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# Beyond the Little Dutch Boy: An Argument for Structural Changes in Tax Deduction Classification

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# BEYOND THE LITTLE DUTCH BOY: AN ARGUMENT FOR STRUCTURAL CHANGE IN TAX DEDUCTION CLASSIFICATION

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*Abstract*: One of the most active disputes in tax law today is the question of the proper tax consequences for a successful plaintiff, a portion of whose taxable damage award is paid to his or her attorney pursuant to a contingent fee arrangement. At issue is whether the plaintiff is taxable on the portion of the award that is payable to the attorney. One aspect of this problem was resolved prospectively by the adoption of the American Jobs Creation Act of 2004, but the problem continues to exist in other areas. The United States Supreme Court resolved a split in the United States Circuit Courts of Appeals with respect to the taxation of contingent attorney's fees in *Commissioner v. Banks*, but that decision provides no comfort for the plight of taxpayers because the government prevailed. Moreover, the attorney's fee dispute is only one small example of a much larger problem. Instead of dealing with the root cause of the problem, the focus (both in the courts and in Congress) has been on whether to provide a "fix" for the specific plight of the taxpayers who have raised issues in court. The courts and Congress, like the Little Dutch Boy, may be willing to plug one hole, but the broader problem is a structural fault in the "dam" of the tax law system—namely, the improper classification of a significant number of expenditures as itemized deductions. This Article argues that the current list of nonitemized deductions wrongly excludes a number of items, especially some that are directly connected to the production of income. This erroneous exclusion imposes an unwarranted and severe tax burden in far more circumstances than the attorney's fee problem on which Congress exclusively focused in the American Job Creation Act of 2004. The harsh consequences resulting from the misclassification of a number of items are exacerbated by the stringent limitations currently imposed on many itemized deductions; but even a repeal of those limitations, which is unlikely to occur, will not cure all of the harm that a wrongful classification causes. This author hopes that highlighting several examples of misclassification will induce Congress to implement a commission to study the entire classification system, rather than to rest on its laurels for solving one small part of the problem in the American Job Creation Act of 2004.



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## INTRODUCTION

One of the most active disputes in tax law today is the question of the proper consequences for a plaintiff who recovers taxable damages and pays a portion of the award to his or her attorney pursuant to a contingent fee arrangement.[1] At issue is whether the plaintiff should be taxed on the portion of the award that is payable to the attorney. The dispute has attracted considerable attention, particularly because the effect of taxing the plaintiff for the attorney's portion of the award has been severe and patently inappropriate. Not only does the tax imposition contravene tax policy,[2] but in the case of discrimination suits, it also frustrates a major purpose of the civil rights legislation that authorized those causes of action.[3] Congress resolved the civil rights aspect of this problem on October 22, 2004, by adopting Section 703 (the Civil Rights Tax Relief provision) of the American Jobs Creation Act of 2004 (the 2004 Act).[4] However, the problem continues to exist in other areas.

Prior to the enactment of the 2004 Act, the United States Supreme Court agreed to resolve a split among the circuit courts of appeals with respect to this tax issue;[5] shortly before publication of this Article, the Supreme Court decided those cases in favor of the Internal Revenue Service (the Service) and held that the amount paid to an attorney under a contingent fee arrangement is taxable to the plaintiff.[6] The recent

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1. *See generally* Deborah A. Geier, *Some Meandering Thoughts on Plaintiffs and Their Attorneys' Fees and Costs*, 88 TAX NOTES 531 (2000); Gregg D. Polsky, *The Contingent Attorney's Fee Trap: Ethical, Fiduciary Duty and Malpractice Implications*, 23 VA. TAX REV. 615 (2004) [hereinafter *Attorney's Fee Trap*]; Gregg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements: Enough with the Fruits and the Trees*, 37 GA. L. REV. 57 (2002) [hereinafter *Fruits and Trees*]; Gregg. D. Polsky & Stephen F. Befort, *Employment Discrimination Remedies and Tax Gross Ups*, 90 IOWA L. REV. 67 (2004).

2. *See infra* Part I.A.

3. *See generally* Laura Sager & Stephen Cohen, *How the Income Tax Undermines Civil Rights Law*, 73 S. CAL. L. REV. 1075 (2000).

4. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546–48.

5. Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003), *cert. granted*, __U.S.__ (Mar. 29, 2004), 124 S. Ct. 1712 (2004), *rev'd*, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005); Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003), *cert. granted*, __U.S.__ (Mar. 29, 2004), 124 S. Ct. 1713 (2004), *rev'd sub nom.* Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005). Upon granting certiorari, the Court consolidated the cases.

6. Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005). The Court held that the plaintiffs are taxable on the amount paid to the attorney. *Id.* The issue may not be definitively resolved because the Court declined to pass upon an issue raised by the taxpayers because it was raised for the first time in the Supreme Court. *Id.* In any event, the Court's resolution of this issue does not affect the analysis and conclusions of this article.

adoption of the 2004 Act's Civil Rights Tax Relief provision did not render the case moot before the U.S. Supreme Court, however, for two separate reasons. First, the relevant provision of the 2004 Act does not apply to judgments and settlements made before the date on which the 2004 Act was enacted. Second, the relevant provision of the 2004 Act does not apply to one of the two consolidated cases in the Supreme Court, *Banaitis v. Commissioner*,[7] because the taxpayer's claim for damages, while arising in a wrongful discharge context, does not involve discrimination or any of the other areas covered by the 2004 Act.[8] This lack of discrimination renders the 2004 Act inapplicable to *Banaitis* even if that case were within the effective date of the Act.

The attorney's fee dispute is one small example of a much larger problem in the classification of deductions. Rather than deal with the problem's root cause, both courts and Congress have continued to focus on whether to provide a "fix" for the specific plight of the taxpayers who have raised issues in court. The courts and Congress, like the Little Dutch Boy,[9] may be willing to plug one hole, but the broader problem is a structural fault in the "dam" of the tax law system—namely, the improper classification as itemized deductions of a significant number of expenditures directly related to the production of income. This Article argues that, instead of plugging one hole at a time, it is time to replace the dam.

Tax law divides deductions into two major categories: itemized and nonitemized.[10] This Article addresses the avowed purpose, description, and significance of that division. Put generally, the law treats itemized deductions much less favorably than nonitemized deductions. For example, the Internal Revenue Code (the Code) applies an overall limitation to the amount of most itemized deductions yet does not apply a similar limitation to nonitemized deductions.[11] The Code places even

7. 340 F.3d 1074 (9th Cir. 2003), *rev'd sub nom.* Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005).

8. *See* American Jobs Creation Act § 703; *Banaitis*, 340 F.3d at 1076–77.

9. The tale of the Little Dutch Boy originates in Mary Mapes Dodge's 1865 book, "Hans Brinker or The Silver Skates." MARY MAPES DODGE, HANS BRINKER OR THE SILVER SKATES 123–26 (1865). In the original, the Little Dutch Boy is a hero when he uses his finger to stop the flow of water from a hole in a dam until help can arrive. *Id.* However, the reference has also come to symbolize a situation where a person plugs leaking holes while ignoring the overall problem.

10. Nonitemized deductions are often referred to as "above-the-line" deductions because they are deducted in determining adjusted gross income. J. MARTIN BURKE & MICHAEL K. FRIEL, UNDERSTANDING FEDERAL INCOME TAXATION 7 (2001).

11. I.R.C. § 68 (2000). Section 68 is scheduled to be phased out beginning in 2006, but it is

greater restrictions on a subset of itemized deductions, classified as "miscellaneous itemized deductions."[12] This Article asserts that the current statutory limitations on certain itemized deductions (especially miscellaneous itemized deductions) are unprincipled. Moreover, even if the current treatment of itemized deductions were acceptable, the inappropriate inclusion of certain deductions in the itemized category causes harsh and unwarranted consequences.

Part I of this Article provides an overview of the federal income tax system and describes nonitemized, itemized, and miscellaneous itemized deductions and how the tax law treats these deductions differently. Part II describes the "Little Dutch Boy" problem of attorney's fees and points out several other areas where the limitations on itemized deductions seriously distort taxable income and cause inequitable consequences. Part III examines whether a principled justification exists for drawing distinctions among the deduction categories and providing significantly different treatment to each. Part IV examines whether the Code includes expenditures that do not belong in the category of itemized deductions and whose inclusion seriously distorts the measurement of taxable income and violates the principle of horizontal equity.[13] Part IV also proposes legislative reform of the delineation and treatment of itemized deductions and explains why only a legislative repeal or modification of that concept will resolve both existing and future problems.

## I. OVERVIEW OF TAXABLE INCOME—THE TAX TREATMENT OF THE CATEGORIES OF DEDUCTIONS

This Part describes the role of deductions in the determination of taxable income and the application of the alternative minimum tax. This Part also describes the different categories of deductions and the treatment of each category. Before the examination of deductions, there is a brief discussion of the role that considerations of equity serve in the tax system.

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scheduled, phoenix-like, to be reborn in full force in 2011. *Id.* The operation of the overall limitation is described *infra* Part I.D.

12. *See* I.R.C. § 67.

13. Horizontal equity requires that persons in like net income positions pay the same amount of tax. Douglas Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1, 1 n.5 (1979).

### A. *Equity as a Principle of Tax Policy*

Equity is an important principle of tax policy. Essentially, equity means treating taxpayers fairly so that people who have the same net income will pay the same amount of income tax, and people who have disparate amounts of net income will pay appropriately different amounts of income tax. The goal of similarly taxing people with like net income is referred to as "horizontal equity," and the goal of differently taxing people with disparate net income is referred to as "vertical equity."[14] A tax law contravenes the principles of horizontal and vertical equity when that law treats a type of expenditure as deductible in some circumstances and as nondeductible in others, unless there is a principled justification for that difference.

Tax rates should be applied to a taxpayer's net income—that is, the taxpayer's gross income less the expenses incurred in producing and collecting that income.[15] To the extent that a taxpayer is taxed on an amount greater than net income, the taxpayer will be taxed on gross income. If a tax system were to tax gross rather than net income, it would disfavor businesses with high costs. For example, if X expends $400,000 to earn one million dollars of gross income, X has netted $600,000 income from that business activity. If Y expends $100,000 to earn $700,000, Y also nets $600,000 of business income. X and Y should bear the same tax on their net income. If they were taxed on gross income, however, X would pay a greater tax than Y. There is no valid reason to favor Y's low-cost business over X's business by imposing a lesser tax on Y.

Tax law provides deductions for some expenditures that are not related to the production of income, such as charitable contributions, medical expenses, and alimony.[16] Whether or not those deductions are appropriate, the taxpayer's net income is the maximum amount that should be taxed. If some taxpayers are taxed on net income and others are not, that violates the principle of equity.

While equity is an important principle of taxation, it can be sacrificed if its application would conflict with another principle of greater

14. WILLIAM D. ANDREWS, BASIC FEDERAL INCOME TAXATION 7–8 (5th ed. 1999).

15. In *Commissioner v. Tellier*, 383 U.S. 687 (1966), the Court said, "[T]he federal income tax is a tax on net income . . . . That principle has been firmly imbedded in the tax statute from the beginning." *Id.* at 691. In *Commissioner v. Sullivan*, 356 U.S. 27 (1958), the Court expressly disapproved of taxing more than net income. *Id.* at 29.

16. I.R.C. §§ 170, 213, 215 (2000).

significance in the context in which the issues arise. For example, a fine payable in a business context is not deductible[17] because allowing a deduction would diminish the deterrent impact of the fine. Similarly, equity can be sacrificed to achieve a programmatic goal. However, in the absence of a competing principle or goal of greater significance, the tax law should not contravene equity principles.

### B. *Taxable Income*

To facilitate understanding of why the current compartmentalization of deductions is structurally unsound, it is useful to briefly outline how individuals determine their tax liability under the current federal income tax system. Tax rates are applied to an individual's "taxable income" to determine tax liability.[18] The taxpayer may then reduce his or her tax liability by any credits to which he or she is entitled.[19] Section 63 of the Code defines taxable income as either (1) gross income minus the deductions allowed (other than the standard deduction)[20] or (2) "adjusted gross income" minus the standard deduction and the deduction for personal and dependent exemptions, whichever the taxpayer chooses.[21]

### C. *Nonitemized Deductions*

Code § 62 defines adjusted gross income (AGI) as gross income minus the deductions listed in § 62(a).[22] The deductions that are used to determine AGI are referred to as "nonitemized deductions."[23] Examples include trade and business deductions (other than the unreimbursed business expenses of an employee),[24] deductions attributable to property

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17. *Id.* § 162(f).

18. *Id.* § 1.

19. DOUGLAS A. KAHN, FEDERAL INCOME TAX 20 (4th ed. 1999).

20. I.R.C. § 63(a). The standard deduction is a specified amount, depending on the taxpayer's filing status, that may be deducted in lieu of utilizing the taxpayer's itemized deductions. *Id.* § 63(b), (c).

21. *Id.* § 63(b).

22. There are a few deductions not listed in I.R.C. § 62 that are allowed in determining adjusted gross income. *See, e.g.*, *id.* § 71(f)(1)(B) (excess alimony payments); *id.* § 164(f) (self-employment taxes); *id.* § 165(h)(4)(A) (personal casualty losses).

23. *See* KAHN, *supra* note 19, at 231.

24. I.R.C. § 62(a)(1). A few specified unreimbursed employee business expenses are allowed nonitemized classification. For example, certain business expenses of performing artists and of state government employees are nonitemized. *Id.* § 62(a)(2)(B)–(C).

held for the production of rents or royalties,[25] the alimony deduction,[26] and moving expenses.[27]

### D. *Limitations on Itemized Deductions*

All deductions that are not nonitemized, other than the deduction for personal and dependent exemptions, are called "itemized deductions."[28] Examples include the interest deduction,[29] charitable contribution deduction,[30] unreimbursed employee business expenses,[31] gambling losses,[32] certain state and local taxes,[33] and the medical expense deduction.[34] Why is the distinction between itemized and nonitemized deductions important? The Code subjects itemized deductions to more limitations than nonitemized deductions.[35] For example, an overall limitation currently applies to all but three of the itemized deductions.[36] Itemized deductions are sometimes referred to as "below-the-line" deductions because they are deducted after the taxpayer determines

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25. *Id.* § 62(a)(4).

26. *Id.* § 62(a)(10).

27. *Id.* § 62(a)(15).

28. *Id.* § 63(d).

29. *See id.* § 67(b)(1). Note that since the adoption of the Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 511(b), § 163, 100 Stat. 2085, 2246–48, no deduction has been allowed to an individual for "personal interest"—i.e., interest not connected with a business or income-producing activity other than "qualified residence interest," interest on certain deferrals of estate tax payments, and interest on "qualified educational loans." I.R.C. § 163(h). No deduction is allowed for interest allocable to the trade or business of being an employee. *Id.* § 163(h)(2)(A).

30. *See* I.R.C. § 67(b)(4).

31. For a detailed discussion of the employee expense deduction, see *infra* Part II.B.

32. Gambling or wagering losses are deductible only to the extent that the taxpayer has gambling or wagering winnings in the same tax year. I.R.C. § 165(d). When a deduction is allowed, it is an itemized deduction. *See id.* §§ 62, 63, 67(b)(3).

33. *See id.* § 67(b)(2).

34. *See id.* § 67(b)(5).

35. *See, e.g., id.* §§ 67, 68. In addition to the generic limitations, there are specific limitations on many itemized deductions contained in the Code sections dealing with the deductions themselves. For example, medical expenses cannot be deducted except to the extent that they exceed 7.5% of a taxpayer's adjusted gross income. *Id.* § 213(a). Nonitemized deductions are generally not subject to such floors (although one exception to this rule is I.R.C. § 274(n), where a fifty-percent limitation is applied to business meals). These limitations are specific to the deduction in question and do not relate to the problem of the detrimental treatment accorded to the class of itemized deductions.

Many income-connected deductions, whether nonitemized or not, are subject to the "at-risk" limitation and the "passive activity loss" limitation. *See id.* §§ 465, 469.

36. *Id.* § 68.

AGI.[37]

### 1. Significance of Excluding Itemized Deductions from Adjusted Gross Income

The exclusion of itemized deductions from AGI has adverse tax consequences both on the use of the standard deduction and on the amount that can be deducted for expenditures that are subject to a floor based on a percentage of AGI. As discussed above, the definition of taxable income is either gross income minus all deductions or AGI minus the standard deduction (and personal and dependent exemption deductions).[38] Thus, a taxpayer can use either itemized deductions or the standard deduction, but not both.[39] As a result, itemized deductions are useful only when and to the extent that they exceed the standard deduction. There is no such limitation on nonitemized deductions, all of which may be utilized by the taxpayer whether he or she itemizes or uses the standard deduction.[40]

Moreover, by not allowing taxpayers to deduct their itemized deductions from their AGI, the Code artificially inflates the taxpayer's AGI. This inflated AGI causes some of the taxpayer's other itemized deductions to be phased out because the Code subjects many of the deductions to a floor that is based on a percentage of the taxpayer's AGI. The higher the taxpayer's AGI, the higher the floor will be, causing more of the taxpayer's deductions to be phased out. Also, an inflated AGI may reduce tax credits. For example, a taxpayer's earned income credit and child tax credit are phased out if the greater of the taxpayer's AGI or earned income exceeds a threshold amount.[41]

### 2. Overall Limitation (Section 68)

A major limitation on the deduction of all but three of an individual's itemized deductions is the so-called "overall limitation" imposed by Code § 68.[42] Section 68 reduces an individual's itemized deductions if

37. BURKE & FRIEL, *supra* note 10, at 8.

38. *See supra* notes 20–21 and accompanying text.

39. *See* I.R.C. § 63(a).

40. For a discussion of possible justifications for the difference in treatment between the two categories, see *infra* Part III.B.

41. I.R.C. § 24(b) (child tax credit); *id.* § 32(a)(2) (earned income credit).

42. This limitation does not apply to the deductions for medical expenses, investment interest, and casualty and theft losses. *Id.* § 68(c).

the individual's AGI for a taxable year exceeds a specific threshold.[43] Currently, if a taxpayer's AGI exceeds a specific threshold, all but three of the taxpayer's itemized deductions, otherwise allowable for the taxable year, will be reduced by three percent of the excess of the individual's AGI over the applicable threshold.[44] However, there is a ceiling on the overall limitation; the amount of the reduction cannot exceed eighty percent of the taxpayer's itemized deductions.[45] This phase-out of itemized deductions is itself being phased out beginning in 2006,[46] but it will spring back to life in 2011.[47]

Because of this overall limitation on itemized deductions, a "double whammy" may be imposed on a taxpayer if the Code improperly classifies an expenditure as an itemized deduction subject to Code § 68. Not only would Code § 68 improperly limit the deduction for the expenditure, but it also would fail to reduce the taxpayer's AGI (as it would if properly characterized as a nonitemized deduction), which can increase the amount that Code § 68 renders nondeductible.[48] One might have thought that one improper treatment would be more than enough.

### 3. *Miscellaneous Itemized Deductions*

The overall limitation is not the only generic limitation on itemized deductions. The Code includes a special subcategory of deductions called "miscellaneous itemized deductions" within the category of itemized deductions.[49] Examples include investment expenses, expenses

43. *Id.* § 68(a). Initially, the threshold amount was $100,000, but it is adjusted upward for inflation each year. *Id.* § 68(b). For the year 2004, the threshold amount is $142,700. Rev. Proc. 2003-85, § 311, 2003-49 I.R.B. 1184, 1189.

44. I.R.C. § 68(a)(1), 68(c).

45. *Id.* § 68(a)(2).

46. *Id.* § 68(f), (g).

47. *Id.*; Economic Growth and Tax Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38. The sunset provision states

> In general.—All provisions of, and amendments made by, this Act shall not apply— (1) to taxable, plan, or limitation years beginning after December 31, 2010; or (2) in the case of title V, to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010 . . . .

*Id.* The sunset provision was used as a means to avoid the "Byrd rule," a senate procedure that requires sixty votes if the provisions affect revenue in years after the years covered in the bill. 2 U.S.C. § 644 (2000). Because the budget adopted by the Senate covered ten years, the sunset provision allowed the Republicans to avoid application of the Byrd rule.

48. The same is true for any miscellaneous itemized deduction which should be classified as a nonitemized deduction.

49. I.R.C. § 67.

incurred for the production of income or for the management, conservation, or maintenance of income-producing property (but which are unrelated to rents, royalties, or the conduct of a business), and most unreimbursed employee business expenses.[50] The Code limits these deductions by both the overall limitation discussed above, and by permitting the taxpayer to deduct the aggregate amount only to the extent that it exceeds two percent of the taxpayer's AGI.[51] Whether the Code classifies an itemized deduction as a miscellaneous itemized deduction depends upon an exclusionary rule: Code § 67(b) lists the itemized deductions that are *not* miscellaneous itemized deductions. Thus, if a deduction[52] is not listed in Code § 67(b) and is not a nonitemized deduction, it is a miscellaneous itemized deduction subject to the two-percent floor.

*4. Nondeductibility in Determining Alternative Minimum Tax*

The discussion above describes the "regular" federal income tax system. However, in 1969, Congress added a computational wrinkle by implementing a back-up system called the alternative minimum tax (AMT).[53] Congress originally designed the AMT to reach only a relatively small number of taxpayers who, it thought, were utilizing too many tax benefits that were granted for programmatic purposes.[54] However, the scope of the AMT has been greatly expanded since its original enactment. It has been predicted that, if no changes to the Code

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50. The label "miscellaneous itemized deductions" is derived from the individual income tax Form 1040. As the legislative history to the adoption of Code § 67 states,

> The list of itemized deductions on Schedule A of Form 1040 includes a category labeled miscellaneous deductions, following the listings for medical expenses, charitable expenses, interest, taxes and casualty and theft losses. Under present law, this category generally includes four types of deductions: (1) certain employee business expenses (sec. 162); (2) expenses of producing income (sec. 212); (3) expenses related to filing tax returns (sec. 212); and (4) expenses of adopting children with special needs (sec. 222).

H.R. REP. NO. 99-426, at 108 (1985). Prior to 1986, this characterization of certain itemized deductions as "miscellaneous" did not have any significance as to how those items were treated for tax purposes, but Form 1040 did separate them for purposes of listing them on the return. *Id.*

51. I.R.C. § 67.

52. This does not apply to a deduction for personal or dependent exemptions. *Id.* §§ 63(d), 67(b).

53. Tax Reform Act of 1969, Pub. L. No. 91-172, § 301(a), 83 Stat. 487, 580–85 (1969). The alternative minimum tax system has been revised several times since 1969. *See* GREGG A. ESENWEIN, CONGRESSIONAL RESEARCH SERVICE REPORT FOR CONGRESS, THE ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS 2 (Jan. 30, 2003).

54. *See* S. REP. NO. 91-552, at 13 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2040. For a more detailed discussion, see *infra* notes 173–78 and accompanying text. The overall limitation imposed by I.R.C. § 68 does not apply to the AMT. I.R.C. § 56(b)(1)(F).

are made, thirty-five million taxpayers (thirty-three percent of the total number of taxpayers) will be subject to the AMT system by 2010.[55]

In effect, taxpayers are required to pay under whichever system produces the greatest tax liability[56]—the regular or the alternative minimum. Although the marginal rates utilized by the AMT often are lower than those of the regular tax, the amount of income subject to the AMT usually will be greater than the amount that is subject to the regular tax. The amount subject to the AMT is equal to the taxpayer's taxable income altered by a number of modifications, including a denial of certain deductions and credits.[57] The Code refers to the modified taxable income as the "alternative minimum taxable income."[58] A taxpayer's alternative minimum taxable income is reduced by an exemption amount that is phased out if the taxpayer's alternative minimum taxable income exceeds a specified amount.[59]

More importantly, the AMT often exceeds the regular tax. A major cause of having a higher AMT is that miscellaneous itemized deductions (such as certain investment expenses, expenses of producing nonbusiness income, and unreimbursed employee expenses)[60] cannot be deducted in determining an individual's AMT.[61] Therefore, many taxpayers will not be able to utilize any of their miscellaneous itemized deductions.

## II. EXAMPLES OF DISTORTIONS OF INCOME CAUSED BY THE MISCLASSIFICATION OF DEDUCTIONS

This Part describes several circumstances in which the Code's treatment of certain expenses as itemized deductions causes harsh and

55. ESENWEIN, *supra* note 53, at 6.

56. I.R.C. § 55(q). If the taxpayer's AMT is greater than the regular tax, Code § 55(a) requires the taxpayer to pay the regular tax plus an additional amount equal to the difference between the AMT and the regular tax. *Id.* § 55(a). In effect then, the taxpayer pays a total tax equal to the greater of the AMT or the regular tax.

57. *Id.* § 56.

58. *Id.* § 55(b)(2).

59. *Id.* § 55(b)(1)(A)(ii), (d)(3).

60. These are itemized deductions that are not listed in I.R.C. § 67(b).

61. I.R.C. § 56(b)(1)(A)(i). Another important disallowance under the alternative minimum tax system is the complete denial of the state and local tax deduction under Code § 164(a). *Id.* § 56(b)(1)(A)(ii); *see* Daniel Shaviro, *Tax Simplification and the Alternative Minimum Tax*, 91 TAX NOTES 1455, 1464 (2001) ("For individuals earning $100,000 or more, the AMT's disallowance of itemized deductions for state and local taxes is by far the largest single preference item.").

inequitable consequences. The circumstances mentioned in this Part are merely illustrations of flaws in the current tax law and do not constitute an exhaustive list of the inequities engendered by the current tax law. Each of these flaws is a hole in the dam and illustrates why Congress should replace the dam.

### A. *Attorney's Fee Where an Award Is Taxable*

The Code's treatment of the attorney's fee payable by a successful plaintiff in a proceeding in which the award obtained by the plaintiff constitutes taxable income[62] provides a glaring example of the improper characterization of certain expenses as miscellaneous itemized deductions, and indeed of their mischaracterization as itemized deductions at all. In such cases, the Service has treated the entire amount of the award as income to the plaintiff and has treated the attorney's fees either as a deduction under Code § 212(1) (an expense for the production or collection of income) or as a deduction under Code § 162 (an unreimbursed employee expense).[63] Under either section, the deduction will be itemized and therefore usually will be either severely limited in amount or entirely disallowed.

This problem has recently generated a significant amount of commentary[64] and litigation, including a U.S. Supreme Court decision.[65] The court decisions and commentary have focused on whether the portion of an award that is paid to the plaintiff's attorney as a contingent fee should be excluded from the plaintiff's gross income.[66] While lower

62. This issue does not arise in cases where the plaintiff receives only compensatory damages on account of a physical injury because the recovery in that case would be nontaxable to the plaintiff. *See* I.R.C. § 104(a)(2). In that case, the plaintiff would not be allowed to deduct the attorney's fee expense. *See id.* § 265(a)(1).

63. *See, e.g.*, Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003), *rev'd*, Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005); Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003), *rev'd sub nom.* Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005).

64. *See generally* Geier, *supra* note 1; Polsky, *Attorney's Fee Trap*, *supra* note 1; Polsky, *Fruits and Trees*, *supra* note 1; Polsky & Befort, *supra* note 1.

65. *See generally* Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005).

66. One commentator has proposed that an attorney's fee should be treated as an expense of liquidating a claim, offsetting the income recognized on the receipt of damages. *See generally* Charles Davenport, *Why Tort Legal Fees Are Not Deductible*, 97 TAX NOTES 703 (2002). Essentially, Davenport contends that the expenses should be capitalized. *See id.* at 705. This is contrary to the normal treatment of expenses incurred in collecting income or in liquidating an asset. In this author's view, Treasury Regulation § 1.212-1(k) is dispositive and indicates that the expense

courts have divided on this issue, a majority have held that the plaintiff must include the entire amount of the award in income. The United States Courts of Appeals for the Second, Third, Fourth, Seventh, Tenth, and Federal Circuits have held that the attorney's fee is included in the plaintiff's gross income,[67] while the Fifth, Sixth, and Eleventh Circuits excluded the fee from the plaintiff's income.[68] The Ninth Circuit is divided within itself on the question, with the answer depending upon the applicable state lien law.[69] The U.S. Supreme Court resolved this issue for the Service in *Commissioner v. Banks*,[70] and Congress, in the 2004 Act, remedied this issue with regard to discrimination and certain

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is currently deductible and not capitalized. Treas. Reg. § 1.212-1(k) (as amended in 1975). Professor Davenport filed an amicus brief for *Commissioner v. Banks*. *See* Brief of Amicus Curiae Professor Charles Davenport in support of respondents, Comm'r v. Banks, __U.S.__ (Jan. 24, 2005) (Nos. 03-892, 03-907).

67. *See* Raymond v. United States, 355 F.3d 107 (2d Cir. 2004), *petition for cert. filed*, 72 U.S.L.W. 1437 (U.S. Apr. 9, 2004) (No. 03-6037); Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001); Kenseth v. Comm'r, 259 F.3d 881, 883 (7th Cir. 2001); Young v. Comm'r, 240 F.3d 369, 379 (4th Cir. 2001); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995); O'Brien v. Comm'r, 319 F.2d 532 (3d Cir. 1963).

68. *See Banks*, 345 F.3d at 386; Davis v. Comm'r, 210 F.3d 1346 (11th Cir. 2000); Cotnam v. Comm'r, 263 F.2d 119 (5th Cir. 1959).

69. *See Banaitis*, 340 F.3d 1074, (9th Cir. 2003) (ruling that, under Oregon law, taxpayer does not include attorney's fees in income), *rev'd sub nom.* Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005); Sinyard v. Comm'r, 268 F.3d 756 (9th Cir. 2001) (suggesting state law does not matter, and holding attorney's fee must be included in taxpayer's income), *cert. denied*, 536 U.S. 904 (2002); Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000) (holding California law does not confer ownership interest to attorney, taxpayer must include fee income); Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000) (holding that, based on Alaska law, taxpayer must include amount paid to attorneys in income). For a discussion of the bizarre split within the Ninth Circuit, see generally Noah M. Burton, *The Taxation of Contingent Attorneys' Fees: How the Ninth Circuit Got Lost in the Forest*, 36 RUTGERS L.J. (forthcoming 2005); Polsky & Befort, *supra* note 1.

70. Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005). Both *Banaitis* and *Banks* were victories for the taxpayers in the courts of appeals (i.e., the attorneys' fees were excluded from the taxpayers' incomes) and were reversed by the Supreme Court under the consolidated case *Commissioner v. Banks*. *Id.* Several law professors filed amicus briefs. The taxpayers in those two cases also argued that the contingent fee arrangement between a plaintiff and his attorney constitutes a partnership, and they contended that the partnership income that is allocated to the attorney is not taxable to the plaintiff. Brief for the Respondent at 15–16, *Banks*, __U.S.__ (Jan. 24, 2005) (Nos. 03-892, 03-907); Brief for the Respondent at 5–21, *Banaitis*, *sub nom.* Comm'r v. Banks, __U.S.__ (Jan. 24, 2005) (Nos. 03-892, 03-907). For one commentator's conclusion that the partnership theory does not prevent taxation of the plaintiff, see generally Gregg D. Polsky, *Contingent Fees: Why the Partnership Theory Doesn't Work*, 104 TAX NOTES 1089 (2004). The Supreme Court rejected the taxpayers' partnership contention and held that no partnership was formed. *Banks*, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005).

other employment cases.[71]

This author agrees that the U.S. Supreme Court is correct in holding that all of the plaintiff's award, including the amount used to pay the attorney, should be included in the plaintiff's gross income under the current Code, regardless of the terms of the applicable state lien law.[72] Notwithstanding, as a matter of good tax policy, the plaintiff should not pay tax on that portion of the award used to pay the attorney's fee, regardless of whether the fee is a fixed amount or a contingent arrangement, because the taxpayer should be taxed only on the net amount obtained from the taxpayer's claims after taking into account the expenses of securing and collecting that claim.[73] The reason that a problem exists is that the attorney's fee should be (but is not) fully deductible by the plaintiff. The fee would be fully deductible if it were not for the restrictions placed on itemized deductions. An example will bring the issue into focus.

Suppose Daniel Defendant makes a false and defamatory statement about Peter Plaintiff. Peter would like to sue Daniel for damages. Peter hires Larry Lawyer to represent him in his lawsuit against Daniel. Larry agrees to represent Peter in the case, and they sign a contract. The contract states that Larry is entitled to forty percent of whatever compensation Peter receives from Daniel Defendant on account of the lawsuit.

Larry successfully represents Peter, and the jury awards Peter $2,000,000 in damages.[74] Pursuant to the representation agreement, Larry is entitled to $800,000 for his services. This leaves Peter with net income of $1,200,000 from the lawsuit. Assume Peter won his suit in 2002, is single, and has no other income or deductions.[75]

What is the correct tax treatment of these events? The theoretical answer reflecting horizontal and vertical equity is obvious. Peter should

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71. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546–48.

72. *Banks*, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005).

73. *See supra* notes 14–15 and accompanying text.

74. Note that it makes no difference whether the damages are compensatory or punitive: both are taxable income to Peter. *See* KAHN, *supra* note 19, at 93–96. It also makes no difference whether the amount is obtained from an award by a judge, jury, or through a settlement agreement with Daniel Defendant. I.R.C. § 104(a)(2) (2000). However, if the damages were compensatory for a physical injury, there would be no tax issue as their receipt would be nontaxable to Peter. *See id.* As a result, there would be no deduction for the attorney's fee. *See id.* § 265(a)(1).

75. Obviously, this is an unrealistic assumption, but it simplifies the calculations and has no effect on the analysis of the issue central to this article.

be taxed only on the *net* income that he received.[76] That is, he should pay federal taxes only on his net income of $1,200,000.[77] The correct treatment would require Peter to include the full $2,000,000 in gross income, but it also would allow Peter to deduct the $800,000 for the attorney's fee expense as a nonitemized deduction. This amount represents the cost of producing income, which should be deducted from gross income to reach net income. Failing to allow a deduction, while including the entire award in income, amounts to taxing the taxpayer on the cost of producing income—the amount paid to the attorney. Taxing such amounts violates the basic principle of income taxation that only net income should be taxed.[78]

It might seem that the current federal income tax system achieves that result, but it does not. Peter should include the full $2,000,000 in income, and the current tax system allows Peter to deduct $800,000 for the payment to the attorney. However, because the attorney's fee expense is classified as a miscellaneous itemized deduction and is subject to the limitations accorded to that classification, the current treatment falls short of the optimum.[79] Instead, the current tax system imposes taxes on an amount greater than the taxpayer's actual net income.

The first limitation that could apply to this payment is the two-percent floor for miscellaneous itemized deductions provided by Code § 67. The tax law further penalizes Peter by increasing the limitation that Code § 67 imposes on the deduction of that fee (i.e., the two percent of AGI floor is higher than it should be).[80] If no other limitation applied, Code § 67 would disallow $40,000 of Peter's deduction for the attorney's fee expense. Based on the highest marginal tax rate for individuals in 2002, Peter would be required to pay an additional $15,440 in federal income

76. *See supra* notes 14–15 and accompanying text.

77. *See* Polsky, *supra* note 1, at 68–70; Sager & Cohen, *supra* note 3, at 1103–04.

78. *See supra* notes 14–15 and accompanying text.

79. Professor Davenport contends that the attorney's fee should offset the amount realized on the claim. *See supra* note 66. If adopted, this would be a departure from the established treatment of expenses incurred to collect income. While the adoption of an offset approach would cure Peter's problem, it would not reach a vast number of other circumstances, such as the problem that an athlete incurs when he pays an agent to negotiate an employment contract. *See infra* note 135 and accompanying text.

80. Peter's payment to his attorney is a miscellaneous itemized deduction; therefore, it is not included in determining his adjusted gross income. *See* I.R.C. § 62(a) (2000). As discussed previously, the two-percent floor for miscellaneous itemized deductions is based on adjusted gross income. *See supra* note 51 and accompanying text.

tax.[81]

Sadly, there is more bad news waiting for Peter in Code § 68. Allowable miscellaneous itemized deductions (that is, the amount in excess of the two-percent floor) are still subject to the overall limitation in Code § 68.[82] In 2002, the Code § 68 threshold amount was $137,300.[83] Because the threshold is compared to the taxpayer's AGI, which does not reflect itemized deductions, Peter's payment to the attorney will not decrease his AGI—causing him to exceed the threshold by a greater amount.

Peter exceeds the threshold amount by $1,862,700. Code § 68 provides that the amount of otherwise allowable itemized deductions shall be reduced by "3 percent of the excess of adjusted gross income over the applicable amount."[84] Thus, Code § 68 would disallow $55,881 of Peter's attorney's fee expense, subjecting Peter to approximately $21,570 in additional federal taxes. All in all, the operation of Code § 67 and § 68 would disallow $95,881 (approximately twelve percent) of Peter's $800,000 "deductible" expense, thereby raising his federal income tax liability by approximately $37,010.

As if the tax consequences from the limitations were not bad enough, the federal tax system exacerbates Peter's problem through the use of the AMT. As noted above, a taxpayer must also determine his tax liability under the AMT system and pay under that system if it produces a greater tax liability than does the "regular" system.[85] Under the AMT system, the Code disallows all miscellaneous itemized deductions.[86] Therefore, while the applicable itemized deduction limitations disallow approximately twelve percent of Peter's attorney's fee deduction under the regular tax system, the AMT system will disallow the deduction entirely. This disallowance of itemized deductions basically ensures that Peter will be subject to the AMT system because the decrease in deductions will increase his tax liability under the AMT, making it

81. The highest individual marginal tax rate in 2002 was 38.6%. I.R.C. § 1.

82. The two-percent floor Code § 67 limitation applies before determining the amount subject to the overall limitation in Code § 68. *See id.* § 68(d).

83. Rev. Proc. 2001-59, 2001-2 C.B. 623.

84. I.R.C. § 68(a)(1). The disallowed amount is subject to an overall limitation of eighty percent of the itemized deductions. *Id.* § 68(a)(2). That is, no more than eighty percent of the taxpayer's itemized deductions can be disallowed under Code § 68. *See id.*

85. *See supra* note 56.

86. *See* I.R.C. § 55(b)(1). The overall limitation on itemized deductions of § 68 does not apply to the alternative minimum tax system. *Id.* § 56(b)(1)(F).

greater than Peter's tax liability under the regular system.

To determine Peter's tax liability under the regular system, he would begin with his gross income, $2,000,000, which is also his AGI.[87] From his AGI, he would deduct his itemized deduction: the attorney's fee expense,[88] reduced by the limitations in Code § 67 and § 68.[89] While taxpayers would normally also reduce their AGI by personal exemptions,[90] Peter's AGI is high enough to phase out the entire amount of Peter's exemption.[91] Therefore, Peter's taxable income is $1,295,881 and his federal income tax liability is approximately $476,408.[92] Under the regular tax system, Peter's liability amounts to approximately forty percent of his actual net income of $1,200,000.

To determine his tax liability under the AMT system, Peter must first calculate his alternative minimum taxable income. The AMT system views all miscellaneous itemized deductions as preference items and disallows 100 percent of such expenses.[93] Therefore, Peter's alternative minimum taxable income is the full $2,000,000. Normally, taxpayers reduce their alternative minimum taxable income by an exemption amount.[94] However, similar to the personal exemption under the regular tax system, Peter's alternative minimum taxable income is high enough to phase out the entire exemption.[95]

Therefore, the full $2,000,000 is Peter's alternative minimum taxable income. Under the AMT system, the first $175,000 is subject to a twenty-six percent tax rate, and everything in excess of that is subject to a twenty-eight percent tax rate.[96] Peter's AMT liability would be $556,500. Because this amount is greater than his tax liability under the regular system, this is Peter's final federal tax liability. The AMT system raises Peter's taxes by $80,092. Based on his "true" net income of

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87. Peter's gross income and adjusted gross income are identical because he has no nonitemized deductions.

88. The attorney's fee is deductible under either § 212 or, in some cases, § 162. *See supra* note 63 and accompanying text.

89. Note that despite the disallowance of a significant portion of his $800,000 "deduction," the allowable portion of that expense would still be greater than the miniscule 2002 standard deduction amount of $4,700. *See* I.R.C. § 63(c).

90. *See id.* § 151.

91. *See id.* § 151(d)(3).

92. For the tax rate tables for 2002, see Rev. Proc. 2001-59, 2001-1 C.B. 623.

93. I.R.C. § 56(b)(1)(A)(i).

94. *See id.* § 55(d).

95. *Id.* § 55(d)(3).

96. *Id.* § 55(b)(1)(A)(i).

$1,200,000, Peter would pay approximately forty-six percent in federal income taxes, which is substantially greater than the highest nominal tax rate.[97]

Peter's tax liability under the current tax system appears even more egregious when compared to the tax Peter would have owed if the attorney's fee had been fully deductible (as it should be). If that were the case, Peter would have paid $117,102 less in federal income tax.[98]

Using dubious legal reasoning based on the assignment of the plaintiff's interest prior to the case being settled, several courts have concluded that plaintiffs should not include in income an amount paid to an attorney pursuant to a contingent fee arrangement (thereby avoiding the deduction classification issue).[99] While this result conforms to the tax policy that a taxpayer is taxed only on net income, it departs from the correct application of the law on income recognition.[100] In any event, even if Peter's problem were cured by excluding the attorney's fee from Peter's income because of the pre-trial assignment of a percentage interest in the award, the ruling would be of no aid to a litigant who pays his attorney an hourly fee.[101] Unless a full deduction is allowed that plaintiff, he will be overtaxed. Relief given only to litigants who have a contingent fee arrangement exacerbates the inequity of failing to tax other litigants correctly.[102]

The denial of a full deduction for attorney's fees is inappropriate because they are a cost of producing or collecting income. The current

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97. In 2002, the highest *marginal* rate for individuals was 38.6%. *Id.* § 1.

98. As shown above, if the $800,000 attorney's fee was fully deductible, Peter's regular tax liability would have been $37,010 less. Because the alternative minimum tax is $80,092 greater than his current regular tax, the alternative minimum tax is $117,102 ($80,092 + $37,010) greater than the tax liability Peter would have had if there were neither a deduction limitation nor an alternative minimum tax.

99. *See, e.g.*, Banks v. Comm'r, 345 F.3d 373, 386 (6th Cir. 2003), *rev'd*, Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005); Banaitis v. Comm'r, 340 F.3d 1074, 1083 (9th Cir. 2003), *rev'd sub nom.* Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005); *see also* Polsky, *Fruits and Trees*, *supra* note 1, at 74–76.

100. For a contrary view, see generally Davenport, *supra* note 66; Robert W. Wood, *Settlements and Judgments: Att'y Fees and Section 104 Cases*, 104 TAX NOTES 733 (2004).

101. If Davenport's proposal for capitalizing attorney's fees, *see supra* note 66, were adopted, it is unclear whether that categorization would be extended to hourly attorney's fees. There are similarities but there also are differences.

102. Admittedly, hourly fee arrangements are rare in these suits. However, there are other nonbusiness suits where hourly fees would be the norm (for example, lawsuits involving investment disputes where the award would be taxable). There is no valid reason to treat the two fee arrangements differently.

system's treatment of attorney's fees is another hole in the dam and further evidence that the dam needs to be replaced. Congress prospectively addressed the treatment of attorney's fees in certain circumstances in the 2004 Act, but that provision leaves the attorney's fee problem unresolved in cases not covered by the 2004 Act. By ruling in favor of the Service on this issue in *Commissioner v. Banks*, the U.S. Supreme Court left to Congress the task of dealing with the contingent fee and other similar problems.[103]

### B. *Employees and Independent Contractors—Different Tax Results for the Same Expense*

Another example of inequitable treatment caused by the itemized deduction classification and its limitations relates to unreimbursed trade or business expenses of employees, as compared to the treatment of self-employed independent contractors.[104] Unreimbursed employee trade or business expenses are specifically excluded from the list of nonitemized deductions in Code § 62.[105] By contrast, any valid trade or business expenses of an independent contractor will qualify as a nonitemized deduction, not subject to the limitations imposed on itemized deductions (under either the "regular" or the AMT system).[106]

Subject to a few narrow exceptions,[107] any trade or business expense of an employee that is not reimbursed by the employer is specifically excluded from the list of nonitemized deductions.[108] Not only does such an expense lose nonitemized deduction status, but because it is not listed

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103. *See* Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005).

104. Of course, independent contractors are self-employed individuals for purposes of both the income tax and the social security tax. Ware v. United States, 67 F.3d 574 (6th Cir. 1995); Treas. Reg. § 31.3401(c)–1(b) (as amended in 1970). Although not all self-employed persons are also independent contractors, this author will often refer only to independent contractors in this Article because their activities more closely resemble those of employees.

105. I.R.C. § 62(a)(1) (2000). Employees can qualify for nonitemized treatment for their business expenses, but only if their employer reimburses them. *Id.* § 62(a)(2)(A). By granting employees a nonitemized deduction for reimbursed expenses, Congress has basically created a wash. That is, the employee has income in the amount of the reimbursement, but also gets a full nonitemized deduction for the business expense. Rather than forcing taxpayers to put both the income and the expense on their return, the Internal Revenue Service allows taxpayers simply to exclude the reimbursement from income. *See, e.g.*, Rev. Rul. 77-351, 1977-2 C.B. 23; Rev. Rul. 76-71, 1976-1 C.B. 308; Rev. Rul. 76-65, 1976-1 C.B. 46; Rev. Rul. 76-62, 1976-1 C.B. 12.

106. *See supra* Part I.D (describing limitations).

107. *See* I.R.C. § 62(a)(2)(B)–(E), (a)(15). These exceptions are discussed *infra* Part IV.B.

108. I.R.C. § 62(a)(1), (2)(A).

in Code § 67(b), it drops all the way down the deduction chain and is classified as a miscellaneous itemized deduction. An employee can take a miscellaneous itemized deduction only to the extent that the aggregate amount of miscellaneous itemized deductions exceeds two percent of his or her AGI.[109] After applying the two-percent floor to the aggregate amount of miscellaneous itemized deductions, any remaining unreimbursed expense will then be subjected to the overall limitation of Code § 68. As a final blow, the miscellaneous itemized deduction will be completely disallowed under the AMT system.[110]

The result of this treatment is that two taxpayers with identical incomes and identical legitimate unreimbursed business expenses will have vastly different tax consequences if one is an employee and one is an independent contractor. This violates the basic principle of horizontal equity. Moreover, this system has become a trap for the unwary. Consider the following illustration.

Assume Paula and Peter are unrelated law professors at Duke University. Both accept offers to teach for one academic year as visiting professors at Stanford Law School, and both rent homes in Palo Alto, each of which has a total rental cost of $40,000 for the period of their visits at Stanford.

Suppose Stanford agrees to pay Paula $200,000 in salary. Paula uses part of that salary to pay the rent for her home, her meals, and her California income taxes. The rental and one-half of her food expenses are deductible business expenses because Paula is temporarily away from her regular place of business (Duke University).[111] However, because Paula is an employee of Stanford, her expenses are miscellaneous itemized deductions.[112] Not only are they subject to the limitations set out in Code § 67 and § 68, they are completely disallowed for purposes of the AMT. Most likely, this will require Paula to determine her federal income tax liability under the AMT system. The AMT is detrimental to Paula not only because it disallows all miscellaneous itemized deductions, but also because it disallows any deduction for the amounts Paula paid to California and North Carolina for state income taxes.[113]

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109. *Id.* § 67(a).

110. *Id.* § 56(b)(1)(A)(i).

111. *Id.* §§ 162(a)(2), 274(n).

112. For many years, an employee's unreimbursed travel expenses were nonitemized deductions, but they were deleted from the nonitemized list in 1986. *See infra* note 155.

113. *See* I.R.C. § 56(b)(1)(A)(ii).

Suppose Stanford also offers Peter a salary of $200,000. However, Peter, a tax professor, negotiates with Stanford to receive a reduced salary if Stanford will pay for his housing. Stanford agrees to pay Peter $160,000 in salary and to pay for the $40,000 rental of a home. Because Peter is reimbursed for the business expense (the rental home away from Peter's regular place of business), the deduction for that expense qualifies for the nonitemized category.[114] Therefore, Peter may deduct the full amount of the rental expense; it is not subject to the Code § 67 and § 68 limitations, and it is fully allowable for purposes of the AMT system. In addition to reducing Peter's tax liability by avoiding limitations on his deduction for the rental expenses, the nonitemized characterization likely will allow Peter to avoid application of the AMT, thereby allowing him to deduct the state income taxes that he pays.[115]

Although Peter and Paula are in identical economic positions (i.e., they both receive $200,000 as payment for services from Stanford Law School, and both incur the same amount of expense), they will incur drastically different federal income tax liabilities. For example, assume that this scenario occurred in 2002, Paula and Peter are both single, both pay $18,000 in California state income tax, and neither has any other income or any deductions other than those described above.[116] Paula has $200,000 in gross income, which is also her AGI because she has no nonitemized deductions. Her itemized deductions are the $40,000 Palo Alto housing expense and the $18,000 California state income tax payment.[117] However, because Paula is an employee, the $40,000 rental deduction is a miscellaneous itemized deduction; therefore, it is subject to the two percent of AGI limitation in Code § 67.[118] The amount of the rental deduction in excess of the Code § 67 floor and the California state income tax payment will be subject to the overall limitation on itemized deductions.[119] Paula's allowable itemized deductions, after applying the

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114. *See id.* § 62(a)(2)(A). Although there are obvious personal elements to these expenses, they are deductible under Code § 162(a)(2) because they are travel expenses incurred away from home that are required by the exigencies of the taxpayer's business.

115. *See id.* § 164(a).

116. For ease of calculation, this author will treat Paula's and Peter's salary from Stanford as having been received in 2002 and they received no salary from Duke that year. These assumptions have no effect on the analysis of the issues.

117. For ease of calculation, this author will ignore all other "away from home" business expenses, such as meals, and will ignore any income taxes that Paula might be required to pay to the State of North Carolina.

118. That limitation will disallow $4,000 ($200,000 x .02) of the rental expense.

119. Under Code § 68, Paula's otherwise allowable itemized deductions are reduced by three

Code § 67 and § 68 limitations, total $52,119. Paula may also reduce her income by her personal exemption of $1,440.[120] Therefore, under the regular federal tax system, Paula's federal taxable income is $146,441 and her federal income tax liability is approximately $38,507.[121]

Paula must also determine her tax liability under the AMT system to see if that amount is greater. The AMT system disallows all deductions for miscellaneous itemized deductions and for state income taxes.[122] Paula's alternative minimum taxable income is $200,000. Paula has an AMT exemption amount of $11,875,[123] leaving her with $188,125 in income subject to the AMT rates. Paula's tax liability under the AMT system is $49,175.[124] This is more than $10,000 greater than her regular federal income tax liability; therefore, she must pay this amount.

On the other hand, Peter will fare much better. Peter also has gross income of $200,000 ($160,000 plus the $40,000 reimbursement for the rental house). Because Stanford reimbursed Peter for the expense, the rental housing expense is classified as a nonitemized deduction.[125] Thus, it is taken into account for purposes of determining AGI, and Peter may deduct the full $40,000 from his gross income. This leaves Peter with AGI of $160,000.[126] Peter may then deduct his itemized deduction (the

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percent of the excess of her adjusted gross income over a threshold amount. In 2002, the threshold amount was $137,300. *See* Rev. Proc. 2001-59, 2001-2 C.B. 623. Paula's adjusted gross income exceeds the threshold by $62,700. Therefore, Paula must reduce her itemized deductions by $1,881 ($62,700 x .03).

120. In 2002, the personal exemption amount was $3,000, but a high-income phase-out can disallow a portion of that amount. Although the phase-out limitation applies to Paula, it will not disallow the entire exemption amount. In order to determine the amount of the exemption that will be phased-out, Paula must compare her adjusted gross income ($200,000) to the threshold amount ($137,300). Paula exceeds the threshold by $62,700. She must reduce her exemption by two percent for every $2,500 or fraction thereof that she exceeds the threshold amount. Paula will reduce her exemption by fifty-two percent, leaving her a personal exemption of $1,440. *See* I.R.C. § 151.

121. For the tax rate tables for 2002, see Rev. Proc. 2001-59, 2001-2 C.B. 623.

122. I.R.C. § 56(b)(1)(A)(i), (ii).

123. Normally, taxpayers may use an alternative minimum tax exemption of $33,750. This amount, however, is subject to be phased-out for high income taxpayers. The exemption is reduced by twenty-five percent of the excess of Paula's alternative minimum taxable income ($200,000) over the threshold amount ($112,500). Paula's excess is $87,500, so her exemption is reduced by $21,875, leaving her with an exemption of $11,875. *See id.* § 55(d).

124. *See id.* § 55(b)(1)(A).

125. Note that it makes no difference for federal tax purposes whether Stanford pays the rental expense directly or reimburses Peter for the expense. *Cf.* Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 729 (1929) (holding employer's payment of federal income taxes on behalf of employee constituted income to employee).

126. For convenience, the Service permits Peter to exclude the $40,000 reimbursement from income and report gross income of only $160,000. *See, e.g.*, Rev. Rul. 77-351, 1977-2 C.B. 23

California income tax)[127] and his personal exemption.[128] Peter's taxable income is $140,281 and his federal income tax liability under the regular system is approximately $36,399.[129]

Peter must also determine his tax liability under the AMT system. Because the housing expense is a nonitemized deduction, Peter is still allowed to deduct it for purposes of the AMT system.[130] Peter's alternative minimum taxable income is $160,000.[131] Peter's exemption amount under the AMT is $21,875.[132] Peter has $138,125 subject to the AMT rates, which produces a tax liability under that system of approximately $35,913.[133] Therefore, Peter's tax liability is greater under the regular system and his final tax liability will be approximately $36,399.

The contrast between these two taxpayers could not be more striking. Although she is in exactly the same economic position as Peter, Paula will pay over $12,000[134] more in federal income taxes—again, a clear violation of the principle of horizontal equity. The classification of the rental expense as a miscellaneous itemized deduction harms Paula because it reduces her allowable deductions (both directly and by

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(reimbursements to military attaches need not be reported as income to extent such expenses are deductible); Rev. Rul. 76-71, 1976-1 C.B. 308 (employees need not report reimbursed educational expenses to extent such expenses are deductible). The tax consequences to Peter are identical regardless of whether he excludes the $40,000 reimbursement or includes it in income and takes a $40,000 nonitemized deduction.

127. For ease of calculation, the author ignores any income taxes that Peter might be required to pay to the State of North Carolina.

128. Note that although the high income limitations also apply to Peter (because his adjusted gross income exceeds the threshold amount in both cases), his disallowances will not be as great as Paula's because his adjusted gross income is much lower. Peter's adjusted gross income exceeds the threshold amount by $22,700 (the threshold happens to be the same both for purposes of the overall limitation and the exemption phase-out). Thus, Peter's overall limitation reduces his itemized deduction by $681 (three percent of $22,700). His personal exemption is reduced by only $600 ($22,700 divided by $2,500, or 9.08, resulting in a loss of twenty percent of his $3,000 exemption amount).

129. For the tax rate tables for 2002, see Rev. Proc. 2001-59, 2001-2 C.B. 623.

130. The expense is not one of the listed modifications of taxable income required by Code § 56.

131. The California income tax payment is disallowed. I.R.C. § 56(b)(1)(A)(ii) (2000).

132. Peter is also subject to the alternative minimum exemption phase-out, but again the reduction will be smaller than Paula's because his comparison benchmark is smaller. Peter exceeds the threshold by $47,500 ($160,000 minus $112,500). Therefore, Peter reduces the exemption by $11,875, leaving him with an exemption of $21,875. *Id.* § 55(d).

133. *See id.* § 55(b)(1)(A).

134. As calculated above, Paula's final income tax liability is $49,175 (calculated under the Alternative Minimum Tax), while Peter's final tax liability is $36,399 (calculated under the regular tax system).

increasing her phase-outs) and pushes her into the AMT system, where other deductions are also restricted.

Another example of egregious overtaxation caused by the wrongful classification of unreimbursed employee expenses is found in the treatment of professional athletes who employ an agent to negotiate their contracts with their team.[135] Note that the nature of the tax injustice in such cases strongly resembles the attorney's fee issue discussed in Part II.A. As compensation, the athlete's agent typically will receive a percentage of the amount that the team agrees to pay the athlete. When an athlete signs a contract for a substantial salary and bonus, the amount of the agent's fee will be very large. The agent's fee is a cost of producing income and should be fully deductible. However, because athletes are employees, an agent's fee will be classified as a miscellaneous itemized deduction, which will cause it to be completely disallowed for purposes of the AMT (to which the athlete is likely to be subject because the agent's fee will be very large). Therefore, under the AMT system, the agent's fee will not be deductible from gross income, which will cause the athlete to be taxed on gross, rather than net, income.

While this treatment of highly paid athletes, or even moderately well-paid academics, may not arouse sympathy because of the size of their incomes, they are not being taxed fairly. The goal of a fair and equitable tax system does not rest on feelings of sympathy. The mistreatment of the athlete who pays a large fee to an agent and the academic who has sizable business travel expenses are merely illustrative of the impropriety of limiting or denying a deduction for employee business expenses. They represent two of the many holes in the dam.

### *C. Income in Respect of a Decedent (IRD)—Defeating the Principal Purpose*

If an individual who earned the right to income dies before it becomes taxable, it will be included in the gross income of the person (or the individual's estate) who receives it after the individual's death.[136] The Code refers to such income as "income in respect of a decedent" (IRD).[137] In addition, the value of the right to the IRD will be treated as

135. This hypothetical was suggested to this author by Professor Gregg Polsky.

136. I.R.C. § 691(a)(1).

137. *Id.*

an asset of the decedent's gross estate and subjected to federal estate taxation if the estate is large enough.[138] However, the amount of the IRD for federal estate tax purposes is not reduced by the potential income tax liability to which the recipient of the IRD will be subjected.[139] If no relief were provided, the imposition of both an estate tax and an income tax on the same amount would improperly result in a higher overall tax liability than would have been incurred if the IRD had been included in decedent's income before he died.

The following illustration shows the nature of this problem.[140] Prior to his death, George, who utilized the cash method of accounting, earned the right to receive a bonus of $5,000,000 payable on January 15, 2005. George died on December 14, 2004. The right to the $5,000,000 bonus constitutes IRD, and it is included in George's gross estate, taxable at a marginal estate tax rate of forty percent. George's estate paid an estate tax of $2,000,000 on the IRD. Pursuant to George's agreement with his employer, the employer paid the $5,000,000 bonus to George's son, Sam, on January 15, 2005. George's will exonerates Sam from any of George's estate tax liability.[141] The IRD of $5,000,000 is included in Sam's gross income, and it is taxable at a marginal rate of forty percent, or $2,000,000. The total taxes paid on the IRD would then be $4,000,000—i.e., an estate tax of $2,000,000 and an income tax of $2,000,000.

The tax consequences are dramatically different if the order of George's death and the payment of the bonus are reversed. If the $5,000,000 bonus had been paid to George on December 1, 2004, and if the marginal income tax rate on that income had been forty percent (the same as Sam's rate), George would have incurred an income tax liability of $2,000,000, reducing his taxable estate by that amount. Even though George's will might still have left $5,000,000 to Sam, only $3,000,000 of the $5,000,000 bonus would have been included in George's gross estate because the other $2,000,000 would have paid George's income taxes. Assuming a marginal estate tax rate of forty percent on that $3,000,000 amount, the estate tax payable thereon is $1,200,000. The total income and estate tax liability arising from the bonus would then

138. *Id.* § 2033.

139. *See id.* § 2053(c)(1)(B).

140. In the illustration, arbitrarily chosen rates are used in order to simplify computations.

141. Because Sam will receive the full $5,000,000 without any reduction for estate tax liability, Sam will have to include the entire $5,000,000 in his gross income.

have been $3,200,000[142]—$800,000 less than the total tax payable if the bonus was paid after George's death.

Congress has attempted to provide relief from the double tax burden described above. A person who incurs income tax on IRD is allowed an income tax deduction for the portion of the decedent's estate tax that is attributable to the IRD.[143] That income tax deduction is referred to as a "deduction for estate tax"[144] because the amount of the deduction is equal to a part of the decedent's estate tax. The estate tax deduction is designed to make the total estate and income tax payable for IRD equal to what the total tax would have been if the IRD had been included in the decedent's gross income before he died.[145]

While the estate tax deduction is an itemized deduction, it is not a miscellaneous itemized deduction;[146] thus it is not subject to the two percent of AGI floor. However, unless the taxpayer is subject to the AMT, the overall limitation of Code § 68 will apply to the estate tax deduction, which may cause a reduction of the amount deductible. If so, the estate tax deduction will fail to accomplish the congressional purpose of equalizing the tax consequences regardless of the order of the payment and the taxpayer's death.

Consider the following illustration of the hardship that the imposition of this limitation can cause.[147] In this illustration, the marginal estate tax rate on the decedent's estate is forty percent, and all the taxpayers are in the forty percent marginal income tax bracket. Professor Roger died possessing a TIAA-CREF account of $5,000,000 of deferred compensation. None of that amount had been taxed during Roger's life because of a favorable deferred compensation provision in the Code.[148] Under Roger's agreement with TIAA-CREF, the $5,000,000 account is payable to Roger's daughter, Della. All of the $5,000,000 will be IRD and will be included in Della's gross income. The $5,000,000 of IRD also is included in Roger's gross estate, which will create a $2,000,000 estate tax liability. Roger's will exonerates Della from incurring any of

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142. Because it is no longer classified as IRD, there is no income tax consequence to Sam. An inheritance of property is not income to the recipient. I.R.C. § 102.

143. *Id.* § 691(c).

144. *Id.*

145. BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 83.1.4 (2d ed. 1991).

146. I.R.C. § 67(b)(7).

147. For ease of calculation, arbitrary figures are used in the illustration.

148. Treas. Reg. § 1.402-1(a)(1)(i) (as amended in 2004).

Roger's estate tax liability, and so other beneficiaries of the estate will bear the tax.

Della must include the $5,000,000 of IRD in her gross income, but she is entitled to an itemized deduction of $2,000,000 for the estate tax paid on the IRD.[149] Della has no other income and has no nonitemized deductions. Her itemized deduction of $2,000,000 is reduced by three percent of the excess of her AGI of $5,000,000 over the threshold amount (which we will assume is $130,000), or $146,100.[150] Thus, the Code § 68 limitation disallows $146,100 of Della's estate tax deduction. Assuming that Della is in a forty percent marginal income tax bracket, the loss of that deduction will increase her income tax liability by $58,440.

In Roger and Della's illustration, the estate tax deduction fell woefully short of carrying out the purpose for which it was adopted. The overall estate and income tax on the $5,000,000 of IRD will be more than $58,000 greater than it would have been if the $5,000,000 had been included in Roger's gross income just before he died. This result conflicts with the legislative purpose for creating the estate tax deduction, which was to equalize the tax consequences incurred when IRD is recognized after the decedent's death with the tax consequences that would have been incurred if the decedent had recognized the income before he died.[151]

In this case, the operation of the limitation on deductions does not treat a taxpayer unfairly so much as it frustrates a legislative purpose of providing a deduction. Congress authorized the estate tax deduction in order to eliminate the double taxation of certain income of an individual who dies before receiving it when it would be taxed only once if the individual received the income before his or her death. Any limitation on that deduction contravenes the express purpose of the provision and evinces yet another hole in the dam.

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149. Because the purpose of allowing an estate tax deduction is to equalize the overall tax consequences, regardless of the order of decedent's death and the receipt of income, the deduction is allowed to the person who includes the item in gross income regardless of whether that person bore any portion of the estate tax. I.R.C. § 691(c)(1)(A), (c)(2).

150. Under Code § 68, Della's otherwise allowable itemized deductions are reduced by three percent of the excess of her adjusted gross income over the threshold amount. Della exceeds the threshold by $4,870,000. Therefore, she must reduce her itemized deductions by $146,100 ($4,870,000 x .03).

151. *See supra* notes 143–45 and accompanying text.

## III. IS THERE A PRINCIPLED JUSTIFICATION FOR THE THREE CATEGORIES?

The examples discussed in Part II illustrate the seemingly harsh and unwarranted tax consequences imposed on some itemized deductions. These consequences occur principally because the Code imposes limitations on the amount that can be deducted. This Part examines whether a principled justification exists for the classification and limitation of itemized deductions. If a principled justification exists, we should either accept it or modify the system by reclassifying some deductions. The Part begins with a review of the history of itemized deductions and the limitations imposed on them. It then analyzes the possible justifications for the current system.

### A. *History of Nonitemized, Itemized, and Miscellaneous Itemized Deductions, and the Alternative Minimum Tax*

In 1944, Congress divided deductions into nonitemized and itemized categories.[152] An individual taxpayer could use the nonitemized deductions, listed in § 22(n) of the Code at that time, no matter how small their total amount.[153] However, itemized deductions would be useful only if the total amount exceeded the optional standard deduction. At the time of its enactment, § 22(n) included the following deductions: (1) trade and business deductions (other than employee expenses);[154] (2) employee travel and lodging expenses;[155] (3) reimbursed employee

152. Congress introduced the concept of "adjusted gross income" in 1944 when Code § 22(n) was added to the 1939 Code. *See* 1 J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS: 1953–1939, at 1400 (1954). Section 22(n) was added by § 8(a) of the Individual Income Tax Act of 1944. *Id.* That same Act added § 23(aa), which created the optional standard deduction for individuals. *Id.* Section 23(aa) allowed an individual taxpayer to take the "standard deduction . . . in lieu of . . . all deductions other than those which under § 22(n) are to be subtracted from gross income in computing adjusted gross income." *Id.*

153. Because nonitemized deductions are taken into account in determining adjusted gross income, they are deductible regardless of whether the taxpayer utilizes the standard deduction. I.R.C. § 63(a), (b).

154. Section 22(n)(1) stated, "[t]he deductions allowed by section 23 which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee." *See* SEIDMAN, *supra* note 152, at 1290.

155. Section 22(n)(2) stated, "[t]he deductions allowed by section 23 which consist of expenses of travel, meals, and lodging while away from home, paid or incurred by the taxpayer in connection with the performance by him of services as an employee." *See* SEIDMAN, *supra* note 152, at 1291. Note that Congress subsequently deleted this item from the nonitemized list in 1986 when it introduced the two-percent floor for miscellaneous itemized deductions in Code § 67. *See* Tax

expenses;[156] (4) deductions attributable to rents and royalties;[157] (5) depreciation and depletion deductions of life tenants and income beneficiaries of trusts;[158] and (6) losses from sales or exchanges of property.[159]

In its report, the House Ways and Means Committee described adjusted gross income as the difference between gross income and "business deductions":

> [T]he bill introduces a new concept, adjusted gross income. It is defined to mean gross income less business deductions, deductions attributable to rents and royalties, and losses treated as losses from the sale or exchange of property . . . . It will be seen, therefore, that in general adjusted gross income means gross income less business deductions.[160]

In its report, the Senate Finance Committee provided a broader definition of the type of deductions allowed in determining AGI:

> Fundamentally, the deductions thus permitted to be made from gross income in arriving at adjusted gross income are those which are necessary to make as nearly equivalent as practicable the concept of adjusted gross income, when that concept is applied to different types of taxpayers deriving their income from varying sources. Such equivalence is necessary for equitable application of a mechanical tax table or a standard deduction which does not depend upon the source of income.[161]

Therefore, as already noted, one important distinction between itemized and nonitemized deductions is that a taxpayer can use nonitemized deductions whether or not he claims the standard

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Reform Act of 1986, Pub. L. No. 99-514, sec. 142, § 247, 100 Stat. 2085, 2117–20.

156. Section 22(n)(3) stated, "[t]he deductions allowed by section 23 (other than expenses of travel, meals, and lodging while away from home) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer." *See* SEIDMAN, *supra* note 152, at 1291.

157. Section 22(n)(4) stated, "[t]he deductions . . . allowed by section 23 which are attributable to property held for the production of rents or royalties." *See* SEIDMAN, *supra* note 152, at 1290.

158. Section 22(n)(5) stated, "[t]he deductions . . . for depreciation and depletion, allowed by section 23(l) and (m) to a life tenant of property or to an income beneficiary of property held in trust." *See* SEIDMAN, *supra* note 152, at 1293.

159. Section 22(n)(6) stated, "[t]he deductions . . . allowed by section 23 as losses from the sale or exchange of property." *See* SEIDMAN, *supra* note 152, at 1290.

160. H.R. REP. NO. 78-1365, at 3 (1944), *reprinted in* SEIDMAN, *supra* note 152, at 1291.

161. S. REP. NO. 78-885, at 24–25 (1944), *reprinted in* 1944 C.B. 858, 877–78.

deduction.[162] Conversely, itemized deductions can only be used if the taxpayer chooses to deduct them in lieu of the standard deduction.

The Tax Reform Act of 1986 introduced miscellaneous itemized deductions to the tax system by adding § 67(a) to the Code.[163] Section 67(a) further limits a special subset of itemized deductions by allowing such deductions to be used by an individual taxpayer only to the extent that the aggregate amount of the deductions exceeds two percent of the AGI of the taxpayer.[164] As discussed in more detail below, the Staff of the Joint Committee on Taxation's description of the provision offered reasons for adopting miscellaneous itemized deductions: (1) some of the items included in miscellaneous itemized deductions have elements of voluntary personal expenditures;[165] (2) typically, the amount of miscellaneous itemized deduction expenditures incurred by a taxpayer are small and do not warrant the expenditure of time and energy of the taxpayer or the government to deal with the reporting and administration of those deductions, a problem amplified by the fact that taxpayers applied the tax law incorrectly when deducting certain expenses.[166]

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162. *See supra* notes 20–21 & 39–40 and accompanying text.

163. Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 132, ch. 1.B.I, 100 Stat. 2085, 2113–16 (adding § 67 to original Chapter 1, Subchapter B, Part I.).

164. This final version was a compromise between the House version, which would have imposed a one-percent floor on miscellaneous itemized deductions; and the Senate version, which would have completely eliminated most miscellaneous itemized deductions. H.R. REP. NO. 99-841, vol. II of 2, at 32–33 (1986).

165. STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 78–79 (Comm. Print 1987) [hereinafter BLUE BOOK]. The report stated,

> Congress concluded that the prior-law treatment of employee business expenses, investment expenses, and other miscellaneous itemized deductions fostered significant complexity, and that some of these expenses have characteristics of voluntary personal expenditures. . . .
>
> . . . .
>
> The use of a deduction floor also takes into account that some miscellaneous expenses are sufficiently personal in nature that they would be incurred apart from any business or investment activities of the taxpayer. For example, membership dues paid to professional associations may serve both business purposes and also have voluntary and personal aspects; similarly, subscriptions to publications may help taxpayers in conducting a profession and also may convey personal and recreational benefits. Taxpayers presumably would rent safe deposit boxes to hold personal belongings such as jewelry even if the cost, to the extent related to investment assets such as stock certificates, were not deductible.

*Id.* The Federal Treasury has specifically stated that the cost of renting a safe deposit box for storing jewelry and other personal effects is not deductible. Treas. Reg. § 1.212-1(f) (as amended in 1975). Considering the small amount involved and the fact that it might be useful for the Service to know that the taxpayer has a safe deposit box, this author finds it surprising that the Service would wish to deny a deduction for any use of a safe deposit box.

166. BLUE BOOK, *supra* note 165, at 78–79. The report stated,

> [f]or taxpayers who anticipated claiming such itemized deductions, prior law effectively required extensive recordkeeping with regard to what commonly are small expenditures.

Therefore, Congress intended to simplify the administration of tax law by allowing a deduction for such items only when the amount is unusually large.[167]

Congress added another limitation to most itemized deductions[168] in the Omnibus Reconciliation Act of 1990.[169] In that Act, Congress added Code § 68, which places an overall limitation on all but three itemized deductions.[170] The House report justified this limitation by stating that when an individual's income is sufficiently high, the denial of some deductions will not impair the individual's ability to pay his or her income tax.[171] The report stressed that the limitation was aimed at "high-income individuals."[172]

Let us turn to consider the function of the AMT.[173] The first minimum tax was introduced in the Tax Reform Act of 1969 to address the concern that some high-income individuals were able to pay little in

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> Moreover, the fact that small amounts typically were involved presented significant administrative and enforcement problems for the Internal Revenue Service. These problems were exacerbated by the fact that taxpayers frequently made errors of law regarding what types of expenditures were properly allowable under prior law as miscellaneous itemized deductions.

BLUE BOOK, *supra* note 165, at 78–79.

167. BLUE BOOK, *supra* note 165, at 78–79. The report stated,

> [s]ince many taxpayers incur some expenses that are allowable as miscellaneous itemized deductions, but these expenses commonly are small in amount, the Congress concluded that the complexity created by prior law was undesirable. At the same time, the Congress concluded that taxpayers with unusually large employee business or investment expenses should be permitted an itemized deduction reflecting that fact....
>
> Accordingly, the Congress concluded that the imposition of a two-percent floor on miscellaneous itemized deductions constituted a desirable simplification of the tax law. This floor will relieve taxpayers of the burden of recordkeeping unless they expect to incur expenditures in excess of the floor. Also, the percentage floor will relieve the Internal Revenue Service of the burden of auditing deductions for such expenditures when not significant in aggregate amount.

BLUE BOOK, *supra* note 165, at 78–79.

168. This includes miscellaneous itemized deductions that are allowed after applying the Code § 67 floor. I.R.C. § 68(d) (2000).

169. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11103(a), 104 Stat. 1388, 1406.

170. The three itemized deductions excluded from the limitation in Code § 68 are (1) the medical expense deduction under Code § 213; (2) the deduction for investment interest under Code § 163(d); and (3) the deduction for casualty and theft losses and wagering losses under Code § 165. I.R.C. § 68(c). The apparent reason for these exclusions is that the three items excluded have severe limitations within the provisions themselves, and presumably Congress felt it would be overkill to add additional limitations.

171. H.R. REP. NO. 101-881, at 361 (1990).

172. *Id.*

173. The AMT is described *supra* Part I.D.4.

taxes by virtue of using special tax preferences in the Code.[174] The Senate report on the Act opined that the morale of a sizeable number of taxpayers who cannot utilize tax reduction Code provisions suffer because of their perception that an inequity in the Code allows other taxpayers to bear less than their fair share of the cost of government.[175] The Senate report expressed concern that, unless all taxpayers were seen as bearing a reasonable share of the cost of government, the self-assessment tax system, the vitality of which depends upon the goodwill and cooperation of the public, might collapse due to a lack of public confidence.[176] Congress intended the AMT to limit the amount of tax preferences that a taxpayer can enjoy.[177] Tax commentators also have described the AMT as a backstop designed to ensure that those with too many special tax benefits still pay some federal tax.[178]

There is no legislative history as to why miscellaneous itemized deductions are denied for purposes of the AMT. Professor Deborah A. Geier, focusing on the legislative history of the Tax Reform Act of 1986, has argued that the exclusion rests on reasoning similar to the justification for detrimental treatment of the deductions under the "regular" tax system—i.e., Congress doubts the legitimacy of the

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174. BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 45.1 (2d ed. 1995).

175. S. REP. NO. 91-552, at 13 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2040.

176. *Id.*

177. *Id.* The report stated,

> [t]he fact that the present law permits a small minority of high-income individuals to escape tax on a large proportion of their income has seriously undermined the belief of taxpayers that others are paying their fair share of the tax burden. It is essential that tax reform be obtained not only as a matter of justice but also as a matter of taxpayer morale. Our individual and corporate income taxes, which are the mainstays of our tax system, depend upon self-assessment and the cooperation of taxpayers. The loss of confidence on their part in the fairness of the tax system could result in a breakdown of taxpayer morale and make it far more difficult to collect the necessary revenues. For this reason alone, the tax system should be improved.

*Id.*

178. KAHN, *supra* note 19, at 545. As Professor Douglas Kahn wrote,

> [m]any of the deductions authorized by the Code do not relate to an accurate determination of the amount of net income earned from income-producing activity as much as they establish tax incentives to encourage or reward a taxpayer for investing in certain areas deemed desirable by Congress. However, Congress felt that virtually all citizens should share the burdensome cost of taxation to some extent; and, therefore, a taxpayer should not be permitted to enjoy an amount of such tax advantages that is out of proportion to the taxpayer's economic income. Accordingly, Congress imposed special taxes on those taxpayers with an excessive amount of such tax advantages.

KAHN, *supra* note 19, at 545.

deductions.[179] The overall limitation of Code § 68, which can eliminate as much as eighty percent of most of a taxpayer's itemized deductions, lends credence to Professor Geier's suggestion. However, focusing on the legislative history of the AMT, one could also conclude that Congress views the miscellaneous itemized deductions as "tax advantages" or "tax preferences" for which no taxpayer should obtain too much benefit.[180]

In sum, there is no principled justification for the overall limitation on itemized deductions. It is purely a backdoor approach to increasing tax liability on higher-bracket taxpayers.[181] In other words, it is a device to raise tax rates without changing the nominal rates. While it is appropriate for Congress to decide whether to raise tax rates, it should do so directly rather than through a circuitous method so that the decision will be subject to public scrutiny.

### B. *Business Versus Personal Expenses: The Original Justification?*

When Congress introduced the concept of itemized deductions in the Individual Income Tax Act of 1944, the defining distinction between nonitemized and itemized deductions might have been that nonitemized deductions were business expenses. The House Ways and Means Committee itself, in its report on the Act, stated, "It will be seen, therefore, that in general adjusted gross income means gross income less business deductions."[182] However, the term "business deductions" does not accurately describe even the original group of nonitemized deductions. The deductions originally classified as nonitemized included "deductions attributable to rents and royalties," "depreciation and depletion deductions of life tenants and income beneficiaries of trusts," and "losses from sales or exchanges of property."[183] Obviously, the original category of nonitemized deductions was broader than just business expenses. Moreover, not all business expenses were included,

179. Geier, *supra* note 1, at 534 ("The complete denial of miscellaneous itemized deductions under the alternative minimum tax has no specific legislative history explaining it but likely rests on similar premises: doubts about the legitimacy of the deductions.").

180. *See supra* notes 173–78 and accompanying text.

181. Some commentators have reached the same conclusion. *See, e.g.*, Robert J. Peroni, *Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System*, 91 TAX NOTES 1415, 1425–26 (2001) ("This is another way of saying that the purpose of section 68 was to raise effective tax rates on higher-income taxpayers in a nontransparent fashion.").

182. H.R. REP. NO. 78-1365, at 3 (1944).

183. *See supra* notes 154–59 and accompanying text.

because most unreimbursed employee expenses did not make the list.[184]

The Senate Finance Committee's report on the Individual Income Tax Act of 1944 provides a better description of the unifying characteristic of nonitemized deductions:

> Fundamentally, the deductions thus permitted to be made from gross income in arriving at adjusted gross income are those which are necessary to make as nearly equivalent as practicable the concept of adjusted gross income, when that concept is applied to different types of taxpayers deriving their income from varying sources.[185]

Looking at this legislative history and reviewing the group that Congress originally classified as nonitemized deductions, it appears that Congress believed that AGI should reflect those expenses that have a strong nexus to the production of income.[186] Those expenses are central to the determination of net income.

This distinction among deductions appears to make sense and appears to be a useful tool for comparing taxpayers and reducing the administrative burden. The application of tax rates to *gross* income would penalize taxpayers engaged in a business with high costs. The Haig–Simons definition of income, the theoretical "ideal,"[187] implicitly allows a deduction for the cost of producing income—i.e., our tax system is built on the concept of taxing net income rather than gross income.[188] To the extent that AGI excludes items that relate more to differences in disposable income than to the production of income, that figure provides a useful base for comparing taxpayers' income status.

The fact that many itemized deductions are unrelated to the cost of

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184. Only employee travel and lodging expenses were classified as nonitemized. As noted above, Congress deleted nonitemized classification for these expenses in 1986. *See supra* note 155.

185. S. REP. NO. 78-885, at 24-25 (1944).

186. Concededly, the list did not adhere perfectly to that standard. For example, unreimbursed employee expenses were designated as itemized. *See supra* note 154 and accompanying text.

187. *See* Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 28 (1992); Daniel N. Shaviro, *Selective Limitations on Tax Benefits*, 56 U. CHI. L. REV. 1189, 1202 (1989). Although it has been described as the ideal, no one has ever seriously proposed a strict application to the federal income tax system.

188. Henry Simons stated, "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and end of the period in question." HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (Univ. of Chi. Press 1980) (1938); *see also* Shaviro, *supra* note 187, at 1202 ("[The Haig–Simons definition of income] requires netting, or the subtraction from gross income of expenses other than those incurred for consumption.").

producing income does not make them illegitimate allowances.[189] However, it does mean that another justification must be found to support their inclusion in our tax system. Without going into details, the Haig–Simons definition of income has served to justify many of these deductions for some commentators.[190] The Haig–Simons definition of income is personal consumption plus accumulation of wealth.[191] Therefore, some commentators contend that many deductions are appropriate because they are not consumption items as the term is used in that definition.[192]

In 1944, Congress first distinguished itemized from nonitemized deductions in order to promote administrative ease and simplicity.[193] The idea, however imperfectly carried out, was to leave intact most of the income-connected deductions, but to substitute a standard deduction for itemized deductions when their aggregate amount was relatively

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189. Take a simple example: A is in the retail business and his gross receipts (minus basis) are one million dollars, but his business expenses are $500,000. B is an investor who earns $500,000 and has no investment expenses. Assuming each taxpayer has no other deductible expenses, it is appropriate to tax A and B equally, because their net income is the same. However, if B's house, which had a basis and fair market value of $200,000, was destroyed by fire that year and B was not insured, one might well conclude that A and B would not be on an equal tax plane in that circumstance. While B's loss does not relate to the production of income, it does reflect differences in financial status that one might wish to take into account in determining tax liability. While B's loss is not at the central core of income measurement, it is not necessarily irrelevant, and Congress can legitimately decide whether to allow a deduction for B's loss.

190. *See, e.g.*, William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972).

191. *See* SIMONS, *supra* note 188, at 50.

192. *See, e.g.*, Andrews, *supra* note 188, at 345–49 (1972) (arguing charitable contribution is not contrary to neutral tax principles because taxpayer is not consuming or accumulating donated money or property).

One might argue that all legitimate deductions should be listed as nonitemized. That is, if Congress had a principled, as opposed to a programmatic, purpose in allowing a deduction, should not that deduction also be allowed when determining adjusted gross income? If adjusted gross income is a useful tool for comparing taxpayers, should not it take into account any principled deduction? All valid deductions should be allowed for some comparison purposes, but perhaps the most important comparison takes place after computing adjusted gross income. Legitimate, non-income-connected expenses should be taken into account in determining *taxable* income—i.e., determining the taxpayer's final tax liability. They are not necessarily required to be allowed for other tax purposes, such as the phasing out of allowances or credits.

193. *See* Individual Income Tax Act of 1944, Pub. L. No. 78-315, ch. 210, § 9(a), 58 Stat. 231, 236–37. Professors Bittker and McMahon report,

> [i]n 1944, Congress enacted a so-called standard deduction, designed to simplify the preparation and audit of individual tax returns by requiring taxpayers to choose between itemizing their personal deductions and deducting a flat allowance in lieu of any itemized deductions to which they were entitled.

BITTKER & MCMAHON, *supra* note 174, at ¶ 21.4[1].

small.[194] To the extent that this was inequitable, Congress erred on the side of allowing too large a deduction for taxpayers using the standard deduction when they had little or no itemized deductions; but, in this author's view, any such inequity was minor and more than compensated by the reduction of administrative cost for both the taxpayers and the government.

Although, as originally enacted, the amount of the discrepancy in tax consequences between the treatment of itemized and nonitemized deductions was fairly small, over time, Congress has greatly expanded the significance of being classified in one category or another. First, Congress introduced harsh limitations, such as Code § 67 and § 68, with respect to itemized deductions, but not with respect to nonitemized deductions.[195] Further, the AMT system does not allow many itemized deductions in calculating alternative minimum taxable income.[196] Second, the original principle behind making the classification (to distinguish expenses tied to the production of income) has become muddled by the inclusion of items in both categories for quite different reasons.[197] Finally, the dollar amount of taxes caused by the wrongful designation of some expenses as itemized deductions has greatly expanded, and it is even confiscatory in some cases.[198]

Before identifying the items that are improperly characterized under current tax law and reflecting on their significance, let us turn to the question of whether the current limitations on itemized deductions are justified. An evaluation of the strength of the possible justifications for imposing those limitations provides a useful backdrop to the consideration of the significance of improper characterization. If the case for the limitations is weak, the injustice of misclassification is even more pronounced.

As discussed in detail below, this author concurs with a number of commentators who have criticized the current limitations on itemized

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194. The original standard deduction was not a fixed dollar amount, but a percentage of gross income subject to a ceiling of a fixed amount. For a brief history of the standard deduction, see Allan J. Samansky, *Nonstandard Thoughts About the Standard Deduction*, 1991 UTAH L. REV. 531, 532–40. For an economic discussion of the standard deduction and the use of floors in the Internal Revenue Code, see generally Louis Kaplow, *The Standard Deduction and Floors in the Income Tax*, 50 TAX L. REV. 1 (1994).

195. *See* I.R.C. § 68 (2000).

196. I.R.C. § 56(b)(1).

197. *See infra* Part IV.

198. *See, e.g.*, Sager & Cohen, *supra* note 3, at 1078 ("If the ratio of attorney's fees to the entire recovery is high enough, a before-tax gain may metamorphose into an after-tax loss.").

deductions;[199] after all, the existence of these limitations make the wrongful designation of certain expenses so egregious. However desirable it might seem to repeal the limitations, repeal does not appear likely to occur in the near future. It is for this reason that this Article addresses the identification of items that have been improperly subjected to the limitations. If these, or similar, limitations are retained in the Code, it becomes vital to examine the items in each category to determine whether they belong there.

### C. *Section 68—The Stealth Tax Increase*

The legislative history of Code § 68 suggests that Congress did not attempt to propose a principled justification for the overall limitation on itemized deductions. The House report stated that it is appropriate to raise taxes on those individuals that have AGI higher than a certain amount:

> The committee determined that it is appropriate to impose a limitation on otherwise deductible expenses of individual taxpayers with AGI exceeding $100,000. The higher an individual's AGI, the less likely it is that an otherwise deductible expense will significantly affect the individual's ability to pay income taxes.[200]

The most direct way to raise taxes is to increase marginal rates, not phase out deductions. It seems that Congress was fearful of the political fallout from raising tax rates and therefore chose the phase-out as a "stealth increase" in tax.

This use of the phase-out is bad policy on several counts. First, taxes should be as transparent as possible so that the public comprehends the extent of its burden, allowing it to make informed decisions about whether that burden is too much, too little, or just right.[201] If Congress is too afraid to explain to the public why taxes must be raised, it should not raise them at all. As Professor Robert J. Peroni stated, "[s]ection 68 was a political gimmick designed to mask the real level of tax increases being enacted into law. Such a gimmick should be beneath the national

199. *See, e.g.*, Peroni, *supra* note 181, at 1425–26 (stating purpose of § 68 was to raise effective tax rates on higher-income taxpayers in nontransparent fashion).

200. H.R. REP. NO. 101-881, at 361 (1990).

201. *See* HENRY C. SIMONS, FEDERAL TAX REFORM 7 (1943) ("We should seek maximum directness in federal taxation, i.e., minimal concealment and fullest exposure of his actual dollar tax burdens to every individual.").

legislative body of the world's most powerful democratic country."[202]

Second, the tax system should also be as transparent as possible for planning purposes. The tax system should be understandable to taxpayers so that they can make informed choices about everyday decisions.[203] For example, a taxpayer may decide to hire an investment advisor, believing that such expenses will be fully deductible, only to find out later that, while such expenses are deductible, they are subject to severe limitations, including a complete disallowance under the AMT system. The overall limitation on itemized deductions therefore adds complexity to the tax system, especially when compared to a straightforward increase in marginal rates.[204]

Third, and most importantly, the overall limitation impinges on horizontal and vertical equity.[205] The provision applies only to a taxpayer who has deductions that are subject to the limitation. A taxpayer with identical income, but who has few or no itemized deductions, is subjected to a much smaller increase in tax. There seems scant merit to raising the tax liability of only those who have deductions that Congress has otherwise determined to be valid for purposes of determining tax liability; certainly, the legislative history provides no clue as to a valid purpose for doing so.

In addition to the deficiencies described above, the overall limitation is inefficient. Congress believed that, as a class, high-income taxpayers have a disproportionately larger amount of itemized deductions than lower-income taxpayers; the overall limitation thus targets high-income taxpayers.[206] While that belief is almost certainly correct, there likely are

202. Peroni, *supra* note 181, at 1426.

203. Professor David Bradford has labeled this "transactional complexity," which "refer[s] to the problems faced by taxpayers in organizing their affairs so as to minimize their taxes within the framework of the rules." DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 268 (1986).

204. For a discussion of the application of this principle to the alternative minimum tax system, see Shaviro, *supra* note 61, at 1457–58 ("[T]he AMT contributes to 'rule complexity,' making the tax law harder to understand, both because its general operation (and various of its provisions) may be impenetrable to the novice, and because it creates confusion about just what the tax law really says."). However, Shaviro argues that obfuscation can be a virtue where it permits "well-meaning policymakers to choose better policies." Shaviro, *supra* note 61, at 1458. To the contrary, it seems that if they truly are better policies, Congress should not have to hide them in complexity. This author believes that a truly democratic system does not rest on hiding legislative policies from the electorate, no matter how benign the motives of the legislature.

205. As noted above, horizontal equity requires that persons in like net income positions pay the same amount of tax. Vertical equity requires that persons in dissimilar net income positions pay appropriately dissimilar taxes. *See* ANDREWS, *supra* note 14, at 7–8.

206. *See* Peroni, *supra* note 181, at 1425–26.

high-income taxpayers who have few itemized deductions.[207] As a result, the overall limitation on itemized deductions is not a good mechanism for capturing the income of wealthy taxpayers.

### *D. Section 67—A "Cure" that Is Worse than the Disease*

Section 67, which was adopted as part of the Tax Reform Act of 1986,[208] imposes a floor of two percent of AGI on all itemized deductions that are not listed in Code § 67(b).[209] The itemized deductions that are subject to that floor are referred to as "miscellaneous itemized deductions." The *Blue Book*'s discussion of the enactment of that provision suggests several justifications for its adoption.[210] As explained more fully below, none of these justifications stands up well to a careful examination, and it is difficult to escape the conclusion that the adoption of that provision was a mistake. Nevertheless, there is no indication of a movement to repair the provision, and it seems likely to be retained for the foreseeable future. The absence of a principled justification for the Code § 67 limitation aggravates the erroneous inclusion of certain items in the list of deductions that are subject to that limitation.

#### *1. First Justification: Reducing Administrative Expense*

The general explanation in the *Blue Book* indicates that Congress believed that Code § 67 would simplify tax administration. The joint committee staff stated that prior law treatment had "fostered significant complexity," "required extensive recordkeeping," and "presented significant administrative and enforcement problems for the Internal Revenue Service."[211] Congress "concluded that the imposition of a two-percent floor on miscellaneous itemized deductions constituted a desirable simplification of the tax law."[212]

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207. For example, many wealthy people retire to communities in states that have no income tax, such as Florida or Texas, and many purchase homes for cash and so have no mortgage interest expense.

208. Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 132(a), ch.1.B.I., 100 Stat. 2085, 2113–15.

209. I.R.C. § 67 (2000).

210. For the pertinent legislative history, see BLUE BOOK, *supra* note 165, at 78–79; *supra* notes 165–67 and accompanying text.

211. BLUE BOOK, *supra* note 165, at 78.

212. BLUE BOOK, *supra* note 165, at 78.

From a taxpayer's viewpoint, the simplification theory is overrated. The committee predicted that "this floor will relieve tax-payers of the burden of recordkeeping unless they expect to incur expenditures in excess of the floor."[213] However, careful taxpayers will keep track of such expenditures because they will not know whether their total will exceed the floor until the end of the tax year. A careful person will keep track of even a small expenditure because it may prove to be deductible if he or she incurs unanticipated expenses during the tax year.[214] Nevertheless, it is likely that some taxpayers do not maintain records of such expenses because of the existence of the two-percent floor.[215] In addition, many persons do not keep records because of ignorance or indolence. Therefore, the justification of reducing the taxpayers' administrative burden has little merit.

Lessening the administrative burden on the Service provides a more persuasive argument than lessening the administrative burden on the taxpayer. Maintaining a floor for miscellaneous itemized deductions means that taxpayers with a small aggregate amount of such expenses will not report items that they otherwise would claim as deductions. With fewer returns containing miscellaneous itemized deductions, the Service will have fewer miscellaneous itemized deductions to audit.

However, the cure may be worse than the disease. As noted in Part II.B above, independent contractors are able to deduct business expenses without a floor limitation.[216] This distinction, which has no persuasive justification, greatly encourages taxpayers to classify themselves as independent contractors, rather than employees, in order to avoid the Code § 67 floor limiting their unreimbursed business expenses. Any administrative convenience gained by the two-percent floor may be offset by the amount of time and resources that the Service must spend

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213. BLUE BOOK, *supra* note 165, at 78.

214. *See* Peroni, *supra* note 181, at 1418.

> Section 67 adds to both computational and transactional tax planning complexity by making it difficult for tax-payers to figure out prior to the end of the tax year whether they will be able to deduct any of their miscellaneous itemized deductions. Given that fact, many taxpayers will likely keep records just in case they do exceed the 2 percent floor.

Peroni, *supra* note 181, at 1418; *see also* Glenn E. Coven, *Congress as Indian-Giver: "Phasing-Out" Tax Allowances Under the Internal Revenue Code of 1986*, 6 VA. TAX REV. 505, 527 (1987) ("[B]enefits must be offset by the complexity and manipulation created by plans to avoid the new floor.").

215. *See* Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121, 167 n.235 (1989) ("The floor is high enough that most taxpayers no longer keep records.").

216. I.R.C. § 62(a)(1) (2000).

auditing and litigating the issue of whether a taxpayer is an employee or independent contractor.[217]

Taxpayers are litigating the independent contractor issue. For example, in *Beitel v. Commissioner*,[218] an unpublished summary opinion of the Tax Court, the taxpayer was an adjunct professor at the University of Idaho. The taxpayer contended that he was an independent contractor in his teaching position and thus deducted his teaching expenses as a nonitemized deduction.[219] The Service argued (correctly) that the taxpayer was an employee of the university, and therefore his unreimbursed expenses were miscellaneous itemized deductions subject to the two-percent floor of Code § 67.[220] This is a revealing case, not because it is unusual for the Service to litigate this particular issue,[221] but rather because the amount of the deficiency was only $126.[222] It seems unlikely that the provision provides much administrative relief to the Internal Revenue Service if it has to spend resources litigating over $126.

Weighed against the income tax benefits of independent contractor status are the greater social security taxes that independent contractors

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217. *See* Peroni, *supra* note 181, at 1418. Peroni stated that,

> [f]rom the IRS perspective, it will be faced with the need to expand resources checking the taxpayer's computation of the floor, issuing a notice of additional tax due to mathematical or clerical error, and checking on the validity of deductions claimed in excess of the 2 percent floor and on claims by taxpayers that they are independent contractors whose business expenses are not subject to the floor.

Peroni, *supra* note 181, at 1418. Note that the troubling distinction between employees and independent contractors is not completely solved by merely abolishing the Code § 67 floor. The distinction will still be important if employee expenses remain an itemized deduction because a taxpayer will only use itemized deductions if they exceed the standard deduction. Such deductions could also be subject to the overall limitation on itemized deductions under Code § 68. However, as Professor Peroni noted, the removal of the floor would lessen the importance of the distinction. Peroni, *supra* note 181, at 1424. Note that one reason that the standard deduction is increased from time to time is to lower the number of returns that are subject to audit.

218. T.C. Summ. Op. 2001-101, No. 17769-99S, 2001 Tax Ct. Summ. LEXIS 205 (T.C. July 5, 2001).

219. *See id.* at *4.

220. *Id.*

221. For additional cases that involve the issue of whether a taxpayer was an independent contractor or employee for purposes of determining the classification of business expenses, see generally Alford v. United States, 116 F.3d 334 (8th Cir. 1997); Weber v. Comm'r, 60 F.3d 1995 (4th Cir. 1995); Butts v. Comm'r, 49 F.3d 713 (11th Cir. 1995); Naughton v. Comm'r, 84 T.C.M. (CCH) 275 (2002); Greene v. Comm'r, 72 T.C.M. (CCH) 1406 (1996); Hathaway v. Comm'r, 72 T.C.M. (CCH) 460 (1996); Potter v. Comm'r, 68 T.C.M. (CCH) 248 (1994); Smithwick v. Comm'r, 68 T.C.M. (CCH) 1545 (1993).

222. *Beitel*, 2001 Tax Court Summ. LEXIS 205, at *2.

bear because they are classified as self-employed.[223] The increase in social security taxes makes it undesirable to obtain independent contractor status in some cases. If the income tax benefit exceeds the additional social security tax cost, independent contractor status will be desirable. However, the amount of additional social security taxes will not always be the proper figure for comparison. Even when the increase in social security taxes is greater than the income tax benefit, the "clients" of an independent contractor will not have to pay social security taxes on his behalf,[224] so the taxpayer may be able to obtain a larger amount of compensation for his work. In that case, some of the additional social security tax will be offset by the additional amount of compensation.[225]

Also note that Code § 67 has aggravated the complexity of the tax law because it has induced courts to reach for convoluted reasons not to apply that provision where its application would cause harsh and unwarranted consequences. The contingent attorney's fee controversy is one obvious example. As previously noted, the correct theoretical tax result, and the result finally reached by the U.S. Supreme Court's resolution of this issue, is for individuals to include the award in their income and take a deduction for the entire fee paid to the attorney.[226] However, because the expense is a miscellaneous itemized deduction, and therefore subject to the limitations of Code § 67 and the AMT, some courts have resorted to dubious legal analysis in order to avoid the application of those provisions.[227] In addition, at least one state legislature has replaced its lien statute for the express purpose of preventing the overtaxation of plaintiffs who have executed a contingent

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223. The total rate of self-employment tax (including the hospital insurance tax) is 15.3%. The total rate of employee tax on wages (including the hospital insurance tax) is 7.65%. I.R.C. § 3101 (2000).

224. *Id.* § 3101.

225. Also, note that the cost of independent contractor classification is mitigated by the fact that one-half of the portion of the tax that is attributable to Medicare is a nonitemized deduction. *Id.* § 164(f).

226. *See supra* Part II.A.

227. *See* Banks v. Comm'r, 345 F.3d 373, 386 (6th Cir. 2003), *rev'd*, Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005); Banaitis v. Comm'r, 340 F.3d 1074, 1083 (9th Cir. 2003), *rev'd sub nom.* Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005); *see also* Polsky, *Fruits and Trees*, *supra* note 1, at 74–76. The expense is also subject to the limitation imposed by Code § 68, but the presence of Code § 67 and the alternative minimum tax likely added considerable weight to some courts' dissatisfaction with the law's treatment of those expenses.

fee contract.[228] It seems undesirable for state laws to be reshaped for the exclusive purpose of curing only one aspect of a problem engendered by a failing in the tax law. The old adage that bad facts make bad law can be turned around to say that "bad law engenders a confused legal structure."[229] It seems that Code § 67 may have created more complexity and administrative problems than it has solved.

In any event, the Service could achieve the administrative advantage of a reduced audit pool without resorting to a floor on miscellaneous itemized deductions. The Service could simply adopt a policy of not auditing returns where the amounts of those deductions are small. In such instances, which are quite common, it is not worth the Service's time to audit returns solely for the purpose of confirming the deductions.

The cost of adopting such a policy is that once it becomes known by taxpayers that their returns are unlikely to be audited, the taxpayers will have less constraint to cheat, or, at least, to adopt aggressive positions. That cost may be rendered less significant by the fact that currently the likelihood of an audit of a return with a small amount of itemized deductions is very small.[230] Even if the floor is deemed a more effective means of reducing the Service's audit burden, cases in which the taxpayer suffers great inequity as a result of the floor, such as the attorney's fee problem, should be exempted.

### 2. *Second Justification: Personal Expenditures*

In addition to lessening the taxpayer's administrative burden, another

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228. In June 2004, the State of Washington enacted a new attorneys' lien law. WASH. REV. CODE § 60.40.010 (2004). The purpose of the new law is to

> end double taxation of attorneys' fees obtained through judgments and settlements, whether paid by the client from the recovery or by the defendant pursuant to a statute or a contract. Through this legislation, Washington law clearly recognizes that attorneys have a property interest in their clients' cases so that the attorney's fee portion of an award or settlement may be taxed only once and against the attorney who actually receives the fee. This statute should be liberally construed to effectuate its purpose. This act is curative and remedial, and intended to ensure that Washington residents do not incur double taxation on attorneys' fees received in litigation and owed to their attorneys.

Attorneys' Liens, ch. 73, § 1, 2004 Wash. Laws 269; *see also* Wood, *supra* note 100, at 736–37 (discussing Washington State law on attorney's fee issue).

229. As it does not roll off the tongue easily, this author does not expect that this will become a popularly used statement.

230. In fiscal year 2000, the *overall* audit rate for individuals was 0.49%. INTERNAL REVENUE SERVICE, STATEMENT BY IRS COMMISSIONER CHARLES O. ROSSOTTI ON AUDIT AND COLLECTION ACTIVITY FOR FISCAL 2000, 2001 TAX NOTES TODAY 33-11 (Feb. 15, 2001). For an interesting discussion of voluntary taxpayer compliance, see generally Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 KAN. L. REV. 971 (2003).

justification offered for the miscellaneous itemized deduction floor is that "some of the expenses have characteristics of voluntary personal expenditures."[231] The joint committee staff stated that the "use of a deduction floor also takes into account that *some* miscellaneous expenses are sufficiently personal in nature that they would be incurred apart from any business or investment activities of the taxpayer."[232] If only some have personal aspects, the justification for including others must rest on different grounds.

Congress has arbitrarily drawn limitations in other parts of the Code where expenditures have mixed business and personal elements. For example, Code § 274(n) allows a deduction for only fifty percent of the cost of business meals.[233] However, the reasoning behind that floor is much stronger than it is for miscellaneous itemized deductions because it is obvious that there are personal benefits derived from the meal. The meals satisfy nutritional needs. Congress decided to draw an arbitrary line and allow fifty percent of each business meal as a deduction. With miscellaneous itemized deductions, however, personal benefits are not as obvious, and in fact seem nonexistent in certain cases.

It is interesting to contrast the treatment of the reimbursement of the cost of an employee's business meal with the reimbursement of other employee business expenses. If an employer reimburses the cost of a business meal to an employee, the employee can exclude the entire reimbursement from income, even though no more than half the cost would have been deductible if there were no reimbursement.[234] Although the meal retains the personal element regardless of whether it is reimbursed by the employer, the employee can exclude the entire amount. However, the Code § 274(n) limitation then applies to the employer. That is, the employer can take a deduction for only half the cost of the reimbursed meal. The Code therefore treats the employer as taking advantage of the personal element of the meal, even though it is the employee who enjoyed the food.[235] Thus, the limitation is overbroad

231. BLUE BOOK, *supra* note 165, at 78.

232. BLUE BOOK, *supra* note 165, at 78 (emphasis added). The joint committee staff lists publication subscriptions and safe deposit boxes (holding both investment and personal assets) as examples of expenditures that could be a mixture of business and personal. BLUE BOOK, *supra* note 165, at 78.

233. I.R.C. § 274(n) (2000). Another example (relating to charitable rather than business expenditures) is that a taxpayer may take a deduction for only eighty percent of the amount donated to a university if the donation gives the taxpayer the right to purchase athletic tickets. *Id.* § 170(l).

234. *Id.* § 274(e)(3).

235. While discussing a different issue, Professor Daniel Halperin's article on imputed interest

in that it can apply to a person or entity that did not receive any personal benefit from the expenditure.[236]

Compare the treatment of a meal reimbursement to the treatment of reimbursed employee expenses other than meals. If the employer reimburses the employee, the expense becomes a nonitemized deduction for the employee.[237] The employee may then deduct the full amount, thereby creating a wash by having income in an amount equal to the reimbursement from the employer.[238] However, unlike the Code § 274(n) limitation on meals, the Code § 67 limitation does not apply to the employer.[239] Therefore, simply because the employer reimburses the employee for the expense, the expense magically loses all of its personal elements. As discussed below, the suggestion that the employer would reimburse only expenses that have no personal aspects is dubious.

The justification for the two-percent floor based on the personal nature of miscellaneous itemized deductions is weak. Many business expenses of self-employed individuals have a personal element; yet Congress has not applied a floor to those expenses, with only a few

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sheds light on the propriety of the tax law's treatment of meals. *See generally* Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506 (1986). Professor Halperin notes that the system can reach the correct result with regard to "disguised loans" by either direct taxation (taxing imputed income on such loans), indirect taxation (denying an otherwise allowable deduction), or substitute taxation (taxing another party to the transaction by denying a deduction to that party). *Id.* Although not the same issue, the concepts Halperin discusses can be applied to the current tax treatment of business meals. When the employee pays for the meal and is not reimbursed, the tax system engages in indirect taxation by denying a deduction for fifty percent of the meal. When the employer reimburses the employee for the expense of the meal, the employee may take a deduction for the entire expense and the employer is now limited to a fifty percent deduction for the expense. The system engages in substitute taxation of the employee by denying a deduction to the employer for half the expense. If both parties were in the same tax bracket, the tax result to the government would be the same. Almost always, however, different rates will apply to the two parties, and therefore taxpayers can structure the transaction to shift taxation to a lower tax rate taxpayer.

236. Note that the limitation in Code § 274(n) is also overbroad in that it applies to the cost of the entire bill, rather than merely the cost of the meal consumed by the payor. For example, A takes B, a client, out for a business lunch. A pays for both meals. B does not include the value of his meal in income. The Code § 274(n) fifty-percent limitation applies to the cost A incurred for B's meal even though A received no personal benefit from that meal. Applying the limitation to both the meals, however, does make sense for administrative and simplification purposes. The treatment of the cost of B's meal is analogous to the disallowance of fifty percent of an employer's reimbursement of the cost of an employee's meal. *See* I.R.C. § 274(n).

237. *Id.* §§ 62(a)(2)(A), 274(e)(3).

238. *See supra* note 126.

239. The employer's reimbursement payment is a nonitemized deduction under I.R.C. § 62(a)(1), and Code § 67 applies only to itemized deductions. I.R.C. § 67(b).

limited exceptions.[240] A taxpayer can choose the amount to expend on business activities and control how enjoyable they will be. The taxpayer's power to control the nature of the expenditure does not detract from its business character or its deductibility. If a self-employed taxpayer travels on business, he or she can travel either first class or economy class. He or she can rent an attractive office with comfortable working conditions or choose a more spartan work environment. Because business is conducted by human beings, it is not always possible to disentangle the personal element of an expense from the business element.[241] Instead, personal and business elements often are inexorably entwined. In a few cases, the Code disallows any deduction (e.g., commuting expenses);[242] in a few others, the Code allows a portion of the deduction (e.g., business meals);[243] in most circumstances, the Code allows the entire cost to be deductible.[244]

The personal element justification for the two-percent floor does not apply to many of the items subject to that limitation because many of the miscellaneous itemized deductions have no personal element whatsoever. Congress itself recognized that only some miscellaneous itemized deductions have a substantial personal element.[245] An obvious case in point is the attorney's fee problem. Similarly, expenses incurred for investment counsel or for aid in preparing an income tax form have no personal element. Therefore, there is no personal element justification for limiting those deductions. In that regard, Professor Peroni dismissed the personal element justification and urged instead that those expenses (and only those expenses) that are generally personal (such as subscriptions to general interest publications and safe-deposit boxes) be denied any deduction.[246] If the entire category of miscellaneous itemized

240. As discussed above, the fifty-percent limitation on business meals applies to independent contractors. *Id.* § 274(n).

241. *See* Jeffrey H. Kahn, *Personal Deductions—A Tax "Ideal" or Just Another "Deal"?*, 2002 L. REV. MICH. ST. U.–DETROIT C.L. 1, 30.

242. Treas. Reg. § 1.262-1(b)(5) (as amended in 1972).

243. *See* I.R.C. § 274(n).

244. For a discussion of several business expenses, see generally Daniel I. Halperin, *Business Deductions for Personal Living Expenses: A Uniform Approach to an Unsolved Problem*, 122 U. PA. L. REV. 859 (1973) (arguing some areas of business expenses are too personal in nature and deductibility for those types of expenses should be restricted).

245. *See* BLUE BOOK, *supra* note 165, at 78.

246. Peroni, *supra* note 181, at 1420. Professor Peroni stated,

> the solution to this problem of taxpayers taking deductions for personal consumption expenses is to disallow the deduction directly to the extent it does not have a sufficient connection to a trade or business or investment activity.... If a particular type of expense is generally

deductions is to be sustained, other justifications will have to be determined to be sufficient.

Even if the personal nature of miscellaneous itemized deductions is of legitimate concern, the two-percent floor is an inappropriate solution. The floor is based on the amount of the taxpayer's AGI.[247] To assume that the proportion of an expense that provides a personal benefit increases with the rise of a taxpayer's AGI is a highly questionable proposition. For example, two taxpayers may have the exact same expense, which is their only miscellaneous itemized deduction. However, one taxpayer has AGI of $100,000, and one has AGI of $200,000. The taxpayer with the lower AGI is allowed to claim $2,000 more in miscellaneous itemized deductions, despite the fact that both expenditures have the same mixture of legitimate and personal elements.[248]

This contention does not mean that all floors based on the taxpayer's AGI are suspect. There are circumstances in which a floor is appropriate. For example, a taxpayer can only deduct medical expenses that exceed 7.5% of his or her AGI.[249] Professor Mark Kelman has argued that the existing medical expense deduction should be removed from the Code because many medical expenses have personal and pleasurable elements.[250] The floor, based on the taxpayer's AGI, addresses that concern.[251]

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> personal in nature (e.g., subscriptions to general interest publications; safe deposit boxes by individual taxpayers), then a specific disallowance provision relating to the particular expense may be appropriate. A deduction floor that may or may not disallow the expense having the predominately personal element and that also disallows other legitimate business or investment expenses is not the appropriate legislative response to this problem.

Peroni, *supra* note 181, at 1420.

247. I.R.C. § 67(a) (2000).

248. Note that the fifty-percent floor that Code § 274(n) imposes on meals is not subject to that objection because the size of that limitation is tied to the amount expended, rather than to the taxpayer's adjusted gross income.

249. I.R.C. § 213(a).

250. Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far From Ideal World*, 31 STAN. L. REV. 831, 874–76 (1979). Examples of such items include an air conditioning unit that would relieve a taxpayer's medical condition but also provide comfort in hot weather, or a swimming pool, which can provide both therapeutic and pleasurable benefits. *See* Kahn, *supra* note 241, at 30.

251. Kahn, *supra* note 241, at 29 ("[B]y utilizing a percentage of adjusted gross income as a floor, rather than adopting a specified floor amount, the tax law reflects the fact that persons with higher incomes, and thus with larger disposable income, likely will spend more on medical matters [especially on medical benefits that also provide personal pleasure] than will those with fewer resources.").

One might contend that the amount of the personal element of miscellaneous itemized deduction expenses is correlated with the size of the taxpayer's AGI. One could argue that those with a greater AGI might be more willing to pay for items whose business or investment benefit would not warrant their cost were it not for the personal benefit that they also provide. Thus, it could be argued that the same reasoning that justifies the medical expense floor could apply in the case of miscellaneous itemized deductions.

However, there is an aspect to the use of a floor for the medical expense deduction that does not apply to miscellaneous itemized deductions. The graduated tax rates already incorporate an allowance for some medical expenses each year; that is one of the justifications for having a zero or low marginal rate for some income levels.[252] The medical expense deduction only comes into play in the case of extraordinary medical expenses. In those cases, the rate schedule must be modified by allowing a deduction to account for the fact that the taxpayer incurred a greater amount of medical expenses than the rate schedule normally presumes.[253] By contrast, the expenses incurred in producing income are not reflected in the tax rate structure, and so a floor on the deduction for such items cannot be said to prevent a double allowance.[254]

The personal element justification appears to apply equally to reimbursed employee expenses or independent contractor expenses, for which no deduction is disallowed. Congress has attempted to suggest a rationale for applying different treatments to seemingly comparable circumstances. In the case of employees, Congress has opined that employers will reimburse any legitimate trade or business expense, thus implying that anything not reimbursed is not sufficiently related to the business and must have personal elements.[255] The Senate Finance

252. *See* Kahn, *supra* note 241, at 28.

253. *See* Kahn, *supra* note 241, at 27–29.

254. *See* Martin J. McMahon, Jr., *Individual Tax Reform for Fairness and Simplicity: Let Economic Growth Fend for Itself*, 50 WASH. & LEE L. REV. 459, 493 (1993) ("Code section 67 cannot be justified on the grounds that nearly all taxpayers have some unreimbursed employee business expenses or Code section 212 expenses and that only excessive expenses affect the individual's ability to pay.").

255. Note, however, that sometimes the employee may also be the employer, as in employee-owned corporations:

> Code section 67 also creates a distinction in practice between owner-employees of closely held corporations and all non-owner employees. Owners of closely held corporations can and do provide themselves with full reimbursement or direct payment by the corporation, as excludable working condition fringe benefits. These include not just legitimate business

Committee stated, "The committee believes that generally it is appropriate to disallow deduction for employee business expenses because employers reimburse employees for those expenses that are most necessary for employment."[256] However, many employers reimburse expenses that have personal elements, such as meals, magazine subscriptions, and club dues. It also seems likely that many employers do not reimburse many legitimate business expenses because they do not wish to undertake a reimbursement plan. As Professor Peroni noted, "such employers pay their employees a higher salary amount and make the employees pay and keep track of their own expenses."[257] Therefore, using employers' reimbursement practices is a poor proxy to judge whether an expense is primarily a personal or legitimate business expense.

Moreover, this reliance on an independent overseer to verify a deduction does not justify the difference in the treatment of independent contractors and employees. As noted above, any valid business expense of an independent contractor is a nonitemized deduction and thus is not subject to the any of the itemized limitations (the overall limitation, the two-percent floor, or the disallowance of the deduction for AMT purposes). This is true despite the fact that there is no "independent" third party reviewing the expenses to determine if they are legitimate (as there is with reimbursed employee expenses).[258] It is difficult to see why Congress should trust independent contractors more than employees with these expenses.[259]

One possible ground for treating independent contractors differently is that they will have to account for their expenses to their clients, so

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> expenses, but many mixed purpose expenses, as well as clearly personal expenses. They avoid even raising the issue of deductibility on their own tax returns.

McMahon, *supra* note 254, at 493.

256. S. REP. NO. 99-313, at 79 (1996); *see* Blake D. Rubin, *Tunneling Under the Two Percent Floor*, 38 TAX NOTES 177, 179 (1988).

257. Peroni, *supra* note 181, at 1422.

258. *See supra* text accompanying note 255.

259. Peroni, *supra* note 181, at 1421. Peroni states,

> an independent contractor has no employer to account to with respect to business expenses; yet, such a taxpayer is able to deduct his or her expenses in full in arriving at adjusted gross income and is not subject to the section 67 floor. It is unclear why Congress believes that independent contractor taxpayers are less likely to try to disguise personal consumption expenditures as deductible business expenses than are employees and all the legislative history of the 1986 act provides no empirical support for such belief.

Peroni, *supra* note 181, at 1421 (citations omitted); *see also* McMahon, *supra* note 254, at 492–93 (stating Congress is "barking up the wrong tree" by focusing on employees rather than independent contractors and employee-owned businesses).

there is no administrative inconvenience in having them report those expenses to the Service. However, independent contractors do not necessarily have to account to their clients. An independent contractor may set out a flat or hourly fee for services and personally absorb any expenses, an allowance for which is incorporated in the size of the fee charged. In summary, the presence of a personal element in some business expenditures does not justify a more restrictive treatment of employee expenses than is accorded to the self-employed.

### 3. *Third Justification: Taxpayers Make Errors in Reporting Deductions*

Another justification offered for the limitation on miscellaneous itemized deductions is that "taxpayers frequently made errors of law regarding what types of expenditures were properly allowable . . . ."[260] That is, Congress questioned the ability of taxpayers to determine which expenses were allowable and believed that they would inadvertently misapply the legal rules. The legislative history listed areas where taxpayers were likely to misapply the law: home office expenses, education expenses, the cost of safe deposit boxes in which no income-producing asset is stored, and the cost of subscriptions to popular magazines that contain business information.[261]

This justification is not persuasive. It is not a compelling rationale to state that because some taxpayers will misinterpret the law, a floor is required to limit some deductions, but not others. First, taxpayers surely make mistakes in applying the law in many areas—not just those listed as miscellaneous itemized deductions. That contention could just as well justify eliminating any provision that provides a benefit for taxpayers. Second, not everyone would make mistakes, so not all taxpayers should be penalized. Third, a floor is not an adequate solution. Taxpayers can still erroneously claim a deduction when the amounts involved are large enough. Because the two-percent floor applies to an aggregate of miscellaneous itemized deductions, the mistaken deduction could be a very small amount as long as the taxpayer has other expenses that place him over the two-percent floor. Fourth, just as with the personal element argument, the mistake of law justification fails to explain the more favorable treatment accorded to independent contractors. There is no

260. BLUE BOOK, *supra* note 165, at 78.

261. S. REP. NO. 99-313, at 78 n.18 (1986); *see* H.R. REP. NO. 99-426, at 109 n.8 (1985); BLUE BOOK, *supra* note 165, at 78 n.52.

apparent basis for a prediction that independent contractors will be better arbiters of tax rules than employees.[262]

The current disparity of treatment is unfair and inefficient in that it induces taxpayers who have significant business expenses to make every effort to be classified as independent contractors, rather than as employees.[263] The absence of a rationale for the disparate treatment may generate cynicism among taxpayers. To quote Congress's own justification for adopting the AMT, a "loss of confidence on [the taxpayers'] part in the fairness of the tax system could result in a breakdown of taxpayer morale and make it far more difficult to collect the necessary revenues. For this reason alone, the tax system should be improved."[264]

### 4. *Fourth Justification: Congress Needs the Additional Revenue*

Finally, Code § 67 has been described as a "bald revenue grab by Congress to make the legislative ledgers balance."[265] Professor Peroni gives a more positive spin to that purpose by noting that § 67 was part of a goal of the "Tax Reform Act of 1986 'to reduce tax rates through base-broadening.'"[266] Revenue-raising is a permissible goal of tax legislation. However, to pass muster as good tax policy, a provision must be equitable and consistent with cost allocation policy. As noted above, the two-percent floor limitation on miscellaneous itemized deductions has no sustainable policy justification, but rather causes inequities.[267]

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262. One possible response to the complaint of unequal treatment of employees and independent contractors is that, instead of expanding the deduction to employees, it should be contracted by denying it to independent contractors and other self-employed persons. It seems highly unlikely that Congress would so greatly expand the denial of deductions. Even if employees and independent contractors were treated equally, this author maintains that limitations should not be applied to business expenses.

263. *See supra* notes 217–25 and accompanying text.

264. S. REP. NO. 91-552, at 13 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2040.

265. *See* Geier, *supra* note 1, at 533. At the time of its enactment, the Joint Committee on Taxation estimated that the provision would raise an additional $19.4 billion over a five year period. BLUE BOOK, *supra* note 165, at 1360.

266. *See* Peroni, *supra* note 181, at 1418 (quoting S. REP. NO. 99-313, at 78 (1986)).

267. The revenue loss from a repeal of Code § 67 could be packaged with an increase in marginal rates, thus leading to a more equitable tax system while maintaining the revenue required for the government.

### 5. *Solution*

Having dismissed the proposed justifications for miscellaneous itemized deductions, what are the possible reforms? There are two choices: either (1) keep the system, but alter the list of deductions that are classified as miscellaneous itemized deductions; or (2) repeal the classification as a whole. At a minimum, some of the items currently classified as miscellaneous itemized deductions should not be subject to those restrictions.

## IV. TIME FOR REFORM: A PROPOSAL FOR RECLASSIFICATION OF THE DEDUCTIONS

As discussed above in Part III, this author believes that the arguments for repealing Code § 67 and § 68 are stronger than those for retaining them. While other commentators have made this point,[268] the provisions remain in the Code. Even the overall limitation, which is subject to a phase-out, will reappear in 2011 if Congress does not make the repeal permanent.[269] If these provisions are to remain, Congress should modify them by removing from the list of itemized deductions those items that are directly connected to the production of income or the inclusion of which contravenes legitimate tax policies. Congress took a modest step in that direction last year when it adopted the Civil Rights Tax Relief provision of the 2004 Act, which provides nonitemized deduction treatment for the attorney's fee and court costs incurred in connection with claims of employment discrimination and with certain claims against the government.[270]

Because Congress appears to be unwilling to repeal the limitations in Code § 67 and § 68, it is time for Congress to review the current classifications of deductions. Reviewing the entire classification system and making appropriate changes may obviate the need for Congress or the courts to adopt piecemeal modifications from time to time as hard cases emerge. A common response to a patently wrong consequence that generates a hue and cry is to fix each specific situation while leaving intact the root cause of the situation. For example, consider the Civil

268. *See generally* Calvin H. Johnson, *Simplification: Replacement of the Section 68 Limitation on Itemized Deductions*, 78 TAX NOTES 89 (1998); Peroni, *supra* note 181.

269. *See supra* note 11.

270. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546–48; *infra* note 302 and accompanying text.

Rights Tax Relief provision of the 2004 Act. It was adopted to respond to the attorney's fee controversy but left unresolved many comparable circumstances in which a similar issue arises.[271]

This Part proposes that Congress reclassify certain deductions. The items discussed in this Part are not an exhaustive list of the items that should be reclassified, but are five egregious examples of changes that need to be made, several of which were noted in the examples discussed in Part II. Highlighting these examples will hopefully induce Congress to implement a commission to study the entire classification system rather than rest on its laurels for solving one small part of the problem with the 2004 legislation.

### A. *Expenses for Production of Income—Code § 212*

Code § 212 allows a deduction for individuals for all ordinary and necessary expenses paid or incurred: "(1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax."[272] Code § 212 is sometimes referred to as a "nonbusiness" deduction provision because it applies to income-producing activities that do not qualify as a trade or business.[273] Most, but not all, deductions allowed under Code § 212 are classified as miscellaneous itemized deductions.[274] On account of that classification, there are many circumstances where the operation of the limitations under Code § 67 and § 68 or the AMT system leads to inequitable tax results.

The contingent attorney's fee problem is a dramatic example. The payment to the attorney should be fully deductible by the plaintiff so that the plaintiff is taxed on a net, rather than a gross, amount. However, because the payment is deductible under either Code § 212 or Code § 162[275] and is not listed as a nonitemized deduction unless the claim

271. *See* American Jobs Creation Act, § 703; *infra* note 302 and accompanying text.

272. I.R.C. § 212 (2000).

273. There are other nonbusiness deduction provisions. For example, I.R.C. § 167(a)(2) allows depreciation deductions for property held for the production of income. *Id.* § 167(a)(2).

274. I.R.C. § 212 expenses attributable to property held for the production of rents and royalties are classified as nonitemized. *Id.* § 62(a)(4); *see infra* notes 306–07 and accompanying text.

275. The fee may be deductible as a trade or business expense under Code § 162(a) if the litigation arises out of the employee's employment. Because the expenses are not reimbursed, they will be classified as miscellaneous itemized deductions and subject to the described limitations. As noted *infra* Part IV.B, this author believes that employee trade or business expenses should be

involves employment discrimination or is otherwise listed in Code § 62(a)(19), it is subject to the limitations of Code § 67 and § 68, and completely disallowed for purposes of the AMT.

Not only does this situation cause some taxpayers to suffer grossly unfair tax consequences, it has led some courts, motivated by concerns for the plight of some taxpayers, to adopt a spurious line of legal reasoning in a flawed effort to cure the problem.[276] In doing so, many courts have sought to utilize lien rules, which differ among the states.[277] Because of those differences and because of the faulty reasoning of those decisions that favored taxpayers, taxpayers have lost in the majority of those cases and, most recently, in the U.S. Supreme Court.[278] Even if the taxpayers had prevailed in the Supreme Court under the state lien argument, the Court's holding would have been of no use to taxpayers in circumstances where the item in question is not a contingent fee for a third party. Even if the U.S. Supreme Court had upheld the taxpayer's case on different grounds, it would likely have had to rely on a misapplication of tax principles in order to achieve that result. Bad decisions nevertheless become precedents that can apply to quite different circumstances. Courts will not necessarily restrict application of the precedent to situations where a taxpayer's plight is sympathetic. If, contrary to its holding for the Service, sympathy for the taxpayers' plight had led the Supreme Court to join a minority of the lower courts and reach a favorable result for the taxpayers, that choice could have led to decisions in future cases that would improperly tax other parties.[279]

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classified as nonitemized. Correct classification of both categories will solve the attorney's fee dilemma, whether the deduction is allowable under Code § 212 or Code § 162. Note that the amount of damages awarded that equals the amount payable to the attorney does not constitute a reimbursement to the plaintiff of that expense, and does not qualify that expense for nonitemization treatment.

276. *See, e.g.*, Banks v. Comm'r, 345 F.3d 373, 386 (6th Cir. 2003), *rev'd*, Comm'r v Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005); Banaitis v. Comm'r, 340 F.3d 1074, 1083 (9th Cir. 2003), *rev'd sub nom.* Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005); *see also* Polsky, *Fruits and Trees*, *supra* note 1, at 74–76 (stating the minority view that a plaintiff excludes income paid to the attorney is based on faulty analysis).

277. Some courts have used a partnership approach to exclude the attorney's fee from the plaintiff's income. *See* Polsky, *Fruits and Trees*, *supra* note 1, at 111–19; *supra* note 70.

278. *See, e.g.*, Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005); Raymond v. United States, 355 F.3d 107 (2d Cir. 2004), *petition for cert. filed*, 72 U.S.L.W. 1437 (U.S. Apr. 9, 2004) (No. 03-6037); Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001); Kenseth v. Comm'r, 259 F.3d 881, 883 (7th Cir. 2001); Young v. Comm'r, 240 F.3d 369, 379 (4th Cir. 2001); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995); O'Brien v. Comm'r, 319 F.2d 532 (3d Cir. 1963).

279. For example, consider the potential consequences from a holding that attorney's fees

*Banaitis v. Commissioner*, one of the two cases that the U.S. Supreme Court decided for the Service, provides a good example of the problem. Banaitis retained a law firm on a contingent fee basis in order to take legal action against two parties—the corporate owner of his former employer for wrongful interference with his employment and his former employer for wrongful discharge.[280] Banaitis's suit was not based on a claim of discrimination. The parties settled the lawsuit for approximately $8,700,000; pursuant to the contingent fee arrangement, the law firm received approximately $3,800,000.[281]

On his tax return, Banaitis excluded all of the damages awarded to him on the contention that they were for physical injuries and therefore were excluded from gross income by Code § 104(a)(2).[282] The Service contended that all of the damages were includable in income.[283] The Ninth Circuit agreed that the physical damage exclusion did not apply;[284] but, reversing the Tax Court, it held that Banaitis was not required to

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incurred in a suit to collect on a claim should be capitalized and offset against the amount collected, rather than treating the fees as a deductible expense. *See supra* note 66 (discussing the "Davenport" approach). Congress expressly provided an ordinary deduction (as contrasted to a capital loss deduction) for expenses incurred for the "*collection* of income" (emphasis added). I.R.C. § 212(1) (2000). Treasury Regulation § 1.212-1(k) makes it clear that attorney's fees incurred in collecting rent, even when incurred in a suit to determine whether the taxpayer has title to the property that produced the rent, are deductible expenses. Treas. Reg. § 1.212-1(k) (as amended in 1975). Thus, if a taxpayer incurs expenses in collecting income that will be treated as a capital gain, the Code permits the taxpayer a deduction from ordinary income for those expenses. If the capitalization approach is adopted, those expenses will offset the capital gains income and effectively will be treated as capital losses. That treatment will disfavor a taxpayer in some circumstances and favor a taxpayer in other circumstances, but in neither case will it comply with the congressional direction to provide ordinary deduction treatment as set forth in I.R.C. § 212(1).

If a taxpayer's claim for capital gain damages arose out of a business operated by a self-employed individual, the attorney's fees should be nonitemized ordinary deductions. I.R.C. § 162(a)(1). If the claim arose in connection with property held for the production of rent, the attorney's fees again should be nonitemized ordinary deductions. *Id.* § 62(a)(4). The Davenport approach would alter those expenses into capital losses, which may be far less useful to the taxpayer. If the taxpayer's claim is for lost wages, the deduction for the attorney's fees would be a miscellaneous itemized deduction subject to limitations. However ill-advised those limitations may be, they were deliberately imposed by Congress, and only Congress has the power to remove them. While the Davenport approach will negate the limitations that Congress imposed on such expenses, it will contravene the will of the legislature, and it will avoid those limitations in only one narrow area in which they apply (which became even narrower after the congressional relief provided for many employee suits by the 2004 Act).

280. *Banaitis*, 340 F.3d at 1077.

281. *Id.* at 1078.

282. *Id.*

283. *Id.*

284. *Id.* at 1079–81.

include the portion of damages paid to the law firm in income[285] (thereby avoiding the miscellaneous itemized deduction limitations). The Ninth Circuit stated that

> [t]he question of whether attorneys fees paid under a contingent fee contract with a plaintiff are includable in the plaintiff's gross income involves two related questions: (1) how state law defines the attorney's rights in the action, and (2) how federal tax law operates in light of this state law definition of interests.[286]

Oregon State law applied in *Banaitis*,[287] and the Ninth Circuit determined that Oregon State provided attorneys with a sufficient property interest in contingent fees to justify a holding that the fee paid to the attorney should not be included in the taxpayer's gross income.[288]

Essentially, the Ninth Circuit treated the contingent fee agreement as an assignment by Banaitis to his attorneys of a portion of his claim against the defendant. Even if the agreement constituted an assignment of part of the taxpayer's claim, it should not prevent Banaitis from being taxed on the entire amount of the settlement. The "assignment" was not made gratuitously; it was a commercial exchange in which Banaitis received the right to the attorney's services. In a commercial exchange, the taxpayer must recognize gain to the extent that the amount he realized exceeded his adjusted basis[289] in the portion of the claim that he "sold."[290] Because the taxpayer's basis in the claim likely will be zero,[291] the entire amount realized by the taxpayer will be income.

In discussing this issue, Professor Gregg Polsky states that the "assignment of income doctrine is inapplicable to contingent fee arrangements because the doctrine does not apply to arm's length commercial transactions."[292] While Professor Polsky sets out two

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285. *Id.*

286. *Id.* at 1081.

287. *Id.* at 1082.

288. *Id.* at 1082–83.

289. A taxpayer's basis in property is the dollar amount that the taxpayer is deemed to have invested in the item for tax purposes. In many cases, a taxpayer's basis in property will be equal to the cost of the property. I.R.C. § 1012 (2000).

290. *Id.* § 1001(a).

291. *Id.* Only dollars invested in an asset can create a basis, and the taxpayers in these cases typically will have no dollars invested in the claim. Dollars spent on enforcing the claim that are deductible expenses are not capitalized, and so are not added to the taxpayer's basis.

292. Polsky, *Fruits and Trees*, *supra* note 1, at 62. In its *Commissioner v. Banks* decision, the Supreme Court applied the assignment of income doctrine instead of adopting Prof. Polsky's approach. Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005).

possible characterizations for the transaction, he believes that the tax results to the plaintiff are the same under either scenario:

> [E]ither the arrangement results in no transfer whatsoever until the attorney is actually paid, or alternatively, the arrangement results in a transfer of property . . . at the time the contingent fee agreement is executed. Further, under either interpretation, the tax consequences to [the plaintiff] are the same. She must include the full amount of the settlement, including the attorney fee portion, in her gross income and may take a miscellaneous itemized deduction for the attorney fee portion.[293]

While it initially appears that the timing of the income recognition could be different depending on which characterization applies, Professor Polsky argued convincingly that, if one accepts that the plaintiff transfers a right to the claim upon execution of the contingent fee agreement, Code § 83 would apply to the transfer.[294]

This is crucial because Code § 83 provides that a transfer of property for services is disregarded for tax purposes if there is a substantial risk of forfeiture until such time as the interest vests.[295] As noted by Professor Polsky, because the attorney would forfeit any interest in the property if he or she were to withdraw from the case, the attorney's interest is subject to substantial risk of forfeiture until the case is finally closed.[296]

Thus, in the attorney's fee scenario, there is no transfer for tax purposes upon execution of the contract. Once the case has been finalized and the risk of forfeiture is removed, the transfer officially occurs for tax purposes. Because the plaintiff transferred property in

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293. Polsky, *Fruits and Trees*, *supra* note 1, at 62–63.

294. Polsky, *Fruits and Trees*, *supra* note 1, at 108–11. I.R.C. § 83(a) provides

> If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—
>
> (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over
>
> (2) the amount (if any) paid for such property,
>
> shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

I.R.C. § 83(a).

295. I.R.C. § 83(a); Treas. Reg. § 1.83-1(a) (as amended in 2003).

296. *See* Polsky, *Fruits and Trees*, *supra* note 1, at 108–09; *see also* I.R.C. § 83(c)(1) ("The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.").

exchange for services, the plaintiff must recognize the difference between the value of the services received from the attorneys and the plaintiff's basis in the property transferred.[297] As the plaintiff will have a zero basis in the property, he or she will recognize the full amount as income.[298] Under Code § 83, unless an attorney makes a Code § 83(b) election,[299] the transfer takes place when the attorney's interest ceases to be forfeitable, and that will occur when the case is resolved. Professor Polsky concludes that, under either characterization (i.e., as an immediate transfer of the claim subject to Code § 83 or no transfer until the attorney is actually paid), the plaintiff should include the full amount in income and the plaintiff should be allowed a miscellaneous itemized deduction for the payment to the attorney.[300]

Professor Polsky determines that only Congress can adequately solve the problem and states "section 62 must be amended to add these attorney's fees to the list of deductions taken into account in computing the taxpayer's adjusted gross income."[301] Professor Polsky is correct; and, to a considerable extent, Congress adopted his proposal when it enacted the Civil Rights Tax Relief provision of the 2004 Act.[302] It is noteworthy that his proposed solution and the 2004 Act properly cover not only contingent fee arrangements, but also attorney's fees based on

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297. I.R.C. § 1001(a); *see* Treas. Reg. § 1.61-2(d)(1) (as amended in 2003).

298. Polsky, *Fruits and Trees, supra* note 1, at 110; *see* Treas. Reg. § 1.83-6(b) (as amended in 2003) ("[A]t the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property.").

299. An interesting issue arising out of Professor Polsky's theory regarding the application of Code § 83 is the possible application of Code § 83(b). Taxpayers can elect, under Code § 83(b), to include in income property that is still subject to substantial risk of forfeiture. So, the attorney could elect under Code § 83(b) to include his or her portion of the claim in income upon execution of the contract, rather than wait until the final disposition of the case. In a separate article, this author has examined the tax consequences of an attorney making that election and the question of whether it could cure the plaintiff's tax problem. *See generally* Jeffrey H. Kahn, *Could One Simple Election Solve the Attorney Fee Issue?*, 105 TAX NOTES 411 (2004).

300. Polsky, *Fruits and Trees, supra* note 1, at 121.

301. Polsky, *Fruits and Trees, supra* note 1, at 121

302. Section 703 of the Act states:

> (a) DEDUCTION ALLOWED WHETHER OR NOT TAXPAYER ITEMIZES OTHER DEDUCTIONS—Subsection (a) of section 62 (defining adjusted gross income) is amended by inserting after paragraph (18) the following new item:
>
> (19) COSTS INVOLVING DISCRIMINATION SUITS, ETC—Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination . . . .

American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546–48.

an hourly payment schedule,[303] which would not have been covered even if the Supreme Court had held for the taxpayers in the recent decision.

However, Professor Polsky's proposal and the 2004 Act, while an improvement, do not go far enough. All ordinary and necessary expenses for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income should be fully deductible. Placing limitations on such expenses violates the basic principle that our tax system should tax only *net* income. Whether it is an attorney's fee or some other expense, taxpayers should be allowed to fully deduct the cost of producing income. While that principle may be contravened because of a competing policy (such as the denial of a deduction for illegal business expenses), there is no competing principle that would justify denying part of the deduction for valid profit-oriented expenses merely because they arose in an activity that does not qualify as a trade or business.[304] The 2004 Act does not go nearly far enough; and, in some respects, is objectionable in that it exacerbates the discriminatory treatment of other parties who are affected by the same plight in connection with claims that do not involve discrimination.[305]

Some expenses under Code § 212(1) and (2) are already fully deductible as nonitemized deductions. Included in the Code § 62 list of nonitemized deductions are deductions attributable to property held for

303. *See id.*

304. Because our society has determined to have an income tax system, we should strive to have that system tax "income" as closely as possible. However, our tax system is also a product of our economic, social, and political values. Some deductions, or denials of deductions, are valid even if they do not serve the values of the income tax. *See, e.g.*, William J. Turnier, *Evaluating Personal Deductions in an Income Tax—The Ideal*, 66 CORNELL L. REV. 262, 286–87 (1980) ("[W]hen certain deductions are necessary to perfect the tax base or are consistent with the values implicit in an income tax, decisionmakers might decide to disallow those deductions because of their negative impact on fundamental economic, social, or political values."). The denial of a deduction for illegal business expenses is an example of where our tax system decided that other principles trump the principle of a "correct" income tax treatment. However, as noted in the text immediately above, there is no competing principle that justifies mechanically limiting or denying a deduction for Code § 212 expenses that are classified as miscellaneous itemized deductions.

305. Note that the 2004 Act would not cover the taxpayer in the *Banaitis* case in the Supreme Court because the taxpayer's claim in that case, while based on a wrongful discharge, did not raise an unlawful discrimination claim or a claim under any statute covered by the 2004 Act. *See* Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003), *rev'd sub nom.* Comm'r v. Banks, Nos. 03-892, 03-907, __U.S.__, 2005 WL 123825 (Jan. 24, 2005). Similarly, the 2004 Act would not cover the taxpayer in *Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004), *petition for cert. filed*, 72 U.S.L.W. 3659 (U.S. Apr. 9, 2004), because that case involved a wrongful termination lawsuit which did not involve any claim of discrimination or a claim under any other statutory provision covered by the 2004 Act. *See* Raymond v. I.B.M. Corp., 954 F. Supp. 744 (D. Vt. 1997).

the production of rents and royalties.[306] There is no principled justification for classifying those expenses as nonitemized when other production of income expenses are classified as itemized. The likely explanation for this difference in treatment is that a lobbying group was able to influence Congress.[307] This dichotomy highlights the unfairness of the current classification system. If nonitemized classification is appropriate for expenses incurred in connection with property held for the production of rents or royalties, it is equally appropriate for any valid expense attributable to the production or collection of income or the management, conservation, or maintenance of property held for production of income.

The case for nonitemized treatment for expenses "in connection with the determination, collection, or refund of any tax"[308] is weaker than the case for the first two subsections of Code § 212. While such tax-connected expenses arise only because a taxpayer has income (and thus could be viewed as part of the cost of producing income), the connection to income production is indirect and thus not comparable to more direct expenses such as payments for the management of investments. It is not a cost of producing income, but rather is a cost of properly accounting to the government the amount of income that was earned. Therefore, Code § 212(3) expenses should not be a nonitemized deduction.

Congress should revise Code § 62 by adding to the list of nonitemized deductions a subsection for the deductions allowed by Code § 212(1), § 212(2), § 167(a)(2), § 611, and comparable provisions that relate to either (1) the production or collection of income or (2) the management, conservation, or maintenance of property held for the production of income. This revision would not only solve the attorney's fee issue, but also would cure the inequitable treatment of many other expenses, as well as many currently unanticipated problems that will arise in the future.

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306. I.R.C. § 62(a)(4) (2000) (classifying as nonitemized "[t]he deductions allowed by Part V (section 161 and following), by section 212 (relating to expenses for production of income), and by section 611 (relating to depletion) which are attributable to property held for the production of rents or royalties").

307. It is easy to infer that the real estate and oil and gas lobbying groups wanted nonitemized classification for these expenses.

308. *Id.* § 212(3).

*B. Employee Trade or Business Expenses*

Another category of deductions that should be reclassified is unreimbursed employee trade or business expenses. These are the only trade or business expenses that are classified as miscellaneous itemized deductions, and even several specified classes of employee expenses are excluded from itemized treatment.[309] Singling out such expenses for limitation is unfair. As noted above, the grounds offered for limiting such expenses apply equally well to trade or business expenses of independent contractors. To reiterate, these limitations violate the basic principle that taxes should be imposed only on *net* income. As shown in the example in Part II.B, limitations on such expenses violate horizontal equity, whether the comparison is made: (1) between an employee and an independent contractor, or (2) between two employees, only one of whom negotiated his compensation to include reimbursements of expenses.

There is little doubt that Congress is aware of the inequity of classifying employee business expenses as itemized deductions because it has granted nonitemized classification for a few specific types of employee business expenses—e.g., business expenses of a performing artist, a state official, up to $250 of certain expenses of elementary and secondary school teachers, and certain expenses of members of the reserve components of the armed forces.[310] Presumably, Congress felt persons in those categories were in need of relief because their financial position typically is such that they cannot readily absorb the tax penalty imposed as a result of an inappropriate classification. Such ad hoc relief measures are unfair to those who lack an organized association to bring their plight to the attention of Congress. It would be far better to remove all of the improper classifications than to make piecemeal adjustments in response to organized complaints. Congress should allow a nonitemized deduction for all ordinary and necessary business expenses of an employee.

The facts of the 1996 Tax Court case of *Brown v. Commissioner*

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309. Certain business expenses of a performing artist, a state official, up to $250 of expenses of eligible educators, and expenses of members of reserve components of the armed forces are classified as nonitemized deductions. I.R.C. § 62(a)(2)(B)–(E). The characterization for educator expenses is scheduled to expire in 2006. *Id.* § 62(a)(2)(D) (as amended by § 307(a) of the Working Families Relief Act of 2004, Pub. L. No. 108-311, sec. 307(a), § 62, 118 Stat 1166, 1179). Employees may also take a nonitemized deduction for qualified moving expenses. *Id.* § 62(a)(15).

310. *See id.* § 62(a)(2)(B)–(E).

provide an interesting illustration of the plight that a low tax bracket taxpayer can suffer because of the treatment of employee business expenses as itemized deductions.[311] In that case, a waitress was required by her employer to pay for any dishes she broke and for the bill of any of her customers who skipped out without paying.[312] She also split her tips with busboys, bartenders, and similar employees.[313] One question raised in the case was whether those payments by the waitress and the portion of her tips that she shared with others were itemized or nonitemized deductions.[314] Because the waitress used the standard deduction, and because the items in question totaled less than that deduction, she would receive no benefit whatsoever from an allowance of a deduction for her expenses if the deduction were itemized. The Tax Court resolved the case without reaching the question of whether her deductions would be itemized.[315] It is clear, however, that any deductions that would be allowable to the waitress for such expenses would be itemized because they were unreimbursed employee business expenses. The facts of this case illustrate that, even if the special limitations on itemized deductions are inapplicable, the characterization of employee business expenses as itemized deductions can cause severe hardship to a taxpayer.

### *C. The Estate Tax Deduction for Income in Respect of a Decedent—Code § 691*

The itemized characterization of the estate tax deduction allowed for IRD interferes with the legislative purpose for granting that deduction. As noted in Part II.C, Code § 691 provides an income tax deduction (called an "estate tax deduction") for the amount of a decedent's estate tax that is attributable to the inclusion in the decedent's gross estate of the right to the IRD that the decedent held at the time of his death. The congressional purpose for allowing the estate tax deduction is to ensure that the overall tax burden imposed on the IRD (both income and estate taxes) will be the same whether the income of the IRD is recognized by the decedent before his death or by the recipient of the item after the decedent's death,[316] as long as the marginal income tax brackets of the

311. 72 T.C.M. (CCH) 59 (1996).

312. *Id.* at 59–60.

313. *Id.*

314. *Id.* at 60–61.

315. *Id.* at 63.

316. *See supra* note 145 and accompanying text.

decedent and the recipient are approximately the same. The congressional purpose for allowing the estate tax deduction can be fulfilled only if the Code permits the taxpayer to deduct the entire amount of the estate tax. Any limitations imposed on that deduction will frustrate the congressional goal of equalizing the tax burden on IRD with the burden that would have been incurred if the income had been recognized during the decedent's life.

Because the estate tax deduction is an itemized deduction, it is subject to limitations. It is not a miscellaneous itemized deduction, so it is not subject to the two percent of AGI floor,[317] and is fully deductible under the AMT system. However, it is subject to the overall limitation on itemized deductions under Code § 68.

If the taxpayer is taxed under the AMT system, the estate tax deduction is allowed in full because Code § 68 does not apply to the AMT calculations. Ironically, a taxpayer whose tax is determined under the AMT gets the full benefit of his estate tax deduction, whereas a taxpayer whose tax is determined by the regular income tax system is denied part of the deduction. Even under the AMT system, the fact that the estate tax deduction is not reflected in the taxpayer's AGI can cause the taxpayer to lose a portion of other deductions.[318] The estate tax deduction should be classified as a nonitemized deduction in order to implement the congressional goal of having the overall burden on IRD be the same regardless of when the IRD is recognized. It seems especially unlikely that Congress would wish that goal to be attained only when the recipient of the IRD is taxed under the AMT system.

One might question whether the fact that the estate tax deduction is not based on the item's connection to income production means that its inclusion in the nonitemized category would be inappropriate. While connection with income production is the central core of nonitemized deductions, that status has been granted in a number of cases in order to carry out some other tax policy. There is no reason not to use nonitemized classification as a tool to accomplish a legitimate tax policy objective.[319] There are numerous examples in Code § 62. For example,

317. *See* I.R.C. § 67(b)(7) (2000).

318. *See, e.g.*, *supra* note 41 and accompanying text (listing deductions that are phased out if the taxpayer's adjusted gross income or earned income exceeds a threshold amount).

319. *See* Turnier, *supra* note 304, at 286. Professor Turnier wrote,

> An ideal tax system should reflect the fundamental economic, social, and political values of the society. To insist that this not be done is to elevate those values implicit in an income tax system over all other fundamental economic, social, and political values. Consequently, adjustments to the tax base in the form of deductions or exclusions may be required where they

the Code grants nonitemized deduction classification to alimony, certain contributions to a medical savings account, the cost of a clean-fuel vehicle, and interest on a qualified education loan.[320]

*D. Investment Interest*

Investment interest is defined in Code § 163(d)(3) as deductible interest paid or accrued on indebtedness allocable to property held for investment. Investment interest is deductible only to the extent of the amount of the taxpayer's "net investment income,"[321] although a carryforward is allowed.[322] In effect, investment interest can offset only net investment income.

Unless investment property for which the loan was taken produces rents or royalties, any investment interest that is deductible must be itemized.[323] However, it is not a miscellaneous itemized deduction,[324] nor is it subject to the Code § 68 overall limitation.[325] Therefore, those two limitations do not apply.

Because investment interest is a cost of producing income, it should be fully deductible.[326] By characterizing it as an itemized deduction, a

> promote a society's fundamental values, even if such deductions constitute a departure from the goal of taxing an income.

Turnier, *supra* note 304, at 286. Although Professor Turnier was discussing whether a deduction or exclusion is valid, the same reasoning applies to the characterization and effectiveness of a deduction.

320. *See* I.R.C. § 62(a)(10), (14), (16), (17).

321. *Id.* § 163(d)(1). "Net investment income" is defined in Code § 163(d)(4).

322. *Id.* § 163(d)(2).

323. *Id.* § 62(a)(4).

324. *Id.* § 67(b)(1).

325. *See id.* § 68(c)(2).

326. Because investment interest is related to the cost of producing income, one might argue that Code § 163 is not necessary because interest would otherwise be covered by Code § 212. As one commentator has noted:

> At this juncture, one might ask why interest requires special rules. Is not interest a cost like any other? If so, why are the general rules applicable to cost deductions insufficient? The argument that costs should be deducted in the same tax period in which related income is included certainly applies to *all* costs, including interest.
>
> Interest requires special tax treatment for several reasons. The primary reason is the general fungibility of money. Taxpayers may incur interest expense to carry many different investments or assets. Some of the investments or assets may generate current income, others deferred income, and still others fully exempt income. The unique problem with interest is identifying the particular expenditure to which interest should be attributed. Only after the expenditure is identified can the proper treatment of the expense be determined.

Cheryl D. Block, *The Trouble with Interest: Reflections on Interest Deductions After the Tax Reform Act of 1986*, 40 U. FLA. L. REV. 689, 695 (1988) (emphasis in original).

taxpayer who uses the standard deduction cannot benefit from the deduction. Further, it does not reduce a taxpayer's AGI, which can cause a loss of portions of other deductions for which a percentage of AGI is a floor or which are subject to phase-out based on AGI.

While the amount of tax at stake in this issue is considerably less than the amounts at stake in most of the other items discussed in this Part, even a relatively small inequity should be corrected. The deduction for investment interest should be made nonitemized, but the restriction in Code § 163(d) preventing it from reducing any income other than net investment income can be retained. Given that restriction, it is especially desirable not to impose any additional limitations on the deduction.

### E. *Interest on an Indebtedness Allocable to an Employee's Trade or Business*

For no apparent reason, the Code denies any deduction for interest expenses incurred in connection with the trade or business of being an employee.[327] It is uncommon for an employee to borrow money for reasons connected with his trade or business, but it is possible. For example, an employee might borrow money to pay for courses that will maintain or improve his skills in his work.[328] A teacher might take out a loan to pay for courses that she is required to take in order to retain her job. An officer of a financially troubled corporation might be required to make a loan to the corporation or lose his job, and the officer might have to borrow the needed funds. Currently, there is no issue as to whether the interest paid on such loans is itemized because Code § 163(h)(2)(A) disallows any deduction for such interest.

Given that the current limitations on the deduction for employee business expenses are unwarranted,[329] the disallowance of any deduction for an employee's interest expenses is indefensible. If an independent contractor took out a loan for a business purpose, all of the interest would be fully deductible as a nonitemized deduction.[330] There is no apparent reason for treating an employee so inequitably. The legitimacy of the employee's claim that the loan is business related is always open

327. I.R.C. § 163(h)(1), (h)(2)(A).

328. While Code § 221 grants a deduction for interest paid on a "qualified education loan," many classes and programs do not qualify for that provision. In any event, the amount of the deduction is subject to a dollar ceiling, and there is a phase-out provision. *Id.* § 221(b).

329. *See supra* Part IV.B.

330. I.R.C. §§ 62(a)(1), 163(h)(2)(A).

to challenge. However, if the employee can demonstrate that there was a valid business purpose for borrowing the funds, the interest that he or she pays, at the very least, should be a deductible expense. Indeed, because it is directly connected with the production of income, it should be made a nonitemized deduction. A general classification of employee business expenses as nonitemized would solve that problem if Code § 163(h) were amended to permit a deduction.

## CONCLUSION

This Article sets forth several examples of areas where the Code creates grossly unfair and indefensible consequences for taxpayers. One example that has attracted a great deal of attention and commentary is the attorney's fee problem, especially when it involves a contingent fee. Because of that attention, Congress addressed the attorney's fee problem in the 2004 Act.[331] However, the provision that Congress adopted not only fails to solve comparable problems, it does not even solve the attorney's fee problem in cases not involving discrimination or otherwise covered in Code § 62(a)(19).

It was a mistake for Congress to address a broad structural problem by sticking a finger in the leaking hole—that is, adopting a solution that remedies only the specific factual circumstance that attracted attention. The root cause of the problems described in this Article is the erroneous characterization of expenses that are directly related to the production of income as itemized deductions. This error of characterization imposes a sizeable penalty on most individual taxpayers only because of the special limitations imposed on many itemized deductions, including the AMT's disallowance of any miscellaneous itemized deductions. Moreover, even if the special limitations on itemized deductions were repealed, the erroneous classification of an expense as an itemized deduction can impose severe hardship on a taxpayer who is in a lower tax bracket and utilizes the standard deduction.[332] Because it is likely that those or similar limitations on itemized deductions will remain operative, it becomes imperative to cure the underlying structural problem—the improper classification of itemized deductions.[333] It is only by doing so

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331. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546–48; *supra* note 302 and accompanying text.

332. *See supra* notes 311–15 and accompanying text.

333. Even if Congress were to repeal Code § 67, § 68, and the alternative minimum tax system, it should still study the current classification of deductions because an item wrongly listed affects a

that the current problems of this nature will be cured and future problems can be avoided.

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taxpayer's adjusted gross income, which is the measurement tool for many phase-out and limitation floors. *See, e.g.*, I.R.C. § 24(b) (stating phase-out for child tax credit is based on adjusted gross income); *id.* § 151(d)(3) (stating phase-out for personal exemptions is based on amount that taxpayer's adjusted gross income exceeds specified threshold).