incidence of home ownership. Vertical inequity is present to the extent that lower income taxpayers itemize less often because they, consequently, are less often able to deduct many income-producing expenses. The impact is also vertically inequitable because low-income taxpayers are discouraged from deducting income-producing expenses for adjusted gross income by the structure of Form 1040A. Non-itemizers deduct income-producing expenses less frequently and in smaller amounts for adjusted gross income than

do itemizers, who tend to have larger incomes, also probably because they keep poorer records and are less knowledgeable concerning what is deductible since so few of their expenses are presently deductible.

Two most probable alternatives would provide more horizontal and vertical equity for the treatment of income-producing expenses. Each choice, however, leads to a loss in tax revenues unless tax rates are changed and to an increase in some administrative costs.

#### Conclusions and Recommendations

The Department of the Treasury and Congress should evaluate the present dichotomous treatment of the income-producing expenses of individuals to determine whether the horizontal and vertical inequities are justified. Based on this dissertation research, historical development, explicit deductibility characteristics, factors in court decisions and the revenue impacts of alternatives do not appear to provide substantive and consistent justification for the present treatment of income-producing expenses.

Serious consideration should be given to the implementation of either of two alternative treatments of income-producing expenses in regard to the location of their deduction in the tax computation process because they would provide a much greater degree of horizontal and vertical equity.

#### Suggestions For Future Research

This research was based on the presently accepted definition of a deductible income-producing expense. A comprehensive study should be made concerning the appropriate criteria for distinguishing

between income-producing and personal expenses in general. This study should probably be based on the assumption that income-producing expenses should be deductible without limit by all payers of Federal income tax.

A comparison of the criteria used to identify individual income-producing expenses should be made with those criteria used to identify the income-producing expenses of other tax entities to ascertain consistency in treatment.

A renewed effort should be made to determine whether the continued discrimination against the non-reimbursed expenses of employees is still justified.

Another fruitful area for investigation would be the identification of aspects of tax law implementation, such as Form 1040A, which may lead to impacts not foreseen nor, possibly, desired by the formulators of the law.

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