Cleveland State University
EngagedScholarship@CSU

Law Faculty Articles and Essays
Faculty Scholarship

1-30-2006

# "Expense" Deductions on "Personal" Gross Income

Deborah A. Geier
*Cleveland State University*, d.geier@csuohio.edu

Follow this and additional works at: https://engagedscholarship.csuohio.edu/fac_articles

Part of the Tax Law Commons

How does access to this work benefit you? Let us know!

## Original Citation

Deborah A. Geier, "Expense" Deductions on "Personal" Gross Income, 110 Tax Notes 550 (2006)

This Article is brought to you for free and open access by the Faculty Scholarship at EngagedScholarship@CSU. It has been accepted for inclusion in Law Faculty Articles and Essays by an authorized administrator of EngagedScholarship@CSU. For more information, please contact research.services@law.csuohio.edu.

capital interest paid to the employee" and describes the proposed regulations as a "big change" from current law.

Not so. Gain or loss recognition is not the established law: As a theoretical matter, the law is unsettled. As a practical matter, the proposed regulations, if promulgated, will be perceived by the public as making no change in the law on this point.

John F. Prusiecki
Law Offices of John F. Prusiecki
Chicago
prusiecki@prusiecki.com
January 23, 2006

## 'Expense' Deductions on 'Personal' Gross Income

To the Editor:

Tom Daley (*Tax Notes*, Jan. 16, 2006, p. 291) asks what code section authorizes deduction of attorney fees in each of four cases where the plaintiff recovers $100,000 of includable damages in actions unconnected with business or investment activity. For example, he asks what code section authorizes deduction of the attorney fee if a plaintiff (let's call him Howard) successfully recovers $100,000 in a suit brought under the Fair Housing Act. Mr. Daley stipulates that Howard's attorney represents him under a contingent-fee arrangement and that the attorney receives $35,000 of the $100,000 gross award.

Although section 62(a)(19) and (e)(15) list attorney fees incurred in Fair Housing Act actions as taken "above the line" to the extent not in excess of the award, Daley is correct to note that a taxpayer must first find and satisfy a code section containing the magic words "there shall be allowed as a deduction" to be entitled to deduct an "expense" outlay. Only if the deduction is allowable under such a code section does the taxpayer then ask where, in the process of filing, is it mechanically taken: "above the line" (because it's listed in section 62) or as an itemized deduction (because it's not so listed). If the deduction is itemized, the further question must be asked whether it is a "miscellaneous itemized deduction" (because it's not listed in section 67(b)), which is reduced for regular tax purposes by the 2 percent floor and completely disallowed for AMT purposes.

The case raising that question for Mr. Daley was *Colvin v. Commissioner*,[1] in which the Fifth Circuit recently affirmed the Tax Court in denying a deduction of attorney fees in connection with an *unsuccessful* suit that Mr. Colvin brought against his homeowners association for fraud, suppression of facts, negligent misrepresentation, libel, slander, abuse of process, and civil rights abuses. That is to say, unlike in the hypothetical noted above, Mr. Colvin was awarded no cash. That fact is the key to understanding the issue that Mr. Daley raises.

At the risk of sounding terribly pedagogic (it's an occupational hazard of being a law professor), let me first digress with some fundamental theory. A tax on "income" is generally intended to reach personal consumption plus net wealth increases (or less net wealth decreases).[2] Therefore, outlays that do not reduce wealth, but rather merely change its form, should be nondeductible under an income tax, and that is the role of the "capitalization" principle. Moreover, even net wealth decreases ("expenses," which are the opposite of a "capital expenditure") should be nondeductible if incurred to purchase personal consumption.

It is a fundamental tenet of an income tax (which differentiates it from, say, an annual wealth tax) that the same dollars should not be taxed to the same taxpayer more than once.[3] One tool used to implement that value is "basis." Thus, when John purchases Blackacre for $20,000, he is denied a deduction for his outlay, as he has merely changed the form in which he is holding his wealth. Because of the nondeduction, the outlay remains in his tax base for the year and is thus taxed. To ensure that those dollars are never taxed to John again, he takes a "basis" in the property of $20,000, which he can recover tax-free when the property is sold for, say, $25,000. In that case, only $5,000 of the $25,000 cash receipt is "new wealth" that has not yet been taxed to John. His $20,000 basis is "old wealth" that has already been taxed to him by the denial of the deduction for the purchase outlay. That amount (equal to the purchase outlay) should not be taxed to John a second time.

Basis is not the only mechanism that ensures that the same dollars are not twice taxed to the same taxpayer. "Expense" deductions have the same role. That is to say, it is not always possible to link income-production outlays to particular identifiable gross income streams. It was easy to link John's outlay in purchasing Blackacre with the "amount realized" on its sale, and thus basis is aptly used as a direct offset to that particular cash stream. But outlays incurred in a business for salary, pencils, utilities, and so on, cannot be linked with any precision to any particular cash stream earned by the business. The outlays relate to *all* of the "gross" income earned by the business. Since every dollar of "gross" income is included, the outlays incurred to produce that stream (like John's basis in Blackacre) must reduce that gross income to ensure that the same dollars are not twice taxed to the same taxpayer. Thus, sections 162 and 212 also have as their role the prevention of doubly taxing the same dollars to the same taxpayer. The effect of denying deduction of an "expense" outlay that produces an

---

[1] *Doc 2005-3283, 2005 TNT 33-14* (5th Cir. 2005).

[2] *See* Joseph M. Dodge, J. Clifton Fleming Jr., and Deborah A. Geier, *Federal Income Tax: Doctrine, Structure, and Policy* (3d ed. 2004) at 37 [hereinafter *Federal Income Tax*].

[3] *See id.* at 47.

includable "gross" income stream is to twice tax the same dollars to the same taxpayer.

I am on record as agreeing with Prof. Charles Davenport, who argued (in *Tax Notes*[4] and in an amicus brief he filed with the Supreme Court in *Banks* and *Banaitis*) that the proper way to view attorney fees incurred by plaintiffs that produce an includable award is that the outlay creates "basis" in that future income stream and should be recovered free of tax as an offset against the award. We need not resort to the "expense" label because there is a direct and unequivocal link between the outlay and the award, just as with John's purchase price for Blackacre and the later sales proceeds when he disposed of it.

Nevertheless, the Supreme Court, while not expressly deciding that this theory was incorrect, declined to apply it in *Banks* and *Banaitis*, saying:

> These arguments, it appears, are being presented for the first time to this Court. We are especially reluctant to entertain novel propositions of law with broad implications for the tax system that were not advanced in earlier stages of the litigation and not examined by the Courts of Appeals. We decline comment on these supplementary theories.[5]

While it is possible that this "capitalization and basis" theory can be forwarded at the trial stage in future litigation and accepted as sound, I have my doubts (even though I continue to think it correct). The subsequent enactment of section 62(a)(19) may be interpreted as implying that Congress, too, categorizes these outlays as "expenses" rather than as capital expenditures that create basis in the award.

If we accept the categorization of the outlays as "expenses," then what code section authorizes their deduction? Mr. Daley asks, in particular, why the "origin of the claim" test applied most famously in *United States v. Gilmore*[6] does not bar deduction. In that case, Gilmore argued that the attorney fees incurred in his divorce action were deductible under section 212(2), which authorizes deduction of "expenses" incurred "for the management, conservation, or maintenance of property held for the production of income." He argued that, as the result of the litigation, he could lose ownership of property that his spouse claimed was community property. He also argued that his spouse's sensational claims of marital infidelity might cause General Motors to revoke his car dealership franchise contract, which was his sole means of support. (It was a simpler time.) Thus, the outlays were necessary to "conserve" those income-producing properties in the sense of "retaining ownership" of them.

The Court rejected his argument by noting that whether attorney fees could be deducted under that theory would turn on whether the plaintiff happened to own income-producing property that could be the subject of a lien to settle an award against him (deductible) or only personal-use property, such as a home (nondeductible). Rather, the Court stated that the origin of the litigation lay in Gilmore's personal life, not income-producing life, so that expense was a nondeductible personal expense rather than a deductible expense under section 212(2). Notice that Gilmore did not receive any cash award as a result of these fees. Thus, denying Gilmore his expense deduction did not double tax the same dollars to him.

A year later, Ruth Wild[7] sought to deduct the attorney fees that she incurred in negotiating an alimony stream, which would be includable in her gross income under section 71(a). The asserted authority for her deduction was section 212(1), which allows deduction of "expenses" incurred "for the production or collection of income." The government argued that the origin of the outlay was in Wild's divorce — a personal transaction — and that *Gilmore* therefore rendered the fee nondeductible. The Tax Court disagreed with the government and allowed the deduction.

The Tax Court sought to distinguish *Gilmore* by arguing, essentially, that *Gilmore* was a section 212(2) case and this was a section 212(1) case. That's nonsense. The "origin of the claim" test applies not only to all of section 212 but also to section 162.[8] But the Tax Court was nevertheless correct in allowing the deduction. If it did not allow the expenses incurred to produce the includable alimony income to reduce that income, Wild would have been twice taxed on the same dollars to the extent of the denied deduction (first by including the "gross" alimony stream and second by denying deduction of the "expense" outlay incurred to produce it, which means the outlay remained in her tax base and thus was taxed).

But what code section provides the authority for the deduction? Most includable gross income stems from business or investment activity. But there is some gross income that does not. Alimony is one example. The more common example is the "hobby" that produces gross income for the hobbyist, even though he is not actually trying to make a "profit" (and, indeed, may know with certainty that he never will make a profit) but rather is engaging in the activity for personal pleasure and recreation. In other words, most "expenses" spent in pursuit of personal consumption produce no gross income: going to the movies or a concert, buying and eating food, and so on. But some personal consumption activities do produce includable gross income.

Before 1969, the common law denied deductions under section 212 if the "primary purpose" of an activity was recreation or pleasure rather than profit.[9] That inquiry smacks of the "origin of the claim" test in *Gilmore*. Both seem to ask whether the outlays at issue

---

[4]Charles Davenport, "Why Tort Legal Fees Are Not Deductible," *Tax Notes*, Nov. 4, 2002, p. 73; Deborah A. Geier, "Attorney's Fees: Davenport Has the Right Idea," *Tax Notes*, Dec. 23, 2002, p. 1627.

[5]*Commissioner v. Banks*, 2005 U.S. LEXIS 1370, 21-22, *Doc 2005-1418, 2005 TNT 15-10* (2005).

[6]372 U.S. 39 (1963).

[7]*Wild v. Comm'r*, 42 T.C. 706 (1964).

[8]*See, e.g., Harden v. Comm'r*, T.C. Memo. 1991-454; *McDonald v. Comm'r*, 592 F.2d 635 (2d Cir. 1978); *Peckham v. Comm'r*, 327 F.2d 855 (4th Cir. 1964).

[9]*See, e.g, Wrightsman v. U.S.*, 428 F.2d 1316 (Ct. Cl. 1970).

have their origin in some profit-seeking activity or property, on one hand, or in personal consumption, on the other. Failure to satisfy the "primary purpose" test meant that any gross income that happened to be earned in a hobby was doubly taxed to the extent of the denied expense deductions. "Personal" gross income was thus treated worse than "business or investment" gross income.

There may, in fact, be legitimate tax policy reasons to treat "hobby" gross income worse than true business or investment gross income. Optimal tax theory, for example, posits that it is economically efficient to raise revenue through taxing "inelastic" items or activities, that is, items or activities that have no ready substitute to which taxpayers may turn in response to the tax.[10] If Mary engages in her hobby whether or not she gets to deduct her expenses (because she truly enjoys it), it may be defendable to tax that activity more heavily than true profit-seeking activities, which would soon be abandoned if we twice taxed the same dollars to the business owner.

Nevertheless, perhaps because the norm that the same dollars should not be twice taxed to the same taxpayer is so strong, Congress enacted section 183 in 1969 chiefly to allow deduction of expenses, losses, and depreciation incurred in producing "personal" gross income. The authority for the deduction is found in section 183(b), which contains the magic words, "there shall be allowed a deduction." But section 183(b) allows deduction only to the extent of the gross income earned from the "personal" activity. In that way, the statute avoids doubly taxing the same dollars to the same taxpayer. The "excess" deductions are disallowed as "personal consumption" expenses. We need not allow deduction of the excess to implement the maxim that the same dollars should not be twice taxed to the same taxpayer. If the activity is not entered into for profit, those "excess" expenses, depreciation, and so on purchase pure personal consumption.

So what about poor Howard described at the beginning of this letter? Remember that he sued under the Fair Housing Act, received $100,000 in includable damages, and paid $35,000 to his attorney (presumably in the same tax year, as it was a contingent fee). While I know of no opinion citing it, section 183(b), at the very least, should provide authority for his attorney fee deduction, as it allows deductions pertaining even to purely "personal" gross income, up to that gross income. Because his expense is less than his gross recovery, he need not worry that section 183(b) caps his deduction to the amount of gross income collected. Having found his authority for the deduction, Howard turns to section 62(a)(19), which then allows him to deduct that amount "above the line."

More difficult, perhaps, are Wild's expenses. The $6,000 outlay that Wild incurred to negotiate her alimony stream was paid in the same year (1960) in which she received nearly $10,000 in alimony. Thus, section 183(b) could have worked for her, too, if it had been in existence, but it was not to be enacted for nearly a decade after the tax year at issue in *Wild*. More important, what if her fee is paid in Year 1 and her alimony is not collected until Year 2 or later? Or what if it is never collected because of a recalcitrant spouse? If section 183(b) is the controlling authority today, it contains no carryover of "unused" deductions. Her only hope would be that section 212(1) could apply, notwithstanding *Gilmore*.

Unlike Gilmore, who sought no monetary award, Wild might plausibly argue that her fee was incurred in an activity engaged in for profit, that is, that the "origin of her claim" is to make a profit from her alimony arrangement if she realistically anticipates that her fee will be less than her expected alimony, which should be the case in most instances. No expense deduction was required to avoid twice taxing Gilmore on the same dollars. Deduction *is* required if we are to avoid taxing Wild twice on the same dollars (assuming she actually collects the alimony).

So it is appropriate at this point to come full circle and argue, once again, that the correct outcome, in my view, is that Wild's outlay shouldn't be considered an "expense" at all, but rather a "capital expenditure" that creates basis in her anticipated alimony stream. Her outlay in negotiating the future alimony is clearly and unequivocally linked to that particular future gross income stream. The outlay should not be allowed to offset income from other sources, such as her wages, by calling it an "expense." As the alimony is received, her basis should be used to offset it until the basis is exhausted.[11]

Contrast this with Colvin, who sued and *lost*. He received no gross income from the suit. He nevertheless sought to deduct his attorney fees, and the Tax Court and Fifth Circuit denied his deduction. Denying Colvin a deduction would not double tax him on the same dollars, as he received no includable award. A deduction would simply shelter income from other sources, such as his wages. If section 183(b) governs his deduction, he would be prevented from deducting his outlay simply because it produced no gross income.

If, instead, his outlay properly produces basis for use as an offset against an income stream, no income stream was forthcoming. Should he be able to deduct his unusable basis as a "loss" under section 165(c)? A "loss" deduction under section 165 is necessarily a deduction of basis, as a "loss" is defined in section 1001 as the excess of basis over amount realized. As his amount realized was zero, his entire basis might be the subject of a loss deduction, but only if the loss were incurred in a "transaction entered into for profit" under section 165(c)(2). Was it? That might turn on whether there was really any chance for him to win. Even a "small chance of making a large profit"[12] is enough under section 183. Should that inform analysis under section 165(c)(2)? Was it a "sure loser" that he engaged in because of dogged spite against the neighbors with whom he was feuding? Or did he

[10]*See Federal Income Tax, supra* note 2, at 130.

[11]For the sake of simplicity, I would not require her to depreciate her basis against the alimony over some set schedule. Rather, let her simply use it as soon as possible against the alimony stream, as received.

[12]*See* Treas. reg. section 1.183-2(a).

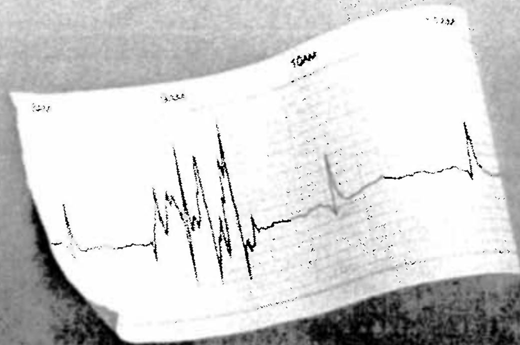
have a legitimate grievance that might have won on another day before another judge or jury?

Food for thought. . . .

Best wishes,

Deborah A. Geier
Leon M. & Gloria Plevin Professor of Law
Cleveland-Marshall College of Law
Cleveland State University
Visiting Professor of Law
Washington University, St. Louis
January 19, 2006

**Guess what time Tax Notes® arrives at the IRS.**



It's a bit scary. You see, *Tax Notes* isn't famous for making nice. It bites and scratches, and sometimes just laughs out loud at judicial, administrative, and legislative developments in the tax law. As for news, it's all there – after all, we're the only publisher focused exclusively on tax policy. Why are we so nuts about tax law? Because our mission is to help the government tax its citizens fairly, simply, and efficiently. For more information and a free trial, visit **taxanalysts.com** or call **800-955-3444.**

TAX NOTES TODAY®

STATE TAX TODAY®

WORLDWIDE TAX DAILY®

RESPECTFULLY DISAGREEABLE SINCE 1970.

analysts®