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DETERMINING DEDUCTIONS DESERVES DEDUCTIBILITY

MALCOLM L. MORRIS*

I. INTRODUCTION

Paying tribute was the insult added to the injury of being conquered. The costs associated with meeting one's federal tax obligation are a similar affront. Although not double taxation *per se*, compliance costs constitute a surcharge on the tax obligation itself. Recent tax "reform" or "simplification" and other measures¹ have only compounded this unpleasantness by adding to the already burdensome tax-filing and record-keeping requirements.² Consequently, the costs attributable to complying with the tax law are escalating.

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1. Within the last 12 years, taxpayers have been subjected to three major pieces of tax legislation: the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, 95 Stat. 172 (1982); the Tax Equity & Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324 (1984); and the Tax Reform Act of 1986 (TRA '86), Pub. L. No. 99-514, 100 Stat. 2085 (1987). There have also been a number of other pieces of tax legislation, such as the Tax Reform Act of 1984 (TRA '84), Pub. L. No. 98-369, 98 Stat. 494 (1986); the Competitive Equity Banking Act of 1987 (COBRA), Pub. L. No. 100-86, 101 Stat. 552 (1989); and the Omnibus Budget Reconciliation Act of 1990 (OBRA), Pub. L. No. 101-508, 104 Stat. 1388 (1991). In addition, occasionally a provision of the Internal Revenue Code ("the Code") is either added, amended, or deleted by some other Congressional action. *See, e.g.*, The Family Support Act of 1988, Pub. L. No. 100-485, § 702, 102 Stat. 2343 (1989) (adding I.R.C. § 62(c) to the Code). (Sections in Title 26 of the United States Code will hereinafter be referred to as I.R.C. § x).

2. *See, e.g.*, Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, § 723, 95 Stat. 324 (1982) (changing information return requirements); Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, §§ 301, 303, 96 Stat. 324 (1984) (amending rules governing requirements for withholding on and reporting of interest and dividend income, and Title III, subtitle B, Parts 1 and 2, containing 11 provisions effecting, expanding, and improving income reporting); Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 976, § 141 (adding new I.R.C. §§ 6707, 6111, requiring tax shelter registration); § 145 (requiring additional reporting with respect to interest payments received); and § 155 (requiring additional substantiation for charitable contributions). The Tax Reform Act of 1986 (TRA '86), Pub. L. No. 99-514, 100 Stat. 2085 (1987), made significant substantive changes to the Code, necessitating numerous concomitant compliance changes. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, §§ 1011(b)(1)(4), 1006(h)(3)(A), 1015(e)(1)(A), 4005(g)(3), 102 Stat. 3342 (1989), affected filing requirements with respect to information returns required for nondeductible IRA contributions, business purchase price allocations, reporting by brokers, and reporting with respect to a variety of real estate transactions. Moreover, the Internal Revenue Service continues to add to its already impressive list of forms, making filing more onerous even where legislation has not changed. For example, see I.R.S. Form 8855, instituted in 1991, which all taxpayers claiming a business use of their home must file.

Perhaps some solace can be had when these compliance expenses are deductible.³ Then, at least, their impact is partially neutralized, as the deduction reduces the overall tax liability. However, even this minor satisfaction has now been eliminated for many taxpayers. Though still deductible, in most instances tax compliance expenses must pass through a newly installed additional "accounting" in order to provide any tax benefits.⁴ A limited number of taxpayers can avoid this obstacle by characterizing the charges as a different type of deductible expense,⁵ but if the cost is incurred to fulfill one's tax obligation, what policy goals permit the deduction in some instances but not others? Why should only selected individuals benefit from a deduction for an expense common to all taxpayers?

The current tax structure produces unfair and uneven results. Change is warranted in the treatment of compliance costs, although whether it makes sense to treat all tax compliance costs similarly is questionable. Analyzing the development of the present rules should provide some insight into how to improve the situation.

II. HISTORICAL HIGHPOINTS

Originally, there was no direct authority allowing a deduction for personal income tax compliance costs.⁶ Early attempts to deduct such charges were unsuccessful,⁷ consistent with the general tenet that deduction sections existed by "legislative grace" and were to be con-

3. I.R.C. § 212(3) (1993) permits a deduction for expenses incurred in the determination of tax liabilities. See *infra* notes 55-103 and accompanying text for an in-depth discussion of this provision.

4. Tax compliance costs are usually classified as "miscellaneous itemized deductions" under Section 67, and as such are not deductible in many situations. See *infra* notes 112-123 and accompanying text; see also I.R.C. § 67(a)-(b)(2) (1993).

5. Taxpayers pursuing a trade or business or engaged in certain income-producing activities are allowed a deduction for tax compliance cost expenses related to the business or activity. See the discussion of Code sections 162(a) and 212, *infra* notes 124-149 and accompanying text.

6. The Revenue Act of 1916, Pub. L. No. 64-271, 39 Stat. 756, 759 (1916) was the original federal income tax legislation. Section 5(a) of that act declared all personal expenses nondeductible. The only deductions specifically allowed were those for business expenses, interest, taxes, losses, expenses for transactions entered into for profit but not related to a trade or business, worthless debts, depreciation arising out of use in business, and certain expenses dealing with oil and gas wells. See *id.* § 5(b).

7. See, e.g., *Appeal of Charles Henry Matlage*, 3 B.T.A. 242 (1925) (disallowed deduction for charge incurred in connection with preparation of individual income tax return); *Hermann v. Commissioner*, 20 B.T.A. 899 (1930) (fee paid to resist a proposed income tax deficiency not deductible because it was a personal expense; filing an income tax return did not constitute carrying on a trade or business); *Keeler v. Commissioner*, 23 B.T.A. 467 (1931) (fees for services in connection with taxpayer's personal income tax liability not deductible even though income was received from taxpayer's trade or business).

strued strictly.⁸ An expense was not deductible unless specifically designated as such. Indeed, from their inception the tax statutes have provided that all expenses not specifically enumerated in the deduction sections are to be deemed personal payments and thus nondeductible.⁹

Despite the absence of specific authority for the deduction, some taxpayers sought relief by asserting that the tax compliance costs were incurred in their businesses and claimed them as trade or business expenses. The courts were hospitable to this approach,¹⁰ but only if the expense could be related to the pursuit of a trade or business.¹¹ The benefit was extended to taxpayers who were able to argue successfully that active involvement in their own personal investment activities constituted a trade or business.¹² However, this investors' tax advantage was relatively short-lived. In *Higgins v. Commissioner*,¹³ the United States Supreme Court held that managing one's own investment activities, no matter how extensive, did not constitute the carrying on of a trade or business. Thus, *Higgins* made all expenses related to such activities personal and nondeductible, effectively blocking the way for deducting tax compliance costs related to them.¹⁴

8. Notable declarations of the proposition that deductions are a matter of legislative grace can be found in *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934), superseded by statute (see *In re Luster*, 134 B.R. 632 (Bankr. N.D. Ill. 1991), *rev'd*, 138 B.R. 875 (N.D. Ill. 1992)); *Davis v. United States*, 87 F.2d 323 (2d Cir.), *cert. denied*, 301 U.S. 704 (1937); *Van Vleck v. Commissioner*, 80 F.2d 217 (2d Cir. 1935), *cert. denied*, 298 U.S. 656 (1936); *Gillette v. Commissioner*, 76 F.2d 6 (2d Cir. 1935).

9. Revenue Act of 1916, Pub. L. No. 64-271, § 2a, 39 Stat. 756, 757 (1916); Internal Revenue Code of 1939, § 524, 53 Stat. 1, 16 (1939).

10. See, e.g., *Forgeus v. Commissioner*, 6 B.T.A. 291 (1927) (attorney's charge for preparing income tax return deductible as an ordinary and necessary business expense where taxpayer was engaged in a trade or business).

11. See *Gillette*, 29 B.T.A. at 564 (attorneys' fees to secure refund of state inheritance tax not deductible because cost not connected to the taxpayer's trade or business); *Bibbs v. Commissioner*, 34 B.T.A. 1028 (1936) (attorney's fee paid defending against deficiency assessment not deductible; taxpayer can be in a trade or business and still have expenses that do not arise out of that enterprise); see also *Kornhauser v. United States*, 276 U.S. 145 (1928) (controlling rule at that time concerning nexus between the expense and the trade or business needed to permit a deduction).

12. See *Roebling v. Commissioner*, 37 B.T.A. 82 (1938) (taxpayer's management of her investments sufficiently "active" to constitute a trade or business; related tax compliance costs deductible); *O'Neal v. United States*, 32 F. Supp. 799 (M.D. Ga. 1940) (attorneys' fees including tax return preparation charge deductible because taxpayer's management conservation and estate-enhancing activities constituted a trade or business). For instances where the activities were considered merely passive, and thus not sufficient to constitute a trade or business, resulting in no deduction for tax compliance cost expenses, see *Kales v. Commissioner*, 34 B.T.A. 1046 (1936), *aff'd*, 101 F.2d 35 (6th Cir. 1939) and *Heilbronner v. Commissioner*, 34 B.T.A. 1200 (1936), *aff'd*, 100 F.2d 382 (2d Cir. 1938).

13. 312 U.S. 212, 217 (1941).

14. See also *Campbell v. Walker*, 208 F.2d 457 (5th Cir. 1953) (loss incurred in handling

A. Early Attempts at Deducting Compliance Costs: The Operation of Section 23(a)(2)

In response to *Higgins*,¹⁵ Congress enacted section 23(a)(2) of the Internal Revenue Code ("the Code"),¹⁶ the predecessor of the present sections 212(1) and (2).¹⁷ The section permitted individuals to take tax deductions for expenses incurred in the production or collection of income when the activity could not qualify as a trade or business, as well as for costs relating to the management, conservation, or maintenance of property used in such an activity. The section did not specifically address tax compliance costs, but the regulations promulgated for it did. These regulations made tax compliance costs deductible if they were attributable to recovering either interest or a tax that could itself be included as income, or if they constituted tax expenses related to property held for the production of income.¹⁸ The regulations also made clear that except for the noted items, costs for tax return preparation, other tax recoveries, and resisting deficiencies were not deductible.¹⁹ Notwithstanding these, albeit limited, deduction opportunities, for the most part the courts refused to allow deductions for income tax compliance costs.²⁰

The situation took a dramatic turn when, in deciding *Trust of Bingham v. Commissioner*,²¹ the Supreme Court nullified a substantial portion of the regulations. The issue in *Bingham* was whether attorneys' fees incurred by a trust in contesting an assessed income tax deficiency were deductible.²² The Government argued that the charges the trustees paid were not related to the production of income, and as such they were not deductible under section 23(a)(2).²³ The Court responded that the Government was reading the section too narrowly. It stated that the provision did not "restrict deductions to those litiga-

personal investments not deductible); *Beck v. Commissioner*, 179 F.2d 688 (7th Cir. 1950) (loss suffered by taxpayers in sale of real estate not deductible).

15. See H. R. REP. No. 2333, 77th Cong., 2d Sess. 74-76 (1942); S. REP. No. 1631, 77th Cong., 2d Sess. 87-88 (1942).

16. Revenue Act of 1938, Pub. L. No. 1, §23(a) (1939) (as amended by the Revenue Act of 1942, Pub. L. No. 753, §§ 121(a)(2), (3), 56 Stat. 798, ch. 619 (1943)).

17. I.R.C. §§ 212(1), (2) (1954).

18. Treas. Reg. § 29.23(a)-15 (prior to 1946 amendment).

19. *Id.*

20. See, e.g., *Higgins v. Commissioner*, 143 F.2d 654 (5th Cir. 1944); *Stoddard v. Commissioner*, 141 F.2d 76 (2d Cir. 1943); *Hord v. Commissioner*, 143 F.2d 73 (6th Cir. 1944) (noted that there might be instances where "attorneys' fees expended in income tax litigation" would be deductible, but failed to provide any further guidance); *Willmott v. Commissioner*, 2 T.C. 321 (1943).

21. 325 U.S. 365 (1945).

22. *Id.*

23. *Id.* at 369.

tion expenses which alone produce income.’²⁴ Rather, the section was intended to allow a deduction for litigation expenses directly connected to, or the proximate result of, managing income-producing property.²⁵ The Court criticized the Government’s regulations for failing to give ample recognition to the part of the statute that authorized deductions for the management and conservation of property held for the production of income, stating that it conflicted with the “meaning and purpose of section 23(a)(2), and so is unauthorized.”²⁶

In response to *Bingham*, the Government revised its regulations by issuing a blanket statement that expenses incurred in determining one’s income tax liability would be deductible.²⁷ The amended regulations also permitted a deduction for any expense incurred in determining a property tax assessable on income-producing property.²⁸ Although the changes probably went beyond what *Bingham* would have required,²⁹ the Government did put a significant restriction on the applicability of section 23(a)(2). Specifically, expenses incurred in contesting a liability (including a tax liability) would not be deductible merely because income-producing property might have to be sold in order to satisfy the liability.³⁰ The meaning of “managing or conserving” property did not include protecting income-producing property from attachment for claims unrelated to the property itself. The regulation used gift taxes illustratively, noting that costs incident to contesting such taxes would not be deductible, even though income-producing property would have to be sold to satisfy the tax.³¹

The lower courts reacted quickly to *Bingham*, handing taxpayers a number of victories.³² One of these, the Tax Court’s decision in *Bagley v. Commissioner*,³³ is particularly noteworthy. In *Bagley*, the taxpayer claimed deductions under section 23(a)(2) for attorneys’ fees for investment counseling and estate planning. The court had no diffi-

24. *Id.* at 376.

25. *Id.*

26. *Trust of Bingham v. Commissioner*, 325 U.S. 365, 377 (1945).

27. T.D. 5513, 1946-1 C.B. 61.

28. *Id.* at 62.

29. See Michael B. Lang, *The Scope of Deductions Under Section 212*, 7 REV. TAX’N INDIVIDUALS 291, 326 n.165 (1983) (citing Samuel Brodsky & David McKibbin, *Deduction of Non-trade or Non-Business Expenses*, 2 TAX. L. REV. 39, 50 (1946)).

30. Treas. Reg. § 29.23(a)-15 (as amended in 1946).

31. *Id.* The regulation did, however, allow a deduction for costs incurred that were allocable to the interest charged on tax deficiencies.

32. See, e.g., *Lykes v. United States*, 84 F. Supp. 537 (S.D. Fla. 1949), *rev’d*, 188 F.2d 964 (5th Cir. 1951); *Sergievsky v. McNamara*, 135 F. Supp. 233 (S.D.N.Y. 1955); *Kohnstamm v. Pedrick*, 66 F. Supp. 410 (S.D.N.Y. 1946).

33. 8 T.C. 130 (1947).

culty concluding that the investment advice charges were deductible.³⁴ However, the estate planning fees created a more complex problem. The court distinguished a \$5,000 fee charged for analyzing and developing various plans affecting income-producing properties from a \$4,000 fee assessed for advising the taxpayer regarding releasing a power of appointment and funding a trust for her daughter.³⁵ The court likened the former to investment counseling costs, stating that the new plan "effected a substantial rearrangement and reinvestment of [the taxpayer's] entire estate of income-producing properties."³⁶ Since investment counsel fees are deductible, so too then must "surrogate" investment counsel charges be deductible.³⁷

However, the court disallowed the entire deduction claimed for the \$4,000 charge; it could not see how advice as to which assets should be used to fund a trust could be directly related to the management, conservation, or preservation of income-producing property, regardless of whether or not income-producing assets themselves were the properties transferred.³⁸ Similarly, although releasing a power of appointment might result in some future savings on estate taxes, the court did not find a nexus between the expense and the conservation of income-producing property sufficient to satisfy the *Bingham* test.³⁹ Thus, the transfer of property in order to reduce income and concomitant taxes does not, in and of itself, constitute management, conservation, or maintenance of income-producing property such as would make the planning costs associated with the transfer deductible.

The Sixth Circuit Court of Appeals in *Cobb v. Commissioner*⁴⁰ reached a similar result, holding that attorneys' fees incurred to defend against a gift tax deficiency were not deductible. The court stated that there was no statutory authority for allowing the deduction of expenses incurred in relation to gift tax issues.⁴¹ In *Cobb*, as in *Bagley*, there was a voluntary transfer of income-producing property that was not directly related to its management, conservation, or maintenance. Though sympathetic to the taxpayer's position, the court determined

34. *Id.* at 134.

35. *Id.* at 135.

36. *Id.*

37. *Id.* Interestingly, the court noted in its findings of fact that part of the \$5,000 was charged for establishing a revocable trust and giving advice with respect to canceling old and acquiring new life insurance. The opinion, however, is noticeably silent on how these activities were "directly connected with the management and conservation of . . . income-producing properties," the basic test for determining deductibility. *Id.* at 133.

38. *Bagley v. Commissioner*, 8 T.C. 130, 135 (1947).

39. *Id.* at 136.

40. 173 F.2d 711 (6th Cir.), *cert. denied*, 338 U.S. 832 (1949).

41. *Id.* at 713.

that the proximity between the expense and the statutory deduction categories was insufficient to satisfy the *Bingham* test.⁴² Further, the court felt constrained by the treasury regulations, especially since the regulations specifically denied deductibility for gift tax-related costs.⁴³

The Supreme Court in *Lykes v. United States*⁴⁴ supported *in toto* both *Cobb* and the treasury regulations it relied upon. In *Lykes*, the Court refused to allow a deduction for attorneys' fees incurred in contesting a gift tax deficiency, primarily because the costs were not proximately related to the production of income.⁴⁵ The Court held that "[l]egal expenses do not become deductible merely because they are paid[-]for services which relieve a taxpayer of liability."⁴⁶ Although the fees were paid before the regulations were revised to specifically deny deductibility of gift tax compliance costs, the Court nonetheless cited with approval the regulations that had since been adopted.⁴⁷

*Selig v. Allen*⁴⁸ put an interesting spin on this issue. There, a widow was faced with a potential estate tax liability on her share of income-producing property that was improperly titled in her deceased husband's name alone.⁴⁹ In order to ensure that her rightful share of the assets was not subjected to her deceased husband's estate tax accounting, the widow incurred attorneys' fees to have her share titled in her name alone.⁵⁰ The court determined that the fees were deductible expenses incurred to conserve income-producing property, since failure to take the retitling action would have resulted in a loss of income-producing property owned by the taxpayer.⁵¹ The Government's chief contention was that the costs were capital expenditures, not deductible expenses, but the court had little difficulty putting that argument to rest.⁵² Of particular interest is that the court focused on the facts that gave rise to the retitling action, concluding it was "conservatory in its nature,"⁵³ thus rendering moot the point that taxes were the threatening risk.⁵⁴

42. *Id.* at 714.

43. *Id.* at 715; Treas. Reg. § 29.23(a)-15 (as amended in 1946).

44. 343 U.S. 118 (1952), superseded by statute (*see* *Accardo v. Commissioner*, 942 F.2d 444 (1991), *cert. denied*, 60 U.S.L.W. 3598 (1992)).

45. 343 U.S. at 124.

46. *Id.* at 125.

47. *Id.* at 126.

48. 104 F. Supp. 390 (M.D. Ga.), *aff'd*, 200 F.2d 487 (5th Cir. 1952).

49. *Id.*

50. *Id.*

51. *Id.* at 392.

52. *Id.*

53. *Allen v. Selig*, 200 F.2d 487, 488 (5th Cir. 1952).

54. The circuit court noted that *Lykes* has never been read to preclude a section 23(a) de-

B. Section 212(3): Congress' Answer to Inequitable Treatment of Compliance Costs

Congress acted to remedy the disparate treatment accorded compliance costs for different taxes with the introduction of section 212(3) of the Code.⁵⁵ The section simply allows individuals to take a deduction for "all the ordinary and necessary expenses paid . . . in connection with the determination, collection, or refund of any tax."⁵⁶ The regulations promulgated for section 212(3) seemed to favor a liberal interpretation of the new provision.⁵⁷ Expenses are deductible when incurred for 1) tax counsel, 2) in connection with the preparation of tax returns, or 3) in connection with any proceeding involved in determining the extent of or contesting a tax liability.

Despite its simplicity, the provision was not uncontroversial. The first case to test the section's application resulted in a taxpayer victory. In *Bonnyman v. United States*,⁵⁸ the court allowed a deduction for legal expenses incurred by a donee as a result of a gift tax deficiency assessment. Looking to the "broad language" of the new section, the treasury regulations, and the Senate Finance Committee Report, the court concluded that the expenses at issue clearly were of a type contemplated by the Code draftsmen.⁵⁹

The next major test came in *Davis v. United States*,⁶⁰ where the Government would not allow a deduction for legal fees incurred for tax advice incident to the negotiation of a marital separation agreement. The Government argued that because there was no "contest" of a tax liability in issue, a deduction was unwarranted.⁶¹ This time it was the Court of Claims, relying on the treasury regulations, that had no difficulty finding the fees deductible as tax-related charges. The court required only that there be an accounting for the costs attributa-

duction merely because the expense incurred would result in relief from a tax liability, *id.* at 489, and that *Lykes* was not applicable to these facts, because here the expense was incurred to have mistitled property retitled, rather than to defend against a tax. *See id.* at 488-89.

55. Internal Revenue Act of 1954, Pub. L. No. 83-591, § 212(3), 68A Stat. 69 (1954).

56. *Id.*

57. Treas. Reg. § 1.212-1(l) (1993).

58. 156 F. Supp. 625 (E.D. Tenn. 1957), *aff'd*, 261 F.2d 835 (6th Cir. 1958).

59. The question of who was actually obligated to pay the deficiency, if any, was also an issue in the case. *Id.* Donors were primarily liable for the gift tax. I.R.C. § 1009 (1939). Donees were secondarily liable under "transferee liability" rules of I.R.C. § 1012 (1939). The court viewed the latter principles as making the donee a proper party to the "contest". *See* 156 F. Supp. 625 at 627-29.

60. 287 F.2d 168 (Ct. Cl. 1961), *aff'd in part, rev'd in part*, 370 U.S. 65 (1962).

61. *Id.*

ble to the tax planning, separate from the billing for other legal services.⁶²

Not deterred, the Government pressed its "necessity of a contest" point in *Kaufmann v. United States*.⁶³ There, the taxpayers incurred accountants' fees for 1) securing a ruling from the I.R.S. on whether a transaction would qualify for "tax free" treatment and 2) determining the basis of the stock received in a reorganization. Relying on the wording of its regulations, the Government argued that a deduction was not warranted because the accountants' activities did not constitute a "contest" of tax liability or a "determination of the extent of" a tax liability.⁶⁴ The Government buttressed its argument by citing the legislative history of section 212(3), claiming that Congress' use of the words "contest" and "contesting" was intended to preclude a deduction for "expenses incident to a determination of tax liability prior to the period when it becomes contested."⁶⁵ In other words, notwithstanding its setback in *Davis*, the Government again seemed to be staking out the position that tax counsel fees, other than those related to an existing tax controversy, were not deductible.

The court made short shrift of the Government's arguments relating to the fees for obtaining the ruling. In the court's view, the ruling helped determine the question of the parties' tax liability⁶⁶ and was obtained solely for the purpose of "comput[ing] . . . the tax liability, if any, which would arise from the exchange."⁶⁷ According to the court, the expense clearly fell within the ambit of the section and was deductible.⁶⁸

The court, however, sided with the Government regarding the fees for determining basis. It concluded that there was no tax controversy at issue to warrant a deduction.⁶⁹ The court deemed the basis of the stock to be informational only, and not sufficiently connected to the determination of a tax.⁷⁰

One must question what purpose basis serves, other than to compute a tax. "Basis" is by definition a tax term, and although based on

62. *Id.* at 170-71. In Revenue Ruling 72-545, 1972-2 C.B. 179, the government liberally identifies those situations in which legal fees incident to a divorce qualify as deductible tax counsel fees.

63. 227 F. Supp. 807 (W.D. Mo. 1963), *appeal dismissed*, 328 F.2d 619 (8th Cir. 1964).

64. *Id.* at 813 (emphasis omitted).

65. *Id.*

66. *Id.* at 814.

67. *Id.* at 815.

68. *Kaufmann v. United States*, 227 F. Supp. 807, 815 (W.D. Mo. 1963), *appeal dismissed*, 328 F.2d 619 (8th Cir. 1964).

69. *Id.*

70. *Id.*

cost, it is something quite different than a yardstick of one's actual initial economic investment.⁷¹ For example, the adjusted basis of property used for computing gain or loss⁷² can be affected by non-investment events such as depreciation⁷³ and certain other business transactions.⁷⁴ It is difficult to envision basis serving any purpose other than assisting in planning for or determining a tax. Purchasers of property will negotiate price based on fair market value, not basis. Thus, the rationale used by the court leaves something to be desired.

Nonetheless, the *Kaufmann* result seems justifiable. Section 212(3) could not be reasonably interpreted to permit deductions for costs only remotely related to determining a tax; otherwise, any property appraisal could become deductible on the theory that it was necessary to assist the taxpayer in deciding what the tax consequences would be should the property be donated to charity.⁷⁵ The appraisal cost of property already contributed to charity is deductible,⁷⁶ but to extend the benefit to all appraisals on the theory that any asset could some day be donated goes too far. The "remoteness" issue is one that warrants further analysis.

A large piece of the "remoteness" puzzle concerns whether or not an existing tax issue, as opposed to a potential future one, is being addressed. Presumably, if the stock in *Kaufmann* had already been sold, the cost of determining its basis would have been deductible. The Government seemed to be pushing for an interpretation of section 212(3) that would limit the scope of deducting tax planning expenses to those pertaining to the current tax year only. In the Government's view, planning for future tax years did not fit into the definitions of "contesting" or "determining" a tax. However, the Government also lost in its attempt to limit section 212(3) to tax advice relating to the year for which the deduction was claimed.

In *Carpenter v. United States*,⁷⁷ the taxpayer sought to deduct tax counsel fees incurred in structuring alimony payments incident to his divorce proceeding. In a *Davis*⁷⁸-revisited opinion, the Court of Claims affirmed its view that section 212(3) was not limited to tax

71. See I.R.C. § 1012 (1993).

72. See *id.* § 1011(a).

73. See *id.* § 1016.

74. See, e.g., *id.* § 301(c)(2) (requiring basis to be reduced by corporate distributions not covered by earnings and profits); *id.* §§ 312, 316.

75. See generally *id.* § 170. For a full discussion of charitable deductions, see 8 MERTENS LAW OF FEDERAL INCOME TAX §§ 31.01-31.141 (1991 & Supp. 1993).

76. Rev. Rul. 67-461, 1967-2 C.B. 125.

77. 338 F.2d 366 (Ct. Cl. 1964).

78. *Davis v. United States*, 287 F.2d 168 (Ct. Cl. 1961), *aff'd in part, rev'd in part*, 370 U.S. 65 (1962).

counsel costs incurred incident to actual controversies.⁷⁹ It noted that even though *Davis* had since been reviewed by the Supreme Court,⁸⁰ the tax counsel fee issue had not been addressed specifically. Additionally, the court observed that in *United States v. Gilmore*,⁸¹ the Supreme Court distinguished sections 212(2) and 212(3) of the Code from one another, so that expenses not deductible under the former nonetheless could be deductible under the latter.⁸² More importantly, the court ruled that a section 212(3) deduction is not limited to expenses incurred in a single year.⁸³ Likening tax counsel fees to deductible investment counsel expenses, the court said that these costs are often prospective in nature.⁸⁴ Tax counsel may be obtained solely for the purpose of avoiding future tax contests, and that alone should not preclude its deductibility.⁸⁵ The court also suggested that limiting section 212(3) to past years only "would defeat the clear purpose" of the provision⁸⁶ and effectively would eviscerate the language in the regulations that allows a deduction for expenses related to *determining* one's tax liability.⁸⁷ In sum, the court was willing to give a much broader interpretation to "determining" one's taxes than was the Government.

After *Kaufmann* and *Carpenter*, the center of attention seemed to shift from "contested tax liabilities" to "tax-related versus personal" expense issues. The pivotal question was whether section 212(3) was being used to convert personal, nondeductible expenditures into deductible expenses. Estate planning fees were the primary culprits. *Bagley* sanctioned a deduction for tax-related estate planning advice. However, *Bagley* also clearly enunciated the principle that fees associated with the purely personal aspect of estate planning charges, such as those incurred in establishing a trust, were not deductible expenses.⁸⁸

In *Sidney Meriams v. Commissioner*,⁸⁹ the Tax Court met the issue head-on, and a divided court confirmed the *Bagley* principles. The *Meriams* court held that estate planning fees are deductible, but only

79. *Carpenter*, 338 F.2d at 368.

80. *United States v. Davis*, 370 U.S. 65 (1962), superseded by statute (see *Laird v. United States*, 16 Cl. Ct. 441 (1989)).

81. 372 U.S. 39 (1963).

82. *Id.* at 48 n.16.

83. *Carpenter v. United States*, 338 F.2d 366, 369 (Ct. Cl. 1964).

84. *Id.*

85. *See id.*

86. *Id.* at 370.

87. *Id.*; Treas. Reg. § 1.212-1(l) (1993).

88. *See Bagley v. Commissioner*, 8 T.C. 130 (1947).

89. 60 T.C. 187 (1973).

to the extent they are attributable to tax planning.⁹⁰ Reasonable and verifiable allocations of charges to these services became the operating rule for determining their deductibility. Notably, the "current versus future" tax determination issue did not go away. Some judges still believed that section 212(3) should not be applied to prospective tax liabilities.⁹¹

There has been little significant litigation recently concerning section 212(3). The provision has been fairly well fleshed out, leaving a vast array of tax-related expenses that qualify for the deduction. With specific reference to federal income-tax related costs, the deductible expenses range from actual tax return preparation,⁹² including charges for determining reportable items,⁹³ to prospective tax avoidance planning,⁹⁴ and the defense of criminal tax charges.⁹⁵ Given this broad range of deductibility, section 212(3) was truly a taxpayer relief provision. Ironically, the push for tax reform and its putative call for lowering taxes has resulted in an elimination of the section 212(3) benefit for all but a handful of taxpayers.

Because access to section 212(3) has been restricted, taxpayers are actively pursuing other means of deducting tax compliance costs. Certain tax compliance costs are deductible under section 162⁹⁶ or section

90. *Id.*

91. *Id.* at 190. Interestingly, some of the *Meriams* judges, in concurring opinions, expressed the view that Code section 212(1) and (2), the successors to the provision used by the *Bagley* court, might still be applicable to estate planning advice, despite the existence of section 212(3). *See id.* at 190 (Scott, J., concurring); *id.* at 191 (Fay, J., concurring); *id.* at 192 (Sterrett, J., concurring). If the taxpayer could show that the expenses incurred met the statutory tests for deductibility related to income-producing property, then section 212(2) could provide a tax benefit. *See id.* at 191 (Fay, J., concurring); *id.* at 192 (Sterrett, J., concurring). However, something more than just transferring income-producing property incident to an overall estate plan would be required for either of these two subsections to apply. *See Wong*, 58 T.C.M. (CCH) 1073 (1989) (disallowing a deduction for legal fees incurred incident to the transfer of income-producing assets into a trust as part of an estate planning transaction).

92. *See, e.g., Crowther v. Commissioner*, 28 T.C. 1293 (1957), *acq.* 1964-2 C.B. 3; *Dawkins v. Commissioner*, 61 T.C.M. (CCH) 2667, 2670 (1991); *Kozera v. Commissioner*, 52 T.C.M. (CCH) 1264, 1267 (1986); Rev. Rul. 89-68, 1989-1 C.B. 82 (fees paid to tax practitioner including fees incurred in ruling request deductible subject to two percent floor).

93. *See Rev. Rul. 67-461*, 1967-2 C.B. 125 (appraisal fee to determine value of property contributed to an organization); Rev. Rul. 58-180, 1958-1 C.B. 153 (appraisal fee to establish casualty loss deductible).

94. *See, e.g., Collins v. Commissioner*, 54 T.C. 1656 (1970); *Goldaper v. Commissioner*, 36 T.C.M. (CCH) 1381 (1977).

95. *See, e.g., Rev. Rul. 68-662*, 1968-2 C.B. 69 (defense of criminal fraud indictment deductible); *Tranquilli v. Commissioner*, 39 T.C.M. (CCH) 874 (1980).

96. I.R.C. § 162 (1993). In general, section 162 allows a deduction for all ordinary and necessary business expenses. *See generally* 6 MERTENS LAW OF FEDERAL INCOME TAX, ch. 25 (1993).

212(2).⁹⁷ Deductibility under section 212(2) sometimes offers benefits not available for 212(3) items; deductibility under section 162 always does. The availability of both deduction provisions for universally incurred expenses to some taxpayers, while others are limited to section 212(3), seems fundamentally unfair. The next section explores this point.

III. COMPUTATIONAL COMPLICATIONS

Section 212(3) of the Code is broad in application and includes costs well beyond those attributable to actually filling out and filing tax forms.⁹⁸ Moreover, the deduction is not limited to costs related to one's federal income tax. The section applies to expenses related to many taxes, income or otherwise,⁹⁹ local¹⁰⁰ or national, foreign¹⁰¹ or domestic. Despite its apparent breadth, however, there is a significant self-imposed limitation upon this Congressional munificence. The benefit is conferred as a deduction, which provides a savings equal only to a percentage of the actual cost incurred.

Initially, one might conclude that a federal subsidy based on one's marginal tax rate is better than none at all, but it is important to view section 212(3) from a broader perspective to determine whether the benefit is truly fact or largely fiction. Closer inspection reveals that the efficacy of section 212(3) is hampered by its interaction with other tax provisions. The direct overriding control of section 67,¹⁰² and the indirect effects of section 62,¹⁰³ severely limit the availability of section 212(3) to most individuals.

The following discussion briefly tracks the statutory scheme to help explain the roles played by sections 62 and 67. Once deductibility un-

97. I.R.C. § 212(2) (1993). In general, section 212(2) permits a deduction for expenses paid for the "management, conservation, or maintenance of property held for the production of income." See generally 6 MERTENS LAW OF FEDERAL INCOME TAX, ch. 25A (1993).

98. I.R.C. § 212(3) (1993).

99. See *Northern Trust Co. v. Campbell*, 211 F.2d 251 (7th Cir. 1954) (legal expenses incurred with respect to an estate tax liability deductible).

100. See *Farnsworth v. Commissioner*, 29 T.C. 1131 (1958) (fees for settling New York state tax controversy deductible), *aff'd*, 270 F.2d 660 (1959); *Reynolds v. United States*, 338 F.2d 1 (2d Cir.) (fees for contesting state tax assessment deductible), *cert. denied*, 380 U.S. 977 (1965).

101. See *Sharples v. United States*, 533 F.2d 550 (Ct. Cl. 1976) (deduction permitted under section 212(3) for legal expenses pursuant to resistance of Venezuelan property tax liability); see also Rev. Rul. 62-9, 1962-1 C.B. 35.

102. Code section 67 limits and sometimes completely disallows deductions permitted by other Code sections. I.R.C. § 67 (1993); see *infra* notes 112-123 and accompanying text.

103. Section 62 identifies certain deductions that are to be subtracted from gross income to determine adjusted gross income. Other deductions are used to convert adjusted gross income into taxable income. See *infra* note 106. Section 62 items are often referred to as "above the line" deductions. All other deductions are "below the line". For a discussion of the impact of this section on tax computation, see *infra* note 106 and accompanying text.

der section 212(3) is established, it must then be determined "where" the deduction is to be taken. More specifically, the inquiry is whether the deduction is taken before or after adjusted gross income¹⁰⁴ has been computed. More often than not, this crucial determination will govern whether any tax benefit for compliance costs will be allowed.

Section 62(a) lists deductions (the so-called "above-the-line deductions") that are used to convert gross income¹⁰⁵ into adjusted gross income. All other deductions¹⁰⁶ are used to convert adjusted gross income into taxable income.¹⁰⁷ By definition, all non-section 62 deductions are *itemized* deductions.¹⁰⁸ In computing taxable income, a taxpayer has the option of reducing his or her adjusted gross income by either the allowable itemized deductions or the statutory standard deduction.¹⁰⁹ (Taxpayers also are entitled to dependency deductions, regardless of which path to taxable income is chosen).¹¹⁰ Electing the standard deduction precludes the use of itemized deductions, but does not affect the availability of the section 62 deductions, which can always be taken to the extent of gross income.¹¹¹ Although the choice between using the standard deduction or itemizing is a relatively easy one, section 67 has made computing itemized deductions, and consequently the "standard deduction versus itemization" decision, more difficult.

Section 67 is high on the list of mischief-makers in the Code. It converts otherwise deductible expenses into unfulfilled tax benefits. In its simplest terms, the section separates itemized deductions into two categories, miscellaneous and nonmiscellaneous.¹¹² Nonmiscellaneous

104. Adjusted gross income is gross income minus the deductions enumerated in I.R.C. § 62(a). See I.R.C. § 62 (1993).

105. Section 61(a) defines the term "gross income," the starting point for all tax computations. *Id.* § 61(a).

106. Any deduction not identified in section 62 is an "other deduction". This includes the standard deduction, see I.R.C. § 63 (1993), and the dependency deduction, see *id.* § 151.

107. Taxable income is the figure to which tax rates are applied. See *id.* § 1. The Code provides alternative ways to compute taxable income—gross income minus all allowable deductions other than the standard deduction, or adjusted gross income minus the standard deduction and personal exemptions. *Id.* § 63(a), (b).

108. *Id.* § 63(d).

109. *Id.* § 63(b).

110. See *id.* §§ 63, 151.

111. A taxpayer cannot have a negative taxable income for computational purposes. Once taxable income is reduced to zero, the taxpayer will not have any income tax liability for that year. Not all deductions in excess of the income for that year will necessarily be lost forever. See, e.g., I.R.C. §§ 172, 1212(b) (1993) (unused losses may be carried back into past years and over into future years).

112. Using the kind of tortuous wording often found in the Internal Revenue Code, section 67(b) classifies all itemized deductions except those specifically enumerated in the section itself as "miscellaneous".

itemized deductions are favored and always are deductible for taxpayers who do not opt for the standard deduction. Section 67 does not affect these items, though such deductions are subject to a different limitation, the so-called "three percent rule."¹¹³

The thrust of section 67 is directed to the newly created category of miscellaneous itemized deductions. These expenses are deductible only to the extent their aggregate exceeds two percent of adjusted gross income.¹¹⁴ As a result, a series of computations must be made to determine whether a miscellaneous itemized deduction may be taken in any given year.

Determining the extent of the miscellaneous itemized deductions requires a two-step computational process. First, all miscellaneous itemized deductions are aggregated. Second, the aggregate sum is compared to two percent of adjusted gross income. The amount by which the aggregate sum exceeds this two percent figure can be added to the nonmiscellaneous items and deducted. The amount below the two percent floor is neither currently deductible nor carried into other tax periods; it is forever lost.¹¹⁵

The intended purpose and actual effect of section 67 was to eliminate deductions as part of the base-broadening effort of the Tax Reform Act of 1986.¹¹⁶ In theory, the broader base permitted lower tax rates, while maintaining revenue neutrality. Although theoretically on target, the classification of certain deductions as "miscellaneous" may have been where Congress missed the mark.

An examination of the particular itemized deductions spared the section 67 accounting fails to provide a clear pattern. However, some general observations can be made. Some of the deductions seem to be aimed at maintaining the integrity of taxing income as a "net" item,¹¹⁷

113. Code section 68 reduces allowable itemized deductions for taxpayers making over \$100,000 per year by three percent of adjusted gross income in excess of \$100,000, *see* I.R.C. § 68(b) (1993), but not to exceed 20% of the total amount of deductions claimed, *see id.* § 68(a)(2). Some deductions are exempt from the limitation, but tax compliance costs are not among those. *See id.* § 68(c).

114. *Id.* § 67(a).

115. *Id.*

116. *See* Joint Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986, H.R. 3838, 99th Cong., 2d Sess., Part III, Title I, at 15 (1987).

117. Consider the "loss" deduction. Code section 67(b)(3) identifies only two subparagraphs of section 165, the loss deduction section, as qualifying for nonmiscellaneous deduction treatment. The first of these relates to personal casualty losses, and the second to gambling losses. Looking at the latter first, the concept of taxing "net" income is clearly met. Section 165(d) permits wagering losses only to the extent they offset wagering gains. The effect of the provision is to tax only gambling gains (as opposed to all "winnings") and prevent gambling losses from offsetting non-gambling income. Of course, the scheme does not guarantee the desired result. Because section 165(d) is an itemized deduction, it will never be utilized if the taxpayer elects the

whereas others appear to be sacred cows that were perhaps too dangerous politically to alter.¹¹⁸

Expenses deductible under section 212 bear the brunt of section 67;¹¹⁹ most other deductions are either protected by section 62, which by definition makes them nonmiscellaneous deductions and thus beyond the reach of section 67,¹²⁰ or by section 67 itself.¹²¹ Moreover, even some of the section 212 expenses can escape section 67 treatment. Section 212 items relating to the production of rents or royalties are section 62 items as well, and therefore they never enter into the "itemizing" calculus.¹²² Essentially, what is left to the clutches of section 67 are those section 212 expenses 1) attributable to the business of being an employee, 2) related to nonrecurring gains or portfolio income, and 3) qualifying as tax compliance expenses.¹²³

The inherent unfairness in the current system comes into focus when tax compliance costs are permitted to be characterized as some-

standard deduction. Thus, it is possible for total gambling winnings to be taxed without any offset for gambling losses. This result, though perhaps unsatisfactory, was not caused by section 67. The loss of the deduction actually results from its exclusion from section 62.

The "net" income justification for subsection 165(c)(3) losses is somewhat more difficult to see, but it exists nonetheless. At first blush, subsection (c)(3) casualty losses seem to be purely personal loss items lacking any nexus to income. However, a closer look at subsection 165(h) shows that these personal losses are deductible only to the extent their aggregate exceeds 10% of adjusted gross income, and they are entirely deductible to the extent they offset gains from similar transactions. For example, the taxpayer who recovers insurance in excess of her adjusted basis for property destroyed by fire will have realized a gain resulting from a casualty-type transaction. Unless otherwise protected, the gain will be recognized. Subsection 165(h)(1) considers such possibilities and permits all losses from casualty transactions to offset similarly created gains before applying the 10% floor. The justification for such a position is deference to the "net" income concept.

118. A review of the legislative history of the Tax Reform Act of 1986 reveals that certain code provisions were "untouchable". See *supra* note 1. Despite efforts to broaden the tax base as extensively as possible, it became apparent that a number of deductions were not on the negotiating table. Among these were the home mortgage interest deduction, I.R.C. § 163(h)(3) (1993); the real estate and state income tax deduction, *id.* § 164(a); and the charitable deduction, *id.* § 170. The medical expense deduction, *id.* § 213, was never seriously threatened, though the floor was increased from five percent to seven and one-half percent of adjusted gross income, which decreased the value of the deduction. The home mortgage deduction underwent some change, but the limits on deductibility that were imposed, including a dollar amount (one million dollars of indebtedness), and the number and type of properties that qualified, were of little import to most taxpayers. The local tax deduction section lost some of its value when the state sales tax deduction was eliminated, but efforts to do likewise to state income taxes failed. See H.R. 3838, 99th Cong., 2d Sess. § 137 (1986) (as passed by the Senate). Indeed, the other deductions in this second, protected category, probably also were viewed as either too embedded in the system or too controversial to be repealed at that time.

119. Section 67 negatively impacts all of the section 212 expenses that are itemized deductions, not just the tax compliance costs of section 212(3).

120. See I.R.C. § 62 (1993).

121. See *id.* § 67(b) (classifying certain deductions as nonmiscellaneous itemized deductions).

122. See *id.* § 62(a)(4).

123. See generally *id.* §§ 67, 212.

thing other than section 212(3) expenses. This is particularly true with regard to costs incurred for executing and filing one's tax return. Such expenses, potentially common to all taxpayers, become deductible for some but not for others.

The questions of whether and when tax compliance costs can be taken above the line are not new ones. Shortly after section 62 entered the Code,¹²⁴ the correlative treasury regulations stressed that expenses must be *directly*, not just remotely, related to the taxpayer's trade or business to qualify for section 62 treatment.¹²⁵ Early tests of this interpretation resulted in taxpayer victories.

First, in *Standing v. Commissioner*,¹²⁶ the Tax Court ruled that fees incurred in challenging a federal income tax deficiency relating to the taxpayer's business income were trade or business expenses and were therefore deductible "above the line". Then, in *Wood v. Commissioner*,¹²⁷ the Tax Court specifically held that section 212(3) did not preempt other Code sections from allowing deductions for tax compliance costs. The court stated that there was nothing to suggest that Congress intended to make section 212(3) the exclusive provision for deducting these types of expenses.¹²⁸ It then held that the taxpayer could deduct federal tax litigation expenses as ordinary and necessary business expenses and did not have to rely on section 212(3) for the deduction.¹²⁹ Thus, the deduction could be taken above the line.

The courts sought to implement the congressional intent "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."¹³⁰ The relevant legislative history stated that the deductions are limited to those that "fall within the category of expenses directly incurred in the carrying on of a trade or business. The connection contemplated by the statute is a direct one rather than a remote one."¹³¹ However, the Senate Report specifically noted that state income taxes incurred on business profits are not

124. Section 62 was originally section 22(n) of the 1939 Internal Revenue Code added by the Individual Income Tax Act of 1944, § 8(a), Pub. L. No. 315, 78th Cong., 1944 C.B. 734, 738.

125. Rev. Rul. 45-5425, 1945 C.B. 10, 16.

126. 28 T.C. 789 (1957), *acq.*, 1958-1 C.B., *nonacq.*, 1958-1 C.B. 7, *acq.*, 1958-2 C.B., *nonacq.*, 1958-2 C.B., *nonacq. withdrawn*, 1992-1 C.B., *acq.*, 1992 C.B., *aff'd*, 259 F.2d 450 (4th Cir. 1958).

127. 37 T.C. 70 (1961), *acq.*, 1969-2 C.B. xxv.

128. *Id.* at 75-76.

129. *Id.* at 76.

130. S. REP. NO. 885, 78th Cong., 2d Sess. 24-25 (1944), *reprinted in* 1944 U.S.C.C.A.N. 1056, 1079; H.R. REP. NO. 1365, 78th Cong., 2d Sess. 21 (1944).

131. S. REP. NO. 885, 78th Cong., 2d Sess. 24-25 (1944), *reprinted in* 1944 U.S.C.C.A.N. 1056, 1079; H.R. REP. NO. 1365, 78th Cong., 2d Sess. 21 (1944).

deductible in computing adjusted gross income.¹³² Thus, when confronted with an attempted deduction for state income tax compliance costs, the Tax Court in *Tanner v. Commissioner*¹³³ denied section 62 treatment for the expenses, relying on the language of the legislative history¹³⁴ and the regulations.¹³⁵

Although federal income tax compliance costs related to challenging deficiencies on business, rent, or royalty income had qualified as "above-the-line" deductions, courts made little mention of actual return preparation expenses for these activities. Temporary regulations¹³⁶ promulgated for section 67 of the Code determined that return preparation expenses are too remotely related to the business, rent, or royalty activity to be considered section 62 items.¹³⁷ All tax preparation fees, including those for preparing federal tax returns, were deductible exclusively under section 212(3) and were therefore required to undergo the section 67 accounting.

The Government amplified its position in a letter ruling,¹³⁸ where it stated that tax advice and return preparation fees are not directly attributable to the taxpayer's trade or business or his rent or royalty activities. Such expenses were said to be incurred in connection with the determination of a tax.¹³⁹ Even if some of the cost arose from reporting trade or business activities or rent or royalty activities, determining the tax is only remotely related to the activity itself.¹⁴⁰ Tax preparation fees, even those incurred for filing schedules relating exclusively to "trade or business" or "rent or royalty" activities, were adjudged too remote from the actual carrying on of the favored activities themselves to justify section 62 tax treatment.¹⁴¹ The letter ruling analogized tax return preparation expenses to state taxes on net income, the use of which has never been permitted when computing adjusted gross income.¹⁴²

132. S. REP. NO. 885, 78th Cong., 2d Sess. 24-25 (1944), *reprinted in* 1944 U.S.C.C.A.N. 1056, 1079.

133. 45 T.C. 145 (1965), *aff'd*, 363 F.2d 36 (4th Cir. 1966).

134. *Id.* at 148 (citing *Commissioner v. Bilder*, 369 U.S. 499 (1961)).

135. *Id.* (citing *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 (1947); *Helvering v. Winmill*, 305 U.S. 79 (1938)).

136. Temp. Treas. Reg. § 1.67-1T-3T (1988).

137. *Id.* at § 1.67-1T(a)(1)(iii) (1988).

138. Priv. Ltr. Rul. 91-26-014 (June 28, 1991), *reconsidered by* Priv. Ltr. Rul. 92-34-009 (August 21, 1992).

139. *Id.* at 8, 9.

140. *Id.*

141. *Id.*

142. *Id.*

The Government subsequently performed an unexpected about face. In Revenue Ruling 92-29,¹⁴³ it held that tax preparation expenses and costs incurred in resolving asserted tax deficiencies properly allocable to a taxpayer's trade or business as a sole proprietor would be treated as section 62 items rather than as miscellaneous itemized deductions. Accordingly, the portion of the taxpayer's tax preparation fee attributable to preparing the tax schedule relating to the taxpayer's trade or business (Schedule C) was held to be deductible in computing adjusted gross income. The ruling relied on legislative history of the adjusted gross income concept to justify this result.¹⁴⁴ The ruling essentially likens the tax preparation fee for Schedule C to a routine cost of doing business.¹⁴⁵ As such the expense is directly connected to the business activity. Therefore, it must be treated in the same manner as other trade or business deductions, as failure to do so would undermine the purpose of section 62(a). The ruling goes on to hold that the allocable portion of the tax preparation fee incurred in preparing tax schedules for "rent or royalty" activities—whose expenses are deductible under sections 212(1) and (2) of the Code—also is deductible when computing adjusted gross income.¹⁴⁶

Arguably, this ruling adds to the already complex maze of deduction interrelations. However, it limits the benefit of "above-the-line" treatment to that portion of tax preparation fees incurred to comply with reporting requirements for the section 62 activities.¹⁴⁷ Deductible costs must be separated into section 62 activities and activities belonging on the personal side of the ledger. The balance between nonpersonal deductible and personal nondeductible expenses ostensibly is maintained, if not reinforced, but with an administrative cost. Now, taxpayers, or more likely those who prepare their returns, will have the opportunity to argue that the preparation of section 62 activity-related schedules¹⁴⁸ is the most time consuming and costly part of the entire return. Although this type of allocation issue is not novel,¹⁴⁹ it

143. Rev. Rul. 92-29, 1992-1 C.B. 20.

144. *Id.* (citing S. Rep. No. 885, 78th Cong., 2d Sess. 24-25 (1944), reprinted in 1944 U.S.C.C.A.N. 1056).

145. *See id.*

146. *Id.*

147. *See id.*

148. Private Letter Ruling 92-34-009 specifically identifies I.R.S. Form 1040, Schedules C (reporting for an individual's trade or business), E (reporting rent and royalty activities), and F (reporting farm income), as ones that will benefit from Revenue Ruling 92-29. According to one author's observation, deducting tax preparation fees "above-the-line" has long been an accepted practice. Phillip P. Storrer, *Deducting Tax-Related Professional Fees*, 51 TAX NOTES 1575 n.3 (June 24, 1991).

149. *See, e.g., Bagley v. Commissioner*, 8 T.C. 130 (1947) (court determined that only a

undoubtedly will spawn additional audits as taxpayers strive for the maximum deduction allowable. Perhaps Revenue Ruling 92-29 only begs the larger question of whether certain tax compliance costs, such as tax preparation fees, should be taken "above the line" universally, and not only when linked to a section 62 activity.

A. Costs Considered

The interplay of section 67 of the Code and Revenue Ruling 92-29 provides favorable tax treatment to self-employed persons and taxpayers who are involved in "rent and royalty" ventures. The question that remains is: Is this result so bad that curative action is required? There are certainly numerous other instances in the Code where some taxpayers reap a benefit not available to others. These are based upon a variety of factors which differentiate taxpayers from one another.¹⁵⁰ But the issue in question is distinguishable in that the expense involved not only is common to all taxpayers, but also originates from a Code requirement that taxpayers file income tax returns.¹⁵¹ Furthermore, Congress intended that section 67 limit the availability of certain deductions,¹⁵² including section 212(3) deductions. This limitation was supposed to be carried out on a more or less even-handed basis. That is, any taxpayer who overcame the two percent floor barrier qualified for the tax benefit. Now, however, the balance has been upset through the administrative, rather than legislative, process. What was originally designed as equal access for all has become a privileged avenue

portion of the attorneys' fees qualified as tax deductible expenses). In *Moyer v. Commissioner*, the court allocated tax counsel fees between the taxpayer and his solely owned corporation. 35 T.C.M. (CCH) 304, 316 (1976). For an allocation of legal fees between exempt and non-exempt classifications, see *Andrews v. Commissioner*, 64 T.C.M. (CCH) 1339 (1992) (legal fees incurred in attempt to obtain Social Security benefits deductible to the extent taxable) and Revenue Ruling 87-102, 1987-2 C.B. 78.

150. Perhaps the most basic distinguishing factor among taxpayers is "family status". Both the standard deduction, I.R.C. § 63(c) (1993), and the taxable income levels at which higher tax rates "kick in," *id.* § 1(a)-(d), are based on the taxpayer's marital status. Variations on income also are used as a distinguishing factor in the Code. *See, e.g., id.* § 135 (allowing an exclusion from income for Series EE savings bond interest used for qualifying educational expenses up to a certain "adjusted gross income" level); *id.* § 86 (excluding from income Social Security receipts below a "modified adjusted gross income" level); *id.* § 21 (phasing out the child care credit based on adjusted gross income). Also, being an employee, as opposed to being self-employed, can result in the loss of tax benefits. *See id.* § 62(a)(1) (denying "above-the-line" treatment for most employee business expenses).

151. Section 6012 sets out the income tax filing requirements.

152. Congress' stated purpose in enacting section 67 was to simplify taxpayers' recordkeeping requirements. "This floor will contribute to simplification by relieving individuals of the burden of recordkeeping unless they expect to incur such expenditures in excess of the percentage floor." SEN. REP. NO. 313, 99th Cong., 2d Sess. 79 (1987).

for but a few. Primarily for this reason, the treatment of tax compliance costs should be reconsidered.

B. Uneven Treatment of Compliance Costs

First, it is beneficial to take a closer look at tax compliance costs to determine which, if not all, of these expenses merit tax treatment reconsideration. Since section 212(3) applies to expenses incurred relative to all taxes, it is worthwhile to isolate those of particular interest. Although section 67 may govern all section 212(3)-type expenses, Revenue Ruling 92-29 carves out special treatment for only one, namely, federal income tax compliance costs.¹⁵³ Of course, the federal income tax is the only tax that touches all federal income tax filers. Federal income tax compliance costs are the only tax-related expenses that by their nature are common to all federal tax filers. Consequently, it seems sensible to treat these costs uniformly. Expenses incurred relative to state, local, foreign, and other federal taxes should not be items of immediate concern.

Limiting reform to federal income tax compliance costs is justifiable. Although costs incurred incident to resolving controversies related to other taxes may deserve deduction status, they are different from federal income tax compliance costs. The latter costs are directly related to one's federal tax liability because they are incurred for no reason other than to comply with the federal income tax itself. Compliance costs for all other taxes, on the other hand, are only indirectly related to one's federal income tax liability.

The case of deductible state income taxes is illustrative. The cost related to establishing the state tax liability directly impacts one's state tax liability. The state tax liability may impact one's federal tax liability,¹⁵⁴ but the compliance costs are incurred to directly affect the state tax charge and not to obtain a reduced federal tax liability. The fact that state income tax also is deductible for federal tax purposes probably plays very little, if any, part in the decision to incur costs incident to state-tax filing. Indeed, compliance costs incurred to challenge taxes other than the federal income tax itself may result in a higher federal tax liability.¹⁵⁵ There is at best only a tenuous causal relation-

153. Revenue Ruling 92-29 also expands section 62 treatment for other deductions that can be directly tied into the section 62 activity. Thus, section 212(2) tax-related expenses would also qualify for "above-the-line" treatment.

154. Section 164(a)(3) permits a deduction for state income taxes paid by individuals. Thus, to the extent these are itemized deductions, the federal tax liability is affected.

155. To the extent one succeeds in challenging a state tax deficiency, there will be a lower state tax deduction. The reduced deduction will result in a higher federal tax liability for taxpayers who itemize deductions.

ship between such compliance costs and one's federal income tax obligation.

There also are other taxes which do not give rise to federal income tax deductions.¹⁵⁶ Payments on some of them, like the federal estate¹⁵⁷ and gift taxes,¹⁵⁸ are specifically denied deductibility.¹⁵⁹ However, compliance costs for contesting or determining these taxes are deductible.¹⁶⁰ Arguably, in these instances there may be no nexus between the federal income tax and the tax compliance cost involved. Permitting income tax deductions for these expenses requires greater explanation.

C. Compliance Costs Analyzed

Direct federal income tax compliance costs can be categorized into three general groups: return preparation fees, audit-related costs, and tax advice charges. Return preparation fees are expenses incurred for the actual preparation of the individual's required federal tax return. A return includes all accompanying schedules that must be executed for a complete return, excluding attachments of copies from other tax filings that serve only informational purposes on the individual's federal tax return.¹⁶¹ Thus, return preparation fees are those directly incurred for executing forms to satisfy one's filing requirement. The definition contemplates reasonable costs incurred to properly complete any schedule. It necessarily follows that the costs are limited to completed transactions.¹⁶² Audit-related costs are those expenses reasonably incurred to defend one's return against government inquiry or challenge, including litigation expenses. Tax advice charges embrace all other compliance costs, including tax planning and counseling fees, and generally apply to structuring one's affairs to achieve certain future tax consequences.

156. As a rule, an expense is deductible only if specifically allowed by the Code. Thus, in general, only those taxes identified in subsections 164(a)(1)-(5) are deductible by individuals. However, subsection 164(a) allows certain taxes not listed in subsections 164(a)(1)-(5) to be deductible if they can qualify as a deduction under either subsection 162(a) or section 212.

157. I.R.C. § 2001 (1993).

158. *Id.* § 2501.

159. *Id.* § 275(a)(3).

160. Section 212(3) does not limit itself to deductible taxes, but includes expenses relating to "any" tax.

161. Thus, if a taxpayer were required to include a Schedule K-1 from a partnership or trust to verify an item on I.R.S. Form 1040 or a schedule thereto, the cost of preparing the K-1 or the underlying partnership or trust return would not be a tax preparation expense.

162. Tax preparation fees are intended to include only those costs incurred as are necessary to prepare the return. Generally, only closed transactions (completed events) are recognized for tax purposes. 12A MERTENS LAW OF FEDERAL INCOME TAX § 195 (1993). Fees for advice for future tax years are not tax preparation expenses.

Of these three categories, the tax advice grouping is clearly distinguishable from the other two. Whereas planning one's affairs to minimize tax exposure is a legitimate activity,¹⁶³ it is a purely voluntary one. One is legally obligated to meet the statutory filing requirements,¹⁶⁴ but not to arrange finances to achieve a certain tax goal.

Because of their special nature, preparation fees and audit-related charges should be targeted for tax treatment different from that of all other section 212(3) items.¹⁶⁵ Revenue Ruling 92-29 has partially provided special recognition for these "target expenses," but has done so unevenly (only for selected taxpayers). The system needs to ensure that all taxpayers are treated equally on this point, especially since some of these costs are directed at the heart of revenue collection—voluntary compliance.

Preparation fees and audit-related expenses merit special tax treatment. Tax preparation assistance is no longer a luxury for the well-to-do or the lazy. As already noted, tax compliance is becoming increasingly difficult. The Government is requiring that more forms be filed, and the forms are becoming more detailed.¹⁶⁶ Entries on some forms can be made only after other forms are completed and other computations are performed,¹⁶⁷ and even those schedules that are self-contained units are not always easy to prepare.¹⁶⁸ In order to fill out the

163. In *Chamberlain v. United States*, the court stated that "a taxpayer has the legal right to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits." 207 F.2d 462, 468 (1954), *cert. denied*, 347 U.S. 918 (1954).

164. Section 6651(a)(1) imposes a penalty on taxpayers who fail to file returns on time. See William Kenny & Larry Jaffe, *Reasonable Cause Can Be a Penalty Defense-But What Is It?* 20 TAX'N LAW. 350 (1992); Malcolm L. Morris, *Reliance on Counsel as Reasonable Cause: To the Back Burner After Boyle?* 31 VILL. L. REV. 525 (1986); Lorraine D. Chatman, *Walden v. Commissioner: What Relief is Available to Taxpayers Whose Tax Return is Lost By the United States Postal Service?* 42 TAX LAW. 735 (1989); 14 MERTENS LAW OF FEDERAL INCOME TAX § 55.68 (1993).

165. Arguably, some audit-related charges also are voluntary in that a taxpayer can accept the Government's recommended change(s) to a return without doing more than signing a form and remitting the deficiency. The decision to challenge the Government's position therefore can be said to be "voluntary". However, to adopt such a position truly stretches the common understanding of "voluntary". Reasonable people would not merely accede to a tax adjustment unless they believed the charge was proper. The Code operates under the rubric that taxpayers deal with each other at arm's length. It seems sensible to conclude that the Government would expect taxpayers to deal with it at arm's length as well. Thus, audit-related expenses, although not required by law, are nonetheless involuntarily incurred.

166. See, e.g., I.R.S. Form EIC for the Earned Income Credit, Section 32 (requiring one to follow an elaborate flowchart just to determine its use).

167. The basic Schedule A for itemized deductions is illustrative. Entries for the medical expense deduction, the charitable deduction casualty losses, and miscellaneous itemized deductions cannot be finalized until adjusted gross income is computed from I.R.S. Form 1040.

168. For example, see I.R.S. Form 3903, which is used for computing the moving expense deduction permitted by Section 217, as well as I.R.S. Form 8892, used for determining allowable passive activity losses permitted by Section 469.

tax schedules, taxpayers not only have to comprehend the instructions, but they must also understand the relevant law. The Government estimates that it takes more than 3 1/2 hours for a taxpayer merely to *execute* the basic Form 1040,¹⁶⁹ and that more than 2 1/2 hours are needed to "learn about the law or the form itself."¹⁷⁰ Furthermore, this does not include the estimated 49 minutes needed to copy, assemble, and send the form.¹⁷¹ If additional schedules are required, that only adds to the time needed to execute the return and acquire the expertise to do so.¹⁷² By its own admission, the Government recognizes that meeting one's tax-filing obligation can be difficult and attributes the difficulty to the complexity of the Code.¹⁷³ Indeed, the complexity is such that taxpayers seeking information from the I.R.S. have been receiving a disquietingly high percentage of incorrect responses.¹⁷⁴ Clearly, the extensive use of return preparers is not merely a product of math-averse taxpayers.¹⁷⁵

It is ironic, if not downright foolish, that a tax system dependent upon voluntary compliance has erected considerable barriers to satisfying one's tax obligation. Substantial compliance with tax laws, the Government's operating goal,¹⁷⁶ is becoming harder for taxpayers to achieve. It is probably the federal fisc that suffers from this complexity, as it is likely that taxpayers' errors will more often than not be made in their own, rather than the Government's, favor.

Rather than battle the forms themselves, many taxpayers retain professional tax preparers. The Government should encourage this course of action; paid preparers are subject to a higher standard of care than

169. 1992 I.R.S. Form 1040, p. 4.

170. *Id.* This statistic probably comes as a great surprise to many a law student who has struggled through an introductory tax course.

171. *Id.*

172. *Id.* The Government provides the following time estimates for "learning the law," "preparation" and "assembly": Schedule B (reporting dividend and interest income), 10 minutes, 17 minutes, and 20 minutes, respectively; Schedule D (reporting capital asset transactions), 55 minutes, 1 hour 8 minutes, and 42 minutes, respectively; and Schedule C (reporting self employment income), 1 hour 5 minutes, 1 hour 57 minutes, and 25 minutes, respectively.

173. 1992 I.R.S. Form 1040, p. 4. In a recent statement, the Internal Revenue Service said that almost one half of filers enlist professional help. IR-93-19, Feb. 18, 1993.

174. The Internal Revenue Service's Director of Taxpayer Services stated that "30.8% of the answers on the toll free system would lead taxpayers to a wrong result." STANDARD FED. TAX REP. 5 (March 15, 1989). Also, I.R.S. publications are routinely amended to correct errors. For example, see Announcement 93-48, 1993-12 I.R.B. 21, correcting an error in an example in Publication 917 (1992).

175. In 1989, a total of 112,136,000 individual income tax returns (I.R.S. Forms 1040, 1040-EZ, and 1040A) were filed with the I.R.S. Of those filed, 48,177,000, or 49%, were signed by a preparer. In 1990, 113,717,000 individual income tax returns were filed, of which 49,680,000, or 44%, were signed by preparers. 12 STAT. OF INCOME BULL. 124 (1992).

176. See Rev. Proc. 64-22, 1964-1 C.B. 689.

individual taxpayers,¹⁷⁷ and thus are likely to file more complete and accurate returns.¹⁷⁸ Increased accuracy means better compliance and possibly greater revenue collection.¹⁷⁹

Can there be any expense more tax-related than audit-related charges? Challenges to taxpayers' positions in a voluntary compliance system are a necessary by-product of human nature— even the best fielders make errors. The more pressing concern arises when taxpayers are called upon to justify positions taken, rather than merely to verify numerical amounts reported. Tax law is a creature of federal statute, interpreted by extensive regulations and case law, augmented by voluminous administrative rulings, and sometimes impacted by relevant local law. By defending a legal position in court, taxpayers, win or lose, help define the law. This body of law provides guidance for better compliance by other filers, thereby enhancing revenue collection and reducing costs. It is again ironic that Congress has decided to reimburse taxpayers for attorneys' fees when they are forced to defend frivolous actions,¹⁸⁰ but will not encourage taxpayers to obtain assistance which could eliminate the waste of time and effort incident to complying with an audit.

Return preparation expenses and audit-related expenses are distinct from other charges under the tax compliance cost umbrella in that they directly relate to actions required by law. Unlike tax advice

177. Section 6694 imposes penalties on paid preparers for certain actions that result in an understatement of tax owed. Section 6695 imposes additional duties on paid preparers. Paid preparers also are subject to liability for failing to inquire into information provided by a taxpayer. See *Brockhouse v. United States*, 749 F.2d 1248, 1251 (7th Cir. 1984) (citing *Marcello v. Commissioner*, 380 F.2d 499, 506 (5th Cir. 1967), cert. denied, 389 U.S. 1044 (1968)). See generally IRA L. SHAFIROFF, *LIABILITY OF TAX RETURN PREPARERS* (1989).

178. See Frederic G. Corneel, *Ethical Guidance for Tax Practice*, 28 TAX L. REV. 1 (1972).

179. One of the major drawbacks of a voluntary compliance system is unreported income. Presumably, paid preparers with knowledge of facts provided by taxpayers will educate clients on the necessity of including receipts in income. This might result in better compliance and enhanced revenue receipts.

180. Section 7430 allows prevailing taxpayers to recover attorneys' fees for frivolous positions taken by the I.R.S. Enacted in 1982, Congress believed that the measure would "deter abusive actions or overreaching by the [I.R.S.] and . . . enable individual taxpayers to vindicate their rights regardless of their economic circumstances." Staff of Joint Comm. on Tax'n, 97th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* 445 (Comm. Print 1982).

The measure also was designed to reduce forum shopping. Prior to its enactment, attorneys' fees were recoverable only in tax cases brought in a district court or in the Court of Claims. The new rule allows recoveries for suits brought in the Tax Court as well. I.R.C. § 7430(c)(6).

Section 7430 has been used in a wide variety of contexts. See, e.g., *Pate v. United States*, 982 F.2d 457 (10th Cir. 1993) (taxpayer recovered reasonable litigation costs incurred as a result of I.R.S. action brought without substantial justification); *Hanson v. Commissioner*, 975 F.2d 1150 (5th Cir. 1992) (attorneys' fees awarded where I.R.S.'s position that statute of limitations on assessing deficiency for a return had not expired was without substantial justification).

charges, they are incurred to satisfy or perfect a legally imposed requirement. Their involuntary nature suggests that they merit some favorable treatment. How that can best be accomplished is not an easy question to answer, but is one worthy of an attempt.

D. Suggested Solutions

Congress has determined that tax compliance costs merit special tax treatment. Unfortunately, it has failed to respect the disparate natures of the myriad costs involved. Administrative rule now has given preference to certain costs, but based upon something other than the character of the expense. The preference provided by Revenue Ruling 92-29 has returned treatment of compliance cost deductions to a pre-*Higgins* era; given the limitations imposed by section 67, tax compliance costs will be deductible principally by taxpayers who can tie the charges to their trades, businesses, or rent or royalty activities. Others who will be permitted to avail themselves of the deduction will be able to do so primarily because of the relative size of their miscellaneous itemized deductions as compared to their adjusted gross incomes. Some curative action should be taken.

Retraction of Revenue Ruling 92-29 would end some unfairness, but that would still leave the target expenses—tax preparation costs and audit-related costs—lacking tax-favored status. The better approach is to devise a means by which these expenses are treated identically for all taxpayers who incur them. A number of options are available.

One way to ameliorate the current disparity is to reclassify all section 212(3) items as nonmiscellaneous itemized deductions. This would eliminate the extra accounting required by section 67; as long as the taxpayer itemized deductions, tax compliance costs would be fully deductible. Of course, non-itemizing taxpayers would not receive any benefit, but that is presently the case anyway. This result is tolerable on the theory that the size of the standard deduction more than compensates taxpayers for deductible expenses foregone by the decision not to itemize.¹⁸¹ This does not, however, provide the equality sought. The target expenses may merit a universal deduction, even for non-itemizers. Thus, the reclassification option, while easy and perhaps not overly costly, leaves much to be desired.

A simple way to overcome the shortcomings of the preceding option is to reposition the deduction for target expenses in the tax calculus.

181. See S. REP. No. 66, 95th Cong., 1st Sess. 4, 15, 47-53 (1977), reprinted in 1977-1 C.B. 469, 470, 473, and 477-81; H.R. REP. No. 1445, 95th Cong., 2d Sess. 29, 32 (1978), reprinted in 1978-3 vol. 1 C.B. 181, 203, 206.

Amending section 62(a) of the Code, the section that defines adjusted gross income, to include the target expenses in the deductions used to compute adjusted gross income would make the deductions available to itemizers and non-itemizers alike. By including only the target expenses, the current tax structure would remain relatively unaltered. All tax preparation costs would be put on an even par with those currently favored by Revenue Ruling 92-29, and the remaining compliance costs would retain their classification as miscellaneous itemized deductions.

One disadvantage common to both "deduction" solutions is that the benefit conferred would be a function of the taxpayer's marginal tax rate.¹⁸² Consequently, the deduction approach has a regressive taint.¹⁸³ Not only would taxpayers in lower brackets receive a smaller benefit, but some taxpayers might actually receive no benefit at all.¹⁸⁴ Opting for a tax credit can provide greater fairness because a credit provides a direct dollar-for-dollar offset against the tax liability.¹⁸⁵ The benefit could be linked to the actual expense, independent of marginal tax rates.

A major disadvantage to using a tax credit is its cost. A full tax credit for targeted expenses would sharply curtail, if not eliminate, any incentive for taxpayers to negotiate a fair fee with their tax preparers. To prevent abuses and protect revenues, any credit proposal would need to include a cap.¹⁸⁶

Another way to minimize costs is to compute the credit as a percentage of the cost incurred. The percentage allowable can be set up on a sliding scale, allowing a higher percentage as a credit to lower

182. "Marginal tax rate" is the actual tax rate at which each additional dollar of income would be taxed. WEST'S TAX LAW DICTIONARY 327 (1992).

183. Taxpayers in a higher tax bracket receive a larger benefit because their higher marginal tax rate is applied to the deduction amount. Consequently, lower income taxpayers effectively pay more in the sense that their lower marginal rates provide less of a benefit. This has been dubbed "upside-down equity". See Stanley S. Surrey, *Tax Incentives As A Device For Implementing Government Policy: A Comparison With Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970); Bonnyman v. United States, 156 F. Supp. 625, 629 (E.D. Tenn. 1957) (criticizing the approach), *aff'd*, 261 F.2d 835 (6th Cir. 1958).

184. Taxpayers who do not itemize deductions or whose aggregate miscellaneous itemized deductions do not exceed two percent of adjusted gross income will not receive the benefit of the otherwise deductible expenses. I.R.C. § 67(a) (1993).

185. For a discussion of the "credit versus deduction" option, see Murray L. Weidenbaum, *Personal Income Tax Credits*, 42 GEO. WASH. L. REV. 516 (1974) (favoring a credit over deductions) and Gerard M. Brannon & Elliot R. Morss, *The Tax Allowance For Dependents: Deductions Versus Credits*, 26 NAT'L TAX J. 599, 602-06 (1973) (arguing that a deduction is more equitable than a credit).

186. A "cap" limits the amount of credit permitted. Caps are currently used throughout the Code. See, e.g., I.R.C. § 21(c) (1993) (the child care credit); *id.* § 121 (limiting the amount of gain arising from the sale of one's principal residence).

income taxpayers, and it also can be matched with a cap or benefit phase-out.¹⁸⁷ Caps and phase-outs, however, can defeat the fairness of using a credit. Thus, the credit approach must be tailored to its objective.

These suggestions represent improvements over the current manner in which the target expenses are treated. Each has its advantages and disadvantages; choosing any one over the others or opting for the status quo may be but a reflection of one's personal tax policy viewpoint. Change that carries a potentially heavy financial cost must be measured against the policy goals of the tax system. After making such an analysis, the reasons for choosing the section 62 approach should become clear.

E. Pursuing Policy

Unfortunately, conventional tax policy debate probably cannot offer much support for the position that target expenses deserve "above-the-line" deduction treatment. First, most tax policy discussion revolves around national fiscal policy issues. The focus usually is on whether an income tax, a direct consumption tax, some other tax, or any combination thereof, is preferable, while little attention is given to the specific provisions within the system chosen. Second, once a specific system or approach is chosen, the bulk of the policy concerns involve broad-based matters, such as whether to employ a uniform or a graduated rate schedule. Tax type and tax structure issues have wide-ranging fiscal implications. The decisions reached with respect to them reflect the major goals of the tax system. These objectives, or macro-criteria,¹⁸⁸ are pivotal concerns that have shaped the Code.

Despite the guidance that macro-criteria might provide, the Code's cloth is not woven from a single policy theme. Rather, it is a patchwork put together over time. This is not surprising since the Code is,

187. See, e.g., *id.* § 21(a)(2) (phasing out the child care credit); *id.* § 219(g) (phasing out the IRA deduction based on certain taxpayers' adjusted gross incomes).

188. Seven macro-criteria are identified in Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 568 (1965). They are: adequacy (to supply "adequate" revenue); practicality (to achieve a "practical" and workable income tax system); equity (to impose "equal" taxes upon those who enjoy equal incomes); stability (to assist in achieving economic "stability"); reduced economic inequality (to "reduce economic inequality"); free market compatibility (to avoid impairment of the operation of the "market-oriented economy"); and political order (to accomplish a high degree of harmony between the income tax and the quest for "political order"). See generally *id.* at 569-97. Professor Sneed states that these macro-criteria have served as the guidelines that shaped our income tax system. *Id.* at 568. He further suggests that other forces of a more political and mono-dimensional nature also have impacted the federal tax legislation. *Id.* at 597-99.

after all, a product of the political process. However, there may be other reasons for its uneven design. One reason is that the Code has been used to achieve a variety of small-scale goals unrelated to the macro-criteria. Another is that, rightly or wrongly, the Code is used to cure nonfiscal national ills. Consequently, some provisions have purposes other than to raise revenue. The argument has been made that by giving preferred tax status to an activity, the Government is in fact subsidizing that activity.¹⁸⁹ The so-called "tax expenditure theory" has gained sufficient currency that all proposed Code changes now are accompanied by cost projections.¹⁹⁰ Given that the present tax system is firmly in place, most current income tax policy concerns do not involve macro-criteria, although large-scale policy issues do occasionally arise.¹⁹¹ More often, however, change is directed toward achieving singular goals. Thus, the Code is more likely to be subjected to mere tinkering rather than major overhaul, and tax policy tends to reveal itself on a provision-by-provision basis.

Ideally, there would be a set formula that Congress could turn to, when considering Code changes, to determine if the proposal would make both sides balance. Unfortunately, no such formula exists, and proposed tax changes must be justified on their own merits. Regrettably, macro-criteria tend to operate primarily on a large scale and are not always useful when considering Code sections individually. Political concerns aside, decisions regarding separate Code sections should have some rational basis, utilizing normative criteria. Cost and fairness are the two criteria that should be used in debating the case for a

189. This position was criticized by Surrey, *supra* note 185. For a recent analysis of the position, see Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155, 1159.

190. An Act, 31 U.S.C. § 1105(a)(16) (1982), requires mention of tax expenditures in the President's annual budget. The Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, 88 Stat. 299 (1976), defines "tax expenditures" as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax or a deferral of tax liability."

191. The Tax Reform Act of 1986, *supra* note 1, presented the first truly major restructuring of the federal income tax since the Code was rearranged in 1954. The Act substituted a modified flat tax system—a two-tiered rate structure—for the then-existing multi-graduated rate structure. To maintain revenue neutrality, The Tax Reform Act of 1986 broadened the tax base by decreasing the number of exclusions from income. *See, e.g.*, I.R.C. §§ 67, 74 (1993) (the later section restricting and eliminating deductions regarding prizes and awards); *supra* notes 112-123 and accompanying text; and the introduction of the passive activity loss rules, I.R.C. § 469 (1993). The Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976), completely revamped the federal estate and gift taxes that had been in place for over four decades. Currently there is discussion about adding an extra tax rate to the federal income tax and implementing a new energy tax. *See Summary of the Administration's Revenue Proposals*, STANDARD FED. TAX REP. 1, 32-43, 64-66 (Feb. 25, 1993).

tax compliance cost deduction.¹⁹² The proposal set out below addresses concerns raised earlier over the deductibility of target expenses and is followed by an analysis addressing the controlling criteria.

Target expenses can be made available to all taxpayers as above-the-line deductions. This would require amending section 62 to identify the proposed deduction as one used in computing adjusted gross income and to define the expenses that would qualify for the special treatment. Consider the following proposal:

Sec. 62(a) General Rule - For the purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(15)(proposed) Qualified Tax Cost Expenses - The deduction allowed by section 212(3) for "qualified tax cost expenses."

(d)(1) (proposed) "Qualified tax cost expenses" are those expenses allowable under section 212(3) relating to a return required to be filed pursuant to section 6012 or 6013

(a) necessary for the preparation of the return; or

(b) incurred exclusively to respond to any inquiry or challenge by the Secretary or his delegate with respect to the return.

(d)(2) Amount Allowable - The maximum amount of qualified tax cost expenses in any given year shall not exceed \$500, no more than half of which can be attributable to subsection (d)(1)(a) items.

(d)(3) Tax advice, planning or similar fees are not "qualified tax cost expenses."

The proposal approaches the problem simply. An "above-the-line" deduction is given for qualified tax cost expenses ("QTC" expenses), a statutory term for target expenses. QTC expenses are defined in a separate subsection of the proposal. A cap is included as a cost containment measure.

Proposed section 62(a)(15) permits "above-the-line" treatment only for expenses that are allowable under section 212(3). This is in keeping with the function of section 62, which is not to grant deductions, but to identify deductions permitted elsewhere in the Code to compute adjusted gross income. Thus, the proposal does not add a new deduction to the Code; it merely repositions in the tax calculus a currently per-

192. In this context, "cost" refers to the lost revenue that would result from implementing the change.

missible deduction. This is consistent with the equity criterion, i.e., creating equal access to the already existing deduction. Further, under section 62, a deduction can only be used once.¹⁹³ Therefore, an item used "above the line" cannot be taken again elsewhere on one's return.

The centerpiece of the proposal is the definition of QTC expenses. Proposed sections 62(d)(1)(a) and (b) provide that tax preparation and audit-related fees qualify for "above-the-line" treatment. The reference to sections 6012 and 6013 makes clear that QTC expenses are limited to federal income tax-related charges. The wording of proposed subsection (d)(1)(a) is broad enough to include charges beyond those for the actual physical execution of the return. Thus, costs for appraisals, computer tax programs, and tax guidance from the government¹⁹⁴ could all be QTC expenses. The "necessary" language of the subsection should cover all bona fide tax preparation costs and prevent more remote expenditures from gaining favored status.

Proposed subsection (d)(1)(b) classifies audit-related costs as QTC expenses. The word "exclusively" ensures that only those costs necessitated by an audit receive special tax treatment. Proposed subsection (d)(3) specifically states that tax advice, tax planning, or similar charges are not QTC expenses. The case of expenses incurred for requests for government rulings on tax questions illustrates how proposed subsections (d)(1)(a) and (d)(3) work together. A "closed transaction" test, similar to the approach taken in *Kaufmann*, is used to determine whether a cost is a QTC expense. If the ruling relates to a matter for a return due in the year of the request or a prior year, the charges would be QTC preparation charges. Charges for rulings addressing prospective transactions would fall under proposed subsection (d)(3) and would not be considered QTC expenses. Rulings addressing both open and closed transactions would require an allocation of the fee to QTC and non-QTC activity, as was done in *Kaufmann*.¹⁹⁵ The subsection reinforces the position that QTC expenses are limited to those charges reasonably incurred solely due to the federal tax filing obligation. Charges to reduce one's tax liability may merit deductibility, but there is no reason to elevate them to QTC status.

The proposal includes a cap, but presents it with a unique twist. Proposed subsection (d)(2) sets an allowable amount of \$500 for QTC expenses. Expenses over the limit, even though they may fall within

193. I.R.C. § 62(a) (1993).

194. Revenue Ruling 89-68, 1989-1 C.B. 82, holds that attorneys' fees and filing costs incurred for obtaining private letter rulings are deductible under Section 212(3).

195. See *supra* notes 63-68 and accompanying text.

the QTC definition, may not receive "above-the-line" treatment. These expenses, however, are still deductible under section 212(3). QTC expenses in excess of \$500 can be aggregated with other miscellaneous itemized deductions to determine their tax fate. In its current form, the proposal imposes a static cap, but a provision adjusting the cap for inflation could be added.

The cap pays homage to the cost criterion. Notice that the proposal actually limits tax return preparation QTC's to \$250. Should the return preparation charge be \$290, only \$250 would receive QTC treatment, even though the taxpayer incurred no other "proposed subsection (d)(1)" costs. The excess \$40 becomes a miscellaneous itemized deduction. However, should a taxpayer incur a \$300 audit-related charge (a proposed subsection (d)(1)(b) expense), the full amount could be applied toward the \$500 limit. The purpose behind the bifurcated cap is to maintain some parity among taxpayers and to minimize the negative impact of the "upside-down equity" that comes with a deduction. The "(d)(1)(a)" limit also reduces the risk that tax preparation fees will be overstated. Given their inherent nature, audit-related expenses should not be so limited. Taxpayers who do not need help executing a return nonetheless may feel outmatched by the Government in an audit.¹⁹⁶ Such taxpayers, not having sought a deduction to offset the cost of meeting their tax obligations, ought to get the full benefit of the cap to defend their actions.

The cap also is necessitated by fiscal restraints. An overly expensive proposal might so impair revenue-raising objectives that it would need a compelling alternative justification. It is doubtful that an equity argument can be fashioned to show that the QTC proposal is justified at any cost.

When considering cost, one should recognize that it cannot be computed in the abstract. Cost should be measured against what is being bought. The maximum cost of the proposal may appear to be \$500 (the maximum QTC amount allowable), multiplied by the mean marginal tax rate of all returns filed. Actually, however, Revenue Ruling 92-29 already permits for some taxpayers what the proposal allows for all. Furthermore, expenses that would qualify as QTC's include section 212(3) expenses that are presently deductible, even if they do not meet the Revenue Ruling 92-29 tests. Although sections 67 and 68 may eliminate, or at least reduce, otherwise allowable section 212(3) deductions, some of those deductions still are being taken. Furthermore,

196. In *Bonnyman*, Judge Taylor observed, "Only an attorney admitted to practice before the Tax Court and skilled in that practice could reasonably be expected to know how to conduct a tax contest." 156 F. Supp. at 629.

since so few of the total returns filed are actually audited, there will not be a significant number of proposed subsection (d)(1)(b) deductions claimed. Finally, if the proposal improves compliance, there should be increased revenue or perhaps more efficient collection procedures.¹⁹⁷ Thus, the true cost of the proposal would be substantially lower than the maximum calculable amount.

Of the proposals identified, making QTC expenses "above-the-line" deductions best addresses the problem. Merely recharacterizing target expenses as nonmiscellaneous itemized deductions does not satisfy the requirements of equity. Adopting a credit may be more equitable than creating a deduction,¹⁹⁸ but it is not cost-effective. Though all taxpayers benefit equally from a credit, an unlimited credit would be too costly. The dollar limit on any cap would have to be so low that it is uncertain whether the cap could encourage taxpayers to seek qualified assistance. Another perceived evil of the credit is that its existence will help set a minimum for tax preparation, regardless of the amount of work required for the task at hand.¹⁹⁹ Thus, the credit does not seem to be the right choice for the type of item involved.

The preferred option is to make target expenses section 62 items. By doing so, the benefit becomes universally available. Cost is somewhat controlled by each taxpayer's marginal rate, and is minimized by the cap. Expenses that exceed the cap would be accorded the same treatment they presently receive.

The proposal advanced here is not flawless. Notably, as a deduction, it still favors high income taxpayers. Nevertheless, it may be preferable to the credit approach for psychological reasons: there is something more appealing about a \$500 deduction, as compared to a \$45 credit, even though in certain circumstances the two have the same tax effect.²⁰⁰ Though higher income taxpayers potentially will reap a greater benefit, the cap should prevent abuse and protect revenue. The deduction approach recognizes the likelihood that higher in-

197. The QTC proposal should provide a dual benefit. The enhanced compliance precipitated by professional preparers under a strict standard of care should reduce omissions and misstatements of income and improperly claimed deductions. The use of professional preparers should also result in greater accuracy in returns generally, which should make audits quicker and easier. A reduction in the amount of time and effort spent per audit will enable the I.R.S. to review more returns, thus encouraging still better compliance.

198. See Brannon & Morss, *supra* note 187.

199. A simple return, such as a 1040A, may actually require only a half hour of work and a \$30 fee. If the credit was set at \$50, it is more than likely the tax preparer would charge \$50. The taxpayer would not have an economic reason to complain or resist payment of the extra \$20 as it reduces his or her tax liability and does not come "out of pocket".

200. A \$500 deduction for a taxpayer in a 15% marginal tax bracket creates a \$45 tax savings ($\$500 \times .15 = \45.00).

come taxpayers have both a greater need for return preparers and a larger relative cost per return. Further, higher income returns are more apt to be audited,²⁰¹ and thus higher income taxpayers are more likely to incur proposed subsection (d)(2)-type charges. There is no ideal solution to the problem, but the proposal represents an improvement over the status quo.

In sum, a tax system dependent upon voluntary compliance requires accurate reporting and proper interpretation of the law. Currently, there is substantial underreporting of income. Penalties improve compliance somewhat,²⁰² but they are not a panacea; the Government should make other efforts to encourage accurate filing. Subsidizing the proper execution of returns is one such response. Another is assisting citizens in defending their good faith actions in meeting the federally imposed obligation.

The new section 62 proposal best meets the policy criteria for evaluating the needed reform. The proposal satisfies the equity criterion by creating equal access to the deduction for target expenses, those expenses necessarily incurred in meeting one's federal tax obligation. Limiting language prevents abuse by excluding tax planning and advice. Further, the cap contains costs, while still allowing excess target expenses to be taken as miscellaneous itemized deductions under section 212(3). Finally, by encouraging the use of professional return preparers, the proposal offsets some of its own cost by the amount of savings realized through enhanced compliance and return accuracy. The QTC proposal is worth considering.

IV. CONCLUSION

Clearly, meeting one's federal income tax obligation has become more difficult as the governing rules have increased in number and complexity. Taxpayers are frustrated by the difficulty of the filing requirements. This can easily lead to inaccurate returns and lost revenue. Many taxpayers have given up the battle and resorted to obtaining professional tax assistance. Recent legislation effectively eliminated the tax deduction that for many years had been available for such tax compliance costs. Now, through administrative rule, some taxpayers have been regranted this tax relief to the exclusion of others, even though the costs incurred are common to all.

201. The I.R.S. routinely reports that taxpayers with incomes in excess of \$50,000 are at greater risk of being audited than taxpayers with lower adjusted gross incomes. See ROBERT S. FINK, *TAX FRAUD* § 1.02[4] (1986).

202. See *supra* note 166.

Allowing deductions for some but not others is inequitable. A section 62 deduction for federal income tax preparation expenses and audit-related expenses should be made available to all taxpayers. Since every taxpayer must comply with the statutorily imposed filing requirements, every taxpayer should be afforded the same deduction opportunities with respect to meeting that obligation. A country founded on the idea of "No taxation without representation" may see as its new rallying cry: "No taxation without *deductible* representation." In sum, costs incurred for determining deductions deserve deductibility.

