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Alan L. Feld

*Boston Univeristy School of Law*

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ALAN L. FELD*

IT IS increasingly common to find families composed of husband, wife and young children, where both husband and wife are gainfully employed. For some, this pattern is regarded as preferable to the older "ideal" family, where the husband was the sole breadwinner and the wife cared for the children, performed household chores and perhaps engaged in social or charitable activities. Where both spouses are gainfully employed, it is often necessary for the family to employ household help to care for the children and do the housework. These expenditures are "necessary" to the gainful employment of both spouses in the sense that if they were not made, at least one spouse could not be employed. Yet the expenditures are for services which ordinarily would be regarded as personal; families may employ a housekeeper even if one spouse stays at home.

From its inception the federal income tax has allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business.[1] Since 1942 ordinary and necessary expenses paid or incurred by an individual for the production or collection of income have also been deductible.[2] Just as fundamental, however, has been the principle that no deduction is allowed for personal, living or family expenses.[3] Apart from a narrow exception enacted by Congress in 1954 and enlarged in 1964,[4] the courts have uniformly treated child care and household expenses as personal and therefore nondeductible.[5]

* ALAN L. FELD (A.B., Columbia, 1960; LL.B., Harvard, 1963) is Associate Professor of Law at Boston University School of Law and a member of the New York Bar.

[1] This deduction now appears as section 162(a).

[2] *See* I.R.C. § 212(1).

[3] I.R.C. § 262. In the Revenue Act of 1913, this provision was a limitation upon the deduction provision, Revenue Act of 1913, § IIB, 38 Stat. 167.

[4] I.R.C. § 214.

[5] *E.g.*, Henry C. Smith, 40 B.T.A. 1038 (1939), *aff'd without opinion*, 113 F.2d 114 (2d Cir. 1940).

The Revenue Act of 1971 substantially liberalized the tax treatment of expenditures for household services and for child and dependent care, where incurred to enable the taxpayer to be gainfully employed.[6] While the act alleviates much of the financial burden of out of pocket employment related costs for many taxpayers, the deduction remains limited by questionable restrictions and a number of administrative issues (pending promulgation of regulations) remain unanswered. Yet in some respects the new provision may be overbroad, permitting too much to be deducted.

## Background

### Pre-1954 Case Law

The Treasury ruled as early as 1923 that the cost of employing a nurse to care for a child so that the mother could be gainfully employed was nondeductible.[7] But the issue appears not to have been litigated until 1939 in the decision of the Board of Tax Appeals in *Henry C. Smith.*[8] The taxpayers argued that expenditures for nursemaids to care for their young child were necessary to their earning their income in a "but for" sense—without providing child care the wife would not have been able to leave the child to pursue her employment. Judge Opper rejected this argument on the basis that it proved too much: All personal expenditures could be justified as contributing to the creation of income. Without food, clothes and shelter, all concededly nondeductible personal items, income could not ordinarily be earned. Although conceding that some normally personal disbursements may become deductible by reason of their connection with transactions entered into for profit, the Board nevertheless concluded that the connection between child care expenses and the income producing activity was too tenuous. The principle as the Board saw it was whether the expense is "usual as the direct accompaniment of business pursuits" or whether it is, despite some relationship to a profitable occupation, "of a character applicable to human beings generally," regardless

[6] Revenue Act of 1971, Pub. L. No. 92-178, § 210, 85 Stat. 518.

[7] I.T. 1767, II-2 C.B. 156 (1923). In accordance with its program of reviewing pre-1954 Code rulings, the Service has declared I.T. 1767 obsolete and not determinative of future transactions, Rev. Rul. 67-466, 1967-2 C.B. 427, presumably because the Revenue Act of 1921, under which I.T. 1767 was issued, is no longer in effect. Apparently, however, the determination of obsolescence has no effect on existing Service policy, despite the similarity in language of section 215(a)(1) of the 1921 act and present section 262.

[8] 40 B.T.A. 1038 (1939), *aff'd without opinion*, 113 F.2d 114 (2d Cir. 1940).

of the individual's occupation. Thus, the particular subjective intent of each taxpayer in making such expenditures should not be considered.

The Board's opinion may have rested on a simple judgment as to the proximate relation of the expenditure to the actual process of earning income, *i.e.*, the expenditure was not "necessary" as required by section 162 and its predecessors. On the other hand, the Board conceivably may have determined that the child care expenditure was not "ordinary," for section 162 distinguishes between those expenditures which are normally business or income related and those which are extraordinary and are therefore nondeductible.[9] In the latter case, a change in the society's business norms so as to regard child care expenditures of a working mother as commonplace business expenditures might give rise to deductibility. If this invitation to future change in the result was implied, it has not been accepted by later courts. On either reading, however, the opinion's refusal to examine the taxpayer's subjective intent in incurring the expense seems sound. The contrary rule, requiring a case by case determination of whether the intent in incurring the expenditure was primarily personal or business, probably would have proved most difficult to administer.[10]

Judge Opper also reasoned by analogy to the exemption from tax for "imputed income" derived from a housewife's labors. The increase in value to the family produced by a wife's household work is not included in income for tax purposes, at least partly on the ground that such work is personal. Even where a husband agrees to pay his wife for such labor, the amount paid is a nondeductible personal expense to the husband and is not income to the wife.[11] Where the wife hires another to take her place in providing the household services, the opinion argued, what changes the work from personal to business related so as to afford the wife a deduction? Here Judge Opper appears to have been on less sound ground. Other work which does not charge the taxpayer with income when performed for himself, nevertheless may result in a deduction when the taxpayer pays another to do the same task. For example,

[9] Compare the reasoning in Welch v. Helvering, 290 U.S. 111 (1933), where the Supreme Court held the individual taxpayer's payment of a corporation's debts, which had been discharged in bankruptcy, not to be "ordinary" after looking to "life in all its fullness" to "supply the answer to the riddle." 290 U.S. at 115.

[10] The Tax Court continues to reject the "but for" argument. *See, e.g.*, Richard W. Drake, 52 T.C. 842 (1969), denying a deduction for a soldier's extra haircuts which the army required twice as frequently as he usually took them.

[11] Rosa E. Burkhart, 11 B.T.A. 275 (1928).

when a lawyer who can type his papers instead hires a secretary for this purpose, her salary is deductible despite the fact that had he done the typing himself, no income would have been imputed to him. Judge Opper may have been adverting in another way to the problem of classifying the activity as inherently work related or personal. In an accounting sense, he viewed the payment for outside household help as related to the wife's nontaxable work at home, separate from the income produced by her work on the job and, accordingly, not to be taken into account as an offset to the latter.

The principle of nondeductibility for child care established in the *Smith* case was followed in *Mildred A. O'Connor*,[12] and approved in a number of subsequent decisions.[13] In addition to section 162, taxpayers unsuccessfully urged the applicability of section 212 and, in one case, the medical expense deduction under section 213.[14] It remained for Congress in 1954 to provide a limited deduction for child care and for the care of other dependents physically or mentally incapable of caring for themselves.

### 1954 Enactment of Section 214

Section 214 granted a limited deduction in special hardship cases, where child care or other dependent care expenses must be incurred in order to permit a family to earn a minimum livelihood. The House version would have limited the deduction only to widows, widowers, divorced persons or working mothers where the husband is incapacitated, to the extent of $600 per year.[15] As finally enacted, section 214 followed the somewhat broader Senate version, extending the deduction to widowers and all working women, subject to a limitation based on adjusted gross income in the case of married women.[16] If the combined adjusted gross income of the wife and her husband was not more than $4,500, the deduction would be allowed in full. The deduction was to be reduced dollar for dollar to the extent the combined adjusted gross income exceeded $4,500. And, no deduction was allowed where the combined adjusted gross

12 6 T.C. 323 (1946).

13 Edward Hauser, 8 T.C.M. 384 (1949); Eugene Lorenz, 8 T.C.M. 720 (1949); Katherine C. Thurston, 10 T.C.M. 809 (1951). Under the 1954 Code see Kenneth S. King, 19 T.C.M. 1519 (1960).

14 George B. Wendell, 12 T.C. 161 (1949).

15 H.R. Rep. No. 1337, 83d Cong., 2d Sess. A61 (1954).

16 A perhaps unintended result of this broader description of taxpayers who may claim the deduction was to allow the deduction, without the income limitation, to a working unwed mother while imposing the limitation on a working wed mother.

income exceeded $5,100. Moreover, a married woman claiming the deduction was required to file a joint return with her husband. Thus, the statutory scheme was to allow some deduction for child care in hardship cases, including low income married couples where the need to work, in an economic sense, was great. In a sense, Congress may be seen as having reached a determination different from prior case law in these limited cases as to the proximity of the expenditure to the process of earning income. But the personal nature of the expenditure continued to be reflected in the treatment of the deduction as an itemized deduction (not available if the taxpayer claimed the standard deduction) rather than as a trade or business deduction.

The section 214 deduction was expressly limited to care whose purpose was to enable the taxpayer to be gainfully employed. The committee reports [17] and the regulations [18] included in this concept expenses incurred while the taxpayer was in active search of gainful employment as well as those incurred during periods of gainful employment. This provided a somewhat more liberal rule in the dependent care area than was generally available for employment seeking expenses.[19] Otherwise, the regulations treated the question of whether the expenditure is to enable the taxpayer to be gainfully employed as one of fact, raising a question as to purpose only where the expenses of providing care were greater than the amounts anticipated to be received from the employment.[20] The Treasury also construed the section to exclude child care where the purpose is to enable a mother to study or take courses.[21] Perhaps then it was unnecessary to elaborate further on the determination of whether dependent care was for the purpose of enabling the taxpayer to be gainfully employed in view of the timing connection between the expense for dependent care and the earning of income.

In 1964 Congress liberalized section 214 by increasing the $600 maximum deduction to $900 where there were two or more de-

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17 H.R. Rep. No. 1337, 83d Cong., 2d Sess. A61 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 221 (1954).

18 Reg. § 1.214-1(a).

19 Reg. § 1.212-1(f); Mort L. Bixler, 5 B.T.A. 1181 (1927). *But see* David J. Primuth, 54 T.C. 374 (1970); Guy R. Motto, 54 T.C. 558 (1970); Kenneth R. Kenfield, 54 T.C. 1197 (1970).

20 Reg. § 1.214-1(f)(4); *see also* Reg. § 1.214-(f)(5) Ex. 4. Compare the statutory presumption in section 183.

21 Rev. Rul. 56-169, 1956-1 C.B. 135. Compare the rule of nondeductibility for education expenses which are not for the purpose of maintaining or improving skills required in the trade or business or for the purpose of retaining an existing position or status. Reg. § 1.162-5(a).

pendents. The $4,500 adjusted gross income ceiling in the case of a working married woman and her husband was increased to $6,000; the age of a child qualifying for the care was increased from below 12 to below 13; and husbands whose wives were incapacitated or institutionalized were added as taxpayers who could claim the deduction.[22] In structure, however, the deduction remained essentially the same: A relief provision for hardship cases and couples with relatively low joint incomes.

The relief provided in 1964, however, soon proved insufficient. By the late 1960's, there was renewed dissatisfaction with the statutory limitations on child care deductions. The substantial increase in family dollar income in the United States in the sixties, due in part to inflation, meant that proportionately fewer families were eligible for the full deduction under the $6,000 adjusted gross income limit.[23] The dollar for dollar reduction for income over $6,000 eliminated any deduction where the joint adjusted gross income exceeded $6,900. At the same time, these inflationary pressures made the $600 deduction for one dependent (or $900 for more than one dependent) relatively less adequate as a child care allowance. Moreover, the limitations on the child care deduction became an ideological matter for women's rights groups, which construed the limitations as one further instance of antifeminine bias.[24] The political importance of this question was no doubt enhanced by the substantial number of working mothers who did not qualify under section 214.[25] Finally, it was believed by many that tax subsidies should be used to reduce the number of welfare recipients by providing prospective employers with tax incentives to create jobs. While such subsidies would be directed principally to creation of jobs in industry,[26] the possibility of creating domestic jobs was also suggested.[27] These sometimes conflicting goals shaped the 1971 amendment of section 214.

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22 Revenue Act of 1964, § 212(a).

23 Between 1963 and 1968 the percentage of United States families with income under $6,000 declined from 47.3 per cent to 28.0 per cent. U.S. BUREAU OF LABOR STATISTICS, HANDBOOK OF LABOR STATISTICS 1970, table 175.

24 *See* the Tax Court's statement in M.P. Nammack, 56 T.C. 1379, 1385 (1971), *aff'd per curiam*, 459 F.2d 1045 (2d Cir. 1972).

25 The number of working mothers with children under 18 years of age rose from 6,526,000 in March 1959 to 9,742,000 in March 1969. U.S. BUREAU OF LABOR STATISTICS, HANDBOOK OF LABOR STATISTICS 1970, table 14.

26 *See* Revenue Act of 1971, § 601, creating a tax credit in support of WIN (Work Incentive Program).

27 *See* S. 2774, 92d Cong., 1st Sess. (1971).

## The Revenue Act of 1971: Amendment of Section 214

The House version of the Revenue Act of 1971 contained no provision affecting section 214 of the Code; however, a liberalizing provision along the lines of the 1964 amendments had been passed by the House as part of H.R. 1, the Social Security Amendments Act of 1971, providing for basic welfare reform,[28] which had been stalled in the Senate Committee on Finance. That committee added to the Revenue Act of 1971 a substantial revision of section 214 which was enacted after some changes on the Senate floor and in the conference committee.[29]

### SUMMARY OF CHANGES TO SECTION 214

The revised deduction section continues to be available only to a somewhat limited class of taxpayers, now described as an individual who, either alone or together with a spouse, maintains a household (*i.e.*, provides over half the cost of maintaining a household) in which at least one "qualifying individual" is a member. A qualifying individual is defined as a dependent under the age of 15 or an incapacitated dependent or spouse.

#### *Effect on Working Couples*

The new provision alters the effect of section 214 on a family with two healthy working spouses and a minor dependent in the following five respects:

(1) *Broadening of the Deductible Expenses.* The deduction is allowed for "employment-related expenses" which not only includes expenses of providing care for a child or other dependent individual but also includes, for the first time, expenses for "household services." [30] As the Senate Committee on Finance noted, expenses for household services "can to some extent be likened to an employee business expense." [31] Expenses for such services as

[28] H.R. 1 would have increased the $6,000 ceiling on combined adjusted gross income in the case of a married working woman to $12,000 and would have increased the maximum amount of deductible child care expense to $750 for care of one child, $1,125 for two children and $1,500 for three children or more.

[29] Revenue Act of 1971, § 210. The act also sought to encourage construction and rehabilitation of child care facilities outside the home by employers by providing a special five year amortization of the cost of such facilities. Revenue Act of 1971, § 313(a), enacting new section 188.

[30] I.R.C. § 214(b)(2)(A).

[31] S. REP. No. 92-437, 92d Cong., 1st Sess. 60 (1971). A similar thought was expressed in 1954 in support of the child care deduction, but without the equivocation "to some extent." S. REP. No. 1622, 83d Cong., 2d Sess. 221 (1954).

cleaning the house, cooking and washing clothes are deductible. Conceivably, such other supporting services as repair work around the house and perhaps even painting the house, are deductible. However, amounts paid to employ an individual "predominantly" as a gardener, bartender, or chauffeur are expressly excluded as deductible expenses for household services.[32] As under prior law, in order to be deductible all of the expenses must be incurred to enable the taxpayer to be gainfully employed.

(2) *Increase in the Amount Deductible.* The amount of the deduction is increased from $600 a year for one child and $900 a year for more than one child to a maximum of $400 a month or a total of $4,800 a year.[33] The amount of deductible expense is determined on a month by month basis, so that a taxpayer who incurred $500 of expense in one month and $300 in another would be permitted a maximum deduction of $700. Except for child care, all services must be performed in the taxpayer's household. Child care services provided outside the taxpayer's household are subject to an additional set of dollar limitations: $200 a month in the case of one child, $300 in the case of two children and $400 in the case of three or more children.[34]

(3) *Increase in the Adjusted Gross Income Limitation.* The Revenue Act of 1971 increases the combined adjusted gross income limitation for working couples from $6,000 to $18,000. A married couple, otherwise qualifying, whose combined adjusted gross income is less than $18,000, may claim the permissible deduction in full.[35] Moreover, the old rule of "wasting" the deduction dollar for dollar by the excess over the adjusted gross income ceiling has been modified to produce a less abrupt reduction equal to one half the excess. When combined with the increase in the maximum deduction allowable under section 214, some deduction is available up to a maximum adjusted gross income of $27,600.

(4) *Enlargement of Class of Dependents.* The class of dependents whose care is deductible was enlarged in two respects.[36] Under old section 214, a dependent who was capable of caring for himself

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[32] S. REP. No. 92–533, 92d Cong., 1st Sess. 42 (1971). The Senate Committee on Finance report had excluded services only of a chauffeur. On the Senate floor, Senator Bennett objected that the expenses for a bartender serving drinks in the home might be a deductible household service and Senator Long agreed to remedy that in conference. 117 CONG. REC. S18553 (daily ed. Nov. 15, 1971).

[33] I.R.C. § 214(c).

[34] I.R.C. § 214(c)(2)(B).

[35] I.R.C. § 214(d).

[36] I.R.C. § 214(b).

had to be both under 13 and either a child or a stepchild of the taxpayer in order to qualify. The new section first increases the age limit from 13 to 15 and, second, eliminates the restriction to children and stepchildren by extending the provision to all of the dependency relationships described in section 152. Since the dependent must be a member of the taxpayer's household,[37] and the taxpayer must provide over one half its support,[38] this seems sound.

(5) *Requirement of Substantially Full-Time Employment.* A new limitation requires that in the case of a married couple either both spouses must be gainfully employed on a substantially full-time basis or one spouse must be physically or mentally incapable of caring for himself.[39] The conference report defines employment on a substantially full-time basis as meaning employment for three fourths or more of the normal work week or the equivalent during the month.[40] This test is applied on a month by month basis. Presumably, the phrase "gainfully employed" incorporates the meaning given similar language in section 214, so as to include the process of actively looking for work as within the rubric of gainful employment and exclude such nonincome producing activities as additional education which is not work related.

### *Other Restrictions*

The importance of two restrictions carried over from prior law will be increased by reason of the increase in the amount deductible and other changes. First, section 214 does not grant a deduction for payments made to the related individuals enumerated in section 152(a)(1)–(8) (such as parents, siblings or descendents) or to an individual claimed as a dependent under section 152(a)(9).[41] This expands a prior restriction disallowing such payments where the related party was claimed as a dependent.[42] Thus, under prior law a related payee could qualify if the taxpayer did not provide over half his support and therefore was not entitled to a dependency exemption. This is no longer the case. It may be argued that such a restriction discriminates against the poor since intrafamily assistance in this form may be more widespread in lower income families, the extended family may reside within a sufficiently close area

[37] I.R.C. § 214(a).
[38] I.R.C. § 152(a).
[39] I.R.C. § 214(e)(2).
[40] S. Rep. No. 92–533, 92d Cong., 1st Sess. 42 (1971).
[41] I.R.C. § 214(e)(4).
[42] I.R.C. § 214(b)(3) (prior to 1971 amendment).

to make such work more practicable, and poorer families may not be able to afford outside help. Moreover, the restriction runs counter to the usual tax treatment of members of a family as separate tax entities. Nevertheless, the limitation appears to carry forward a sound policy, reflected in other Code provisions, of policing certain kinds of intrafamily transactions by denying a party the tax benefits of the transaction.[43] Such policing is necessary to prevent taxpayer abuses. In the case of child care expenditures, it would be difficult to ascertain whether payments between family members had been made, particularly where the recipient is not otherwise subject to federal income taxation. Even where proof of payment can be had, since the money remains within the family unit, it is questionable whether there has been a sufficient change in economic circumstances to warrant the deduction.

Perhaps less justifiable is the second restriction carried over from prior law, that the deduction allowed by section 214 must be itemized and may not be claimed if the standard deduction is claimed.[44] Since itemization of deductions is correlated with adjusted gross income levels, the effect of this requirement would seem to fall most heavily on lower income families.[45] Moreover, to the extent that child care and related expenditures are regarded as business related, it would seem appropriate to treat them like other trade or business expenses, permitting deduction to those taxpayers who nevertheless use the standard deduction; section 62(8) gives such treatment to the moving expenses deduction, which also combines income earning and personal consumption benefits. On the other hand, the standard deduction is in lieu of personal deductions and if the personal element is thought to predominate, itemization of section 214 deductions might be more appropriate.

The new section also modifies the treatment of taxpayers other than working couples who previously were within section 214. They too share in the increase in the amount of the permissible deduction and the broadening of deductible expenditures to include household services. But for the first time, they are subject to the adjusted gross income ceiling.[46] In the case of dependents other than children under 15, the amount of the deduction is subject to an additional dollar for dollar reduction equal to the individual's adjusted gross

[43] Compare I.R.C. §§ 267, 318, and 1239. *See* Rosa E. Burkhart, 11 B.T.A. 275 (1928).
[44] I.R.C. §§ 62, 63(b).
[45] INTERNAL REVENUE SERVICE, 1969 STATISTICS OF INCOME, INDIVIDUAL INCOME TAX RETURNS, tables 2.1 and 2.6 (1971).
[46] I.R.C. § 214(d).

income plus nontaxable disability payments in excess of $750. In the case of an incapacitated spouse the reduction is only for disability payments.[47] Thus, for example, if the qualifying dependent is a parent of the taxpayer who has dividend or other investment income in excess of $750, the permissible deduction will be reduced dollar for dollar by the excess over $750.[48] Such excess is presumably deemed to be in the nature of compensation to the taxpayer for the expense of the dependent's care, notwithstanding the fact that the dependent may keep the income so earned without paying it over to the taxpayer. This reduction is applied first to the portion of the dependent care expense which is in excess of $400 per month (the nondeductible portion), and then to the deductible portion of the expense. After this reduction is made, the limitation for adjusted gross income in excess of $18,000 is applied on a 50 per cent basis.[49]

## Evaluation of New Section 214

New section 214 is generally more advantageous than its predecessor to the taxpayer who can qualify for the deduction. But measured by the basic problem of tax administration presented by dependent care expenses, the new provision may be both more bountiful than necessary to meet the objections to the prior section, while remaining too restrictive to meet them fully. This proposition will be examined first in the context of child care expenses.

A major problem presented by a deduction for child care expenses is the familiar difficulty of distinguishing personal expenditures from those incurred to earn income, where a particular expenditure performs both functions. The same problem has arisen in a variety of forms in the travel and entertainment area. The businessman's cocktail with a business associate,[50] and the business convention in Miami Beach or Puerto Rico,[51] present a similar problem of tax administration—how to distinguish the expense for personal gratification from the legitimate business expenditure.[52] Rightly or

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47 I.R.C. § 214(e)(5).

48 The personal exemption also will amount to $750 per person beginning in 1972. Revenue Act of 1971, § 201(b). Unlike the personal exemption, however, where additional exemptions are given for age or blindness, there are no such special exemptions under section 214(e)(5).

49 S. Rep. No. 92-533, 92d Cong., 1st Sess. 42 (1971).

50 I.R.C. §§ 274(a)(1)(A) and (e)(1); Rev. Rul. 63-144, 1963-2 C.B. 129 (questions 15-20).

51 Rudolph v. United States, 370 U.S. 269 (1962).

52 For a description of some of the excesses possible in these and related areas see

wrongly, mothers rather than fathers are generally regarded as having the primary family responsibility for child rearing during working hours. When a mother wants to work she generally must find a substitute to assume this responsibility in her absence. The expenses of this care are to enable the mother to work and are incident to the process of earning income. At the same time, the services provided are of a kind which mothers who do not work also incur occasionally in order to relieve themselves temporarily of child care responsibility. The gratification obtained by the working mother in her job differs from the psychic returns of other taxpayers in that it includes the additional satisfaction of having someone else take care of the children. Of course, the extent of the enjoyment derived from this service will vary among working mothers; indeed, for some the anxiety of being concerned about the welfare of the children under the care of others will outweigh any satisfaction. Generally, however, child care expenses serve both a personal and an income producing function.

The judicial solution to the question of deducting child care expenses was to deny any deduction because their personal nature was too predominant. This solution has been objected to on the ground that it creates an undue tax barrier to a wife seeking gainful employment.[53] In general, the argument goes, the tax laws should not discourage one form of economic activity relative to another. The disincentive arises because the working wife must, in effect, pay taxes on her gross earnings and spend her after-tax dollars for child care. Stated another way, the failure to allow child care expenses as an offset to the wife's income for tax purposes results in a tax on her gross earnings rather than her net earnings.

By reason of the progressive rate structure, the amount of the tax disincentive resulting from nondeductibility increases with the taxpayer's marginal tax bracket: The higher the taxpayer's taxable income (computed without regard to the child care expenses), the higher the applicable tax rate and the greater the cost in actual tax dollars of child care expenses. Moreover, where married taxpayers file joint returns, the cost in tax dollars will increase as the combined taxable income increases whether the taxable income is

STERN, THE GREAT TREASURY RAID ch. 6 (1965). A similar problem is presented by the taxability of food or lodging received by the employee on the employer's business premises for the convenience of the employer. I.R.C. § 119.

[53] The arguments are summarized in Blumberg, *Sexism in the Code: A Comparative Study of Income Taxation of Working Wives and Mothers*, 21 BUFFALO L. REV. 49 (1971).

derived from the wife's efforts, outside investments or the husband's compensation. Thus, for example, where the joint taxable income would be $50,000 if only the husband worked, any added income of the wife will be taxed starting at a rate of 50 per cent. Consequently, she must earn double her child care expenses to break even after taxes.[54]

As another instance, consider the case of a wife contemplating part-time teaching for which she will incur an additional $2,000 in child care expenses but from which she expects to earn $6,000. Without tax considerations, this would be expected to net her $4,000. Computing taxes without a deduction for child care expenses and assuming that she and her husband have only enough additional taxable income to absorb all deductions and exemptions, her tax bill would be $1,000 and she would net $3,000. With deductibility however, her tax bill would decline to $620 and her net after taxes and expenses would be $3,380. Nondeductibility thus may be said to create a disincentive to her working of $380 of additional tax cost. In other words, the deduction of child care expenses would be worth $380 to her, increasing her net earnings by 12.67 per cent.

Set forth on page 428 in tabular form is the amount of the tax disincentive to this hypothetical part-time teacher at varying levels of joint taxable income. As can readily be noticed, where the combined taxable income moves from $40,000 to $50,000, the deduction for child care expenses becomes more valuable to the working wife than the net earnings otherwise received by her. At $50,000 the wife would net $880 ($6,000 less $2,000 child care expenses and $3,120 in tax) if child care expenses are nondeductible. With a deduction however, the net rises to $1,940 ($6,000 less $2,000 in child care expenses and $2,600 in tax)—more than twice as much. Thus, to the extent that the additional tax cost of not being able to deduct child care expenses actually deters wives from taking jobs, it might be expected that this deterrent effect would be greatest in families where the combined taxable income already is high.[55]

This argument for full deductibility of child care expenses is open to at least two arguments in rebuttal. First, deductibility rests

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[54] This discussion treats the husband's income as a given and the wife's as marginal or discretionary. Arithmetically, one could as easily treat the wife's income as a given and the husband's as discretionary and subject to the higher marginal tax rate. It is submitted that probably in the majority of cases the former represents the psychological fact.

[55] Especially is this likely to be so since the wife will not be as compelled by economic circumstances to be gainfully employed.

CHANGE IN INCOME TAX LIABILITY OF MARRIED COUPLE FILING JOINT RETURN RESULTING FROM FULL DEDUCTIBILITY OF CHILD CARE EXPENDITURES

| | | *Changes in family income attributable to wife's earnings of $6,000* | | | | |
|---|---|---|---|---|---|---|
| (1) Joint taxable income without wife's earnings | (2) Federal income tax | (3) Additional tax (child care expenses of $2,000 nondeductible) | (4) Additional net earnings ($4,000 less additional tax) | (5) Additional tax (child care expenses of $2,000 deductible) | (6) Tax benefit of deduction (3)—(5) | (7) Tax benefit as a percentage of net earnings without deductions |
| $ —0— | $—0— | $1,000 | $3,000 | $ 620 | $ 380 | 12.67% |
| 10,000 | 1,820 | 1,440 | 2,560 | 940 | 500 | 19.53 |
| 20,000 | 4,380 | 2,000 | 2,000 | 1,280 | 720 | 36.00 |
| 30,000 | 7,880 | 2,460 | 1,540 | 1,620 | 840 | 54.55 |
| 40,000 | 12,140 | 2,920 | 1,080 | 1,920 | 1,000 | 92.59 |
| 50,000 | 17,060 | 3,120 | 880 | 2,060 | 1,060 | 120.45 |
| 100,000 | 45,180 | 3,720 | 280 | 2,480 | 1,240 | 442.86 |

on the close relationship between child care expenses and the earning of income while it ignores the personal dimension of the expenditure. To the extent that child care expenses would be incurred in any event in order to free the mother of child care responsibilities, the expenditure should not properly be regarded as earnings related. Moreover, even where the expense would not be incurred but for the opportunity to enter into gainful employment, the working wife is likely to receive personal gratification from the child care. Accordingly, at least in some degree, the expenditure does not represent a disincentive to work but a means of obtaining personal gratification. In view of the inherent difficulty in determining what part of the expenditure should be regarded as business related rather than personal, the tax base should not be further eroded by permitting a deduction.

A second argument in opposition to deductibility is that a tax disincentive to the gainful employment of mothers is desirable and should be retained. Young children, it is argued, should receive the loving attention of their natural mothers rather than be left to the care of strangers. To allow deductibility of child care expenses would be to subsidize mothers leaving their children with others, would erode the family structure and would harm the upbringing of children.[56] While a tax subsidy might be justified where the family is in great economic need, as was provided under old section 214, it is unsound for the family not subject to such overriding economic pressure.

Of course, Congress may properly resolve differing views as to the relationship of child care expenditures to the process of earning income and as to the probable effect of changes in the tax law on the social role of the working wife-mother. Section 214 as enacted in 1954 and amended in 1964 did so. The changes made by the Revenue Act of 1971, on the other hand, are more difficult to rationalize as a resolution of these questions, for they remove the disincentive to working wives in some but not all cases, while simultaneously creating new potential sources of tax inequity. The problems presented by the new provision will be considered in connection with four important new features: Inclusion of household expenses as a deductible item, increase in the amount deductible, imposition of the $18,000 adjusted gross income ceiling, and imposition of the requirement for healthy, married couples of substantially full-time employment.

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[56] 117 CONG. REC. S18553 (daily ed. Nov. 15, 1971) (remarks of Senator Bennett).

## Technical Analysis of New Section 214

DEDUCTIBILITY OF HOUSEHOLD EXPENSES

New section 214 allows a deduction for "expenses for household services," as well as dependent care, if they are incurred "to enable the taxpayer" to be gainfully employed.[57] This new category of deductible expenses appears to be surprisingly open ended. The term "household services" is given no statutory elaboration and in common layman's understanding means any services for the benefit of the household.

### *Household Services*

The Senate Committee on Finance Report adduced two reasons for enlarging the deduction, neither of which is of substantial help in delineating the class of deductible expenditures: (1) Domestic help in addition to child care is "needed" because the adult members of the household are employed full time; (2) it is desirable to provide employment opportunities "for persons presently having difficulty in this respect."[58] The report expressly negated deductibility for the services of a chauffeur. On the Senate floor, concern was expressed that without conference committee modification, the term "household services" was broad enough to include the services of a bartender to serve drinks in the home.[59] Bartending services were carved out in the conference report, as were services of a gardener and chauffeur,[60] but other services which appear to be equally "personal" presumably continue to be included.

The basic kind of expenditure apparently intended to be made deductible by this term is the cost of employing a maid or cook in the home. But subject only to the limitation that the expenditure enable the taxpayer to be gainfully employed, a variety of other services performed in the household may now give rise to deductions. Thus, household services may include the cost of a handyman, the cost of a television repairman or indeed the cost of a doctor's house call. Although inclusion of the latter might appear to avoid the limitation of the medical expense deduction, nevertheless, under old section 214, medical expenses could constitute deductible

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[57] I.R.C. § 214(b)(2)(A).

[58] S. REP. No. 92-437, 92d Cong., 1st Sess. 62 (1971).

[59] 117 CONG. REC. S18552 (daily ed. Nov. 15, 1971) (remarks of Senator Bennett).

[60] S. REP. No. 92-533, 92d Cong., 1st Sess. 42 (1971). The report ties these exclusions to the requirement of the statute that the expenses be incurred to enable the taxpayer to be gainfully employed and states that the three excluded classes of services are by way of example. It does not further elaborate the principle.

section 214 expenses provided the same expenditure was not also used under section 213 either as a medical expense deduction or in computing the 3 per cent of adjusted gross income limitation.[61] Presumably, this construction of section 214 will be carried over, rendering the expenditure deductible under either section 213 or 214. Services whose cost ordinarily would have to be capitalized are not expressly designated as nondeductible. To be sure, "expenses" modifies "household services" and may be construed as meaning noncapital expenditures. But under section 213 which also uses the word "expenses" the regulations allow deductions for capital expenditures whose primary purpose is for medical care.[62] The modifying words ordinary and necessary which appear in sections 162 and 212 and are generally understood to exclude capital expenditures, are absent from both sections 213 and 214.

### *Gainful Employment Requirement*

The statute does require that expenses for household services be incurred to enable the taxpayer to be gainfully employed. The conference committee exclusion of bartending, gardening and chauffeuring services exemplifies this requirement.[63] But unless given some new meaning by regulation, this requirement will likely not provide a significant limitation on the deductibility of other kinds of household services.

While similar language was used under old section 214 to limit the deductibility of child and dependent care expenses, the relationship between the expenditure and the earning of income was relatively easy to determine: It was essentially the "but for" argument rejected in the *Smith* case.[64] The expenditure was incurred to free a particular block of time, and it was relatively simple to establish what the taxpayer did with the time. If the taxpayer was gainfully employed or actively seeking such employment during that period, the expenditure met the test and was deductible; otherwise, it was not.[65] The regulations in fact state as a prerequisite to deductibility that the expenditure be for care while the taxpayer is

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[61] Reg. § 1.214-1(g). *Cf.* B. Manischewitz Co., 10 T.C. 1139 (1948).

[62] Reg. § 1.213-1(e)(1)(iii). Presumably, if a deduction is to be allowed for the expense of services which should be capitalized, the amount of the deduction should be reduced by the amount of the addition to the permanent value of the home as under section 1.213-1(e)(1)(iii) of the regulations.

[63] S. Rep. No. 92-533, 92d Cong., 1st Sess. 42 (1971).

[64] Henry C. Smith, 40 B.T.A. 1038 (1939), *aff'd without opinion*, 113 F.2d 114 (2d Cir. 1940).

[65] Reg. §§ 1.214-1(f)(1) and (3). The issue does not appear to have been litigated.

gainfully employed or in search of gainful employment and provide for allocation where the expenditure is partly for care when no employment is involved.[66] Thus, although there may have been personal as well as income earning motives in incurring the expense, a gainful employment motivation at least was demonstrably present. Presumably, this will continue to be the rule for dependent care expenses.

By their nature, however, household services do not generally free the taxpayer for a specific time span which can validate the gainful employment motivation for the expenditure. Rather, the primary notion in permitting the deduction appears to be one of providing tax relief for an expense which would not otherwise have been incurred but for the gainful employment of the adult members of the household—as in employing an individual who cleans the house instead of the working wife who would otherwise be expected to perform this service. Such expenditures present a kind of "but for" reasoning in reverse: But for the activity of earning income, the expenditure for the household service would not be incurred. This standard is more difficult to apply in practice so as to give some limiting guideline to distinguish expenditures normally regarded as personally motivated from those whose relationship to gainful employment is at least clear, if not predominant. Indeed, it is difficult to conceive of an expense for household services which cannot arguably be related to the fact that both spouses are gainfully employed.

By regulation, the Treasury may seek to deny the deduction in gross cases where neither the taxpayer nor members of his household would have performed the service if there had been no employment. This would exclude, for example, complicated plumbing repairs if the taxpayer could not have performed them himself, or the television repairman's and the doctor's housecalls if the taxpayer could not have provided the services himself. Such a rule, however, would introduce more difficult questions of fact than the more easily ascertainable former standard of whether the expenditure was incurred, and the adult members of the household were gainfully employed. This new standard might involve inquiries into the taxpayer's capacity to perform household tasks and

[66] The regulations also provide that a determination of whether the expenditures were incurred to enable the taxpayer to be gainfully employed depends upon the "facts and circumstances" of the particular case. Reg. § 1.214-1(f)(4). The only example given where there "may" be disallowance under such a test, however, is where the amounts anticipated to be earned are less than the cost of the dependent care.

whether historically he had ever performed such tasks during periods when either spouse was not gainfully employed. The need for such inquiries may render such a rule administratively unworkable.

At the least, however, the Treasury could impose another kind of limitation, expanding on the suggestions in the conference report. Presumably, the element linking the three examples of household services which do not qualify for deduction—bartending, chauffeuring and gardening—is that they are usually regarded as luxuries and not necessities in the functioning of a household. Perhaps in this sense they do not "enable" the taxpayer to be gainfully employed. The regulations should exclude as household services those services generally regarded as a luxury. Again substantial questions of fact may be presented. For example, without its specific inclusion in the conference report, one might not have classified gardening services with the other services, at least in its lowly yard work form. Nevertheless, the task of determining what services are included or excluded under this standard is possible, since it is applied by reference to general societal standards rather than individual preferences. As to the substance of such a rule, there is no doubt that new section 214 was not intended to permit the deduction of personal luxuries.

*Place of Performance of Services*

The statute does require household services to be performed in the taxpayer's household.[67] This eliminates deductions for such expenses as the services component of restaurant meals or the cost of sending clothes out to be dry cleaned. This distinction is not entirely rational. The expense of cleaning clothes or having meals prepared may or may not be related to gainful employment whether done in the home by a cook or outside the home by a commercial establishment. As for the other stated purposes of the provision—enabling unemployed individuals to obtain jobs—commercial cleaning establishments and restaurants are employers and presumably jobs are created by encouraging expenditures outside the home as well. Yet the limitation appears rational as a restraint on the imagination of taxpayers in purchasing services to be deducted. It also prevents deductions of personal travel and entertainment expenses under section 214.

Deductibility of household services eliminates in many cases the

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67 I.R.C. § 214(c)(2)(A).

need to allocate between child and dependent care services and other services performed by the same person (as where a housekeeper watches the children and also does housework). A deduction for the full amount of the compensation paid in such cases conceivably might be justified as obviating the need to apportion the compensation between the services performed. But the failure to limit the deduction to such cases means that new instances for allocation will arise. For example, where a family rents a furnished apartment in a residence hotel, presumably the rent is to be allocated between deductible household services, such as the services of a maid in cleaning and making beds, and nondeductible expenses of occupancy. It would seem unfair to disallow any deduction in such a case simply because the services component of the charge is not separately stated by the hotel. By analogy, perhaps the maintenance charges paid by the owner of a cooperative apartment should be apportioned between deductible section 214 household services and nondeductible personal expenditures. Presumably the taxpayer may treat as deductible household services the portion of his maintenance costs attributable to the salaries of the doorman, elevator man, janitor or private guards (but not gardeners). His allocable share of these costs should be deductible as household services performed in his home; the statute does not make the deduction contingent on the taxpayer's owning his home directly. By the same token, may an apartment tenant deduct the portion of his rent allocable to janitorial and other personal services provided by the landlord? The regulations could properly exclude services which normally are incidental to the leasing of apartment space, whether by a tenant or a tenant-owner of a cooperative apartment, as compared with the significant additional services available in a hotel or rooming house.[68] Nevertheless, even with such a limitation, the inclusion of household services under new section 214, far from simplifying tax administration, appears likely to create difficult problems of administration.

### *Taxpayers Affected*

Although the class of expenditures where a deduction may be permitted seems overbroad, the class of taxpayers who may claim the deduction seems unduly narrow. Inclusion of household services presumably reflects a judgment that such services are neces-

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68 A similar distinction is made in defining rents for subchapter S corporation purposes. Reg. § 1.1372-4(b)(5)(vi).

sary to earning income where there are two working spouses in a household.[69] Yet the same could be said of a married couple without dependent children where both spouses work full time, or of any employed single individual who lives alone. But the deduction may not be claimed by these taxpayers, because they do not support households containing one or more "qualifying individuals" (dependents under 15 or an incapacitated dependent or spouse).[70] Once it is decided that expenses for household services are necessary to earn income, however, this latter requirement makes little sense. Either the deduction should be extended to all taxpayers who are gainfully employed or it should not be available to anyone. It is submitted that the deduction for household services expenses as now permitted by new section 214 is an undesirable erosion of the long standing bar to deduction of personal expenses[71]; consequently, the deduction should be restricted or eliminated. In the alternative, it would seem unfair not to extend it to all cases where the adult members of the household are gainfully employed.

## Amount Deductible

New section 214 increases the maximum amount which may be deducted annually from $900 to $4,800. The previous maximum made it likely that an amount at least equal to the deduction claimed would have been paid by the taxpayer in money. Problems of substantiation and record keeping and the treatment of compensation paid in kind by the taxpayer did not become significant and the regulations and published rulings do not consider these matters. Liberalization of the dollar maximum requires clarification of the rules for substantiation of payments.

### *Cash Payments—Substantiation*

Although payments in money present no valuation problem, a payment in cash may raise questions as to proof of payment. Section 214 imposes no special requirements as to record keeping and substantiation, despite the possibility of inflated claims where payment is made in cash. This is in contrast to the special record keeping requirements applicable to substantiate travel and entertainment expenses.[72] Thus, where the taxpayer's records are not ade-

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69 S. Rep. No. 92-437, 92d Cong., 1st Sess. 62 (1971).
70 I.R.C. § 214(a).
71 I.R.C. § 262.
72 I.R.C. § 274(d).

quate, he would presumably be entitled to deduct a reasonably estimated amount—a la the *Cohan* rule for travel and entertainment expense deductions before 1963.[73] In unmodified form, such a rule suggests the possibility of widespread taxpayer abuse by claiming deductions for unsupported expenditures for household help. Another abuse to which cash payments may give rise is the failure by the recipient to report the payment as income although the taxpayer claims a deduction. The prospect of such abuses would be lessened if the Treasury, as part of the substantiation for this deduction, required the taxpayer to comply with the employment tax requirements for domestics. Although withholding of tax on compensation paid to workers engaged in domestic service is not required,[74] a taxpayer employing someone in his home for domestic service who earns at least $50 in any quarter is subject to social security tax with respect to cash wages paid[75] and is required to withhold social security taxes imposed on such wages.[76] In addition to assuring the accuracy of claimed deductions, requiring compliance with the social security tax may achieve greater symmetry of tax treatment. It is more likely that the employee will include the compensation in income if he knows that a report will be submitted to the Service than if he is paid in cash without such filing. Where the taxpayer employs a number of different persons for household services, paying each less than $50 in any quarter, it would still be possible to claim a significant deduction without offering such substantiation, but the burden would be on the taxpayer to prove he had actually made such arrangements.

*Payments in Kind*

The problems of determining the amount of the deduction become far more serious in dealing with payments in kind. Consider for example the case where a working wife obtains live-in help in return for a cash payment plus room and board. Since the statute does not limit the deduction to cash payments, the expense of providing food, shelter and other noncash benefits may be deducted under section 214. Estimation of the taxpayer's expense of providing a place to sleep and such supporting services as utilities is therefore required. In addition, any restraint on overstating de-

[73] Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930).
[74] I.R.C. § 3401(a)(3).
[75] I.R.C. §§ 3111, 3121(a)(7).
[76] I.R.C. § 3101. The Treasury may require such substantiation under the general authority of section 6001.

ductions due to the employee's inclusion of the actual amount in income vanishes. The employee is authorized to exclude from his gross income the value of meals and lodging furnished for the convenience of the employer on the employer's premises.[77] Social security taxes are inapplicable to noncash compensation of domestics.[78] The taxpayer accordingly has no countervailing pressure to claim a lower rather than a higher amount of compensation.

The valuation problem is in many respects analogous to a taxpayer's use of a portion of his home as an office. An allocation between the deductible expense of carrying on his trade or business and his nondeductible personal expense must be made.[79] Under this approach, the deductible expense for the dwelling is determined by adding the cost of depreciation, interest, utilities and related services; determining the percentage of use attributable to the deductible purpose on the basis of square footage or other method; and computing the applicable percentage of the total. As to the portion of deductible food costs for household services, adoption of a rule of thumb such as dividing the total cost of the family's food bill by the number of consumers, instead of tracing actual consumption, is preferable.

One issue unresolved by the foregoing approach is the degree to which the compensation paid to the live-in domestic should be included in the base in computing the total expense of the dwelling or meals. There are at least three possibilities: (1) Compensation to the housekeeper should be included in its entirety in determining total expenses; (2) only the cash compensation should be included; and (3) all compensation should be excluded. It may be argued that part of the noncash compensation received by the housekeeper is the allocable share of his services. In that event, determination of the amount of the noncash compensation becomes somewhat circular but can be computed algebraically.[80] However, this method

[77] I.R.C. § 119. Although the statute speaks of the employer's "business premises," the regulations interpret this as the place of the employee's employment. Reg. § 1.119-1(c)(1).

[78] I.R.C. § 3121(a)(7)(A).

[79] Rev. Rul. 62-180, 1962-2 C.B. 52.

[80] If $x$ is the amount of noncash compensation to the housekeeper for shelter, $a$ is the sum of expenses for the household other than compensation to the housekeeper, $b$ is the housekeeper's cash compensation and $P$ is the percentage of use attributable to the housekeeper, then:

$$x = P(a+b+x)$$

$$x = Pa+Pb+Px$$

$$x-Px = Pa+Pb$$

$$x(1-P) = Pa+Pb$$

$$x = \frac{P(a+b)}{1-P}$$

may give the taxpayer an undue benefit by permitting a deduction for the housekeeper's expenditure of services on himself, unless the taxpayer first takes the value of such services into income.[81] This objection seems sound; therefore, the base for computing noncash compensation should not include the employee's compensation.

In all events, determination of the amount of deductible noncash compensation is likely to present some substantial administrative and evidentiary problems. If these problems are sufficiently troublesome in practice, amendment of the statute may be required to regulate the form of compensation and to provide for methods of substantiation.

***Deduction in Excess of Spouse's Income***

A further problem concerning the amount of the deduction is the degree to which it may exceed the amount earned by the working spouse. Under old section 214, the cost of dependent care could exceed the amount anticipated to be received by the taxpayer from the employment—and, a fortiori, the amount actually received—but this fact might indicate the expenditure was not to permit the taxpayer to be gainfully employed.[82] Under new section 214 with its liberalized provision, this requirement needs reaffirmation and development. It may be argued that, in general, Congress did not intend the deduction for dependent care and household services expenditures to be available to offset income other than the income earned by the spouse's gainful employment. An exception may occur where the spouse incurs "start up" expenses in seeking gainful employment but the income attributable thereto is not realized until a subsequent year.

Without express statutory authority,[83] the regulations should probably not limit absolutely the deductibility of expenses for dependent care and household services to income earned during the year. At the same time, it would seem appropriate to apply a test analogous to that used in section 183, for activities not engaged in for profit. If the expenditures were to enable the taxpayer to be gainfully employed, as demonstrated by the receipt in the current year or a subsequent year of earnings in excess of the

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[81] *Cf.* Reynard Corporation, 30 B.T.A. 451 (1934), *nonacq.* 1964-2 C.B. 9-10, (*substituting nonacq. for prior acq.*, XIII-1 C.B. 13 (1934)), on the issue of whether the corporation was entitled to deduct depreciation on property furnished rent free to its president.

[82] Reg. § 1.214-1(f)(4).

[83] *See* I.R.C. § 165(d), authorizing a deduction for wagering losses only to the extent of wagering income.

expenses, then all the expenditures should be currently deductible. If the earnings do not exceed the expenses, then the expenses should be deductible only to the extent of the earnings attributable to them, after initially reducing such earnings by any other deductions attributable thereto. For example, if the taxpayer incurred $1,000 of otherwise deductible expenses for household services, earned $400 in the current year and nothing in a subsequent year, and incurred $20 of state income tax on such earnings, only $380 of the expenses would be deductible. Such a rule would limit the use of section 214 as a "shelter" for other income.

## The Adjusted Gross Income Ceiling

### *Potential Effect*

Old section 214 limited the dependent care deduction, in the case of working couples, to those with less than $6,000 of adjusted gross income. This limited the class of families who could claim the deduction to those believed to be in sufficient economic need to necessitate both spouses working.

A comparison of adjusted gross income levels reported on federal income tax returns is instructive. For 1964, the year in which the adjusted gross income ceiling was increased to $6,000, 9.6 million out of 32.8 million, or 29.6 per cent of the joint returns on which some tax was payable, met this adjusted gross income limitation.[84] For 1969, the last year for which such data has been published, the percentage had declined to 16.2 per cent.[85] It is at least plausible to describe these limited groups as representing a level of economic need. The same cannot be said, however, for the new combined adjusted gross income ceiling of $18,000. Although statistics are not available using $18,000 as a breaking point, 80.4 percent of the 1969 taxable joint returns having a combined adjusted gross income below $15,000 would have met this test. If we make the conservative assumption that half of the returns between the $15,000 and $20,000 adjusted gross income levels were below $18,000, the percentage rises to 86.1 per cent.

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84 Internal Revenue Service, 1964 Statistics of Income, Individual Income Tax Returns, table 5 (1967). "Taxable" joint returns would appear to be a more relevant point of comparison than all joint returns, whether taxable or not, since a deduction is of no consequence to returns not subject to tax. The relevant percentage of all joint returns is higher, approximately 40.6 per cent.

85 Internal Revenue Service, 1969 Statistics of Income, Individual Income Tax Returns, table 1.5 (1971). The comparable figure for 1969 for all joint returns, taxable and nontaxable, is 24.2 per cent.

The new group eligible to claim the deduction under section 214 thus comprises approximately 86.1 per cent of the total taxable joint returns filed, or more than six sevenths of such returns. It would be difficult to support the view that the new income levels operate to limit the deduction to poor families whose economic need is so great that the cost of child care becomes necessary to earning the family's livelihood. On the contrary, the only apparent reason for excluding the upper seventh of such returns is to avoid the revenue cost—an entirely arbitrary distinction.[86] A possible argument in support of the dollar limitation is the desire to render a progressive tax benefit by preventing the well to do from sharing in it. Moreover, where the income produced by the wife's working is so removed from economic hardship, there is a greater likelihood that personal rather than economic ends are served by incurring the child care or household services expenses and being gainfully employed. But this test is not applied elsewhere. A taxpayer having substantial investment income is not thereby prevented from deducting the ordinary and necessary expenses incurred in earning personal services income. By a parity of logic, all such deductions could be limited to taxpayers with adjusted gross income of less than $18,000. A partial explanation may be that the adjusted gross income ceiling represented part of the structure of the prior statute, which was politically easier to carry over in liberalized form by increasing the adjusted gross income level than repeal it entirely. This is suggested by the fact that the $18,000 limitation was introduced by amendment on the Senate floor and the earlier statement by the chairman of the Senate Committee on Finance that the natural proponents of a liberalized deduction, such as women's rights groups, had not actively made their case with the members of his committee.[87] The limitation meanwhile continues as a part of the statute, presumably aimed at eliminating the well to do from the full benefits of the deduction.

On the other hand, from the standpoint of eliminating the disincentive to working wives, the limitation is counter-productive. As discussed above, the tax disincentive of nondeductibility of child care expenses—the degree to which a working wife is eco-

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[86] The old income limitation recently withstood constitutional attack, Michael P. Nammack, 56 T.C. 1379 (1971), *aff'd per curiam*, 459 F.2d 1045 (2d Cir. 1972). The greater irrationality of the new limitations might be grounds for failing to follow *Nammack* in any future litigation, but it remains most unlikely that a court would invalidate a tax provision for arbitrariness.

[87] N.Y. Times, Nov. 6, 1971, at 1, col. 8, and at 19, cols. 4–5.

nomically discouraged by an inability to offset such expenses against income for tax purposes—increases as the joint taxable income of the husband and wife increases. Retention of the adjusted gross income cutoff, even at the substantially higher level of the Revenue Act of 1971, preserves the disincentive precisely at those income levels where it is greatest and most likely to discourage the wife-mother from working.

To return to the earlier hypothetical case of a working mother who can earn $6,000 by incurring child care expenditures of $2,000,[88] new section 214 reduces the disincentive to work at the lower end of the taxable income scale only. In tabular form, the results under new section 214 are:

| *Joint taxable income without wife's earnings* | *Federal income tax* | *Net amount of wife's earnings subject to tax* | *Additional tax on wife's earnings* | *Additional net earnings* |
|---|---|---|---|---|
| $ —0— | $—0— | $4,000 | $ 620 | $3,380 |
| 10,000 | 1,820 | 4,000 | 940 | 3,060 |
| 20,000 | 4,380 | 6,000 | 2,000 | 2,000 |
| 30,000 | 7,880 | 6,000 | 2,460 | 1,540 |
| 40,000 | 12,140 | 6,000 | 2,920 | 1,080 |
| 50,000 | 17,060 | 6,000 | 3,120 | 880 |
| 100,000 | 45,180 | 6,000 | 3,720 | 280 |

To the extent that the provision may be said to reach a social judgment about mothers being engaged in work outside the home, the provision's message is: "Upper income mothers should stay home and take care of their children. Mothers in poor and middle income families may go out and work."

### *Adjusted Gross Income Standard*

Another question may be raised more generally as to the appropriateness of using adjusted gross income as a measurement of family income and entitlement to the deduction. Assuming that any limitation based on family income is appropriate, section 214 extends the disparities between adjusted gross income and family income into the child care area. Adjusted gross income is a rough measure of family income, subject to exclusions from gross income

[88] *See* text following note 54 *supra.*

and a number of additional deductions. Exclusions from gross income ranging from state and municipal bond interest to fellowship grants may increase family economic income to more than $18,000 without affecting adjusted gross income. Perhaps more importantly, deductions in arriving at adjusted gross income such as the deduction for long-term capital gains, depreciation and depletion may reduce it below $18,000 in a year when the family economic income may be well in excess of that amount.[89] Thus, a married couple owning a limited partnership interest in a real estate syndication providing substantial depreciation deductions, could claim the section 214 deduction even though their compensation and other income far exceeds $18,000.

To be sure, adjusted gross income is used as a measurement of income in two other situations where similar equity considerations are relevant—the medical deduction under section 213 and the charitable contribution deduction under section 170. In the former case, where 3 per cent of adjusted gross income is used to reduce the medical expense in arriving at the medical deduction, disparities between adjusted gross income and economic income are relatively less important since they are taken into account only to the extent of 3 per cent. Thus, $1,000 of excess depreciation would have the effect of decreasing the medical expense limitation by $30, a relatively small amount. In the case of the charitable contribution deduction, where a percentage of adjusted gross income limits the amount of the deduction, the disparities between adjusted gross income and economic income become more significant. But the limitations are generous with respect to most taxpayers and even for those who exceed them, there are carryover provisions to make the deduction available in a later year.[90] But as used in section 214, the disparities between adjusted gross income and economic income produce a 50 per cent reduction in the permissible deduction without any carryover or offsetting benefit.

One of the advantages of the adjusted gross income standard is its very existence. Use of such a standard permits the dependent care and household services provision to approximate a family income concept without having to review the justice of each and every exclusion from gross income or deduction to adjusted gross in-

[89] I.R.C. §§ 62(3) and (5).

[90] I.R.C. §§ 170(b)(1) and (d)(1). Adjusted gross income is also used in determining use of the optional tax table and the amount of the standard deduction. Those who claim the special deductions which account for the disparity between adjusted gross income and economic income are unlikely to relinquish the privilege of itemizing deductions required in these cases.

come. While such review might be desirable as a general matter of tax policy, to require it in the context of a limitation on a deduction for household services and dependent care expenditures would seem quixotic to many of its potential proponents. Doubtless, the supporters of any exclusion or deduction which might be regarded as a loophole would defend the provision against any such characterization here. A possible solution, embodying a more appropriate limitation (assuming any is to apply), may be to utilize the adjusted gross income standard, increased by any tax preference items in section 57(a). This would reduce the application of a least some tax shelter type deductions. While the list of tax preferences in section 57(a) may be incomplete, it is at least one which Congress has agreed upon for some tax purposes.

*Monthly Determination*

As noted, both qualification for the deduction and the maximum amount allowable are determined on a monthly rather than an annual basis. The "wasting" provision, which reduces the permissible deduction for adjusted gross income in excess of $18,000, may be determined monthly on the basis of the excess allocable to the month in question. Although it is anticipated that the reduction ordinarily would be computed on a yearly basis, the statute and the conference report clearly intend it be done on a month by month basis where appropriate.[91]

Such an allocation may create unanticipated problems since the monthly allocation of a year's adjusted gross income is not a concept otherwise employed by the Code. In most cases of taxpayers who qualify under section 214, compensation income is likely to be the only significant element of adjusted gross income and presents little difficulty. Compensation can generally be matched with the months when the services were performed. But adjusted gross income also includes items of income and deduction not so easily traced. Unless some rules of allocation are provided by regulation or otherwise, there might be opportunities for taxpayers to use allocation to defeat, at least in part, the apparent purpose of the adjusted gross income limitation. To illustrate, suppose a husband and wife, both of whom are employed by their family corporation, earn a combined reasonable compensation of $18,000. Suppose further that in December they receive a $10,000 dividend on their stock in the corporation. Is the dividend allocable only to the month

[91] I.R.C. § 214(d); S. Rep. No. 92-533, 92d Cong., 1st Sess. 42 (1971).

in which received, in which event the section 214 deduction would be allowed for the remaining eleven months, although adjusted gross income for the year (assuming no other income or adjustments) would be $28,000? Conversely, consider the case of a taxpayer whose earnings from a sole proprietorship for the first eleven months of the year aggregate $29,000 but who has a $10,000 loss in December.[92] Should the deduction be allowed for December only or should some deduction be allowed in all twelve months? The conference report cites one example where allocations on a monthly basis are appropriate, a change in marital status, but this affords little aid in determining the method of allocation to be applied to the above examples.[93]

One simple rule would be to apply the usual tax rules as to timing of income and deductions, but on a monthly rather than an annual basis. Unfortunately, this rule produces results which appear to be contrary to the intent of the income limitation—to restrict the deduction to taxpayers of limited family income. Thus, under such a rule, the husband and wife receiving the dividend would be able to qualify for the deduction for eleven months, while the sole proprietor would qualify in only one. Looking to family income, the couple should have no deduction while the sole proprietor should qualify for some deduction for the entire year.

A preferable alternative rule would be to ratably allocate annual adjusted gross income on a monthly basis, except where an unusual and normally nonrecurring event significantly alters adjusted gross income. In order to be "significant" a change in adjusted gross income would have to exceed some dollar amount; a possible threshold is $3,000 (the minimum for income averaging).[94] Thus, the ratable allocation would be made for regular dividends, small amounts of capital gain, bonuses and normal business operations. But for the unusual event—which in addition to a change in marital status might include a change in employment producing a change in the level of compensation or a large windfall or substantial capital gains—no allocation would be made. As applied to the two examples above, the rule would allocate the dividend to the entire year, permitting no section 214 deduction, on the ground that dividends normally are recurring. The sole proprietor's operating loss

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[92] Note that subsection 214(d) apparently requires that adjusted gross income for the year must exceed $18,000 before any reduction is made, whether on an annual or a monthly basis.

[93] S. Rep. No. 92-533, 92d Cong., 1st Sess. 43 (1971).

[94] I.R.C. § 1301.

would be allocated to the year, if such losses were a usual part of the business, but would be limited to the month in which incurred, if extraordinary. On the other hand, if instead of a $10,000 dividend the husband and wife had realized a $10,000 gain on liquidation of the corporation, it would seem appropriate to permit the first eleven months of the year to qualify for section 214 purposes.[95]

### The Requirement of Substantially Full-Time Employment

The requirement of substantially full-time employment presents some interpretive problems, especially when measured arithmetically as suggested by the conference report.[96] The latter, carrying forward similar language in the Senate Committee on Finance report,[97] defines the statutory phrase as meaning three quarters or more of the normal or customary work week. The problem is determining the normal or customary work week. One possibility is that it is the same for everyone, roughly 40 hours. However, in that event, the conference report could simply have referred to a requirement of a 30 hour work week. More probably, the reference was intended to vary the number of hours depending on the nature of the work. Where the work week is clearly defined, there is little problem. If a person works a three day week where a five day week is normal, apparently he does not satisfy the test. Similarly a person who works from 10 A.M. to 4:30 P.M. on a job where the usual hours are 9 A.M. to 5:30 P.M. would qualify, assuming a lunch break of half an hour.[98] Where the work week is more flexible, however, how is the test applied? What is the work week of a lawyer, or other professional or self-employed person who can set his own time? Suppose it can be shown that some lawyers habitually take long weekends and work a 30 hour week, while others work a 50 hour week? What is the work week of a concert pianist, who may practice 40 hours a week and make one two hour public appearance a month?

The purpose of the substantially full-time employment requirement is not stated in the committee reports and did not exist under old section 214. There, the rule that the expenditure enable the taxpayer to be gainfully employed, applied by matching the time

[95] As another possible variation, the above rule might be used to allocate income, while losses might always be spread ratably through the year. This would be similar to the rule for subchapter S corporations, sections 1373(b) and 1374(b).

[96] S. REP. No. 92-533, 92d Cong., 1st Sess. 42-43 (1971).

[97] S. REP. No. 92-437, 92d Cong., 1st Sess. 62 (1971).

[98] Query, how should lunch and coffee breaks be treated in measuring the work week?

periods of dependent care and gainful employment, sufficiently assured the relationship of the expenditure to the earning of income.[99] But as to household services, if the rationale is to allow a deduction for services necessitated by the taxpayer's absence from the home by reason of employment, it might be appropriate not to allow a deduction for part-time work. In that event, the purpose of the statute would appear to be met if some substantial amount of time is spent away from home, and the language of the statute could be applied flexibly so long as this criterion is met.

Unfortunately, the statute as drafted does not distinguish between child care and household services expenses in this regard. As a result, the working wife who works less than three quarters of a normal work week may not deduct her child care expenses. Thus, the substitute teacher who works one day a week, although otherwise qualifying, may not deduct child care expenses. Such a provision is likely to have its greatest impact in the middle and higher income families, because the economic need to work full time is less great and the ability to establish flexible work schedules with employers may be greater. This result seems unwarranted. The section should be amended so as to limit the requirement of substantially full-time employment to household services and permit the deduction of child care expenses for part-time work.

### Application to Other Dependent Care

Section 214 continues to apply to taxpayers whose household includes an incapacitated dependent. The matters discussed with respect to child care are applicable here as well, except that as previously noted, the requirement of substantially full-time gainful employment does not apply. In addition, since the care is for an incapacitated person, the possibility of obtaining a deduction for the expenditure as a medical expense may be present. This may be important to a taxpayer if he is unable to claim all or part of the expense as a deduction under section 214 by reason of the adjusted gross income limitation of $18,000, the monthly dollar limitation of $400 or the special reduction provision under section 214(e)(5). On the other hand, a medical deduction under section 213 may be less favorable to a taxpayer by reason of the 3 per cent of adjusted gross income reduction of the expenditure.

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[99] On the other hand, it is possible for both spouses to be employed on a substantially full-time basis and have at least one spouse at home at all times to care for children, as where both spouses teach, but at different hours.

## Conclusion

New section 214 attempts to strike a new balance between deductible business related expenses and nondeductible personal expenses for dependent care and household services. This new balance may be needed to accommodate the changing economic position of wives and mothers who wish to work. In the view of many, such a change would simply restore the tax system to neutrality in this regard.

But the structure of new section 214 does not adequately carry out these purposes and further creates potential inequities in the tax law. Retention of an adjusted gross income limitation at the higher level and imposition of the substantially full-time employment requirement perpetuates a disincentive to wives being gainfully employed in precisely the cases where the tax structure may have the greatest effect on taxpayer's decisions. At the same time, permitting a deduction for household services appears to be an undue expansion of the area of deductible personal expenditures. Together with the failure to require special record keeping rules and the ability to deduct noncash expenditures, the provision may have unintentionally created a potential source of widespread avoidance. At the least, it has added substantial administrative burdens in policing the provision. And while some of the problems presented can be resolved by regulation, others will require statutory change. Both types of change are needed to resolve the problem of dependent care expenditures in an equitable fashion.

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Address all correspondence regarding *editorial* matters to Professor Victor Zonana, Editor-in-Chief, New York University School of Law, 40 Washington Square South, New York, New York 10012. *Business* correspondence, including all subscription matters, should be directed to Matthew Bender & Company, Inc., 1275 Broadway, Albany, New York 12201.