The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity

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I. Introduction

It is common knowledge in the tax field that, if a taxpayer is reimbursed for an expenditure or loss, there is no difference in the federal income tax[2] consequences whether either the reimbursement is excluded from the taxpayer's gross income and

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[2] Unless stated otherwise, the author is discussing federal income tax considerations throughout the article.

no deduction is allowed for the expenditure or loss, or instead a full deduction[3] is allowed for the expenditure or loss and the reimbursement is included in the taxpayer's gross income.[4] To illustrate, consider the circumstances of an employer's reimbursement of an employee's business expense.

G expends $2,000 for travel expenses for a business trip that G made on behalf of her employer. In the same year, the employer reimburses G for the $2,000 expense. Apart from this expenditure and the reimbursement, G had taxable income of $35,000 that year. If G is allowed a full deduction for the $2,000 she spent and is required to include the reimbursement in her gross income, she will still have $35,000 in taxable income.[5] If, instead, the reimbursement is excluded from G's gross income and no deduction is allowed for her payment of the travel expenses, she will also have taxable income of $35,000. So, on its face, it would

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[3] In general, the deduction must be a nonitemized deduction to be fully deductible. An itemized deduction is subject to limitations so that all or part of the item may not be deductible. *See* Jeffrey H. Kahn, *Beyond the Little Dutch Boy: An Argument for Structural Change in Tax Deduction Classification*, 80 WASH. L. REV. 1, 8 (2005).

[4] *See*, *e.g.*, Lawrence Zelenak, *The Taxation of Tax Idemnity Payments: Recovery of Capital and The Contours of Gross Income*, 46 TAX L. REV. 381, 386-87 (1991) ("Not allowing a deduction for a loss, but treating a recovery of the loss in a later year as a return of capital, yields the same result – no net income – as allowing a deduction for the loss and taxing the recovery.").

[5] The $2,000 deduction for the expenditure will wash out the $2,000 income from the reimbursement, and so the taxpayer will be left with the $35,000 of taxable income.

appear that, for income tax purposes, the exclusion of the reimbursement is identical to allowing a deduction for the expenditure.[6] Indeed, it is because of that identity that the Internal Revenue Service (the Service) permits an employee simply to exclude a reimbursement for a deductible employee expense rather than to include the reimbursement and take a deduction for the expenditure.[7]

While there is no difference in tax consequences for an exclusion or deduction when the expenditure or loss is reimbursed, there is a significant difference if no deduction is allowed and the taxpayer is not fully reimbursed. There are numerous provisions in the Internal Revenue Code[8] (the Code) where a reimbursement of an expenditure or loss is excluded from income even though no deduction is allowable to the taxpayer for the portion of an

[6] Of course, the taxpayer's *gross income* will be greater if a deduction is chosen instead of an exclusion. But, the taxpayer's taxable income, which is the figure to which tax rates are applied, will be identical in either case. The size of a taxpayer's gross income is not irrelevant, but it is significant in only a limited number of circumstances. *See, e.g.*, I.R.C. § 543(b)(2). Also, if the reimbursement is received in a year after the expenditure, the tax consequence of a deduction for the latter or an exclusion of the former will depend upon the taxpayer's marginal tax bracket in each year. But if we ignore tax rate differentials, the deduction and the income items are equal and so net out to zero. Any difference in tax brackets is random and will sometimes favor the taxpayer and sometimes favor the government.

[7] Treas. Reg. § 1.162-17(b)(1). To qualify for exclusion, the employee must have been required to provide the employer with an accounting of the expenses and done so. *Id*.

[8] References herein to the Internal Revenue Code ("Code" or "I.R.C.") are to the Internal Revenue Code of 1986, as amended.

expenditure or loss that is not reimbursed. Since the exclusion and deduction approaches generally are identical for tax purposes, one might expect there to be parallel treatment of reimbursed and unreimbursed expenditures and losses. That is, one might expect a taxpayer who incurs an expenditure or loss to be treated the same by the tax law whether the item is reimbursed or not. Yet, there are many cases in which that is not so. The disparate treatment of reimbursed and unreimbursed taxpayers in those cases seems inequitable to some who believe that either deductions should be allowed for unreimbursed items or, if not, no exclusion should be allowed for the receipt of a reimbursement.[9] While not all commentators have urged that parallelism should be the rule, the question of whether to adopt parallel treatment in specific circumstances is frequently discussed in tax courses.[10]

If the tax law were both to exclude from income the receipt of a recovery or reimbursement for a loss or expenditure and also to allow an unrestricted deduction to a taxpayer who incurred the same type of loss or expenditure but who was not reimbursed, the author would describe that approach as "parallel" treatment. By

[9] *See, e.g.*, KLEIN, BANKMAN & SHAVIRO, FEDERAL INCOME TAXATION at pp. 123, 141 (13th ed. 2003); KLEIN, BANKMAN & SHAVIRO, TEACHER'S MANUAL – FEDERAL INCOME TAXATION 56 (13th ed. 2003); SCHMALBECK & ZELENAK, FEDERAL INCOME TAXATION 490 (2004) ("There is no obvious policy justification for this general disfavoring of deductions relative to exclusions."). *Contra*, Sophie Hudson CITE; and Zelenak, *supra* note 4, at 387.
[10] *Id*.

"parallel" treatment, the author means that similar, but not necessarily identical, situations are given the same tax treatment. If such situations are treated differently by the tax law, the author refers to that approach as "nonparallel" treatment. Nonparallel treatment results in disparate tax treatment of taxpayers who occupy similar positions, and that difference violates the principle of horizontal equity.[11] Nonparallel treatment is then one type of violation of the principle of horizontal equity. Consider the following illustration of nonparallel treatment by the Code.

Code section 104(a)(2) excludes from income compensatory damages received by a taxpayer on account of a physical injury.[12] In essence, as shown above, this exclusion is the same, for tax purposes, as requiring the taxpayer to include the damage payment in income but also providing a matching full deduction for the amount of the damages.[13] Thus, the Code

[11] The meaning of "horizontal equity" is explained at *infra* note 15.

[12] One exception to that exclusion is that a reimbursement of medical expenses that were previously deducted by the injured party are included in the latter's income. I.R.C. § 104(a).

[13] For the deduction to be an *exact* equivalent to an exclusion of the payment, the deduction would have to be allowable in the same year that the injured taxpayer received the payment from the tortfeasor, and that will not usually be the case. But, the principal significance of there being a different time sequence is that the marginal rates for the deduction and the income may differ because they fall in different tax years; and that difference in marginal rates can be ignored because it will have a random effect. *See supra* note 6. While the difference in time also raises a "time value" issue, the amount of time value money likely will be small.

provides the equivalent of a deduction for a loss based on a physical injury for which compensation is received. That suggests that, in order to have parallel treatment, taxpayers should be allowed a deduction for a loss resulting from an uncompensated physical injury.

No such deduction currently exists, and so the Code does not adopt parallel treatment in this circumstance. That is, the Code effectively provides a deduction for the taxpayer who happens to be compensated for a physical injury,[14] but provides no corresponding relief for a taxpayer who is not compensated. This lack of parallelism also results in a contravention of the principle of horizontal equity.[15] Assume A and B are injured in separate car

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[14] As noted, the exclusion from income is equivalent to allowing a deduction for the loss.

[15] Horizontal equity requires that persons in like net income positions pay the same amount of income tax. Douglas Kahn, *Accelerated Depreciation – Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1, 1 n.5 (1979). The goal of differently taxing individuals with disparate net income is referred to as vertical equity. WILLIAM ANDREWS, BASIC FEDERAL INCOME TAXATION 7-8 (5th ed. 1999). The goal of vertical equity generally includes a requirement that there be an "appropriate" difference in taxation. *See* Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607, 607 (1993). Many people disagree about what type of difference is appropriate.

Horizontal and vertical equity are two aspects of the same principle. *See id*. at 612 and Louis Kaplow, *A Note on Horizontal Equity*, 1 FLA. TAX REV. 191, 195 (1992). *Contra* Richard A. Musgrave, *Horizontal Equity: A Further Note*, 1 FLA. TAX REV. 354 (1993) (contending that horizontal equity has independent significance that is distinct from vertical equity). While, for accidents and sustain similar physical injuries that are valued at the same amount.[16] A's injuries were caused by a wealthy individual and A is compensated one million dollars for the damages caused by the accident. B is struck by an individual with limited means and is not able to recover any damages for his injuries. Assume that, other than the damage recovery, A and B have the same amount of taxable income.

Since A's injury was physical, A is able to exclude the one million dollars recovery from income under Code section 104(a)(2) and therefore is not taxed on that amount. A and B are treated as having equal income for tax purposes and will pay the same amount of income tax. By providing A an exclusion (the equivalent of allowing A a deduction for the injury) and denying a deduction to B, the tax system has violated horizontal equity since A and B are taxed the same amount even though A has received one million dollars more in that year than B.[17] Putting it differently, A effectively is allowed a deduction for his injury (offsetting the compensation received), while B is denied a

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convenience, this article refers only to horizontal equity, it applies equally to vertical equity.

[16] There are serious administrative difficulties in determining the value of an uncompensated physical injury, the presence of which is itself one of the reasons for not allowing a deduction for those losses.

[17] As noted, this assumes that A and B are equals for purposes of income comparisons. Also note that while nonparallel treatment will contravene the principle of horizontal equity, it is only one of the ways in which equity can be violated.

deduction for a virtually identical (but uncompensated) injury. As we shall see later in this article, while horizontal equity can be obtained by allowing a full deduction for such losses, that remedy contravenes other policies. Horizontal and vertical equity, as is true for parallelism, are merely one of the myriad goals of a good tax system and so must give way when weightier considerations point in a different direction.[18] The treatment of personal injury damages is discussed in Part IV B in this article.

The principal issue that this article addresses is whether parallelism should be a compelling goal of the tax system. That question arises in connection with numerous Code provisions, of which the treatment of physical damages is merely one example. The issue of whether to adopt parallelism obviously arises whenever the Code allows an exclusion for a reimbursement or recovery of a nondeductible item, but it also arises when there are limitations on the amount of deduction allowable that do not apply if the item is reimbursed or otherwise recovered.[19]

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[18] Some commentators contend that horizontal and vertical equity have no independent significance. *See* Kaplow, *supra* note 15 and McDaniel & Repetti, *supra* note 15.

[19] While the lack of parallelism exists just as much when the amount of deduction allowable is limited to less than the full amount of the expenditure or loss, the commentary objecting to nonparallel treatment has focused primarily on cases where no deduction is allowable. Nonparallelism can also arise in other circumstances. For example, Professors Dodge and Soled state that the nonrecognition granted by Code § 1031 for exchanges of certain like-kind property is contrary to tax policy because a sale of

It is the thesis of this article that there can be different considerations applicable to reimbursed expenditures and losses than apply to unreimbursed items. There may be compelling reasons for excluding a reimbursement from income that do not apply to the determination of whether to allow a deduction for unreimbursed items. And, there can be compelling reasons to deny a deduction for an unreimbursed item that do not apply to the treatment of reimbursements.[20] In other words, the apparent equivalence of the deduction and exclusion is deceptive because different policy considerations can apply to each. So, the crucial question in such cases is whether the goal of parallel treatment is sufficiently strong to outweigh the other considerations.

This analysis has led the author to conclude that parallel treatment not only is not compelled, it is not always desirable because of countervailing considerations that weigh more heavily. Each instance of nonparallel treatment must be examined to determine whether the contravention of parallelism is warranted.[21]

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such property immediately followed by a reinvestment is a taxable transaction. Joseph M. Dodge & Jay A. Soled, *Debunking the Basis Myth Under the Income Tax,* FSU College of Law Public Law Research Paper No. 149; FSU College of Law-Econ Research Paper No. 05-17 (available at ssrn.com/abstract=681578). The disparity of treatment noted by Professors Dodge and Soled is similar to the nonparallelism that is examined in this article, but does not fall within the definition of nonparallelism as used herein.

[20] *See* Zelenak, *supra* note 4, at 387.

[21] *See* Hudson, *supra* note 9, at __. If you determine that there is no merit to allowing an exclusion, then obviously that exclusion

This article will examine a number of provisions where the Code fails to provide parallel treatment for exclusions and deductions, including some in which no deduction is allowable for unreimbursed items and some where deductions are allowable but are subject to limitations. In each case, the relevant considerations will be examined.[22]

II. Horizontal Equity – The Musgrave/Kaplow Exchange

The principle of horizontal equity[23] typically will not resolve a question as to what tax treatment is proper for a specific circumstance because its application rests on a determination that parties are in equal positions; and the determination of equality rests on a choice of the contact points that are to be compared, about which reasonable people can disagree and often do so. For individual income tax purposes, equality refers to income, and thus income is the item on which individuals are to be compared; but

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should be repealed. However, the reason for that repeal would be to eliminate an unwarranted tax benefit rather than to obtain parallel treatment even though one consequence of the repeal would be the elimination of the nonparallelism that existed.

[22] This article addresses only a small number of instances of nonparallelism to illustrate the type of analysis that is required. There are numerous nonparallel provisions that are not discussed herein. For example, most of the employee fringe benefits that are excluded from an employee's income would not be deductible if paid by the employee or by a self-employed individual. Also, the deferral provided for employee retirement plans is more extensive than that provided for the self-employed. Each of those nonparallelisms should be examined in the same manner that is applied to the ones discussed herein.

[23] *See supra* note 15.

there is not universal agreement as to what items are to be taken into account to determine a person's income.[24]

Some commentators have concluded that horizontal equity is not a useful concept for determining whether a provision is good or bad because the horizontal equity concept rests on a choice of what the proper measurement of income should be.[25] Even if one concurred with that view, horizontal equity might be seen as a surrogate for "basic economic or justice decisions"[26] or as a signal that a problem exists. In other words, the fact that two persons who appear to be in similar income circumstances are taxed differently suggests that there may be a flaw somewhere in the tax system. By contrast, Professors McDaniel and Repetti rejected that view and concluded that the concept of horizontal equity not only does not aid in uncovering tax problems, but can actually conceal problems and lead policymakers astray because it places an obstacle between the policymaker and the actual problem.[27] The two professors contend that it is better to go directly to the underlying problem than to focus on the fact that a flaw in the tax system has caused some persons to be treated inequitably. In an important sense, while the author does not agree with many of the conclusions that

[24] *See e.g.*, Kahn, *supra* note 15.
[25] Kaplow, *supra* note 15 and McDaniel & Repetti, *supra* note 15. *Contra*, Musgrave *supra* note 15.
[26] McDaniel & Repetti, *supra* note 15, at 619.
[27] *Id*. at 622.

the two professors reached, the thesis and analysis of this article conforms to the policy that Professors McDaniel and Repetti advocate. The focus of this piece is on the difference in tax treatment of what appear to be very similar items rather than on the inequitable consequence of that treatment; and so the analysis set forth herein directly addresses the underlying problem.

Whatever may be the merits of the conflicting views on the role of horizontal equity, the parallelism concept, which is the focus of this article, is not subject to those objections. If two persons receive different tax treatment for the same type of expenditure, which is what the author refers to as nonparallel treatment, that disparate treatment raises serious issues of propriety whether or not those issues are classified as violations of horizontal equity. Regardless of the name given to this problem, it is a goal of the tax system to avoid its occurrence. The establishment of equal treatment of the same items not only serves the normative goal of "fairness;" it also provides the taxpaying public with confidence that they are being treated fairly; and that perception is as important as the reality. Fairness of treatment then is a normative value on which the parallelism concept is based. The word "parallelism" was chosen by the author to designate that goal because it is useful to have a common term to refer to it.

Professor Musgrave stated that almost everyone agrees with the principle that people in equal positions should be given equal treatment.[28] Professors Kaplow, McDaniel and Repetti, while disagreeing with Professor Musgrave's thesis, do not reject that statement. Rather, they question the utility of the concept of equality because of the difficulty in determining the proper items of comparison.[29] But, for purposes of an income tax, there is no dispute that income is the proper measure for comparisons; and when the items to be compared are indistinguishable, there is no need to refer to or resolve questions of what constitutes income.

Putting aside the question of the significance of the horizontal and vertical equity concepts, let us now focus on parallelism. Clearly, parallelism (i.e., equal treatment of similar items) must be taken into account in evaluating some provisions. To take it into account, however, does not mean that it must prevail over other legitimate goals of the tax system with which it is in conflict. As will be shown later in this article, the principle of

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[28] Musgrave, *supra* note 15, at 355.

[29] On the issue of whether "equality" has any meaning in the administrative of justice, Compare Peter Weston, *The Empty Idea of Equality*, 95 HARV. L. REV. 537 (1982) with Erwin Chemerinsky, *In Defense of Equality: A Reply to Professor Weston*, 81 MICH. L. REV. 575 (1983); Anthony D'Amato, *Comment: Is Equality a Totally Empty Idea*, 81 MICH. L. REV. 600 (1983); Kenneth L. Karst, *Why Equality Matters*, 17 GA. L. REV. 245 (1983); Kenneth W. Simons, *Equality As a Comparative Right*, 65 B.U.L. REV. 387 (1985). *See also* McDaniel & Repetti, *supra* note 15, at 612, n. 28.

parallelism is merely one factor to be considered and does not unilaterally provide a definitive answer as to whether a tax provision should be retained. However, merely because a principle is not sufficient by itself to determine a result does not mean that it is a nullity.

Parallelism is related to the horizontal equity principle in that nonparallel treatment will result in unequal treatment of some persons. While this article focuses on parallelism, all that is written herein also applies to the broader principle of horizontal equity. For those few who consider horizontal equality to be irrelevant, the application of this article's reasoning to that principle is of no consequence; but many persons do give weight to horizontal equity; and even those who do not frown on unequal treatment of the same item.

III. The Beguiling Attractiveness of Parallelism

It is easy to see why many find the concept of parallelism so attractive. Parallelism requires that taxpayers with the same loss or expenditure be treated the same. Lack of parallelism instinctively appears to be unfair. Indeed, there is a perverseness in the tax law's more favorable treatment of the reimbursed party than is provided to the one who is not compensated for his loss or expenditure since the latter is more deserving of sympathy. In the example above concerning the physical injuries suffered by A and

B, why does A receive what amounts to a deduction for his loss but B does not? Both A and B suffer the same type and dollar amount of loss but the tax system treats them differently by effectively allowing A a deduction but denying any deduction to B even though A clearly is the better off of the two.

As noted above, a failure to provide parallel treatment violates the frequently cited goal of horizontal equity. In our example, A and B will be taxed the same despite the large difference in their income. Horizontal equity can be achieved only if A and B are given parallel treatment, either by providing a deduction to both or by denying a deduction to both.

However, upon a more careful review, it becomes clear that parallelism is not always the optimum result. To illustrate, consider the case of a refunded income tax payment.[30] X pays a federal income tax of $23,000 for the year 2000. None of that payment is deductible.[31] In the year 2003, it is determined that X should have paid an income tax for 2000 of only $20,000. Accordingly, the Service returns $3,000 to X. X is not required to include that refund in income. The $3,000 refund is excluded from X's gross income because it is not an accession of wealth but instead a return

[30] For a similar example involving a refunded fine, see Zelenak, *supra* note 4, at 387. *See also* DODGE, FLEMING & GEIER, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY 246-50 (3rd ed. 2004).
[31] I.R.C. § 275(a).

of the money erroneously paid to the government. As noted, the effect of this exclusion is equivalent to allowing X a deduction for the $3,000 overpayment in the year that he received the refund.[32]

Also, for the year 2000, Y paid a federal income tax of $23,000. In the year 2005, it is discovered that Y should have paid an income tax of only $20,000. Because the statute of limitations for claiming a refund had expired, Y does not receive a refund for his $3,000 overpayment of the year 2000 tax. Y is not allowed a deduction for that unrefunded overpayment. But, X is allowed to exclude the $3,000 refund he received. It is unlikely that the lack of parallel treatment for X and Y will bother anyone even though the tax favored party, X, is better off economically than is the disfavored Y. It illustrates that each case must be judged on the considerations that apply.

While the visceral reaction to the nonparellelism in the above scenario is that it is appropriate, let us examine the treatment more closely to see why that is so. Why should Y be denied a deduction for the overpayment of his taxes? One answer is that a deduction is allowed for a loss only if there are compelling reasons for it. Losses incurred in a business or profit-seeking activity are

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[32] Another way to view this occurrence is to apply the transactional approach and treat the refund as a retroactive reduction of the payment that was previously made. This same approach can be applied to other circumstances. One example is the discussion of tax indemnity payments in Part IV C of this article.

generally deductible[33] Personal losses are not deductible unless they are the product of a theft or casualty.[34] Y's loss is not a business or profit-oriented loss and is not a casualty or theft loss.

A second and even more compelling reason for denying a deduction is that the qualification for such a deduction would turn on a finding that the tax for the year 2000 was overpaid. The point of having a statute of limitations is to prevent the necessity of examining the correctness of returns for which the statutory period has run. For the allowance of a deduction to have any meaning, the prior return for the year 2000 would have to be kept open, and that would frustrate the purpose of having a limitations period.

On the other hand, if the overpayment is refunded before the statute of limitations has run, there is no policy that would be frustrated by excluding the refund from the taxpayer's gross income. To the contrary, there is a policy reason to exclude the refund and that policy would be contravened if it were taxed. The refund is a return of the taxpayer's money and there are strong reasons not to tax someone on the recovery of his own money because the taxpayer has not realized a gain in any meaningful

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[33] I.R.C. § 165(c)(1), (2).
[34] I.R.C. § 165(c)(3). The rationale for allowing a deduction for casualty and theft losses is discussed in Jeffrey Kahn, *Personal Deductions—An 'Ideal' or Just Another 'Deal'?*, 2002 M.S.U.D.C.L. Law Review 1, 37-40. *See also infra* text accompanying notes 52-55.

sense.[35] The entire system of utilizing basis to determine gain[36] rests on the notion that one should not be taxed on the recovery of one's own money.

In sum, there are strong policy reasons to deny a deduction for an unrefunded overpayment of taxes; but, not only are there no policy reasons to tax a refund, there are policy considerations that require its exclusion. The critical question then is whether the goal of parallel treatment is important enough to warrant either granting a deduction for the unrefunded overpayment or, instead, taxing the refund. In other words, does the goal of parallel treatment outweigh either of the considerations discussed above? The resolution of that question turns on value judgments. The author believes that it is obvious that parallel treatment in this case is less important than the considerations whose satisfaction results in nonparallel treatment.

Let us examine one variation of the scenario set forth above. Assume that in Y's case, the Service voluntarily refunded the overpayment even though the statute of limitations on refund

[35] An exception to that policy occurs when the tax benefit rule applies to a recovery because the taxpayer had previously taken a deduction that provided him with a tax benefit. I.R.C. § 111. *See also* DOUGLAS A. KAHN & JEFFREY H. KAHN, FEDERAL INCOME TAX 183-84 (5th ed. 2005). The reason for this exception is to prevent the taxpayer from retaining a tax benefit for an expenditure which he subsequently recovered. The policy of preventing a taxpayer from retaining a deduction for which he is no longer entitled outweighs the policy of not taxing a return of capital.
[36] I.R.C. § 1001(a).

claims had run. Obviously, that is unrealistic,[37] but let us consider the tax consequences nevertheless.

In the author's view, the refund should not be taxed. Since the parties involved, who are at arms' length, have concluded that there was an overpayment, the Service should accept that conclusion. It does not require a reexamination of the year 2000 tax return because the parties have reached an agreement. The fact that one of the parties is the Service itself makes the case much stronger, but the result should be the same if the payor were a third party other than the Service.[38] The only question that might arise is whether the return of the funds is due to some reason other than a determination that there was an overpayment –i.e., was this a disguised compensation for some service or property? That issue does not arise when the payor is the Service itself.

The above example is meant to illustrate the type of analysis that is required when examining provisions that provide nonparallel treatment. The next section of the article will examine a number of specific Code provisions that produce nonparallel results for taxpayers. In each case, the author will analyze whether such treatment is justified after examining the policies underpinning the provisions.

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[37] *See* I.R.C. §§ 6402(a), 6514, 7405.

[38] For a more detailed discussion of this issue, see *infra* Part IV C of the article.

IV. Selected Nonparallel Tax Provisions

A. Damage to Property

If a taxpayer receives compensation for damaged property, the taxpayer includes the recovery in income only to the extent that it exceeds the basis of the property.[39] For purpose of this rule, it does not matter whether the payor is the person who damaged the property or an insurer.[40] As discussed in detail below, this exclusion is in sharp contrast to the severe restrictions on the amount of deduction allowable to a taxpayer who is not compensated for the loss when the property in question was not used for a business or profit-making purpose.

Prior to examining these conflicting treatments, it is useful to review the tax treatment where a taxpayer voluntarily sells personal use property. For example, X owns a personal use automobile with a basis of $5,000. X sells the automobile to Y for $8,000 cash, thereby realizing and recognizing a gain of $3,000.[41] X is required to include the $3,000 gain that he recognizes in his income. However, X pays no tax on the other $5,000 that X receives from Y. The tax system treats the $5,000 cash as a

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[39] See KAHN & KAHN, *supra* note 35, at 77-78; Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944). In appropriate circumstances, a taxpayer can defer all or part of the gain realized on an involuntary conversion by investing in similar property within a specified time period. I.R.C. § 1033.

[40] *See* KAHN & KAHN, *supra* note 35, at 77.

[41] I.R.C. § 1011.

nontaxable return of capital as measured by X's basis in the automobile.

What are the tax consequences to X if the automobile's fair market value is less than X's basis? Assume X receives only $3,000 cash from Y for his personal car. Now, X realizes and recognizes a $2,000 loss on the transaction. Again, X pays no tax on the return of capital, in this case the $3,000 cash. But what of the $2,000 basis that X failed to recover? The current tax system will not allow X any deduction for the $2,000 recognized loss since the automobile was personal use, rather than business or investment, property.[42]

What is the justification for not allowing X to deduct the loss that he recognized in an arm's length transaction with an unrelated person? Basically, the loss is seen as an element of the personal consumption of the asset. The decline in value of a personal use asset that arises because of wear and tear, exhaustion or obsolescence is not deductible because it is seen as a cost of the personal use or consumption of the asset. That treatment is consistent with the Haig-Simons definition of income.[43] Even if the

[42] I.R.C. § 165.

[43] The Haig-Simons definition of income is the most commonly cited definition for tax policy purposes. It defines income for a period as the sum of the increase in wealth accumulated by the person plus the market value of the person's personal consumption. *See* HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (Univ. of Chi. Press 1980) (1938). Thus, in the above example, the system

decline in the asset's value is due to market factors – as contrasted to wear and tear or exhaustion - that decline in value is seen as part of the cost of owning the asset and so is seen as part of the cost of personal consumption.

Professor Richard Epstein argued that such market decline is not an element of consumption and therefore should be deductible under our tax system.[44] In order to distinguish between personal consumption and market decline, Professor Epstein suggested that taxpayers should be required to reduce their basis in all depreciable assets (business, investment and personal use) under a cost recovery system. While no deduction would be allowable for the depreciation of personal use assets, a taxpayer would still reduce his basis in that property to reflect the personal consumption. Under such a system, the taxpayer would be allowed a deduction for any loss recognized on a sale of a personal use asset on the assumption that such loss was not due to consumption by the taxpayer and therefore should be deductible as a true loss of wealth under the Haig-Simons definition of income. As discussed by Professor Epstein, this proposed system would not always

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denies a deduction to X because it assumes that the decline in value of the automobile is due to the personal consumption or use by X. As consumption is one element of income under Haig-Simons, there should be no deduction for that use.

[44] Richard A. Epstein, *The Consumption and Loss of Personal Property Under the Internal Revenue Code*, 23 STAN. L. REV. 454, 461 (1970).

benefit taxpayers since it could cause recognition of gain, or a greater amount of gain, when the item is sold for more than the adjusted basis.[45]

One problem with Professor Epstein's proposal is that it imposes a significant administrative burden. It seems likely that individuals generally are not equipped to deal with the effects of depreciation on personal items even when it is deductible. For example, when an individual sells a residence for which he had been taking a deduction for the business use of part of that property, unless the individual consults a tax expert, it seems unlikely that, in reporting the tax consequences of the sale, the individual will reflect the resulting reduction of basis and the inapplicability of the Code section 121 exclusion of gain to the portion of the property that was so used. It is doubtful that individuals would do any better in reflecting a decline in basis for exclusively personal use property. It is just a bit too complex a system to expect average persons to understand it, much less to recall it when the time arrives. But, let us put aside administrative concerns and consider the merits of Professor Epstein's proposal. The treatment of gains and losses are examined separately.

First, let us examine the treatment of a gain under Professor Epstein's proposal. Assume the following facts in which the

[45] *Id*.

Epstein system has been adopted and Code section 121 has been repealed. G purchased a residence on leased land for $100,000. Assume that the nondeductible depreciation for the building is $5,000 per year. After four years, G sold the residence for $115,000, and G's adjusted basis in the residence, under Professor Epstein's system, is $80,000. So, G has a gain of $35,000. Of that gain, $15,000 is attributable to appreciation in value that took place while G held the property. But, what of the remaining $20,000 of gain? That is attributable to the reduction in basis caused by the nondeductible depreciation. Would it be appropriate to tax G on that $20,000 of gain?

The depreciation of G's basis reflects the fact that the amount expended by G to purchase the residence was used up (i.e., consumed) in the year for which the depreciation is charged.[46] If the tax law were to include in G's income the imputed income from his use of the residence, a deduction would then have to be allowed for the depreciation of the property (i.e., the amount that G paid for each year's "income" from the property would be allocated to that "income"). Since imputed income from the use of property is not taxed, no deduction is allowed for the portion of the purchase price that is allocable to each year's use. But, Professor Epstein's system would reduce the basis of the property to reflect

[46] *See* Kahn, *supra* note 15, at 13-14.

that a portion of the purchase price was consumed by G and so should not shelter the proceeds of the sale from being taxed. While there is merit to that analysis, there are reasons to oppose the application of that system to the recognition of gain.

The $20,000 of gain that G recognized is attributable to nondeductible depreciation. It is possible to view that gain as a "recapture" of the depreciation, and the current tax law generally does so when the depreciation is deductible.[47] Apart from the "recapture" rules, the reduction of basis for depreciable property can cause gain recognition on the disposition of the property. Should the recapture of a nondeductible item be included in income for the same reasons? In analogous circumstances, the tax benefit rule and Code section 111 do not tax the recovery of a *deducted* item when the deduction did not provide a tax benefit.[48] While the tax benefit rule does not apply to prevent the reduction of basis for depreciation that is an allowable deduction,[49] it would contravene the principles on which the tax benefit rests to tax the recovery of nondeductible depreciation. While Code section 111 applies only to the recovery of a *deduction* that did not create a tax

[47] *See* I.R.C. §§ 1245 and 1250. For a contrary view of that gain, see Kahn, *supra* note 15, at 46-53. In the case of real property that has been held for more than one year, only the accelerated portion of depreciation is subjected to the recapture rules.
[48] *See* Kahn & Kahn, *supra* note 35, at 183-84.
[49] I.R.C. § 1016(a)(2) reduces basis for the amount of depreciation deduction that was allowable to the taxpayer regardless of whether it gave rise to a tax benefit.

benefit, it would be perverse to tax the recovery of an item for which no deduction was allowable when the recover of a deducted item is not taxed if the deduction did not provide a tax benefit. The policies that underlie the tax benefit rule support the exclusion of gain generated by a reduction in basis for nondeductible depreciation. On balance, the author finds the reasons for not taxing such gain stronger than the reasons for doing so.

As to Professor Epstein's proposal to allow a loss deduction when the personal use asset is sold for less than its adjusted basis, he is correct that the recognized loss reflects a decline in market value, assuming that the depreciation schedule that is adopted accurately reflects the taxpayer's consumption. However, a decline in market value can be seen as a form of consumption in that it is part of the cost the taxpayer incurs to have and use the item. Later in this article, the author discusses the limitations imposed by Congress on the deduction allowable for a casualty or theft loss of personal use property.[50] In that discussion, the author notes that there is reason to distinguish casualty and theft losses from a decline in value due to market conditions; but even in the former circumstance, Congress allows only a very restricted amount of deduction.[51] There is much less reason to allow any deduction for a loss due to decline in market conditions, since that loss of value

[50] *See infra* the text accompanying notes 55 to 62.
[51] I.R.C. § 165(h).

is part of the cost of enjoying the use of the item. The author concludes that, while Professor Epstein's proposal is intriguing, it is not a desirable reform.

Returning to the hypothetical, what should be the tax consequence if, instead of a voluntary sale, X's personal automobile were damaged in an accident or stolen, and X received no compensation for the loss? One reasonable approach is to treat X's loss as part of X's consumption (i.e., personal use to the exclusion of others) of the automobile, and so deny any deduction for the loss – that is, "part of the cost of possessing an asset is the risk that it might be damaged or stolen."[52] That approach would provide X with the same tax treatment he would have received if he had voluntarily sold the automobile for a loss.[53]

Instead, a different, but also reasonable, approach would allow X to deduct a casualty or theft loss. A casualty or theft loss is different from a loss on a voluntary sale in that it is sudden, unexpected, and involuntarily forced on the taxpayer. The loss that a taxpayer incurs from an accident or theft does not look like a consumption of the item; to the contrary, it can be viewed as depriving the taxpayer of the use or consumption of the asset. For

[52] Kahn, *supra* note 34, at 37.

[53] The Joint Committee of Taxation clearly takes this view of casualty and theft losses as the deduction is listed in the tax expenditure budget. *See* Staff of Joint Comm. on Taxation, ___ Cong., Estimates of Federal Tax Expenditures for Fiscal Years ____ (Comm. Print __). *See also* Kahn, *supra* note 34, at 37.

example, consider the plight of an employee who collects his pay in cash and is promptly mugged by a thief who takes the cash. It is difficult to view the employee as having consumed the stolen cash in the ordinary sense of that term.[54]

Yet, a loss attributable to sudden and unexpected outside forces does bear some similarity to a loss attributable to outside forces that impacted negatively on the market value of an asset, and no deduction is allowed for losses attributable to market fluctuations. It would not be unreasonable to treat both of those losses the same and deny a deduction for both. But, it also would not be unreasonable to focus on the differences between market fluctuation losses and casualty losses and make some tax

[54] Without a casualty and theft deduction, the tax system would treat the employee whose cash was stolen the same as another employee with the same pay who is able to safely deposit his earnings into the bank and spend it on whatever he chooses. As noted by Professor Kaplow, the deduction will not put the two taxpayers on equal footing ex ante. In order to do so, the government would have to transfer funds to the employee in order to compensate for the theft. Louis Kaplow, *The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums*, 79 CAL. L. REV. 1485, 1492-93 (1991) ("If one wished to provide fully equal treatment to these precasualty equals, it would be necessary to make a transfer from the fortunate to the unfortunate that compensated completely for the latter's losses...To accomplish this transfer through the tax system, instead, a 100% credit rather than a deduction would be necessary, with taxes on each income class raised sufficiently to cover the costs.") However, contrary to Professor Kaplow's inference, the purpose of the deduction is not to make the unfortunate employee whole, but instead is meant to reflect the fact that because of the differences in their net wealth position, the two taxpayers should not be taxed the same. The deduction accomplishes that goal.

allowance for the latter. Congress determined that the consumption element of a casualty or theft loss was too significant to allow a full deduction for it, but the nature of that type of loss did not warrant ignoring it for tax purposes. So, Congress adopted a middle ground. It allowed a deduction for casualty and theft losses of personal use property, but it imposed severe limitations on the amount that can be deducted. Indeed, the limitations are so severe that most taxpayers who suffer such losses will not qualify for any deduction at all.

Code section 165(c)(3) allows a deduction for "losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft."[55] The taxpayer's loss is the lesser of the item's decline in value or the taxpayer's basis in the item.[56] These losses are sometimes referred to as "personal casualty losses."[57] The limitations on those deductions include:

1. No deduction is allowable to the extent that the taxpayer is reimbursed for the loss or has a reasonable prospect of being reimbursed.[58]

[55] A deduction for certain casualties was included in the first income tax act of 1913. Revenue Act of 1913, ch. 16, § IIB, 38 Stat. 167.
[56] Treas. Reg. § 1.165-7(b)(1).
[57] I.R.C, § 165(h)(3)(B).
[58] Treas. Reg. § 1.165-1(d)(2).

2. For each casualty or theft, no deduction is allowable for the first $100 of loss from each event.[59] The excess amount can be deducted without restrictions only to the extent that the taxpayer has personal casualty gains[60] that year. The excess of a taxpayer's personal casualty losses for a year (minus the $100 floor) over the taxpayer's personal casualty gains for that year is sometimes referred to as the "net personal casualty loss."[61] The restrictions on the deduction of a net personal casualty loss are described below.

3. A taxpayer's net personal casualty loss is deductible only to the extent that it exceeds 10 percent of the taxpayer's adjusted gross income.[62] In addition, the deductible net personal casualty loss (i.e., the amount in excess of 10 percent of the taxpayer's adjusted gross income) is characterized as an itemized deduction (but not as a miscellaneous itemized deduction) and is thereby subjected to the limitations placed on that category of deductions.

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[59] I.R.C. § 165(h)(1).

[60] "Personal casualty gains" are defined as any "recognized gain from any involuntary conversion of property….arising from fire, storm, shipwreck, or other casualty, or from theft." I.R.C. § 165(h)(3)(A).

[61] I.R.C. § 165(h)(2) uses the term "net casualty loss," but the author has chosen to use "net personal casualty loss" for greater clarity.

[62] I.R.C. § 165(h)(2)(A).

Returning to the situation that began this discussion in which a taxpayer receives compensation for damaged property, the same considerations that apply to a voluntary sale apply here as well. It is appropriate that Congress excludes from income the amount of the compensation that does not exceed the taxpayer's basis in the damaged property since that amount is properly characterized as a return of capital. This exclusion conforms to the well established principle that a return of one's capital is not taxable. The damages received are not income to the extent of the taxpayer's basis because the dollars received are treated as a replacement of the dollars the taxpayer is deemed to have invested in the property that were lost due to the casualty or theft. Since the cash reimbursement effectively constitutes a withdrawal by the taxpayer of that amount of his investment in the property, the taxpayer's basis is reduced accordingly.[63] That reduction does not constitute a deferral of income because the value of the property has correspondingly declined.

If the taxpayer collects insurance for the damaged or stolen property pursuant to an insurance contract, instead of receiving a payment from the wrongdoer, the insurance proceeds are not included in income to the extent of the taxpayer's basis unless the

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[63] *See* Rev. Rul. 71-161, 1971-1 C.B. 76.

taxpayer had previously taken a deduction for that loss.[64] Insurance proceeds are received pursuant to a contract for reimbursement of a loss, and are not income to the extent they merely replace the lost investment in the damaged or stolen property. Since the insurance proceeds provide the taxpayer with cash in hand in place of part or all of his investment in the property, the taxpayer's basis in the property is reduced accordingly.

It is true that there is a superficial equivalence between excluding the taxpayer's recovery and allowing a full deduction for the loss – a deduction that is not allowed to unreimbursed taxpayers who are subject to severe restrictions on deductibility.[65] However, as already noted, the policy of excluding returns of capital is entrenched in the tax system, and the conflicting principle of parallelism is not strong enough to outweigh that policy. Similarly, in the view of Congress, the reason for denying a full deduction to a casualty or theft loss because of its points of

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[64] In their casebook, Professors Dodge, Fleming and Geier note that the receipt of insurance proceeds raises some different considerations from those that apply to a tortfeasor's payments. Nevertheless, they agree that the amount that does not exceed basis should be excluded, and the author concurs. *See* DODGE, FLEMING & GEIER, supra note 30, at 251-53.

[65] A possible justification for imposing a limitation on the deduction of such losses is a concern over the genuineness and extent of the claimed loss. The author gives little credence to that suggestion because limitations are a poor vehicle for dealing with that concern – that is, the limitations are overinclusive in that they also apply to genuine losses and are underinclusive in that they allow a deduction for an improper claim to the extent that they exceed the statutory limits.

contact with personal consumption outweigh the principle of parallelism, and so the latter principle is not strong enough to justify allowing a full deduction. One might disagree with the weight given by Congress to those conflicting principles in choosing between them, but the author does not see how the Congressional choice can be seen to be unreasonable. To the contrary, although it is a difficult issue, the author deems the Congressional solution to be a valid compromise between two polar positions.[66]

B. Physical Injury

Returning now to the tax law's nonparallel treatment of taxpayers who suffer physical injuries that was noted earlier in this article, you will recall that compensatory damages received for a physical injury generally are excluded from the income of the injured party by Code section 104(a)(2), but no deduction is allowed an injured party for uncompensated personal injuries.[67] Is there a justification for that treatment?

Initially, one might inquire as to what reasons there might be for excluding compensatory damages for physical injuries from income. A person typically has no basis (i.e., no dollar investment)

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[66] The author finds the case for some deduction stronger for loss of property due to theft then for casualty losses. *See* Kahn, *supra* note 34, at 37-40.

[67] If the injured party incurred medical expenses, that amount can be deductible subject to restrictions. I.R.C. § 213.

in his bodily parts[68]; and so, if the same treatment that applies to compensation received for damage to or loss of personal use property were adopted, the entire amount of the compensation received for a physical injury would be included in income. Congress has never stated its reasons for providing an exclusion for physical injury damages even though that exclusion has been in the statutory tax law in one form or another since 1919[69] and has undergone Congressional modifications from time to time.[70] Commentators have speculated as to the likely reasons for that exclusion, and the author has adopted the following rationales that appear the most persuasive.[71]

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[68] Moreover, a taxpayer has the burden of establishing his basis and it is doubtful that many persons could satisfy that burden of proof in the case of human capital. In the unlikely event that a taxpayer could prove that he had some basis in his human capital, but could not show the exact amount, the taxpayer might be allowed a basis; but, even then, the amount likely would be minimal after making all assumptions in favor of the government – an application of the so-called "Cohan rule." *See* Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930); Estate of Goldstein v. Commissioner, 33 T.C. 1032, 1037-38 (1960).

[69] Revenue Act of 1918, Pub. L. 65-254, section 213(b)(6), 40 Stat. 1057, 1066 (1919). The early history of the statutory exclusion has been set forth in several articles. *See*, *e.g.*, Margaret Henning, *Recent Developments in the Tax Treatment of Personal Injury and Punitive Damage Recoveries*, 45 TAX LAW. 783, 784-95 (1992).

[70] In its most recent amendment in 1996, Congress limited the exclusion to compensatory damages for *physical* injuries and made clear that punitive damages are taxable. Small Business Protection Act of 1996, Pub. L. 104-188, section 1605, 110 Stat. 1755, 1838 (1996)

[71] The rationales adopted in this article was propounded in Douglas Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?*, 2 FLA. TAX REV. 327, 348-356 (1995).

The loss suffered from a physical injury is sometimes referred to as a loss of "human capital." The physical attribute that was lost (e.g., a damaged or severed limb, a loss of sight or hearing) is not something that the victim normally would sell in a commercial market. In the author's view, the tax law is aimed at commercial transactions; and its application to non-commercial transactions should be viewed with some skepticism. If income is received in a non-commercial transaction, the absence of a commercial source is not sufficient to preclude the tax law from reaching that income and taxing it. But, if there are other considerations favoring an exclusion, the non-commercial nature of the transaction can be an added factor weighing in favor of the exclusion. If a non-commercial personal attribute is voluntarily placed in the commercial market, the tax law should address it. But if a victim's non-commercial personal attribute is involuntarily converted to cash because of a tort, then that event can legitimately be viewed as outside of the commercial zone in which the tax law typically operates and that fact combined with other considerations that favor exclusion may be enough to justify it.

Obviously, while the view that there is a non-commercial zone in which the tax law does not always operate is a datum favoring an exclusion of compensatory damages for a physical injury, it disfavors allowing a deduction for an uncompensated personal injury. This disfavor of a deduction is a factor for not allowing one, but it is not conclusive in itself or even entitled to much weight. Deductions have been allowed in other areas for non-commercial events such as costs incurred because of an illness or losses from a casualty to or theft of personal use property.[72] When there are competing considerations that warrant taking a non-commercial event into account, the tax law appropriately has done so. As we shall see, there are other stronger reasons for denying the deduction. Let us first review the considerations supporting an exclusion.

The tax law reflects a policy of allowing relief for taxpayers whose property is involuntarily converted into cash. Code section 1033 permits a deferral (or roll-over) of all or part of the income realized on an involuntary conversion if property that is similar or related in service or use to the converted property is purchased within a specified period of time. In the case of a physical injury, however, it is not feasible for the victim to purchase a replacement for what was lost. So, the approach adopted for property in Code section 1033 is not available for physical injuries. The exclusion from income of physical injury damages could be the relief that Congress adopted given that the choice of a deferral through a roll-over is not readily available for

[72] I.R.C. §§ 213 and 165(c)(3).

this type of involuntary conversion. It is doubtful that concern over the involuntariness of the conversion of the victim's personal attribute is sufficient by itself to warrant granting an exclusion, but that consideration can be added to others so that their cumulative effect is sufficient to induce Congress to grant the exclusion.

Another consideration favoring exclusion is that taxing the victim on compensatory damages might cause a dramatic increase in the amount of damages awarded. Some of the added amount may not be collectible if it exceeds insurance coverage. In any event, Congress may not wish to have the tax laws be the engine that drives damage awards to dizzying heights. Note that the concern over higher damages award is not based on sympathy for tortfeasors. An increase in damage awards would cause an increase in insurance premiums that would be borne by much of the public. Moreover, the insurers would take into account the possibility that victims could be in high tax brackets, and that possibility would further impact the premiums charged.

Another consideration is the appearance to the public that a tax on such compensatory damages would have. It is difficult to determine the dollar value of a lost personal attribute since personal attributes are not bought and sold in the market place.[73]

[73] The difficulty of valuing the loss incurred from an uncompensated physical injury is one factor in not providing a deduction. While that difficulty is not a sufficient obstacle by itself

Since the damaged or lost attribute cannot be replaced, dollars are the only means of compensating the victim, and the proper dollar substitute cannot be established with precise and scientific accuracy. The dollar amount awarded is merely a rough estimate of what will substitute for the loss that the victim suffered. The compensation is intended to put the victim back in roughly the same position he occupied before the accident, or as close to that as dollars can accomplish. It would be unseemly, even rapacious, for the government to take a portion of the funds that were given to make the victim whole and thereby leave the victim uncompensated for part of his loss. The government does not wish to be seen as a cold-hearted creditor capitalizing on the misfortune of others.

As noted above, if damage awards were made taxable, the amount awarded might be increased to provide greater relief to the victim. However, it is unlikely that additional amounts will be awarded in all cases, and the amount of an additional award in a specific case will not necessarily be sufficient to offset the tax that the victim must pay.

But, is it not equally unseemly for the government to give no deduction to a victim who is not compensated for her injury? Since the victim has no dollar investment (i.e., basis) in the lost

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to warrant denying a deduction, it is one consideration to be added to others that weigh against allowing a deduction.

attributes, there typically is nothing to deduct.[74] The failure to provide a deduction for that loss does not have the rapacious character that depriving a victim of a significant portion of her compensation has.[75]

A majority of the public likely would react adversely to the government's seizing any of a victim's compensation even though little or no objection has been raised to the government's failure to provide victims with a tax deduction. This difference in attitude and perception is referred to as a "framing effect."[76] For example,

[74] There are instances in the Code where a taxpayer is allowed to take a deduction beyond his investment. For example, the Code allows a taxpayer to deduct the fair market value of some types of property donated to charity. On account of this rule, a taxpayer may deduct all or a portion of the unrealized appreciation of an asset. *See* Treas. Reg. § 1.170A-1(c) and I.R.C. § 170(e). However, this is clearly a subsidy provision intended to encourage charitable giving. *See* Kahn, *supra* note 34, at 46-47. Another subsidy provision is the percentage depletion rules that, in some cases, allow a taxpayer to take a deduction greater than his investment. *See* I.R.C. § 611. Even Congress expressed its concern that the percentage depletion provision does not contribute to the accurate measurement of a taxpayer's income by listing it as a tax preference item under the alternative minimum tax system. I.R.C. § 57(a)(1).

[75] Note that the Code does provide a deduction for any medical expenses that the injured taxpayer incurs. I.R.C. § 213.

[76] *See* Edward Zelinsky, *Do Tax Expenditures Create Framing Effects? Volunteer Firefighters, Property Tax Exemptions, and the Paradox of Tax Expenditure Analysis,* 24 VA. TAX REV. 797, 807-811 (2005). Professor Zelinsky cites other commentators who have noted the existence of a framing effect, and he cites experiments that have demonstrated that that effect does exist. *See also* Edward J. McCaffery & Jonathan Baron, *Framing and Taxation: Evaluation of Tax Policies Involving Household Composition*, 25 JOUR. OF ECON. PSYCHOLOGY 679 (2004) (available online at www.sciencedirect.com).

Professor Zelinsky has suggested that the "framing effect" may explain why the publication of so-called Tax Expenditure Budgets has had such little effect on the adoption or maintenance of tax expenditures.[77] It would seem that even if the view that exclusions are the equivalent of a deduction were publicized, the public would not regard them as interchangeable. This "framing effect" is a factor in the existence of many of the nonparallel treatments of the tax law.

The tax law does not exclude all compensatory damages for personal injuries. A victim of defamation or discrimination currently is taxed on the damages received for his injuries since he did not incur a physical injury. Why has there not been a hue and cry raised in opposition to the government's taking a significant portion of those damages? The author believes that the explanation is that the public's depth of sympathy for a victim who suffers a serious physical injury (such as a loss of a limb) is far greater than it is for the victim of non-physical injuries. That is not to say that there is no sympathy for victims who do not incur physical injuries, but only that the depth of sympathy is far less. Moreover, the compensatory damages received for non-physical injuries are generally regarded as substitutes for lost income as

[77] *Id.* at 823. For a critical view of the tax expenditure concept, see Kahn, *supra* note 34. *See also* Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical Review*, 54 TAX NOTES 1661 (1992).

contrasted to a damaged or lost body part. The taking of even a significant portion of those damages does not have the rapacious character that does the taking of damages for physical injuries.

The cumulative effect of the several considerations described above makes a compelling case for an exclusion.[78] None of those considerations apply to the granting of a deduction. But,

[78] One problem with allowing the exclusion of compensatory physical injury damages is that, in settling a dispute, the parties may characterize as compensatory damages payments made for an entirely different purpose (this general issue can arise around any exclusion). For example, part of the agreed-upon payment could represent punitive damages, which are included in income. I.R.C. § 104(a)(2). The wrong-doer generally has little at stake in whether the damages are labeled compensatory or punitive and thus may be willing to classify the entire amount as compensatory in exchange for a lower overall payment. *See* KAHN & KAHN, *supra* note 35, at 95-96. It may be difficult to show that the payments were made for another purpose, but if the amount paid is obviously excessive, the Service and the courts will re-characterize the payment and include some of it in income. *See* Robinson v. Commissioner, 70 F.3d 34 (5th Cir. 1997).

The possibility of false characterization of the nature of a payment is not limited to disguised punitive damage payments. The entire settlement, or a portion thereof, could be made because of the nuisance aspect of a claim, and so could be made to end a dispute and the bad publicity generated by it. It is especially difficult to identify that situation, but in rare cases, a court may make that determination and include part of the payment in income. *See* Amos v. Commissioner, T.C. Memo 2003-329. This case involved a photographer who was kicked during a basketball game by Dennis Rodman, a professional basketball player. The Tax Court had to determine whether the $200,000 settlement between Rodman and the taxpayer was taxable to Amos or whether it was excluded as compensation for a physical injury under Code § 104. This was an easy case for the Service to argue that a portion, if not all, of the compensation paid to Amos should be taxable since the settlement contract itself expressly provided that a portion of the proceeds was for the taxpayer's agreement to, among other things, not defame Rodman or disclose the existence of the agreement. *Id*.

parallelism is a principle that does favor allowing a deduction, and so what considerations negate that factor? To some extent, the non-commercial zone consideration disfavors the allowance of a deduction, but not strongly so. Similarly, the administrative difficulty in placing a dollar value on uncompensated personal losses militates against allowing a deduction, but not conclusively. The major reason that no deduction is allowed is that no dollar investment was lost and the goal of parallelism is not a strong enough consideration to promote a deduction when there are no other factors that favor it. This suggests that parallelism is not a major goal for those that write the tax laws and that it is not a sufficient policy in itself to affect tax decisions. Nonparallel treatment may offend those who like a more tidy system, but it has been given little weight by tax policy makers, and, in the view of the author, justifiably so. The framing effect is one reason that exclusions and deductions have not been regarded as identical so that different tax treatment has not offended many. Consider the example of the refund of the overpayment of an income tax that was discussed earlier in this article.[79] The lack of parallel treatment in that case is unlikely to offend more than a small minority of persons. That suggests that while parallel treatment has an appeal

[79] *See supra* Section III of the article.

in the abstract, it has little influence on the evaluation of specific provisions.

C. Clark v. Commissioner

The third example of nonparallel treatment arises from a tax case, rather than a tax provision. In fact, this is one area where, if the Service were given a choice, it would likely opt to provide for parallel treatment by denying an exclusion for the reimbursed taxpayer.

Clark v. Commissioner[80], a 1939 Board of Tax Appeals[81] case, involved a couple that, based on the advice of tax counsel, filed a joint return for their 1932 tax year. In 1934, the Clarks were audited and the Service contended that, based on errors in the return, the Clarks owed over $30,000 more in federal income taxes. After discovering the error, the Clarks also learned that if they had filed separate returns, rather than filing jointly, they would have owed almost $20,000 less in income taxes; and they were not permitted to change their filing status.

The tax counsel who prepared the Clarks' return, admitting the error, transferred to the Clarks an amount equal to the overpayment. The Service contended that this payment was

[80] 40 B.T.A. 333 (1939), *acq*. 1957-1 C.B. 4. The Service initially nonacquiesced in *Clark* (1939-2 C.B. 45) but, eighteen years later, changed to an acquiesce.
[81] The current Tax Court was originally known as the United States Board of Tax Appeals.

income to the Clarks. The Clarks argued that the "payment constituted compensation for damages or loss caused by the error of tax counsel, and that [they] therefore realized no income from its receipt in 1934."[82]

One interesting aspect of this case is that, whichever way the court ruled, the policy would fail in some manner the principle of horizontal equity. As set out in a hypothetical by Professors Klein, Bankman and Shaviro in their casebook[83], assume we have three taxpayers. One individual, A, hires a good tax preparer and therefore does not overpay his income taxes. Another individual, B, hires a bad preparer, and overpays by $10,000. Finally, a third individual, C, hires a bad preparer and also overpays by $10,000. However, five years later, C noticed the error and, like the *Clark* case, the preparer agreed to reimburse C for the overpayment. If the $10,000 payment is excluded from C's income, then C will be treated similarly to A, i.e., it would be as if C had received good advice from the beginning. However, such treatment would fail horizontal equity when we compare B and C. By excluding the $10,000 payment, C and B are taxed equally even though C received $10,000 more income.

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[82] *Clark*, 40 B.T.A. 333, 335. The court held for the taxpayers. For a thorough analysis of the *Clark* case concluding that it was correctly decided by the Board of Tax Appeals, see Zelenak, *supra* note 4.

[83] KLEIN, BANKMAN & SHAVIRO, *supra* note 9, at 123.

If we tax the payment to C, horizontal equity is met when we compare B and C, but not when we compare C and A. Either C must be overtaxed as compared to A or undertaxed as compared to B. While discussing this hypothetical in their casebook, Professors Klein, Bankman and Shaviro note: "We cannot avoid committing one or the other of these two 'errors' (of the overall tax system, not the decision-maker) given that [A] and [B] are not being taxed correctly relative to each other."[84] This scenario illustrates why horizontal equity often is not a useful tool for policy analysis. The resolution of the question of equity requires a determination of the party to whom the comparison is to be made. In the above case, there is no reason to favor either A or B as the proper object of comparison and yet equality cannot be obtained with both unless a deduction were allowable for a tax overpayment. There are good reasons not to allow a deduction for tax overpayments.[85]

The court in *Clark* held for the taxpayer,[86] thereby committing the "error" that Clark was undertaxed as compared to others who overpaid but were not able to recover anything from their preparer. This decision created nonparallel treatment for these

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[84] *Id*. *See also* Zelenak, *supra* note 4, at 388-89.
[85] *See supra* text accompanying notes 30 and 31 (hypothetical involving taxpayer Y).
[86] The court's decision in *Clark* seems to rely on cases that were later repudiated but the result in the case could be justified on a different ground which may have lead to the Service's eventual acquiescence.

types of expenditures. That is, the court provided an exclusion if the taxpayer is reimbursed for their overpayment, but no deduction is allowable if the taxpayer is not reimbursed.

The Service, although it did acquiesce to the *Clark* decision,[87] subsequently attempted to narrow the scope of the case as much as possible. For example, in 1992, the Service published Private Letter Ruling (PLR) 9211015. The ruling described a fact pattern where, because of a CPA firm's negligence, an investment fund failed to qualify as a regulated investment company (RIC) for certain tax years. This failure lead to the investment fund's paying higher federal income taxes as well as other penalties and interest. The fund was reimbursed by the CPA's insurer for those expenses. The issue was whether this reimbursement was income to the investment fund.

The Service described the issue as whether the reimbursement was a recovery of lost profits and therefore taxable to the fund or a replacement of the fund's capital which would not be includible in income. As noted by the Service "[p]ayment by the one causing a loss that does no more than restore a taxpayer to the position he or she was in before the loss was incurred is not

[87] 1957-1 C.B. 4. *See also* Rev. Rul. 57-47, 1957-1 C.B. 45 (excluding a reimbursement of tax overpayment caused by a tax preparer's error).

includible in gross income because there is no economic gain."[88] The Service then concluded that this reimbursement should be classified as a return of capital and ruled that the investment fund would not have to include the amount in income.[89]

However, in 1997, the Service reversed its position. In a new ruling, the Service specifically revoked its earlier ruling in PLR 9211015.[90] Attempting to distinguish *Clark*, the Service stated:

> The indemnity payment that Fund received as a reimbursement for the additional federal income taxes and associated penalties and interest it incurred are distinguishable from the indemnity payments in Clark…the preparers' error in filing returns or claiming refunds caused the taxpayer to pay more than their minimum proper federal income tax liabilities based on the underlying transactions for the year in question. In this case, however, the CPA firm's error altered the underlying entity status of Fund. Fund incurred the minimum proper federal income liability as a Subchapter C corporation during the period it did not qualify as a RIC. The CPA firm's reimbursement… was not made to compensate Fund for a tax liability in excess of Fund's proper federal tax liability for the tax years relating to the firm's negligence. Instead, the reimbursement was a payment of Fund's proper tax liability.[91]

[88] PLR 9211015.
[89] *Id*.
[90] PLR 9743035. *See also* PLR 9833007.
[91] PLR 9743035. *See* Old Colony Trust Company v. Commissioner, 279 US 716 (1929) and Treas. Reg. § 1.61-14 for the position that a person's payment of a taxpayer's tax liability is income to the taxpayer.

This reasoning is weak, at best. The Clarks also paid the correct amount of liability according to their filing status; although it is true that the accountant's error in *Clark* did not change the underlying structure of the Clark family. In the PLR, two adverse parties determined that the accountant's mistake caused the taxpayer to overpay their federal tax liability. While qualifying as a RIC may have required the taxpayer to incur expenses that it did not pay on account of the mistake, that fact merely should have reduced the size of the taxpayer's damage and accordingly reduced the amount of the accountant's liability. If the parties neglected to take any such additional expenses into account in setting the amount to be paid, it nevertheless should not affect the tax treatment of the payment by the CPA firm's insurer because the amount of damages was set by parties at arm's length and should be respected by the Service.

In the author's opinion, the *Clark* reasoning should also apply to the PLR facts. The accountant is simply repaying the taxpayer for lost capital based on the accountant's error.[92] This should be treated similarly to payments made for causing damage to property, i.e., unless and until the accountant's payment exceeds the taxpayer's "basis" in his tax payment (i.e., the amount that the

[92] To the extent that the payment represented interest on the accountant's obligation or was a return of a previously deducted item (such as the accountant's fee) it would be taxable. Rev. Rul. 57-47, 1957-1 C.B. 23.

taxpayer paid), the payment by the accountant should be treated similarly to a return of capital and thus nontaxable. That is not to say that the taxpayer actually has a “basis”. One can have a basis only in tangible or intangible property. But, basis is comprised of dollars that have been invested; and so the replacement of dollars is equivalent to a replacement of basis, both of which represent a return of capital.

Professor Zelenak maintains, in his article on *Clark,*[93] that a reimbursement of income tax liability can be excluded only to the extent that the tax payment can be classified as a “loss.” He maintains that otherwise the repayment is taxable under the *Old Colony*[94] doctrine. The author does not agree that the taxpayer’s tax payment has to be classified as a loss in order for the reimbursement to be excluded. In the author’s view, it is sufficient that the party making the reimbursement (the accountant[95] in the letter ruling) made an error that caused the taxpayer to pay out dollars that he would not have had to pay if the accountant had not made an error. It is sufficient that there is a nexus between the third party’s error and the amount of payment that was reimbursed. It should not matter that the taxpayer actually owed the tax he paid; the significant fact is that the third party’s error caused the

[93] Zelenak, *supra* note 4.
[94] Old Colony Trust Company v. Commissioner, 279 U.S. 716.
[95] While the reimbursement was made by the accountant’s insurer, it was made on behalf of the accountant.

taxpayer to have a greater tax liability than he would have incurred if the third party had not made the error.

Consider this example: B owes a fine to the state of X that is due to be paid on a specified date. A fine is not a deductible expense.[96] B's attorney, T, holds a sizeable amount of B's funds in a fiduciary account. B requests T to use some of those funds to pay the fine, and T undertakes to make a timely payment to the state. T fails to make the payment on time, and so B is fined an additional $20,000 for not paying on time. The additional fine is not deductible.[97] B properly owes the additional fine to the state. Because the additional fine was attributable to T's error, T reimburses B for the additional $20,000 fine that B incurred. The fact that B was liable for the additional fine should not cause the reimbursement to be income to B. The reimbursement is replacing dollars that B would not have had to pay to the state if T had done his job properly.

PLR 9728052 presents a variation on this theme. In that ruling, the taxpayer had agreed upon a settlement with his former wife to pay her an annual amount for a specified number of years. The settlement agreement provided that if the wife died before the payment period expired, the taxpayer would continue to make payments to her estate. This provision disqualified the payments

[96] I.R.C. § 162(f), and Treas. Reg. § 1.212-1(p).
[97] *Id*.

made to the wife for alimony treatment and made them nondeductible.[98] The taxpayer agreed to this settlement on the erroneous advice of his attorney that the payments to the wife would be deductible. The taxpayer sought indemnification from the attorney's malpractice insurer for the additional taxes he incurred, and will incur in the future, because of the disallowance of the deduction that he had anticipated receiving. The Service ruled that since the taxpayer properly owes the taxes in question, any indemnification he receives from the attorney's insurer will be included in his income.

Presumably, the taxpayer would not have executed an agreement providing for post mortem benefits to the wife if he had been correctly advised as to the tax consequences of that provision. However, the wife likely would have rejected an agreement without that provision unless the amount of the annual payments was increased. It is difficult, if not impossible, to determine just how much the attorney's error cost the taxpayer since one can only speculate as to what the terms of the final settlement would have been. In determining the amount of the taxpayer's damages, any additional amounts that the taxpayer would have had to pay should be offset against the additional tax liability he incurred. In the view of the author, however, whatever figure the taxpayer and the

[98] I.R.C. § 71(b)(1)(D).

attorney's insurer agree upon, regardless of whether it reflects offsetting costs that the taxpayer might have incurred, should be accepted by the Service because it will be the product of an arms-length agreement. There is no risk of collusion in this circumstance, and the bona fides of such an agreement are beyond question, since the insurer has no extrinsic motives (such as silencing the bad publicity that a dispute would bring to the attorney) for settling the issue.[99]

In his article about the *Clark* issue, Professor Zelenak also discusses the question of how a tax reimbursement payment that is made pursuant to a tax indemnity agreement should be treated, and concludes that such payments should be taxed.[100] While accepting much of what Professor Zelenak said in that article, the author comes to a different conclusion. A tax indemnity agreement is a guarantee of the tax treatment that a taxpayer will have in a transaction and an agreement to indemnify the taxpayer for any additional taxes incurred if the actual tax treatment is different from the one that was promised. A tax indemnity agreement can be granted in several distinct circumstances. It can be given by a seller to induce a buyer or investor to enter into a transaction. Or, a third party, such as a broker or promoter, could provide a prospective

[99] Even if the payment were made directly by the attorney, the possibility of collusion or ulterior motive is not significant enough to change the tax result.
[100] Zelenak, *supra* note 4, at 397.

buyer with a tax indemnity agreement for the same purpose. Indeed, an insurance company that has no connection to the investment could insure that the taxpayer will receive a specified tax treatment.[101] Since Professor Zelenak focuses on a seller's indemnification agreement, the author will discuss that situation first.

The Service currently treats tax indemnification payments that a taxpayer receives as income to the taxpayer, and Professor Zelenak concluded that the Service is correct in doing so.[102] He argues that the additional tax that the taxpayer paid cannot be characterized as a loss because that would permit "private parties to manufacture a loss out of nothing with no regard to the actual nature of the asset in question, through the simple means of misrepresentation by the seller."[103] He points out that to exclude the tax reimbursement from income is to permit the parties to provide the investor with a tax-free return on his investment, thereby providing a benefit to the seller or the investor or both that they could not otherwise obtain. Before examining that contention, let us focus on the nature of a tax reimbursement payment.

As previously discussed, when a taxpayer receives a reimbursement from the person who caused the taxpayer to pay a

[101] *See infra* note 114.
[102] Zelenak, supra note 4, at 397.
[103] *Id*. at 398.

higher tax through that person's error, the payment should be excluded from the taxpayer's income as a damage payment to replace lost dollars. The situation is analogous to the receipt of damages for injury to property where the amount received is excluded from income to the extent it does not exceed the taxpayer's basis, albeit the taxpayer's basis is reduced by the reimbursement if the taxpayer still has the asset.[104] But, a payment received pursuant to a tax indemnification agreement is on quite a different footing. Such a payment does not constitute damages paid for causing an injury. Instead, the payment is made under a contractual arrangement. How should that contractually mandated payment be treated for tax purposes? Let us first consider the case of a seller-provided indemnification, and then consider a third party indemnification.

The payment that the taxpayer receives from the seller is made pursuant to a guarantee of the seller that was designed to induce the taxpayer to make the investment. In effect, the seller became an insurer, and the payment to the taxpayer can be seen as insurance proceeds. If a taxpayer who owned automobile insurance has his personal use automobile destroyed in a storm, and if the taxpayer does not qualify for a casualty deduction because of the insurance coverage, the insurance proceeds that are paid to the

[104] There is no meaningful reduction of the taxpayer's basis if the asset in question was destroyed or was stolen and never recovered.

taxpayer are excluded from his income to the extent of his basis in the automobile.[105] The "insurance" proceeds received under a tax indemnity contract should be treated similarly - i.e., they should be excluded from income to the extent they do not exceed the dollars that were "lost" by the taxpayer because of the additional tax payment.

Alternatively, the tax indemnity agreement can be viewed as an agreement by the seller to reduce the purchase price in the event that the tax treatment of the transaction is different from what the parties anticipated. In the case of a seller-provided tax indemnity, the reduction of purchase price characterization seems to be a better view than the insurance analogy since that is the true consequence of the seller's refunding part of the purchase price to the purchaser. The additional tax that the purchaser had to pay is merely the measuring standard for the amount of purchase price to be refunded.

Regardless of which characterization is chosen, if the indemnification payment is excluded from the taxpayer's income, it will reduce the cost of the transaction to him, which will mean a reduction of his basis or of his expenses.

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[105] *See supra* note 39 and the text thereto. The payments will reduce the taxpayer's basis in the automobile; but since the car was destroyed, the reduction of the taxpayer's basis has no significance.

Consider this analogous situation. K wishes to purchase a house as his personal residence, but deems the asking price to be too high because he will have to make extensive repairs if he purchases the house. The seller induces K to purchase the house by guaranteeing that the repairs will not exceed $20,000. K purchases the house, and makes the repairs which cost $35,000. The seller then pays K $15,000 pursuant to the guarantee. K does not have income because of the receipt of that payment. The payment is a reduction of the cost of the house to K, and so reduces his basis.[106]

In his article,[107] contrary to the analysis above, Professor Zelenak makes a strong case for taxing tax indemnification payments that are made by a seller. He illustrated the objectionable feature of an exclusion from income by the following example.[108]

X wishes to sell its bond[109] to F. The bond will pay $100 on maturity. F will buy X's bond for $100 only if it will provide F with a 10% return after taxes. All of F's income will be taxed at a flat 20% rate.[110] If the interest payable on the bond is taxable, X could meet F's demand by providing an annual payment of $12.50 on the bond, which would provide F with an after-tax return of

[106] The reduction of basis may not be of any consequence because of the exclusion from income provided by Code § 121 for a specified amount of gain on the sale of a principal residence.
[107] Zelenak, *supra* note 4.
[108] *Id.* at 398-99.
[109] The issuing of a bond is a form of borrowing money.
[110] An unrealistic assumption that is adopted for the sake of simplicity.

$10.[111] X would thereby pay 12.5% on the bond, and F would net a 10% return after taxes.

Instead, X issues F a bond for $100 that pays F only $10 per year, but X guarantees that the interest payments will not be included in F's income. If the interest is taxed by the Service, X will reimburse F for any tax he incurs. The interest F received is taxed, and F pays a tax of $2 per year thereon. Pursuant to the indemnification agreement, X pays F $2 per year. If the $2 indemnification payment that F receives is excluded from his income, F will have his desired 10% after-tax return; but Professor Zelenak states that the cost to X will be only $12 per year ($10 interest plus the $2 indemnification). So, instead of X's paying 12.5% on the bond, X will pay only 12%.

If instead, the $2 indemnification payment to F were taxable, X would have to pay F $2.50 to provide F with $2 after taxes. In that case, X would pay the same 12.5% that X would have paid if X had acknowledged from the beginning that the interest on the bond would be taxable.

In fact, however, even if the tax indemnification payments are excluded from income, X may have to pay more than 12% on the bond. If excluded from income, each $2 indemnification

[111] Eighty percent of $12.50 is $10.

payment made to F will reduce F's basis in the bond.[112] When the bond matures (unless F dies before then so that the basis of the bond will be stepped up under Code section 1014), F will recognize gain on the difference between the $100 proceeds that F will receive and F's adjusted basis in the bond. Pursuant to the indemnification agreement, X will then pay F the amount of tax that F incurred on that gain. That additional payment by X will increase the total amount it pays on the bond to constitute an annualized rate of something more than 12% of the original $100 purchase price. This potential additional cost to X does not eliminate the tax advantages of the arrangement, but it does reduce them.

Note that the tax benefit created by the above-described arrangement need not be captured exclusively by the seller. The benefit could be divided between the parties by the seller's paying a slightly higher interest rate on the bond. That possibility increases the risk that parties will enter into a collusive arrangement to take advantage of this tax reduction.

What does this problem tell us about the question of whether tax indemnification payments by sellers should be excluded from income? Not all seller indemnification agreements

[112] Under a transactional analysis, the payment is a reduction of the price that F paid for the bond and thus reduces his basis. *See supra* text accompanying note 106.

are vulnerable to this abuse. Does the fact that some agreements will provide a tax benefit, and that some parties will make a tax indemnification arrangement in bad faith to obtain a tax benefit, mean that all seller-made tax indemnity payments should be taxed?

The answer to that question is in doubt. The problem, so ably described by Professor Zelenak, shows that there is a strong policy reason to tax such indemnification payments. While it might be possible to distinguish potentially abusive indemnification arrangements from those that are not, that would impose a great burden on the Service to identify the different situations. The better rule is to apply the same approach to all seller-made tax indemnification agreements - either tax the payments or exclude them.

On the other hand, the problem described by Professor Zelenak, while a significant consideration, is only one of several factors to be considered. There also exist strong reasons not to tax the indemnification payments and to treat them as a reduction of the purchaser's basis - i.e., the transactional view that the arrangement constitutes a reduction of the purchase price, and the insurance analogy. Perhaps, the issue should be resolved on the basis of empirical studies to determine whether the potential abuse of the arrangement actually occurs to a significant extent.[113]

Note that the possibility of abusive manipulation by parties to obtain tax benefits is mitigated by the vulnerability of such arrangements to be struck down as shams. The difficulty that the Service would encounter in identifying and prosecuting those arrangements that are shams renders that remedy of less practical value. But, if the occurrences of sham transactions are rare, the remedy of disregarding them may be adequate.

Let us now turn to consider a tax indemnity provision that is made by a third party (a broker for example) rather than by a seller.[114] There seems to be no potential for abuse in that case, and so the indemnification payments should be excluded from income.

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[113] It would be difficult to determine the extent to which sham transactions are taking place because of the secretive nature of such transactions. But, at the present time, it is not possible to obtain any empirical information since the Service's position that tax indemnity payments are taxable has not been challenged.

[114] There are two types of parties who may be willing to make an indemnification agreement. First, there is a promoter who has an interest in seeing that the deal is accomplished. Second, there is a third-party insurance provider who may examine a proposed deal and provide tax indemnity insurance (sometimes referred to as transaction tax risk insurance). *See* Kylie D. Logue, *The Problem of Tax Law Uncertainty and the Role of Tax Insurance*, CITE. *See also* Kenneth A. Geary, *New Opportunities for Tax Lawyers: Insuring Tax Transactions*, 104 TAX NOTES 26 (2004). Professor Logue briefly mentioned the tax treatment issue (both in terms of whether the premiums are deductible and whether the proceeds are excluded). Logue at n.86. Professor Logue did not resolve the question of whether the receipt of insurance proceeds in such cases will be income to the insured, and he characterized that as a difficult issue. *Id*.

In most cases, the payments will reduce the taxpayer's basis or reduce expenses the taxpayer incurred.

Return to the hypothetical above where a buyer was induced to purchase a residence by a guarantee that necessary repairs would not exceed $20,000. In the hypothetical, the guarantee was made by the seller. Instead, change the facts so that the guarantee was made by the real estate agent with whom the house was listed. The repairs actually cost $35,000, and so the real estate agent pays the buyer $15,000 pursuant to the indemnification agreement. In the author's view, the payment will not be included in the buyer's income, but it will reduce his basis in the house.

Consider the Tax Court's decision in *Freedom Newspapers, Inc. v. Commissioner.*[115] In that case, the taxpayer was induced by a broker to purchase four businesses even though the taxpayer did not wish to own one of them. The broker convinced the taxpayer to make the purchase by promising to sell the unwanted business or to pay the taxpayer $100,000 if the broker were unable to make the sale. The broker was unable to make the sale, and so paid $100,000 to the taxpayer per its guarantee. The court treated the $100,000 payment as a reduction of the purchase price paid by the taxpayer for the business, and so excluded it from income. While it

[115] 36 T.C.M. 1755 (1977).

is unusual for a payment by a third party to be treated as a reduction of the purchase price paid to another, the broker was so connected to the purchase of the business that the court deemed his payment to the taxpayer as part of the overall purchase transaction. This approach could well apply to the scenario concerning K's purchase of a residence described above so that K's basis in the house would be reduced by the $15,000 payment he received.

Returning to the tax indemnity payment, it seems that the payment might reduce the taxpayer's basis in an investment that was the subject of the arrangement or it might reduce costs that the taxpayer incurred in the program, but it would not be taxable to the taxpayer when received. In short, it should be treated the same as an insurance payment.[116] The question is whether the payment should be treated as a return of part of the taxes the taxpayer paid, which would have no effect on the taxpayer's basis in any property, or whether it should be treated as a reduction of the amount of the taxpayer's investment or costs incurred in the transaction that he was induced to undertake? The purpose of the broker's indemnity agreement was to induce the taxpayer to engage in a transaction, and so the payment can be seen as a reduction of the costs the taxpayer incurred in that transaction.

[116] A payment by an insurer pursuant to an insurance contract should be given the same tax treatment – i.e., not income to the insured.

That approach would conform to the Tax Court's decision in the *Freedom Newspapers* case described above.[117]

An alternative characterization of the payment is to treat it as a reduction of any fee the payor may have received from the taxpayer in the transaction. If so, the payment would be income to the taxpayer only to the extent that the taxpayer had previously deducted the fee (that is, income under the tax benefit rule).[118] This characterization would be proper if the guarantee made by the payor was a sham, and the parties knew from the outset that the payment would be made.[119] If the guarantee was bona fide (i.e., not a sham), it is a close question which of the two possible characterizations is better. In the author's view, the better characterization is to treat the guarantee as an insurance arrangement, especially if it were possible for the amount subject to the guarantee to exceed the payor's fee.[120]

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[117] 36 T.C.M. 1755. *Cf.* Johnson v. Commissioner, 66 T.C. 896 (1976), *aff'd per curiam* by a divided court, 574 F. 2d 189 (1978).
[118] I.R.C. § 111.
[119] This is merely an application of the sham transaction doctrine.
[120] Preferring the characterization of the indemnification payment as an insurance payment rather than as a reduction of the broker's fee may appear to be inconsistent with the author's preference for the characterization of a seller's indemnification as a reduction of the purchase price rather than as insurance. However, the author believes that the different circumstances of those two situations warrant different characterizations.

In any event, if the broker's fee is not deductible, it may well be treated as part of the purchaser's cost of the property. If so, a characterization of the indemnification payment as a reduction of

If the payment is treated as insurance proceeds, it would seem to be a deductible expense of the payor, provided that the guarantee met the ordinary and necessary standard of business deductions.[121] Would it be erroneous to allow the payor a deduction and yet have no corresponding income to the taxpayer? In the author's view, that is not an error. An insurance company that made a payment on a damage claim can deduct its payment even though it is not income to the person who received the payment.

In conclusion, reimbursements should be excluded from income when they are paid for additional taxes that were incurred because of the payor's error regardless of whether the error was made in preparing the tax return. If the reimbursement is made pursuant to a tax indemnity agreement of a third party, it should be excluded from income; but the reimbursement may reduce a taxpayer's costs in acquiring assets or engaging in a transaction. If the reimbursement is made pursuant to a tax indemnity agreement of a seller, it is a difficult question as to whether it should be taxed because of the problems that Professor Zelenak described. In the author's view, unless empirical evidence demonstrates that the

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the broker's fee will reduce the purchaser's basis, and thus will have the same tax effect as would an insurance payment.

[121] I.R.C. § 162(a).

problem that Professor Zelenak describes is extensive, the indemnification payments should be excluded.

D. Employee Business Expenses

Federal income tax deductions can be divided into several categories. First, they can be either itemized or nonitemized deductions. Nonitemized deductions are deducted from an individual taxpayer's gross income to determine the individual's adjusted gross income. In general, there are no limitations on the amount of an individual's nonitemized dedutions. Most nonitemized deductions are those listed in Code section 62(a), but a few nonitemized deductions are listed instead in other Code sections.[122] All deductions that are not nonitemized, other than the deductions for personal exemptions, are itemized deductions.[123]

Itemized deductions can be deducted only if neither the taxpayer nor the taxpayer's spouse elect to use a standard deduction.[124] In addition, all but three types of itemized deductions

[122] For example, Code §§ 71(f)(1)(B) (excess alimony payments), 164(f) (self-employment taxes) and 165(h)(4)(A) (personal casualty losses that do not exceed the taxpayer's personal casualty gains) are nonitemized deductions that are not listed in Code § 62(a).
[123] I.R.C. § 63(d).
[124] I.R.C. § 63(b), (c)(6)(A). The standard deduction is a specified dollar amount allowable to individuals in lieu of their itemized deductions. I.R.C. § 63(b), (c), (f). Thus, an individual can either take his itemized deductions or a standard deduction, but cannot take both. On the other hand, an individual can take all of his nonitemized deductions even if he elects to use the standard deduction.

are subject to an overall limitation that applies if the individual's adjusted gross income exceeds a specified amount.[125] This overall limitation is scheduled to be phased out temporarily beginning in the year 2006, but it is scheduled to come back in full force in 2011.[126] In addition to the general limitations that apply, certain itemized deductions have specific limitations that apply only to that deduction.[127]

A subcategory of itemized deductions, referred to as "miscellaneous itemized deductions," is subjected to another limitation.[128] All itemized deductions that are not listed in Code section 67(b) are miscellaneous itemized deductions.[129] The total of an individual's miscellaneous itemized deductions for a taxable year can be deducted only to the extent that the total exceeds 2% of the individual's adjusted gross income for that year.[130] This 2% of adjusted gross income floor is in addition to all other limitations that apply to the deduction. In addition, miscellaneous itemized

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[125] I.R.C. § 68(a). Initially, the threshold specified amount was $100,000, but it is adjusted annually for inflation. I.R.C. § 68(b). For the year 2005, the threshold amount is $145,950. Rev. Proc. 2004-71, 2004-50 I.R.B. 970. The three itemized deductions that are excluded from this overall limitation are medical expenses, investment interest, and certain losses. I.R.C. § 68(c).

[126] I.R.C. § 68(f), (g). Economic Growth and Tax Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38.

[127] For example, medical expenses can be deducted only to the extent that they exceed a percentage of the individual's adjusted gross income. I.R.C. § 213(a).

[128] I.R.C. § 67(a).

[129] I.R.C. § 67(b).

[130] I.R.C. 67(a).

deductions are not deductible at all when the taxpayer is subject to the alternative minimum tax.[131] If the alternative minimum tax system is not amended, it is predicted that by 2010, one-third of the total number of taxpayers will be taxed under the alternative minimum tax system rather than the "regular" system.[132]

Subject to a few exceptions,[133] unreimbursed business expenses of an employee are itemized deductions.[134] Since the itemized deduction for employee business expenses is not listed in Code section 67(b), it is a miscellaneous itemized deduction. On the other hand, to the extent that an employee's business expense is reimbursed by the employer, the deduction for that expense is a nonitemized deduction that is not subject to any limitations.[135] Indeed, since the nonitemized deduction for the expense will wash

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[131] I.R.C. § 56(b)(1)(A)(i).

[132] Gregg A. Esenwein, Congressional Service Report for Congress, The Alternative Minimum Tax for Individuals 6 (January 30, 2003).

[133] Certain expenses connected with an employee's claim based on discrimination are nonitemized deductions. I.R.C. § 62(a)(19) [20]. Certain business expenses of qualified performing artists, a state official, members of reserve components of the armed forces, and up to $250 of specified expenses of eligible educators are nonitemized deductions, and so are not subject to the limitations that apply to itemized deductions. I.R.C. § 62(a)(2)(B)-(E). The provision for the deduction of a limited amount of educators' expenses is scheduled to expire in 2006. I.R.C. § 62(a)(2)(D) (as amended by § 307(a) of the Working Families Relief Act of 2004, Pub. L. No. 108-311, sec. 307(a), § 62, 118 Stat. 1166, 1179). Employees can also take a nonitemized deduction for qualified moving expenses. I.R.C. § 62(a)(15).

[134] I.R.C. § 62(a)(1), (2).

[135] *Id*.

out the inclusion of the reimbursement in the employee's gross income, the Service simplifies the reporting of those items by allowing the employee, instead of deducting the expense, simply to exclude the reimbursement from income. This alternative of an exclusion from income is allowed only if the employee is required to account to the employer, and does so.[136]

Employee business expenses then are another example of nonparallel treatment by the Code. Is there a justification for treating employees whose business expenses are reimbursed by their employer more favorably than employees who bear the expense themselves? The difference can be nothing more than formulaic – i.e., in some cases, it merely reflects the manner in which the employer and employee have chosen to characterize their arrangement. Take the example of a college professor, X, who accepts a teaching visit at another college for an academic year, consisting of nine months. X will return to his home school when the nine-month period is finished. Since X is away from home temporarily, his living expenses at the visiting school, including his lodging, will constitute deductible business expenses under Code section 162(a)(2). However, only one-half of his expenses for meals are deductible.[137] In negotiating his salary at the visiting school, X requests and receives a larger salary to

[136] Treas. Reg. § 1.162-17(b)(1).
[137] I.R.C. § 274(n).

compensate for the extra living expenses he will incur. All of X's salary, including the added amount, is included in X's gross income. While X's living expenses (including one-half of the cost of his meals) are deductible, they are miscellaneous itemized deductions; because of the limitations on those deductions, X will obtain little or no benefit from them. However, if X does not seek a higher salary and, instead, obtains an agreement from the visiting school to reimburse X for all or part of his living expenses (or to pay some of those expenses directly), all of the reimbursed expenses, including 100% of the cost of his meals,[138] will be nonitemized deductions that are fully deductible. Alternatively, if X accounts to the visiting school (his employer) for his reimbursed expenses, he can simply exclude the reimbursement from his income.[139] Whatever may be the proper tax treatment of all employee business expenses, there is no justification for having dramatic differences in the tax treatment of employees based on such a substantively meaningless distinction, especially when the result can easily be manipulated by some taxpayers.[140]

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[138] Without the reimbursement, only 50% of the cost of the meals would have been deductible as a miscellaneous itemized deduction. *Id*. The 50% limitation would apply to the deduction allowable to the school for its reimbursement of the employee's meal; but since the school will be a nonprofit organization, deductions are of no consequence to it.

[139] *See supra* note 136 and the text thereto.

[140] For a numerical example illustrating the large tax difference, see Kahn, *supra* note 3, at 21-25.

In a prior article, the author criticized the Code's imposition of restrictions on employee business expenses,[141] and only a summary of some of that discussion will be repeated in this piece. Several commentators, including the author, have questioned whether there is a justification for imposing general restrictions on itemized deductions.[142] Regardless of whether the current treatment of itemized and miscellaneous itemized deductions is proper, unreimbursed employee expenses should not be included in the list of those deductions.

Let us focus on the justifications offered for the miscellaneous itemized deduction provision since that is the principal restriction on deductibility and since those also seem to be the justifications for any restrictions on itemized deductions. Four justifications have been suggested:[143] (1) Reducing administrative burdens for the Service and the taxpayer for the treatment of small amounts that do not warrant that time and

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[141] *See* Kahn, *supra* note 3, at 20-25.
[142] Kahn, *supra* note 3, at 29-53; Robert J.Peroni, *Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System*, 91 TAX NOTES 1415 (2001). *See also* Martin J. McMahon, Jr., *Individual Tax Reform for Fairness and Simplicity: Let Economic Growth Fend for Itself*, 50 WASH. & LEE L. REV. 459, 493 (1993).
[143] The first three of these justifications are suggested in Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1896, at 78-79 (Comm. Print 1987). The fourth is suggested by some commentators. *See*, *e.g.*, Deborah A. Geier, *Some Meandering Thoughts on Plaintiffs and Their Attorneys' Fees and Costs*, 88 TAX NOTES 531, 533 (2000).

expense, (2) Some of the included items have elements of personal expenditures and would have been incurred even if no business purpose had also been present, (3) Taxpayers make errors in reporting itemized deductions, and (4) The government needs the additional revenue that the imposition of the limitations will bring. In a prior article, the author dealt with each of those purported justifications and concluded that they do not justify the restrictions.[144]

As to the first justification of administrative burden, while the provision will ease the record-keeping burden of some taxpayers, it will do little for prudent taxpayers who will retain records of those expenses since they will not know until the end of the year whether they will benefit from itemizing their deductions.[145] While the limitations on employee business expenses will ease the Service's auditing burden by removing those items from many taxpayers' returns, there are offsetting auditing burdens created by the provision because some individuals will seek classification as independent contractors,

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[144] Kahn, *supra* note 3, at 40-53.

[145] *See* Peroni, *supra* note 142, at 1418. *Contra* Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121, 167 n.235 (1989) ("The floor is high enough that most taxpayers no longer keep records."). If Professor Schenk is correct, it is likely that some of those taxpayers would have been entitled to itemized deductions if they had kept records, and a system which discourages record-keeping to the detriment of some taxpayers could be viewed as undesirable.

rather than as employees, in order to escape the imposition of those limitations. The Service will have to determine whether independent contractor classification is proper, and may have to litigate that issue.[146]

The second justification that many miscellaneous itemized deductions have substantial personal elements is equally true of business expenses of the self-employed and of reimbursed employee expenses. One reason for preferring reimbursed employee expenses is the assertion that the employer will reimburse an employee for any legitimate business expense. But, many employers do not reimburse employee expenses because they do not wish to undertake the administrative burden of maintaining a reimbursement plan; instead those employers pay their employees a higher salary and leave the administration of the costs to the employees.[147] Another contention is that an employer will oversee the legitimacy of expenses he reimburses, but that will not apply to an employee of a corporation in which the employee has a controlling interest (i.e., a closely held corporation).[148] Moreover, many legitimate business expenses of self-employed

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[146] *See* Kahn, *supra* note 3, at 41-43. *See also* Glen E. Coven, *Congress as Indian-Giver: "Phasing-Out" Tax Allowances Under the Internal Revenue Code of 1986*, 6 VA. TAX REV. 505, 527 (1987) ("[B]enefits must be offset by the complexity and manipulation created by plans to avoid the new floor.").
[147] *See* Peroni, *supra* note 142, at 1422.
[148] McMahon, *supra* note 142, at 493.

individuals also have elements of personal enjoyment that accompany them, but those expenses have not been subjected to the restrictions applied to employee expenses. Also, many employers reimburse employee's travel expenses by providing the employee with a per diem allowance for which no accounting is made to the employer, and yet those employee expenses are nonitemized deductions.[149]

The third justification that taxpayers make errors in reporting deductions is subject to three responses: (1) Errors are made in many parts of a tax return, and there is no reason to single out employee business expenses as being more prone to error than other items; (2) Not everyone makes mistakes, and it is harsh to punish the innocent for the errors of others; and (3) Creating a floor for the deduction is not an adequate solution since those with large amounts of such items that are properly deductible can still make an error in taking an unwarranted deduction of a small item.

The fourth justification of raising revenue can apply to any provision that raises tax costs, and revenue can be raised with provisions that do not distinguish taxpayers on such a formulaic basis.

In sum, the lack of parallel treatment (and resulting violation of horizontal equity) is egregious in this case because the

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[149] Treas. Reg. § 1.62-1T(e)(1).

difference between those who do and do not qualify for a deduction can be so nominal as to make the distinction arbitrary and opens the way to manipulation. While manipulation is not available to all employees, it worsens the case for the restrictive treatment of employee expenses that some employees can easily avoid those restrictions while others cannot.

The question is whether the justifications for distinguishing unreimbursed employee expenses outweigh the lack of parallel treatment. In this case, the goal of parallelism is especially strong given the manner in which the limitations can be so easily circumvented by an arrangement between an employee and his employer. On the other side, the justifications for different tax treatment do not hold up well under scrutiny and can be considered weak. On balance, this is a case where parallelism and horizontal equity should prevail.[150]

E. Life Insurance Proceeds.

When an individual dies, no deduction is allowed for the loss of that individual's human capital. Yet, the receipt of the proceeds of a life insurance policy typically is excluded from the

[150] Another objection to the limitation on employee expense deductions is that they do not apply to independent contractors, whose business expenses are nonitemized deductions and fully deductible. That difference in treatment raises an issue of horitzontal equity unless a good reason exists for treating independent contractors more favorably. In a prior article, the author questioned whether the distinction is warranted. *See* Kahn, *supra* note 3, at 62-63.

recipient's income under Code section 101(a)(1). There are several exceptions to that exclusion. Interest received on the insurer's retention of the proceeds is taxable when distributed.[151] The interest element in amounts that are paid to beneficiaries in installments is taxable.[152] If the insurance contract had been transferred for consideration prior to the insured's death, the "transfer for value" rule could cause the recognition of income in the amount by which the proceeds exceed the consideration and premiums previously paid by the distributee; but there are circumstances in which the transfer for value rule does not apply.[153]

The exclusion of the life insurance proceeds, while denying a deduction for the loss of human capital on the death of an uninsured individual, contravenes the principle of parallelism. The context of this situation may seem familiar to the reader since the circumstance is similar to the issue discussed in Part IV B of this article dealing with damages received for a physical injury. Especially when the physical injury results in death, the circumstances have much in common. In both cases, the payments (damage payments or life insurance proceeds) are not necessarily

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[151] I.R.C. § 101(c).
[152] I.R.C. § 101(d).
[153] I.R.C. § 101(a)(2). For example, the transfer for value rule does not apply to transfers made to: a corporation of which the insured is a shareholder or officer, a partnership in which the insured is a partner, or a partner of the insured. I.R.C. § 101(a)(2)(B).

made to the estate of the decedent; they often are payable to someone who survived the decedent. But they are both paid to replace the human capital that was lost because of the decedent's death.[154]

The reasons for not allowing a deduction for the loss of unreimbursed human capital that are discussed in Part IV B apply equally to the instant situation and will not be repeated here. However, the reasons for excluding damages for physical injuries do not apply to the same extent to the receipt of life insurance proceeds.

One might contend that the receipt of life insurance proceeds is not as easily classified as an involuntary conversion since a voluntary decision was made to purchase the insurance contract.[155] However, the death of the insured that triggered the payment of the proceeds usually is involuntary. By analogy, the receipt of insurance proceeds for the loss of property incurred from

[154] Damages for wrongful death can include payments for more than the loss of human capital. For example, in some states, damages can be ordered for the pain and suffering that the victim incurred. Nevertheless, damages for the loss of human capital will be a part of the award.

[155] There are some commentators who argued that because life insurance premiums are not deductible, the proceeds should be excluded. *See* SCHMALBECK & ZELENAK, *supra* note 9, at 106-07 (discussing, but not advocating, the argument). However, the author believes that the nondeductability of premiums is attributable to the consumption element of obtaining the risk coverage that insurance provides, and has little, if any, effect on the excludability of the proceeds.

a casualty or theft is treated as an involuntary conversion. There seems no reason to regard the receipt of life insurance proceeds differently. The policy of treating involuntary conversions liberally should apply to the receipt of life insurance proceeds. That consideration alone is not sufficient to justify an exclusion, but it lends support to that treatment if other considerations point in the same direction.

The human capital that was lost by the insured's death is not bought and sold in commercial markets.[156] The insurance proceeds are designed to replace that capital with dollars since monetary replacement is all that is available. There is a significant non-commercial element to the insurance even though it involves dollars. If the government were to tax the proceeds, or so much of the proceeds as exceeded the premiums paid, it would be preventing the insured from providing adequate substitution to his beneficiaries of what they lost when he died. While there is some unpleasant aspect to the government's cashing in on the insured's death to the detriment of his family in many cases, it lacks the rapacious appearance that the taxation of damages would

[156] Obviously, people do exploit their human capital commercially. For example, an employed person receives wages in return for the use of his human capital. But, that is a type of leasing arrangement as contrasted to a disposition of the capital.

engender.[157] This consideration has less force here then when applied to the receipt of damages for physical injuries.

The case for excluding life insurance proceeds on principled grounds is not as strong as it is in the case of physical injury damages. It seems likely that the proceeds are excluded to encourage the purchase of life insurance on the ground that having families protected from destitution (or protecting families from having to liquidate family-owned businesses) because of the loss of an income producer is socially desirable, and so life insurance should be encouraged by the tax law to implement that policy. In addition, if the insurance proceeds were taxed, an insured individual would need to purchase a much higher amount of insurance to cover his needs. While Congress may wish to encourage the purchase of life insurance coverage, it has no reason to wish to increase the cost of that coverage.

The adoption of that policy of encouraging the acquisition of life insurance is buttressed by the considerations noted above, acknowledging that some are weaker here than in the case of physical damages. However persuasive one does or does not find that justification, it has no application to the question of allowing a deduction for the death of an uninsured person. The lack of

[157] The lack of concern for this appearance is reflected in the application of an estate tax on the death of an individual, but that tax applies only to wealthy individuals.

parallelism appears justified if one accepts the apparent rationale for excluding the life insurance proceeds, but is not justified if one concludes that the grounds for excluding the proceeds are inadequate. In the latter case, it is not a question of applying parallelism, but merely that there are not strong enough grounds for providing an exclusion.

F. Meals and Lodging

Meals and lodging that are furnished to an employee, his spouse and dependents, on the employer's business premises for the convenience of the employer, are excluded from the employee's income by Code section 119(a) if certain conditions are satisfied.[158] The "business premises" requirement has been expanded to a small extent by the judicial and administrative construction of that term, but the expansion is very narrow and limited.[159] Also, in certain circumstances, an employer's furnishing of meals to employees can be excluded as a de minimis fringe

[158] In the case of lodging, there is an additional requirement that the employee have been required by his employer to accept the lodging as a condition of his employment. For a discussion of the application of this exclusion, see KAHN & KAHN, *supra* note 35, at 164-68.

[159] "Business premises" must be either premises "where the employee performs a significant portion of his duties or…where the employer conducts a significant portion of his business. Lindeman v. Commissioner, 60 T.C. 609, 615 (1973) *Acq*. *See* KAHN & KAHN, *supra* note 35, at 165-66 for a discussion of when the lodging can be physically separated from the employer's regular place of business because business is also conducted at the lodging.

benefit under Code section 132(e)(2). Yet, if not provided by the employer or incurred in connection with business moving or entertainment or travel away from home, the employee's cost of such meals and lodging is not deductible.[160] The question is whether that nonparallel treatment is justified.

It is easy to understand why an individual's cost of meals and lodging for himself and his immediate family generally are not deductible because they constitute personal consumption. The Code expressly provides, subject to specific exceptions, "no deduction shall be allowed for personal, living, or family expenses."[161] Even if that provision were omitted from the Code, such expenses would not be deductible because they would not fit within any Code provision granting a deduction. The denial of a deduction for such expenses comports with a fundamental principle of taxation that no deduction is allowable for personal consumption.

While the reasons for excluding from an employee's income the meals and lodging provided by the employer for the employer's convenience are not set forth in any authoritative statement, the likely purposes of the exclusion are reasonably discernable. The exclusion initially was established by two

[160] Treas. Reg. § 1.262-1(b)(5).
[161] I.R.C. § 262(a).

administrative rulings in 1919.[162] One of those rulings exempted from gross income the value of meals and lodging furnished to a seaman while aboard ship. As to the exclusion of the lodging, it is easy to see why the government agreed to exclude it from income. A seaman has to live somewhere when he is not at sea, and often that meant that the cost of lodging at sea duplicated an expense that the seaman also incurred to maintain a home on land. The duplicated or added expense of a berth at sea was attributable to the requirements of the seaman's work. In the case of many seamen, the employer's provision of lodging did not add to the seaman's wealth since it did not relieve him of the expense of maintaining a home. Moreover, the berth provided by the employer typically would be spartan; and since comparable quarters were not sold on the market, it would be difficult to value.[163]

The circumstance in which the lodging exclusion was applied to a seaman is one in which an expense paid by the employee for that lodging would be deductible today. If the seaman had to pay for his lodging, the expense would qualify today under Code section 162(a)(2) as a deductible business travel expense away from home. But, even in that case, the exclusion is a

[162] O.D. 265, 1 C.B. 71 (1919); O.D. 11, 1 C.B. 66 (1919).

[163] Another early illustration of the rule was its application to the Army's provision of lodging quarters (or the commuted value of the lodging) to officers. Jones v. United States, 60 Ct. Cls. 552 (1925).

nonparallel provision because the seaman's deduction would be an employee business expense and so would be subject to the severe limitations imposed on miscellaneous itemized deductions.[164] Moreover, unlike the case of the seaman, many of the circumstances to which the exclusion has been applied are ones in which no deduction would have been allowable to the employee if he had borne the cost of the meals and lodging.

Even from the time of its initiation in 1919, the exclusion was not limited to circumstances where the lodging constituted a double expense. In the other 1919 ruling,[165] cash paid to an employee of the American Red Cross for maintenance expenses was held to be excluded from income to the extent that the employee's actual maintenance expenses did not exceed the amount he received. However, cash payments of that nature would not qualify for Code section 119 today and would be included in the employee's income.[166] There is still no requirement of a double

[164] *See supra* note 130 and accompanying text. In a prior article, the author concluded that the limitations on the deduction of employee business expenses are unwarranted. Kahn, *supra* note 3. If the seaman were required by the employer to pay a specified amount for his lodging then the proper treatment is to reduce the seaman's salary by the amount he is required to pay back to the employer and to treat the seaman as having been furnished the lodging. *See* Treas. Reg. § 1.119-1(b), and *infra* note 182.
[165] OD. 11, *supra* note 162.
[166] *See* Commissioner v. Kowalski, 434 U.S. 77 (1977). While it is clear that Congress intended to tax cash receipts for meals and lodging, that distinction has been criticized as irrational. *See* Adrian A. Kragen and Klonda Speer, *IRC Section 119: Is*

expense in current law, and so one has to search elsewhere for a rationale for the exclusion.

As to the seaman's meals that his employer provided, there was no double expense, and so once again we see that the double expense justification does not explain the adoption of what constitutes a much broader rule. We must look further for an explanation.

One year after the promulgation of the two 1919 rulings, Treasury amended its regulations to provide that meals and lodging furnished to an employee for the convenience of the employer is excluded from income.[167] From that time on, the exclusion was established, but it underwent many alterations over the years.[168] On account of the confusion as to the application of the exclusion and of Congressional dissatisfaction with the restrictive construction that the government adopted, Congress enacted Code section 119 as part of the Internal Revenue Code of 1954.[169] Unfortunately, the statutory codification of the exclusion did not

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Convenience of the Employer A Valid Concept?, 29 HASTINGS L.J. 921 (1978).

[167] Amendment to Article 33 of Regulation 45, Treas. Reg. 45, art.33 (1920 ed.), T.D. 2992, 2 C.B. 76 (1920).

[168] For a history of the tax law's treatment of the exclusion, see Kragen and Speer, *supra* note 148, at 922-927.

[169] H.Rept. No. 1337, 83d Cong. 21d Sess., at A38-A39 (1954); Kragen and Speer, *supra* note 166.

dispel all of the confusion over its application, and questions continued to be litigated and alterations made.[170]

What then is the rationale for the exclusion? Professor Kragen and Ms. Speer stated:

> The premise underlying exclusion in section 119 is that the greater the employer's control of the employee's enjoyment of the meals or lodging, the less likely they will be considered as compensation and the less directly will the employee be held to have benefitted. If the employee is benefitted only indirectly, the value of the accommodations provided will be excluded from income, even though some compensation factor is present.[171]

While there is no authoritative support for the proposition, there is reason to believe that the tax law generally will not tax benefits received by someone who obtains those benefits by being the incidental beneficiary of actions taken by another for the other's own purposes other than a compensatory purpose. For example, if an applicant for employment is invited by a prospective employer to travel to the employer's location for an interview, and if the prospective employer reimburses the applicant for his travel expenses, the reimbursement will be excluded from the applicant's income.[172] It is in the prospective employer's economic interest to have the applicant come to it rather than to

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[170] *Id*. See also the student note, J.Patrick McDavitt, *Dissection of A Malignancy: The Convenience of the Employer Doctrine,"* 44 NOTRE DAME L.R. 1104 (1969).
[171] *See* Kragen and Speer, *supra* note 166.
[172] Rev. Rul. 63-77, 1963-1 C.B. 177. *See infra* Part IV G of the article.

send its agents to the applicant. The applicant benefits from being provided travel to the interview, but the prospective employer did not provide that travel in order to compensate the applicant. The applicant can be viewed as an incidental beneficiary of a business act of the prospective employer.[173]

When meals and lodging are provided by an employer for its own business purposes, an employee's benefit can be seen as noncompensatory and incidental to the employer's action. While, in many cases, the parties are aware that the employee does benefit financially from the arrangement, and so it can affect the compensation paid to the employee and thereby has a compensatory element, compensation for services is not the primary motivating force.[174]

Another reason for the exclusion is the administrative difficulty of arriving at a fair valuation of the benefits the employee received. When property is received or given in kind, the income tax law typically values it at the price that would be paid by a willing buyer from a willing seller where both parties have full knowledge of relevant information and neither is under a

[173] The treatment of the reimbursement of an applicant's expense is discussed in Part IV G of this article.
[174] See Treas. Reg. 1.119-1(a)(2) ("[I]f the employer furnishes meals to his employee for a substantial noncompensatory business reason, the meals so furnished will be regarded as furnished for the convenience of the employer, even though such meals are also furnished for a compensatory reason.")

compulsion to buy or sell.[175] Of course, property is bought and sold in different markets (e.g., retail, wholesale, private sale), and the geographic location of the market can alter the price. But, that factor has not proved to cause difficulty in the tax law's determination of value. In some cases, the benefits received by the employee are not ones that are sold on the market, and so valuation becomes more speculative in that case. But, that is not always true, and sometimes (for example, in the case of meals for restaurant employees) the same items are sold to the public.[176]

But, the problem of determining the value of the employee's benefits is more difficult than merely determining the market value of the items. One aspect of meals and lodging that qualify for the exclusion is that the employee has little or no choice as to whether to accept them. In the case of lodging, acceptance must be a condition of the employee's employment.[177] So, while the market puts one value on the benefit received, it may have a much lower subjective value to the employee. While the tax law does not ordinarily accommodate subjective differences,[178] it seems unrealistic to ignore them in this situation. Consider the

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[175] *See*, *e.g.*, Treas. Reg. § 1.170A-1(c)(2).
[176] *See* Kragen and Speer, *supra* note 166, at 949.
[177] I.R.C. § 119(a)(2). While Code § 119 does not require that the employee accept provided meals, practical considerations often will mean that he has no realistic opportunity to eat elsewhere. Time constraints often make the proffered meal the only one that is feasible.
[178] *Cf.* Pevsner v. Commissioner, 628 F.2d 467 (5th Cir. 1980).

plight of a janitor who is employed by a luxury hotel in an isolated area and is provided a room in the basement of the hotel for his living quarters, a room that would not otherwise be rented to clients of the hotel. If the location and elegance of the hotel is taken into account, the room will have a much greater value than the janitor could afford or would ever pay. But the room likely does have a subjective value to the janitor that is significantly less than its market value. The difficulty of establishing that subjective value is a factor in allowing the exclusion and thereby avoiding that problem.

Are those reasons adequate to justify the exclusion? In the case of a double expenditure for lodging, it would seem so; but that is not the typical application of the rule. The rule of exclusion provides a great advantage to taxpayers who are employed in jobs that require them to live on the business premises, and that difference in treatment of employees violates the principle of horizontal equity.[179] Of course, the same can be said of all fringe benefits that are excluded from income. But the value of meals and lodging can be quite substantial, and so considerations of equity take on greater weight. Professor Kragen and Ms. Speer concluded that the exclusion is not justified and should be repealed; although

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[179] The employee's advantage is mitigated to the extent that the benefit he receives is reflected in a reduction of the employee's salary.

they did not believe that there is political support for repeal.[180] In the author's view, the exclusion should be retained for the reasons stated above, but should be modified to be more restricted in some areas and more expansive in others.[181]

In any event, if the reasons for having the exclusion, perhaps with modifications, are deemed adequate, as the author believes them to be, there should be no concern that a deduction is not allowed for the cost of such items when they are not provided by the employer. There are good reasons not to allow a deduction, and the valuation and incidental benefit rationales for the exclusion do not apply to the situation where the employee pays for his lodging and meals.[182] While the exclusion does violate horizontal equity by discriminating against employees whose jobs do not require them to live on the business premises, those persons have a greater choice as to where to live or eat, and so they are not in the

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[180] Kragen and Speer, *supra* note 166, at 949.

[181] Professors Kragen and Speer recommended modification because they did not believe that repeal was feasible politically. *Id*. While the scope of the exclusion should be narrowed in some respects, it should be broadened in others. For example, the denial of an exclusion for cash reimbursements is not warranted. *Id*.

[182] There is an exception, and properly so, if the employee is charged a fixed amount for the meals and lodging, and is required to pay it regardless of whether he accepts the benefit. Treas. Reg. § 1.119-1(a)(3), (b). In that case, the situation is substantively identical to the situation where the employee is provided the meals or lodging and is paid a lower salary. The additional salary which must be returned to the employer is merely a bookkeeping item and should be disregarded since it does not alter the substance of the arrangement. *See supra* note 164.

identical position of the tax-favored employee. Moreover, some of an employee's advantage from the exclusion will be lost to the extent it causes a reduction of the employee's salary; but that reduction of the employee's benefit may be offset by the benefit the employer enjoys from paying lower wages, which violates the horizontal equity principle as to the employers. It is a value judgment as to whether the disparate treatment is so offensive as to warrant repealing the exclusion, but the author does not deem it to be so.[183]

G. Job Interview Expenses.

Treasury Regulation section 1.212-1(f) states that "expenses such as those paid or incurred in seeking employment or in placing oneself in a position to begin rendering personal services for compensation" are not deductible under Code section 212. The construction of that provision has had a checkered history,[184] but it finally has been construed to mean that expenses of seeking employment in a trade or business in which the taxpayer is not already actively engaged are not deductible; but expenses of

[183] Food and lodging are only one example of nonparallel treatment provided by the Code in the employee benefit area. The two largest, in terms of dollar amounts, examples are employer provided health insurance and retirement benefits. In order to determine whether such nonparallel treatment is justified, each item must be examined separately to see if there are countervailing considerations which outweigh the goal of parallelism.

[184] *See* KAHN & KAHN, *supra* note 35, at 446-48, and the discussion in Rev. Rul. 75-120, 1975-1 C.B. 55.

seeking employment in the same trade or business in which the taxpayer is already engaged (or was previously engaged if the unemployment gap is not too great) is deductible as a business expense under Code section 162.[185] However, even when deductible, since it will be an employee business expense, it will be a miscellaneous itemized deduction that is subject to severe limitations on the amount that can be deducted.[186]

The reason for denying a deduction for expenses of seeking employment in a new trade or business is that the taxpayer is not yet engaged in that trade, and so the expenditures cannot qualify as business expenses. As to whether they could be treated as incurred "for the production of income" within the meaning of Code section 212(1), they will not qualify for deduction under that provision because they are capital expenditures (i.e., expenditures incurred in an attempt to create a relationship that will produce future income). Capital expenditures are not currently deductible.[187] Even if such expenses were held to be deductible, and they have not been, the deduction would be a miscellaneous itemized deduction, which is subject to severe limitations as to the amount that can be deducted.[188]

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[185] Rev. Rul. 75-120, 1975-1 C.B. 55.
[186] Those limitations are discussed in Part IV D of the article.
[187] I.R.C. § 263.
[188] Those limitations are discussed in Part IV D of the article.

In contrast to the treatment of unreimbursed expenses incurred in seeking employment, consider the tax treatment of a taxpayer who is reimbursed by a prospective employer for the cost of traveling to the employer's location, including living costs incurred while at the location. In Revenue Ruling 63-77,[189] the Service held that the taxpayer can exclude such reimbursements from his income. This exclusion is not parallel to the treatment of unreimbursed expenses since the latter are either not deductible at all or are deductible as miscellaneous itemized deductions subject to severe limitations.

The justification for excluding the reimbursements was briefly noted above in connection with the tax treatment of an employer's provision of meals and lodging to an employee.[190] It is in the business interests of the prospective employer to have the employee travel to the prospective employer's location so that the employer can interview him. The applicant is performing an act for the benefit of the prospective employer, and so the costs incurred in that act should be borne by the prospective employer on whose behalf they are incurred. In this light, note that the Service has ruled that "[i]t is ... a well established position of the Internal Revenue Service that reimbursements for expenses on behalf of another in a nonemployment context are not includible in the

[189] 1963-1 C.B. 177.
[190] *See supra* Part IV F of the article.

taxpayer's income."[191] Of course, the applicant also benefits from making the trip to the employer's location in that he obtains an opportunity to receive a job offer, and he may enjoy the trip, especially if the prospective employer is located in an interesting or attractive city. But, the purpose of the prospective employer in making the reimbursement is not to compensate the applicant; it is made to pay the costs of actions for the prospective employer's benefit. The applicant can be seen as an incidental beneficiary of the prospective employer's expenditures, and should not be taxed for the benefits he enjoyed as an incidental consequence of the prospective employer's business activity.

Another element of job interviewing expenses should be noted. One problem with allowing full deductions for job interviewing expenditures is the difficulty in determining whether the applicant's interest in the job is bona fide. If a full deduction were allowed, a taxpayer might arrange an interview with a firm in a resort town in order to qualify his travel for a deduction. While that may also occur when the prospective employer reimburses the applicant for his expenses, the difference in that latter case is that an independent party made a judgment that the applicant has a serious interest in the job; and the strength of that judgment is evidenced by the fact that the prospective employer expended its

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[191] Rev. Rul. 80-99, 1980-1 C.B. 10.

own funds to bring the applicant to the interview. There is merit to the government's accepting the bona fides of a taxpayer's action where a third party has demonstrated its belief that the action is business related.[192]

The lack of parallel treatment here is not sufficient to warrant making any changes. There are good reasons not to allow a deduction for unreimbursed expenses incurred in seeking a job in a new trade or business. The question of whether deductible expenses in interviewing for a job in the same trade or business should be subjected to severe restrictions raises issues as to whether those limitations are defensible at all, and, if so, whether they are defensible in the context of employee business expenses. The resolution of those issues is broader than the question of parallelism and has little to do with the subject of this article.[193] There are good reasons for excluding reimbursements from income that have no application to unreimbursed expenses. Parallelism is not a meaningful issue in this context.

V. Conclusion

A proposal for the repeal or alteration of a specific tax provision often will utilize the principle of parallelism or horizontal equity to support that proposal. While those two

[192] The same substantiation argument could apply in other situations where an exclusion is allowed.
[193] For a discussion of those issues, see Kahn, *supra* note 3.

principles are not irrelevant, they should have little weight and often are utilized inappropriately. The application of those principles rests initially on a determination that persons who are given different tax treatments occupy essentially the same income positions. The identification of the points of contact between two taxpayers that are sufficient to make their income positions equal invokes value judgments over which reasonable people can, and often do, disagree. But, the source of the frailty of the utility of those two principles lies deeper than the mere difficulty of identifying those items that constitute their relevant points of comparison.

Horizontal equity applies to two persons who are in very similar income positions. Nonparallelism refers to providing different tax treatment to circumstances that are essentially the same. Two persons are rarely in identical circumstances, and two circumstances that appear to be the same can have significant differences. To resolve whether two persons or circumstances are to be treated the same by the tax law, it is necessary to determine whether the differences that exist are relevant for that purpose. The problem is that even factual circumstances that are similar can raise quite different tax policy considerations that lead to treating them differently for tax purposes.

For example, in the case of two persons who incurred a similar loss for which one was reimbursed and one was not, an obvious difference between them is that one was reimbursed. If the tax excludes the reimbursement from income but denies a deduction for the loss, does that violate horizontal equity? Given that the exclusion of the reimbursement from income has the identical tax consequence to allowing a deduction for the loss, it is easy to leap to the conclusion that the tax treatment is equivalent to allowing a deduction for reimbursed taxpayers while denying one to unreimbursed taxpayers.

However, as shown in the text, the apparent equivalence of an exclusion to a deduction is an illusion. The tax policy considerations that arise in connection with the tax treatment of a reimbursement can be quite different from the policies that arise from the tax treatment of an unreimbursed loss. Those differences in tax policy considerations turn the apparent identity of the two situations into a mirage that vanishes under inspection. Even if the similarity of the circumstances of the two taxpayers is deemed sufficient to invoke the principle of horizontal equity, that principle may be outweighed by other considerations that point in the opposite direction. Putting it differently, horizontal equity is merely one consideration or goal to be weighed together with other relevant considerations.

Each instance of different tax treatments must be examined separately to determine whether the difference is warranted. As to the tax provisions discussed in this article, the reader can see that different tax treatment is warranted for most of those provisions, but is not proper for some.[194]

Although the principles of parallelism and horizontal equity often are proffered as justifications for a proposed change in the tax law, the proponents typically attribute far more weight to those principles then they deserve. Moreover, in the case of some provisions, the principles are inapplicable because the apparent equivalence of circumstances proves to be an illusion. It is for this reason that the author's title to this article refers to the "mirage of equivalence."

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[194] This article has covered only a few instances of nonparallel treatment in the Code, but there are many others (especially in the employee fringe benefit area).