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Costly Mistakes: Undertaxed Business Owners and Overtaxed Workers

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Abstract

This Article advocates fundamental changes in the federal income tax base by systematically challenging conventional understandings of consumption and investment. As signaled by its title, "Costly Mistakes," this Article's thesis has to do with the disparate treatment of expenditures incurred by business owners and workers. Where the current tax law treats a business owner's expenditure as investment, the Article sometimes finds consumption and questions why the law should allow the expenditure to be deducted. Where the tax law treats a worker's expenditure as consumption, the Article sometimes finds investment and questions why the law does not allow at least a partial deduction.

Through an historical analysis of the development of the modern tax law with special attention to Justice Cardozo's 1933 U.S. Supreme Court opinion in Welch v. Helvering *and a review of Welch's judicial and legislative progeny, the Article demonstrates that the deference the tax law traditionally has accorded business owners results in their undertaxation. Through an analysis of the tax law's treatment of workers, it further shows how its structural and substantive rules treat workers primarily as consumers, rather than as producers, and why that results in their overtaxation. The Article then investigates the economic inefficiencies produced by the tax law's generous treatment of business owners' outlays and its unduly restrictive treatment of workers' outlays. It goes on to suggest how to scrutinize and reform the tax treatment of workers and how to extend that approach to business owners with far-reaching implications. Finally, the Article relates the undertaxation of business owners and the overtaxation of workers to the broader social policy discussions concerning the high rate of unemployment in the private sector and the escalating*

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deficits in the public sector. It concludes that the success of the U.S. economy in the twenty-first century requires the tax law to treat both business owners and workers as producers. It further concludes that the tax law's continuing failure to acknowledge that business owners and workers are both consumers and producers undermines the goals of efficiency and fairness.

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INTRODUCTION

This Article begins as do countless others on the taxation of income. It embraces the late nineteenth-century work of the German legal scholar Georg von Schanz along with the efforts in the 1920s and 1930s of the American economists Robert M. Haig and Henry C. Simons to define the ideal income tax base as the sum of consumption and change of investment between two points in time.[1] It diverges from traditional tax policy articles, however, because it advocates fundamental changes in the federal income tax base by systematically challenging conventional understandings of what constitutes consumption and investment. As signaled by its title, "Costly Mistakes," this Article's thesis has to do with the tax law's disparate treatment of expenditures incurred by business owners and workers. Where the current tax law, supported by a broad consensus of policymakers, treats a business's expenditure as investment, this Article sometimes finds consumption and questions why the law should allow for any or full recovery; where the tax law treats a worker's expenditure as consumption, this Article sometimes finds investment and questions why the law does not allow for full, or at least partial, recovery.

The idea that a business can consume likely strikes most tax experts and taxpayers as incongruous, because businesses by definition dedicate themselves exclusively to the production of profit. A business does not go on vacation, enjoy a bottle of wine, or sleep well on a state of the art mattress. This Article contends, however, that consumption under the Schanz-Haig-Simons definition of income has come to be defined too narrowly as a result of the undue deference accorded business owners in their pursuit of profits. The idea that a worker's expenditure constitutes an investment, rather than consumption, likely strikes most tax policy experts and, in fact, most taxpayers as entirely plausible. Not surprisingly, some tax scholars and policymakers have made strong arguments that the tax law should allow for recovery of particular kinds of income-related expenditures, such as outlays for education, health care, or child care.[2] This Article differs from these earlier efforts in three distinct ways.

1 HENRY C. SIMONS, PERSONAL INCOME TAXATION 50–51 (1938); Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 1, 27 (Robert Murray Haig ed., 1921); Georg Schanz, *Der Einkommensbegriff und die Einkommensteuergesetze*, 13 FINANZARCHIV 1–87 (1896).

2 *See, e.g.*, Gwen Thayer Handelman, *Acknowledging Workers in Definitions of* Consumption *and* Investment: *The Case of Health Care*, *in* TAXING AMERICA 119, 121 (Karen B. Brown & Mary Louise Fellows eds., 1996); Denise D. J. Roy, *Consumption in Business/Investment at Home: Environmental Cleanup Costs Versus Disability Access Costs*, *in* TAXING AMERICA, *supra*, at 170, 171 (criticizing the personal/business dichotomy for its "contribut[ing] to the anomalous distinction between the treatment of certain expenditures relating to medical care and the treatment of environmental cleanup costs"); Hamish P. M. Hume, Note, *The Business of Learning: When and How the Cost of Education Should Be Recognized*, 81 VA. L. REV. 887, 889 (1995); *see also infra* notes 178–83 (discussing and critiquing the tax code's treatment of child care costs).

First, this Article shows why and how modern tax law has associated productivity and efficiency with business owners while coupling consumerism with workers. The deference the law traditionally has accorded business owners and the law's corresponding failure to recognize workers as producers account for most of its costly mistakes. This Article asserts that any solution to the overtaxation of workers implicates and depends upon corrective measures to end the undertaxation of business owners and that both types of reforms require a reevaluation of tax policymakers' traditional understanding of investment and consumption.

Second, it introduces two principled methods for the law to distinguish workers' investments from their consumption: a remoteness criterion and cost constraint rule. First, if an expenditure does not directly relate to the production of income or cost savings, it should not be recoverable by a worker because its relationship to that worker's trade or business is too tangential and speculative. Second, even if an expenditure is deemed directly related to a worker's trade or business, it may nevertheless not be recoverable in full, if the expenditure fails to fall within established cost parameters. A remoteness criterion, applied along with a cost constraint rule, establishes an analytical framework for the tax law to treat the worker as a producer. In an effort to curb current tax law's deference to business owners and move toward a tax system that treats all producers in the market place comparably, whether they are business owners or workers, this Article also explores how its proposed analytical framework might be applied to expenditures incurred by business owners.

The third distinctive feature of this Article's analysis is the case it makes for why the costly mistakes of undertaxation of business owners and overtaxation of workers fail to meet the needs of the U.S. economy in the twenty-first century. Tax rules that treat workers primarily as consumers, rather than as producers, may at one time have been justified in an economy primarily based on mass production of manufactured goods. However, a tax system that does not recognize the central importance of a trained, creative, and reliable work force in today's service and technology sectors undermines economic growth. The fundamental changes in the law that the Article advocates for Congress to enact will result in a tax system that adheres closely to the principles underlying the ideal definition of income and also one that enhances the efficiency and growth of the U.S. economy.

For the purposes of this Article's thesis, the term *business owners* is used to encompass all types of entities, including sole proprietorships, to the extent that they derive income from the investment of capital as they carry on active businesses. This Article uses the term *workers* to encompass employees and owners of unincorporated businesses to the extent that they derive income from their own labor. In accordance with these definitions, this Article's analysis will show how the current tax system undertaxes self-employed taxpayers on their income from capital and overtaxes them on their income from labor. The analysis also will show how the tax law simultaneously undertaxes and overtaxes the income earned by those who, as employees, enjoy significant perquisites as part of their work, such as luxurious offices, access to private jets, and the like. Under the current tax system, these costs represent necessary expenditures incurred in the production of business income, and employers recover them immediately or over a number of taxable years using statutorily authorized amortization schedules.[3] As this Article demonstrates, the more appropriate tax approach to these costs is to treat a portion as compensation to the employees who receive the perquisites. In some instances, the costs should be recoverable by the employer, but, in others, the costs may represent corporate waste and should not reduce the employer's taxable income at all. This distinct treatment of high-income employees has to be considered in the broader analysis of this Article, which advocates for all employees and self-employed persons to recover the costs they incur in the production of their income from labor, including, for example, expenditures related to health care, education, child care, or commuting.

Part I lays a foundation for the thesis of costly mistakes by looking to the role business owners and workers played in the debates leading to the enactment of the modern federal income tax in 1913 and its subsequent development during the Great Depression up to World War II. This Part argues that Justice Benjamin N. Cardozo's opinion in *Welch v. Helvering*[4] was the most important early development of the modern tax law related to both the business owner/worker divide and the tax law's insistence on deference to the judgment of business owners.

Part II documents the current law's deference to business owners first by reviewing the progeny of *Welch*. Then, through an analysis of *INDOPCO, Inc. v. Commissioner*,[5] this Part demonstrates how deference to business owners' judgment has precluded consideration of the

3 *See infra* Part II.A.

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

5 INDOPCO, Inc. v. Comm'r, 503 U.S. 79 (1992).

possibility that some business owners' expenditures should not be recoverable under the tax law at all. Finally, this Part examines the effect of deference to business owners' judgment on expenditures by a business owner that provide no benefit to that business owner and instead, represent a transfer of wealth to another individual taxpayer or entity. This Part ultimately concludes that a robust jurisprudence has not developed in this area because courts have made the "necessary" requirement found in I.R.C § 162[6] meaningless.

Part III turns its attention to the tax law's treatment of workers and shows how the tax law's structural and substantive rules mistakenly classify workers' outlays as consumption and ignore how all or a portion of those outlays contribute to the workers' productivity. It does so by analyzing a range of expenditures that have personal as well as business attributes. It also compares the tax treatment of expenditures incurred by workers with the tax treatment of those very same types of expenditures incurred by employers on behalf of their employees. This Part concludes that the primary explanation for the current tax law's costly mistakes is undue deference to business owners and deep skepticism of workers' expenditures that are related to their economic productivity.

Part IV demonstrates how the tax law's generous treatment of business owners' expenditures and its unduly restrictive treatment of workers' expenditures result in economic inefficiencies. Part V advocates a redefinition of the current tax base to establish workers as producers, curb the deference traditionally accorded business owners, and reconceive the meaning of investment for businesses and the meaning of consumption for workers. This Part discusses the implications of these three goals on two major tax policy areas that have greatly influenced tax reform discussions in recent years: the consumption tax and tax expenditure analysis. It then goes on to suggest structural and substantive reforms regarding the treatment of workers' expenditures. Finally, it suggests how this Article's proposed framework for analysis and reform of the tax treatment of workers could be extended, with far-reaching implications, to business owners.

The Conclusion underscores the importance of the issues raised in this Article. It connects the ideal definition of income to the broader social policy discussions taking place today. Tax reform that acknowledges both business owners and workers as agents of economic growth could go a long way to help solve the dual problems of

6 I.R.C. § 162 (2006).

the high rate of unemployment in the private sector and the escalating deficits in the public sector. At the same time, the tax reforms this Article advocates address a long-standing unfairness in the tax law that policymakers have failed to recognize.

This brief preview of this Article's thesis may make readers highly skeptical that these costly mistakes can be remedied. Concerns undoubtedly will be raised about the administrative feasibility of this Article's proposed solutions and the risk that those solutions will reduce significantly the tax base on which the government assesses needed revenues. We would ask that you not prejudge or dismiss out of hand the central thesis because of these practical concerns. With regard to the question of administrative complexity, it is important to remember that current law does not itself meet the criterion of simplicity. The questions to ask should be how this Article's solutions integrate into familiar rules and practices and whether the benefits from economic efficiency and fairness warrant any added complexity. With regard to the concern about the erosion of the tax base, it is important to remember that current law allows for that very erosion through overly liberal deductions for business owners' expenditures. Moreover, to make the tax base argument is to concede the very point of this Article.

Yet another concern raised by this Article's thesis deals with whether treatment of workers as producers may undermine the tax system's progressivity by benefiting high-income workers more than low-income workers. Again, that is not a reason in itself to dismiss the project at the outset. The first response to this concern is that it is hard to justify the law's singling out workers, high-income or otherwise, for harsher treatment merely because they produce income as workers rather than as business owners. The second is that, if the reforms bring the definition of taxable income in closer alignment with the Schanz-Haig-Simons ideal, then the tax system will array all taxpayers—business owners, high-income workers, and low-income workers—more properly in accordance with their ability to pay. In other words, costly mistakes in the tax base should not be used to assure a progressive income tax, and progressivity concerns should not short-circuit the determination of the appropriate definition of taxable income.

I. Historical Origins of Costly Mistakes

This Part explains how early tax law developments led to the undertaxation of business owners and the overtaxation of workers. The debates surrounding the enactment of the income tax in 1913, the law's key statutory language, and changes made to the income tax in response to World War I and the Great Depression reveal that workers failed to achieve the status of producers within the early income tax regime and, therefore, received less favorable tax treatment than business owners. This Part then turns its attention to the U.S. Supreme Court's role in the development of the income tax with a particular focus on Justice Cardozo's opinion in *Welch v. Helvering.* The analysis shows that, as Justice Cardozo established the business owner as an iconic and noble figure, he made deference to a business owner's judgment a principle of taxation.

The "single most important reason for the eventual enactment of the" modern federal income tax in 1913 "was a growing conviction among people from nearly all walks of life that the existing tax system failed, almost entirely, to reach the great fortunes that had been amassed as a result of industrialization."[7] Throughout the debates over the income tax, workers were seldom the center of attention.[8] The debate concerning the income tax and the related issue of protective tariffs mostly relegated labor, along with other low-income producers, such as farmers, to predictable roles. For example, after portraying labor as discontented, big business's response was to urge "everyone to meet the problem by resorting to a more Spartan mode of living," including to eat less and curb the desire for the latest in clothing and shoe apparel.[9] At other times, the debates depicted wage earners as dependents whose well-being was connected integrally to the success of their industrial employers.[10] When the skill, industry, and diligence of workers—whether employees, merchants, farmers,

7 John D. Buenker, The Income Tax and The Progressive Era 28 (1985). More evidence of early twentieth-century hostility toward big business emerges from the then growing concerns about overcapitalization (or stock watering) by large corporations. *See* Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 Ind. L.J. 53, 75–81 (1990).

8 *See* Roy G. Blakey & Gladys C. Blakey, The Federal Income Tax 71–103 (1940) (documenting the legislative history of the Revenue Act of 1913); John F. Witte, The Politics and Development of the Federal Income Tax 77–78 (1985) (noting that, as a result of compromise, the final Revenue Act of 1913 dropped a proposed exemption for dependent children but allowed for a number of business-related deductions). Politically, workers' organizations did not play a major role in the design of the income tax as compared to agrarian interests, which enjoyed "national party and legislative power." Elizabeth Sanders, Roots of Reform: Farmers, Workers, and the American State, 1877-1917, at 413 (1999). Representatives from farming states, both democrats and republicans, had significant influence on the 1913 tax enactments and the 1916 revisions made to it. *See id.* at 228–32.

9 Buenker, *supra* note 7, at 35.

10 *See id.* at 34–36.

artisans, or other sole proprietors and small business owners—were considered, frequently it was only to contrast them with those in the idle capitalist and investor classes.[11]

Yet a focus on the hostility toward big business fails to capture the cultural role that big business played at the inception and early decades of the income tax, because, in fact, the success of big business generated high regard at the same time that it provoked antagonism. The work of Ajay K. Mehrotra captures the complex position of big business in the development of the income tax. He persuasively argues that accounting data and the wherewithal to accumulate that data, which both management and investors needed to evaluate the success or failure of business initiatives and to grow large corporations into ever larger ones, provided the means by which the government could confidently assess a tax on business income.[12] The dual sentiments of anxiety and reverence for large-scale, industrial capitalism together in the end became impetuses for the modern income tax. As the debate about the inception of an income tax focused on capitalists, their efficiencies, and their profits, proponents and opponents all but ignored labor's productive role in the economy and how wage earners contributed to the efficiencies and profits enjoyed by businesses large and small.

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11 *See* Deborah A. Geier, *The Taxation of Income Available for Discretionary Use*, 25 VA. TAX REV. 765, 817–18 (2006) (noting contemporary desires to tax capital income more heavily than earned income); Ajay K. Mehrotra, *American Economic Development, Managerial Corporate Capitalism, and the Institutional Foundations of the Modern Income Tax*, 73 LAW & CONTEMP. PROBS. 25, 40, 43–46 (2010) (describing contemporary commentary on early twentieth-century disparities in wealth).

12 *See generally* Mehrotra, *supra* note 11. Mehrotra attributes the adoption of the modern graduated income tax to two economic factors beyond the social and political issues discussed in the text. The first is that changes in the economy, including mass migration, urbanization, and industrialization, led to an "expansion of the market as an institution, and the concomitant growth in cash transactions," which were "critical to the evolution of the modern income tax." *Id.* at 27. As he notes, "the market's cash nexus permitted more and more individuals to derive a greater portion of their income and wealth from the sale of their labor services or the deployment of their physical and financial capital." *Id.* The well-developed market, in turn, allowed governments to measure income more easily and then to tax that income. *Id.* The second economic factor, which made the first possible, was the development of "economic organizations and administrative procedures that gave government authorities new 'tax handles' with which to assess and collect personal and business income." *Id.* In other words, "integrated, multi-unit business corporations," made it easier for government "to identify and access sources of tax revenue." *Id.* One aspect of those tax handles was the "more-rational and routinized systems of accounting to accurately calculate [the large corporations'] profits and investment returns." *Id.* at 27–28.

It is not that politicians and policymakers ignored issues related to wage labor generally.[13] After all, this was a time when legislation addressing child labor, the use of injunctions in labor disputes, and the length of the work day gained a good deal of attention.[14] When it came to the income tax, however, wealthy families, with their corporate holdings and substantial dividend and interest income, garnered the attention of this new progressive revenue regime, and it seems few people took into account the effect of that regime on workers as producers.[15]

The language in the Revenue Act of 1913[16] itself provides some further evidence of how wage earners did not rise to the status of producers at the inception of the modern income tax law. The Act defined the tax base to include income produced by labor—"salaries, wages, or compensation for personal service of whatever kind and in whatever form paid"[17]—even as opponents and proponents understood that the great majority of wage earners would not be subject to the tax.[18] Yet the statute only concerned itself with "business"—and expressly excluded "personal, living, or family expenses"—when it

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13 *See* MARC KARSON, AMERICAN LABOR UNIONS AND POLITICS: 1900–1918, at 42–89 (1958) (tracing the growth of the American Federation of Labor's political influence between 1906 and 1916); *see also* MICHAEL KAZIN, THE POPULIST PERSUASION 53–54 (1995) (describing how, during the early decades of the twentieth century, organized labor, particularly the American Federation of Labor, pursued the interests of union workers through the lens of "producerism").

14 *See* KAZIN, *supra* note 13, at 81, 85–86. *See generally* GENDER, CLASS, RACE AND REFORM IN THE PROGRESSIVE ERA (Noralee Frankel & Nancy S. Dye eds., 1991) (discussing the role of women in progressive reforms, including child labor bans, minimum wage statutes, juvenile justice codes, housing, and health legislation).

15 To some extent the income tax law anticipated and perhaps reinforced the consumer movements that emerged during the Progressive Era and during the Great Depression. *See generally* LIZABETH COHEN, A CONSUMERS' REPUBLIC: THE POLITICS OF MASS CONSUMPTION IN POSTWAR AMERICA 20–28 (2003) (describing the first and second wave of the consumer movement in the United States). Before the twentieth century, the U.S. citizenry "overwhelmingly pointed to the vitality of production and the power of producers" when considering the nation's strength and vitality. *Id.* at 21. The Progressive Era, however, ushered in "a significant shift in thought in which there was a recognition in "the centrality of consumers to the nation's economy and polity." *Id.* Notably, "organized workers . . . now accepted the reality of industrialized labor and began to agitate for a 'living wage' adequate to provide an 'American standard of living' for working-class consumers." *Id.* at 22.

16 Revenue Act of 1913, Pub. L. No. 63-16, 38 Stat. 114.

17 *Id.* § 2(B), 38 Stat. at 167.

18 *See* BLAKEY & BLAKEY, *supra* note 8, at 81–82, 88–89 (discussing congressional debates over the size of the personal exemption and the income levels at which tax rates would increase); BUENKER, *supra* note 7, at 14–15 (noting that "'the three percent' . . . were candidly acknowledged as the sole beneficiaries of preventing a federal income tax").

provided for the deduction of "necessary expenses."[19] Notably, when it came to deductions, the Act's exclusive use of the term "business" is in direct contrast to the language found in an earlier attempt in 1894 to institute a federal income tax. That statute provided that "necessary expenses actually incurred in carrying on any business, occupation, or profession shall be deducted."[20] Although much of the rest of this statutory provision relates to costs incurred by taxpayers holding real property and capital expenditures inapplicable to wage earners, and although the $4,000 exemption meant that no one expected many of them would pay the tax, the 1894 Act's broad language equating wage earners with business marks a moment when Congress did not distinguish between business owners and their employees.[21] Undue focus on the Revenue Act of 1913's omission of language referring directly to wage earners is not warranted, but it does support the view that, at its inception, the modern income tax primarily paid attention to the most successful of professionals, business owners, and the investor class.[22]

With the onset of World War I and the growing need for revenue, the government enacted new kinds of taxes (e.g., an estate tax on individuals and an excess profits tax on businesses), raised the income tax rates considerably, and broadened the tax to include more people.[23] W. Elliot Brownlee concludes that this new tax regime, representing redistributional policies, was the "most significant domestic initiative to emerge from the war."[24] By the end of 1918, the tax affected about fifteen percent of U.S. households.[25] Of the total amount of revenues

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19 Revenue Act of 1913 § 2(B), 38 Stat. at 167. ("That in computing net income for the purpose of the normal tax there shall be allowed as deductions . . . the necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses . . . .").

20 Tariff of 1894, ch. 349, § 28, 28 Stat. 509, 553. The full implications of this statutory language and the income tax itself never were realized, because, in 1895, just one year after its enactment, the U.S. Supreme Court held the tax unconstitutional in *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, *aff'd on reh'g*, 158 U.S. 601 (1895). For a discussion of the events leading up to *Pollock*, existing precedent, and the majority's decisionmaking, see BUENKER, *supra* note 7, at 16–21.

21 Tariff of 1894, § 28, 28 Stat. at 554. The Act defines income as including "the income of any person" derived from an exhaustive list of sources. *Id.*

22 *See* BUENKER, *supra* note 7, at 29 (breaking down income tax payments by profession following the enactment of the Revenue Act of 1913).

23 War Revenue Act, Pub. L. No. 65-50, § 2, 40 Stat. 300, 301 (1917) (raising the highest marginal rate to fifty percent); *id.* §§ 200–214, 40 Stat. at 302–08 (imposing an excess profits tax); Revenue Act of 1916, Pub. L. No. 64-271, § 200–212, 39 Stat. 756, 777–80 (imposing an estate tax); *see also* W. ELLIOT BROWNLEE, FEDERAL TAXATION IN AMERICA 62–63 (2d ed. 2004) (explaining these changes).

24 BROWNLEE, *supra* note 23, at 59.

25 *Id.* at 63; *see also* Ajay K. Mehrotra, *Taxation: United States Law*, *in* 5 THE OXFORD

from the personal income tax, one percent of the families accounted for eighty percent of the revenues.[26] Higher estate tax rates on the wealthiest of decedents and the excess-profits tax further added to the taxation of the rich.[27] After the war, the progressive individual income tax, albeit with lower rates than during the war years, remained a mainstay of the federal government.[28] States also began to rely on this form of taxation to meet their revenue needs.[29] In a sense, a stasis took hold in which the appetite for tariffs or a national sales tax ebbed, and—even as "pockets of privilege" crept into the tax law—"normal" came to mean a progressive individual income tax and a corporate income tax, both of which addressed concerns about concentrations of wealth and equitable distribution of the obligations of the federal government.[30]

The onset of the Great Depression and the legislative activity accompanying the New Deal did not radically change either the individual income tax or the polity's understanding of the tax. It is true that for a time during the Depression legislation raised rates and imposed new taxes on dividends, excess profits, and undistributed corporate profits, but the rhetoric surrounding these taxes remained familiar.[31] President Franklin D. Roosevelt justified increases in an array of taxes on corporations and the wealthy to control concentrations of economic power, ensure fairness based on ability to pay, and create greater opportunities for the less wealthy.[32] In opposition, business interests argued that the Democratic tax proposals stifled economic growth.[33] Whereas in the late-nineteenth and early-twentieth centu-

INTERNATIONAL ENCYCLOPEDIA OF LEGAL HISTORY 439, 443–44 (Stanley N. Katz ed., 2009) (noting the same as well as the war-time tax regime's postwar effects).

26 BROWNLEE, *supra* note 23, at 63.

27 *Id.* at 63–65. The excess-profits tax accounted for nearly two-thirds of the federal tax revenues during the war. *Id.* at 64–65.

28 *See* Mehrotra, *supra* note 25, at 444 (noting that, even as marginal tax rates were lowered and the excess-profits tax was eliminated, Secretary of the Treasury Andrew Mellon "and many other lawmakers recognized the importance of direct and progressive taxation").

29 *See id.*

30 *See* BROWNLEE, *supra* note 23, at 75–77, 79. Treasury Secretary Mellon, however, supported such policies as much out of "enlightened self-interest" as anything; supporting *some* form of progressive taxation, he argued, would demonstrate corporations' "civic responsibility and [would] defuse radical attacks on capital." *Id.* at 76–77.

31 *See id.* at 84–99 (detailing Franklin D. Roosevelt's Depression-era tax policies); Mehrotra, *supra* note 25, at 444–45 (same).

32 *See* BROWNLEE, *supra* note 23, at 90 ("[Roosevelt] justified his tax-reform program in terms of both its inherent equity and its ability to liberate the energies of individuals and small corporations, thereby advancing recovery."); Mehrotra, *supra* note 25, at 445 (noting Roosevelt's "desire to use the tax system more forcefully to attack the growing wealth disparity").

33 *See* BROWNLEE, *supra* note 23, at 98–99.

ries, policymakers and politicians viewed the federal income tax as an alternative to a tariff regime, after the Great Depression and on the eve of World War II, the income tax was an entrenched fixture of government.[34] Political clashes surrounding the income tax revolved around the nature and level of corporate taxes, individual income tax rates, and the composition of the tax base, which included skirmishes over the ever-growing number of provisions favorable to moneyed interests.[35] Regardless of the differences, in both periods in the history of the income tax—World War I and the New Deal—the tensions surrounding the basic question of how much to ask the wealthy and the corporations they controlled to pay for government, relative to the middle and working classes, went on unabated. Up to this point in the fiscal history of the United States, the vast majority of wage earners did not pay federal income taxes, and the focus of the levy remained primarily on the wealthy thanks to the exemption provisions. The income tax was viewed as and, in fact, generally was a tax on wealthy industrialists and financiers who enjoyed substantial profits from their investments, including gains from the sale of tangible and intangible property, dividends, interest, and rents.[36]

A history of the development of the income tax law before World War II also has to take into account the substantial role that the U.S. Supreme Court played. Most notably, in its 1920 decision of *Eisner v. Macomber*,[37] a five-to-four Court held that the Sixteenth Amendment did not allow for the treatment of stock dividends as income, resulting

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34 *See id.* at 79 ("The large revenues from income taxation provided the basis for the expansion of federal domestic programs and for the political reinforcement of the World War I tax system.").

35 *See id.* at 94–101. It is interesting to note the efforts the wealthy took to reduce their tax bills through deductions. Such efforts led Congress to pass legislation to restrict certain deductions, including a provision to limit the deductibility of corporate yachts and country estates. *Id.* at 96–98.

36 *See* Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1, 14–16, 64 (2002); Assaf Likhovski, *The Duke and the Lady:* Helvering v. Gregory *and the History of Tax Avoidance Adjudication*, 25 CARDOZO L. REV. 953, 974–75 (2004) (considering this phenomenon from a number of different perspectives). At no time during the 1930s did more than five percent of the population file taxable returns. Carolyn C. Jones, *Mass-Based Income Taxation: Creating a Taxpaying Culture, 1940–1952*, *in* FUNDING THE MODERN AMERICAN STATE, 1941–1995, at 107, 113–14 (W. Elliot Brownlee ed., 1996). Wage earners, however, were not immune from taxation on their wages. As of 1935, with the institution of the Social Security system, many workers began to have employment taxes withheld from their wages and salaries by their employers. The government's successful experience with the Social Security tax made wage earners an obvious source of revenue during World War II and gave impetus to the idea of a mass-based income tax. *See* BROWNLEE, *supra* note 23, at 110.

37 Eisner v. Macomber, 252 U.S. 189 (1920).

in their exclusion from taxation upon their receipt.[38] This decision, which embraced tax deferral on increases in investors' wealth, can be viewed as a continuation of the probusiness sentiments found on the previous century's Supreme Court when it checked Congress's power to tax by holding the income tax instituted by the Act of 1894[39] unconstitutional in *Pollock v. Farmers' Loan & Trust Co.*[40] For purposes of this Article's thesis, the more important Supreme Court decision in the early years of the income tax is *Welch v. Helvering*, interpreting, without recourse to constitutional analysis, the statutory provision allowing a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[41]

Welch, probably more than any other case, solidifies the income tax law's deference to business owners and their acumen. It did not have anything to do with the political struggles to tax industrialists, financiers, and other wealthy investors. On the contrary, the business history of the taxpayer Thomas Welch reflects many of the harsh economic forces, including monopolistic practices, that marked the early decades of the twentieth century. Within this context, it is no wonder that respect for businesses' strategies to establish efficient and rational operations—which, from the outset, had some influence on the structure of the income tax—unreservedly emerges.

Starting in 1906, Thomas Welch and his father, E. L. Welch, ran a grain brokerage business, E.L. Welch & Company, in Minnesota.[42]

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38 *Id.* at 219. Both Justices Oliver Wendell Holmes and Louis D. Brandeis wrote separate and strong dissents. *See id.* at 219 (Holmes, J., dissenting); *id.* at 220 (Brandeis, J., dissenting).

39 Tariff of 1894, ch. 349, 28 Stat. 509.

40 Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, *aff'd on reh'g*, 158 U.S. 601 (1895). For further discussion of the jurisprudential significance of *Eisner v. Macomber*, see Marjorie E. Kornhauser, *The Story of* Macomber: *The Continuing Legacy of Realization*, *in* TAX STORIES 93, 112–15 (Paul L. Caron ed., 2d ed. 2009).

41 Welch v. Helvering, 290 U.S. 111, 113 (1933) (citing Revenue Act of 1924, ch. 234, § 214(a)(1), 43 Stat. 253, 269).

42 Transcript of Record at 5, 10, *Welch*, 290 U.S. 111 (No. 33) [hereinafter "Transcript of Record"]. Thomas Welch served as secretary of the corporation and owned ten shares, while his father, who was president, owned the rest. *Id.* at 28. Thomas Welch testified that "[t]he largest part of its business was handling grain on commission." *Id.* He went on to describe how his father had responsibility for the financial business and then described his duties as follows:

> [I kept] in very close touch with the customers of the corporation and travelled [sic] out in the country through the summer and fall three or four months, and then took complete charge of the grain as it came in, and handled the cash grain and practically loaded 85 or 90 per cent, in addition to cash sales, the details in regard to it, the grading of grain and trading and futures.

Id. at 29.

After World War I, agricultural prices dropped dramatically, the railroad companies used their dominance in the market to set high rates for the storage and shipment of grain, and farmers established cooperatives so that they might be able to have more market power to set prices for their products and control operating costs.[43] In this economic environment, E.L. Welch & Company and Thomas Welch could not survive financially and both declared bankruptcy in 1922.[44] Thomas Welch picked himself up and managed to get a contract with the Kellogg Company under which he agreed to purchase grain for Kellogg for commission payments.[45] From Welch's point of view, good business sense and moral business practices demanded that he make every effort to repay the discharged debts of E.L. Welch & Company.[46] Given his taxable commissions from 1924 through 1928, Welch seems to have vindicated the wisdom of his strategy. In 2012 dollars, he earned more than $411,000 in one year, while his lowest year of commissions still brought in more than $242,000.[47] Over the same five-year period he made payments to creditors totaling approximately $622,624 out of earnings totaling $1,568,486. By most people's measure, Welch had worked his way back to prosperity and good standing.

Even as Justice Cardozo, writing for a unanimous Court, denies Welch a deduction for his repayment of discharged debts, he establishes the business owner in the tax law as a noble warrior doing his level best to withstand the onslaughts of marketplace predators. Cardozo stipulates that Welch's payments to the creditors of E.L. Welch

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43 *See* Joel S. Newman, *The Story of* Welch*: The Use (and Misuse) of the "Ordinary and Necessary" Test for Deducting Business Expenses*, *in* TAX STORIES, *supra* note 40, at 199–200.

44 *See* Transcript of Record, *supra* note 42, at 28.

45 *Id.* at 20.

46 *Id.* at 20, 31. When asked about his motive for the payments on the discharged debts, Welch responded, "Well, it was to reestablish my credit for one thing, reestablish my business, and, further, it was a matter of a moral obligation." *Id.* at 31.

47 *Welch*, 290 U.S. at 112–13 ("In 1924, the commissions were $18,028.20; the payments $3,975.97; in 1923 [sic], the commissions $31,377.07; the payments $11,968.20; in 1926, the commissions $20,925.25, the payments $12,815.72; in 1927, the commissions $22,119.61, the payments $7,379.72; and in 1928, the commissions $26,177.56, the payments $11,068.25."). All adjustments to 2012 dollars are based on the *CPI Inflation Calculator*, BUREAU OF LABOR STATISTICS, http://www.bls.gov/data/inflation_calculator.htm (last visited Jan. 19, 2013). The Commissioner had assessed tax deficiencies for these years totaling $3,072.96 in 1932, which was the year in which the parties litigated the matter before the Board of Tax Appeals. Welch v. Comm'r, 25 B.T.A. 117, 117 (1932). In 2012 dollars, that would be equivalent to approximately $51,500 based on the CPI Inflation Calculator. In his petition to the Board of Tax Appeals, Welch stated that he paid his creditors (who were mainly the company's customers) "as soon as his ability permitted, and each year since [his] bankruptcy, has paid out all his earnings except necessary living expenses to such customers." Transcript of Record, *supra* note 42, at 5.

& Company, made in order to restore his reputation and gain goodwill with his customers, satisfied the *necessary* prong of the "ordinary and necessary" rule.[48] "We may assume that the payments to creditors of the Welch Company were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. He certainly thought they were, and we should be slow to override his judgment."[49] With this statement, Cardozo disregards the Government's view that the Court hold "necessary" to mean "essential, needful, requisite, or indispensable."[50] Instead, Cardozo's statement concerning deference to Welch's business judgment seems to track Welch's brief, which states the following:

> It will not, we think, be disputed as a general proposition that business men should have a free hand to adopt such means as will result in increased business and increased income, resulting in increased revenue to the Government, and that the Government should not exercise a supervisory power over the methods adopted, or determine after the event whether the course adopted was wise or unwise, advisable or inadvisable, prudent or imprudent, so long as no law is violated. It is the taxpayer, whose investment is at stake, who should determine ways and means and not the Government.[51]

Further evidence that Cardozo embraces the interpretation sought by Welch—that "necessary" means "convenient" or "suitable"[52]—is that, just as Welch did in his brief, Cardozo cites *M'Culloch v. Maryland*'s[53] discussion of the word "necessary" in the Constitution's Necessary and Proper Clause.[54] Welch quoted *M'Culloch* extensively in his brief[55] while the Commissioner ignored the case in his.[56]

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48 *Welch*, 290 U.S. at 113.

49 *Id.* (citation omitted).

50 Brief for Respondent at 6, *Welch*, 290 U.S. 111 (No. 33).

51 Brief for Petitioner at 10, *Welch*, 290 U.S. 111 (No. 33).

52 *Id.* at 16–17.

53 M'Culloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819).

54 U.S. CONST. art. I, § 8, cl. 18; *see Welch*, 290 U.S. at 113 (citing *M'Culloch*, 17 U.S. (4 Wheat.) 316).

55 *See* Brief for Petitioner, *supra* note 51, at 16–17.

56 *See* Brief for Respondent, *supra* note 50. Cardozo also comes close to embracing the meaning of "necessary" suggested by the Eighth Circuit Court of Appeals, which stated that "[t]here may be room for argument and difference as to whether payments of this character, under the circumstances here, are 'necessary' or not. It would be rather clear that they would be helpful in a business way, and that helpfulness might approach or reach necessity." Welch v. Comm'r, 63 F.2d 976, 977 (1933).

Cardozo not only articulates a statutory interpretation of "necessary" that demands deference to the judgment of business owners, but he also demonstrates that deference by not making any attempt to justify Welch's payments to the creditors of the defunct E.L. Welch & Company.[57] The record showed that Welch sought and received the advice of three bankers, all of whom insisted that his future success depended on his repaying the old debts.[58] The record also showed Welch's business success over the five tax years in question.[59] For Cardozo, these facts apparently had no relevance, because presumably Welch still would have satisfied the "necessary" requirement, even if he had not received the bankers' advice and even if his attempt to continue to make a living as a grain broker was not as successful as it was.[60] Arguably, as a matter of constructing his opinion, Cardozo spends little time on the deference issue because he thinks the language of "ordinary" creates the more difficult challenge for the taxpayer to surmount in his appeal.[61] Nevertheless, the rhetorical effect of his stark statement put the Commissioner and taxpayers on notice that the "necessary" requirement places little or no limit on the deductibility of business owners' expenditures. Thanks to *Welch*, the requirement essentially becomes tautological with business judgment, and business judgment means anything a business owner deems necessary as a rational profit seeker.

It is when Cardozo turns his attention to the term "ordinary" that Welch loses his case. This is also the place where Welch becomes the *every businessman*, noble in the conduct of his rational pursuit of profit. With nearly every paragraph that grapples with the statutory meaning of "ordinary," the every businessman grows in stature. At the outset, Cardozo seems to equate the question of ordinary with the question of whether an expenditure should be capitalized. For example, Cardozo writes that "the problem is not solved when the payments are characterized as necessary. Many necessary payments are charges upon capital."[62] Cardozo follows that observation with a hy-

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57 *See Welch*, 290 U.S. at 113 ("[W]e should be slow to override [Welch's] judgment.").

58 Transcript of Record, *supra* note 42, at 31.

59 *Id.* at 29, 31 (providing further details of Welch's gross income and payments to creditors and Welch's testimony about how he built up a large new business by dealing with a number of E.L. Welch & Company's creditors).

60 *See Welch*, 290 U.S. at 113 ("There is no need to determine whether [the payments to creditors] are both necessary and ordinary.").

61 *See id.* at 113–15 (describing the standard for "ordinary" and its application to the facts in *Welch*).

62 *Id.* at 113. In the notification to Thomas Welch of a deficiency for his 1924 and 1925 taxes, the Commissioner indicated that the basis for the deficiency was that the payments for

pothetical, based to a degree on the facts in *Kornhauser v. United States*,[63] in which a businessman incurs legal fees because of a "once in a lifetime" event putting the "safety of a business" at risk.[64] Cardozo uses this scenario to show that "ordinary" does not mean that "payments must be habitual or normal in the sense that the same taxpayer will have to make them often."[65] Just in case the reader missed the point about the businessman's bravery as he operates in the marketplace, Cardozo goes on to link the deduction of legal fees as a "defense against attack."[66]

The safe ground upon which Cardozo finds himself when he reflects on the meaning of "ordinary" with regard to his hypothetical concerning "legal fees" eludes him when he returns to the facts of *Welch* in the next paragraph of the opinion:

> The line of demarcation is now visible between the case that is here and the one supposed for illustration [i.e., the hypothetical on legal fees]. We try to classify this act as ordinary or the opposite, and the norms of conduct fail us. No longer can we have recourse to any fund of business experience, to any known business practice. Men do at times pay the debts of others without legal obligation or the lighter obligation imposed by the usages of trade or by neighborly amenities, but they do not do so ordinarily, not even though the result might be to heighten their reputation for generosity and opulence. . . . There is nothing ordinary in the stimulus evoking it, and none in the response. . . . The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.[67]

At this point, Cardozo seems no longer to be trying to distinguish between an expenditure that a taxpayer can deduct immediately and one that he needs to charge to capital. Instead, Cardozo is asking whether the payments on the discharged debts are business expenditures at all. As he discusses this aspect of "ordinary," his use of the word "opulence" jars. It has a negative connotation, and it would seem to equate Welch with a spendthrift or suggest he may have acted in bad

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discharged debts of E.L. Welch & Company were "in the nature of capital expenditures." Transcript of Record, *supra* note 42, at 10.

63 Kornhauser v. United States, 276 U.S. 145 (1928) (having to do with the deductibility of legal fees for an accounting to the taxpayer's former law partner).

64 *Welch*, 290 U.S. at 114.

65 *Id.*

66 *Id.*

67 *Id.* at 114–15.

taste.[68] At the least, it is the one time in the opinion in which Cardozo places Welch among those very rich who were the primary targets of the tax law. Yet the overall tenor of Cardozo's struggle over how to treat Welch's payments for the previously discharged debts of the now defunct E.L. Welch & Company remains primarily respectful to Welch as a businessman. In fact, one senses that the reason why Cardozo finds this such a hard case is because he cannot overcome his astonished admiration for Welch's commitment to make good on those debts.

Yet that astonished admiration concerning a business practice of repayment of discharged debts is odd in itself. For one thing, Welch based a good deal of his argument on *A. Harris & Co. v. Lucas*,[69] which dealt with a company paying debts previously discharged in bankruptcy.[70] For another, as noted earlier, the record showed that Welch had received advice to repay E.L. Welch & Co.'s debts from three different bankers.[71] Finally, although the Commissioner did argue that the "payments were unusual and gratuitous rather than ordinary and necessary" and went on to say they were "not common, usual, [or] often recurring," he never went so far as to say they were beyond the norms of conduct or known business practice.[72] Why does Cardozo misleadingly treat the payments as an oddity in business, especially given that his statements here undermine the earlier part of the opinion in which he states so forthrightly that "we should be slow to override his [Welch's] judgment"?[73]

The next paragraph in Cardozo's opinion accentuates the incoherence of the one just discussed, because, in the first several sentences, he returns to the issue of capitalization and then adds an argument concerning the deference the Court owes to rulings by the Commissioner:

> The Commissioner of Internal Revenue resorted to that standard [i.e., the statutory standard] in assessing the petitioner's income, and found that the payments in controversy came closer to capital outlays than to ordinary and necessary

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68 Opulence derives from the Latin ops, meaning wealth or riches, and has had that connotation consistently over the centuries. *See* 2 THE NEW SHORTER OXFORD ENGLISH DICTIONARY 2012 (Lesley Brown ed., 1993) (definition of "opulent"); A NEW LATIN DICTIONARY 1272 (Charlton T. Lewis & Charles Short eds., 2d ed. 1907) (definition of "ops").

69 A. Harris & Co. v. Lucas, 48 F.2d 187 (5th Cir. 1931).

70 *See* Brief for Petitioner, *supra* note 51, at 5–7, 11 (citing *A. Harris & Co.*, 48 F.2d 187).

71 Transcript of Record, *supra* note 42, at 31.

72 Brief for Respondent, *supra* note 50, at 6.

73 Welch v. Helvering, 290 U.S. 111, 113 (1933).

> expenses in the operation of a business. His ruling has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong. Unless we can say from facts within our knowledge that these are ordinary and necessary expenses according to the ways of conduct and the forms of speech prevailing in the business world, the tax must be confirmed.[74]

The Commissioner had argued in the alternative that the payments were not ordinary and necessary and, that even if they were, they should be classified as capital.[75] Notably, neither the Commissioner nor Welch had made the deference argument in their briefs. With these few sentences, however, Cardozo would seem to have resolved all outstanding issues in favor of the Commissioner. What may at first seem like a pithy opinion, in fact, could have been even more concise. If Cardozo had just followed the Commissioner's lead, he would not have needed to concern himself at all with whether payment of a previously discharged debt is beyond the ken of "any known business practice."[76]

Moreover, Cardozo would have had no need to go through his now famous list of "bizarre analogies."[77] Where usually that term would have a pejorative overtone, he turns it into an affirmation of the dignity and decency of the every businessman, even as he rejects the appropriateness of the law's allowing an immediate deduction for the expenditures he describes:

> One man has a family name that is clouded by thefts committed by an ancestor. To add to his own standing he repays the stolen money . . . . The payments figure in his tax return as ordinary expenses. Another man conceives the notion that he will be able to practice his vocation with greater ease and profit if he has an opportunity to enrich his culture. Forthwith the price of his education becomes an expense of the business, reducing the income subject to taxation. There is little difference between these expenses and those in controversy here. Reputation and learning are akin to capital as-

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74 *Id.* at 115 (citations omitted).

75 Brief for Respondent, *supra* note 50, at 9 (arguing that "[i]f the payments made by petitioner do not meet the requirement of being 'ordinary and necessary' expenses of the taxable year in carrying on a business, it is unnecessary to inquire further in an attempt to classify them. But if they are capital expenditures they are necessarily not within the class of current business expenses. If these payments may be regarded as being connected with petitioner's business, we believe they are essentially capital expenditures."(citations omitted)).

76 *Welch*, 290 U.S. at 114.

77 *Id.* at 115.

> sets, like the good will of an old partnership. For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business.[78]

It may be that Cardozo believes it is "bizarre" to allow an immediate deduction for any of these types of expenditures, but he certainly does not mean to suggest that they are anything less than astute and decent. Although Cardozo ends up with a muddled opinion on the law, he is quite clear on the respect owed to the middle-class businessman and his efforts "to hew a pathway to success."[79]

Both the press and legal scholars virtually ignored *Welch* at the time the Supreme Court decided it.[80] Current scholarship has much to say about Cardozo's faulty reasoning and confusing exposition.[81] *Welch*'s importance goes beyond its status as precedent on a range of questions, including whether Commissioners' rulings are presumed correct, whether the term "ordinary" refers only to the distinction between those expenditures that are capital in nature and those that are currently deductible, and whether the term "necessary" merely means "appropriate and helpful." *Welch*'s further consequential reach comes from Cardozo's having made the noble business owner an integral part of tax jurisprudence. For, of course, Cardozo did not create him; he had been there from the start of the modern tax law as someone whose skill and hard work in the face of protective tariffs and monopoly power earned him the good standing of his neighbors and a symbolic role in policy debates. That commentators have overlooked this

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78 *Id.* at 115–16 (citation omitted).

79 *Id.* at 116. Cardozo does not explicitly acknowledge the financial struggles faced by business owners, even as he writes during the depths of the Great Depression. More specifically he does not dwell on the fact that Welch and E.L. Welch & Company had found it impossible to avoid bankruptcy in the early 1920s. *See* Joseph A. Schumpeter, *The Decade of the Twenties*, 36 AM. ECON. REV. (PAPERS & PROC.) 1, 5 (1946) ("[T]hroughout the twenties, as always, prosperity as well as recession was essentially 'spotty'. . . . Conditions always differed in different industrial and geographical sectors . . . ."). Nevertheless, the financial challenges that Welch encountered in the early 1920s and the economic hardships that many business owners were confronting during what must have seemed in 1933 as a deep, persistent, and unrelenting economic downturn may well have contributed to the respect Cardozo shows toward the every businessman.

80 *See* Newman, *supra* note 43, at 197–98 (noting that neither the popular press nor "a single law review case note" wrote about *Welch*).

81 *See, e.g.*, MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 138–40 (11th ed. 2009) ("Unfortunately, Justice Cardozo's opinion contains so much soggy philosophy that its main thesis . . . has been a source of some confusion."); Newman, *supra* note 43, at 207–09 ("On the facts, [Justice Cardozo] was wrong on the personal versus business issue, and he was wrong on the ordinary versus bizarre issue. As to ordinary versus capital, he was right, but his opinion gave us very little guidance.").

central aspect of *Welch* is unsurprising. The influence of Cardozo's iconic figure mostly remains unnoticed as it is embedded in legislation, regulations, rulings, and court decisions. It is only when the tax law's treatment of workers is set alongside its treatment of business owners that the force and impact of Cardozo's every businessman on our current tax regime emerges.

II. Deference to Business Owners' Judgment

This Part analyzes the case law to demonstrate how deference to business owners' judgment leads to mistakes in tax jurisprudence. The first Section shows how the courts, thanks to *Welch*, have essentially eviscerated the requirement of "necessary" as applied to business owners. The next Section, through an analysis of *INDOPCO, Inc. v. Commissioner*, demonstrates how deference to business owners' judgment has precluded consideration of the possibility that some business owners' expenditures should not be recoverable under the tax law at all. The last Section examines the effect of deference to business owners' judgment on expenditures that provide no benefit to a business owner and, instead, represent a transfer of wealth to another individual taxpayer or entity.

A. Welch*'s Progeny*

Welch v. Helvering laid the foundation for a standard of extreme deference to business owners. Thus, in its subsequent decisions, the Supreme Court has seldom questioned whether a business owner's expenditure is a cost incurred to produce income. The Court has occasionally disallowed deductions when they clearly related to personal matters, such as divorce,[82] or where the taxpayer was not engaged in a trade or business and therefore did not qualify as a business owner.[83]

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82 *See* United States v. Gilmore, 372 U.S. 39, 42, 48–49, 51–52 (1963) (holding that the taxpayer's legal expenses incurred in a divorce proceeding, notwithstanding the fact that they enabled him to retain his ownership interests in car dealerships and preserve his business reputation, were not sufficiently related to his income-producing activity and were, therefore, personal in nature); *see also* United States v. Patrick, 372 U.S. 53, 56–57 (1963) (deciding that legal expenses incurred in a divorce proceeding and in connection with property transfers pursuant to a divorce settlement, notwithstanding the fact that they enabled the taxpayer to preserve ownership of a newspaper publishing company, were personal and not deductible under I.R.C. § 212 as expenses for the production of income).

83 *See, e.g.*, City Bank Farmers Trust Co. v. Helvering, 313 U.S. 121, 124–26 (1941) (holding that commissions paid to a trustee were nondeductible because the trust was not carrying on any trade or business); United States v. Pyne, 313 U.S. 127, 130–32 (1941) (vacating and remanding lower court decision that an executor of an estate was carrying on a business and entitled to a deduction for expenses incurred while administering the estate); Higgins v. Comm'r, 312 U.S.

In a few instances, the Court has disallowed a stockholder's deduction on the grounds that certain expenses related to the corporation itself and not to the stockholder.[84] In a handful of cases, the Court has disallowed deductions where they have violated a "sharply defined" public policy,[85] but it has declined to do so in just as many cases, finding no such policy exists.[86]

212, 218 (1941) (holding that salaries and expenses related to management of the taxpayer's investments in stocks and bonds were not deductible because the taxpayer was not carrying on a trade or business); Van Wart v. Comm'r, 295 U.S. 112, 115–16 (1935) (holding that an attorney's fee paid by a guardian in connection with litigation to procure income for his ward was nondeductible because the guardian was not carrying on a trade or business).

84 *See* Whipple v. Comm'r, 373 U.S. 193, 201–03 (1963) (disallowing a bad debt deduction on a loan from the taxpayer to a soft drink franchise of which he was the principal owner because, although the taxpayer provided some services to the corporation, his return was that of an investor and he did not carry on the trade or business that gave rise to the loss); Deputy v. du Pont, 308 U.S. 488, 493–95 (1940) (disallowing a deduction for expenditures incurred by a du Pont shareholder who borrowed additional shares in order to transfer them to new key executives because the expenses "proximately result[ed] not from the taxpayer's business but from the business of the du Pont Company" and, therefore, the expenses were not ordinary to the taxpayer's business, which involved the enhancement and preservation of his investments).

85 *See, e.g.*, Cammarano v. United States, 358 U.S. 498, 505, 508 (1959) (upholding, against a First Amendment challenge, a regulation prohibiting a trade or business deduction for lobbying expenses and disallowing a deduction for a beer distributor's lobbying expenses incurred in an effort to defeat the State of Washington's initiative to make the State the exclusive retailer of beer and wine); Tank Truck Rentals, Inc., v. Comm'r, 356 U.S. 30, 33–35 (1958) (holding that fines paid by a trucking company for an intentional violation of state maximum weight limits were nondeductible because to allow a deduction would frustrate the "sharply defined" state policy); Hoover Motor Express Co. v. United States, 356 U.S. 38, 40 (1958) (same except that the violations were inadvertent); Textile Mills Sec. Corp. v. Comm'r, 314 U.S. 326, 335–38 (1941) (upholding a regulation prohibiting a trade or business deduction for lobbying expenses and disallowing a deduction for lobbying expenses incurred by German textile interests seeking to recover properties seized in the United States during World War I pursuant to the Trading with the Enemy Act).

86 *See, e.g.*, Comm'r v. Tellier, 383 U.S. 687, 694–95 (1966) (allowing a deduction for legal expenses of a securities dealer convicted of securities law violations and mail fraud, reasoning that no "sharply limited and carefully defined" policy was violated when a defendant in a criminal proceeding exercised his constitutional right to employ a lawyer to defend himself); Comm'r v. Sullivan, 356 U.S. 27, 29 (1958) (allowing a deduction for rents and salaries incurred to carry on a gambling operation that was illegal under state law because there was no evidence of a federal policy to disallow deductions for gambling businesses and the costs were not incurred in an attempt "to avoid the consequences of violations of the law"); Lilly v. Comm'r, 343 U.S. 90, 96–97 (1952) (allowing a deduction for kickbacks paid to doctors who sold the taxpayer's eyeglasses reasoning that, even though the kickbacks may have been unethical, there was no "sharply defined national or state polic[y]" proscribing them (internal quotation marks omitted)); Comm'r v. Heininger, 320 U.S. 467, 474–75 (1943) (allowing a deduction for legal expenses incurred by a mail-order seller of false teeth to contest unsuccessfully the Postmaster General's fraud order barring him from using mails, because a challenge to a fraud order did not violate the policy of the fraud order statute, which was to protect the public and not to punish the subject of the fraud order).

Following one aspect of Justice Cardozo's rationale in *Welch,* the Court has in several cases disallowed a deduction under I.R.C. § 162[87] on the grounds that the expenditures were capital in nature because they failed to meet the requirement of "ordinary."[88] Implicit in the capitalization cases, however, is the assumption that the expenditures are allowable costs incurred in order to produce income; the only issue has been *when* the expenditures should be recovered.[89] In fact, Supreme Court cases, in accordance with *Welch*, have long made the "necessary" prong of I.R.C. § 162 almost meaningless. For example, in the 1966 case *Commissioner v. Tellier*,[90] the Court described the *Welch* interpretation of "necessary" as a well-established principle: "Our decisions have consistently construed the term 'necessary' as imposing *only the minimal requirement* that the expense be 'appropriate and helpful' for 'the development of the [taxpayer's] business.'"[91]

The lower courts have followed the Court's lead by likewise adopting a posture of utmost deference to the business owner's application of the "necessary" standard. For example, in *Urbauer v. Commissioner*,[92] the Tax Court upheld a taxpayer's deductions for country club dues and fees for golf and bowling tournaments solely on the basis of the taxpayer's averred belief that his rubbing elbows with country club members would enhance his business.[93]

Similarly, in *Heineman v. Commissioner*,[94] the Tax Court allowed Ben Heineman, the president and CEO of Northwest Industries,

87 I.R.C. § 162 (2006).

88 *See* INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 88, 90 (1992) (holding that investment banking, legal, and accounting fees paid by the taxpayer in connection with its being acquired by another company were capital, notwithstanding the fact that the expenditures did not create or enhance a separate and distinct asset; for further discussion of this case, see *infra* Part II.B.); Comm'r v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971) (deciding that mandatory premium payments made by a bank to the Federal Savings and Loan Insurance Corporation were capital and created or enhanced a "separate and distinct additional asset," i.e., rights in a secondary reserve fund, and were, therefore, not ordinary); United States v. Hilton Hotels Corp., 397 U.S. 580, 583–84 (1970) (holding that legal, consulting, and other fees paid by an acquiring firm in connection with minority appraisal rights were capital); Woodward v. Comm'r, 397 U.S. 572, 577–78 (1970) (holding that legal, accounting, and appraisal expenses incurred as a part of the taxpayer's effort to acquire a minority stock interest were capital).

89 For a more detailed discussion of capitalization, see *infra* notes 110–31 and accompanying text.

90 Comm'r v. Tellier, 383 U.S. 687 (1966).

91 *Id.* at 689 (quoting *Welch v. Helvering*, 290 U.S. 111, 113 (1933)) (emphasis added).

92 Urbauer v. Comm'r, 63 T.C.M. (CCH) 2492 (1992).

93 *Id.* at 2498. In the aftermath of cases like *Urbauer*, Congress enacted I.R.C. § 274(a)(3) (2006), which disallows deductions for country club dues. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13210, 107 Stat. 312, 469.

94 Heineman v. Comm'r, 82 T.C. 538 (1984).

Inc.—a Chicago railroad conglomerate—to deduct maintenance for and depreciate the cost of an office dwelling about 100 yards from his vacation home situated on the shores of Lake Michigan in Sister Bay, Wisconsin.[95] The office, which cost about $250,000, consisted of "a single room suspended from the side of the limestone cliff by a cantilevered steel frame anchored in the cliff wall."[96] Each summer, Heineman and his wife would sail on the lake for six weeks, and then, for the month of August, retire to their home in Sister Bay.[97] Heineman would review long-range business plans for several hours a day in the cliffside office.[98] At trial, he admitted that he spent August in Sister Bay in order to escape the hot summer weather in Chicago, but he also argued that he was more effective in his work because he was insulated from the daily distractions of his Chicago office.[99] The government argued that the construction costs for the Sister Bay office were not necessary, because the reasons for Heineman's working there in August were primarily personal and he easily could have prevented daily distractions at his Chicago office by ordering his staff not to permit interruptions when he was at work in his office.[100]

Heineman's reputation as a "Master of the Universe" preceded him.[101] In a fawning profile, *Time* had breathlessly described him as the "bold, brainy lawyer" who was singlehandedly reviving the long-haul passenger rail system by adapting it to short-haul suburban commuters.[102] Heineman embodied everything Justice Cardozo admired

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95 *Id.* at 545–46. To be precise, Heineman was a worker, and not a business owner, as this Article defines those terms; he was an employee of Northwest Industries, Inc. However, upper managerial workers are often conceptualized as agents of business owners with the primary responsibility to maximize returns on business owners' capital investments. *See infra* notes 139–46 and accompanying text. As demonstrated by the *Heineman* case itself, the courts view expenditures incurred by upper management as equivalent to expenditures incurred by business owners.

96 *Heineman*, 82 T.C. at 540.

97 *Id.*

98 *Id.*

99 *Id.*

100 His office in Chicago essentially was structured as an inner sanctum. It "consisted of a suite which contained a board of directors' office, a directors' lounge, a conference room, his own office, and separate offices for his administrative assistant, his secretary, and a special assistant." *Id.*

101 Novelist Tom Wolfe used this term in this context in *Bonfire of the Vanities* to describe the privileged, ambitious, and arrogant young men who worked as Wall Street investment bankers during the 1980s. *See* TOM WOLFE, THE BONFIRE OF THE VANITIES 10–12 (1987).

102 *Commuter's Friend: Ben Heineman*, TIME, Dec. 15, 1958, at 70. In the clipped newsroom cadences of the era, the profile glowingly describes Heineman:

> [Heineman] learned that what was needed was radical modernization. He chopped the North Western's managerial deadwood, hired bright young railroad pros. He brought in modern bookkeeping machines and mechanized track-laying equip-

in the noble businessman and more. The Tax Court could barely contain its admiration of Heineman as it deferred to his judgment about the necessity of his adjourning to Sister Bay for the summer:

> In his testimony, the petitioner described the work that he carried on in the Sister Bay office in August and explained why he could not secure the necessary isolation in his Chicago office. He stated that he could perform the work of reviewing the long-term plans more effectively in the Sister Bay office. We found his testimony to be persuasive. We accept his claim that if he were in Chicago, there would be some demands on his time that could not be resisted. Despite the offices that Northwest provided him in Chicago and the staff that assisted him, there would be requests by people in and out of the corporation to see him, and it would be impracticable to say "no" to some of those requests. It is his judgment that his review of the long-term plans and the contemplation and thinking that such work requires could be performed more effectively at his office in Sister Bay; his reasons for reaching that judgment were convincing, and we will not substitute our judgment for his.[103]

Of course, some taxpayers push beyond even the expansive boundaries of "necessary" established by *Welch*. In one amusing example, the Tax Court in *Henry v. Commissioner*[104] disallowed deductions related to the taxpayer's ownership of a yacht.[105] The principal argument for deductibility put forth by the taxpayer, a CPA, was that he flew a red, white, and blue flag bearing the numerals "1040" "[a]s a conversation piece."[106] Notwithstanding decisions like *Henry*, it is in-

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> ment, completely dieselized the line. He also became the foremost critic of union featherbedding in rails, trimmed his own payrolls from 26,300 to 18,500—but was a shrewd enough labor negotiator to avoid a full-scale strike.

Id.

103 *Heineman*, 82 T.C. at 543–44. *Heineman* predated the enactment of I.R.C. § 280A, which limits home office deductions. However, I.R.C. § 280A likely would not have changed the outcome in *Heineman* because it is inapplicable to a separate structure not attached to the taxpayer's residence. I.R.C. § 280A(c)(1)(C) (2006). Where the taxpayer is an employee, he must also show that the use of the separate structure is for the "convenience of his employer." *Id.* § 280A(c)(1). Given the judicial gloss put on that requirement in the I.R.C. § 119 context, Ben Heineman would have had little trouble satisfying it. *See infra* Part III.C.2.

104 Henry v. Comm'r, 36 T.C. 879 (1961).

105 *Id.* at 886.

106 *Id.* at 880. The taxpayer stated that the flag "provoked inquiries" to which the taxpayer would respond by indicating that he was both a CPA and an attorney.

disputable that courts rarely invoke the "necessary" requirement as their basis for disallowing a business owner's deduction.[107]

B. *INDOPCO and Unrecoverable Costs*

As mentioned above, the Supreme Court sometimes has disallowed a business owner's deduction under I.R.C. § 162 on the grounds that the expenditure is capital.[108] Indeed, this was arguably why the Court denied Thomas Welch a deduction for the amounts he paid to discharge the bad debts of his former employer. The ensuing Supreme Court jurisprudence relating to capitalization does not revisit the issue Cardozo agonized over in *Welch*—that is, whether "ordinary" under I.R.C. § 162 means something more than "not chargeable to capital."[109] Instead, so long as an expenditure is not too personal in nature,[110] the Court seems implicitly to have rejected the possibility that a business owner's expenditure might not be recoverable—that is, that the expenditure is neither deductible nor chargeable to capital. The Court's decision in *INDOPCO, Inc. v. Commissioner*, in which the record showed that the expenditures bore only a tenuous relation to the production of income, illustrates the strength of the presumption that all business expenditures are recoverable.[111]

In *INDOPCO*, the National Starch Corporation paid investment banking, legal, accounting, and other miscellaneous fees in connection with a merger in which Unilever acquired all the stock of National Starch.[112] National Starch claimed the fees as deductions under I.R.C. § 162.[113] The government argued that the fees were nondeductible capital expenditures, and the Court agreed.[114] Much of the Court's analysis focused on whether its prior decision in *Commissioner v. Lincoln Savings & Loan Ass'n*[115] required a "separate and distinct asset"

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107 An informal sampling by Joel Newman indicates that of the thousands of cases citing *Welch* in recent years, ninety percent do so solely for the proposition that an Internal Revenue Service ("IRS") ruling is presumed to be correct, and the taxpayer has the burden to prove otherwise. *See* Newman, *supra* note 43, at 219 & n.99.

108 *See supra* note 88 and accompanying text.

109 *See generally supra* text accompanying notes 48–78.

110 For examples of such cases, see *supra* note 82. For discussion of the tax system's treatment of specific expenditures viewed to have a substantial consumption component, such as education, child care, and meals, see *infra* Part III.

111 *See* INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 88 (1992).

112 *Id.* at 81–82.

113 *Id.* at 82.

114 *See id.* at 90. The government also argued that the expenses were a constructive dividend. *See infra* note 127 and accompanying text.

115 Comm'r v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345 (1971).

to be created or enhanced in order for an expenditure to be classified as capital.[116] (National Starch was the target of the acquisition, and thus did not itself acquire any asset.[117]) The Court held that no separate and distinct asset was required.[118] It further found that the acquisition by Unilever provided National Starch significant long-term benefits contrary to National Starch's argument that the benefit was "entirely speculative" or "merely incidental."[119] The Court concluded, therefore, that the expenditures facilitating the acquisition were capital.[120]

On its face, the *INDOPCO* decision says nothing about whether National Starch's expenses would have been deductible if the Court had found that they were not capital expenditures. The Tax Court, in finding the expenses to be capital, explicitly stated that it did not need to decide whether the expenses would otherwise be deductible, which suggests the possibility that if the expenses were *not* capital, they might also fail the test for deductibility.[121] From this, one might infer that the Supreme Court, having found that the expenditures were capital, likewise did not reach the question of whether the expenses were deductible, and likewise would not rule out the possibility that an expenditure might be *neither* capital *nor* deductible. However, the Third Circuit, in its decision affirming the Tax Court, suggested otherwise. Citing the Supreme Court's 1966 decision in *Commissioner v. Tellier*,[122] the Third Circuit observed that the Court used "ordinary" to mean "not capital, and therefore deductible": "The Court has stated, in somewhat circular fashion, that the principal function of the term 'ordinary' is to distinguish between expenses currently deductible and capital expenditures which, if deductible at all, must be amortized

116 *See INDOPCO*, 503 U.S. at 85–87.

117 *Id.* at 80.

118 *Id.* at 89–90. "In short," the Court noted, "the creation of a separate and distinct asset well may be a sufficient, but not a necessary, condition to classification as a capital expenditure." *Id.* at 87.

119 *Id.* at 88 (internal quotation marks omitted). The Court quoted documents written by or provided to National Starch that indicated that the benefits of the merger consisted of "'synergy'" with Unilever and access to Unilever's "'enormous resources, especially in the area of basic technology.'" *Id.*

120 *See id.* at 88–90. *INDOPCO* raised taxpayer concerns about the possibility of a greatly expanded capitalization requirement, but these have proved to be unfounded. Subsequent case law and regulatory guidance imposes a considerably diminished capitalization requirement. *See* Joseph Bankman, *The Story of* INDOPCO*: What Went Wrong in the Capitalization v. Deduction Debate?*, *in* TAX STORIES, *supra* note 40, at 225, 238–44.

121 *See* Nat'l Starch & Chem. Corp. v. Comm'r, 93 T.C. 67, 73 (1989).

122 Comm'r v. Tellier, 383 U.S. 687 (1966).

over the useful life of the asset."[123] The Third Circuit's language suggests that "ordinary" means nothing more than "not capital," and if an expenditure otherwise met the requirements of I.R.C. § 162, it would be deductible.

Thus, the Tax Court and Third Circuit decisions in *INDOPCO* present two possible views with respect to capitalization and deductibility: (1) expenditures that are not capital might also fail to be ordinary and, therefore, might be nondeductible (suggested by the Tax Court); or (2) expenditures that are not capital are therefore ordinary and are thus deductible (suggested by the Third Circuit). The *INDOPCO* taxpayer, National Starch, appeared to gamble that the Supreme Court would adopt the Third Circuit's view. It argued that the expenses were not capital because the acquisition by Unilever produced an "entirely speculative" or "merely incidental" future benefit.[124] At the same time, National Starch made no separate arguments establishing any current benefits flowing from the expenditures.[125] (Indeed, the Tax Court found that there was "no evidence of an[y] immediate benefit" to National Starch from its affiliation with Unilever.[126]) National Starch's argument was risky: the Court might have agreed that the expenses were not capital, but then have gone on to disallow the deduction because the expenses provided no present benefit to National Starch's business.[127] If the acquisition by Unilever provided only speculative or incidental future benefits and even less in the way of present benefits to National Starch's business, it would seem quite plausible that the acquisition expenditures should not be recoverable either immediately under I.R.C. § 162 or in future years as capital expenditures.[128]

Of course, the Supreme Court held that National Starch's expenses were capital and, therefore, did not reach the question of

123 Nat'l Starch & Chem. Corp. v. Comm'r, 918 F.2d 426, 428–29 (1990).

124 *INDOPCO*, 503 U.S. at 88 (internal quotation marks omitted).

125 *See id.* at 88–90.

126 *Nat'l Starch & Chem. Corp.*, 93 T.C. at 76.

127 *See* Calvin H. Johnson, *The Expenditures Incurred by the Target Corporation in an Acquisitive Reorganization Are Dividends to the Shareholders: (Pssst, Don't Tell the Supreme Court)*, 53 TAX NOTES 463, 469 (1991).

128 *See id.* at 469; *see also* Trust Under the Will of Bingham v. Comm'r, 325 U.S. 365, 374 (1945) (holding that expenses must be "directly connected with or proximately result[ ] from the conduct of the business"); Kornhauser v. United States, 276 U.S. 145, 153 (1928) (characterizing as "sound" the Board of Tax Appeals rulings "that where a suit or action against a taxpayer is directly connected with, or . . . proximately resulting from, his business, the expense incurred is a business expense").

whether the expenses would otherwise have been deductible.[129] However, in the aftermath of *INDOPCO*, it is clear that the Third Circuit's view has prevailed. Virtually all of the activity around capitalization—administrative guidance, legislation, case law, scholarly writing—has assumed that the taxpayer's choice is between immediate cost recovery and delayed cost recovery.[130] Almost no one has considered seriously the third possibility, suggested by the Tax Court, of no recovery at all.[131] The *Welch* deference to business owners is evident in the presumption that almost all expenditures—even those that have little or no connection to increased profitability—are presumed to be recoverable.

C. *Expenditures That Do Not Benefit the Business Owner*

Another basis for a challenge to deductions claimed by a business owner arises when an expenditure provides no benefit to that business owner and, instead, represents a transfer of wealth to another individual taxpayer or entity. The courts have occasionally disallowed a deduction on these grounds, when, for instance, a corporate taxpayer's expenditure can be characterized as a constructive dividend to a shareholder.[132] For example, in *INDOPCO*, the government made the argument—not addressed by either the Supreme Court or the lower courts—that National Starch's expenditures primarily benefited its shareholders by facilitating the sale of their shares to Unilever and, therefore, should be treated as a constructive dividend from National

129 *INDOPCO*, 503 U.S. at 90.

130 *See* James Atkinson & Eric Lucas, *The 2011 'Repair Regulations': A Detailed Look*, 134 TAX NOTES 1269, 1271–72, 1288 (2012) (discussing Treasury Regulations that allow taxpayers to choose between capital or ordinary treatment for certain expenditures); Bankman, *supra* note 120, at 236, 246; Peter L. Faber, INDOPCO*: The Still Unsolved Riddle*, 47 TAX LAW. 607, 628, 633, 635 (1994) (citing Revenue Rulings and Tax Court applying *INDOPCO* and suggesting a different approach to the issue); John W. Lee, *Transaction Costs Relating to Acquisition or Enhancement of Intangible Property: A Populist, Political, but Practical Perspective*, 22 VA. TAX REV. 273, 308–09 (2002) (noting the IRS's post-*INDOPCO* auditing priorities for audits of large corporations); Ethan Yale, *When Are Capitalization Exceptions Justified?*, 57 TAX L. REV. 549, 597–98 (2004) (discussing post-*INDOPCO* regulations).

131 Two notable exceptions are Calvin H. Johnson, who has argued that the reorganization fees in *INDOPCO* ought not to be recoverable, and Denise D. J. Roy, who criticizes the disparate treatment of "business" and "personal" expenses under the current tax law and argues that the law should not presume that business expenses are recoverable. *See* Johnson, *supra* note 127, at 463–64; Roy, *supra* note 2, at 171, 173.

132 *See, e.g.*, Jack's Maint. Contractors, Inc. v. Comm'r, 703 F.2d 154, 156 (5th Cir. 1983) (holding that a corporation's payment of legal fees of its CEO and principal shareholder in a criminal prosecution for personal tax evasion was a constructive dividend to the CEO-shareholder and, therefore, not deductible).

Starch to its shareholders.[133] On this characterization, the various fees incurred by National Starch in connection with the merger would be neither deductible nor capital expenditures; they would be entirely unrecoverable.[134]

In fact, the tax law seldom inquires into whether a business owner's expenditures do not benefit the business owner, especially when the primary beneficiaries of a business's largesse are upper management. Business owners regularly provide their upper managerial class with costly furniture, artwork, luxurious travel accommodations, and meals, all the while recovering these expenditures as costs of carrying on their trades or businesses.[135] Some of the most patently personal of these expenditures—meals and entertainment, travel, and

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133 The Tax Court alluded to the constructive dividend argument in its opinion, but specifically stated that it did not need to reach it because it had found the expenditures to be capital in nature. *See* Nat'l Starch & Chem. Corp. v. Comm'r, 93 T.C. 67, 73, 78–79 (1989). Neither the Third Circuit nor the Supreme Court mentioned the constructive dividend argument. The issue did, however, arise in oral argument before the Court. *See* Transcript of Oral Argument at 17–18, *INDOPCO*, 503 U.S. 79 (No. 90-1278), 1991 WL 636242 at *42–43. Moreover, it is intriguing that the Court cited Calvin Johnson's article, *supra* note 127, in which he argues that target-corporation expenditures should be treated as a dividend. *See INDOPCO*, 503 U.S. at 84 n.4.

134 *See* Johnson, *supra* note 127, at 463–64 ("The parties before the court in *Indopco* are battling it out on a nonissue—whether the fees are an intangible asset or a current expense of the corporation. Both are right that the other side is wrong, and both are wrong that they themselves are right."). I.R.C. § 162(a)(1) addresses the issue of constructive dividends by disallowing deductions for compensation for services in excess of "reasonable" amounts. I.R.C. § 162(a)(1) (2006). Although Congress adopted broad statutory language, the regulations make clear that the primary target of this provision is a closely held corporation paying excessive compensation to an employee-shareholder. *See* Treas. Reg. § 1.162-7(b)(1) (2012) (explaining that "[a]n ostensible salary paid by a corporation may be a distribution of a dividend on stock"). For further discussion of this provision and its historically narrow application, see Joy Sabino Mullane, *Incidence and Accidents: Regulation of Executive Compensation Through the Tax Code*, 13 LEWIS & CLARK L. REV. 485, 506–09 (2009).

135 *See, e.g.*, Tomoeh Murakami Tse, *At Rescued Banks, Perks Keep Rolling*, WASH. POST, Oct. 20, 2009, at A12 (detailing some corporate executives' receipt of corporate jets, country club memberships, and financial help with personal tax liabilities and the tax implications of these perks); Chris Kirkham, *For-Profit College Chiefs Unwind at Lavish Tahoe Resort*, HUFFINGTON POST (Feb. 17, 2012, 4:44 PM), http://www.huffingtonpost.com/2012/02/17/for-profit-college-chiefs-lake-tahoe_n_1283331.html ("Five dozen executives [of for-profit colleges] . . . gathered at the Ritz-Carlton, paying nearly $400 a night. They enjoyed the ski slopes, a spa and cocktail lounges, putting their taxpayer-financed revenues to lavish effect."). One recently reported "common corporate tax trick" is to provide executives and board members with perquisites, such as private jet travel (for both personal and business use), chauffeured cars, home alarm systems, and even private residences, all under the guise of security. *See* Steven M. Davidoff, *For Some Corporate Chiefs, Private Security is a Tax Break*, N.Y. TIMES, Apr. 11, 2012, at B6 (contrasting the practice with "Justice Ginsburg [who] flies commercial").

luxury cars—are now subject to statutory limitations.[136] However, many other expenses continue to fly under the radar. It is unclear, for example, why a corporate executive must have a mahogany desk or a corporate jet to fly him to business meetings when a Steelcase desk and commercial air travel are available at a fraction of the cost.[137]

One argument in favor of the law allowing a deduction for these seemingly wasteful expenditures is that the perquisites are necessary in order to recruit and retain qualified managers.[138] On this rationale, the managerial perquisites would be treated as deductible compensation to the managers, but the managers would be required to include the benefits in income.[139] Alternatively, closer scrutiny of these types of expenditures might lead to the conclusion that such amounts are wealth transfers to managers and have little or nothing to do with the

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136 *See, e.g.*, I.R.C. § 274 (disallowing deductions for certain entertainment or amusement activities); *id.* § 280F (limiting depreciation for "luxury automobiles").

137 In the rare instance where the executive himself incurs the expense, it ought likewise to be disallowed. *Cf.* Noyce v. Comm'r, 97 T.C. 670, 682–85, 691 (1991) (allowing a corporate executive to deduct the cost of a private jet for business travel beyond the company's reimbursement, which was "to the extent of commercial coach rates", even though company's policy was to reimburse employees only for coach class commercial air travel); Heineman v. Comm'r, 82 T.C. 538, 545–46 (1984) (allowing a corporate executive to deduct maintenance costs and depreciation for a cliffside office adjacent to his vacation home). For further discussion of *Heineman*, see *supra* notes 94–103 and accompanying text.

138 *See* David A. Westbrook, *Notes Toward a Theory of the Executive Class*, 55 BUFF. L. REV. 1047, 1049–52, 1061 (2007) (arguing that disapproval over executive compensation "rests on a fundamental misapprehension of what 'executive compensation' is and how it works"). Another response would attempt to provide a business rationale for the expenditures—i.e., a luxurious office is necessary to impress clients or competitors or travel by private jet saves precious time. *See Noyce*, 97 T.C. at 670 (noting the taxpayer's argument that use of a private jet allowed him to attend more meetings on behalf of the company of which he was an executive). We argue in Part V that these types of expenses ought to be treated in parity with "mixed business/personal" expenses, such as commuting and clothing costs. Thus, if deductible at all, the deduction should be limited by a remoteness criterion and a cost constraint rule. *See infra* Part V.

139 One prominent example of this type of situation involved the former General Electric chief executive Jack Welch, who, on retirement, received country club and opera memberships, the use of a corporate jet, and a New York City apartment. *See* Geraldine Fabrikant, *G.E. Expenses for Ex-Chief Cited in Filing*, N.Y. TIMES, Sept. 6, 2002, at C1. When in-kind benefits of this sort are included in an executive's income, the common practice of business owners is to "gross up" the executive's salary to take into account the additional tax liability incurred by the executive; the corporation then deducts the gross up as additional compensation. *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 95–111 (2004) (detailing the methods available to structure executive retirement packages).

profitability of the business.[140] In accordance with this analysis, excessive compensation would not be deductible.[141]

This type of close examination of management perquisites is theoretically sound. In corporate law, there is a well-developed theory regarding the agency costs resulting from the separation of management from ownership, which focuses on managers' incentives and ability to divert corporate resources for their personal gain.[142] In practice, however, neither corporate law nor tax law has implemented successfully theoretical limits on managerial compensation. In corporate law, the business judgment rule almost always protects managers' decisions about how much to pay themselves—whether through perquisites or salary.[143] In the tax arena, the *Welch* deference to business owners operates much the same way as the business judgment rule. The Internal Revenue Service ("IRS") rarely succeeds when it challenges the deductibility of compensation,[144] and aside from the occasional political gesture in response to media reports of managerial egregious ex-

140 *See* Edward A. Zelinsky, *The Tax Policy Case for Denying Deductibility to Excessive Executive Compensation: Disguised Dividends, Reasonable Compensation, and the Protection of the Corporate Income Tax Base*, 58 TAX NOTES 1123, 1124 (1993) (arguing that "managers of publicly held corporations, given their *de facto* ability to set their own compensation levels, in effect constitute themselves an unofficial class of shareholders, paying themselves a disguised dividend . . . and thus diverting to themselves earnings otherwise payable to shareholders").

141 Aaron Zelinsky and Edward Zelinsky have proposed that deductions for excessive compensation should be denied on these grounds. *See* Aaron S.J. Zelinsky, Comment, *Taxing Unreasonable Compensation: § 162(a)(1) and Managerial Power*, 119 YALE L.J. 637, 638 (2009) (proposing that the IRS use I.R.C. § 162(a)(1) to render excessive executive compensation in publicly-held companies nondeductible); Zelinsky, *supra* note 140, at 1123–24 (1993) (arguing that the elimination of a deduction for excessive compensation "will, in the aggregate, enhance the accuracy with which the [C]ode measures the corporate income tax base"); *cf.* Linda Sugin, *Encouraging Corporate Charity*, 26 VA. TAX REV. 125, 127–29 (2006) (proposing that corporate philanthropy be moved from I.R.C. § 170 to I.R.C. § 162, thus permitting a distinction between valid business expenditures and managerial waste).

142 *See* BEBCHUK & FRIED, *supra* note 139, at 15–17 (2004) (giving an overview of the problem of agency costs in the context of publicly traded companies); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (outlining the agency costs inherent in any principal-agent relationship).

143 *See* Lawrence A. Cunningham, *A New Legal Theory to Test Executive Pay: Contractual Unconscionability*, 96 IOWA L. REV. 1177, 1211–13 (2011) (discussing the difficulty facing shareholders attempting to make a successful claim of corporate waste); Steven C. Caywood, Note, *Wasting the Corporate Waste Doctrine: How the Doctrine Can Provide a Viable Solution in Controlling Excessive Executive Compensation*, 109 MICH. L. REV. 111, 115 (2010) (calling the "standard adopted for the corporate waste doctrine . . . impossibly high").

144 *See, e.g.*, Exacto Spring Corp. v. Comm'r, 196 F.3d 833, 839 (7th Cir. 1999) (reversing a Tax Court decision upholding an IRS determination that an executive was over-compensated, because "the investors in [the executive's] company are obtaining a far higher return than they had any reason to expect," which made the executive's salary "presumptively reasonable"); *see*

cess,[145] the courts, Congress, and the IRS have not had much interest or success in their attempts to limit business deductions on this basis.[146]

In sum, *Welch*'s deference to business owners has taken deep root in the tax law. Analysis of the Supreme Court's jurisprudence following *Welch* revealed how the Court has essentially abolished the statutory requirement that an expense be "necessary" in order to be deductible.[147] This Part also demonstrated that when the tax law determines that an expenditure should not be capitalized, it presumes that the expenditure meets the statutory requirement of "ordinary" and is therefore recoverable immediately, even when the connection between the expenditure and income production is speculative or incidental.[148] Finally, this Part challenged current law's unwillingness, in the name of *Welch*, to distinguish managerial compensation from diversions of corporate resources that solely benefit corporate executives.[149]

III. Skepticism toward Workers

As discussed above, the tax system accords great deference to business owners' judgments about whether expenditures are necessary to economic productivity. This Part explores the counterpoint to this deference—the tax law's deep skepticism that any expenditures incurred by workers are related to their economic productivity. The tax law classifies most outlays for education, health care, and child care as consumption, even though those costs contribute to productivity as much as, if not more than, a home office suspended over Lake Michigan or a merger creating speculative and incidental future benefits in the way of "synergy."[150] Other worker expenses, such as work-related

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also Mullane, *supra* note 134, at 506–09 (noting that I.R.C. § 162(a)(1) has "rarely been used" to challenge excessive compensation and discussing the application of § 162(a)(1)).

145 Notably, I.R.C. § 162(m)—the "congressional response" to "[i]ntense media coverage of contemporary executive pay practices"—imposes a one million dollar cap on the deductibility of compensation paid to any single individual. Mullane, *supra* note 134, at 520–21; *see also* I.R.C. § 162(m) (2006). However, the limitation is easily circumvented because the statute explicitly excludes "performance-based compensation" from the dollar amount of the cap. Mullane, *supra* note 134, at 521.

146 *See* Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 Wash. & Lee L. Rev. 877, 880–81 (2007) (concluding that § 162(m) has been "likely ineffective" and urging Congress to consider its efficacy before it responds to recent outcries to control executive compensation).

147 *See supra* Part II.A.

148 *See supra* Part II.B.

149 *See supra* Part II.C.

150 *See generally supra* Part II.A–B (giving examples of these expenditures).

travel or meals, admittedly can have a substantial consumption component. With respect to those expenditures, what is striking is the disparate tax treatment they are given depending on whether they are incurred by an employer on behalf of an employee or by the employee herself. When incurred by an employee, the tax system imposes a multitude of limitations on the ability of that employee to recover these costs, reflecting the dominant characterization of employees as consumers rather than producers. At the same time, when incurred by employers on behalf of their employees, the very same outlays are presumed to be deductible, reflecting the deference generally enjoyed by business owners.

A. *Education*

Education unquestionably contributes to workers' productivity.[151] Economists and policymakers perennially bemoan the future of the under-educated U.S. workforce and call for more government investment in education.[152] These calls have become even more urgent as the U.S. economy has shifted from manufacturing to service and technology.[153] A common metric demonstrating the income producing value of education is the link between higher educational levels and higher incomes. For example, in 2011, those with a college degree earned about sixty-six percent more than those with a high school degree; those with a professional or doctoral degree earned nearly two and a half times the amount earned by high school degree holders.[154] The correlation between levels of education and income is strong and persistent.[155]

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151 *See infra* note 254 and accompanying text.

152 *See infra* notes 285–87 and accompanying text.

153 *See, e.g.*, PETER F. DRUCKER, THE AGE OF DISCONTINUITY 266–67 (1969); JOSEPH E. STIGLITZ, PUBLIC POLICY FOR A KNOWLEDGE ECONOMY 21 (1999), http://akgul.bilkent.edu.tr/BT-BE/knowledge-economy.pdf; David Stern, *Human Resource Development in the Knowledge-Based Economy: Roles of Firms, Schools and Governments*, *in* ORG. FOR ECON. CO-OPERATION & DEV., EMPLOYMENT AND GROWTH IN THE KNOWLEDGE-BASED ECONOMY 189, 189 (1996); TASK FORCE ON THE FUTURE OF AM. INNOVATION, THE KNOWLEDGE ECONOMY: IS THE UNITED STATES LOSING ITS COMPETITIVE EDGE? 1 (2005), *available at* cte.ed.gov/nationalinitiatives/gandctools_viewfile.cfm?d=600189.

154 *Education Pays*, BUREAU LABOR STAT., www.bls.gov/emp/ep_chart_001.htm (last updated Mar. 23, 2012).

155 *See* SANDY BAUM ET AL., COLL. BD. ADVOCACY & POLICY CTR., EDUCATION PAYS 2010, at 11–16 (2010), http://advocacy.collegeboard.org/sites/default/files/Education_Pays_2010.pdf (extensively detailing the relationship between income level and level of education); Stuart Lazar, *Schooling Congress: The Current Landscape of the Tax Treatment of Higher Education Expenses and a Framework for Reform*, 2010 MICH. ST. L. REV. 1047, 1049–50 (demonstrating

Despite the clear link between education and worker productivity, from the earliest days of the income tax, the courts and the IRS have treated educational expenses as personal and nondeductible.[156] In the aftermath of *Welch*, educational expenses could have been accorded the same expansive treatment given to other business expenditures. After all, Justice Cardozo, in dicta (and as part of his list of "bizarre analogies"), did analogize education to a capital asset: education, he noted, was "akin" to an investment in the taxpayer's trade or business.[157] Instead, however, the courts and the IRS have interpreted Cardozo's dicta as precedent for the disallowance of educational expenses, reasoning that they are "an inseparable aggregate of personal and capital expenditures."[158]

The post-*Welch* interpretation of "necessary" in the context of educational expenses exemplifies the highly restrictive standard applied to workers as compared to business owners. Recall that, as applied to business owners, the "necessary" requirement is almost always presumed satisfied under a standard of extreme deference to the business owner; any expense that is "appropriate and helpful" will pass muster.[159] By contrast, in order for a worker's educational expense to meet the "necessary" standard, the education must be *required*.[160] Thus, for example, in *Hill v. Commissioner*,[161] the Fourth Circuit held that a public school teacher could deduct the costs of a summer school course, because the course allowed her to meet the state law's requirements for renewal of her certificate.[162] However, in

the income differential for individuals with different levels of education from 2005 through 2008).

156 *See, e.g.*, I.T. 1520, I-2 C.B. 145 (1922), *revoked by* I.T. 2688, XII-1 C.B. 251 (1933) (holding that research expenses by a college professor were personal, nondeductible expenses); *In re* Driscoll, 4 B.T.A. 1008, 1009 (1926) (holding that voice lessons in preparation for a professional singing career were personal). For detailed accounts of the history of the tax treatment of educational expenses, see Jay Katz, *The Deductibility of Education Costs: Why Does Congress Allow the IRS to Take Your Education So Personally?*, 17 Va. Tax Rev. 1, 16–37 (1997); Lazar, *supra* note 155, at 1057–68; James L. Musselman, *Federal Income Tax Deductibility of Higher Education Expenses: The Good, the Bad, and the Ugly*, 35 CAP. U. L. REV. 923, 927–34 (2007).

157 Welch v. Helvering, 290 U.S. 111, 115–16 (1933).

158 Treas. Reg. § 1.162-5(b)(1) (2012); *see* Lazar, *supra* note 155, at 1059, 1071–72 (noting that Treas. Reg. § 1.162-5(b)(1) "provides an implicit approval to the idea espoused by the Supreme Court in *Welch* that an educational expense can be a business expense, while limiting the scope of such holding by denying capitalization of these business expenses because they are also personal expenses").

159 *See supra* notes 82–107 and accompanying text.

160 *See* Lazar, *supra* note 155, at 1061–64 (describing the evolution of this rule).

161 Hill v. Comm'r, 181 F.2d 906 (4th Cir. 1950).

162 *Id.* at 911. This was by no means an easy win for the taxpayer. The Tax Court had disallowed the deduction, reasoning that the taxpayer could have satisfied the state law require-

Cardozo v. Commissioner,[163] the Tax Court held that a professor's expenses for study and research in Europe were not "necessary," because the taxpayer's employer—a university—had neither authorized the trip nor required it as a condition of his employment.[164] Regardless of whether *Cardozo* reached the correct outcome (as it probably did), the interpretation of "necessary" to mean "required" stands in stark distinction to the *Welch* "appropriate and helpful" interpretation applied to expenditures incurred by business owners.[165]

Current law generally treats educational costs as personal expenses and allows no recovery through deductions or capitalization. A worker is allowed to deduct higher educational expenses only under limited circumstances: (1) the education must maintain or improve her skills in her trade or business or (2) it must be expressly required by her employer or by law.[166] In any case, the education acquired cannot be necessary to meet the minimum qualifications for the worker's trade or business and it cannot qualify the worker for a new trade or business.[167] In addition to this limited I.R.C. § 162 deduction for the costs of higher education, the tax law provides a panoply of tax preferences for education, including the I.R.C. § 25A Hope and Lifetime Learning Credit,[168] the I.R.C. § 221 deduction for educational loan interest,[169] the I.R.C. § 127 exclusion for employer-provided educational assistance,[170] the I.R.C. § 529 exclusion for qualified tuition programs,[171] and the I.R.C. § 530 exclusion for "Coverdell" educational savings accounts.[172] A distinguishing feature of all of these provisions is their characterization as tax expenditures—that is, preferences that purposely reduce tax liability below "normal" levels in order to advance social policy goals—rather than as legitimate costs incurred to

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ment through the less costly alternative of her taking an exam on selected books. *See* Hill v. Comm'r, 13 T.C. 291, 294 (1949).

163 Cardozo v. Comm'r, 17 T.C. 3 (1951).

164 *Id.* at 6.

165 *See* Welch v. Helvering, 290 U.S. 111, 113 (1933).

166 Treas. Reg. § 1.162-5(a) (2012).

167 *Id.* § 1.162-5(b)(2)–(3).

168 I.R.C. § 25A (2006).

169 *Id.* § 221. This deduction, however, is capped at $2,500 per year and changes based on the taxpayer's income. *Id.* § 221(b).

170 *Id.* § 127. This exclusion too has a cap, set at $5,200. *Id.* § 127(a)(2).

171 *Id.* § 529.

172 *Id.* § 530. For a complete list and thorough discussion of educational tax preferences, see Lazar, *supra* note 155, at 1074–107.

produce income under the Schanz-Haig-Simons definition of income.[173]

B. *Health Care, Child Care, and Other "Mixed" Business/Personal Expenditures*

Two other major categories of expenditures that are integral to workers' productivity are health care and child care costs. As with education, both of these categories have personal and social dimensions that do not fit comfortably within the dehumanized corporate business model of economic productivity. Businesses, after all, do not have families and do not require medical care. And, as with education, the tax system has been reluctant to recognize these outlays as necessary for the production of workers' income.

The tax system's treatment of child care closely parallels its treatment of education. Work-related child care expenses were treated as personal expenditures in the early years of the income tax.[174] In 1954, Congress enacted a limited deduction for child care costs.[175] It was limited in amount and designed to be available only to parents who were required to work, such as widows and widowers.[176] In addition, it was a so-called "below-the-line" deduction, so only those who itemized deductions could make use of it, thereby automatically disqualify-

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173 *See* STAFF OF J. COMM. ON TAXATION, 112TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2011-2015, at 3–4, 10, 12–14 (Comm. Print 2012) (defining tax expenditures and classifying a number of educational provisions in the tax code as such). Many scholars have criticized the current law's treatment of educational expenses and have argued that expenses ought to be at least either partially deductible or capitalized and recoverable in future years in order to measure income from labor accurately. *See, e.g.*, David S. Davenport, *Education and Human Capital: Pursuing an Ideal Income Tax and a Sensible Tax Policy*, 42 CASE W. RES. L. REV. 793, 796, 802–04 (1992); Katz, *supra* note 156, at 3–4; Lazar, *supra* note 155, at 1114, 1127; Hume, *supra* note 2, at 887–89. *But see* Joseph M. Dodge, *Taxing Human Capital Acquisition Costs—Or Why Costs of Higher Education Should Not Be Deducted or Amortized*, 54 OHIO ST. L.J. 927, 929 (1993) (critiquing proposals to make educational costs deductible "from the point of view of the 'tax policy' norms of neutrality, (horizontal) equity, and the Haig-Simons definition of 'income'" (footnotes omitted)). For further discussion of tax expenditure analysis, see *infra* note 299 and accompanying text.

174 *See, e.g.*, Smith v. Comm'r, 40 B.T.A. 1038, 1039 (1939), *aff'd per curiam*, 113 F.2d 114 (2d Cir. 1940) ("We are not prepared to say that the care of children, like similar aspects of family and household life, is other than a personal concern. The wife's services as custodian of the home and protector of its children are ordinarily rendered without monetary compensation. There results no taxable income from the performance of this service and the correlative expenditure is personal and not susceptible of deduction.").

175 I.R.C. § 214 (1954).

176 The exclusion also applied to, inter alia, "a mother whose husband is incapable of self-support because mentally or physically defective." *Id.*

ing the vast majority of taxpayers who used the standard deduction.[177] The structure of the deduction and its legislative history reflect Congress's skepticism that child care is a legitimate business expense and embrace a restrictive interpretation of "necessary" far removed from the "helpful and appropriate" *Welch* interpretation.[178] As Congress expanded the deduction over time, and eventually replaced it in 1976 with a child care credit,[179] it continued to express ambivalence about the law's treatment of child care expenses as legitimate costs incurred to produce income.[180] Under current law, primarily two provisions take account of child care costs: the I.R.C. § 21[181] child care credit and the I.R.C. § 129[182] exclusion for employer provided child care. Like the provisions for education, these are treated as tax expenditures, rather than as trade or business expenses.[183]

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177 *See id.*

178 The original House bill limited the child care deduction only to widows, widowers, "divorced person[s], or a working mother whose husband is incapacitated"; the Senate expanded the provision to cover working women. H.R. REP. NO. 83-1337, at 30 (1954); S. REP. NO. 83-1622, at 220 (1954). Notably, the House Report compared a widower's child care expenses with "an employee's business expense." H.R. REP. NO. 83-1337, at 30. The Minority Views appended to the House Report characterized the $600 annual deduction authorized by the 1954 Code as "almost too small to be taken seriously." *Id.* at B11 (Minority Views) ("Those who imagine that any mother can hire adequate child care help for $11.54 a week have simply lost touch with realities. This $600 limitation greatly restricts the tax relief accorded.").

179 *See* I.R.C. § 21 (2006).

180 *See* Deborah Dinner, *The Universal Childcare Debate: Rights Mobilization, Social Policy, and the Dynamics of Feminist Activism, 1966–1974*, 28 LAW & HIST. REV. 577, 618 (2010) (explaining that Congress classifies child care costs as a personal expense rather than as a business expense); Nancy C. Staudt, *Taxing Housework*, 84 GEO. L.J. 1571, 1602 (1996) (stating that "[t]ax scholars . . . point out that Congress has limited the childcare deduction provisions, unlike other business expense provisions found in the Code").

181 I.R.C. § 21.

182 *Id.* § 129.

183 *See* STAFF OF J. COMM. ON TAXATION, 112TH CONG., *supra* note 173, at 11 (listing the child care credit and exclusion for employer-provided child care as tax expenditures).

Many scholars have criticized the tax law's treatment of child care expenses and posited that they ought to be at least partially deductible under a Schanz-Haig-Simons definition of income. *See, e.g.*, Grace Blumberg, *Sexism in the Code: A Comparative Study of Income Taxation of Working Wives and Mothers*, 21 BUFF. L. REV. 49, 64 (1971) ("A working mother's provision for child care is a nondiscretionary expense directly related to the fact of her employment."); Mary L. Heen, *Welfare Reform, Child Care Costs, and Taxes: Delivering Increased Work-Related Child Care Benefits to Low-Income Families*, 13 YALE L. & POL'Y REV. 173, 216 (1995) (proposing an expanded child care tax credit, but arguing that "a better solution would be to increase funding for work-related child care block grant programs, or to combine the two efforts"); Allan J. Samansky, *Child Care Expenses and the Income Tax*, 50 FLA. L. REV. 245, 279–80 (1998) (making the case to deduct "at least a portion of child-care expenses" based on a comparison of two hypothetical families' child care costs); Lawrence Zelenak, *Children and the Income Tax*, 49 TAX L. REV. 349, 409–16 (1994) (discussing a number of issues related to child care allowances). *But see* Tsilly Dagan, *Ordinary People, Necessary Choices: A Comparative Study of Childcare Ex-*

While the tax system has been reluctant to acknowledge the trade or business aspects of education and child care, it has been even more disinclined to see the connections between health care and a worker's productivity. Medical expenses—without any regard for their connection to a taxpayer's trade or business—have been deductible since 1942.[184] The deduction, authorized by I.R.C. § 213,[185] is characterized as a "personal deduction," meaning that medical expenses are classified as an exception to the general tax principle that consumption should not be deductible to determine taxable income.[186] The deduction for medical expenses has always been limited by a significant "floor" tied to adjusted gross income ("AGI")—that is, only those medical expenses in excess of a percentage (under current law, 7.5%) of AGI, are deductible.[187] In addition, it is a below-the-line deduction, so only those taxpayers who itemize their deductions can deduct any of their medical expenses.[188] Whether a medical expense might alternatively be deductible as a trade or business expense has seldom been explored.[189]

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penses, 11 THEORETICAL INQUIRIES L. 589, 620–29 (2010) (arguing that the Schanz-Haig-Simons definition is incapable of adequately reflecting outlays, such as child care, and advocating for the adoption of additional norms into the definition of income).

184 Revenue Act of 1942, Pub. L. No. 77-753, § 127, 56 Stat. 798, 825.

185 I.R.C. § 213.

186 STAFF OF J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 50 (Comm. Print 1987) (stating that "medical expenses essentially are personal expenses and thus, like food, clothing, and other expenditures of living and other consumption expenditures, generally should not be deductible in measuring taxable income").

187 *See id.* at 50–51 (explaining the congressional rationale for the 7.5% floor). At one time, the floor amount was as low as 3% of AGI. Congress then increased it to 5% before Congress settled in 1986 on its current amount of 7.5%, where it has remained. *See* Janene R. Finley & Amanda M. Grossman, *Equity in Reforming the Tax Treatment of Health Insurance Premiums*, 34 SETON HALL LEGIS. J. 1, 6 n.29 (2009). In addition to the floor, until 1965, the tax law also imposed a ceiling. *See* Social Security Amendments of 1965, Pub. L. No. 89-97, § 106(a)(2), 79 Stat. 286, 336 (capping the deduction at $150).

188 *See* STAFF OF J. COMM. ON TAXATION, 99TH CONG., *supra* note 186, at 51.

189 For instance, when blind taxpayers engage the services of readers solely for work purposes, the IRS has held that the payments to the readers are deductible under I.R.C. § 162 and not under I.R.C. § 213. *See* Rev. Rul. 75-316, 1975-2 C.B. 54, 55 (allowing a deduction under I.R.C. § 162 where "the readers' services are required and used solely in the conduct of the work of the blind individuals"); *see also* Rev. Rul. 75-317, 1975-2 C.B. 57, 58 (allowing a taxpayer with a disability to deduct costs under I.R.C. § 162 for a companion on business trips if, inter alia, that companion is not otherwise necessary to assist the taxpayer more than incidentally in the conduct of the taxpayer's personal activities).

Gwen Thayer Handelman is one the few scholars to reconceptualize health care expenditures as investments in workers' productivity rather than as consumption. *See* Handelman, *supra* note 2, at 135–36; *see also* Morgan Holcomb & Mary Patricia Byrn, *When Your Body Is Your Business*, 85 WASH. L. REV. 647, 675–85 (2010) (arguing that surrogate parents' expenses ought to be deductible as trade or business expenses rather than medical expenses); Lawrence

In addition to I.R.C. § 213, there are other tax provisions related to health care. The law excludes from income employer-provided health insurance.[190] It also excludes from income medical expenses paid from Flexible Spending Accounts[191] and Health Reimbursement Accounts.[192] In addition, I.R.C. § 106 provides for tax deferred treatment of amounts invested in Medical Savings Accounts.[193] As is true for tax provisions on education and child care, all of these health care provisions are treated as tax expenditures.[194]

Workers incur a variety of other expenditures related to their work, such as outlays for commuting and clothing. These are often described as "mixed personal and business" expenses, which reflects the reality that they have an element of consumption but are also connected to the worker's trade or business.[195] Yet the tax law generally treats these outlays as purely personal. Commuting costs, for example, have long been held to be nondeductible on the grounds that they reflect taxpayers' personal choices as to how far to live from their workplaces.[196] Similarly, with rare exceptions, clothing is considered a

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Zelenak, *The Reification of Metaphor: Income Taxes, Consumption Taxes and Human Capital*, 51 TAX L. REV. 1, 28–34 (1995) (making an ad absurdum argument that many personal expenses should be allowable as trade or business deductions if humans are viewed as "income producing machines"). Much of the other scholarly work has focused on whether medical expenses in general are consumption or whether they ought to be excluded from the income tax base as some form of nonconsumption. *See* Jeffrey H. Kahn, *Personal Deductions—A Tax "Ideal" or Just Another "Deal"?*, 2002 L. REV. MICH. ST. U. DETROIT C.L. 1, 25–35 (describing this debate).

190 I.R.C. § 106.

191 *Id.* § 125.

192 *Id.* §§ 105–106.

193 *Id.* § 106(b).

194 *See* STAFF OF J. COMM. ON TAXATION, 112TH CONG., *supra* note 173, at 42 (listing the medical expense deduction, employer-paid health insurance, health savings accounts, and other related items as tax expenditures); Adam Chodorow, *Charitable FSAs: A Proposal to Combine Healthcare and Charitable Giving Tax Provisions*, 2011 BYU L. REV. 1041, 1044 (2011) (stating that "most agree that provisions in the Code related to healthcare spending are subsidies").

195 Thomas D. Griffith, *Efficient Taxation of Mixed Personal and Business Expenses*, 41 UCLA L. REV. 1769, 1770 (1994). In measuring poverty, the National Academy of Sciences recommended that work-related expenses, including child care, commuting costs, and "miscellaneous expenses," be treated as nondiscretionary expenses and subtracted from a family's resources. *See* MEASURING POVERTY 9–10 (Constance F. Citro & Robert T. Michael eds., 1995). In 2011, an interagency task force, including the U.S. Census Bureau and the Bureau of Labor Statistics, adopted this recommendation. *See* KATHLEEN SHORT, U.S. CENSUS BUREAU, THE RESEARCH SUPPLEMENTAL POVERTY MEASURE: 2010, at 4–5, 21–22 (2011), http://www.census.gov/hhes/povmeas/methodology/supplemental/research/Short_ResearchSPM2010.pdf (noting that "[g]oing to work and earning a wage often entails incurring expenses, such as travel to work and purchase of uniforms and tools").

196 *See* Comm'r v. Flowers, 326 U.S. 465, 473–74 (1946) (withholding a deduction for commuting expenses where the taxpayer, an attorney, "desire[d] to maintain a home in Jackson

purely personal expense, even when such clothing is required as a condition of employment and is worn exclusively at work.[197]

C. *Different Outcomes for Similar Expenditures*

When employees incur expenditures, the tax system imposes a multitude of limitations on the ability of the employees to recover those costs. At the same time, when employers incur identical costs on behalf of their employees, those outlays are presumed to be deductible and not subject to the limitations that the Internal Revenue Code ("Code") applies to employees. This disparate treatment occurs in both structural and substantive ways.

1. *Structural Biases: Expenses Incurred by Employees in the Course of Their Employment*

Even if employees' expenditures are clearly deductible under I.R.C. § 162, they may be subject to what this Article refers to as structural limitations. These structural limitations have a bias: the law restricts only the ability of employees to deduct expenditures borne by them and does not impose those limitations for the same types of expenditures when they are borne by their employers.

An expenditure borne by a business owner in this context can take one of two forms: (1) employees initially incur an expense for a work-related good or service and are subsequently reimbursed by their employers (a "reimbursed employee expense") or (2) the employers pay directly for the same work-related good or service (a "working condition fringe benefit"). An expenditure borne by the employee typically takes the form of an "unreimbursed employee expense." A reimbursed employee expense is fully deductible as a so-

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[Mississippi] while working in Mobile [Alabama]"). *See generally* Tsilly Dagan, *Commuting*, 26 VA. TAX REV. 185, 190, 202–03 (2006) (reviewing the law governing deductions for commuting expenses); William A. Klein, *Income Taxation and Commuting Expenses: Tax Policy and the Need for Nonsimplistic Analysis of "Simple" Problems*, 54 CORNELL L. REV. 871, 872–79 (1969) (discussing tax treatment of commuting expenses and noting that "[a]lthough these rules seem sensible, they produce some anomalous and disturbing results that raise serious doubts about their soundness").

197 *See* Pevsner v. Comm'r, 628 F.2d 467 (5th Cir. 1980). Clothing expenses are deductible only if the clothing is worn exclusively at work, is worn as a condition of employment, and is not adaptable for general usage as ordinary clothing. *Id.* at 469. Generally the tax law appropriately treats expenditures workers incur for food and lodging as personal and not deductible. *But see* I.R.C. § 119(a) (providing an exclusion from income for the value of meals and lodging provided to an employee by the employer "for the convenience of the employer"); *id.* § 162(a)(2) (allowing a deduction for the costs of food and lodging "while away from home in the pursuit of a trade or business"). For a more detailed discussion of meals, see *infra* notes 206–33 and accompanying text.

called "above-the-line" deduction, which means it is subtracted from gross income to determine AGI.[198] Thus, though the employee has income equal to the amount of reimbursement by the employer, the income is fully offset by the above-the-line deduction. A similar result obtains in the case of a working condition fringe benefit. The value of the good or service provided by the business owner to the employee is excluded from the employee's income—the equivalent of an inclusion in the employee's income coupled with an offsetting deduction.[199]

By contrast, an unreimbursed employee expense is a below-the-line, or "itemized" deduction, subtracted from AGI to arrive at taxable income,[200] and as such, is subject to numerous limitations.[201] Unreimbursed employee expenses—along with other itemized deductions—are subject to a phase-out at relatively high levels of AGI,[202] and also are not deductible to calculate the alternative minimum tax.[203]

Another structural limitation on unreimbursed employee expenses is created by the standard deduction. Because taxpayers are allowed to take the standard deduction, their itemized deductions are meaningfully reflected as an offset to their income only to the extent their itemized deductions exceed the standard deduction.[204] In addition, unreimbursed employee expenses are classified into the subcategory of "miscellaneous itemized deductions," which are deductible

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198 I.R.C. § 62(a)(2)(A).

199 A working condition fringe benefit is defined in I.R.C. § 132(d) to be "any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167." *Id.* § 132(d). Although the definition turns on whether an employee would be allowed a deduction under I.R.C. § 162 or § 167, a working condition fringe benefit is not subject to the structural limitations imposed on unreimbursed employee expenses described below. *See* Treas. Reg. § 1.132-5(a)(vi) (2012).

200 *See* I.R.C. § 62(a)(2)(A) (only considering "reimbursed" employee expenses to be above-the-line deductions).

201 *See generally* Jeffrey H. Kahn, *Beyond the Little Dutch Boy: An Argument for Structural Change in Tax Deduction Classification*, 80 WASH. L. REV. 1 (2005) (providing a detailed analysis and history of the distinction between itemized and nonitemized deductions and arguing that the Code's current list of nonitemized deductions improperly excludes certain expenses that contribute to the production of income).

202 *See* I.R.C. § 68.

203 *Id.* § 56(b)(1)(A)(i).

204 *Id.* § 63(c) (providing for the standard deduction); *id.* § 63(e) (allowing taxpayers to elect to itemize). *See generally* John R. Brooks II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX L. 203 (2011) (critiquing the standard deduction because it is currently designed to achieve both progressivity and simplification and proposing instead a zero-bracket amount that is independent of a redesigned approach to simplify itemized deductions).

only to the extent that, in the aggregate, they exceed two percent of AGI.[205]

2. *Substantive Biases: The Case of Meals*

The structural biases described above start with the presumption that an expenditure meets the I.R.C. § 162 threshold for deductibility (i.e., that it is both "ordinary" and "necessary"), but that it is nonetheless subject to structural limitations when employees, rather than the business owners employing them, incur the expenditure. In addition to these structural biases, there are many instances of substantive bias in the treatment of expenditures—that is, situations where the same type of expenditures are allowed as a deduction when incurred by a business owner, but disallowed when incurred by an employee. The tax law's treatment of expenditures for meals illustrates this type of substantive bias.

a. *Meals Purchased by Business Owners*

Meals are quintessential items of consumption under the Schanz-Haig-Simons definition of income. However, I.R.C. § 119 allows an employee to exclude from income the value of certain meals provided by the employer "for the convenience of the employer."[206] I.R.C. § 119 has its roots in an early administrative doctrine finding that meals provided to an employee for the convenience of the employer did not constitute income.[207] First articulated in 1919 and 1920, the doctrine excluded from employees' incomes the value of employer-

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205 I.R.C. § 67(a). Robert J. Peroni finds among the several reasons articulated in the legislative history for the law's imposing the "2 percent floor" on unreimbursed employee expenses that "employers reimburse employees for those expenses that are most necessary for employment." Robert J. Peroni, *Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System*, 91 TAX NOTES 1415, 1420 (2001) (internal quotation marks omitted). Peroni finds this rationale to be questionable and without empirical support. *Id.* at 1419–22; *see also* Kahn, *supra* note 201, at 62–63 (arguing that the treatment of unreimbursed employee trade or business expenses violates the tax law's commitment to horizontal equity). Leandra Lederman, on the other hand, argues that the more generous rules for reimbursed employee expenses make sense, because employers act as effective third-party enforcers of the tax law: it is not only in their interest to monitor employee expenses, but they have better information about the expenses than the IRS does. *See* Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 718–20 (2007).

206 I.R.C. § 119(a). Other conditions must be met in order for the exclusion to apply. Meals must be furnished on the business premises of the employer. *Id.* § 119(a)(1). The statute also extends to lodging, which the employer must require the employee to accept as a condition of employment. *Id.* § 119(a)(2).

207 For a detailed history of the convenience-of-the-employer doctrine, see *Commissioner v. Kowalski*, 434 U.S. 77, 84–90 (1977).

provided meals and living quarters that were characterized by the employer as noncompensatory and necessary to the employer's business.[208] With its reliance on the employer's characterization of meals as necessary for the conduct of the employer's business, the doctrine foreshadowed the standard of extreme deference to business owners articulated in *Welch*. In 1954, when I.R.C. § 119 codified the doctrine, there was some indication that Congress intended to diminish the ability of the employer to dictate the scope of the exclusion by merely an avowal that food should or should not be treated as compensation to an employee.[209] Yet the courts have continued to vest employers with the same authoritative power, as is illustrated by the case of *Boyd Gaming Corp. v. Commissioner*.[210]

Boyd Gaming operated a casino that, consistent with traditional practices in the gaming industry, regularly provided meals to its employees on the business premises during their regular work hours.[211] Boyd Gaming took the position that the meals were excluded from its employees' income under I.R.C. § 119, which in turn enabled the casino to deduct fully the costs of the meals and avoid the percentage limitation on meal deductions imposed by I.R.C. § 274(n).[212] An additional wrinkle in the case came as a result of a newly enacted "catch-all rule" under I.R.C. § 119(b)(4), which provides that if more than half of the meals provided to employees are found to be provided for the convenience of the employer, then *all* meals provided by that employer are deemed to be for the convenience of the employer.[213] The

208 *See* O.D. 265, 1 C.B. 71 (1919) (holding that "[b]oard and lodging furnished seamen in addition to their cash compensation is held to be supplied for the convenience of the employer"); T.D. 2992, 2 C.B. 76 (1920) (similar holding).

209 The legislative history of I.R.C. § 119 indicates that Congress intended to overturn the strand of prior law that had relied exclusively on the employer's characterization of the meals or lodging. *See* S. REP. No. 88-1622, at 190 (1954). Congress instead *endorsed* the alternate strand of prior law, which focused on whether the meals or lodging were necessary in order for employer's business to operate. *Id.* at 190–91. Congress intended to create an exclusion in cases where the "employee must accept . . . meals or lodging in order properly to perform his duties." *Id.* at 190.

210 Boyd Gaming Corp. v. Comm'r, 177 F.3d 1096 (9th Cir. 1999).

211 *Id.* at 1097.

212 *Id.* I.R.C. § 274(n) imposes a cap on an employer's deductions for meals unless the meals were a "de minimis fringe" as defined by I.R.C. § 132(e). *See* I.R.C. § 274(n)(2) (2006); *Boyd*, 177 F.3d at 1097 (explaining the provision in more detail).

213 I.R.C. § 119(b)(4). Congress added this provision to I.R.C. § 119 only a year before the Ninth Circuit decided *Boyd*. *See* Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 5002, 112 Stat. 685, 788.

IRS challenged the applicability of I.R.C. § 119 on the grounds that the meals were not provided for the convenience of the employer.[214]

The Tax Court found that most of the meals were not for the convenience of the employer.[215] In its analysis, the Tax Court adopted the approach taken in the Treasury regulations, which finds a meal to be for the convenience of the employer if it is provided for a "substantial noncompensatory business reason."[216] The Tax Court methodically examined all meals provided by the casino, weighing several factors identified in the regulations as germane to the inquiry, such as whether the meal was provided so that an employee would be able to respond to work emergencies arising during the meal period; whether the employee's meal break was too short to enable her to eat elsewhere; and whether the meal was provided before, during, or after the employee's work period.[217]

In a complete rejection of the Tax Court's holding and methodology, the Ninth Circuit held that, because Boyd Gaming had a policy that required employees to remain in the casino complex, all meals were provided for the convenience of the employer.[218] Once Boyd Gaming adopted its "stay-on-premises" policy, the Ninth Circuit reasoned that "the 'captive' employees had no choice but to eat on the premises. . . . [T]he furnished meals here were, in effect, indispensable to the proper discharge of the employees' duties."[219] It seemed not to matter that the policy had never been enforced, or that the business rationale for Boyd Gaming's adoption of it was tenuous at best.[220] The Ninth Circuit first rebuked the lower court for its attempt "to second guess Boyd's business judgment."[221] The court then found that Boyd Gaming had provided "credible and uncontradicted evidence" in support of its rationale for its "stay-on-premises" policy, and, in language reminiscent of *Welch* and its progeny, found that Boyd Gaming's judgment should be given absolute deference:

> While reasonable minds might differ regarding whether a "stay-on-premises" policy is necessary for security and logistics, the fact remains that the casinos here operate under this policy. Given the credible and uncontradicted evidence re-

214 *Boyd*, 177 F.3d at 1097.

215 Boyd Gaming Corp. v. Comm'r, 74 T.C.M. (CCH) 759, 798–99 (1997).

216 Treas. Reg. § 1.119-1(a)(2)(i) (2012).

217 *Boyd*, 74 T.C.M. (CCH) at 793–98.

218 *Boyd*, 177 F.3d at 1101.

219 *Id.* (internal quotation marks omitted).

220 *See Boyd*, 74 T.C.M. (CCH) at 795–96.

221 *Boyd*, 177 F.3d at 1100.

> garding the reasons underlying the "stay-on-premises" policy, we find it inappropriate to second guess these reasons or to substitute a different business judgment for that of Boyd.[222]

It is clear that the convenience-of-the-employer requirement has returned to the deferential standard Congress had turned away from when it enacted I.R.C. § 119. All that is required is a declaration that the purpose of meals serves a noncompensatory business purpose, and the inquiry is generally over.[223] An employer's fiat can convert the prototypical item of consumption—food—into a noncompensatory business cost, resulting in an exclusion of the meal's value from an employee's income. By contrast, when incurred by employees themselves, the tax rules treat the very same expenditures much less favorably.

b. Meals Purchased by Employees

From the perspective of an employee who receives a meal excluded in accordance with I.R.C. § 119, the exclusion is the equivalent of an inclusion in her income coupled with an offsetting deduction. However, if an employee purchases the meal herself, rather than having it be provided by her employer, it is unlikely that the meal will be deductible. Similarly, if she is provided a cash meal allowance by her employer in order to purchase the meal, the exclusion under I.R.C. § 119 does not apply.[224] She may be able to exclude a cash meal allowance as a de minimis fringe benefit under I.R.C. § 132(e). However, the scope of this exclusion is much more limited than I.R.C. § 119's.[225]

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222 *Id.* at 1101.

223 *See* Burgess J.W. Raby & William L. Raby, Kowalski *Test for Employee Meals: A Real Free Lunch*, 83 TAX NOTES 1187, 1189 (1999) (describing the tax planning implications of *Boyd* and suggesting that many businesses could provide free meals to their employees at no tax cost to those employees). The deferential standard extends to lodging as well. For example, nonprofit organizations, such as museums and educational institutions, furnish free luxury housing to their chief executives and assert that the housing is excludable under I.R.C. § 119 because the executives use the housing to meet and schmooze with donors. *See* Jane Zhao, Note, *Nights on the Museum: Should Free Housing Provided to Museum Directors Also Be Tax-Free?*, 62 SYRACUSE L. REV. 427, 427–28, 445 (2012); Kevin Flynn & Stephanie Strom, *Fine Perk for Museum Chiefs: Luxury Housing (It's Tax-Free)*, N.Y. TIMES, Aug. 10, 2010, at A1.

224 *See* Comm'r v. Kowalski, 434 U.S. 77, 94–95 (1977).

225 Under the regulations for I.R.C. § 132(e), a cash meal allowance may qualify as a de minimis fringe benefit if the employer provides the allowance on an occasional basis when an employee works overtime and uses the allowance to purchase and consume the meal during the overtime period. *See* Treas. Reg. § 1.132-6(d)(2)(i) (2012). Contrast the parameters of the I.R.C. § 132(e) exclusion with the holding in *Boyd*, in which the court held that I.R.C. § 119

More generally, an employee who purchases a meal, whether or not it is funded by her employer, cannot easily deduct the cost of the meal as a trade or business expense. Meals are presumptively personal under I.R.C. § 262.[226] Thus, meals are generally not deductible as ordinary and necessary business expenses under I.R.C. § 162 unless eaten under unusual or constraining circumstances.[227] Under the assumption that a meal purchased by an employee manages to clear the "ordinary and necessary" hurdle of I.R.C. § 162, the law still imposes additional constraints and limitations on the deductibility of its cost under I.R.C. § 274.[228] The expense must be directly related to or associated with "the active conduct of the taxpayer's trade or business,"[229] must be substantiated with specificity,[230] cannot be "lavish or extravagant under the circumstances,"[231] and the deduction is limited to fifty percent of the expense.[232]

The treatment of meals under I.R.C. § 119 provides a striking example of the persistence of *Welch*'s deference to business owners. All business owners need to do is assert the existence of a business purpose for giving their employees meals and I.R.C. § 119 allows the employees to exclude the value of the meals from their income. In effect, the meals are transformed into deductible business expenses for the employees. At the same time, however, when employees themselves incur the cost of a meal under the same working conditions, the tax law effectively denies them a deduction.[233]

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applied to daily meals provided to nearly all employees in the course of their regular work schedule. *Boyd*, 177 F.3d at 1101.

226 *See* Treas. Reg. § 1.262-1(b)(5).

227 *See* Moss v. Comm'r, 80 T.C. 1073, 1080–81 (1983), *aff'd*, 758 F.2d 211 (7th Cir. 1985) (disallowing an attorney's deduction for the cost of daily lunches at which he and the other attorneys in his law firm would discuss the firm's pending matters and discuss other issues that arose in their practice).

228 *See generally* Richard Schmalbeck & Jay A. Soled, *Elimination of the Deduction for Business Entertainment Expenses*, 123 TAX NOTES 757 (2009) (providing an overview and critique of these limits in the context of business entertainment expenses).

229 I.R.C. § 274(a) (2006).

230 *Id.* § 274(d).

231 *Id.* § 274(k)(1)(A).

232 *Id.* § 274(n). By contrast, an employer who provides a meal that qualifies for exclusion from the employee's income under I.R.C. § 119 is permitted to deduct the entire cost of the meal. *See* Boyd Gaming Corp. v. Comm'r, 177 F.3d 1096, 1101 (9th Cir. 1999); *supra* notes 210–22 and accompanying text.

233 This Article does not contend that employees who incur the costs of meals under certain working conditions ought to be accorded the same expansive treatment for meals provided for in I.R.C. § 119. Nor does this Article claim that employers unfairly benefit more than employees with respect to meals—it acknowledges that the tax savings resulting from an employer-provided meal may be shared between the employer and the employee. *But see* Jeffrey H. Kahn, *The*

3. *Other Substantive Biases*

Other statutory provisions, cases, and administrative guidance replicate the disparate treatment described in the previous subsection. In each instance, expenditures paid or reimbursed by business owners are presumed to be recoverable, but those incurred by employees are much more likely to be treated as consumption and therefore unrecoverable.[234]

For example, courts have denied deductions to elementary, high school, and college teachers for out-of-pocket expenditures for school supplies, such as encyclopedias and other books, electronic equipment, and other supplemental learning materials.[235] At the same time, educational supplies provided to teachers by a school system presumably are excluded from a teacher's income as a working condition fringe benefit, and any expenditures reimbursed by the school presumably are recoverable as above-the-line reimbursed employee expenses.[236] Similarly, courts have disallowed deductions taken by employees for office furniture and decorations while allowing deductions taken by business owners for similar types of expenditures.[237] In

Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity, 57 HASTINGS L.J. 645, 683–87 (2006) (arguing that the disparate treatment of employers and employees in the treatment of meals violates horizontal equity). Rather, the significance of the tax treatment of meals stems from the differing standard that applies when a business owner, rather than an employee, incurs the same cost.

234 *See generally* Cheryl A. Cunagin, Note, *The Double Standard Under Section 162: Why the Employee Business Deduction Is No Longer for Employees,* 82 KY. L.J. 771, 779–81 (1994) (giving numerous examples of this "differing standard[ ]").

235 *See, e.g.*, Mann v. Comm'r, 65 T.C.M. (CCH) 2598, 2601–2603 (1993); Mathes v. Comm'r, 60 T.C.M. (CCH) 704, 709 (1990); Patterson v. Comm'r, 30 T.C.M. (CCH) 1003, 1007–08 (1971); Wheatland v. Comm'r, 23 T.C.M. (CCH) 579, 581–82 (1964). In these cases, the taxpayers were denied any tax deduction for the teaching-related expenditures they incurred. However, even if the courts had allowed a deduction under I.R.C. § 162 for a teacher's out-of-pocket expenses for supplies, the deduction would have been subject to the structural limitations described above. Since 2002, elementary and secondary school teachers have been allowed a special above-the-line deduction of up to $250 for school supplies and supplemental learning materials. Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 406(a), 116 Stat. 21, 43 (codified at I.R.C. § 62(a)(2)(D)). Of course, even teachers sometimes push the boundaries of deductibility. *See, e.g.*, Garcia v. Comm'r, T.C. Summ. Op. 2005-2, at 3–4, 7–9 (2005) (disallowing deductions for an English teacher's theater and movie tickets, dry cleaning, travel, and other expenses); Tesar v. Comm'r, 73 T.C.M. (CCH) 2709, 2710–11, 2713 (1997) (disallowing a mathematics teacher's deductions for 16,000 comic books purchased for nearly $30,000 for the student comic book club, 12,000 of which ended up in the teacher's private collection at home).

236 It appears that the IRS has never asserted that a teacher has income by reason of school supplies provided or reimbursed by the school.

237 *Compare* Henderson v. Comm'r, 46 T.C.M. (CCH) 566, 567 (1983) (disallowing an employee's deduction for the costs of a print and a plant for employee's office), *with* Associated

some cases involving employees' expenditures, courts have articulated explicitly a standard for deductibility that is much stricter than the deferential approach established in *Welch.* They have held that, in order for an employee to deduct an unreimbursed expenditure, the employee must show that the expenses were a condition of her employment and that she could not be reimbursed.[238]

In its administrative guidance, the IRS, like the courts, relies on employer reimbursement as the litmus test for a determination of the deductibility of employee expenses. For example, in considering whether a corporate officer can deduct travel and entertainment expenses incurred in the conduct of corporate business, the IRS finds a presumption in favor of deductibility when the corporation either reimburses the expense or explicitly requires the officer to incur the expense.[239] More broadly, under IRS regulations for "accountable plans," an employee whose expenses are reimbursed by her employer need not report or substantiate to the IRS either the reimbursement or the expenditure.[240] Instead, the employee must, when seeking reimbursement from her employer, submit "an expense account or other required written statement to the employer showing the business nature and the amount of all the employee's expenses."[241] In addition to the requirement that the employee's reimbursed expenses be ordinary and necessary, the regulation seems to impose an even higher standard by stipulating that the reimbursed expenditures must be incurred "solely for the benefit of his employer."[242] However, in

Obstetricians & Gynecologists, P.C. v. Comm'r, 46 T.C.M. (CCH) 613, 614–15, 617 (1983), *aff'd*, 762 F.2d 38 (6th Cir. 1985) (allowing a corporation to deduct expenditures for decorating services and office furniture, but not allowing a depreciation deduction for numerous pieces of art in a medical office). As is true for school supplies, the IRS does not seem to have ever asserted that an employee has income by reason of employer-provided office furniture or decorations.

238 *See, e.g.*, Heidt v. Comm'r, 274 F.2d 25, 28 (7th Cir. 1959) (disallowing a deduction for a corporate officer's car expenses for business travel); Dunkelberger v. Comm'r, 64 T.C.M. (CCH) 1567, 1569 (1992) (disallowing deductions for a manager's costs of meals and snacks intended to promote office morale and for costs of flowers sent to a hospitalized co-worker); Fountain v. Comm'r, 59 T.C. 696, 708 (1973) (disallowing a deduction for a corporate officer's car expenses for business travel); Roach v. Comm'r, 20 B.T.A. 919, 925–27 (1930) (disallowing a deduction for studio head's travel and entertainment expenses).

239 *See* Rev. Rul. 57-502, 1957-2 C.B. 118 ("Reimbursement for [corporate traveling and entertainment expenses] to the corporate officer or a resolution requiring the assumption of such expenses by him would tend to indicate that they are a necessary expense of his office.").

240 *See* Treas. Reg. § 1.162-17(b) (2012). The taxpayer need only state that the expenses which she charged to her employer or for which she was reimbursed "did not exceed the ordinary and necessary business expenses paid or incurred by the employee." *Id.* § 1.162-17(b)(1).

241 *Id.* § 1.162-17(b)(4); *see also id.* § 1.62-2 (providing extensive guidance on the use of accountable plans and employee reimbursement).

242 *Id.* § 1.162-17(b)(1).

practice, the IRS requires less. For example, it requires that entertainment and meals either have a main, and not incidental, business purpose, or that they be associated with the employee's trade or business.[243] It is not necessary for the employee to have devoted more time to business than to entertainment, and there is no requirement to show that business income or some other business benefit actually resulted from each expenditure.[244] While the IRS acknowledges the theoretical possibility that a reimbursed expense might not be a valid trade or business expense of the employee,[245] as a practical matter, the fact of reimbursement appears to establish deductibility in all cases.[246]

In addition to judicial decisions and administrative guidance, the Code explicitly discriminates between business owners and employees. For instance, interest on indebtedness properly allocable to a trade or business is deductible under I.R.C. § 163 unless that trade or business consists of employee-provided services.[247] In that case, the interest is deemed personal and nondeductible.[248]

In sum, this Part has shown that the tax law misclassifies employees' expenditures related to their economic productivity, such as outlays for education, health care, and child care, as exclusively personal in nature. In addition, employee expenses, such as work-related travel or meals, are treated in strikingly different fashion depending on whether they are incurred by an employee or by an employer on behalf of an employee. When incurred by an employee, the tax system imposes a multitude of limitations on the ability of the employee to

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243 *See* DEP'T OF THE TREASURY, INTERNAL REVENUE SERV., TRAVEL ENTERTAINMENT, GIFT, AND CAR EXPENSES 9–10 (2012), www.irs.gov/pub/irs-pdf/p463.pdf.

244 *Id.* at 10.

245 *See id.* at 30 (example of partially nondeductible reimbursed employee expense).

246 We were unable to identify any instance in which reimbursed employee expenses under an accountable plan have been challenged as nondeductible. The issue may be highlighted soon, however, in connection with one university making buyout payments to another when it hires an athletic coach. Douglas Kahn and Jeffrey Kahn, in arguing that the coaches should be able to exclude the payments from their income, treat the fact of reimbursement as highly significant for the determination of deductibility. *See* Douglas A. Kahn & Jeffrey H. Kahn, *Tax Consequences When a New Employer Bears the Cost of the Employee's Terminating a Prior Employment Relationship*, 8 FLA. TAX REV. 539, 545–49 (2007); Douglas A. Kahn & Jeffrey H. Kahn, *Will the Tax Man Cometh to Coach Rodriguez?*, 120 TAX NOTES 474, 475–77 (2008).

247 I.R.C. § 163(a), (h)(2)(A) (2006).

248 *Id.* § 163(h)(1). This disallowance of a deduction for interest incurred by employees in the conduct of their employment services was enacted by the Tax Reform Act of 1986, along with changes that generally disallowed deductions for personal interest incurred by taxpayers (prior to 1986, personal interest had been deductible). *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 511(b), 100 Stat. 2085, 2246. The legislative history is silent as to why interest incurred by employees in the conduct of their employment services should be treated as personal interest. *See generally* STAFF OF J. COMM. ON TAXATION, 99TH CONG., *supra* note 186.

recover these costs, reflecting the dominant characterization of employees as consumers rather than as producers. At the same time, when incurred by employers on behalf of their employees, the identical outlays are presumed to be deductible and unrestricted by the limitations applied to employees, reflecting the undue deference that the tax law consistently gives to the judgment exercised by business owners.

IV. The Costs of Undertaxed Business Owners and Overtaxed Workers

The overly generous treatment of business owners' expenditures and the unduly restrictive treatment of workers' expenditures significantly compromise the principles of equity and efficiency that undergird the U.S. tax system. With respect to issues of equity, income is mismeasured in ways that undermine fairness and progressivity. The taxable income of business owners is understated because they are allowed to deduct outlays that are not related to the income-producing activity. At the same time, the taxable income of workers is overstated because they are not permitted to deduct outlays that are related to their income-producing activity. The resulting inequities are particularly troubling in today's economy, where, as a share of the total national income, large corporations' profits are at an all-time high and workers' incomes are at their lowest levels since 1965.[249]

With respect to efficiency, the undertaxation of business owners likely leads to a variety of resource misallocations. For example, the tax-favored treatment of business ownership encourages individuals to become business owners rather than to engage in other more socially and economically productive activities, whether as employees in the same type of enterprise or in some entirely different market activity.[250] Of course, it is difficult, if not impossible, to ascertain and quantify the nature and extent of the societal loss that arises from people choosing to become business owners rather than, for example, teachers, first

249 *See* Floyd Norris, *As Corporate Profits Rise, Workers' Income Declines*, N.Y. Times, Aug. 6, 2011, at B3.

250 Lederman has argued that the tax law's liberal loss deductibility rules for active trades and businesses under I.R.C. § 162 encourage taxpayers to make investments in active businesses rather than passive activities. *See* Leandra Lederman, *The Entrepreneurship Effect: An Accidental Externality in the Federal Income Tax*, 65 Ohio St. L.J. 1401, 1444–55 (2004). Similarly, the overly generous treatment of business deductions under I.R.C. § 162 encourages investment in nonproductive activities—so-called hobbies—the losses from which have been limited under I.R.C. § 183. *See* Leandra Lederman, *A Tisket, a Tasket: Basketing and Corporate Tax Shelters*, 88 Wash. U. L. Rev. 557, 569–70 (2011).

responders, or prosecutors. The goal of this Part is a more focused one: to identify and provide evidence for some of the more specific ways in which the undertaxation of business owners and overtaxation of workers create misallocations and leave all of us worse off.

A. *Underinvestment in Worker Productivity*

By favoring employer-provided expenses on behalf of employees through more lenient structural features and substantive standards of deductibility, the tax system assumes that employers are best able to determine the appropriate type and level of employee-related expenditures necessary to enhance productivity. The tax system further assumes that costs for education, health care, and child care are personal and, therefore, unrelated to workers' productivity. These assumptions are wrong. As management scholar Jeffrey Pfeffer states, "[a] truly enormous body of research from a number of countries shows that how people are managed affects quality, profitability, productivity and total returns to shareholders."[251] Moreover, the types of employee-related costs that are proven to increase productivity include many of the expenditures that the tax law treats as consumption. For example, employers who provide on-site child care garner lower absenteeism rates and greater productivity from their employees.[252] Employer-provided health insurance increases employee productivity.[253] Education and on-the-job training for employees similarly increase produc-

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251 Jeffrey Pfeffer, *Human Resources from an Organizational Behavior Perspective: Some Paradoxes Explained*, 21 J. ECON. PERSP. 115, 119 (2007). After conducting a comprehensive survey of the literature, Pfeffer concludes:

> 1) employee attitudes and related behaviors are generally poor, 2) employees and how they are managed are important sources of company success and competitive advantage, 3) and methods for achieving a culture of high-performance are known, but apparently not implemented. Although one could dismiss the results of any single survey or study as possibly flawed or not representative, the overwhelming preponderance of evidence makes such a position virtually untenable.

Id. at 130. *See generally* JODY HEYMANN & MAGDA BARRERA, PROFIT AT THE BOTTOM OF THE LADDER 6–10 (2010) (concluding, based on a wide-ranging multi-year investigation researching the relationship between profitability in the marketplace and good working conditions for bottom tier employees in a range of different size firms, business sectors, and locations around the world, that the majority of the companies studied had increased their profitability as a result of their investments in bottom tier employees).

252 *See* Peter D. Brandon & Jeromey B. Temple, *Family Provisions at the Workplace and Their Relationship to Absenteeism, Retention, and Productivity of Workers: Timely Evidence from Prior Data*, 42 AUSTL. J. SOC. ISSUES 447, 458 (2007) ("The findings . . . indicate that family provisions [such as child care] enhance firms' abilities to retain workers and increase worker performance but that these effects operate in conjunction with other workplace features.").

253 *See* Ellen O'Brien, *Employers' Benefits from Workers' Health Insurance*, 81 MILBANK Q. 5, 21, 29 (2003).

tivity.[254] Employer-provided work-life benefits, such as those related to children, elder care, flexible work schedules, physical and psychological well-being, and professional development, create a reciprocally positive relationship between employer and employee and provide tangible economic benefits to both.[255]

A conundrum raised by this research is why, in light of the evidence, employers do not invest more in their employees. Pfeffer notes several theories to explain this inefficient conduct: (1) business owners mindlessly copy what others do in order to achieve social legitimacy and to conform to social expectations for appropriate behavior;[256] (2) powerful external constituencies, such as investment analysts and bankers, view investments in employees as a waste of money (at the same time that countervailing external constituencies, such as unions, have lost power);[257] (3) the costs of investments in employees tend to be overvalued relative to the benefits, because the costs are easier to observe and measure;[258] and (4) business owners make assumptions about employees—for instance, that employees are "effort adverse" and self-interested—that lead to underinvestment in employees, which in turn causes these assumptions to become self-fulfilling.[259]

The tax system embodies the same flawed belief system that underlies Pfeffer's theories explaining prevailing human resource inefficiencies. In the face of all the evidence that worker productivity is enhanced by education, health care, and child care, the tax system persistently misclassifies these expenditures as primarily personal. Similarly, despite all the indications that employers do not invest adequately in their employees, the tax system persists in the mistaken presumption that employers are the best arbiters of how much to in-

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254 *See* Sandra E. Black & Lisa M. Lynch, *Human-Capital Investments and Productivity*, 86 AM. ECON. REV. 263, 265 (1996).

255 *See* Lori Muse et al., *Work-Life Benefits and Positive Organizational Behavior: Is There a Connection?*, 29 J. ORGANIZATIONAL BEHAV. 171, 172, 174 (2008) (noting that "[w]ork-life benefit programs can be interpreted as a signal that the organization cares about the well-being of its employees . . . creating a desire within employees to reciprocate"); Bart L. Weathington & Allan P. Jones, *Measuring the Value of Nonwage Employee Benefits: Building a Model of the Relation Between Benefit Satisfaction and Value,* 132 GENETIC, SOC., & GEN. PSYCHOL. MONOGRAPHS 292, 322–23 (2008) ("Economic satisfaction was positively related to both motivation and trust, suggesting that a minimum level of satisfaction with economic concerns is necessary for employees to have confidence in their organization and exert more than minimal effort."). *See generally* JOAN WILLIAMS, UNBENDING GENDER 64–114 (2000) (discussing the business case for family-friendly policies).

256 *See* Pfeffer, *supra* note 251, at 126.

257 *Id.* at 126–27.

258 *Id.* at 127–28.

259 *Id.* at 128–29.

vest in the productivity of their employees. At the same time the tax system reflects these mistaken beliefs, it encourages an underinvestment in worker productivity that in turn reinforces the tax system's flawed assumptions.

B. *Misallocation of Resources and Misvaluation of Assets*

As discussed above, the tax system presumes almost all business owners' costs to be recoverable, even those, such as corporate reorganization fees or excessive managerial compensation and perquisites, that have little or no connection to the productivity of the business. By contrast, the tax system limits or denies workers recovery of many of the costs they incur to produce income. This disparate tax treatment of outlays by business owners and workers can have market effects.

The tax deduction for interest on a home mortgage is a good example of how the tax law can distort resource allocation and market values. Because it treats owner-occupied housing more favorably than other assets, the interest deduction leads to overinvestment in homeownership and results in inflated housing prices.[260] The deleterious economic effects of the home mortgage interest deduction have been extensively studied and are quite complex.[261] The economic effects of overly generous deductions for business owners' expenses and of unduly restrictive deductions for workers' income-producing costs have not yet been systematically studied, but they are bound to be even more multifaceted and difficult to track than the adverse consequences associated with the interest deduction for home mortgages.

The tax rules relating to cost recovery for investments in various types of business assets illustrate the complexity of these effects. On one hand, there is evidence that accelerated depreciation or investment tax credit for certain types of assets causes an overinvestment in those assets.[262] Furthermore, accelerated cost recovery for many tan-

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260 As Dennis Ventry summarizes, "In the end, the [home mortgage interest deduction] 'amounts to a huge subsidy that causes massive, efficiency-draining distortions in the economy,' creating 'less business capital, lower productivity, lower real wages, and a lower standard of living.'" Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 LAW & CONTEMP. PROBS. 233, 279 (2010) (quoting Martin A. Sullivan, *The Economics of the American Dream*, 106 TAX NOTES 407, 407 (2005)).

261 For a discussion of the various effects of the home mortgage deduction, see *id.* at 277–81 and the sources cited therein.

262 *See* PRESIDENT'S ECON. RECOVERY ADVISORY BD., THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION 78–79 (2010), http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf (noting that "accelerated depreciation and expensing provisions are the largest single tax expenditure . . . for

gible assets may cause business owners to overinvest in those assets and underinvest in workers.[263] On the other hand, cost recovery for certain intangible assets, such as goodwill and know-how, is more tax-favored than it is for tangible assets;[264] this may create the opposite incentive: overinvestment in workers. This is because the expenditures related to the creation of goodwill and know-how, such as advertising, research, experimentation, and training programs, often involve a high proportion of expenditures on labor.[265] Because these expenditures are immediately deductible (rather than being recovered over the life of the asset created), business owners may have an incentive to overinvest in good will and know-how, which could result in an overinvestment in workers.[266]

These conflicting incentive effects are not corrective of each other. The misallocations and misvaluations will occur unevenly in different sectors of the economy depending on the size and nature of the trade or business, the level of competition in the sector, the supply of labor in a geographic area, and other variables. However, what is most important to recognize is that undue deference toward business owners' judgments and undue skepticism toward workers' judgments

businesses"); U.S. DEP'T OF THE TREASURY, TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS: BACKGROUND PAPER 27–28 (2007), http://www.treasury.gov/press-center/press-releases/Documents/07230%20r.pdf (finding that "[i]nvestment in intangible[ ] [assets] might be excessively encouraged by the tax system, relative to investment in tangible assets," because the former are immediately deductible while the latter are typically depreciated over time); Peter S. Fisher, *Corporate Tax Incentives: The American Version of Industrial Policy*, 19 J. ECON. ISSUES 1, 6–8 (1985) (discussing the effects of accelerated cost recovery). *But see* Austan Goolsbee, *Investment Subsidies and Wages in Capital Goods Industries: To the Worker Go the Spoils?*, 56 NAT'L TAX J. 153, 153–54 (2003) (finding that tax subsidies for investment drive up the wages of workers in industries that sell capital goods).

263 *See* Russell W. Coff & Eric G. Flamholtz, *Corporate Investments in Human Capital: How Financial Accounting Standards Undermine Public Policy*, 5 STAN. L. & POL'Y REV. 31, 35–36 (1993) (discussing the manner in which "IRS regulations concerning the amortization of acquired intangible assets hinder transactions involving human assets"); Catherine Rampell, *Companies Spend on Equipment, Not Workers*, N.Y. TIMES, June 10, 2011, at A1 (reporting that, since the post-2008 recovery began, "businesses' spending on employees has grown 2 percent as equipment and software spending has swelled 26 percent").

264 *See* Yale, *supra* note 130, at 565 (stating that intangibles are "dramatically undertaxed" relative to other assets, because costs are immediately deductible).

265 *See* U.S. DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON DEPRECIATION RECOVERY PERIODS AND METHODS 39–40 (2000).

266 *See id.* at 40. The 2000 Treasury Report posits that the preferential treatment of intangibles might be justifiable in order to offset an underinvestment in intangibles. That underinvestment results when a business owner is unable to recover an investment fully, as for example, in the situation where a business owner provides training to a worker who then takes her skills to a new job. *See id.*

not only lead to miscalculation of taxable income, but likely introduce inefficiencies and misvaluations into the economy.

In the realm of financial accounting, Russell W. Coff and Eric G. Flamholtz explore a similar set of inefficiencies and misvaluations created by mistakes in the accounting rules.[267] As described by Coff and Flamholtz, accounting standards treat outlays for tangible goods, such as plants and equipment, as assets.[268] By contrast, the standards treat outlays associated with people, such as research and development and worker training, as expenses.[269] This treatment overstates the value of tangible property relative to workers' inputs to productivity.[270] Coff and Flamholtz argue that these flawed accounting standards have led U.S. businesses and government policymakers to undervalue workers, which perpetuates a continuing pattern of overinvestment in tangible assets and underinvestment in workers.[271]

Marleen A. O'Connor makes similar observations about the systematic undervaluation of workers in her survey on the disclosure of workplace practices among Fortune 500 companies.[272] O'Connor examines the extent to which the companies disclose information about factors that might aid in an accurate assessment of the value of their workforce, including diversity, workplace training, workplace safety, employee turnover, and labor relations.[273] She finds they provide little useful information and argues for more extensive disclosure consistent with agreed-upon reporting standards.[274] To illustrate the phenomenon of undervalued workers, along with the problems it creates, O'Connor cites a New York Times story about a major round of layoffs at AT&T:

> We often evaluate companies as if human capital doesn't matter. And so a company like AT&T can lay off 40,000 knowledge workers, and the market will respond positively

267 *See* Coff & Flamholtz, *supra* note 263, at 32.

268 *Id.*

269 *Id.* at 32–33.

270 *See id.* at 32–34. Coff and Flamholtz trace this disparate treatment to the desire for greater certainty after the crash of 1929. *Id.* at 32. They suggest, however, that even before the crash, the accounting profession's bias toward easily measurable data resulted in less observable drivers of profitability often being overlooked. *Id.* at 32–33. In the decades that followed the crash, they attribute the overemphasis on tangible investments to the nature of U.S. businesses in the New Deal era, which were largely in the manufacturing and industrial sectors. *Id.* at 33.

271 *Id.* at 32–37.

272 Marleen A. O'Connor, *Rethinking Corporate Financial Disclosure of Human Resource Values for the Knowledge-Based Economy*, 1 U. PA. J. LAB. & EMP. L 527, 531–34 (1998).

273 *Id.* at 534–35.

274 *Id.* at 535–46, 549–51.

> because expenses are trimmed. If corporations booked their investments in workers as capital assets, as I believe they should, AT&T would not have been able to eliminate those jobs without writing down $4 billion to $8 billion of assets. Then the market response would be different. Instead of applauding the company's executives, we'd be looking to give them the boot.[275]

Reminiscent of Pfeffer's "self-fulfilling prophecy" theory about why firms fail to make adequate investments in their employees, O'Connor theorizes that the failure of companies to disclose information about their investments in employees, along with the failure of investors to demand it, have what she calls a "catch 22" quality: "[U]ntil we obtain better empirical support about how human capital values relate to the bottom line, it will be difficult to mobilize pressure from investors . . . which is needed to make managers publish figures that might place them at a disadvantage."[276] In the meantime, investors and managers persist in their distorted belief system that workers are not important to economic productivity.[277] O'Connor cites another revealing anecdote in which a CEO describes financial analysts' reactions to a report about employee training at his company:

> When I brief Wall Street analysts on our current earnings, sale projections, downsizing program, and capital spending plans, they busily punch all these numbers right into their laptops as I speak. When I then start telling them about our plans to invest in training and reform the workplace, they sit back in their chairs and their eyes glaze over.[278]

This anecdote illustrates that financial analysts undervalue investments in workers, but more importantly, it also shows how managers use financial analysts' mistaken understanding of the value of employee investment to justify their own continued underinvestment in workers.[279]

By describing some of the implications of the accounting errors that understate the value of investment in human capital, Coff and Flamholtz and O'Connor provide further support for Pfeffer's self-fulfilling prophecy theory. These mistakes lead to underinvestment in

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275 *Id.* at 527 (quoting Tom DeMarco, *Human Capital, Unmasked*, N.Y. TIMES, Apr. 14, 1996, at F13).

276 *Id.* at 549.

277 *See id.* at 532.

278 *Id.* at 548 (quoting THOMAS KOCHAN & PAUL OSTERMAN, THE MUTUAL GAINS ENTERPRISE 114 (1994)).

279 *See id.* at 548–49.

workers by businesses, which, in turn, entrenches the view that expenditures related to workers do not contribute long-term value to businesses. The tax law, animated by attitudes and beliefs about the centrality of business owners' roles in the promotion of economic growth, makes the same mistakes. It reinforces the view that the business owner, and not the worker, is the primary driver of economic growth. The tax law's fundamental mistakes—deference to business owners and skepticism of workers—ultimately result in decreased productivity and profitability.

C. *The Twenty-First Century Economy*

The problems described above are even more acute in light of today's economy. The tax law's assumption that employers can be relied upon to make investments in their employees' productivity might have seemed at least plausible during the mid-twentieth century "golden age" of employment, when most employees worked for a single employer for their entire working lives and employers invested in their workers' productivity by providing training and medical and retirement benefits.[280] But the golden age now has been supplanted by an entirely different employment model. In the twenty-first century economy, innovation and flexibility are paramount over stability and loyalty, and markets for both capital and labor are globalized and fiercely competitive.[281] Business owners increasingly use independent contractors, temporary workers, and free agents in part to avoid having to make the sorts of investments they traditionally have made in full-time employees.[282] It is difficult to estimate the numbers of freelancers, but estimates range as high as one-third of the civilian work force, and there is widespread agreement that the numbers are trending upward.[283] As the number of freelance workers increases, the re-

280 *See generally* ROBERT B. REICH, THE FUTURE OF SUCCESS 93–104 (2000) (describing the history of modern U.S. employment and changes from mid-twentieth century to the turn of the twenty-first century, including heightened job instability, erosion of benefits, and widening inequality).

281 *See generally* ROBERT B. REICH, SUPERCAPITALISM 50–130 (2007) (detailing the causes and effects of this trend from the 1950s through the present).

282 *See* REICH, *supra* note 280, at 98.

283 *See id.* (estimating ten percent to thirty percent depending on how the group is defined); JEFFREY A. EISENACH, NAVIGANT ECON., THE ROLE OF INDEPENDENT CONTRACTORS IN THE U.S. ECONOMY 20, 42 (2010), http://www.naviganteconomics.com/docs/Role%20of%20Independent%20Contractors%20December%202010%20Final.pdf (indicating that independent contractors comprise approximately ten percent of the work force overall and that independent contractors comprise a much higher proportion in certain "key industries," such as construction and professional and business services); Sara Horowitz, *The Freelance Surge Is the Industrial*

maining workers who *do* have employers are experiencing shorter tenures and fewer investments in their productivity by their employers.[284]

At the same time that business owners' investments in their workers are on the decline, the development of workers has never been more important. Many economists and policymakers believe that the future prosperity of the United States depends on how well its workers can perform in the "knowledge economy"[285] with its focus on services, technology, and the production of knowledge.[286] As Peter F. Drucker puts it: "The most valuable assets of a 20th-century company was [sic] its production equipment. The most valuable asset of a twenty-first-century institution, (whether business or nonbusiness) will be its knowledge workers and their productivity."[287] The tax system erroneously assumes that business owners will take care of workers' development. At the same time, it limits or denies workers recovery of costs they incur to prepare and maintain their capacity to remain highly productive. The consequence of these two costly mistakes is a tax system that does not promote and, in fact, obstructs U.S. workers' competitive strengths in the twenty-first century economy.

In the financial accounting world, Drucker's twenty-first century vision of workers at the center of business productivity has gained widespread acceptance. In 2001, the Steering Committee of the Financial Accounting Standards Board Business Research Project stated: "The important assets of enterprises are increasingly intangi-

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Revolution of Our Time, ATLANTIC (Sept. 1, 2011, 10:30 AM), http://www.theatlantic.com/business/archive/2011/09/the-freelance-surge-is-the-industrial-revolution-of-our-time/244229/ (reporting that, as of 2005, one-third of the workforce consisted of freelancers and that that proportion has increased since then).

284 *See* REICH, *supra* note 280, at 101–03; Pfeffer, *supra* note 251, at 116–18.

285 Peter Drucker first used the term "knowledge economy" in 1969 to describe the shift in the U.S. economy from manufacturing to service and technology. *See* Drucker, *supra* note 153, at 263–86.

286 *See* ROBERT B. REICH, THE WORK OF NATIONS 8–9 (1991) ("The real economic challenge facing the United States in the years ahead . . . is to increase the potential value of what its citizens can add to the global economy, by enhancing their skills and capacities . . . ."); STIGLITZ, *supra* note 153, at 1 (giving "examples of the ways in which the role of government in the knowledge economy may differ markedly from that in the industrial economy"); TASK FORCE ON THE FUTURE OF AM. INNOVATION, *supra* note 153, at 1 (identifying "key benchmarks in six essential areas" that help define the knowledge economy and concluding that, although the United States maintains its advantage as measured against some benchmarks, its advantage for others is "eroding rapidly"); Walter W. Powell & Kaisa Snellman, *The Knowledge Economy*, 30 ANN. REV. SOC. 199, 199–201 (2004) (attempting to define the knowledge economy); Stern, *supra* note 153, at 249.

287 Peter F. Drucker, *Knowledge-Worker Productivity: The Biggest Challenge*, 41 CAL. MGMT. REV. 79, 79 (1999) (emphasis removed).

ble. There is general agreement among business observers and analysts that the big contributors to business success are a company's people, its customers, its knowledge base, and its reputation."[288]

Scholars, policymakers, and regulators have extensively studied the failure of businesses to report the value of their workers (and more broadly, intangible assets) on their financial statements, and on the basis of those studies, have formulated many reform proposals.[289] There continues to be a great deal of debate over the appropriate way to provide information about internally created intangible assets and worker productivity. Proposals run the gamut, from the inclusion of these items as assets on the balance sheet to the encouragement of businesses to disclose nonfinancial metrics, such as workers' average experience levels and retention periods as well as the extent of worker training.[290] There is, however, no debate about the high cost of the failure to correct these accounting mistakes. "If we don't understand what is happening in our economy at the basic level of the firm, then all our business and economic decisions are suspect. Capital may be misallocated, opportunities wasted, resources misused and detrimental policies adopted."[291]

In comparison to the accounting field, tax scholars and policymakers have paid scant attention to the undervaluation of workers by

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288 STEERING COMM. OF THE FIN. ACCOUNTING STANDARDS BD., IMPROVING BUSINESS REPORTING 22 (2001), http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175819611134&blobheader=application%2Fpdf.

289 *See* BARUCH LEV, INTANGIBLES 86–91, 107–27 (2001) (attributing the disclosure failure to "the politics of intangibles' disclosure" and proposing a solution that facilitates "two of the major forces characterizing modern economies: the democratization and the externalization of decisionmaking processes both within organizations and in capital markets"); WAYNE S. UPTON, JR., FIN. ACCOUNTING STANDARDS BD., BUSINESS AND FINANCIAL REPORTING: CHALLENGES FROM THE NEW ECONOMY 1, 3 (2001), http://www.fasb.org/articles&reports/sr_new_economy.pdf (offering three propositions to enable "accounting to keep pace with a changing economy"); KENAN PATRICK JARBOE, ATHENA ALLIANCE, REPORTING INTANGIBLES 5–7, 10 (2005), http://www.athenaalliance.org/pdf/ReportingIntangibles.pdf (discussing the proposals of a number of organizations); Robert S. Kaplan, *Conceptual Foundations of the Balanced Scorecard*, *in* 3 HANDBOOK OF MANAGEMENT ACCOUNTING RESEARCH 1253, 1253–68 (Christopher S. Chapman et al. eds., 2009) (discussing the success of the "balanced scorecard," which "retains financial metrics as the ultimate measures for company success, but supplements these with metrics from three additional perspectives (customer, internal process, and learning and growth)"); Philip Siegel and Carl Borgia, *The Measurement and Recognition of Intangible Assets*, 1 J. BUS. & PUB. AFFAIRS, para. 18–20, 50–52 (2007), *available at* http://www.scientificjournals.org/journals2007/articles/1006.htm (demonstrating how accounting standards fail to measure correctly or recognize fully intangible assets, in an effort to "lead to the reporting of quality earnings that reflect the qualities of relevance and reliability").

290 *See* JARBOE, *supra* note 289, at 20–25 (describing various proposals to account for intangible assets).

291 *Id.* at 2.

businesses in the twenty-first century economy. To be sure, they have noted the increasing importance of intangible assets in the U.S. economy.[292] Furthermore, they are cognizant that intangible assets like goodwill and know-how are tax favored, relative to other assets, because the costs incurred to produce these intangible assets—in large part labor—are immediately deductible.[293] However, the twenty-first century economy has prompted little in the way of tax research and reform proposals. In surveying the tax literature on depreciation of intangible assets, David A. Weisbach finds depreciation to be fraught with intractable measurement problems and gloomily concludes that "[t]here have been essentially no attempts in the last 20 years . . . to gather data on how depreciation patterns have changed in response to technology, which means that it is not clear that current law can easily be made any more accurate."[294] Weisbach's pessimism cannot be ignored, but the implications of a reconception of workers as major contributors to productivity are too profound to simply throw up one's hands. Efforts in the accounting world inspire some hope that the tax system can likewise be improved.[295] Many of the tax issues surrounding the twenty-first-century economy have to do with the law's timing of recovery for investments related to a dedicated and skilled work force. Reform proposals related to these types of capitalization ques-

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292 *See* DEP'T OF THE TREASURY, *supra* note 265, at 25 (discussing depreciation and deductions for intangible assets); David A. Weisbach, *Measurement and Tax Depreciation Policy: The Case of Short-Term Intangibles*, 33 J. LEGAL STUD. 199, 201 (2004) (addressing whether "intangibles that are likely to have a short life should be treated differently than intangibles with a long expected life").

293 *See* DEP'T OF THE TREASURY, *supra* note 265, at 39–40 (explaining that low tax rates on intangibles, such as workers' training, may encourage investment in those intangibles); Weisbach, *supra* note 292, at 206–07 (noting the immediate benefit of certain types of intangible assets and comparing the 3.8% effective tax rate on intangible assets to the economy-wide average of 21.5%); Yale, *supra* note 130, at 565 (making similar observations).

294 Weisbach, *supra* note 292, at 207.

295 *See generally supra* notes 288–91 and accompanying text. The contrast between the accounting and tax fields is perhaps unsurprising, given that from the self-interested standpoint of business owners, the preferred outcomes are at polar opposites: their "capitalizing" worker investments for accounting purposes (that is, their reporting them as assets on the balance sheet), rather than "expensing" them, has the salutary effect of increased profits reported to investors; their capitalizing worker investments for tax purposes, rather than deducting them, has the undesirable effect of increased taxable income and higher taxes. Accordingly, for accounting purposes, business owners have an interest in "getting it right," and accurately reflecting the value of their investments in workers, while for tax purposes, they have an interest in "getting it wrong," and deducting costs whenever possible. *See* Olufunmilayo B. Arewa, *Measuring and Representing the Knowledge Economy: Accounting for Economic Reality Under the Intangibles Paradigm*, 54 BUFF. L. REV. 1, 66–80 (2006) (describing the challenges and uncertainties arising from previous attempts to account for intangibles in financial reporting and how they facilitated fraudulent overstatements of the value of intangible assets by Enron and other corporations).

tions are beyond the scope of this Article and need to be addressed separately. What is worthy of note, however, is that such a project starts with the recognition of workers as producers.

V. Tax Reform Implications

This Article has shown how our modern income tax regime has, from its inception, reflected and contributed to a cultural, economic, and political environment that overvalues business owners' and undervalues workers' contributions to production and economic growth. For Congress to address the inefficiencies resulting from the costly mistakes of undertaxation of business owners and overtaxation of workers and thus make the tax law more responsive to the twenty-first-century economy, it must commit itself to reforms that further the following three goals: (1) establish the worker as a producer, (2) curb the deference traditionally accorded business owners, and (3) reconceive the meaning of investment for businesses and the meaning of consumption for workers. Congress has an array of paths for achieving these goals, and its transition toward a tax law that neither undertaxes business owners nor overtaxes workers will undoubtedly be marked by incoherent compromises. Nevertheless, if tax policy debates were responsive to these three goals, a redefinition of the tax base for all income producers, whether they are business owners or workers, starts to become achievable. Additionally, long-held tax principles that treat most, if not all, of business owners' expenditures as investments and most, if not all, of workers' income-producing costs as consumption would no longer go unchallenged.

The debate we are encouraging policymakers to have will have an immediate effect on two major tax policy areas: the consumption tax and tax expenditure analysis. Notwithstanding the richness of the research on proposals to substitute or supplement the current income tax with a consumption tax, few tax scholars and policymakers have addressed the question whether businesses consume.[296] The underly-

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296 The modern debate between a consumption tax and an income tax began with William Andrews' article, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974). It was followed by a number of articles and books debating questions of fairness and economic efficiency. *See, e.g.*, DAVID F. BRADFORD & U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM (2d ed. 1984); ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed. 1995); EDWARD J. MCCAFFERY, FAIR NOT FLAT: HOW TO MAKE THE TAX SYSTEM BETTER AND SIMPLER (2002); LAURENCE S. SEIDMAN, THE USA TAX: A PROGRESSIVE CONSUMPTION TAX (1997); William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975); Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961 (1992); Alvin C. Warren, Jr., *Fairness and a Con-*

ing premise in their discussions is that all expenditures incurred by a business represent investments and, therefore, should escape taxation. As Michael J. Graetz stated in his discussion of the implications of an individual consumption tax, "a decision to move to a tax on consumption at the individual level . . . implies elimination of taxes on business income; businesses are engaged in production, not consumption."[297] In their discussions of the consumption tax, a few scholars have considered the expenditures that workers incur in the production of income, but not as part of a sustained analysis; likewise, consumption tax scholarship has continued to consider the worker primarily as a consumer and not a producer.[298] If those who study the consumption tax were to consider what it would mean to curb the traditional defer-

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sumption-Type or Cash Flow Personal Income Tax, 88 HARV. L. REV. 931 (1975). In more recent years, risk analysis has dominated scholarly discussions of the consumption tax. *See, e.g.*, Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter?*, 47 TAX L. REV. 377 (1992); Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006); David A. Weisbach, *The (Non)Taxation of Risk*, 58 TAX L. REV. 1 (2004); Lawrence Zelenak, *The Sometimes-Taxation of the Returns to Risk-Bearing Under a Progressive Income Tax*, 59 SMU L. REV. 879 (2006). For a rare example of a scholar questioning whether some expenditures represent consumption by the business because they do not contribute to the production of income, see Roy, *supra* note 2, at 182–84.

297 Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1636 (1979).

298 For example, when Graetz considers how a consumption tax, rather than an income tax, might differently draw the distinction between personal and business expenditures, he suggests that a consumption tax

> would focus not on the taxpayer's motivation or potential business benefits, but instead on the consumption aspects of such expenditures. Deductions would be disallowed to the extent that immediate personal benefits are enjoyed, while costs associated with deferred consumption would be deductible as saving. Deductions for travel, meals, lodging, and entertainment, for example, would be more limited than under the current income tax. On the other hand, items such as educational expenses, job-seeking expenses, and legal expenses which do not tend to provide current consumption benefits would probably be more generally deductible than under the income tax.

Id. at 1589. When Edward J. McCaffery considers the implementation of the consumption tax, he acknowledges that the tax could provide for exclusions for health, child care, and perhaps educational expenditures. MCCAFFERY, *supra* note 296, at 89, 130, 155. Except for child care, however, he discusses these categories of expenditures as exceptional consumption items rather than as costs incurred to earn income. *Id.* at 155; *see also* SEIDMAN, *supra* note 296, at 92–94 (under a consumption tax regime, advocating that at least a portion of the costs of higher education and vocational training be treated as investment and not consumption). *But see* HALL & RABUSHKA, *supra* note 296, at 107, 114–15 (justifying a consumption tax that treats all medical and child care costs as consumption while omitting any consideration of educational expenditures and arguing that "the special problems of helping families with child care and other responsibilities should be attacked specifically within the welfare system, not with the scattergun of the tax system").

ence accorded to business owners, treat workers as producers, and reconceive the meaning of investment and consumption, both proponents and opponents would find much that is missing in the current literature.

For many of the same reasons, the work done to date on tax expenditure analysis—which is dedicated essentially to the identification of those provisions of the current tax system that deviate from the Schanz-Haig-Simons ideal tax base—needs to be rethought.[299] Once the analysts treat workers as producers, those items traditionally identified as tax expenditures, such as health care or child care, would be recategorized, at least in part, as exclusions (if provided by an employer) or recoverable costs (if incurred by the worker); this analysis assures that the tax law accurately reflects a worker's taxable income. By contrast, once analysts no longer defer to the judgment of business owners, those myriad costs that they have left virtually unexamined may find their way on to a list of tax expenditures.

The importance of renewed tax policy discussions regarding the consumption tax and tax expenditure analysis should not be underestimated. Tax scholars and policymakers look to these two research areas often when they are proposing tax reforms. Moreover, in recent years, these two research areas have set the agenda for policy discussions concerning fairness, progressivity, economic growth, and simplification.[300]

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299 Some scholars tentatively have begun to address these questions. *See, e.g.*, J. Clifton Fleming, Jr. & Robert J. Peroni, *Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the "New Paradigm" and Its Denouement*, 30 VA. TAX REV. 135, 163 (2010) ("[Schanz-Haig-Simons] is not the exclusive criterion of good tax policy. It must be weighted against other important criteria . . . . Nevertheless, the SHS definition does provide a principled structure that is useful for testing the efficacy of tax provisions and opposing ill-advised tax policy moves."); Edward D. Kleinbard, *The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes*, 36 OHIO N.U. L. REV. 1, 4–5 (2010) (discussing criticisms of current tax expenditure analysis and calling "important . . . the charge that the 'normal' tax baseline ha[s] no logical foundation and appear[s] to be used to advance a normative goal"); Linda Sugin, *Tax Expenditures, Reform, and Distributive Justice*, 3 COLUM. J. TAX L. 1, 39–41 (2011) (noting that "[t]ax expenditures differ from each other because they reflect different spending policies, and consequently, cannot be treated as monolithic," and suggesting four categories of expenditures in order to provide nuance to the debate over the propriety of expenditures).

300 *See, e.g.*, STAFF OF J. COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 1 (Comm. Print 2008) (recognizing that current tax expenditure analysis "no longer provides policymakers with credible insights into the equity, efficiency, and ease of administration issues raised by a new proposal or by present law" and ultimately advocating a "new paradigm for classifying tax provisions as tax expenditures"); STAFF OF J. COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES (Comm. Print 2005) (proposing to reform a large number of individual-related and

As for what difference it would make to revamp the income tax law to treat workers as producers, one obvious reform would be to treat workers' income-producing costs the same as the costs incurred by business owners. Workers' costs would no longer be subject to limitations as itemized deductions.[301] Instead, the Code could define AGI under I.R.C. § 62 to include any expenditure allowable to a worker as a cost incurred to produce income. As indicated above, there are other provisions in the Code that deny workers the full status of a producer. For example, I.R.C. § 163(h) treats interest paid on loans allocable to the "trade or business of performing services as an employee" as personal interest and not deductible, whereas it allows for the deductibility of interest paid or accrued on indebtedness allocable to all other trades or businesses.[302] A final structural issue that a revamped tax law could address would be to reform the Code so that it no longer uses an employer's judgment to determine whether income in kind should be excludible to a worker.[303] This change would include elimination of the distinction between reimbursed and unreimbursed expenditures.[304] A worker's expenditure, whether reimbursed or not, would be recoverable so long as it otherwise qualifies under the general rules applicable to all income producers. Similarly, the tax law should eliminate concepts such as the convenience-of-the-employer requirement found in I.R.C. § 119.[305] Such rules merely perpetuate *Welch*'s business deference approach. Instead, the tax rules should focus on workers as producers and ask whether workers' expenditures increase their productivity.

The proposed structural changes are likely to engender criticisms concerning administrability. The removal of employees' expenditures

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business-related tax expenditures); BIPARTISAN POLICY CTR., RESTORING AMERICA'S FUTURE 12 (2010) (recommending, inter alia, a broader tax base, a limitation on, or the elimination of, many deductions and credits, and the adoption of a 6.5% "national Debt Reduction Sales Tax"); NAT'L COMM'N ON FISCAL RESPONSIBILITY & REFORM, THE MOMENT OF TRUTH 29–32 (2010) (advocating a "zero-base budgeting" approach, which would "eliminat[e] all income tax expenditure"); PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 55–57 (2005) (discussing the implications of a proposal to adopt a consumption tax base); PRESIDENT'S ECON. RECOVERY ADVISORY BD., *supra* note 262, at 77–80 (proposing the elimination or reduction of tax expenditures).

301 *See supra* notes 198–205 and accompanying text. There is some precedent for this approach under current law: moving expenses are deductible above the line for all workers, whether they are employees or self-employed. *See* I.R.C. §§ 62(a)(15), 217 (2006).

302 I.R.C. § 163(h)(2)(A). For a more detailed discussion of this section, see *supra* notes 247–48 and accompanying text.

303 *See supra* Part II.C.2.

304 *See supra* Part II.C.3.

305 *See supra* Part II.C.2.a.

from the categories of itemized and miscellaneous deductions undoubtedly increases the opportunity for erroneous calculation—both intentional and unintentional—of taxable income and thus puts significantly more pressure on the IRS to develop effective auditing procedures. However, one problem with this argument is that administrability concerns are not qualitatively different for employees than for self-employed taxpayers. Limitations on deductions may be appropriate for the fair and orderly administration of the income tax law, but those limitations should not turn on whether the taxpayer is an employee or a business owner. This particular criticism also ignores that the proposed structural changes reduce complexity, because the tax law would no longer require taxpayers to allocate expenditures between income from a business and income from employment. In particular, the growth of part-time employment and the increase in the number of persons who operate as independent contractors over the last several decades have created significant auditing issues.[306] These trends are only likely to continue and represent yet another example of how the current tax law does not meet the needs of the U.S. economy in the twenty-first century.[307] To the extent that this Article's proposed structural changes do create compliance problems, perhaps Congress could consider a standard deduction for income producers as an alternative to itemization of the costs they incur to produce income. However Congress decides to define and implement the concept of AGI, it is crucial that the tax law treat business owners and workers in the same manner. This one basic concept, perhaps more than any other, assures that workers share with business owners the status of producers.

Even if Congress is able to redress the Code's structural problems so as to eliminate the disparate tax treatment of business owners and workers, it must still face the question of what workers' expenditures should be recoverable consistent with the Schanz-Haig-Simons definition of taxable income. Consideration, for example, of educational

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306 *See* Karen R. Harned et al., *Creating a Workable Legal Standard for Defining an Independent Contractor*, 4 J. BUS. ENTREPRENEURSHIP & L. 93, 93–94 (2010) (noting that the number of "non-traditional work arrangements is increasing" and that "[a]udits for [worker] misclassifications are becoming more frequent"). In early 2005, 10.3 million Americans were independent contractors. News Release, Bureau of Labor Statistics, Contingent and Alternative Employment Arrangements 5 (July 27, 2005), *available at* http://www.bls.gov/news.release/conemp.nr0.htm.

307 MBO PARTNERS, THE STATE OF INDEPENDENCE IN AMERICA 3 (2011), http://info.mbopartners.com/rs/mbo/images/MBO%20Partners%20Independent%20Workforce%20Index%202011.pdf (noting that the U.S. independent workforce is expected "to grow more than 20 million over the next two years").

expenditures demonstrates both the challenge and the potential of what it would mean in practice to establish the worker as a producer, curb the deference traditionally accorded business owners, and reconceive the meaning of investment for businesses and the meaning of consumption for workers. With regard to education, current law is a patchwork of rules that are difficult to reconcile with each other.[308] In disallowing most deductions for education (except for certain expenditures for higher education), the courts and the IRS have struggled to draw an impossible line between investments in future income production and what the IRS calls an "inseparable aggregate of personal and capital expenditures."[309]

The better approach would be to start with the premise that educational expenses are an investment in the production of income, but that they may not be deductible where they are too remote—i.e., too speculative or tangential to the production of income—when judged at the time the educational expenses are incurred. Under this approach, one might find the costs of high school or a college education too remote to allow for their deductability. Once taxpayers enroll in training programs, professional schools, or graduate schools, however, the connection to income from a trade or business is sufficiently direct to allow for recovery of educational expenses either immediately or over a reasonable number of years as workers obtain employment in their respective areas of newly acquired expertise. This remoteness criterion also places workers' expenditures for child care, health care, commuting, clothing, and other similar outlays in a different light when it demands that the following question be asked: Is an expenditure too speculative or too tangential to a worker's ability to earn income? Whereas current law treats all these expenditures as personal and, if it allows any recovery, views that recovery as a tax expenditure and not an investment under the Schanz-Haig-Simons definition of income,[310] the remoteness criterion provides a fair and practical means for the law to acknowledge workers' income-producing costs.

In fact, that is the central importance of the remoteness criterion. In the twenty-first century economy, where business owners no longer promise their employees economic security and rely heavily on temporary workers, freelancers, and other types of independent contractors, workers have to take more responsibility for their skill levels, health, and family obligations to assure that they are, and remain, pro-

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308 *See supra* notes 160–72 and accompanying text.

309 Treas. Reg. § 1.162-5(b)(1) (2012).

310 *See generally supra* Part III.A–B.

ductive in the work place. The remoteness criterion acknowledges that they, like their business owner counterparts, contribute to economic growth. With its adoption, the tax law would not treat most, if not all, of workers' expenditures as consumption, but would recognize that at least some part of many of their expenditures represents investments in themselves as producers.

Yet another hurdle faced by tax rules that allow recovery for the costs of education, child care, commuting, and other similar outlays is that, even if an expenditure is not deemed too remote, it may still represent a mix of consumption and investment. Accordingly, some cost constraints on these items would seem appropriate. For example, recovery for clothing expenditures could be allowed as a deduction, but only to a maximum limit based on a percentage of the worker's salary. Further, commuting expenditures could be made available to those workers who can demonstrate limits on their choice of where to live. For example, a two-worker family might be able to recover commuting expenditures for the one worker whose work is the furthest away.

It is important to see how the remoteness criterion and cost constraint rule work together to determine which expenditures are recoverable and provide a path for the tax law to treat the worker as a producer. The remoteness criterion does not allow the business/personal dichotomy to short-circuit the question of whether workers' expenditures directly—rather than speculatively or tangentially—increase their income or reduce their income-producing costs. The fact that a cost constraint rule would limit recovery of an expenditure having to do with education, health care, or the like should make it that much easier to acknowledge that these types of items have a direct connection, in whole or in part, to the production of income.

If the remoteness criterion and cost constraint rule can distinguish workers' investments from their consumption, an obvious question to ask is whether they should be used to distinguish business owners' investments from their consumption. The application of both the remoteness criterion and cost constraint rule would challenge the tradition of deference to the judgment of business owners at the same time that it would reduce the distinction between business owners and workers as producers. As between the remoteness criterion and cost constraint rule, the latter seems the easiest to introduce into the Code. For the most part, current law generally defers to the judgment of the business owner in such a way that many expenditures that are a mix of consumption and investment are treated as investment and, therefore, recoverable.[311] Current law, however, does make some exceptions that come close to the cost constraint rule with regard to mixed expenditures incurred by workers.

For example, the Code generally limits the deduction for business meals and entertainment to fifty percent of their cost[312] and denies a deduction if the costs are "lavish or extravagant under the circumstances."[313] It also places limitations on the amount of depreciation deductions and rental deductions available for luxury automobiles.[314] It is no surprise that things like business meals, entertainment, and automobiles have captured the attention of Congress, because these types of expenditures have such an obvious and significant consumption component. Deference to business judgment, however, has left a whole range of other expenditures beyond review. We have in mind a host of other expenditures that, although necessary to carry on a trade or business, should nevertheless not be recoverable to the extent that the expenditure exceeds pre-established limits. One place that Congress might look to establish these proposed cost constraints is to the government standards, developed by the U.S. General Services Administration, which cover a wide range of expenditures for land, buildings, equipment, travel, etc. The effect of the cost constraints may be that some employees who enjoy, for example, mahogany desks and travel to highly desirable locations will have to recognize income to the extent that the cost of these luxury items exceed pre-established limits. In that case, the employer may still be able to recover the expenditure, because it represents salary or wages in kind. Alternatively, the amount an expenditure exceeds a cost limit may constitute business waste and, therefore, would be unrecoverable to the business owner.[315] Whether recoverable by the business owner or not, the injection of cost constraints into the tax law means that the progressivity of the tax law will be enhanced, because the taxable income of some workers, in particular those holding upper management positions, will be identified more accurately.

The remoteness criterion is only hinted at under current law[316] and would go the furthest to challenge deference to business owners

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311 *See supra* Part II.A.

312 I.R.C. § 274(n) (2006).

313 *Id.* § 274(k)(1)(A).

314 *See id.* § 280F.

315 *See supra* notes 140–41 and accompanying text.

316 *See* Trust Under the Will of Bingham v. Comm'r, 325 U.S. 365, 376 (1945) (holding that expenses must be "directly connected with or proximately result from" the conduct of the business); Kornhauser v. United States, 276 U.S. 145, 153 (1928) (holding that "where a suit or action

and, ultimately, policymakers' traditional understanding of the Schanz-Haig-Simons definition of income. Although the full implications of a remoteness criterion for business owners would require extensive analysis and need to be the subject of a separate article, it is intriguing to think about what type of expenditures would be unrecoverable if a business owner were required to demonstrate that the economic benefit (meaning either increases in revenue or reductions in costs) resulting from an expenditure is neither too speculative nor too tangential. Questionable cost recoveries under the remoteness criterion would seem to include, for example, costs incurred to effectuate a merger or expansion, if the merger or expansion fails to occur or if its benefits are merely speculative or incidental. If, indeed, costs that provide only speculative or incidental benefits are not recoverable, then other types of expenditures, such as business expansion costs, research and development costs, environmental cleanup costs, oil and gas exploration costs, and pre-publication costs, warrant closer scrutiny. The remoteness criterion might even call into question outlays as basic as property taxes on business property, which seem to have little or no obvious effect on a business's revenue or other costs in a year.

What appeared as a quite workable and modest criterion when applied to determine what expenditures incurred by a worker warranted recovery under the tax law seems far-reaching and radical when applied to business owners. And that may be the most important lesson to be learned from this Article. Once workers occupy the center of tax analysis, not only can conventional rules of taxation no longer withstand scrutiny, but the meaning of taxable income itself profoundly changes.

Conclusion

Tax reform has taken on heightened importance in recent years as policymakers seek to reduce the jobs deficit in the private sector and deficit spending in the public sector. This Article provides a framework for tax reform that addresses both of these challenges by placing workers at the center of its analysis. This Article demonstrates the inextricable link between an accurate definition of income and the need for a trained, creative, and reliable workforce to produce that income. It further demonstrates that the tax law can meet the

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against a taxpayer is directly connected with, or . . . proximately resulted from, his business, the expense incurred is a business expense" (citations omitted)); Treas. Reg. § 1.162-1(a) (2012) ("Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business . . . .").

economic and social challenges of the twenty-first century only if it treats both business owners and workers as agents of economic growth. Once policymakers reject an income tax regime that for nearly a hundred years has lionized business owners for their skill and acumen and misjudged workers as primarily consumers, they can begin to imagine an income tax that adheres to the principles underlying the ideal definition of income and enhances the efficiency and growth of the U.S. economy.

Answers must be provided to address (1) the administrative concerns about the feasibility of proposals to correct these costly mistakes; (2) unease about a significant reduction of the tax base in recognition of workers' income-producing costs; and (3) apprehension that a recognition of workers as producers may benefit high-income workers more than low-income workers and, thereby, undermine efforts to maintain a progressive tax system. These issues should not deter a serious analysis of the costly mistakes this Article has identified. What the central thesis of this Article shows is that the current tax regime is no longer, if it ever was, an acceptable option and that reform of these costly mistakes is essential. Once implemented, the reforms will more closely align the definition of taxable income with the Schanz-Haig-Simons ideal. That means the tax system will array all taxpayers—business owners and workers—more properly in accordance with their ability to pay and will greatly inform and affect the resulting progressive schedule of tax rates.

No one doubts that highly skilled and dedicated workers have the potential to expand the private sector and provide ever more job opportunities. Further, no one questions the proposition that highly skilled and dedicated workers can lead the public sector to do more for less. What this Article shows is that the success of the U.S. economy in the twenty-first century requires the tax law to treat both business owners and workers as producers. It also shows that the tax law's continuing failure to treat business owners and workers as both consumers and producers undermines the goals of efficiency and fairness.