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Federal Income Tax Deductions for City Officials

Charles S. Rhyne and Brice W. Rhyne†*

With the recent increases in federal income taxes, city officials are more and more concerned with the problem of ordinary and necessary expenses which may be deducted from their municipal compensation in arriving at their federal income tax liability. In fact it has been stated that some businessmen are refusing to serve as part-time city councilmen or in other part-time city offices because of the great sacrifice in time and expense involved in rendering this vital public service, sometimes referring to uncertainty of the deductibility of such expense as a reason for such refusal.

It has been suggested that a short review of the chief statutory provisions, regulations and rulings on legal deductions which have application to income of city officials from cities would prove of value.¹

The writing of such a review is difficult under ordinary circumstances, but the Bureau of Internal Revenue has just added to the difficulty by recent, and as yet, unofficial rulings which "muddy the waters" of what is at best a relatively complex and uncharted field of law.

STATUS OF CITY OFFICIALS AS TAXPAYERS

The first and most important question is whether city officials are engaged in a "trade or business" within the meaning of the Internal Revenue Code. This may seem like an unusual and artificial application of the term "trade or business" but it has important federal income tax consequences on allowable expense deductions as compared with the status of a mere

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1. The deductions from income received from sources other than a public office and personal or other deductions allowed by the Internal Revenue Code are not considered herein.

“employee.” Since the code provides in direct language that “The term ‘trade or business’ includes the performance of the functions of a public official,”² one would think that the matter is thus settled beyond question. But the Bureau of Internal Revenue is causing increasing confusion by their differing rulings on allowable deductions for public officials and their claim that the recent amendment to the Internal Revenue Code on “self-employment” income³ for social security purposes has changed the provisions just quoted above and made public officials “mere employees.” This recent amendment provides:

“The term ‘trade or business’ when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in section 23, except that such term shall not include—(1) The performance of the functions of a public office; . . .”

Since the “self-employment” provisions relate to social security, it could hardly be expected that in adopting them the Congress intentionally effected a change in the tax status of public officials for other purposes. The bureau has also advised, unofficially, that the withholding tax regulation providing that federal, state and municipal officials are “employees” for the purpose of withholding of taxes applies to all provisions of the Internal Revenue Code.⁴ It is implied that this regulation makes public officials “mere employees” for withholding purposes. But again a mere regulation cannot repeal an express statutory provision to the contrary.

Under these circumstances and in an effort to clarify the situation, the National Institute of Municipal Law Officers, on January 21, 1952, submitted a request to John B. Dunlap, Commissioner of Internal Revenue, Washington, D. C., reading as follows:

“The National Institute of Municipal Law Officers is the official organization of the legal representatives of nearly seven hundred of the major cities of the Nation. One phase of the work of these representatives is to give legal advice to the nearly five thousand city councilmen who serve these cities.

“We have been requested to obtain an official ruling from

2. Int. Rev. Code § 48(d).

3. Int. Rev. Code § 481.

4. Int. Rev. Code Reg. 111, § 405.102.

the Bureau of Internal Revenue on questions that are of vital importance to the continued ability of municipalities to attract capable persons from private business to carry on essential municipal business on a part time basis as city councilmen. These questions relate to allowable deductions on Federal income tax returns of certain ordinary and necessary expenses incurred by these part time city councilmen in carrying out their official duties.

"More and more businessmen are refusing to serve as councilmen because of the great sacrifice in time and money which is involved. But it is believed that if they are assured of Federal income tax deductions for the ordinary and necessary expenses involved in such service these persons might be more favorably inclined toward such service. Much confusion exists today as to the proper answers to the questions herein presented.

"City councilmen usually receive from \$5.00 to \$25.00 for each city council meeting attended and the councils usually meet from one to four times per month.

"As examples only of the questions which have arisen most frequently, we have been asked to inquire whether it is permissible to deduct from a city councilman's income the following expenses if borne by the city councilman:

"1. The cost of operation of his personal car on city business, such as inspecting sub-divisions, storm drains, streets, contacting residents on complaints, etc.?

"2. The costs involved in scheduled, but unofficial, meetings to discuss city business or to exchange information regarding city operations with city officials from other cities?

"3. The costs involved in attending conferences of city officials on city business, or in attending to city business outside of the home city, when authorized by the city council? (Costs would include that of operating personal car, meals and hotel expenses.)

"4. The costs of books, periodicals, etc., purchased solely for the information they contain which is useful in performing city duties?

"5. Entertainment expenses which are ordinary and neces-

sary in carrying out his duties and the conduct of his office as a city councilman?

"6. If it is not permissible to deduct the above items from the city official's income from the city, would it be permissible to include these costs in the general deductions as contributions made to a governmental agency for public purposes, when these are itemized on income tax returns?

"We believe that your early attention to this request would be in the public interest and respectfully request an answer to these questions at the earliest possible time so that the city officials affected may make out their Federal Income Tax forms properly for 1951."

The Bureau's response, dated February 5, 1952, was as follows:

"Further reference is made to your letter dated January 21, 1952, in which you state that you are the official organization of the legal representatives of nearly seven hundred of the major cities of the Nation. One phase of the work of these representatives is to give legal advice to the nearly five thousand city councilmen who serve these cities.

"You set forth several items of expense incurred by the city councilmen, and request to be advised whether such expenses would constitute allowable deductions, for Federal income tax purposes, either as ordinary and necessary business expenses or as contributions to the municipalities which they serve.

"Inasmuch as the inquiries presented in your letter would affect returns which have already been filed, this office is unable to make rulings with respect thereto.

"Under established procedure this office does not issue rulings with respect to returns already filed except on request of a field officer, since the jurisdiction of such returns is with the field offices. If the taxpayer is unable to reach an agreement with the collector of internal revenue, he may request that the matter be referred to the internal revenue agent in charge. If he is unable to reach an agreement with the internal revenue agent in charge, he may appeal the matter to the Appellate Staff. The internal revenue agent in charge will advise him as to procedure. This procedure was adopted to enable taxpayers to adjust their tax problems in their home districts."

It can thus be seen that the bureau is insisting upon continuing rather than ending the existing confusion.

Under these circumstances all one can do is set forth certain data collected on the general rulings in this field.

EXPENSE DEDUCTIONS IN GENERAL

The deductions from the total amount of salary and expenses received for adjusted gross income to city officials in connection with their public office, Item 2, Page 1, Form 1040, are limited by two provisions of the Internal Revenue Code.⁵

In general business expense, to be deductible as such, must be both "ordinary" and "necessary." The terms "ordinary" and "necessary" have been defined by the United States Supreme Court.⁶ As there defined, to be "ordinary," expenses need not be habitual or normal in the sense that the same taxpayer will have to make them often. And expenses may be "ordinary" and still be unique or non-recurring to the particular taxpayer. The word connotes "not unusual in the life of the group or community of which the taxpayer is a part." The term "necessary" according to the Court means "appropriate and helpful in the development of the taxpayer's business." In addition, the business expense must also be reasonable in amount.⁷

The code permits the deduction of expenses of travel, meals and lodgings, while away from home paid or incurred by the taxpayer in connection with the performance of his official duties for the city.⁸ This would permit deduction of expenses for travel, meals and lodging by city officials while attending state or national municipal organization meetings, whether or not he is reimbursed; however, he must be away overnight in order to claim this deduction.

The code also permits deductions for expenses which are paid or incurred under reimbursement, or other expense allowance arrangement, with the city.⁹ Thus, for example, a city official who incurs expenses (other than "travel expenses" while away from home as mentioned above) in performing his official duties for the city for which he is reimbursed or for which he receives

5. Int. Rev. Code § 22(n)(2) and (3).

6. *Welch v. Helvering*, 290 U.S. 111 (1933).

7. *Commission v. Lincoln Electric Co.*, 176 F. 2d 815 (6th Cir. 1949), cert. denied 338 U.S. 949 (1950) (element is inherent in phrase "ordinary and necessary"—Congress did not intend deductions in an unlimited amount).

8. Int. Rev. Code § 22(n)(2).

9. Int. Rev. Code § 22(n)(3).

a per diem allowance, would include in his gross income the amount of the per diem or reimbursement, but would be entitled to deduct as deductions from adjusted gross income (Item 2, Page 1, Form 1040) the amounts paid out by him for expenses not in excess of the reimbursement allowance.¹⁰

This provision allows deductions for expenses paid or incurred by a city official in the operation of his automobile on city business in inspecting subdivisions, storm sewers, streets, contacting residents on complaints, et cetera, *provided*, he is given reimbursement or a per diem allowance from the city, and provided he includes the reimbursement or per diem allowance in his gross income before deducting the full expenses involved. This provision would also permit the deduction of expenses incurred in attending local area meetings of municipal officials, and entertainment expenses where there is reimbursement or a per diem allowance arrangement with the city for the meeting.

If the city official is not reimbursed or does not receive a per diem allowance, he may not deduct these expenses in Item 2, Page 1, Form 1040, in arriving at his adjusted gross income. This makes clear one of the big differences in a mere "employee" and a person engaged in a "trade or business." However, he may still list these expenses on Page 3, Form 1040, as miscellaneous expenses, *in lieu* of the optional standard deduction.¹¹

If the requirements of travel expenses while away from home¹² and the reimbursement or per diem allowance arrangement are met,¹³ the city official may deduct these by adding all expenses paid to him into his gross income and then deduct his actual expenses therefrom to arrive at his adjusted gross income, Item 2, Page 1, Form 1040, and still be entitled to the optional standard deduction.

A member of a state legislature may deduct hotel expenses incurred while away from home performing legislative duties during the legislative session. Also, the actual expenses incurred in travel in performance of his official duties were held to be deductible.¹⁴

One of the best interpretations of the statutory provisions on deductions allowed a person in public office is contained in a

10. Int. Rev. Code Reg. 111, § 29.23(a)-2.

11. Int. Rev. Code § 22(aa).

12. Int. Rev. Code § 22(n)(2).

13. Int. Rev. Code § 22(n)(3).

14. I.T. 3368, Cum. Bull. 29 (June 1940).

letter from the Commissioner of Internal Revenue, dated July 20, 1945¹⁵ in answer to a letter requesting a ruling on the special \$2,500 expense payment to members of Congress of the United States. The letter ruling stated in part:

"Inasmuch as the term 'trade or business,' however, includes the performance of the functions of a public office, (Sec. 48 (d), I.R.C.) in computing his net income a Congressman is entitled to deduct, among other things, expenses which he sustains as ordinary and necessary, within the purview of section 23 (a) (1) (A) of the Code, in the performance of his duties. . . .

"Consonant therewith, a Congressman will be permitted to claim the \$2,500 expense allowance as a deduction from gross income by listing it as 'fully expended in the performance of official duties,' provided, however, that a Congressman, if so requested by the internal revenue agent examining his return, will, like any other taxpayer who receives an expense allowance from his employer, be required to substantiate the claimed deduction by showing that the entire \$2,500 was used for expenses which were properly deducted under section 23 (a) (1) (a) under the Code. Compare Section 29.23 (A)-2, Treasury Regulation III."

TRAVEL, MEALS AND LODGING WHILE AWAY FROM HOME

Travel expenses, including railroad fares or expenses in operation of personal automobile, meals and lodging are business expenses of a city official when these expenses are in performance of his official duties, whether or not he is reimbursed therefor.

"Travel expenses" means the cost of transportation fares, meals, and lodging *while away from home* on business. It includes porters' tips, hire of public stenographers, baggage charges, and similar expenses necessary to travel. Entertainment expenses cannot be included in travel expenses. You cannot deduct laundry and other personal expenses. Any amount paid to cover "travel expenses" must be included in wages. One can deduct full "travel expenses" from wages before writing the balance of wages in Item 2, Page 1, Form 1040.¹⁶

The Tax Court of the United States had disagreed with the

15. Published in 278 P-H Federal Income Tax Service § 76 (1948).

16. Bureau booklet, "How to Prepare Your U.S. Income Tax Return for 1951 on Form 1040."

Bureau of Internal Revenue which has ruled that in order for the taxpayer to be allowed deductions for travel expenses "while away from home," the trip must be "overnight." The court held that travel while away from home "in its 'plain, ordinary and popular' sense means . . . travel while away from one's home. There is no connotation that the trip must be an overnight one. . . ." ¹⁷ The Commissioner of Internal Revenue has not acquiesced in this decision, still maintains that travel while away from home means "overnight," and they are still litigating the *Waters* case. It may be pointed out that the decision of the court permitted only transportation expenses and nothing for meals and lodging.

In order to claim deductions for travel expenses, the taxpayer must attach to his return a statement showing (1) the nature of the business in which engaged, (2) the number of days away from home during the taxable year on account of business, (3) the total amount of expenses incident to meals and lodging while absent from home on business during the taxable year, and (4) the total amount of other expenses incident to travel and claimed as deductions.¹⁸ Claims for travel expense deductions must be substantiated, when required by the commissioner, by evidence showing in detail the amount and nature of the expenses incurred.¹⁹

Proper evidence might consist of cancelled checks (preferably to names of payees, rather than to cash), expense records, receipted hotel bills, transportation ticket stubs, and the like. Commuter fares, that is, street car or bus, are not deductible.²⁰

Deductions for travel expenses are allowed when properly supported by records of business expenses.²¹ For example, deductions have been allowed an army officer for travel expenses in connection with official duties.²² The keeping of adequate records is important, for certain rural mail carriers were denied deductions for use of their automobiles in the delivery of mail because of improper records.²³

While no rulings on cases involving city officials can be located, the travel expenses permitted under this regulation have

17. *Waters*, 12 T.C. 414, Dec. 16, 1873 (1951).

18. Int. Rev. Code Reg. 111, § 29.23(a)-2.

19. *Ibid.*

20. *Ibid.*

21. *Wallace G. Kay*, 10 B.T.A. 534 (1928).

22. *R. C. Musser*, 3 B.T.A. 498 (1925).

23. I.T. 3541, 1 Cum. Bull. 41 (1942).

been held deductible when included in gross income by an individual in the performance of his duties as an employee of the N.R.A.,²⁴ when incurred by a "dollar-a-year" man while rendering services to the federal government,²⁵ when incurred by a taxpayer employed by the United States who expended his own funds for subsistence and transportation of himself and his secretary, in an amount in excess of his allowance for that purpose,²⁶ and when expended by field officers of the Bureau of Internal Revenue.²⁷ These field officers were permitted to deduct amounts expended by them for such days as they received a per diem allowance, the amount received per diem being included in gross income.

USING A PERSONAL CAR FOR CITY BUSINESS

The expenses incurred by a city official on city business *while away* from home for use of his personal automobile are covered under the previous heading, *Travel, Meals and Lodging*, and will not be discussed further herein.

The expense incurred by a city official in using his personal car within the city while on a reimbursement or expense allowance is deductible from gross income in arriving at adjusted gross income before writing the balance of income from the city on Item 2, Page 1, Form 1040.

If the city official is not reimbursed or given a per diem allowance for the expense incurred in the use of his personal car on city business, he may list these expenses on Page 3 of Form 1040, along with interest, taxes, contributions, and medical and miscellaneous expenses. However, it is to be borne in mind this is not in addition to but in lieu of the standard deduction which is permitted.

If the city official is reimbursed and his expenses come to more than the actual reimbursement, he must include the reimbursement in gross income and he may then deduct the full amount of reimbursed expenses before the writing of the balance of his receipts from the city in Item 2, Page 1, Form 1040. The balance must be deducted from adjusted gross income in

24. I.T. 2721, Cum. Bull. 38 (1933). To the same effect, J. C. Palmer, 1 B.T.A. 882 (1925).

25. G.C.M. 23672, Cum. Bull. 66 (1943).

26. D. C. Jackling, 9 B.T.A. 312 (1927). To the same effect John J. Ide, 43 B.T.A. 799 (1941).

27. I.T. 1380, 1-2 Cum. Bull. 88.

computing net income (as a miscellaneous deduction, Page 3, Form 1040), unless the standard deduction is claimed.²⁸

DEPRECIATION, AND OPERATION EXPENSES FOR AUTOMOBILE
USED ON CITY BUSINESS AT HOME

Expenses of operation and maintenance of an automobile are allowable as deductions to the extent they represent the cost of transportation actually required in carrying on a trade or business. If the new unofficial position of the bureau is officially announced and upheld by the courts and city officials are mere employees, such expenses are deductible only if the taxpayer received a reimbursement or per diem allowance from his employer. While they do not involve city officials, rulings permitting depreciation, operation or maintenance deductions where a personal automobile was used partially for business and partially for personal use which illustrate the possible rulings for city officials are as follows: 50% for business use;²⁹ maintenance, depreciation and insurance in the amount of 50%;³⁰ one 80% business deduction;³¹ and a 70% deduction,³² all of which were based on proper records.

It is for the city official to determine whether the extent of his use of his automobile warrants the necessity of holding himself ready to make proof of the allocation required by the cases. The starting point in making proof is an accurate statement of the total expenses, including all items that enter into the cost of operation of the automobile, including its capital costs for depreciation purposes. The total amounts expended should not, if possible, be mere estimates on the taxpayer's part.

This does not mean that the Bureau of Internal Revenue may wholly deny allocated business expenses where the amount claimed has support only in the taxpayer's personal estimates. In the *George M. Cohan*³³ case, a federal court directed the board to find some basis for making an allowance for entertainment and travel expenses where evidence showed that considerable sums were spent, although no records were kept.

28. Harold R. Love, 10 T.C.M. 606, Dec. 18,419 (M) (1951).

29. *Wagner v. Lucas*, 38 F. 2d 391 (D.C. Cir. 1930).

30. *Albert Nelson*, 6 T.C. 764 (1946).

31. *Appeal of J. R. James*, 2 B.T.A. 1071, Dec. 917 (Acq.) (1925).

32. *Conelo*, 41 B.T.A. 713, Dec. 11, 05 (1940).

33. *Cohan v. Commissioner*, 39 F. 2d 540 (2d Cir. 1930).

ENTERTAINMENT EXPENSES

The amount a city official may deduct from his gross income in arriving at his adjusted gross income on Page 1 of Form 1040 is probably limited to *reimbursed* entertainment expenses which are directly connected with his services performed for the city. There is at least one specific ruling which has held these expenses deductible even though no reimbursement or per diem allowance was provided. This case involved a naval officer who had been appointed Governor of American Samoa. He used his personal funds for dinners, luncheons, teas, transportation, and household entertainment expenses. The Board of Tax Appeals held that these expenditures were deductible as "ordinary and necessary expenses." The board stated:

"There was no definite understanding between the petitioner and the officials of the Department of the Navy or the President that petitioner would be compelled to extend these courtesies or spend the money therefor. On one occasion, however, the petitioner received orders from both the President and the Department of the Navy to extend all possible courtesy to a British Commission which visited Samoa, but no allowance was made for expenditures on their account.

"In making these expenditures petitioner believed he was carrying on his profession or business of being a naval officer and the position of Governor of American Samoa, and upholding the dignity and prestige of the United States. He considered that he could not decline the invitations from foreign officials nor refuse to return them in kind without lowering the dignity and respect of the United States. These expenditures were imposed on him entirely outside of his own volition. They were an absolutely necessary incident to his position. He could not consistently with his duties have refrained from making the expenditures.

"If he had failed to extend courtesies to a foreign official he probably would not have been demoted, but he would have been liable to being summarily detached for failing in official courtesy, his record would have been impaired, and it probably would have resulted in his loss of future promotion. . . ." ³⁴

A city official is in the same classification and should, there-

34. *Harris-Emery Co. v. Commissioner*, 10 B.T.A. 297, Dec. 3686 (1928).

fore, be permitted to deduct any entertainment expenses which are reimbursed (or according to this decision even though not reimbursed) and which are "ordinary and necessary" and reasonable in amount in performance of their public office.

Entertainment expenses deductions meet with considerable skeptical opposition from internal revenue examining agents, and the taxpayer should be able to, upon request, furnish additional information in the nature of dates, names, and exact amounts, if he claims these deductions.

TECHNICAL BOOKS AND MAGAZINES

In order for the present day city official to be well informed on the multitude of problems confronting municipalities, it is necessary that he subscribe to many technical books and periodicals. However, under the bureau's "unofficial" ruling the subscription costs for technical books and periodicals can only be listed on Page 3, Form 1040, under miscellaneous expenses, unless of course an officer such as a city attorney is given an allowance for law books, et cetera. The Bureau of Internal Revenue has published a special bulletin on this subject which is the "law" to collectors and the other officials of the bureau. This bulletin states that the cost of technical periodicals and books purchased by a business or professional man which have a temporary value are deductible as an expense of doing business.³⁵

CONTRIBUTIONS

As already indicated above, contributions to cities are deductible under certain conditions and limitations. It may be helpful here to quote the ruling of E. I. McLarney, Deputy Commissioner of Internal Revenue, on October 8, 1951, to Samuel H. Sabin, General Counsel of the Federal Civil Defense Administration, which discusses the applicable law and rulings. This ruling is as follows:

"Reference is made to your letter dated June 28, 1951, addressed to Mr. Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, with which you enclosed a copy of a letter from Mr. L. W. Argetsinger, Jr., Director of Civil

35. Bureau Bulletin "F," Government Printing Office, Washington, D.C. (contains information on temporary books, periodicals, et cetera, and depreciation allowance tables for permanent libraries, machines, equipment, et cetera).

Defense for Schuyler County, New York, to Colonel Lawrence Wilkinson, New York State Civil Defense Director, wherein he requests to be advised (1) whether the value of building materials donated by a supplier to a county civil defense organization for the purpose of building observation posts would be deductible for Federal income tax purposes and if so, he requests to be advised what the value of such contributions would be and (2) whether the value of time donated by carpenters in building the observation posts would be deductible for Federal income tax purposes.

"You state that the Schuyler County Civil Defense organization is a public, governmental body of Schuyler County, and the observation posts, when completed, would be the property of the County.

"Section 23 (o) (1) of the Internal Revenue Code, as amended, provides that in the case of an individual, contributions or gifts, payment of which is made within a taxable year, to or for the use of the United States, any State, Territory, or any political subdivision thereof or the District of Columbia or any possession of the United States for exclusively public purposes, are deductible for Federal income tax purposes in an amount which, when added to the other contributions allowable under section 23 (o), does not exceed 15 percent of the taxpayer's adjusted gross income.

"Section 23 (q) (1) of the Code, as amended, provides for the deduction of similar contributions in the case of a corporation in an amount which, when added to the other contributions allowable under section 23 (q), does not exceed 5 percent of the taxpayer's net income as computed without the benefits of such section.

"If the contribution or gift is other than money, the basis for the calculation of the amount thereof is the fair market value of the property at the time of the contribution or gift.

"The Bureau has held that if property contributed to an organization which qualifies under the provisions of section 23 (o) or (q) of the Internal Revenue Code is of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by a taxpayer primarily for sale to customers in the ordinary course of his trade or business, the fair

market value of such property at the time of the contribution or gift would be includible in the donor's gross income. A contrary conclusion was reached by the Tax Court of the United States in *Estate of W. G. Farrier v. Commissioner*, 15 T. C. 277. Notwithstanding this decision of the Tax Court, the Bureau at present adheres to the position outlined above.

"Therefore, it is held that a supplier who contributes building materials to the Schuyler County Civil Defense organization would be entitled to claim a deduction in his Federal income tax return for the fair market value of such building materials at the time of the contribution or gift, limited to the extent provided in section 23(o) or (q) of the Code. It is further held that the supplier would be required to include in his gross income the fair market value of the materials at the time of the contribution. The cost of the donated building materials will presumably have been included in the cost of goods sold.

"It is the opinion of this office that the fair market value of the building materials contributed by a supplier would be the price at which such materials would be sold at wholesale or at retail, as the case may be.

"The Bureau has construed the term 'contributions or gifts' to mean gifts of money or property.

"Accordingly, it is held that a carpenter who donates his time to build observation posts for the Schuyler County Civil Defense organization would not be entitled to claim a deduction for the value of his time for Federal income tax purposes."

CONCLUSION

One cannot write with much certainty in this field when the Bureau of Internal Revenue insists upon maintaining a position of refusal to eliminate existing confusion both as to its past and future rulings. It is to be hoped that in the future the existing uncertainties will be clarified and city officials will no longer be in doubt as to what they can claim as deductions for federal income tax purposes.