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COSTLY MISTAKES: UNDERTAXED BUSINESS OWNERS AND OVERTAXED WORKERS

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This Article advocates for fundamental changes in the federal income tax base by systematically challenging conventional understandings of consumption and investment. As signaled by our title, "Costly Mistakes," our thesis has to do exclusively with the deductibility of expenditures by business owners and workers. Where the current tax law treats a business owner's expenditure as investment, we sometimes find consumption and question why the law should allow the expenditure to be deducted. Where the tax law treats a worker's expenditure as consumption, we sometimes find investment and question why the law does not allow at least a partial deduction. Through an historical analysis of the development of the modern tax law with special attention to Justice Cardozo's 1933 U.S. Supreme Court opinion in Welch v. Helvering and a review of Welch's judicial and legislative progeny, the Article demonstrates that the deference the tax law traditionally has accorded business owners results in their being undertaxed. Through an analysis of the tax law's treatment of workers, it further shows how its structural and substantive rules treat workers primarily as consumers, rather than as producers, and why that results in their being overtaxed. The Article then

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investigates the economic inefficiencies produced by the tax law's generous treatment of business owners' outlays and its unduly restrictive treatment of workers' outlays. It goes on to suggest an analytical framework for scrutinizing and reforming the tax treatment of workers and how that same framework could be extended to business owners with far-reaching implications. Finally, the Article relates the undertaxation of business owners and the overtaxation of workers to the broader social policy discussions of high unemployment in the private sector and high deficits in the public sector. It concludes that the success of the U.S. economy in the twenty-first century requires the tax law to treat both business owners and workers as producers. It further concludes that the tax law's continuing failure to acknowledge that business owners and workers are both consumers and producers undermines the goals of efficiency and fairness.

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INTRODUCTION

This Article on the taxation of income begins as countless others do. It embraces the late nineteenth-century work of the German legal scholar Georg von Schanz along with the efforts in the 1920s and 1930s of the American economists Robert M. Haig and Henry C. Simons to define the ideal income tax base as the sum of consumption and investment between two points of time.[1] It diverges from traditional tax policy articles, however, because it advocates for fundamental changes in the federal income tax base by systematically challenging conventional understandings of consumption and investment. As signaled by our title, "Costly Mistakes," our thesis has to do exclusively with the treatment of expenditures by business owners and workers. Where the current tax law supported by a broad consensus of policy makers treats a business's expenditure as investment, we sometimes find consumption and question why the law should allow any or full recovery; where the tax law treats a worker's expenditure as consumption, we sometimes find an investment and question why the law does not allow full or at least partial recovery.

The idea that a business can consume likely strikes most tax experts and taxpayers as incongruous, because businesses by definition dedicate themselves exclusively to the production of profit. A business does not go on vacation, enjoy a bottle of wine, or sleep well on a state-of-the art mattress. We contend, however, that consumption under the Schanz-Haig-Simons definition of income has come to be defined too narrowly as a result of the undue deference accorded business owners in their pursuit of profits. The idea that an expenditure by a worker constitutes an investment, rather than consumption, likely strikes most tax policy experts and, in fact, most taxpayers as entirely plausible. Not

[1] Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, in THE FEDERAL INCOME TAX 1–28, 27 (Robert M. Haig, ed., 1921); Georg von Schanz, *Der Einkommensbegriff und die Einkommensteuergesetze*, 13 FINANZARCHIV 1–87 (1896); HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY, 50–51.

surprisingly, some tax scholars and policy makers have made strong arguments that, because they represent costs of producing income, the tax law should allow for recovery of particular kinds of expenditures, such as health care, child care, or education.[2] This Article differs from these earlier efforts in three distinct ways.

First, starting with an analysis of the development of the modern tax law, we show why and how it has associated productivity and efficiency with business owners and consumerism with workers. The deference the law traditionally has accorded business owners and its failure to recognize workers as producers account for most of its costly mistakes. This Article asserts that any solution to the overtaxation of workers implicates and depends upon correcting the undertaxation of business owners and that both types of reforms require a redefinition of tax policy makers' traditional understanding of investment and consumption.

Second, it introduces two principled methods for the law to distinguish workers' investments from their consumption: a remoteness criterion and cost constraint rules. If an expenditure does not directly relate to the production of income or cost savings, it should not be recoverable by a worker, because its relationship to that worker's trade or business is too tangential and speculative. Even if an expenditure is deemed directly related to a worker's trade or business, it may nevertheless not be recoverable in full, if it fails to fall within established cost criteria defining reasonableness. A remoteness criterion applied along with cost constraint rules establishes an analytical framework for the tax law to treat the worker as a producer. This Article goes further by suggesting how this same analytical framework could be applied to expenditures incurred by business owners. To use the remoteness criterion and impost cost constraint rules would curb current tax

[2] *See, e.g.*, Gwen Thayer Handelman, *Acknowledging Workers in Definitions of* Consumption *and* Investment: *The Case of Health Care*, *in* TAXING AMERICA 119 (Karen B. Brown & Mary Louise Fellows eds., 1996); Hamish P. M. Hume, *The Business of Learning: When and How the Cost of Education Should be Recognized*, 81 Va. L. Rev. 887 (1995); Denise D. J. Roy, *Consumption in Business/Investment at Home: Environmental Cleanup Costs Versus Disability Access Costs*, *in* TAXING AMERICA, *supra*, at 170.

law's deference to business owners and would place business owners and workers in equivalent positions within our tax system.

The third distinctive feature of this Article's analysis of the tax treatment of workers is the case it makes for why the costly mistakes of undertaxation of business owners and the overtaxation of workers fail to meet the needs of the U.S. economy of the twenty-first century. Whatever the justification may have been for treating workers primarily as consumers, rather than producers, in an economy primarily based on mass production of manufactured goods, a tax system that does not recognize the central importance of a trained, creative, and reliable work force in a high-tech and service economy undermines economic growth. The fundamental changes in the law that we advocate Congress enact will result in a taxation system that adheres closely to the principles underlying the ideal definition of income, and also one that enhances the efficiency and growth of the U.S. economy.

For the purposes of our thesis, we use the term *business owners* to encompass all types of entities, including sole proprietors, to the extent that they derive income from the investment of capital in the carrying on of active businesses. We use the term *workers* to encompass sole proprietors to the extent that they derive income from their labor and employees. In accordance with these definitions, our analysis will show how the current tax system undertaxes self-employed taxpayers on their income from capital and overtaxes them on their income from labor. The analysis also will show how the tax law simultaneously undertaxes and overtaxes the income earned by those, who as employees, enjoy significant perquisites as part of their work, such as expensive office furniture, access to private jets, and the like. Under the current tax system, these costs represent necessary expenditures of doing business and employers recover them immediately or amortize them over a number of taxable years. As this Article demonstrates, the more appropriate treatment of these costs is that a portion of them represent compensation to the employees who receive the perquisites. In some instances, the costs should be recoverable by the employer, but, in others, the

costs may represent corporate waste and should not reduce the employer's taxable income at all. This distinct treatment of high-income employees has to be considered in the broader analysis of this Article, which advocates for all employees and sole proprietors to recover the costs of producing their income from labor, including, for example, expenditures related to health care, education, child care, or commuting.

This brief preview of our thesis may make readers highly skeptical of the feasibility of correcting these costly mistakes both because of the administrative issues our solutions raise and because the approach risks significantly reducing the tax base on which to assess needed revenues. We would ask that you not prejudge or dismiss out of hand the central thesis because of these practical concerns. With regard to the question of administrative complexity, it is important to remember that current law does not itself meet the criterion of simplicity. The questions to ask should be how our solutions integrate into familiar rules and practices and whether the benefits from economic efficiency and fairness warrant any added complexity. With regard to the concern about the erosion of the tax base, it is important to remember that current law allows for that very erosion through overly liberal deductions for business owners' expenditures. Moreover, to make the tax-base argument is to concede the very point of this Article: Only undue respect for business owners explains why current law tolerates their undertaxation, and overtaxation of workers enables the overly generous tax treatment of business owners.

Another major concern raised by our thesis has to do with whether treatment of workers as producers may have the effect of benefiting high-income workers more than low-income workers and, thereby, undermine the progressivity of the tax system. Again, that is not a reason in itself to dismiss the project at the outset. The first response to this concern is that it is hard to justify singling out workers, high-income or otherwise, for more harsh treatment merely because they produce income as workers, rather than as business owners. The second is that, if the reforms bring the definition of taxable income in closer alignment with the Schanz-

Haig-Simons ideal, then that means the tax system will array all taxpayers—business owners, high-income workers, and low-income workers—more properly according to their ability to pay. In other words, costly mistakes in the tax base are a poor substitute for assuring a progressive income tax, and progressivity concerns should not short-circuit the determination of the appropriate definition of taxable income.

Part I lays a foundation for the thesis of costly mistakes by looking to the role business owners and workers played in the debates leading to the enactment of the modern federal income tax in 1913 and its subsequent development during the Great Depression up to World War II. It argues that of all the developments during the early years of the modern tax law specifically related to the business owner/worker divide and the tax law's insistence on deference to the judgment of business owners, the most important is the opinion in 1933 by Justice Benjamin N. Cardozo in *Welch v. Helvering*.[3] Part II documents current law's deference to business owners first by reviewing the progeny of *Welch*. Then, through an analysis of *INDOPCO v. United States*, this part demonstrates how deference to business owners' judgment has precluded consideration of the possibility that some business owners' expenditures should not be recoverable under the tax law at all.[4] Finally, it examines the effect of deference to business owners' judgment on expenditures that benefit someone other than the business owner. A robust jurisprudence has not developed in this area, because courts have made the "necessary" requirement found in I.R.C § 162 meaningless. Part III turns its attention to the tax law's treatment of workers and shows how the tax law's structural and substantive rules mistakenly classify workers' outlays as consumption and ignores how all or a portion of those outlays contribute to the workers' productivity. Part IV demonstrates how the tax law's generous treatment of business owners' expenditures and its unduly restrictive treatment of

[3] 290 U.S. 111 (1933).
[4] 503 U.S. 79 (1992).

workers' expenditures result in economic inefficiencies. Part V advocates a redefinition of the current tax base through the implementation of three goals: establishing workers as producers, curbing the deference traditionally accorded business owners, and reconceiving the meaning of investment for businesses and the meaning of consumption for workers. It discusses the implications of these three goals on two major tax policy areas that have influenced greatly tax reform discussions in recent years—the consumption tax and tax expenditure analysis. It then goes on to suggest structural and substantive reforms regarding the treatment of expenditures incurred by workers. Finally, it suggests how our proposed framework for analyzing and reforming the tax treatment of workers could be extended to business owners with far-reaching implications. The Conclusion underscores the importance of the issues raised in this Article by connecting the ideal definition of income to the broader social policy discussions taking place today. Tax reform that acknowledges both business owners and workers as agents of economic growth can be a key to solving the dual problems of the jobs deficit in the private sector and deficit spending in the public sector at the same time that it addresses a long-standing unfairness in the tax law that policy makers have failed to address or even recognize.

I. HISTORICAL ORIGINS OF COSTLY MISTAKES

The "single most important reason for the eventual enactment of the" modern federal income tax in 1913 "was a growing conviction among people from nearly all walks of life that the existing tax system failed, almost entirely, to reach the great fortunes that had been amassed as a result of industrialization."[5] Throughout these debates, which included discussion of tariffs and their role in revenue raising and providing protection to domestic industries from competition abroad, workers were seldom a center

[5] JOHN D. BUENKER, THE INCOME TAX AND THE PROGRESSIVE ERA 28 (1985).

of attention.[6] When workers were considered, they were grouped with merchants, farmers, artisans, and other sole proprietors and small business owners where their skill, industry, and diligence were contrasted with those in the idle capitalist and investor classes.[7] Yet, a focus on the hostility toward big business fails to capture the cultural role that big business played at the inception and early decades of the income tax, because, in fact, the success of big business generated high regard at the same time it provoked antagonism. The work of Ajay K. Mehrotra captures the complex position of big business in the development of the income tax. He persuasively argues that accounting data and the wherewithal to accumulate that data, which both management and investors needed to evaluate the success or failure of business initiatives and to grow large corporations into ever larger ones, provided the means by which the government could confidently assess a tax on business income.[8] The dual sentiments of anxiety and reverence for large-scale, industrial capitalism together in the end become the impetus for the modern income tax. As the debate about the inception of an income tax focused on capitalists, their efficiencies, and their profits, however, proponents and opponents all but ignored workers' productive roles in the economy and how they contributed to the efficiencies and profits enjoyed by businesses large and small.

The language in the Tax Act of 1913 itself provides some evidence of broader cultural attitudes toward labor. It defined the tax base to include income produced by labor—"salaries, wages, or compensation for personal service of whatever kind and in whatever form paid"—even as opponents and proponents understood that the great majority of wage earners would not be

[6] ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX 71-103 (1940); JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 77 (1985).

[7] Ajay K. Mehrotra, *American Economic Development, Managerial Corporate Capitalism, and the Institutional Foundations of the Modern Income Tax*, LAW & CONTEMP. PROBS., Winter 2010, at 25, 40; Deborah A. Geier, *The Taxation of Income Available for Discretionary Use*, 25 VA. TAX REV. 765, 818 (2006).

[8] Mehrotra, *supra* note 7.

subject to the tax.[9] Yet, the statute only concerned itself with "business" when it provided for the deduction of "necessary expenses."[10] Notably, the exclusive focus on business when it comes to deductions is in direct contrast to the language found in an earlier attempt in 1894 to institute a federal income tax. That statute provided that "necessary expenses actually incurred in carrying on any business, occupation, or profession shall be deducted."[11] Although much of the rest of this statutory provision relates to deductions incurred in the carrying of real property and capital expenditures inapplicable to workers and although the $4,000 exemption meant that no one expected many workers would pay the tax, the 1894 Act's broad language equating workers with business marks a moment when Congress did not distinguish between business owners and their employees.

Undue focus on the omission of language referring directly to wage earners is not warranted, but it does support the view that, at its inception, the modern income tax paid primary attention to the most successful of professionals, business owners, and the investor class.[12] The debate concerning the income tax and the related issue of protective tariffs mostly relegated labor, along with other low-income producers, such as farmers, to the predictable roles of the discontented due to the decrease in real wages and increase in costs of living or as dependents relying on the success of their industrial employers to remain profitable.[13] For example, one of big business's response to the discontented was to urge

[9] Act of 1913, Pub. L. No. 63-16, ch. 16, § II. B, 38 Stat. 167 (1913).
[10] *Id.* ("That in computing net income for the purpose of the normal tax there shall be allowed a deduction . .. the necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses . . . ").
[11] Act of 1894, Pub. L. No. 53-227, ch. 349, § 28, 28 Stat. 79 (1894). The full implications of this statutory language and the income tax itself never were realized because in 1895, just one year after its enactment, the Supreme Court held the tax unconstitutional in Pollock v. Farmers' Loan and Trust Co., 157 U.S. 429, *aff'd on rehearing*, 158 U.S. 601 (1895). For a discussion of the events leading up to *Pollock*, existing precedent, and the majority's decisionmaking, see BUENKER, *supra* note 5, at 16–21; SIDNEY RATNER, AMERICAN TAXATION: ITS HISTORY AS A SOCIAL FORCE IN DEMOCRACY 193–210 (1942).
[12] BUENKER, *supra* note 5, at 29.
[13] *Id.* at 34–35; RATNER, *supra* note 11, at 316–17.

"everyone to meet the problem by resorting to a more Spartan mode of living," including not to eat as much and to curb their desire for the latest in clothing and shoe apparel.[14]

Theodore Roosevelt's failed campaign for the presidency in 1912 is also indicative of the general attitudes toward labor, even as he was sympathetic to the economic vulnerability of labor. At the same time he developed initiatives to curb monopolistic abuses, he promoted a program to advance the interests of small businesses and workers, which included a protective tariff "aimed at giving labor an adequate standard of living."[15] It is not that policy makers ignored workers' issues generally. After all this was a time when legislation addressing child labor, the use of injunctions in labor disputes, and the length of the work day gained a good deal of attention.[16] When it came to the income tax, however, wealthy families with their corporate holdings and substantial dividend and interest income garnered the attention of this new progressive revenue regime and it seems few people took into account the effect of that regime on workers as producers.

With the onset of World War I and the growing need for revenue, the government enacted new kinds of taxes (e.g., an estate tax on individuals and an excess profits tax on businesses), raised the income tax rates considerably, and broadened the tax to more people.[17] W. Elliot Brownlee concludes that this new tax regime, representing redistributional policies, was the "most significant domestic initiative to emerge from the war."[18] By the end of 1918,

[14] BUENKER, *supra* note 5, at 35.
[15] RATNER, *supra* note 11, at 316.
[16] *Id.* at 339–40. *See also* GENDER, CLASS, RACE, AND REFORM IN THE PROGRESSIVE ERA (Noralee Frankel & Nancy S. Dye eds., 1991) (discussing progressive reforms, including child labor bans, minimum wage statutes, juvenile justice codes, housing, and health legislation).
[17] War Revenue Act of 1917, ch. 63, 40 Stat. 300 (1917); Revenue Act of 1916, ch. 463, 39 Stat. 756 (1916); W. ELLIOT BROWNLEE, FEDERAL TAXATION IN AMERICA: A SHORT HISTORY 62–63 (2d ed. 2004).
[18] BROWNLEE, *supra* note 7, at 59.

the tax affected about fifteen percent of U.S. households.[19] Of the total amount of revenues from the personal income tax, 1 percent of the families accounted for 80 percent of the revenues.[20] Higher estate tax rates on the wealthiest of decedents and the excess-profits tax further added to the taxation on the rich.[21] After the war, the progressive individual income tax, albeit with lower rates than during the war years, remained a mainstay of the federal government and states also began to rely on this form of taxation to meet their revenue needs.[22] In a sense, a stasis took hold in which the appetite for tariffs or a national sales tax ebbed and "normal," even as "pockets of privilege" crept into the tax law, came to mean a progressive individual income tax and a corporate income tax to address concerns about concentrations of wealth and equitable sharing of the obligations of the federal government.[23]

The onset of the Great Depression and the legislative activity accompanying the New Deal did not radically change the individual income tax or the understanding of it in the polity. It is true that for a time legislation raised rates and imposed new taxes on dividends, excess profits, and undistributed corporate profits, but the rhetoric surrounding these taxes remained familiar.[24] President Franklin D. Roosevelt justified increases in an array of taxes on corporations and the wealthy as a means of controlling concentrations of economic power, ensuring fairness based on ability to pay, and creating greater opportunities for the less

[19] *Id.* at 63; Ajay K. Mehrotra, *Taxation: United States Law*, in 5 THE OXFORD INTERNATIONAL ENCYCLOPEDIA OF LEGAL HISTORY 439, 443–44 (Stanley N. Katz ed., 2009).
[20] BROWNLEE, *supra* note 17, at 63.
[21] *Id.* at 63–65. The excess-profits tax ended up accounting for most of the federal tax revenues during the war. *Id.* at 65.
[22] Mehrotra, *supra* note 19, at 444.
[23] BROWNLEE, *supra* note 17, at 75–76, 79.
[24] *Id.* at 84–99; Mehrotra, *supra* note 19, at 444. For examples of the kinds of new restrictions on deductions and losses that were enacted in the 1930s, see Richard C.E. Beck, *Deductibility of Treble Damages Paid for Breach of National Health Service Corps Scholarship Contracts: The Misuse of I.R.C. § 265(A)(1) in* Stroud v. United States *and of the Origin of the Claim Test in* Keane v. Commissioner, 1 CHARLESTON L. REV. 1, 13 (2006); Sharon C. Nantell, *A Cultural Perspective on American Tax Policy*, 2 CHAP. L. REV. 33, 53 (1999).

wealthy. In opposition, business interests argued that the Democratic tax proposals stifled economic growth.[25] Whereas in the late nineteenth century policy, politics, and rhetoric viewed the federal income tax as an alternative to a tariff regime, after the Great Depression and on the eve of World War II, the income tax was an entrenched fixture of government. Political clashes surrounding the income tax revolved around the nature and level of corporate taxes, individual income tax rates, and the composition of the tax base, which included skirmishes over the ever-growing number of provisions favorable to moneyed interests.[26] Regardless of the differences, in both periods in the history of the income tax, the tensions surrounding the basic question of how much to ask of the wealthy and the corporations they controlled to pay for government relative to the middle and working classes went on unabated. Up to this point in the fiscal history of the United States, the vast majority of wage earners did not pay federal income taxes and the focus of the levy remained primarily on the wealthy thanks to the exemption provisions. The income tax was viewed and, in fact, generally was a tax on wealthy industrialists and financiers who enjoyed substantial profits from their investments, including gains from the sale of tangible and intangible property, dividends, interest, and rents.[27]

The U.S. Supreme Court after the adoption of the Sixteenth Amendment continued to have a considerable influence on the development of the income tax law. Most notably, in its 1920 decision of *Eisner v. Macomber*, a divided Court (5–4) held that

[25] BROWNLEE, *supra* note 17, at 90, 98–99.

[26] *Id.*, at 94–101. It is interesting to note the efforts the wealthy took to reduce their tax bills through deductions. It resulted in Congress passing legislation to restrict their deductions, including placing limits on the deductibility of corporate yachts and country estates. *Id.* at 96–98.

[27] *See* Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1, 64 (2002); Assaf Likhovski, *The Duke and the Lady:* Helvering v. Gregory *and the History of Tax Avoidance Adjudication*, 25 CARDOZO L. REV. 953, 974 (2004). At no time during the 1930s did more than 5 percent of the population file taxable returns. Carolyn C. Jones, *Mass-Based Income Taxation: Creating a Taxpaying Culture, 1940–52*, in FINDING THE MODERN AMERICAN STATE, 1941–1995, 107, 113–14 (W. Elliot Brownlee ed., 1996).

the Sixteenth Amendment did not allow for the treatment of stock dividends as income, thereby excluding them from taxation upon their receipt.[28] Both Justices Oliver Wendell Holmes and Louis D. Brandeis wrote separate and strong dissents.[29] This decision can be viewed as a continuation of the pro-business sentiments found on the previous century's Supreme Court when it checked the scope of Congress's governing authority by holding the income tax instituted by the Act of 1894 unconstitutional in *Pollock v. Farmers' Loan and Trust Co*.[30] For purposes of this Article's thesis, however, the more important Supreme Court decision in the early years of the income tax is *Welch v. Helvering* interpreting, without recourse to constitutional analysis, the statutory provision allowing a deduction for "[a]ll the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[31]

Welch, probably more than any other case, solidifies the income tax law's deference to business owners and their acumen. It did not have anything to do with the political struggles to tax industrialists, financiers, and other wealthy investors. On the contrary, Welch's business history reflects many of the economic forces, including monopolistic practices, that marked the early decades of the twentieth century. Within this context, it is no wonder that the respect for businesses' strategies to establish an efficient and rational operations, which, from the outset, had some influence on the structure of the income tax, unreservedly emerges. Starting in 1906 Thomas Welch and his father, E. L. Welch, had run a grain brokerage business (E.L.Welch Company) in Minnesota.[32] After World War I, agricultural prices dropped

[28] 252 U.S. 189 (1920).
[29] *Id.* at 219 (Holmes, J., dissenting); *id.* at 229 (Brandeis, J., dissenting).
[30] 157 U.S. 429, aff'd on rehearing, 153 U.S. 601 (1895). For further discussion of *Eisner v.* Macomber, see Majorie Kornhauser, *The Story of* Macomber*: The Continuing Legacy of Realization*, in TAX STORIES 93, 112–15 (Paul Caron ed., 2d ed. 2009).
[31] 290 U.S. 111, 113 (1933), citing Revenue Act of 1924, ch. 234, § 214(a)(1), 43 Stat. 253, 269 (1924).
[32] Transcript of Record at 10. Thomas Welch served as secretary of the corporation and owned 10 shares and his father, who was president, owned the rest. *Id.* at 28. Thomas Welch testified that "the largest part of its business was handling grain on commission."

dramatically, the railroad companies used their dominance in the market to set high rates for storing and shipping grain, and farmers established cooperatives so that they might be able to have more market power in the setting of prices for their products and costs of operation.[33] In this economic environment, E.L. Welch Company and Thomas Welch could not survive financially and both declared bankruptcy in 1922.[34] Thomas Welch picked himself up and managed to get a contract with the Kellogg Company under which he agreed to purchase grain for Kellogg for which he would be paid commissions.[35] From Welch's point of view, good business sense and moral business practices demanded that he make every effort to repay the discharged debts of E.L. Welch Company.[36] Given his taxable commissions from 1924 through 1928, Welch seems to have vindicated the wisdom of his strategy. In 2011 dollars, he earned a little more than $400,000 in one year and his lowest year of commissions was about $240,000. In 2011 dollars over the five year period, he made payments to creditors of approximately $625,410 out of earnings of $1,547,661.[37] By most

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Id. He went on to describe how his father had responsibility for the financial business and he was the one who kept "in very close touch with the customers of the corporation and travelled out in the country through the summer and fall three or four months, and then took complete charge of the grain as it came in, and handled the cash grain and practically loaded 85 or 90 perent, in addition to cash sales, the details in regard to it, the grading of grain and trading and futures." *Id.* at 29.

[33] Joel S. Newman, *The Story of* Welch*: The Use (and Misuse) of the "Ordinary and Necessary" Test for Deducting Business Expenses*, in TAX STORIES, *supra* note 30, at 199–200.

[34] Transcript of Record at 28.

[35] *Id.* at 20.

[36] When asked about his motive for the payments on the discharged debts, Welch responded "Well, it was to reestablish my credit for one thing, reestablish my business, and, further, it was a matter of a moral obligation." *Id.* at 31.

[37] 290 U.S. at 113 ("In 1924, the commissions were $18,028.20, the payments $3,975.97; in 1925, the commissions $31,377.07, the payments $11,968.20; in 1926, the commissions $20,925.25, the payments $12,815.72; in 1927, the commissions $22,119.61, the payments $7,379.72; and in 1928, the commissions $26,177.56, the payments $11,068.25"). All adjustments to 2011 dollars are based on the U.S. Dep't of Labor, Bureau of Labor Statistics, CPI Inflation Calculator, http://www.bls.gov/data/inflation_calculator.htm. The Commissioner had assessed tax deficiencies for these years totaling $3,072.96 in 1932, which was the time the parties litigated the matter before the Board of Tax Appeals. Welch v. Commissioner, 25 B.T.A.

people's measure, Welch had worked his way back to prosperity and good standing.

Even as Justice Benjamin N. Cardozo, writing for the unanimous Court, denies Welch a deduction for his repayment of discharged debts, he establishes the business owner in the tax law as a noble warrior doing his level best to withstand the onslaughts of marketplace predators. Cardozo stipulates that Welch's payments to the creditors of E.L. Welch Company, made in order to restore his reputation and gain goodwill with his customers, satisfied the *necessary* prong of the "ordinary and necessary" rule.[38] "We may assume that the payments to creditors of the Welch Company were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. He certainly thought they were, and we should be slow to override his judgment."[39] With this statement, Cardozo disregards the Government's urging that the Court hold necessary to mean "essential, needful, requisite, or indispensable."[40] Instead, Cardozo's statement concerning deference to Welch's business judgment seems to track Welch's brief, which states the following:

> It will not, we think, be disputed as a general proposition that businessmen should have a free hand to adopt such means as will result in increased business and increased income, resulting in increased revenue to the Government, and that the Government should not exercise a supervisory power over the methods adopted, or determine after the event whether the course adopted was wise or

117, 117. In 2011 dollars that would be equivalent to approximately $50,815 based on the CPI Inflation Calculator, *supra*. In his petition to the Board of Tax Appeals, Welch states that he paid the creditors "as soon as his ability permitted, and each year since said bankruptcy, has paid out all his earnings except necessary living expenses to such customers." Transcript of Record at 5.

[38] 290 U.S. at 113.

[39] *Id.*, citing McCulloch v. Maryland, 17 U.S. 316, 4 Wheat. 316 (1819).

[40] Brief for Respondent at 6.

> unwise, advisable or inadvisable, prudent or imprudent, so long as no law is violated. It is the taxpayer, whose investment is at stake, who should determine ways and means and not the Government.[41]

Further evidence that the Court seems to embrace the interpretation sought by Welch—"convenient" or "suitable"[42]—is that Cardozo includes a citation to *McCulloch v. Maryland*, having to do with the meaning of necessary as used to delineate congressional powers under section 8 of Article I of the constitution, which Welch quotes extensively in his brief and which the Commissioner ignores in his.[43]

Cardozo not only articulates a statutory interpretation of "necessary" that demands deference to the judgment of business owners, but he, in fact, demonstrates that deference by not making any attempt to justify Welch's payments to the creditors of the now defunct E.L. Welch Company. The record shows that Welch sought and received the advice of three bankers all of whom insisted that his future success depended on his repaying the old debts.[44] It also shows how successful he was in earning commissions over the five tax years in question.[45] For Cardozo, these facts apparently have no relevance, because, presumably, even if Welch had not received that advice and even if his attempt to continue to make a living as a grain broker was not as successful as it was, it would not have mattered. Arguably, as a matter of

[41] Brief for Petitioner at 10.
[42] *Id.* at 16–17, referencing McCulloch v. Maryland, 17 U.S. 316, 4 Wheat. 316 (1819).
[43] 290 U.S. at 113. The Court also comes close to embracing the meaning of necessary suggested by the Eight Circuit Court of Appeals, 63 F.2d 976, 976 (1933), which stated that "[t]here may be room for argument and difference as to whether payments of this character, under the circumstances here, are 'necessary' or not. It would be rather clear that they would be helpful in a business way, and that helpfulness might approach or reach necessity."
[44] Transcript of Record at 31
[45] *Id.* at 29, 31 (providing further details concerning Welch's gross income and payments to creditors and describing in his testimony how he built up a large business by doing business with a number of E.L. Welch Company's creditors).

constructing his opinion, Cardozo spends little time on the deference issue, because he thinks the language of *ordinary* creates the most difficult challenge for the taxpayer to surmount in his appeal. Nevertheless, the rhetorical effect of his stark statement put the Commissioner and taxpayers on notice that the necessary requirement placed little or no limit on the deductibility of business owners' expenditures. Thanks to *Welch*, the requirement essentially becomes tautological with business judgment and business judgment means anything a business owner deems necessary as a rational profit-seeker.

Cardozo spends most of the opinion struggling with the term *ordinary*. It is here that Welch loses his case, but it is also the place where he becomes the *every businessman*, noble in the conduct of his rational pursuit of profit. With nearly every aspect of the opinion that follows the every businessman grows in stature. At the outset, Cardozo seems to equate the question of ordinary with the question of whether an expenditure should be capitalized when he writes that "the problem is not solved when the payments are characterized as necessary. Many necessary payments are charges upon capital."[46] He follows that with a hypothetical, based to a degree on the facts in *Kornhauser v. United States*, in which a businessman incurs legal fees because of a "once in a lifetime" event putting the "safety of a business" at risk for the purpose of showing that ordinary does not mean that "payments must be habitual or normal in the sense that the same taxpayer will have to make them often."[47] Just in case the reader missed the point about the businessman's bravery as he operates in the marketplace, Cardozo goes on to link the deduction of legal fees as a "defense against attack."[48]

[46] 290 U.S. at 113. The basis given by the Commissioner to Thomas Welch when notifying him of a deficiency for his 1924 and 1925 taxes was that the payments for discharged debts of E.L. Welch Company were "in the nature of capital expenditures." Transcript of Record at 10.
[47] 290 U.S. at 114, citing Kornhauser v. United States, 276 U.S. 145 (1928) (having to do with the deductibility of legal fees for an accounting to the taxpayer's partner).
[48] *Id.*

The safe ground upon which Cardozo finds himself when considering the meaning of ordinary with regard to his "legal fees" hypothetical, eludes him when he gets back to the facts of *Welch* in the next paragraph of the opinion:

> The line of demarcation is now visible between the case that is here and the one supposed for illustration [i.e., the legal fees hypothetical]. We try to classify this act as ordinary or the opposite, and the norms of conduct fail us. No longer can we have recourse to any fund of business experience, to any known business practice. Men do at times pay the debts of others without legal obligation or the lighter obligation imposed by the usages of trade or by neighborly amenities, but they do not do so ordinarily, not even though the result might be to heighten their reputation for generosity and opulence. . . .There is nothing ordinary in the stimulus evoking it, and none in the response. . . . The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.[49]

At this point, Cardozo seems to be no longer trying to distinguish between an expenditure that a taxpayer can deduct immediately and one that he needs to charge to capital. Instead, he is asking whether the payments on the discharged debts are business expenditures at all. As he discusses this aspect of ordinary, the word "opulence" jars. It has a negative connotation because it would seem to equate Welch with a spendthrift or suggest he may have acted in bad taste. At the least, it is the one time in the opinion that Cardozo places Welch among those very rich who were the primary target of the tax law. Yet, the overall tenor of Cardozo's struggle with how to treat Welch's payments for the

[49] *Id.*

previously discharged debts of the now defunct E.L. Welch Company remains primarily respectful to Welch as a businessman. In fact, one senses that the reason why Cardozo finds this such a hard case is because he cannot overcome his astonished admiration for Welch's commitment to make good on those debts.

Yet, that astonished admiration concerning a business practice of paying back discharged debts is odd in itself. For one thing, Welch based a good deal of his argument on *Harris & Company v. Lucas*, which had to do with a company paying debts previously discharged in bankruptcy.[50] For another, as noted earlier, the record showed that Welch had received the advice about repaying the debts from three different bankers.[51] Finally, although the Commissioner did argue that the "payments were unusual and gratuitous rather than ordinary and necessary" and went on to say they were "not common, usual, [or] often recurring," he never went so far as to say they were beyond the "norms of conduct" or "known business practice."[52] Why did Cardozo misleadingly treat the payments as an oddity in business, especially given that it undermines the earlier part of the opinion in which he stated so forthrightly that "we should be slow to override his [Welch's] judgment"?[53]

The next paragraph in Cardozo's opinion accentuates the incoherence of the one just discussed, because, in the first several sentences, he returns to the issue of capitalization and then adds the argument of the deference the Court owes to rulings by the Commissioner:

> The Commissioner of Internal Revenue resorted to that standard [i.e., the statutory standard] in assessing the petitioner's income, and found that the payments in controversy came closer to capital

[50] Brief of Petitioner, at 5, 6, 7, 11, citing Harris & Company v. Lucas, 48 F.2d 187 (5th Cir. 1931).
[51] Transcript of Record at 31.
[52] Brief of Respondent at 6.
[53] 290 U.S. at 113.

> outlays than to ordinary and necessary expenses in the operation of a business. His ruling has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong. . . . Unless we can say from facts within our knowledge that these are ordinary and necessary expenses according to the ways of conduct and the forms of speech prevailing in the business world, the tax must be confirmed.[54]

The Commissioner had argued in the alternative that the payments were not ordinary and necessary and, even if they were, they should be classified as capital.[55] Notably, the Commissioner had not argued the deference argument in its brief and Welch had not raised it either. With these few sentences, however, Cardozo would seem to have resolved all outstanding issues in favor of the Commissioner. What may at first seem like a pithy opinion, in fact, could have been even more concise. If Cardozo had just followed the Commissioner's lead, he would not have needed to concern himself at all with whether paying a previously discharged debt is beyond the ken of "any known business practice."

Moreover, Cardozo would have had no need to go through his now famous list of "bizarre analogies."[56] Where usually that term would have a pejorative overtone, he turns it into an affirmation of the dignity and decency of the every businessman, even as he rejects the appropriateness of allowing an immediate deduction for the expenditures he describes:

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[54] *Id.* at 115.

[55] Brief of Respondent at 9 (arguing that "[i]f the payments made by petitioner do not meet the requirement of being "ordinary and necessary" expenses of the taxable year in carrying on a business, it is unnecessary to inquire further in an attempt to classify them. . . . But if they are capital expenditures that are necessarily not within the class of current business expenses. If these payments may be regarded as being connected with petitioner's business, we believe they are essentially capital expenditures").

[56] 290 U.S. at 115.

> One man has a family name that is clouded by thefts committed by an ancestor. To add to his own standing he repays the stolen money . . . . Another man conceives the notion that he will be able to practice his vocation with greater ease and profit if he has an opportunity to enrich his culture. . . . There is little difference between these expenses and those in controversy here. Reputation and learning are akin to capital assets, like the good will of an old partnership. . . . For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business.[57]

It may be that Cardozo believes it is "bizarre" to allow an immediate deduction for any of these types of expenditures, but he certainly does not mean to suggest that they are anything less than astute and decent. Although Cardozo ended up writing a muddled opinion on the law, he could not have been clearer on the respect owed to the middle-class businessman and his efforts "to hew a pathway to success."

Both the press and legal scholars virtually ignored *Welch* at the time the Supreme Court decided it.[58] Recent scholarship has much to say about Cardozo's faulty reasoning and confusing exposition.[59] *Welch*'s importance goes beyond its treatment as precedent on a range of questions, including whether Commissioner's rulings are presumed correct, whether the term *ordinary* refers only to the distinction between those expenditures

[57] *Id.*
[58] *See* Newman, *supra* note 33, at 197–98.
[59] *See* Marvin A. Chirelstein, FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS 138–40 (11th ed. 2009); Newman, *supra* note 33, at 207–09.

that are capital in nature and those that are currently deductible, or whether the term *necessary* merely means "appropriate and helpful." The power of *Welch* lies in its naming of the noble business owner, for, of course, Cardozo did not create him. He had been there from the start of the modern tax law as someone whose skill and hard work in the face of the consumption taxes and monopoly power and with little political influence earned him the good standing of his neighbors and a symbolic role in policy debates. That commentators have overlooked this central aspect of *Welch* is unsurprising. The influence of Cardozo's iconic figure mostly remains unnoticed as it embeds itself in legislation, regulations, rulings, and court decisions. It is only when the tax law's treatment of workers is set alongside its treatment of business owners that the force and impact on our current tax regime of Cardozo's every businessman emerges.

II. DEFERENCE TO BUSINESS OWNERS' JUDGMENT

This part analyzes the case law to demonstrate how deference to business owners' judgment leads to mistakes in tax jurisprudence. The first section shows how the courts, thanks to *Welch*, have essentially eviscerated the requirement of "necessary" as applied to business owners. The next section, through an analysis of *INDOPCO v. United States*, demonstrates how deference to business owners' judgment has precluded consideration of the possibility that some business owners' expenditures should not be recoverable under the tax law at all. The last section examines the effect of deference to business owners' judgment on expenditures that benefit someone other than the business owner.

A. WELCH PROGENY

Welch v. Helvering laid the foundation for a standard of extreme deference to business owners. In its subsequent decisions,

the Supreme Court has seldom questioned whether the business owner's expenditure is a legitimate cost of producing income. The Court has occasionally disallowed deductions when they clearly relate to personal matters, such as divorce,[60] or on the grounds that that the taxpayer is not engaged in a trade or business and is thus not a "true" business owner.[61] In a couple of instances, the Court has disallowed a stockholder's deduction on the grounds that the expense related to the corporation itself, and not the stockholder.[62] In a handful of cases, the Court has disallowed deductions where they have violated public policy,[63] but it has declined to do so in just as many cases.[64] Following Justice Cardozo's approach in *Welch*, the Court has in several cases disallowed a I.R.C. § 162 deduction on the grounds that the expenditure must be capitalized, and is therefore not ordinary.[65] Implicit in the capitalization cases, however, is the assumption that the expenditures are allowable costs of producing income; the only issue being *when* the expenditure should be recovered. There is no question that the expenditure will be recovered, albeit at some point later in time rather than as a current deduction.[66]

Welch and subsequent Supreme Court jurisprudence have rendered the "necessary" prong of I.R.C. § 162 almost meaningless. In 1966, in *Commissioner v. Tellier*, the Court

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[60] *See* United States v. Gilmore, 83 S. Ct. 623 (1963); United States v. Patrick, 372 U.S. 53 (1963).

[61] *See* City Bank Farmers' Trust Co. v. Helvering, 313 U.S. 121 (1941); Higgins v. Commissioner, 312 U.S. 212 (1941); United States v. Pyne, 313 U.S. 127 (1941); Van Wart v. Commissioner, 295 U.S. 112 (1935).

[62] *See* Whipple v. Commissioner, 373 U.S. 193 (1963); Deputy v. du Pont 308 U.S. 488 (1940).

[63] *See* Cammarano v. United States, 358 U.S. 498 (1959; Tank Truck Rental v. Commissioner, 356 U.S. 30 (1958); Hoover Motor Express Co. v. U.S. (1958); Textile Mills Securities Corp. v. Commissioner, 314 U.S. 326 (1941).

[64] *See* Commissioner v. Sullivan, 356 U.S. 27 (1958); Lilly v. Commissioner, 343 U.S. 90 (1952); Comissioner v. Tellier, 383 U.S. 687, 689 (1966); Commissioner v. Heiniger, 320 U.S. 467 (1943.

[65] *See* INDOPCO v. Commissioner, 503 U.S. 79 (1992); Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345 (1971); Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Hilton Hotels Corporation, 397 U.S. 580 (1970).

[66] For a more detailed discussion of capitalization, see infra notes 77-91 and accompanying text.

described the *Welch* interpretation of "necessary" as a well-established principle: "Our decisions have consistently construed the term "necessary" as imposing *only the minimal requirement* that the expense be "appropriate and helpful" for "the development of the [taxpayer's] business."[67]

The lower courts have followed the Court's lead by likewise adopting a posture of utmost deference to the business owner with respect to their application of the "necessary" standard. For example, in *Urbauer v. Commissioner*, [68] the Tax Court upheld a taxpayer's deductions for country club dues and fees for golf and bowling tournaments, solely on the basis of the taxpayer's averred belief that rubbing elbows with country club members would enhance his business.[69]

Similarly, in *Heineman v. Commissioner*,[70] the Tax Court allowed Ben Heineman, the CEO of Northwest Industries, Inc., a Chicago railroad conglomerate, to deduct maintenance for and depreciate the cost of an office dwelling about 100 yards from his vacation home in Sister Bay, Wisconsin, on the shores of Lake Michigan. The office, which cost about $250,000, consisted of a single room suspended from the side of the limestone cliff by a cantilevered steel frame anchored in the cliff wall. Each summer, Heineman and his wife would spend six weeks sailing on the lake, and then, for the month of August, retire to their home in Sister Bay. Heineman would spend several hours a day in the cliffside office, reviewing long-range business plans. At trial, he admitted that he spent August in Sister Bay in order to escape the hot summer weather in Chicago, but he also argued that he was more effective in his work because he was insulated from daily distractions of his Chicago office. The government argued that the construction costs for the Sister Bay office were not necessary

[67] Commissioner v. Tellier, 383 U.S. 687, 689 (1966) (citations omitted and emphasis added).
[68] T.C. Memo 1992-170.
[69] T.C. Memo 1992-170 at 16. In the aftermath of cases like *Urbauer*, Congress enacted I.R.C. § 274(a)(3), which disallows deductions for country club dues. Omnibus Reconciliation Act of 1993, 107 Stat. 469, 542.
[70] 82 T.C. 538 (1984)

because his reasons for working there in August were primarily personal, and that he could have easily have prevented daily distractions at his Chicago office by ordering his staff not to permit interruptions to the inner sanctum of his office.[71]

Heineman's reputation as a "Master of the Universe"[72] preceded him. In a fawning profile, Time Magazine had breathlessly described him as the "bold brainy lawyer" who was singlehandedly reviving the long-haul passenger rail system by adapting it to short-haul suburban commuters.[73] Heineman embodied everything Justice Cardozo admired in the noble business man, and more. The Tax Court can barely contain its admiration of Heineman in deferring to his judgment about the necessity of adjourning to Sister Bay for the summer:

> In his testimony, the petitioner described the work that he carried on in the Sister Bay office in August and explained why he could not secure the necessary isolation in his Chicago office. He stated that he could perform the work of reviewing the long-term plans more effectively in the Sister Bay office. We found his testimony to be persuasive. We accept his claim that if he were in Chicago, there

[71] His office in Chicago consisted of a suite which contained a board of directors' office, a directors' lounge, a conference room, his own office, and separate offices for his administrative assistant, his secretary, and a special assistant. 82 T.C. at 540.

[72] Novelist Tom Wolfe coined this term in BONFIRE OF THE VANITIES, to describe the privileged, ambitious and arrogant young men who worked as Wall Street investment bankers during the 1980s.

[73] *Business: BEN HEINEMAN*, TIME (Dec. 15, 1958), http://www.time.com/time/magazine/article/0,9171,810772-1,00.html (last visited Oct. 9, 2011). In the clipped newsroom cadences of the era, the profile glowingly describes Heineman:

> [Heineman] learned that what was needed was radical modernization. He chopped the North Western's managerial deadwood, hired bright young railroad pros. He brought in modern bookkeeping machines and mechanized track-laying equipment, completely dieselized the line. He also became the foremost critic of union featherbedding in rails, trimmed his own payrolls from 26,300 to 18,500—but was a shrewd enough labor negotiator to avoid a full-scale strike.

> would be some demands on his time that could not be resisted. Despite the offices that Northwest provided him in Chicago and the staff that assisted him, there would be requests by people in and out of the corporation to see him, and it would be impracticable to say "no" to some of those requests. It is his judgment that his review of the long-term plans and the contemplation and thinking that such work requires could be performed more effectively at his office in Sister Bay; his reasons for reaching that judgment were convincing, and we will not substitute our judgment for his.[74]

Of course, some taxpayers push beyond the expansive boundaries of "necessary" established by *Welch*. In one amusing example, *Henry v. Commissioner*, the Tax Court disallowed deductions related to the taxpayer's ownership of a yacht.[75] The principal argument for deductibility put forth by the taxpayer, a CPA, was that he flew a red, white and blue flag bearing the numerals "1040." Notwithstanding decisions like *Henry*, it is indisputable that courts rarely invoke the "necessary" requirement as the basis for disallowing a business owner's deduction.[76]

B. INDOPCO AND NONRECOVERABLE COSTS

[74] 82 T.C. at 543-44 (citations omitted). *Heineman* predated the enactment of Section 280A, which limits home office deductions. However, Section 280A likely would not have changed the outcome in *Heineman* because it is inapplicable to a separate structure not attached to the taxpayer's residence. I.R.C. § 280A(c)(1)(C). Where the taxpayer is an employee, he must also show that the use of the separate structure is for the "convenience of the employer." I.R.C. § 280A(c)(1). Given the gloss put on that requirement in the Section 119 context, Ben Heineman would have no trouble satisfying it.

[75] Henry v. Commissioner, 36 T.C. 879 (1961).

[76] According to an informal sampling by Joel Newman, of the thousands of cases citing *Welch* in recent years, 90 percent do so for solely proposition that an IRS ruling is presumed to be correct, and the taxpayer has the burden of proving otherwise. *See* Newman, *supra* note 33 at 218-19.

As mentioned above, the Court sometimes has disallowed a business owner's deduction under I.R.C. § 162 on the grounds that the expenditure is capital. Indeed, this was arguably the Court's reason for denying Thomas Welch a deduction for the amounts he paid to discharge the bad debts of his former employer. The ensuing Supreme Court jurisprudence relating to capitalization does not revisit the issue Cardozo agonized over in *Welch*—that is, whether "ordinary" under I.R.C. § 162 means something more than "not chargeable to capital." Instead, the Supreme Court's persistent silence on that question generally has been viewed as an implicit assumption that all business owner expenditures are recoverable either as immediate deductions under I.R.C. § 162 or as charges to capital. So long as an expenditure is not too closely related to personal consumption,[77] the Court seems implicitly to have rejected the possibility that a business owner's expenditure might be so remotely connected to the production of income that it should be nonrecoverable—that is, neither deductible nor chargeable to capital.

One of the most important of the capitalization cases, *INDOPCO v. United States* involves expenditures that arguably bore only a tenuous relation to the production of income.[78] The National Starch Corporation paid investment banking, legal, and accounting fees in connection with a merger in which Unilever acquired all the stock of National Starch. National Starch claimed the expenses as deductions under I.R.C. § 162. The government argued that the expenses were capital in nature, and the Court

[77] *See* United States v. Gilmore, 83 S. Ct. 623 (1963) (holding that taxpayer's legal expenses incurred in divorce proceeding, that enabled him to retain his ownership interests in car dealerships and preserve his business reputation were not sufficiently related to his income-producing activity, and were personal). *See also* United States v. Patrick, 372 U.S. 53 (1963) (deciding that legal expenses incurred in a divorce proceeding and in connection with property transfers pursuant to a divorce settlement, that enabled taxpayer to preserve ownership of newspaper were personal, and not deductible under Section 212 as expenses for the production of income). The treatment of specific expenditures that have a personal component, such as education, childcare, and meals, is discussed in Part III below.

[78] 503 U.S. 79 (1992).

agreed. [79] Much of the Court's analysis focused on whether its prior decision, *Commissioner v. Lincoln Savings & Loan Association*, required a "separate and distinct asset" to be created or enhanced in order for an expenditure to be classified as capital.[80] (National Starch was the target of the acquisition, and thus did not itself acquire any asset.) The Court held that no separate and distinct asset was required.[81] Contrary to the taxpayer's argument that the benefit was "entirely speculative" or "merely incidental," the Court found that National Starch's acquisition by Unilever provided significant long-term benefits to National Starch.[82] Therefore, the expenditures facilitating the acquisition were capital.[83]

On its face, the *INDOPCO* decision says nothing about whether National Starch's expenses would have been deductible in the absence of the finding that they were capital. The Tax Court, in finding the expenses to be capital, explicitly stated that it did not need to decide whether the expenses would otherwise be deductible, which suggests the possibility that if an expense were *not* capital, it might also fail the test for deductibility.[84] From this, one might infer that the Supreme Court, having found that the expenditures were capital, likewise did not reach the question of whether the expenses were deductible, and likewise would not rule out the possibility that an expenditure might be *neither* capital *nor* deductible. However, the Third Circuit, in its decision affirming the Tax Court, suggested otherwise. It observed that the Court used "ordinary" to mean "not capital, and therefore deductible":

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[79] *See id.*at 90. The government also argued that the expenses were a constructive dividend. *See infra* note 93 and accompanying text.
[80] *See* 503 U.S. at 85-87.
[81] *Id.* at 89.
[82] The benefits consisted of "synergy" with Unilever and access to Unilever's enormous resources, especially in the area of basic technology. *Id.* at 88.
[83] *See id*. at 88-89. *INDOPCO* raised taxpayer concerns about the possibility of a greatly expanded capitalization requirement, but these have proved to be unfounded. Subsequent case law and regulatory guidance imposes a considerably diminished capitalization requirement. *See* Joseph Bankman, *The Story of Indopco: What Went Wrong in the Capitalization v. Deduction Debate* in TAX STORIES, *supra* note 30, 225, 240-44.
[84] *Id.* at 73.

> The Court has stated, in somewhat circular fashion, that the principal function of the term "ordinary" is to distinguish between expenses currently deductible and capital expenditures which, if deductible at all, must be amortized over the useful life of the asset. *See Commissioner v. Tellier, 383 U.S. 687, 689-90, 16 L. Ed. 2d 185, 86 S. Ct. 1118 (1966)*.[85]

The Third Circuit's language suggests that "ordinary" means nothing more than "not capital", and if an expenditure otherwise met the requirements of I.R.C. § 162, it would be deductible.

Thus, the Tax Court and Third Circuit decisions in *INDOPCO* present two possible views with respect to capitalization and deductibility: (1) expenditures that are not capital might also *not* be ordinary and, therefore, might be nondeductible (suggested by the Tax Court) or (2) expenditures that are not capital are *necessarily* ordinary and therefore, deductible (suggested by the Third Circuit). The INDOPCO taxpayer, National Starch, appeared to gamble that the Court would adopt the Third Circuit view: It argued that the expenses were not capital because its being acquired by Unilever produced an "entirely speculative" or "merely incidental" future benefit. At the same time, National Starch made no separate arguments establishing any current benefits flowing from the expenditures.[86] (Indeed, the Tax Court found that there was no evidence of any immediate benefit to National Starch from its affiliation with Unilever.[87]) It was a risky argument, because the Court might have agreed that the expenses were not capital, and then gone on to disallow the deduction because the expenses provided no present

[85] 918 F.2d at 428-29.
[86] 503 U.S. at 88.
[87] 93 T.C. at 76.

benefit to National Starch's business.[88] If the acquisition by Unilever provided only speculative or incidental future benefits and even less in the way of present benefits to National Starch's business, it would seem quite plausible that the acquisition expenditures should not be recoverable either immediately under I.R.C. § 162 or in future years.[89]

Of course, the Supreme Court held that National Starch's expenses were capital, and thus did not reach the question of whether the expenses would have been otherwise deductible. However, in the aftermath of *INDOPCO*, it is clear that the Third Circuit view has prevailed:. Virtually all of the activity around capitalization—administrative guidance, legislation, case law, scholarly writing—has assumed that the choice is between immediate cost recovery or delayed cost recovery.[90] Almost no one has considered seriously the third possibility, suggested by the Tax Court, of no recovery at all.[91] The *Welch* deference to business owners is evident in the presumption almost all expenditures—even those that have little or no connection to increased profitability—are presumed to be recoverable.

C. PRIMARY BENEFICIARY IS NOT THE BUSINESS OWNER

Another basis for questioning business owner deductions arises when an expenditure primarily benefits someone other than

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[88] *See* Calvin H. Johnson, *The Expenditures Incurred by the Target Corporation in an Acquisitive Reorganization are Dividends to the Shareholders: (Pssst, Don't Tell the Supreme Court)*, 53 TAX NOTES 463, 469 (Oct. 28, 1991).

[89] *See id*. at 469.

[90] *See* Bankman, *supra* note 83; Peter L. Faber, *Indopco: The Still Unsolved Riddle*, 47 TAX LAW. 607 (1994); John W. Lee, *Transaction Costs Relating to Acquisition or Enhancement of Intangible Property: A Popular, Political but Practical Perspective*, 22 VA. TAX REV. 273 (2002); Ethan Yale, *When Are Capitalization Exceptions Justified*? 47 TAX L. REV. 549 (2004).

[91] Two notable exceptions are Calvin Johnson, who has argued that the reorganization fees in INDOPCO ought to nonrecoverable, and Denise Roy, who observes a disparate treatment under current law of 'business' and 'personal' expenses, and argues that business expenses should not be presumed to be recoverable. *See* Johnson, *supra* note 88; Roy, *supra* note 2.

the taxpayer is. The courts have occasionally disallowed a deduction on these grounds.[92] When a corporate taxpayer is involved, the primary beneficiary is likely to be a shareholder, and the expenditure likely to be characterized as a constructive dividend to the shareholder. For example, in *INDOPCO*, the government made the argument—not addressed by either the Supreme Court or the lower courts—that National Starch's expenditures primarily benefited its shareholders by facilitating the sale of their shares to Unilever, and therefore, the expenses were a constructive dividend from National Starch to its shareholders.[93] On this characterization, the payments would be neither deductible business expenses nor capital expenses; they would be entirely nonrecoverable.[94]

Congress has acknowledged the constructive dividend basis for disallowing a deduction in I.R.C. § 162(a)(1), which disallows deductions for compensation in excess of "reasonable" amounts.[95] The legislative history and antecedent case law for this provision indicate that the normal presumption of deductibility should be not apply where purported compensation payments were in reality dividends or other nondeductible expenditures, such as gifts.[96]

Beyond the limited situations of constructive dividends or gifts, however, the tax law seldom questions whether business owners' expenditures primarily benefit someone else, especially

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[92] *See, e.g., Jack's Maintenance Contractors, Inc. v. Commissioner*, 703 F.2d 154, 156 (5th Cir. 1983) (corporation's payment legal fees of CEO and principal shareholder in criminal prosecution for personal tax evasion was a constructive dividend to the CEO-shareholder, and not deductible).

[93] The Tax Court alluded to the argument in its opinion, but specifically stated it did need not reach the argument. Nat'l Starch & Chemical Corp. v. Commissioner, 93 TC 67, 73, 78-79 (1989). Neither the Third Circuit nor the Supreme Court mentioned the constructive dividend argument. The issue did, however, arise in oral argument before the Court. *See* Bankman, *supra* note 83, at 233-34. Moreover, it is intriguing that the Court cited Calvin Johnson's article, in which he argue that target corporation acquisition expenses should be treated as a dividend. 503 U.S. at 84, n. 4.

[94] *See* Johnson, *supra* note 88.

[95] *See also* Treas. Reg. § 1.162-7(b)(1) ("an ostensible salary paid by a corporation may be a distribution of a dividend on stock").

[96] *See* Joy Sabino Mullane, *Incidence and Accidents: Regulation of Executive Compensation through the Tax Code*, 13 LEWIS & CLARK L. REV. 485, 507-09 (2009).

when the primary beneficiaries are upper management. Business owners regularly provide their managerial class with costly furniture, artwork, luxurious travel accommodations and meals, all the while recovering these expenditures as the cost of carrying on a trade or business. Some of the most patently personal of these expenditures—meals and entertainment, travel, and luxury cars—are now subject to statutory limitations.[97] However, many other expenses continue to fly under the radar. It is unclear, for example, why a corporate executive must have a mahogany desk or a corporate jet to fly him to business meetings when a Steelcase desk and commercial air travel are available at a fraction of the cost.[98]

One argument in favor of allowing a deduction for these seemingly wasteful expenditures is that the perquisites are necessary in order to recruit and retain qualified managers.[99] On this rationale, the managerial perquisites would be treated as deductible compensation to the managers, but the managers would be required to include the benefits in income.[100] Alternatively, a

[97] *See, e.g.*, I.R.C. §§ 274, 280F.

[98] In the rare instance where the executive himself incurs the expense, it ought likewise to be disallowed. *Cf.* Noyce v. Commissioner, 97 T.C. 670, 682-85 (1991) (allowing corporate executive to deduct the cost of private jet for business travel, even though company's policy was to reimburse employees only for coach class commercial air travel); *Heineman*, *supra* notes 70-74 and accompanying text (allowing corporate executive to deduct maintenance for and depreciate the cost of a cliffside office adjacent to his vacation home).

[99] *See* David A. Westbrook, *Notes Toward a Theory of the Executive Class*, 54 BUFFALO L. REV. 1047, 1049-52, 1061 (2007). Another response would attempt to provide a business rationale for the expenditures—*i.e.*, a luxurious office is necessary to impress clients or competitors; travel by private jet saves precious time, *etc*. We argue in Part V below that these types of expenses ought to be treated in parity with "mixed business/personal" expenses such as commuting and clothing. Thus, if deductible at all, the deduction should be limited by the remoteness criterion and the cost constraint rule.

[100] In extreme cases, where the perquisites clearly bear no relation to conduct of the business, the executive acknowledges their compensatory nature and includes them in income. One prominent example is that of former General Electric chief executive Jack Welch, who, on retirement, received country club and opera memberships, the use of a corporate jet and New York City apartment. *See* Amy Borrus, *Exposing Execs' "Stealth" Compensation*, BLOOMBERG BUSINESSWEEK, http://www.businessweek.com/bwdaily/dnflash/sep2004/nf20040924_8648_db016.htm (Sept. 24, 2004). However, the common practice is to "gross up" the executive for their

closer scrutiny of these types of expenditures might lead to the conclusion that such amounts are wealth transfers to managers having little or nothing to do with increasing the profitability of the business. This analysis would apply more broadly to disallow deductions for excessive compensation.[101]

This type of scrutiny is theoretically sound: In corporate law, there is a well developed theory of the agency costs of separating business management and ownership, which posits that managers have the incentive and power to divert corporate resources for their personal gain rather than maximizing profit for their shareholders.[102] In practice, however, neither corporate law nor tax law succeeds in implementing theory. In corporate law, the business judgment rule almost always protects managers' decisions about how much to pay themselves—whether through perquisites or salary.[103] In the tax arena, the *Welch* deference to business owners operates much the same way as the business judgment rule. The Internal Revenue Service (IRS) rarely succeeds in challenging the deductibility of compensation,[104] and aside from the political gesture in response to media reports of managerial egregious

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additional tax liability; the corporation then deducts the gross-up as additional compensation.

[101] *See* Aaron S.J. Zelinsky, *Comment: Taxing Unreasonable Compensation: § 162(a)(1) and Managerial Power*, 119 YALE L.J. 637 (2009); Edward A. Zelinsky, *The Tax Policy Case for Denying Deductibility to Excessive Executive Compensation: Disguised Dividends, Reasonable Compensation, and the Protection of the Corporate Income Tax Base*, 58 TAX NOTES 1123 (Feb. 22, 1993); *see also* Linda Sugin, *Encouraging Corporate Charity*, 26 VA. TAX REV. 125 (2006) (proposing that corporate philanthropy be moved from I.R.C. § 170 to I.R.C. § 162, thus permitting a distinction between valid business expenditures from managerial waste).

[102] *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 95-111 (2004).

[103] *See* Steven C. Caywood, *Wasting the Corporate Waste Doctrine: How the Doctrine can Provide a Viable Solution in Controlling Excessive Executive Compensation*, 109 MICH. L. REV. 111, 115 (2010); Lawrence A. Cunningham, *A New Legal Theory to Test Executive Pay: Contractual Unconscionability*, 96 IOWA L. REV. 1177, 1211 (2011).

[104] *See, e.g.*, Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir. 1999); *see also* Mullane, *supra* note 96, at 506-09.

excess,[105] neither the courts, Congress, nor the IRS have had much interest or success in limiting business deductions on this basis.

III. SKEPTICISM TOWARDS WORKERS

As discussed above, the tax system accords great deference to business owners' judgments about expenditures that are necessary to economic productivity. This Part explores the counterpoint to this deference—the deep skepticism of workers' expenditures related to their economic productivity. It classifies outlays for education, healthcare and childcare as purely personal consumption, even though these contribute as much, if not more, to productivity than a home office suspended over Lake Michigan or merger creating speculative and incidental future benefits in the way of "synergy." Other worker expenses, such as work-related travel or meals, are less clearly connected with the production of income. With respect these expenditures, what is striking is the disparate treatment they are given depending on whether they are incurred by a business owner or a worker. When incurred by a worker, the tax system imposes a multitude of limitations on the ability to the worker to recover these costs, reflecting the dominant characterization of workers as consumers rather than producers. At the same time, when incurred by employers on behalf of their employees, the very same outlays are presumed to be deductible, without the limitations applied to workers, reflecting the deference given to business owners.

A. EDUCATION

Education unquestionably contributes to workers' productivity.[106] Economists and policymakers perennially bemoan

[105] I.R.C. § 162(m) imposes a one million dollar cap on the deductibility of compensation paid to any single individual, but the limitation is easily circumvented, because the statute explicitly excludes "performance-based compensation" from the dollar amount of the cap. *See* Mullane, *supra* note 96; Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code* , 64 WASH. & LEE L. REV. 877 (2007).
[106] *See infra* note 183 and accompanying text.

the future of the under-educated U.S. workforce and call for more government investment in education.[107] These calls have become even more urgent as the United States economy has shifted from manufacturing to services and technology.[108] Another metric demonstrating the income-producing value of education is the link between higher education levels and higher incomes. For example, in 2010, those with a college degree earned about sixty-six percent more than those with a high school degree; those with a professional or doctoral degree earned more than two and a half times than high school degree holders.[109] The correlation between education and earnings levels is strong and persistent.[110]

Despite the clear link between education and worker productivity, the courts and the IRS from the earliest days of the income tax have treated education expenses as personal and nondeductible.[111] *Welch* could have marked a change in the treatment of education expenses, and led to the same expansive treatment accorded to other business expenditures in the aftermath of *Welch*. After all, Justice Cardozo, in dicta, did analogize education to a capital asset–an investment in the taxpayer's trade or business, albeit as part of his list of "bizarre analogies."[112]

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[107] *See infra* notes 210-211 and accompanying text.
[108] *See id.*
[109] U. S. DEP'T. OF LABOR, BUREAU OF LABOR STATISTICS, EMPLOYMENT PROJECTIONS, EDUCATION PAYS (2011), http://www.bls.gov/emp/ep_chart_001.htm (2011).
[110] *See* Stuart Lazar, *Schooling Congress: The Current Landscape of the Tax Treatment of Higher Education Expenses and a Framework for Reform*, 2010 MICH. ST. L. REV. 1047, 1049-51 (2010); SANDY BAUM *ET AL.*, COLLEGE BOARD ADVOCACY AND POLICY CENTER, EDUCATION PAYS 2010: THE BENEFITS OF HIGHER EDUCATION FOR INDIVIDUALS AND SOCIETY, at 11-17 (2010), http://trends.collegeboard.org/downloads/EducationPays2010.pdf.
[111] *See, e.g.*, I.T. 1520 I-2 C.B. 145 (1922), *revoked by* I.T. 2688, XII-1 C.B. 250 (1933) (research expenses by college professor were personal, nondeductible expenses); Appeal of Driscoll (voice lessons in preparation for professional singing career were personal). For a detailed account of the history of the tax treatment of educational expenses, see Jay Katz, *The Deductibility of Education Costs: Why does Congress Allow the IRS to Take Your Education So Personally?*, 17 VA. TAX REV. 1, 17-37 (1997); Lazar, *supra* note 110, at 1057-68; James L. Musselman, *Federal Income Tax Deductibility of Higher Education Costs: The Good, the Bad and the Ugly*, 35 CAP. U.L .REV. 923, 927-34 (2007)..
[112] 290 U.S. at 115-16.

Instead, however, the courts and IRS have interpreted Cardozo's dicta as a further limitation on the deductibility of education expenses as "an inseparable aggregate of personal and capital expenditures."[113]

The post-*Welch* interpretation of "necessary" in the context of education expenses exemplifies the highly restrictive standard applied to workers as compared to business owners. Recall that, as applied to business owners, the "necessary" requirement is almost always presumed satisfied under a standard of extreme deference to the business owner; any expense that is "appropriate and helpful" will pass muster.[114] In contrast, in order for a worker's education expense to meet the "necessary" standard, the education must be *required*.[115] Thus, for example, in *Hill v. Commissioner*, the Fourth Circuit held that a public school teacher could deduct the costs of a summer school course where it was required under state law for her to renew her certificate.[116] However, in *Cardozo v. Commissioner*, the Tax Court held that a professor's expenses for study and research in Europe were not "necessary" because the taxpayer's employer had neither authorized the trip nor required it as a condition of maintaining his position.[117] Regardless of whether *Cardozo* reached the correct outcome (as it probably did), the interpretation of "necessary" to mean "required" stands in stark contrast to the *Welch* "appropriate and helpful" interpretation as applied to business owners.

Current law generally treats educational costs as personal and allows no recovery through deduction or capitalization. Only under limited circumstances is a worker allowed to deduct higher education expenses: (1) the education must maintain or improve her skills in her trade or business, or (2) it must be required by her

[113] Treas. Reg. § 1.162-5(b)(1). *See* Lazar, *supra* note 110, at 1059, 1072-72.
[114] *See supra* notes 60-76 and accompanying text.
[115] *See* Lazar, *supra* note 110 at 1061-64.
[116] 181 F.2d 906 (4th Cir. 1950), *rev'g*, 13 T.C. 291 (1949). This was by no means an easy win for the taxpayer. The Tax Court had disallowed the deduction, reasoning that could have satisfied the state law requirement through the less costly alternative of taking an exam on selected books. Hill v. Commissioner, 13 T.C. 291, 294 (1949).
[117] 17 T.C. 3 (1951).

employer or by law, but in either case the education cannot be to meet the minimum qualifications for the trade or business and the education cannot qualify her for a new trade or business.[118] In addition to this limited I.R.C. § 162 deduction for higher education costs, the tax law provides a panoply of education tax preferences including the I.R.C. § 25A American Opportunity Credit and Lifetime Learning Credit, the I.R.C. § 221 deduction for education loan interest; the I.R.C. § 527 exclusion for employer-provided education assistance; the I.R.C. § 529 exclusion for qualified tuition programs; and the I.R.C. 530 exclusion for "Coverdell" education savings accounts.[119] A distinguishing feature of all these provisions is their characterization as tax expenditures—that is, preferences that purposely reduce tax liability below "normal" levels in order to advance social policy goals—rather than reflecting education as a legitimate cost of producing income under the Schanz-Haig-Simons definition of income.[120]

B. HEALTHCARE, CHILDCARE AND OTHER "MIXED" BUSINESS/PERSONAL EXPENSES

Two other major categories of expenditures that are integral to workers' productivity are healthcare and childcare expenses. As with education, both of these suffer from having personal and human dimensions that do not fit comfortably within the dehumanized corporate business model of economic productivity.

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[118] Treas. Reg. § 1.162-5.

[119] For a complete list of education tax preferences, see Lazar, *supra* note 110, at 1074-1107.

[120] *See* U.S. CONG., J. COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2011-2015, at 10, 12, 13, 14 (2012). Many scholars have criticized the current law treatment of education expenses, and have argued that they ought to be at least partially deductible or capital in order properly to measure income from labor. *See, e.g.*, David S. Davenport, *Education and Human Capital: Pursuing an Ideal Income Tax and a Sensible Tax Policy*, 42 CASE W. L. REV.793 (1992); Hamish P.M. Hume, *The Business of Learning: How and When the Cost of Education Should be Recognized*, 81 VA. L. REV. 887 (1995); Katz, *supra* note 111; Lazar, *supra* note 110. *But see* Joseph M. Dodge, *Taxing Human Capital Acquisition Costs -- Or Why Costs of Higher Education Should Not Be Deducted or Amortized*, 54 OHIO ST. L.J. 927 (1993).

Businesses, after all, do not have families and do not require medical care. And as with education, the tax system has been reluctant to recognize these outlays as necessary for the production of workers' income.

The tax system's treatment of childcare closely parallels that of education. Work-related childcare expenses were treated as personal expenditures in the early years of the income tax.[121] In 1954, Congress enacted a limited deduction for childcare expenses. It was limited in amount and designed to be available only to parents who were required to work—widows and widowers, for example. In addition, it was a "below-the-line" deduction, so only those who itemized deductions could make use of it, thereby automatically disqualifying the vast majority of taxpayers who used the standard deduction. The deduction and its legislative history reflect skepticism that childcare is a legitimate business expense and embrace a restrictive interpretation of "necessary" far removed from the "helpful and appropriate" *Welch* interpretation.[122] As Congress expanded the deduction over time, and eventually replaced it in 1976 with a childcare credit,[123] it continued to express ambivalence about treating childcare expenses as legitimate costs of producing income.[124] Under current law, primarily two provisions take account of childcare costs—the

[121] Smith v. Commissioner, 40 B.T.A. 1038 (1939), *aff'd per curiam*, 113 F.2d 114 (2d Cir. 1940).

[122] The original House bill limited the child care deduction to widows, widowers, and "divorced persons" only; the Senate expanded the provision to cover working women. H.R. REP. NO. 83-1337, at 4055; S. REP. NO. 83-1622, at 4857. The Minority Views appended to the House Report characterized the $600 deduction authorized by the 1954 Code as' almost too small to be taken seriously." H.R. REP. No. 83-1337 (Minority Views), at 4603 ("Those who imagine that any mother can hire adequate child care help for $11.54 a week have simply lost touch with realities. This $600 limitation greatly restricts the tax relief accorded.)

[123] I.R.C. § 21.

[124] *See* Deborah Dinner, *The Universal Childcare Debate: Rights Mobilization, Social Policy, and the Dynamics of Feminist Activism, 1966-1974*, 28 LAW & HIST. REV. 577, 618 (2010) (stating that Congress classifies as a personal living expense rather than as a business expense); Nancy C. Staudt, Taxing Housework, 84 GEO. L.J. 1571, 1602 (1996) (stating that "[t]ax scholars ... point out that Congress has limited the childcare deduction provisions, unlike other business expense provisions found in the Code.").

I.R.C. § 21 childcare credit and the I.R.C. § 129 exclusion for employer provided childcare. Like the education provisions, these are treated as tax expenditures rather than as normal trade or business expenses.[125]

The tax system has been even more disinclined to view healthcare as a legitimate trade or business expense than education or childcare. Medical expenses—without regard to any connection to trade or business--have been deductible since 1942.[126] The deduction, authorized by I.R.C. § 213, is characterized as a "personal deduction," meaning that medical expenses are classified as consumption that ought not to be deductible in measuring income.[127] It has always been limited by a significant "floor" tied to adjusted gross income—that is, only those medical expenses in excess of a percentage (under current law 7.5 percent) of adjusted gross income, are deductible.[128] In addition, it is a "below-the-line"

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[125] U.S. CONG., J. COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2011-2015, at 14 (2012) (listing the childcare credit and exclusion for employer-provided childcare as tax expenditures).

Many scholars have criticized the tax law's treatment of childcare expenses and posited that they ought to be at least partially deductible under a Schanz-Haig-Simons definition of income. *See, e.g.*, Grace Blumberg, *Sexism in the Code: A Comparative Study of Income Taxation of Working Wives and Mothers*, 21 BUFF. L. REV. 49 (1971); Mary L. Heen, *Welfare Reform, Child Care Costs, and Taxes: Delivering Increased Work-Related Child Care Benefits to Low-Income Families*, 13 YALE L. & POL'Y REV. 173 (1995); Alan J. Samansky, *Childcare Expenses and the Income Tax*, 50 FLA. L. REV. 245 (1998); Staudt, *supra* note 124; Lawrence Zelenak, *Children and the Income Tax*, 49 TAX L. REV. 349 (1994). *But see* Tsilly Dagan, *Ordinary People, Necessary Choices: A Comparative Study of Childcare Choices*, 11 THEORETICAL INQ. L. 589 (2010) (arguing that the Haig-Simons definition is incapable of adequately reflecting outlays such as childcare, and advocating the adoption of additional norms into the definition of income).

[126] Revenue Act of 1942, ch. 619, § 127, 56 STAT. 798 (Oct. 21, 1942).

[127] STAFF OF J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 50 (Comm. Print 1987) ("medical expenses essentially are personal expenses and thus, like food, clothing, and other expenditures of living and other consumption expenditures, generally should not be deductible in measuring taxable income.")

[128] The floor amount was decreased to 3 percent of adjusted gross income, and then increased to 5 percent, before settling at 7.5 percent, where it has remained since 1986. *See* Janene R. Finley, *Equity in Reforming the Tax Treatment of Health Insurance Premiums*, 34 SETON HALL LEGIS. J. 1, 6-7 & n.29 (2009). In addition to the floor, the tax law also imposed ceiling of various amounts until 1965. Social Security Amendments of 1965, P.L. 89-97, 79 STAT.286 (July 30, 1965).

deduction, so only those taxpayers who itemize their deductions can deduct any of their medical expenses. Whether a medical expense might alternatively be deductible as a trade or business expense has seldom been explored.[129]

Along with the I.R.C. § 213 deduction, there are provisions relating to the treatment of medical expenses: the I.R.C. § 106 exclusion for employer-provided health insurance; the exclusion for medical expenses paid from Flexible Spending Accounts (I.R.C. § 125) and Health Reimbursement Accounts (I.R.C. §§ 105, 106); and the tax deferred treatment under I.R.C. § 106 of amounts invested in Medical Savings Accounts. As is true for education and childcare tax provisions, all of these healthcare provisions are treated tax expenditures.[130]

In addition to education, childcare and healthcare, workers incur a variety of expenditures related to their work, outlays for commuting, clothing, and food and lodging, to name a few noteworthy examples. These are often described as "mixed personal and business" expenses, which reflects the reality that they have an element of personal consumption but are also

[129] In a couple of instances—for example, where a blind taxpayer engaged the services of a reader for solely work purposes, the IRS has found that expenditures related to the disability are deductible under I.R.C. § 162 and not under I.R.C. § 213. See Rev. Rul. 75-316, 1975-2 C.B. 54; see also Rev. Rule. 75-317, 1975-2 C.B. 57 (certain travel expenses incurred by disabled taxpayer to pay for companion on business trips are deductible under I.R.C. § 162; others are deductible under I.R.C. § 213.

Gwen Handelman is one the few scholars to reconceptualize healthcare expenditures as investments in workers' productivity rather than consumption. *See* Handelman, *supra* note 2, at 135-141. *See also* Morgan Holcomb & Mary Patricia Byrn, *When Your Body is Your Business*, 85 WASH. L. REV. 647 (2010) (arguing that surrogate parents' expenses ought to be deductible as trade or business expenses rather than medical expenses); Lawrence Zelenak, T*he Reification of Metaphor: Income Taxes, Consumption Taxes and Human Capital*, 51 TAX L. REV. 1, 28-34 (making an *ad absurdum* argument that many personal deductions should be allowable as trade or business deductions if humans are viewed as "income-producing machines"). Much of the other scholarly work has focused on whether medical expenses in general are consumption or whether they ought to be excluded from the income tax base as some form of "nonconsumption." *See* Jeffrey H. Kahn, *Personal Deductions – A Tax "Ideal" or Just Another Deal?* 2002 L. REV. M.S.U.-D.C.L. 1, 25-35 (dscribing this debate).

[130] U.S. CONG., J. COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2011-2015, 42 (2012) (listing health expense deduction, employer-paid health insurance, medical savings accounts, and related items as tax expenditures).

connected to the worker's trade or business.[131] Yet the tax law generally treats these outlays purely personal. The cost of commuting, for example, has long been held to be nondeductible on the grounds that it is the taxpayer's personal choice whether, and how far, to live from his place of work.[132] Similarly, clothing is considered a purely personal expense except in rare instances, even when such clothing is required as condition of employment and is worn exclusively at work.[133] Food and lodging expenses are treated as nondeductible personal expenses except in limited circumstances.[134]

C. DIFFERENT OUTCOMES FOR SIMILAR EXPENDITURES

When expenditures are incurred by a worker, the tax system imposes a multitude of limitations on the ability to the worker to recover these costs. At the same time, when incurred by

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[131] *See, e.g.*, Thomas D. Griffith, *Efficient Taxation of Mixed Personal and Business Expenses*, 41 UCLA L. REV. 1769, 1770 (1994). In measuring poverty, the National Academy of Sciences recommended that work-related expenses such as commuting, childcare, and the purchase of tools and uniforms, be treated as nondiscretionary expenses and subtracted from resources. *See* MEASURING POVERTY: A NEW APPROACH, at 5 (Constance F. Citro & Robert T. Michael, eds., 1995). In 2011, an interagency task force including the U.S. Census Bureau, the Bureau of Labor Statistics, the Council of Economic Advisers, U.S. Department of Health and Human Services, and the Office of Management and Budget adopted this recommendation. *See* KATHLEEN S. SHORT, U.S. CENSUS BUREAU CURRENT POPULATION REPORTS, THE RESEARCH SUPPLEMENTAL POVERTY MEASURE: 2010, at 21 (2011), http://www.census.gov/hhes/povmeas/methodology/supplemental/research/Short_ResearchSPM2010.pdf

[132] Commissioner v. Flowers, 326 U.S. 465 (1946). *See generally* Tsilly Dagan, *Commuting*, 26 VA. TAX REV. 185 (2006); William A. Klein, Income Taxation and Commuting Expenses: Tax Policy and the Need for Nonsimplistic Analysis of "Simple" Problems, 54 CORNELL L. REV. 871 (1969).

[133] Pevsner v. Commissioner, 628 F.2d 467 (5th Cir. 1980). Clothing expenses are deductible only if the clothing worn exclusively at work, as a condition of employment, and is not adaptable for general usage as ordinary clothing. *Id.* at 262.

[134] *See* I.R.C. § 119 (providing an exclusion from income for meals and lodging provided to an employee by the employer "for the convenience of the employer"); I.R.C. § 162(a)(2) (allowing deduction for food and lodging "while away from home in pursuit of a trade or business"). *See infra* notes 143-163 and accompanying text for a more detailed discussion of meals.

employers on behalf of their employees, the very same outlays are presumed to be deductible, without the limitations applied to workers. This differential treatment occurs in both structural and substantive ways.

1. Structural Biases: Expenses Incurred by Workers in the Course of Their Employment

Even if expenditures by workers are clearly deductible under I.R.C. § 162, they may be subject to what we refer to as structural limitations. These structural limitations are unidirectional in their bias: The law restricts the ability of workers to deduct expenditures borne by them, while imposing no limitations for the same expenditures borne by the business owners who employ them.

An expenditure borne by a business owner in this context can take one of two forms: (1) workers initially incur an expense for a work-related good or service and are subsequently reimbursed by their employers (a "reimbursed employee expense) or (2) the employers pay directly for the same work-related good or service (a "working condition fringe benefit"). An expenditure borne by the worker typically takes the form of an "unreimbursed employee expense." A reimbursed employee expense is fully deductible as a so-called "above-the-line" deduction, which means it is subtracted from gross income in arriving at adjusted gross income (AGI).[135] Thus, though the worker has income equal to the amount of reimbursement by the employer, the income is fully offset by the above-the-line deduction. A similar result obtains in the case of a working condition fringe benefit: The value of the good or service provided by the business owner to the worker is excluded from the worker's income—the equivalent of an inclusion in the worker's income coupled with an offsetting deduction.[136]

[135] I.R.C. § 62(a)(2)(A).
[136] A working condition fringe benefit is defined to be "any property or services provided to an employee of the employer to the extent that, if the employee paid for such property

In contrast, an unreimbursed worker expense is a so-called "below-the-line," or "itemized" deduction, subtracted from AGI in arriving at taxable income,[137] and as such, is subject to numerous limitations.[138] Unreimbursed employee expenses—along with other itemized deductions—have been in the past subject to a phase-out at relatively high levels of adjusted gross income,[139] and also are not deductible for alternative minimum tax purposes.[140] Another structural limitation on unreimbursed worker expenses is created by the standard deduction: Because taxpayers are allowed the standard deduction regardless of their actual costs of producing income, their itemized deductions are meaningfully reflected as an offset to their income only to the extent they exceed the standard deduction.[141] In addition, unreimbursed worker expenses are classified into the subcategory of "miscellaneous itemized deductions," which are deductible only to the extent they exceed two percent of AGI.[142]

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or services, such payment would be allowable as deduction under section 162 or 167." I.R.C. § 132(d). Although the definition turn on whether an employee would be allowed a deduction under 162 (or 167), a working condition fringe benefit is not subject to the structural limitations imposed on unreimbursed employee expenses described below. *See* Treas. Reg. § 1.132-5(a)(vi).

[137] I.R.C. § 62(a)(1).

[138] *See generally* Jeffrey H. Kahn, *Beyond the Little Dutch Boy: An Argument for Structural Change in Tax Deduction Classification*, 80 WASH. L. REV. 1 (2005) (providing a detailed analysis and history of the distinction between itemized and non-itemized deductions).

[139] I.R.C. § 68.

[140] I.R.C. § 56(b)(1)(A)(i).

[141] I.R.C. § 63(c). *See generally* John R. Brooks, II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX L. 203 (2011).

[142] I.R.C. § 67. Robert Peroni finds that, among the several reasons articulated in the legislative history for imposing the "2 percent floor" on unreimbursed employee expenses, is that 'employers reimburse employees for those expenses that are most necessary for employment.' Peroni finds this rationale to be questionable and without empirical support. *See* Robert J. Peroni, *Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System*, 91 TAX NOTES 1415, 1419-22 (May 28, 2001); *see also* Kahn, *supra* note 138, at 62-63. Leandra Lederman, on the other hand, argues that the more generous rules for reimbursed employee expenses make sense because employers act as effective third-party enforcers of the tax law—it is in their interest to monitor employee expenses and they have better information about the expenses than the

2. Substantive Biases: The Case of Meals and Lodging

The structural biases described above start with the presumption that an expenditure meets the I.R.C. § 162 threshold for deductibility, but that it is nonetheless subject to structural limitations when workers, rather than the business owners employing them, incur the expenditure. In addition to these structural biases, there are many instances of substantive bias in the treatment of expenditures—that is, situations where the exact same expenditures are allowed as a trade or business deduction when incurred by a business owner, but disallowed when incurred by a worker. We explore the case of meals and lodging to illustrate this sort of substantive bias.

Meals Purchased by Business Owners

Meals and lodging are quintessential items of personal consumption under the Schanz-Haig-Simons definition of income. However, I.R.C. § 119 allows a worker to exclude from income the value of certain meals or lodging provided by the employer "for the convenience of the employer."[143] I.R.C. § 119 has its roots in an early administrative doctrine finding that meals or lodging provided to a worker for the convenience of the employer did not constitute income.[144] First articulated in 1919 and 1920, the doctrine excluded from income meals that were characterized by the employer as noncompensatory and necessary to the functioning of the employer's business.[145] With its reliance on the employer's

IRS. *See* Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STANFORD L. REV. 695, 718-21 (2007).

[143] Other conditions must also be met in order for the exclusion to apply. Meals must be furnished on the business premises of the employer, and lodging must be required to be accepted as a condition of employment. I.R.C. § 119.

[144] For a detailed history of the convenience-of-the-employer doctrine, see Commissioner v. Kowalski, 434 U.S. 77, 84-95 (1977).

[145] O.D. 265, 1 Cum. Bull. 71 (1919); T.D. 2992, 2 Cum. Bull. 76 (1920).

characterization of meals or lodging as necessary for business, the doctrine foreshadowed the standard of extreme deference to business owners articulated in *Welch*. In 1954, when the doctrine was codified in I.R.C. § 119, there was some indication that Congress intended to diminish the ability of the employer to dictate the scope of the exclusion by merely declaring that food or lodging should or should not be treated as compensation to the worker.[146] Yet, the courts have continued to vest employers with the same dictatorial power, as is illustrated by the case of *Boyd Gaming Corporation v. Commissioner*.[147]

Boyd owned a casino that, in keeping with traditional practices in the gaming industry, regularly provided meals to its employees on the business premises during their regular work hours. Boyd took the position that the meals were excluded from the income of the employees under I.R.C. § 119, which in turn enabled the casino to deduct fully the costs of the meals, and avoid the percentage limitation on meal deductions imposed under I.R.C. § 274(n).[148] The IRS challenged the applicability of I.R.C. § 119 on the grounds that the meals were not provided "for the convenience of the employer."

The Tax Court found that most of the meals were not for the convenience of the employer. In its analysis, the Tax Court adopted the approach of Treasury regulations, which find a meal to be for the convenience of the employer if it is provided for a "substantial noncompensatory business purpose."[149] The Tax Court methodically examined all meals provided by the casino, weighing

[146] The legislative history of I.R.C. § 119 indicates that Congress intended to overturn the strand of prior law that had relied exclusively on the employer's characterization. Congress instead endorsed the alternate strand of prior law which focused on whether the meals or lodging were necessary to the functioning of the employer's business Congress intended to create an exclusion in cases where "an employee must accept... meals or lodging in order properly to perform his duties." S. REP. NO. 1622, at 190.
[147] Boyd Gaming Corp. v. Commissioner, 177 F.3d 1096 (9th Cir. 1999).
[148] *Id.* at 1097. An additional wrinkle involved the so-called "catch-all rule" under newly enacted I.R.C. § 119(b)(4). Under that rule, as long as more than half of meals provided to employees were found to be provided for the convenience of the employer, *all* meals would be deemed to be provided for the convenience of the employer.
[149] Treas. Reg. § 1.119-1(a)(2).

several factors identified in the regulations as germane to the inquiry, such as whether the meal was provided so that an employee would be able to respond to work emergencies arising during the meal period; whether the employee's meal break was too short to enable her to eat elsewhere; and whether the meal was provided before, during, or after the employee's work period.[150]

In a complete rejection of the Tax Court's result and methodology, the Ninth Circuit held that because Boyd had a policy prohibiting employees from leaving the casino complex, all meals were provided for the convenience of the employer. Once Boyd adopted the "stay-on-premises" policy, the Ninth Circuit reasoned, "the 'captive' employees had no choice but to eat on the premises. . . . [T]he furnished meals here were, in effect, 'indispensable to the proper discharge' of the employees' duties."[151] It seemed not to matter that the policy had never been enforced, or that the business rationale for adopting it was tenuous at best.[152] The Ninth Circuit rebuked the lower court for "attempting to second guess Boyd's business judgment." The court found that Boyd provided "credible and uncontradicted evidence" in support of its rationale for its "stay-on-premises" policy—apparently related to reasons of security and logistics—and, in language reminiscent of *Welch* and its progeny, found that Boyd's judgment should be given absolute deference:

> While reasonable minds might differ regarding whether a "stay-on-premises" policy is necessary for security and logistics, the fact remains that the casinos here operate under this policy. Given the credible and uncontradicted evidence regarding the reasons underlying the "stay-on-premises" policy, we find it inappropriate to second guess these

[150] Boyd Gaming Corp. v. Commissioner, T.C. Memo 1997-445, 46-48.
[151] 177 F.3d at 15-16 (quoting, 442 F.2d 606 (9th Cir. 1971).
[152] Boyd Gaming Corp. v. Commissioner, T.C. Memo 1997-445, 55-56.

> reasons or to substitute a different business judgment for that of Boyd.[153]

In other contexts as well, the convenience-of-the-employer requirement essentially reverted to the meaning Congress rejected when it enacted I.R.C. § 119. All that is required is a declaration that the purpose of meals or lodging serves a noncompensatory business purpose, and the inquiry ends there. For example, nonprofit organizations such as museums and education institutions regularly furnish free luxury housing to their chief executives, and assert that the housing is excludable under I.R.C. § 119 because the executives use the housing for meetings and schmoozing with donors.[154] Quintessential items of personal consumption—food and lodging—are converted into legitimate costs of doing business by fiat of the employer, resulting in an exclusion of the items from the worker's income, and a deduction to that worker's employer. In contrast, the very same expenditures, when incurred by workers themselves, are unlikely to receive such favorable treatment.

Meals Purchased by Workers

From the perspective of a worker who receives a meal excluded in accordance with I.R.C. § 119, the exclusion is the equivalent of an inclusion in her income coupled with an offsetting deduction. If a worker purchases the meal herself, rather than being provided one by her employer, it is unlikely that the meal will be deductible. If she is provided a cash meal allowance by her employer in order to purchase the meal, the exclusion under I.R.C. § 119 does not apply.[155] She may be able to exclude a cash meal allowance as a de minimis fringe benefit under I.R.C. § 132(e).

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[153] 177 F.3d at 17-18.
[154] Kevin Flynn & Stephanie Strom, *Fine Perks for Museum Chiefs: Luxury Housing (It's Tax-Free)*, N. Y. TIMES, (Aug. 10, 2010).
[155] Commissioner v. Kowalski, 434 U.S. 77, 94-95 (1977).

However, the scope of this exclusion is much narrower than that of I.R.C. § 119.[156]

More generally, a worker who purchases a meal, whether or not funded by her employer, cannot easily deduct the cost of the meal as a trade or business expense. Meals are presumptively personal under I.R.C. § 262.[157] Meals are generally not deductible as ordinary and necessary business expenses under I.R.C. 162 unless eaten under unusual or constraining circumstances.[158] Assuming a meal manages to clear the "ordinary and necessary" hurdle of I.R.C. § 162, it faces additional constraints and limitations under I.R.C. § 274:[159] It must be directly related to or associated with the active conduct of the taxpayer's trade or business;[160] it must be substantiated with specificity;[161] it cannot be lavish or extravagant;[162] and the deduction is limited to 50 percent of the expense.[163]

3. Other Substantive Biases

The case of meals and lodging provides a striking example of the persistence of *Welch*'s deference to the business owner. All a business owner need do is assert the existence of a business purpose, and I.R.C. § 119 transforms food and lodging for the

[156] Under the regulations, a cash meal allowance may qualify as a de minimis fringe benefit if provided on an occasional basis, when an employee works overtime, and is used to purchase a meal consumed by the employee during the overtime work period. *See* Treas. Reg. § 1.132-6(d)(2) (occasional meal money). Contrast this with *Boyd*, where the court held that I.R.C. § 119 applied to daily meals provided to all employees in the course of their regular work schedule. Boyd Gaming Corp. v. Commissioner, 177 F.3d 1096, 1101 (9th Cir. 1999),

[157] Treas. Reg. § 1.262-1(b)(3), (5).

[158] Moss v. Commissioner, 80 T.C. 1073, 1081 (1980), *aff'd* 758 F.2d d211 (7th Cir. 1985), *cert. denied*, 474 U.S. 797.

[159] *See generally*, Richard Schmalbeck & Jay A. Soled, *Elimination of the Deduction for Business Entertainment Expenses*, 123 TAX NOTES 575 (2009).

[160] I.R.C. § 274(a).

[161] I.R.C. § 274(d).

[162] I.R.C. § 274(k).

[163] I.R.C. § 274(n). In contrast, an employer who provides a meal that qualifies for exclusion from the employee's income under I.R.C. § 119 is permitted to deduct the entire cost of the meal. *See* Boyd, 177 F.3d at 1099.

owner's employees into deductible business expenses. At the same time, when workers incur identical expenditures, they are denied the deduction under the current tax regime.[164] Many other examples of this disparate treatment appear in statutory provisions, case law, and administrative guidance. The dominant theme that runs throughout these examples is that expenditures paid or reimbursed by business owners are presumed to be recoverable, while those incurred by workers are much more likely not to be.[165]

For example, courts have denied deductions to elementary, high school, and college teachers for out-of-pocket expenditures for school supplies such as encyclopedias and books, electronic equipment, and other supplemental learning materials.[166] At the same time, educational supplies provided to teachers by a school presumably are excluded from the teachers' income as a working condition fringe benefit and any expenditures reimbursed by the school presumably are recoverable as above-the-line reimbursed employee expenses.[167] Similarly, courts have disallowed workers' deductions for office furniture and decorations, while upholding business owners' deductions for similar types of expenditures.[168]

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[164] At least in theory, the worker benefits from the business owner's ability to provide a taxfree meal to the worker. The significance of the case of meals lies in the differing standard that applies to business owners and workers with to the exact same outlay. *See* Jeffrey H. Kahn, *The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity*, 57 HASTINGS L.J. 645, 683-87 (2006) (arguing that the disparate treatment of employers and workers in the treatment of meals violates horizontal equity).

[165] *See generally* Cheryl A. Cunagin, *The Double Standard under Section 162: Why the Employee Business Deduction is No Longer for Employees*, 82 KY. L.J. 771 (1994).

[166] *See* Mann v. Commissioner, 66 T.C.M. (CCH) 2598 (1993); Mathes v. Commissioner, 60 T.C.M. (CCH) 704 (1990); Patterson v. Commissioner, 30 T.C.M. (CCH) 1003 (1971); Wheatland v. Commissioner, 23 T.C.M. (CCH) 579 (1964). In these cases, the deduction was completely disallowed. However, even if a teacher's out-of-pocket expenses for supplies were deductible under Section 162, they were subject to the structural limitations described above. Since 2002, elementary and secondary school teachers have been allowed a special above-the-line deduction for up to $250 of school supplies and supplemental learning materials. I.R.C. § 62(a)(2)(D).

[167] It appears that the IRS has never asserted that a teacher has income by reason of school supplies provided or reimbursed by the school.

[168] *Compare* Henderson v. Commissioner, 46 T.C.M. (CCH) 566 (1983) (disallowing employee's deduction for a print and a plant for employee's office) *with* Associated Obstetricians and Gynecologists, P.C. v. Commissioner, 46 T.C.M. (CCH) 613, *aff'd*, 762 F.2d 38 (6th Cir. 1985) (allowing corporation's deductions for decorating services

In some cases involving worker expenditures, courts have explicitly articulated a standard much stricter than the deferential approach established in *Welch*: In order to deduct an unreimbursed expenditure, the worker must show that the expenses were a condition of her employment and that she could not be reimbursed.[169]

In its administrative guidance, the IRS, like the courts, relies on employer reimbursement as the litmus test for determining the deductibility of employee expenses. For example, in considering whether a corporate officer can deduct travel and entertainment expenses incurred while conducting corporate business, the IRS finds a strong presumption in favor of deductibility when the corporation either reimburses the expense or explicitly requires the officer to incur the expense; conversely, in the absence of such evidence, the IRS suggests a presumption of nondeductibility.[170] More broadly, under IRS regulations for "accountable plans," a worker whose expenses are reimbursed by her employer need not report or substantiate to the IRS either the reimbursement or the expenditure.[171] Instead, the worker must, when seeking reimbursement from her employer, submit "an expense account or other required written statement to the employer showing the business nature of and the amount of all the employee's expenses."[172] In addition to requiring that the worker's expenses be ordinary and necessary, the regulation seems to impose an even higher standard by requiring that the expenditures

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and office furniture). As with school supplies, the IRS does not seem to have ever asserted that an employee has income by reason of employer-provided office furniture or decorations.

[169] *See, e.g.*, Roach v. Commissioner, 20 B.T.A. 919, 925-26 (1930) (disallowing studio head's travel and entertainment expenses); Heidt v. Commissioner, 274 F.2d 25, 28 (7th Cir. 1959) (disallowing corporate executive's car expenses for business travel); Fountain v. Commissioner, 59 T.C. 696, 708 (1973) (same); Dunkelberger v. Commissioner, 64 T.C.M. (CCH) 1567 (1992) (disallowing manager's purchase of meals and snacks to promote office morale and flowers sent to hospitalized co-worker).

[170] *See* Rev. Rul. 57-502, 1957-2 C.B. 118.

[171] *See* Treas. Reg. § 1.162-17(b).

[172] Treas. Reg. §§ 1.162-17(b)(4); 1.62-2.

be incurred "solely for the benefit of his employer."[173] However, in practice, the IRS requires less: It requires that entertainment and meals, for example, have a main, and not incidental, business purpose, or be associated with the trade or business.[174] It is not necessary to devote more time to business than entertainment, and there is no requirement to show that the business income or other business benefit actually resulted from each expenditure.[175] While the IRS acknowledges the theoretical possibility that a reimbursed expense might not be a valid trade or business expense of the employee,[176] as a practical matter, the fact of reimbursement appears to establish deductibility in all cases.[177]

In addition to judicial decisions and administrative guidance, the Internal Revenue Code explicitly discriminates between business owners and workers. For instance, interest on indebtedness properly allocable to a trade or business is deductible under I.R.C. § 163 unless that trade or business consists of performing services as an employee. In that case, the interest is deemed to be personal and nondeductible.[178]

In sum, this Part has shown that workers' expenditures related to their economic productivity, such as outlays for education, healthcare and childcare, misclassified as purely personal consumption. In addition, other worker expenses, such as work-related travel or meals, are treated in strikingly different

[173] Treas. Reg. § 1.162-17(b)(1).
[174] *See* IRS PUBLICATION 463, TRAVEL ENTERTAINMENT, GIFT AND CAR EXPENSES, at 9-10 (2011).
[175] *See id.* at 10.
[176] *See id.* at 30 (example of partially nondeductible reimbursed employee expense).
[177] We were unable to identify any instance in which reimbursed employee expenses under an accountable plan have been challenged as nondeductible. The issue may be highlighted soon, however, in connection with buyout payments made by one university to another in hiring sports coaches. Professor Douglas Kahn and Jeffrey Kahn, in arguing that the coach should be able to exclude the payment from income, interpret the fact of reimbursement as highly significant in establishing deductibility. *See* Douglas A. Kahn & Jeffrey H. Kahn, *Tax Consequences When a New Employer Bears the Cost of the Employee's Terminating a Prior Employment Relationship*, 8 FLA. TAX REV. 539 (2007); Douglas A. Kahn & Jeffrey H. Kahn, *Will the Taxman Cometh to Coach Rodriguez*, 120 TAX NOTES 474 (Aug. 4, 2008).
[178] I.R.C. § 163(a), (h)(2)(A).

fashion depending on whether they are incurred by a business owner or a worker. When incurred by a worker, the tax system imposes a multitude of limitations on the ability to the worker to recover these costs, reflecting the dominant characterization of workers as consumers rather than producers. At the same time, when incurred by employers on behalf of their employees, the very same outlays are presumed to be deductible, without the limitations applied to workers, reflecting the deference given to business owners.

IV. THE COSTS OF UNDERTAXING BUSINESS OWNERS AND OVERTAXING WORKERS

The overly generous treatment of business owners' expenditures and the unduly restrictive treatment of workers' expenditures adversely impact both the equity and the efficiency of our tax system. With respect to equity, income is mismeasured in ways that undermine fairness and progressivity. Income of business owners is understated because they are allowed to deduct outlays that are not related to the production of that income. At the same time, the income of workers is overstated because they are not permitted to deduct outlays that are related to the production of income. The resulting inequities are particularly troubling in today's economy, when large business owners' profits are at an all-time high, and workers' income is at its lowest since 1965.[179]

With respect to efficiency, the undertaxation of business owners likely leads to a variety of resource misallocations. At a general level, one can speculate that the tax-favored treatment of business ownership encourages individuals to become business owners rather than engaging in other, more socially productive activities, whether as workers in the same enterprise, or some entirely different activity. Of course, it's difficult, if not impossible, to ascertain and quantify the nature and extent of the societal loss that arises from people choosing to become business

[179] *See* Floyd Norris, *As Corporate Profits Rise, Workers' Income Declines*, N.Y. TIMES, Aug. 6, 2011, at B3.

owners than, say, teachers or engineers or corporate workers. Our goal in this Part is a more focused one: to identify and provide evidence for some of the more specific ways in which the undertaxation of business owners and overtaxation of workers create misallocations and leave all of us worse off.

A. UNDERINVESTMENT IN WORKER PRODUCTIVITY

By favoring employer-provided expenses on behalf of workers—through more lenient structural features and substantive standards of deductibility when those expenses are incurred by employers, the tax system assumes that employers are best able to determine the appropriate type and level of worker expenditures that will enhance productivity. The tax system further assumes, in its treatment of education, healthcare and childcare costs, that these costs are personal consumption, and therefore unrelated to worker productivity. These assumptions are wrong. According to management scholar Jeffrey Pfeffer, the "overwhelming preponderance of evidence" indicates that business owners underinvest in their workers, even though these investments increase productivity and profitability.[180] Moreover, the types of investments that are proven to increase productivity include many of the expenditures treated as personal consumption by the tax law. For example, employers who provide on-site child care garner lower absenteeism rates and greater productivity from their

[180] Jeffrey Pfeffer concludes, after conducting a comprehensive survey of the literature:

> 1) [E]mployee attitudes and related behaviors are generally poor, 2) employees and how they are managed are important sources of company success and competitive advantage, 3) and methods for achieving a culture of high-performance are known, but apparently not implemented. Although one could dismiss the results of any single survey or study as possibly flawed or not representative, the overwhelming preponderance of evidence makes such a position virtually untenable.

Jeffrey Pfeffer, *Human Resources from an Organizational Behavior Perspective: Some Paradoxes Explained*, 21 J. ECON. PERSPECTIVES 115, 130 (2007). *See generally* Jody Heymann & Magda Barrera, PROFIT AT THE BOTTOM OF THE LADDER: CREATING VALUE BY INVESTING IN YOUR WORKFORCE (2010).

workers.[181] Employer-provided health insurance increases worker productivity and firm profitability.[182] Education and on-the-job training for employees similarly increase productivity and profitability.[183] Employer-provided work-life benefits, such as those related to children, flexible work schedule, physical and psychological well-being, professional development, and eldercare, create a reciprocally positive relationship between employer and employee, that benefits both.[184]

A conundrum raised by this research is why, in light of the evidence, employers do not invest more in their workers. Pfeffer puts forth several theories about why business owners underinvest in workers: (1) Business owners mindlessly copy what others do in order to achieve social legitimacy and to conform to social expectations for appropriate behavior;[185] (2) Powerful external constituencies such as investment analysts and bankers view investments in workers as a waste of money (at the same time that countervailing external constituencies, such as unions, have lost power);[186] (3) The costs of investments in workers tend to be overvalued, relative to the benefits, because the costs are easier to observe and measure;[187] and (4) Business owners make assumptions about workers—that they are "effort adverse" and self-interested—which leads to underinvestment in workers, which in turn causes these assumptions to become self-fulfilling.[188] The

[181] *See* Peter D. Brandon & Jeromey B. Temple, *Family Provisions at the Workplace and Their Relationship to Absenteeism, Retention, and Productivity of Workers: Timely Evidence from Prior Data,* 42 AUSTRAL. J. SOC. ISSUES 447 (2006).
[182] *See* Ellen O'Brien, *Employers' Benefits from Workers' Health Insurance*, 81 MILBANK Q. 5 (2003).
[183] *See* Sandra E. Black & Lisa M. Lynch, *Human Capital Investment and Productivity*, 86 AM. ECON. REV. 263 (1996).
[184] *See* Lori Muse *et al, Work-Life Benefits and Positive Organizational Behavior: Is There a Connection?*, 29 J. ORG. BEHAVIOR 171 (2008); Bart L. Weathington & Allan P. Jones, *Measuring the Value of Nonwage Employee Benefits: Building a Model of the Relation Between Benefit Satisfaction and Value*, 132 GENETIC, SOCIAL, AND GENERAL PSYCHOLOGY MONOGRAPHS 292 (2008).
[185] Pfeffer at 126.
[186] *Id.* at 126-27.
[187] *Id.* at 127-28.
[188] *Id.* at 128-29.

tax system embodies the same flawed belief system that underlies Pfeffer's theories. In the face of all the evidence that worker productivity is enhanced by education, healthcare and childcare, it persists in mistakenly classifying these expenditures as primarily personal. Similarly, despite all the indications that employers do not invest adequately in their employees, the tax system persists in the mistaken presumption that employers are the best arbiter of the how much to invest in the productivity of their employees. At the same time the tax system reflects these mistaken beliefs, it encourages an underinvestment in worker productivity that in turn reinforces the mistaken beliefs.

B. MISALLOCATION OF RESOURCES AND MISVALUATION OF ASSETS

As discussed above, the tax system presumes almost all business owners' costs to be recoverable, even those–such as corporate reorganization fees or excessive managerial compensation and perquisites–that have little or no connection to the productivity of the business. In contrast, the tax system limits or denies workers recovery of many of their costs. This differential tax treatment of outlays by business owners and workers can affect the market values of assets, similar to the way that the home mortgage interest deduction, by treating owner-occupied housing more favorably than other assets, causes an overinvestment in home ownership and inflation of housing prices.[189]

The deleterious economic effects of the home mortgage interest deduction have been extensively studied and are highly complex.[190] The economic effects of overly generous deductions

[189] As Dennis Ventry summarizes, "In the end, the [home mortgage interest deduction] 'amounts to a huge subsidy that causes massive, efficiency-draining distortions in the economy,' creating 'less business capital, lower productivity, lower real wages, and a lower standard of living.'" Dennis Ventry, *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 L. & CONTEMP. PROB. 233, 278 (2009).

[190] For a discussion of the various effects of the home mortgage deduction, see *id.* at 277-81.

for business owners for a variety of expenses and of unduly restricting workers from deducting a variety of legitimate costs of producing income are bound to be even more complex, and have not been systematically studied. There is some evidence that accelerated depreciation or investment tax credits for certain types of assets cause an overinvestment in these assets.[191] There is also anecdotal evidence that the tax-favored treatment of certain kinds of business outlays, in particular accelerated cost recovery for many tangible assets, causes an underinvestment in workers.[192] At the same time, some policy makers argue that the tax system is skewed in favor of human capital.[193] Even if that is true, the two types of mistakes are not corrective of each other. The misallocations and misevaluations will occur unevenly in different sectors of the economy depending on the size and nature of the trade or business, the level of competition in the sector, the supply of labor in a geographic area, and other similar kinds of variables. What is most important to recognize is that undue deference toward business owners' judgment and undue skepticism toward workers' judgment not only lead to miscalculation of taxable income, but likely introduce inefficiencies and misvaluations into the economy.

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[191] *See, e.g.*, PRESIDENT'S ECONOMIC RECOVERY ADVISORY BOARD, REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE AND CORPORATE TAXATION , at 78-79 (August 2010), http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf; U.S. TREASURY DEPT, BACKGROUND PAPER FOR TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS, at 27-28 (July 23, 2007), http://www.treasury.gov/press-center/press-releases/Documents/07230%20r.pdf; Peter S. Fisher, *Corporate Tax Incentives: The American Version of Industrial Policy*, 19 J. ECON. ISSUES 1, 5-8 (1985). *But see* Austan Goolsbee, *Investment Subsidies and Wages in Capital Goods Industries: To the Worker Go the Spoils?* 56 NAT'L TAX J. 153 (2003) (tax subsidies to investment drive up workers' wages).

[192] *See, e.g.*, Catherine Rampell, Companies Spend on Equipment, Not Workers, N.Y. TIMES, June 9, 2011.

[193] *See, e.g.*, U.S. TREASURY DEPT, BACKGROUND PAPER FOR TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS, *supra* note 191 at 29 (arguing that the nontaxation of foregone earnings during training and education amounts to an immediate deduction for investment in human capital).

In the realm of financial accounting, Russell Coff and Eric Flamholtz have examined how accounting standards affect the asset values and resource allocations. They find that financial accounting standards, by overreporting nonhuman capital and underreporting human capital, both reflect and influence judgments about the relative worth of nonhuman and human capital. According to Coff and Flamholtz, the accounting standards treat outlays for tangible goods, such as plant and equipment, as assets while, in contrast, those standards treat outlays associated with people as expenses.[194] Coff and Flamholtz trace this disparate treatment to the desire for greater certainty after the crash of 1929, but they suggest that even before this, the accounting profession was biased in favor of reporting easily measurable data, with the result that less observable drivers of profitability were often overlooked.[195] Going forward, they attribute the overreporting of nonhuman investments to the nature of U.S. businesses in the New Deal era, which were, for the most part, in the manufacturing and industrial sectors.[196] As Coff and Flamholtz observe, accounting standards are increasingly anachronistic, in view of the shift of American businesses away from the hard-asset intensive manufacturing and industry sectors towards the human-capital-intensive service and technology sectors.[197]

According to Coff and Flamholtz, the flawed accounting standards have contributed to the failure of U.S. businesses to ascribe adequate value to human capital and have led to serious errors in the allocation of resources.[198] They argue further that government policies relating to economic growth are based on flawed assumptions about the level of overall economic investment, because it does not include investments in human capital. This perceived economic underinvestment leads to

[194] Russell W. Coff & Eric G. Flamholtz, *Corporate Investments in Human Capital: How Financial Accounting Standards Undermine Public Policy*, 5 STANFORD L. & POL'Y REV. 31, 32 (1993).
[195] *Id.* at 32-33.
[196] *Id.* at 33.
[197] *Id.*
[198] *Id.* at 32.

recommendations of increased support for investment in "hard" assets—a recommendation based on the flawed assumption that expenditures related to workers do not "count" as investments. Government policy initiatives, such as investment tax credits for hard assets, in turn lead to a further overinvestment in these assets relative to investments in human capital.[199] Similarly, generous tax depreciation allowances for hard assets, coupled with tax rules limiting the ability of businesses to amortize human capital investments, lead to a further devaluation of human capital, with negative consequences for U.S. competitiveness and productivity.[200]

Professor Marleen O'Connor makes similar observations about the systematic undervaluation of human capital in her survey on the disclosure of workplace practices among Fortune 500 companies.[201] O'Connor examines the extent to which the companies disclose information about factors that might aid in an accurate assessment of the value of the workforce, including diversity, workplace training, workplace safety, employee turnover, labor relations, etc. She finds that they provide little useful information, and argues for more extensive disclosure consistent with agreed-upon reporting standards. To illustrate the phenomenon of undervalued human capital, along with the problems it creates, O'Connor cites a New York Times story about a major round of layoffs at AT&T:

> We often evaluate companies as if human capital doesn't matter. And so a company like AT&T can lay off 40,000 knowledge workers, and the market will respond positively because expenses are trimmed. If corporations booked their investments in workers as capital assets, as I believe they

[199] *Id.* at 34-35.
[200] *Id.* at 35-37.
[201] Marleen A. O'Connor, *Rethinking Corporate Financial Disclosure of Human Resource Values for the Knowledge Based Economy*, 1 U. PA. J. LAB. & EMP. L 527 (1998).

> should, AT&T would not have been able to eliminate those jobs without writing down $4 billion to $8 billion of assets. Then the market response would be different. Instead of applauding the company's executives, we'd be looking to give them the boot.[202]

Reminiscent of Pfeffer's "self-prophecy" theory about why firms fail to make adequate investments in their workers, O'Connor theorizes that the failure of companies to disclose information about its investment in workers, along with the failure of investors to demand it, has what she calls a "Catch 22" quality: "[U]ntil we obtain better empirical support about how human capital values relate to the bottom line, it will be difficult to mobilize pressure from investors…, which is needed to make managers publish figures that might place them at a disadvantage."[203] In the meantime, investors and managers persist in their distorted belief system that human capital is not important to economic productivity. O'Connor cites another revealing anecdote, in which a CEO describes investors' reaction to hearing about employee training at his company:

> When I brief Wall Street analysts on our current earnings, sale projections, downsizing program, and capital spending plans, they busily punch all these numbers right into their laptops as I speak. When I then start telling them about our plans to invest in training and reform the workplace, they sit back in their chairs and their eyes glaze over.[204]

This anecdote illustrates that investors undervalue investments in human capital, but more importantly, it also shows how managers

[202] *Id.* at 527.
[203] *Id.* at 549.
[204] *Id.*at 548.

use investors' mistaken judgments to justify their own continued underinvestment in workers.

In describing some of the implications of the accounting errors understating the value of human capital investments, Coff and Flamholtz and O'Connor provide further support for Pfeffer's self-fulfilling prophecy theory. The mistakes lead to further underinvestment in human capital by businesses, which, in turn, further entrenches the view that expenditures related to workers do not contribute long-term value to the business. The tax law, animated by attitudes and beliefs about the centrality of business owners in creating economic growth, makes the same mistakes and further reinforces and entrenches the view that the business owner, and not the worker, is the primary driver of economic growth. These mistakes, including deference to business owners and skepticism of workers, ultimately result in decreased productivity and profitability.

C. THE TWENTY-FIRST CENTURY ECONOMY

The problems described above are even more acute in light of today's economy. The tax law's assumption that employers can be relied upon to make investments in their employees' productivity might have seemed at least plausible during the mid-twentieth century "golden age" of employment, when most employees worked for a single employer for their entire working lives, and employers invested in their workers' productivity by providing training and medical and retirement benefits.[205] But the golden age has been supplanted by an entirely different employment model in the twenty-first century. In the twenty-first century economy, innovation and flexibility are paramount over stability and loyalty, and markets for both capital and labor are

[205] *See generally* Robert B. Reich, THE FUTURE OF SUCCESS 88-107 (2000) (describing history of modern U.S. employment and changes from mid-twentieth century to turn of twenty-first century—heightened job instability; erosion of benefits; widening inequality).

globalized and fiercely competitive.[206] Businesses increasingly use independent contractors, temporary workers and free agents, in part to avoid having to make the sorts of investments they traditionally made in full time employees.[207] It is difficult to estimate of the numbers of "freelancers," but estimates range as high as one-third of the workforce, and there is widespread agreement that the numbers are trending upward.[208] As the number of freelance workers increases, the remaining workers who *do* have employers are experiencing shorter tenures and less in the way of employer investments in their productivity.[209]

At the same time that employer investments in workers are on the decline, the development of workers has never been more important. Many economists and policymakers believe that the future prosperity of the United States depends on how well its workers can perform in the "Knowledge Economy," with its focus on services, technology and the production of knowledge.[210] As Professor Peter Drucker puts it: "[T]he most valuable assets of a 20th-century company were its production equipment. The most valuable asset of a 21st-century institution, whether business or nonbusiness, will be its knowledge workers and their

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[206] *See generally* Robert Reich, SUPERCAPITALISM (2007) 50-130.
[207] *See* Reich, THE FUTURE OF SUCCESS, at 98-99.
[208] *See id.* at 98 (ten to thirty percent, depending on how the group is defined); Sara Horowitz, *The Freelance Surge is the Industrial Revolution of Our Time*, THE ATLANTIC, Sept. 1, 2011, http://www.theatlantic.com/business/archive/2011/09/the-freelance-surge-is-the-industrial-revolution-of-our-time/244229/ (as of 2005, one-third of workforce consisted of freelancers; proportion has increased since then); Jeffrey Eisenach, *The Role of Independent Contractors in the U.S. Economy*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1717932 20, 42 (2010) (independent contractors comprise ten percent of the workforce overall;contractors, a much higher proportion in certain key industries such as construction and professional and business services).
[209] *See* Robert Reich, SUPERCAPITALISM (2007) 101-03; Pfeffer, *supra* note 180 at 116-18.
[210] *See* Walter W. Powell & Kaisa Snellman, *The Knowledge Economy*, 30 ANN. REV. SOC. 199, 199-201 (2004); Task Force on the Future of American Innovation, *The Knowledge Economy: Is the United States Losing its Competitive Edge?* (Feb. 16, 2005); Robert Reich, THE WORK OF NATIONS: PREPARING OURSELVES FOR 21ST CENTURY CAPITALISM (1992); Joseph E. Stiglitz, *Public Policy for Knowledge Economy* (1999); The Knowledge Economy (Dale Neef, ed., 1997).

productivity."[211] The tax system, by erroneously assuming that employers will take care of worker development, and at the same time by limiting or denying the ability of workers themselves to recover the costs of producing income from their labor, obstructs the ability of U.S. workers to compete in the twenty-first century economy.

V. TAX REFORM IMPLICATIONS

This Article has shown how our modern income tax regime has, from its inception, reflected and contributed to a cultural, economic, and political environment that overvalues business owners' and undervalues workers' contributions to production and economic growth. For Congress to address the inefficiencies resulting from the costly mistakes of undertaxing business owners and overtaxing workers, it must commit itself to reforms that further the following three goals: establishing the worker as a producer, curbing the deference traditionally accorded business owners, and reconceiving the meaning of investment for businesses and the meaning of consumption for workers. There are an array of paths to our achieving these goals and the transition toward a tax law that neither undertaxes business nor overtaxes workers will undoubtedly be marked by incoherent compromises. Nevertheless, if tax policy debates have to respond to, if not embrace, these three goals, it begins the process of redefining the tax base for all income producers, whether they are business owners or workers. Their integration into tax analysis challenges long-held tax principles that treat most, if not all, business owners' expenditures as an investment and workers' costs of employment, whether it be health care, commuting expenditures, childcare, or education, as consumption.

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[211] Peter F. Drucker, MANAGEMENT CHALLENGES FOR THE 21ST CENTURY (1999). Drucker first used term "Knowledge Economy" in 1969 to describe the shift in the U.S. economy from manufacturing to services and technology. Peter Drucker, THE AGE OF DISCONTINUITY: GUIDELINES TO OUR CHANGING SOCIETY 263-86 (1969).

An immediate effect of challenging the traditional definition of the tax base certainly will be on two major tax policy areas—the consumption tax and tax expenditure analysis. Notwithstanding the richness of the research on proposals to substitute or supplement the current income tax with a consumption tax, few, if any, scholars and policy makers have addressed the question whether businesses consume.[212] The underlying premise in all their discussions is that all expenditures incurred by a business represent an investment and, therefore, should escape taxation. If the topic is raised at all, it is thought to be a corner problem of little interest as compared to the overarching question of promoting investment through a tax on consumption.[213] Similarly, nowhere in this discussion do tax scholars focus on the many expenditures a worker incurs in the production of income. Instead, these scholars take as a given that workers primarily are consumers and, if attention has been paid to the tax base for consumers, it has concerned the appropriate treatment of durable consumer goods and personal residences.[214] Up until now, much of the criticism of the consumption tax has focused on its adverse distributional consequences in reducing taxes on the wealthy and increasing taxes on lower-income persons. As part of the anti-progressive criticism of the consumption tax, opponents have argued that it essentially operates

[212] *See* Roy, *supra* note 2, at 182-84 (arguing that some non-personal business expenses represents consumption that should not be deductible).
[213] *See* Dale W. Jorgenson & Peter J. Wilcoxen, *The Long Run Dynamics of Fundamental Tax Reform*, 87 AM. ECON. REV. 126, 127 (1997) (stating that consumption tax would increase investment in US at least in short term); Malcolm Gillis, Peter Mieszkowski & George R. Zodrow, *Indirect Consumption Taxes: Common Issues and Differences Among the Alternative Approaches*, 51 TAX L. REV. 725, 728-29 (1996).
[214] *See* Lawrence Zelenak, *Tax Policy and Personal Identity over Time*, 62 TAX L. REV. 333, 374-75 (2009); Noel B. Cunningham & Deborah H. Schenk, *Taxation without Realization: A "Revolutionary" Approach to Ownership*, 47 TAX L.REV. 725, 800 (1992); Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155, 1165 (1988). *But see* William J. Turnier, *Theory Meets Reality: The Case of Double Taxation on Material Capital*, 27 VA. TAX REV. 83, 96-100 (2007); Lawrence Zelenak, *The Reification of Metaphor: Income Taxes, Consumption Taxes and Human Capital*, 51 TAX L. REV. 1, 28-34 (1995).

as a tax on wages.[215] If those who study the consumption tax were to consider what it would mean to treat workers as producers, curb the traditional deference accorded business owners, and reconceive the meaning of consumption and investment, both proponents and opponents would find much that is missing in the current literature.

For many of the same reasons, all the work done to date on tax expenditure analysis–which is dedicated essentially to identifying those provisions of the current tax system that deviate from the Schanz-Haig-Simons ideal tax base–needs rethinking.[216] Once the analysts treat workers as producers, do not defer to the judgment of business owners, and redefine consumption and investment for both business owners and workers, those items traditionally identified as a tax expenditure, such as employer provided health care or child care, for example, would be recategorized, at least in part, as a cost that the tax law should allow a worker to recover in order to determine accurately that worker's taxable income. In contrast, once analysts no longer defer to the judgment of business owners, those myriad costs that they have left virtually unexamined, as, for example, expensive office space, may find their way into the list of tax expenditures.

The importance of changing tax policy discussions regarding the consumption tax and tax expenditure analysis should not be underestimated. Analysts look to these two research areas often when proposing tax reforms. Moreover, these two research areas have set the agenda in recent years in policy discussions concerning fairness, progressivity, economic growth, and simplification.[217]

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[215] *See* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 197-200 (4th ed. 2008); Alvin Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931, 938-941 (1975).

[216] *See, e.g.,* Edward D. Kleinbard, *The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes*, 36 OHIO N.U. L. REV. 1 (2010; J. Clifton Fleming, Jr. & Robert J. Peroni, *Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the "New Paradigm" and Its Denouement*, 30 VA. TAX REV. 135 (2010).

[217] *See, e.g.,* PRESIDENT'S ECONOMIC RECOVERY ADVISORY BOARD, REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE AND CORPORATE TAXATION 77-79

As for what difference it would make to revamp the income tax law to meet the first goal of treating workers as producers, one obvious reform would be to treat workers' costs of producing income the same as the costs incurred by business owners. That would mean that these costs would no longer be subject to limitations as itemized deductions.[218] Instead, the Code could define AGI under I.R.C. § 62 to include any expenditure allowable to a worker as a cost of producing income. As indicated above, there are other provisions in the Code that deny workers the full status of a producer. For example, I.R.C. § 163(h) treats interest paid on loans allocable to the "trade or business of performing services as an employee" as personal interest and not deductible, whereas it allows for the deductibility of interest paid or accrued on indebtedness allocable to all other trades or businesses.[219] A final aspect of the structural changes that a revamped tax law could address would be to reform current law so that it no longer uses an employer's judgment to determine whether income in kind should be excludible to a worker.[220] This change would include eliminating the distinction between reimbursed and unreimbursed expenditures. [221] A worker's expenditure, whether reimbursed or not, would be recoverable so long as it otherwise qualifies under the general rules applicable to all income producers. Also, the tax law should eliminate concepts, such as the convenience-of-the employer requirement found in I.R.C. § 119. They merely perpetuate *Welch*'s business deference approach. Instead, the tax rules should focus on the worker as producer and ask whether the expenditure increases the productivity of the worker.

(2010); PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM xiv (2005); JOINT COMM. ON TAXATION. 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 1 (Comm. Print 2005).

[218] *See supra* notes 137-142 and accompanying text. There is some precedent for this approach under current law: moving expenses are deductible "above the line" for all workers, whether employees are self-employed. See I.R.C. §§ 62, 217.

[219] *See supra* note 178 and accompanying text.

[220] *See supra* notes 143-163 and accompanying text.

[221] *See supra* notes 169-177 and accompanying text.

The proposed structural changes are likely to engender criticisms concerning administrability. By removing employees' expenditures from the categories of itemized and miscellaneous deductions, the opportunity for erroneous, intentional or unintentional, calculation of taxable income undoubtedly rises and puts significantly more pressure on the IRS to develop effective audit procedures. One problem with this argument is that administrability concerns are not qualitatively different for employees than for self-employed taxpayers. Limitations on deductions may be appropriate for the fair and orderly administration of the income tax law, but those limitations should not turn on whether the taxpayer is an employee. Another problem with the criticism is that it ignores that the proposed structural changes eliminate some of the complexities of the current law, because it no longer requires a taxpayer to allocate expenditures between income from a business and income from employment. In particular, the growth of part-time employment and the increase in the number of persons who operate as independent contractors in the U.S. economy over the last several decades have created significant audit issues.[222] These trends only are likely to grow and represent yet another example of how the current tax law does not meet the needs of the U.S. economy in the twenty-first century.[223] To the extent that the structural changes proposed do create compliance problems, perhaps Congress could consider a standard deduction for income producers as an alternative to itemizing the costs of income producing that would operate similar to the standard deduction found in I.R.C. § 63(b) and (c). However Congress decides to define and implement the concept of AGI, it is crucial that the tax law treat business owners and workers in the

[222] Karen R. Harned et al., *Creating a Workable Legal Standard for Defining an Independent Contractor*, 4 J. BUS. ENTREPRENEURSHIP & L. 93, 93-94 (2010). In 2005, 10.3 million Americans were independent contractors. U.S. Bureau of Labor Statistics, Contingent and Alternative Employment Arrangements, July 27, 2005, http://www.bls.gov/news.release/conemp.nr0.htm.

[223] MBO Partners, The State of Independence in America 3 (Sept. 2011), http://info.mbopartners.com/rs/mbo/images/MBO%20Partners%20Independent%20Workforce%20Index%202011.pdf.

same manner. This one issue, perhaps more than any other, assures that workers share with business owners the status as producers.

Even if Congress finds its way to redress the structural problems so as to eliminate the differential tax treatment of business owners and workers, it still faces the question as to what expenditures by workers should be recoverable consistent with the Schanz-Haig-Simons definition of taxable income. Consideration, for example, of education expenditures demonstrates the challenge and the potential of what it means in practice to implement the three goals of establishing the worker as a producer, curbing the deference traditionally accorded business owners, and reconceiving the meaning of investment for businesses and the meaning of consumption for workers. With regard to education, current law is a patch quilt of rules difficult to reconcile one to the other.[224] In disallowing most deductions for education except for certain higher education expenses in limited circumstances, the courts and IRS have struggled to draw an impossible line between investments in future income production and what the IRS calls an "inseparable aggregate of personal and capital expenditures."[225] The better approach would be to start with the premise that education expenses are an investment in the production of income but that they may not be deductible where too remote—i.e., too speculative or tangential—when judged at the time the education expenses are incurred. Under this approach, one might find high school or college education too remote to allow for a deduction. However, once taxpayers enroll in training programs, professional schools, or graduate schools, however, the connection to income from a trade or business is sufficiently direct to allow for recovery of educational expenses immediately or over a reasonable number of years as workers obtain employment in their respective areas of newly acquired expertise. This remoteness criterion also places workers' expenditures for child care, health care, commuting, clothing, and other similar expenditures in a different light,

[224] *See supra* notes 115-118 and accompanying text.
[225] Treas. Reg. § 1.162-(5)(b)(1).

because it asks the question whether the expenditures are too speculative or too tangential to workers' ability to earn wages and salaries. Whereas current law treats all these expenditures as personal and, if it allows any recovery, views that recovery as a tax expenditure and not an investment under the Schanz-Haig-Simons definition of taxable income, the remoteness criterion provides a fair and practical means for acknowledging workers' costs of producing income. In fact, that is the central importance of the remoteness criterion. In the twenty-first century economy, where business owners no longer promise their employees economic security and rely heavily on temporary workers, free lancers, and other types of independent contractors, workers have to take much more responsibility for their skill levels, health, and family obligations to assure that they are and remain productive in the work place. The remoteness criterion acknowledges that they, like their business owner counterparts, contribute to economic growth. It does so by not treating their expenditures as personal consumption, but as investments in themselves as producers.

Yet another hurdle faced by allowing recovery for education, child care, commuting, and similar expenditures is that, even if the expenditure, is not deemed too remote, it may still represent a mix of consumption and investment. Some cost constraints on these items would seem appropriate. For example, recovery for clothing expenditures could be allowed, but only as a percentage of salary, up to some maximum salary limit. Also, commuting expenditures could be made available to those workers who can demonstrate limits on choice of where to live. For example, a two-worker family might be able to recover commuting expenditures, for the one worker whose work is the furthest away. It is important to see the interrelationship between the remoteness criterion and the institution of cost constraints into the determination of recoverable expenditures and how together they provide a path for the tax law to treat the worker as a producer. The remoteness criterion does not allow the business/personal dichotomy to short-circuit the question about whether workers' expenditures directly and not speculatively or tangentially, increase

their respective wages or reduces their respective costs of producing those wages. The fact that a cost constraint rule will limit the recovery of an expenditure having to do with education, health care, or the like should make it that much easier to acknowledge that these types of items have a direct connection, in whole or in part, to wage earning.

If the remoteness criterion and cost constraint rule assist in distinguishing investment from consumption for workers, the obvious question to ask would seem to be whether they should play a role in distinguishing investment from consumption for business owners. The implementation of both would challenge the tradition of deference to the business judgment of owners at the same time that it would reduce the distinction between business owners and workers as producers. As between the remoteness criterion and cost constraints, the latter seems the easiest to introduce into the Code. For the most part, current law generally defers to the judgment of the business owner in a way that many expenditures that are a mix of consumption and investment are treated as investment and, therefore, recoverable.[226] Current law, however, does make some exceptions that come close to the cost constraints rule previously discussed with regard to mixed expenditures incurred by workers. For example, the Code limits the deduction for business meals and entertainment to 50 percent of their cost[227] and denies a deduction if they are "lavish or extravagant under the circumstances."[228] It also places limitations on the amount of depreciation deductions and rental deductions available for luxury automobiles.[229] It is no surprise that things like business meals, entertainment, and automobiles have captured the attention of Congress, because these types of expenditures have such an obvious and significant consumption component. Deference to business judgment, however, has left a whole range of other expenditures beyond review. We have in mind a host of

[226] *See supra* notes 60-76 and accompanying text.
[227] I.R.C.§ 274(n).
[228] I.R.C. §274(k)(1).
[229] I.R.C. §280F.

other expenditures that, although necessary for the carrying on of a trade or business, should nevertheless not be recoverable to the extent that the expenditure exceeds pre-established limits. One place that Congress might look to establish those cost constraints is to the government standards developed by the U.S. General Services Administration across a wide range of expenditures regarding land, buildings, equipment, travel, etc. The effect of the cost constraint may be that some workers enjoying, for example, mahogany desks and travel to highly desirable locations will have to recognize income. In that case, the business owner may still be able to recover the expenditure, because it represents salaries or wages in kind. Alternatively, the amount an expenditure exceeds the cost limit may constitute business waste and, therefore, would be unrecoverable to the business owner.[230] Whether recoverable by the business owner or not, the injection of cost constraints into the tax law means that the taxable income of some workers, in particular those holding upper management positions, will be identified more accurately, with the effect of better preserving the progressivity of the tax law.

The remoteness criterion is only hinted at under current law[231] and would go the furthest in challenging deference to business owners and, ultimately, our traditional understanding of the Schanz-Haig-Simons definition of income. Although the full implications of a remoteness criterion for business owners would require extensive analysis and need to be the subject of a separate article, it is intriguing to think about what type of expenditures would be unrecoverable if a business owner were required to demonstrate that the economic benefit (meaning either increases in

[230] *See supra* note 101 and accompanying text.

[231] *See Kornhauser v. United States*, 276 U.S. 145, 152 (1928) (holding that where a suit or action against a taxpayer is directly connected with, or proximately resulted from, his business, the expense incurred is a business expense). *Trust of Bingham v. Commissioner*, 325 U.S. 365, 374 (1945) (holding that expenses must be directly connected with or proximately result from the conduct of the business); Treas. Reg. § 1.162-1(a) ("business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business).

revenue or reductions in costs) resulting from an expenditure is neither too speculative nor too tangential. Questionable cost recoveries under the remoteness criterion would seem to include, for example, costs incurred to effectuate a merger or expansion, if the merger or expansion fails to occur or if its benefits are merely speculative or incidental. If, indeed, costs that provide only speculative or incidental benefits are nonrecoverable, then other some types of expenditures, such as business expansion costs, research and development costs, environmental cleanup costs, oil and gas exploration costs, and pre-publication costs, warrant closer scrutiny. The remoteness criterion might even call into question outlays as basic as property taxes on business property, which seem to have little or no obvious effect on a business's revenue or other costs in a year.

What seemed like a quite workable and modest rule when applied to determining what expenditures incurred by a worker warranted recovery under the tax law, seems far reaching and radical when applied to business owners. And that may be the most important lesson to be learned from this Article. Once we place workers at the center of our tax analysis, we not only end up challenging conventional rules of taxation, but we also are forced to confront the very meaning of taxable income itself.

CONCLUSION

Tax reform has taken on heightened importance in recent years as policymakers seek to reduce the jobs deficit in the private sector and deficit spending in the public sector. This Article provides a framework for tax reform that solves the dual challenges of unemployment and deficit spending by placing workers at the center of its analysis. With the dominance of technology and service industries in today's economy, this Article demonstrates the inextricable link between an accurate definition of income and the need for a trained, creative, and reliable workforce to produce that income. It demonstrates that the tax law only can meet the economic and social challenges of the twenty-

first century if it treats both business owners and workers as agents of economic growth. Once policymakers reject an income tax regime that for nearly a hundred years has reified business owners for their skill and acumen and dismissed workers as primarily consumers, they can begin to imagine an income tax that adheres to the principles underlying the ideal definition of income and enhances the efficiency and growth of the U.S. economy. No one doubts that highly skilled and dedicated workers have the potential to expand the private sector and provide ever more job opportunities. Further, no one questions the proposition that highly skilled and dedicated workers can lead the public sector to do more for less. What this Article shows is that the success of the U.S. economy in the twenty-first century requires the tax law to treat both business owners and workers as producers. It also shows that the tax law's continuing failure to treat business owners and workers as both consumers and producers undermines the goals of efficiency and fairness.