Chapter 5: Deductions

A. Introduction

Corporate taxpayers file a form 1120 with the IRS each year. On this form, the corporation lists all items of its gross income as well as all its allowable deductions, and the excess (if any) of gross income over deductions is the corporation's taxable income. §63(a). The corporation then multiplies its tax rate of 21% times its taxable income to determine its tax liability. That tax liability is then reduced for tax payments made throughout the year as well as for any other tax credits, and the resulting tax liability is then owed to the government.

For noncorporate taxpayers, the computation is slightly more complex. If an individual engages in one or more trades or businesses (excluding the trade or business of being an employee), the taxpayer lists the items of gross income and allowable deductions allocable to the trade or business on a Schedule C that will be included with the basic 1040 form. A separate schedule C is prepared and filed for each distinct trade or business (excluding the trade or business of being an employee).

The taxpayer's form 1040 includes all items of gross income as well as the net income or loss from each trade or business, and the total of these items is called the taxpayer's "adjusted gross income." §62[1]. All deductions that can be claimed by the taxpayer that are not allocable to a trade or business are then listed on schedule A, also filed with the taxpayer's form 1040. Such deductions include employee business expenses, expenses incurred in connection with investment activity, and deductions allowable to the taxpayer but not connected to any profit-seeking activity such as the deduction for certain home mortgage interest payments (deductions unconnected to profit-seeking activity usually are called "personal" deductions). All the deductions reported on Schedule A are called "itemized" deductions. See §63(d).

The taxpayer is permitted to claim her itemized deductions, but she also is permitted to claim her "standard" deduction in lieu of her itemized deductions. See §63(b). For a married couple filing a joint return (as well as for a surviving spouse), the standard deduction is $24,000. §§63(c)(2)(A), 63(c)(7)(A)(ii). For unmarried taxpayers as well as for married taxpayers filing separately, the standard deduction is $12,000. §§63(c)(2)(C), 63(c)(7)(A)(ii), Accordingly, a taxpayer will claim her itemized deductions only if they, in the aggregate, exceed the applicable standard deduction. Note than if a married couple has, say, $28,000 of itemized deductions, the couple benefits from those deductions only to the extent of $4,000: if they had no itemized deductions, they would be still able to claim their standard deduction of $24,000. The excess of the taxpayer's adjusted gross income over her itemized deduction or standard deduction (whichever is used by the

[1] Certain employee business expenses are allowed as business deductions rather than itemized deduction. See §62(a)(2).

taxpayer) is her taxable income, and that taxable income is taxed in accordance with the rate schedules in §1.

1. Itemized Deductions

Itemized deductions of individual taxpayers (that is, deductions that are claimed on Schedule A rather than on Schedule C in connection with a trade or business) include the following: deductible interest under §163 paid in connection with investment activity as well as allowable home mortgage interest; state and local income taxes under §164(a)(3) (including state income taxes arising from both trades and businesses and investment activity) and state property taxes under §164(a)(1)-(2) imposed on property not held for the production of income; excess medical deductions as defined in §213; ordinary and necessary expenditures deductible under 212 incurred in connection with investment activity (as opposed to a trade or business); most ordinary and necessary expenditures deductible under §162 incurred in connection with the trade or business of being an employee;[2] and charitable contributions under §170.

2. Miscellaneous Itemized Deductions

An individual taxpayer's itemized deductions[3] can be divided into two categories: "miscellaneous itemized deductions" and other itemized deductions. The category of miscellaneous itemized deductions id defined in §67(b) by exclusion: they are all itemized deductions *other than* those listed in §67(b). The most important miscellaneous itemized deductions are ordinary and necessary expenditures incurred in connection with profit-seeking activity that does not rise to the level of a trade or business (i.e., investment expenses) and most employee business expenses.[4]

Historically, a taxpayer's miscellaneous itemized deductions could be claimed only to the extent they exceeded 2% of the taxpayers adjusted gross income.[5] §67(a)(2). So, for example, if a taxpayer had wages of $100,000, no business deductions, and miscellaneous itemized deductions of $3,500, the taxpayer could claim only $1,500 of her itemized deductions. The 2% floor imposed by §67(a) was called the "two-percent haircut" imposed on miscellaneous itemized deductions.

When Congress cut the corporate tax rate to 21% and dramatically expanded bonus depreciation under §168(k) as part of the TCJA of 2017, it needed to raise revenue to offset this loss of corporate revenue. One way it did this was by eliminating all miscellaneous itemized deductions. §67(g). This substantially changes the calculus in making investments because many of the costs associated with investment now are not

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[2] For those employee business expenditures allowable without itemizing, see §62(a)(2).

[3] Recall that corporate taxpayers do not itemize deductions nor claim a standard deduction: all activities of a corporate taxpayer are treated as incurred in connection with a trade or business.

[4] Some employee business expenses are not itemized deductions and so cannot be "miscellaneous itemized deductions." See §62(a)(2).

[5] Recall that "adjusted gross income" equals gross income less those deductions that are not itemized (i.e., deductions incurred in connection with a trade or business other than the trade or business of being an employee).

deductible. For example, investment advisors who charge a fee for service now must explain to their clients that their fees no longer are deductible.

Question

Q-1. How might an investment advisor restructure her compensation arrangement to give some tax benefit to her clients for the cost of her service?

B. Business Deductions

1. What is a Trade or Business

While the phrase "trade or business" is used throughout the Internal Revenue Code, it is not defined in any statutory provision. The government has long argued that a taxpayer is engaged in a trade or business only if the taxpayer has a profit-seeking intention and holds herself out as selling goods or services to customers. But the courts have not embraced this definition. However, the courts have agreed that all profit-seeking activities of a *corporate* taxpayer are treated as arising in connection with the corporation's trade or business.

Higgins v. Commissioner

312 U.S. 212 (1941)

MR. JUSTICE REED delivered the opinion of the Court.

Petitioner, the taxpayer, with extensive investments in real estate, bonds and stocks, devoted a considerable portion of his time to the oversight of his interests and hired others to assist him in offices rented for that purpose. For the tax years in question, 1932 and 1933, he claimed the salaries and expenses incident to looking after his properties were deductible under [the predecessor of §162.] The Commissioner refused the deductions. The applicable phrases are: 'In computing net income there shall be allowed as deductions: (a) Expenses. * * * All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.' There is no dispute over whether the claimed deductions are ordinary and necessary expenses. As the Commissioner also conceded before the Board of Tax Appeals that the real estate activities of the petitioner in renting buildings constituted a business, the Board allowed such portions of the claimed deductions as were fairly allocable to the handling of the real estate. The same offices and staffs handled both real estate and security matters. After this adjustment there remained for the year 1932 over twenty and for the year 1933 over sixteen thousand dollars expended for managing the stocks and bonds.

Petitioner's financial affairs were conducted through his New York office pursuant to his personal detailed instructions. His residence was in Paris, France, where he had a second office. By cable, telephone and mail, petitioner kept a watchful eye over his securities. While he sought permanent investments, changes, redemptions, maturities and accumulations caused limited shiftings in his portfolio. These were made under his own orders. The offices kept records, received securities, interest and

dividend checks, made deposits, forwarded weekly and annual reports and undertook generally the care of the investments as instructed by the owner. Purchases were made by a financial institution. Petitioner did not participate directly or indirectly in the management of the corporations in which he held stock or bonds. The method of handling his affairs under examination had been employed by petitioner for more than thirty years. No objection to the deductions had previously been made by the Government.

The Board of Tax Appeals held that these activities did not constitute carrying on a business and that the expenses were capable of apportionment between the real estate and the investments. The Circuit Court of Appeals affirmed, and we granted certiorari . . . .

Petitioner urges that the 'elements of continuity, constant repetition, regularity and extent' differentiate his activities from the occasional like actions of the small investor. His activity is and the occasional action is not 'carrying on business.' On the other hand, the respondent urges that 'mere personal investment activities never constitute carrying on a trade or business, no matter how much of one's time or of one's employees' time they may occupy.'

Since the first income tax act, the provisions authorizing business deductions have varied only slightly. The Revenue Act of 1913 allowed as a deduction 'the necessary expenses actually paid in carrying on any business.' By 1918 the present form was fixed and has so continued. No regulation has ever been promulgated which interprets the meaning of 'carrying on a business,' nor any rulings approved by the Secretary of the Treasury, i.e., Treasury Decisions. Certain rulings of less dignity, favorable to petitioner, appeared in individual cases but they are not determinative.

Even acquiescence in some Board rulings after defeat does not amount to settled administrative practice. Unless the administrative practice is long continued and substantially uniform in the Bureau and without challenge by the Government in the Board and courts, it should not be assumed, from rulings of this class, that Congressional reenactment of the language which they construed was an adoption of their interpretation.

. . . .

Petitioner relies strongly on the definition of business in Flint v. Stone Tracy Company: "Business' is a very comprehensive term and embraces everything about which a person can be employed.' This definition was given in considering whether certain corporations came under the Corporation Tax law which levies a tax on corporations engaged in business. The immediate issue was whether corporations engaged principally in the 'holding and management of real estate' were subject to the act. A definition given for such an issue is not controlling in this dissimilar inquiry.

To determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case. As the Circuit Court of Appeals observed, all expenses of every business transaction are not deductible. Only those are deductible which relate to carrying on a business. The Bureau of Internal Revenue has this duty of determining what is carrying on a business, subject to reexamination of the facts by the Board of Tax Appeals and ultimately to review on the law by the courts on which jurisdiction is conferred. The Commissioner and the Board appraised the evidence here as insufficient to establish petitioner's activities as those of carrying on a business. The petitioner merely kept records and collected interest and dividends from his securities, through managerial attention for his investments. No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board. Its conclusion is adequately supported by this record, and rests upon a conception of carrying on business similar to that expressed by this Court for an antecedent section.

The petitioner makes the point that his activities in managing his estate, both realty and personalty, were a unified business. Since it was admittedly a business in so far as the realty is concerned, he urges, there is no statutory authority to sever expenses allocable to the securities. But we see no reason why expenses not attributable, as we have just held these are not, to carrying on business cannot be apportioned. It is not unusual to allocate expenses paid for services partly personal and partly business.

Affirmed.

Note

1. *The short life and subsequent resurrection of the* Higgins *decision*. *Higgins* deferred to the Tax Court's determination that some profit-seeking activities did not fall within the statutory term "trade or business,"[6] and so ordinary and necessary expenditures made in connection with such activites were not deductible. Because an income tax demands that expenditures made in attempting to generate income must be deductible (at some point), the *Higgins* decision could not stand. Congress could have defined "trade or business" to include all profit-seeking activity but instead added the predecessor of §212(1)-(2). However, Congress has endorsed drawing a line between a "trade or business" and other profit-seeking activity in a variety of Code provisions. See, e.g., §166(d) (nonbusiness bad debts), 199A (qualified business income), 280A(c)(1) (allowance of certain expenses in connection with business use of a home), §1231(b).

[6] The Tax Court began as an administrative court located within the Internal Revenue Service called the Board of Tax Appeals. The Tax Court is now an independent court created by Congress under Article I of the Constitution.

Commissioner v. Groetzinger

480 U.S. 23 (1987)

JUSTICE BLACKMUN delivered the opinion of the Court.

The issue in this case is whether a full-time gambler who makes wagers solely for his own account is engaged in a "trade or business," within the meaning of §§ 162(a) and 62(1) of the Internal Revenue Code of 1954, as amended. The tax year with which we here are concerned is the calendar year 1978; technically, then, we look to the Code as it read at that time.

. . . Respondent Robert P. Groetzinger had worked for 20 years in sales and market research for an Illinois manufacturer when his position was terminated in February 1978. During the remainder of that year, respondent busied himself with parimutuel wagering, primarily on greyhound races. He gambled at tracks in Florida and Colorado. He went to the track 6 days a week for 48 weeks in 1978. He spent a substantial amount of time studying racing forms, programs, and other materials. He devoted from 60 to 80 hours each week to these gambling-related endeavors. He never placed bets on behalf of any other person, or sold tips, or collected commissions for placing bets, or functioned as a bookmaker. He gambled solely for his own account. He had no other profession or type of employment.

Respondent kept a detailed accounting of his wagers and every day noted his winnings and losses in a record book. In 1978, he had gross winnings of $70,000, but he bet $72,032; he thus realized a net gambling loss for the year of $2,032.

Respondent received $6,498 in income from other sources in 1978. This came from interest, dividends, capital gains, and salary earned before his job was terminated.

On the federal income tax return he filed for the calendar year 1978 respondent reported as income only the $6,498 realized from nongambling sources. He did not report any gambling winnings or deduct any gambling losses. He did not itemize deductions. Instead, he computed his tax liability from the tax tables.

Upon audit, the Commissioner of Internal Revenue determined that respondent's $70,000 in gambling winnings were to be included in his gross income and that, pursuant to § 165(d) of the Code, a deduction was to be allowed for his gambling losses to the extent of these gambling gains. But the Commissioner further determined that, under the law as it was in 1978, a portion of respondent's $70,000 gambling-loss deduction was an item of tax preference and operated to subject him to the minimum tax under § 56(a) of the Code. At that time, under statutory provisions in effect from 1976 until 1982, "items of tax preference" were lessened by certain deductions, but not by deductions not "attributable to a trade or business carried on by the taxpayer." § 57(a)(1) and (b)(1)(A), and § 62(1), and (b)(1)(A), and § 62(1).

These determinations by the Commissioner produced a § 56(a) minimum tax of $2,142 and, with certain other adjustments not now in dispute, resulted in a total asserted tax deficiency of $2,522 for respondent for 1978.

Respondent sought redetermination of the deficiency in the United States Tax Court. That court, in a reviewed decision, with only two judges dissenting, held that respondent was in the trade or business of gambling, and that, as a consequence, no part of his gambling losses constituted an item of tax preference in determining any minimum tax for 1978. 82 T.C. 793 (1984). . . .

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The phrase "trade or business" has been in § 162(a) and in that section's predecessors for many years. Indeed, the phrase is common in the Code, for it appears in over 50 sections and 800 subsections and in hundreds of places in proposed and final income tax regulations. The slightly longer phrases, "carrying on a trade or business" and "engaging in a trade or business," themselves are used no less than 60 times in the Code. The concept thus has a well-known and almost constant presence on our tax-law terrain. Despite this, the Code has never contained a definition of the words "trade or business" for general application, and no regulation has been issued expounding its meaning for all purposes.[7] Neither has a broadly applicable authoritative judicial definition emerged.[8] Our task in this case is to ascertain the meaning of the phrase as it appears in the sections of the Code with which we are here concerned.[9]

In one of its early tax cases, Flint v. Stone Tracy Co., 220 U.S. 107 (1911), the Court was concerned with the Corporation Tax imposed by § 38 of the Tariff Act of 1909, ch. 6, 36 Stat. 112-117, and the status of being engaged in business. It said: " 'Business' is a very comprehensive term and embraces everything about which a person can be employed." 220 U.S., at 171. It embraced the Bouvier Dictionary definition: "That which occupies the time, attention and labor of men for the purpose of a livelihood or profit." Ibid. See also Helvering v. Horst, 311 U.S. 112, 118 (1940). And Justice Frankfurter has observed that "we assume that Congress uses common words in their popular meaning, as used in the common speech of men." Frankfurter, Some Reflections on the Reading of Statutes, 47 Colum.L.Rev. 527, 536 (1947).

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[7] Some sections of the Code, however, do define the term for limited purposes. See § 355(b)(2), 26 U.S.C. 355(b)(2) (distribution of stock of controlled corporation); §§ 502(b) and 513(b), 26 U.S.C. 502(b) and 513(b) (exempt organizations); and § 7701(a)(26), 26 U.S.C. 7701(a)(26) (defining the term to include "the performance of the functions of a public office").
[8] Judge Friendly some time ago observed that "the courts have properly assumed that the term includes all means of gaining a livelihood by work, even those which would scarcely be so characterized in common speech." Trent v. Commissioner, 291 F.2d 669, 671 (CA2 1961).
[9] We caution that in this opinion our interpretation of the phrase "trade or business" is confined to the specific sections of the Code at issue here. We do not purport to construe the phrase where it appears in other places.

With these general comments as significant background, we turn to pertinent cases decided here. Snyder v. Commissioner, 295 U.S. 134 (1935), had to do with margin trading and capital gains, and held, in that context, that an investor, seeking merely to increase his holdings, was not engaged in a trade or business. Justice Brandeis, in his opinion for the Court, noted that the Board of Tax Appeals theretofore had ruled that a taxpayer who devoted the major portion of his time to transactions on the stock exchange for the purpose of making a livelihood could treat losses incurred as having been sustained in the course of a trade or business. He went on to observe that no facts were adduced in *Snyder* to show that the taxpayer "might properly be characterized as a 'trader on an exchange who makes a living in buying and selling securities.' " Id., at 139. These observations, thus, are dicta, but, by their use, the Court appears to have drawn a distinction between an active trader and an investor.

In Deputy v. Du Pont, 308 U.S. 488 (1940), the Court was concerned with what were "ordinary and necessary" expenses of a taxpayer's trade or business, within the meaning of § 23(a) of the Revenue Act of 1928. In ascertaining whether carrying charges on short sales of stock were deductible as ordinary and necessary expenses of the taxpayer's business, the Court assumed that the activities of the taxpayer in conserving and enhancing his estate constituted a trade or business, but nevertheless disallowed the claimed deductions because they were not "ordinary" or "necessary." 308 U.S., at 493-497. Justice Frankfurter, in a concurring opinion joined by Justice Reed, did not join the majority. He took the position that whether the taxpayer's activities constituted a trade or business was "open for determination," id., at 499, and observed:

> " '. . . carrying on any trade or business,' within the contemplation of § 23(a), involves holding one's self out to others as engaged in the selling of goods or services. This the taxpayer did not do. . . . Without elaborating the reasons for this construction and not unmindful of opposing considerations, including appropriate regard for administrative practice, I prefer to make the conclusion explicit instead of making the hypothetical litigation-breeding assumption that this taxpayer's activities, for which expenses were sought to be deducted, did constitute a 'trade or business.' " Ibid.

Next came Higgins v. Commissioner, 312 U.S. 212 (1941). There the Court, in a bare and brief unanimous opinion, ruled that salaries and other expenses incident to looking after one's own investments in bonds and stocks were not deductible under § 23(a) of the Revenue Act of 1932, as expenses paid or incurred in carrying on a trade or business. While surely cutting back on Flint's broad approach, the Court seemed to do little more than announce that since 1918 "the present form of the statute was fixed and has so continued"; that "no regulation has ever been promulgated which interprets the meaning of 'carrying on a business' "; that the comprehensive definition of "business" in *Flint* was "not controlling in this dissimilar inquiry"; that the facts in each case must be examined; that not all expenses of every business transaction are deductible; and that "no matter how large the estate or how

continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board." 312 U.S., at 215-218. The opinion, therefore—although devoid of analysis and not setting forth what elements, if any, in addition to profit motive and regularity, were required to render an activity a trade or business—must stand for the propositions that full-time market activity in managing and preserving one's own estate is not embraced within the phrase "carrying on a business," and that salaries and other expenses incident to the operation are not deductible as having been paid or incurred in a trade or business.[10] See also United States v. Gilmore, 372 U.S. 39, 44-45 (1963); Whipple v. Commissioner, 373 U.S. 193 (1963). It is of interest to note that, although Justice Frankfurter was on the *Higgins* Court and this time did not write separately, and although Justice Reed, who had joined the concurring opinion in *Du Pont*, was the author of the Higgins opinion, the Court in that case did not even cite *Du Pont* and thus paid no heed whatsoever to the content of Justice Frankfurter's pronouncement in his concurring opinion.[10] Adoption of the Frankfurter gloss obviously would have disposed of the case in the Commissioner's favor handily and automatically, but that easy route was not followed.

Less than three months later, the Court considered the issue of the deductibility, as business expenses, of estate and trust fees. In unanimous opinions issued the same day and written by Justice Black, the Court ruled that the efforts of an estate or trust in asset conservation and maintenance did not constitute a trade or business. City Bank Farmers Trust Co. v. Helvering, 313 U.S. 121 (1941); United States v. Pyne, 313 U.S. 127 (1941). The *Higgins* case was deemed to be relevant and controlling. Again, no mention was made of the Frankfurter concurrence in *Du Pont*. Yet Justices Reed and Frankfurter were on the Court.

Snow v. Commissioner, 416 U.S. 500 (1974), concerned a taxpayer who had advanced capital to a partnership formed to develop an invention. On audit of his 1966 return, a claimed deduction under § 174(a)(1) of the 1954 Code for his pro rata share of the partnership's operating loss was disallowed. The Tax Court and the Sixth Circuit upheld that disallowance. This Court reversed. Justice Douglas, writing for the eight Justices who participated, observed: "Section 174 was enacted in 1954 to dilute some of the conception of 'ordinary and necessary' business expenses under § 162(a) (then § 23(a)(1) of the Internal Revenue Code of 1939) adumbrated by Mr. Justice Frankfurter in a concurring opinion in *Deputy v. Du Pont* . . . where he said that the section in question . . . 'involves holding one's self out to others as engaged in the selling of goods or services.' " 416 U.S., at 502-503. He went on to state, *id*., at 503, that § 162(a) "is more narrowly written than is § 174."

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[10] See, however, § 212 of the 1954 Code, 26 U.S.C. 212. This section has its roots in § 23(a)(2) of the 1939 Code, as added by § 121 of the Revenue Act of 1942, 56 Stat. 819. It allows as a deduction all the ordinary and necessary expenses paid or incurred "for the management, conservation, or maintenance of property held for the production of income," and thus overcame the specific ruling in Higgins that expenses of that kind were not deductible. The statutory change, of course, does not read directly on the term "trade or business." Obviously, though, Congress sought to overcome Higgins and achieved that end.

From these observations and decisions, we conclude (1) that, to be sure, the statutory words are broad and comprehensive (*Flint*); (2) that, however, expenses incident to caring for one's own investments, even though that endeavor is full time, are not deductible as paid or incurred in carrying on a trade or business (*Higgins*; *City Bank*; *Pyne*); (3) that the opposite conclusion may follow for an active trader (*Snyder*); (4) that Justice Frankfurter's attempted gloss upon the decision in *Du Pont* was not adopted by the Court in that case; (5) that the Court, indeed, later characterized it as an "adumbration" (*Snow*); and (6) that the Frankfurter observation, specifically or by implication, never has been accepted as law by a majority opinion of the Court, and more than once has been totally ignored. We must regard the Frankfurter gloss merely as a two-Justice pronouncement in a passing moment and, while entitled to respect, as never having achieved the status of a Court ruling. One also must acknowledge that Higgins, with its stress on examining the facts in each case, affords no readily helpful standard, in the usual sense, with which to decide the present case and others similar to it. The Court's cases, thus, give us results, but little general guidance.

III

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The issue this case presents has "been around" for a long time and, as indicated above, has not met with consistent treatment in the Tax Court itself or in the Federal Courts of Appeals. The Seventh Circuit, in the present case, said the issue "has proven to be most difficult and troublesome over the years." 771 F.2d, at 271. The difficulty has not been ameliorated by the persistent absence of an all-purpose definition, by statute or regulation, of the phrase "trade or business" which so frequently appears in the Code. Of course, this very frequency well may be the explanation for legislative and administrative reluctance to take a position as to one use that might affect, with confusion, so many others.

Be that as it may, this taxpayer's case must be decided and, from what we have outlined above, must be decided in the face of a decisional history that is not positive or even fairly indicative, as we read the cases, of what the result should be. There are, however, some helpful indicators.

If a taxpayer, as Groetzinger is stipulated to have done in 1978, devotes his full-time activity to gambling, and it is his intended livelihood source, it would seem that basic concepts of fairness (if there be much of that in the income tax law) demand that his activity be regarded as a trade or business just as any other readily accepted activity, such as being a retail store proprietor or, to come closer categorically, as being a casino operator or as being an active trader on the exchanges.

It is argued, however, that a full-time gambler is not offering goods or his services, within the line of demarcation that Justice Frankfurter would have drawn in *Du Pont*.

Respondent replies that he indeed is supplying goods and services, not only to himself but, as well, to the gambling market; thus, he says, he comes within the Frankfurter test even if that were to be imposed as the proper measure. "It takes two to gamble." Brief for Respondent 3. Surely, one who clearly satisfies the Frankfurter adumbration usually is in a trade or business. But does it necessarily follow that one who does not satisfy the Frankfurter adumbration is not in a trade or business? One might well feel that a full-time gambler ought to qualify as much as a full-time trader, as Justice Brandeis in *Snyder* implied and as courts have held. The Commissioner, indeed, accepts the trader result. In any event, while the offering of goods and services usually would qualify the activity as a trade or business, this factor, it seems to us, is not an absolute prerequisite.

We are not satisfied that the Frankfurter gloss would add any helpful dimension to the resolution of cases such as this one, or that it provides a "sensible test," as the Commissioner urges. It might assist now and then, when the answer is obvious and positive, but it surely is capable of breeding litigation over the meaning of "goods," the meaning of "services," or the meaning of "holding one's self out." And we suspect that—apart from gambling—almost every activity would satisfy the gloss. A test that everyone passes is not a test at all. We therefore now formally reject the Frankfurter gloss which the Court has never adopted anyway.

Of course, not every income-producing and profit-making endeavor constitutes a trade or business. The income tax law, almost from the beginning, has distinguished between a business or trade, on the one hand, and "transactions entered into for profit but not connected with . . . business or trade," on the other. See Revenue Act of 1916, § 5(a), Fifth, 39 Stat. 759. Congress "distinguished the broad range of income or profit producing activities from those satisfying the narrow category of trade or business." Whipple v. Commissioner, 373 U.S., at 197. We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

It is suggested that we should defer to the position taken by the Commissioner and by the Solicitor General, but, in the absence of guidance, for over several decades now, through the medium of definitive statutes or regulations, we see little reason to do so. We would defer, instead, to the Code's normal focus on what we regard as a common-sense concept of what is a trade or business. Otherwise, as here, in the context of a minimum tax, it is not too extreme to say that the taxpayer is being taxed on his gambling losses, a result distinctly out of line with the Code's focus on income.

We do not overrule or cut back on the Court's holding in *Higgins* when we conclude that if one's gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business within the meaning of the statutes with which we are here concerned. Respondent Groetzinger satisfied that test in 1978. Constant and large-scale effort on

his part was made. Skill was required and was applied. He did what he did for a livelihood, though with a less-than-successful result. This was not a hobby or a passing fancy or an occasional bet for amusement.

We therefore adhere to the general position of the *Higgins* Court, taken 46 years ago, that resolution of this issue "requires an examination of the facts in each case." 312 U.S., at 217. This may be thought by some to be a less-than-satisfactory solution, for facts vary. But the difficulty rests in the Code's wide utilization in various contexts of the term "trade or business," in the absence of an all-purpose definition by statute or regulation, and in our concern that an attempt judicially to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code. We leave repair or revision, if any be needed, which we doubt, to the Congress where we feel, at this late date, the ultimate responsibility rests.

The judgment of the Court of Appeals is affirmed.

It is so ordered.

Justice WHITE, with whom THE CHIEF JUSTICE and Justice SCALIA join, dissenting.

The 1982 amendments to the Tax Code made clear that gambling is not a trade or business. Under those amendments, the alternative minimum tax base equals adjusted gross income reduced by specified amounts, including gambling losses, and increased by items not relevant here. See 26 U.S.C. 55(b),55(e)(1)(A), 165(d). If full-time gambling were a trade or business, a full-time gambler's gambling losses would be "deductions . . . attributable to a trade or business carried on by the taxpayer," and hence deductible from gross income in computing adjusted gross income, 26 U.S.C. 62(1), though only to the extent of gambling winnings, 26 U.S.C. 165(d). To again subtract gambling losses (to the extent of gambling winnings) from adjusted gross income when computing the alternative minimum tax base would be to give the full-time gambler a double deduction for alternative minimum tax purposes, which was certainly not Congress' intent.[11] Thus, when Congress amended the alternative

[11] Consider two single individuals filing for the tax year ending December 31, 1986: A has $75,000 in nongambling income, and $75,000 in itemized nongambling deductions; B, a full-time gambler, has $75,000 in gambling winnings, $75,000 in gambling losses, $75,000 in nongambling income, and $75,000 in itemized nongambling deductions. A's gross income and adjusted gross income are both $75,000, and so is his alternative minimum tax base. The alternative minimum tax assessed on A is 20% of the excess of $75,000 over $30,000, see 26 U.S.C. 55(a), 55(f)(1)(B), or $9,000. Assuming that full-time gambling is a trade or business, B has gross income of $150,000, adjusted gross income of $75,000 (because his gambling losses are attributable to a trade or business), and an alternative minimum tax base of zero (because gambling losses are deducted from adjusted gross income in computing the alternative minimum tax base). Thus, if full-time gambling were treated as a trade or business, B's gambling losses would shield him against the $9,000 minimum tax that Congress clearly intended him to pay. "The Code should not be interpreted to allow [a taxpayer] 'the practical equivalent of a double deduction,' Charles Ilfeld Co. v. Hernandez, 292 U.S. 62, 68 (1934),

minimum tax provisions in 1982, it implicitly accepted the teaching of Gentile v. Commissioner, 65 T.C. 1 (1975), that gambling is not a trade or business. Groetzinger would have had no problem under the 1982 amendments.

One could argue, I suppose, that although gambling is not a trade or business under the 1982 amendments, it was in 1978, the tax year at issue here. But there is certainly no indication that Congress intended in 1982 to alter the status of gambling as a trade or business. Rather, Congress was correcting an inequity that had arisen because gambling is not a trade or business, just as 40 years earlier Congress had, by enacting the predecessor to 26 U.S.C. 212, corrected an inequity that became apparent when this Court held that a full-time investor is not engaged in a trade or business. See Higgins v. Commissioner, 312 U.S. 212 (1941). In neither case did Congress attempt to alter the then-prevailing definition of trade or business, nor do I think this Court should do so now to avoid a harsh result in this case. In any event, the Court should recognize that its holding is a sport that applies only to a superseded statute and not to the tax years governed by the 1982 amendments. Accordingly, I dissent.

Notes

1. *What is the holding of* Groetzinger? The Court held for the taxpayer that his full-time activity in furtherance of obtaining gambling profits constitutes a "trade or business" within the meaning of §162. It thus rejected the government's contention that operating a "trade or business" requires holding oneself out as selling goods or services to customers (it is hard to characterize racetracks as "customers" of the taxpayer). The Court also has held that trading stocks for one's own account – regardless of the level of activity – cannot constitute a "trade or business." Whipple v. Commissioner, 373 U.S. 193 (1963). And it is well established that the activity of being an employee is a "trade or business." Is there a clear line between a "trade or business" and mere "investment activity"?

2. *The alternative minimum tax.* The dissent in *Groetzinger* argued that the treatment of gambling losses under the alternative minimum tax established that gambling losses are not described in §162 for purposes of the regular income tax. The alternative minimum tax was enacted in response to newspaper reports that several profitable companies and millionaires paid no federal income tax in a particular year by exploiting multiple tax-minimizing statutory provisions. Under the AMT, multiple tax preferences are removed from the AMT tax base,[12] the taxpayer is given is a substantial exemption amount, and then the AMT is computed based on the excess of this modified tax base over the exemption amount using a relatively flat rate of taxation.[13] A taxpayer then pays the greater of her regular tax liability and her AMT tax liability.[14]

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absent a clear declaration of intent by Congress." United States v. Skelly Oil Co., 394 U.S. 678, 684 (1969). There is no such clear declaration of intent accompanying the 1982 amendments.

[12] See §56(b)-(e), §57.

[13] See §55(b).

[14] Technically, a taxpayer pays her regular tax liability and then, if her AMT tax liability is greater than her regularity, she pays such excess in addition to her regular tax liability. Of course, this

It is worth observing that the dissent's argument is weaker than it appears. Congress has provided that wagering losses are deductible only to the extent of wagering gains, §165(d), a limitation that applies whether wagering is treated as a trade or business, an investment activity, or pure entertainment. But while the dissent emphasized the tax treatment of wagering losses under the regular income tax and the AMT, until 2017 there was no limit imposed on deductions under §§162 or 212 on ordinary and necessary expenses incurred in connection with gambling activity. As to such expenses, treatment of gambling as a trade or business opens the door to §162. However, since 2017 (and expiring after 2025), the limitation in §165(d) traditionally applicable only to wagering losses has been extended to all deductions associated with "carrying on any wagering transaction."

Nickerson v. Commissioner

700 F.2d 402 (1983)

PELL, CIRCUIT JUDGE.

Petitioners appeal the judgment of the United States Tax Court finding that profit was not their primary goal in owning a dairy farm. Based on this finding the tax court disallowed deductions for losses incurred in renovating the farm. The sole issue presented for our review is whether the tax court's finding regarding petitioners' motivation was clearly erroneous.

I. Facts

Melvin Nickerson (hereinafter referred to as petitioner) was born in 1932 in a farming community in Florida. He worked evenings and weekends on his father's farm until he was 17. Petitioner entered the field of advertising after attending college and serving in the United States Army. During the years relevant to this case he was self-employed in Chicago, serving industrial and agricultural clients. His wife, Naomi W. Nickerson, was a full-time employee of the Chicago Board of Education. While petitioners were not wealthy, they did earn a comfortable living.

At the age of forty, petitioner decided that his career in the "youth oriented" field of advertising would not last much longer, and he began to look for an alternative source of income for the future. Petitioners decided that dairy farming was the most desirable means of generating income and examined a number of farms in Michigan and Wisconsin. After several years of searching, petitioners bought an 80-acre farm in Door County, Wisconsin for $40,000. One year later they purchased an additional 40 acres adjoining the farm for $10,000.

The farm, which had not been run as a dairy for eight years, was in a run-down condition. What little equipment was left was either in need of repair or obsolete. The

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amounts to no more and no less that paying the greater of the regular tax liability and the AMT tax liability.

tillable land, about 60 acres, was planted with alfalfa, which was at the end of its productive cycle. In an effort to improve this state of affairs petitioners leased the land to a tenant-farmer for $20 an acre and an agreement that the farmer would convert an additional ten acres a year to the cultivation of a more profitable crop. At the time of trial approximately 80 acres were tillable. The rent received from the farmer was the only income derived from the farm.

Petitioner visited the farm on most weekends during the growing season and twice a month the rest of the year. Mrs. Nickerson and the children visited less frequently. The trip to the farm requires five hours of driving from petitioners' home in Chicago. During these visits petitioner and his family either worked on their land or assisted neighboring farmers. When working on his own farm petitioner concentrated his efforts on renovating an abandoned orchard and remodeling the farm house. In addition to learning about farming through this experience petitioner read a number of trade journals and spoke with the area agricultural extension agent.
Petitioners did not expect to make a profit from the farm for approximately 10 years. True to their expectations, petitioners lost $8,668 in 1976 and $9,872.95 in 1977. Although they did not keep formal books of account petitioners did retain receipts and cancelled checks relating to farm expenditures. At the time of trial, petitioners had not yet acquired any livestock or farm machinery. The farm was similarly devoid of recreational equipment and had never been used to entertain guests.

The tax court decided that these facts did not support petitioners' claim that the primary goal in operating the farm was to make a profit. We will examine the tax court's reasoning in more detail after setting out the relevant legal considerations.

II. The Statutory Scheme

Section 162(a) of the Internal Revenue Code of 1954 allows deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Section 183, however, limits the availability of these deductions if the activity "is not engaged in for profit" to deductions that are allowed regardless of the existence of a profit motive and deductions for ordinary and necessary expenses "only to the extent that the gross income derived from such activity for the taxable year exceeds [otherwise allowable deductions]." I.R.C. Sec. 183(b)(2). The deductions claimed by petitioners are only allowable if their motivation in investing in the farm was to make a profit.

Petitioners bear the burden of proving that their primary purpose in renovating the farm was to make a profit. Although petitioners need only prove their sincerity rather than their realism the factors considered in judging their motivation are primarily objective. In addition to the taxpayer's statements of intent, which are given little weight for obvious reasons, the tax court must consider "all facts and circumstances with respect to the activity," including the following:

(1) *Manner in which the taxpayer carries on the activity.* The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit....

(2) *The expertise of the taxpayer or his advisors.* Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. . . .

(3) *The time and effort expended by the taxpayer in carrying on the activity*. The fact that the taxpayer devotes much of his personal time and effort to carrying on the activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit.... The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

(4) *Expectation that assets used in activity may appreciate in value*. . . .

(5) *The success of the taxpayer in carrying on other similar or dissimilar activities*. . . .

(6) *The taxpayer's history of income or losses with respect to the activity*. . . .

(7) *The amount of occasional profits, if any, which are earned*. . . .

(8) *The financial status of the taxpayer*. . . .

(9) *Elements of personal pleasure or recreation.* The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. . . .

Treas. Reg. Sec. 1.183-2(b)(1)-(9). None of these factors is determinative, nor is the decision to be made by comparing the number of factors that weigh in the taxpayer's favor with the number that support the Commissioner. Id. There is no set formula for divining a taxpayer's true motive, rather "[o]ne struggles in vain for any verbal formula that will supply a ready touchstone. The standard set 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." Welch v. Helvering, 290 U.S. 111, 115 (1933). Nonetheless, we are given some guidance by the enumerated factors and by the Congressional purpose in enacting section 183.

> The legislative history surrounding section 183 indicates that one of the prime motivating factors behind its passage was Congress' desire to create an objective standard to determine whether a taxpayer was carrying on a business for the purpose of realizing a profit or was instead merely attempting to create and utilize losses to offset other income.

Jasionowski v. Commissioner, 66 T.C. 312, 321 (1976).

Congressional concern stemmed from a recognition that

> "[w]ealthy individuals have invested in certain aspects of farm operations solely to obtain 'tax losses'--largely bookkeeping losses--for use to reduce their tax on other income.... One of the remarkable aspects of the problem is pointed up by the fact that persons with large nonfarm income have a remarkable propensity to lose money in the farm business."

S.Rep. No. 91-552, 91st Cong., 1st Sess., reprinted in 1969 U.S.Code Cong. & Ad.News 2027, 2376. With this concern in mind we will now examine the decision of the tax court.

III. Decision of the Tax Court

The tax court analyzed the relevant factors and determined that making a profit was not petitioners' primary goal in engaging in farming. The court based its decision on a number of factors that weighed against petitioners. The court found that they did not operate the farm in a businesslike manner and did not appear to have a concrete plan for improving the profitability of the farm. The court believed that these difficulties were attributable to petitioners' lack of experience, but did not discuss the steps actually taken by Melvin Nickerson to gain experience in farming.

The court found it difficult to believe that petitioners actually believed that the limited amount of time they were spending at the farm would produce a profit given the dilapidated condition of the farm. Furthermore, the court found that petitioners' emphasis on making the farm house habitable rather than on acquiring or repairing farm equipment was inconsistent with a profit motive. These factors, combined with the consistent history of losses borne by petitioners, convinced the court that "petitioner at best entertains the hope that when he retires from the advertising business and can devote his complete attention to the farming operation, he may at that time expect to produce a profit." The court did not think that this hope rose to the level of a bona fide expectation of profit.

IV. Review of the Tax Court's Findings

Whether petitioners intended to run the dairy farm for a profit is a question of fact, and as such our review is limited to a determination of whether the tax court was "clearly erroneous" in determining that petitioners lacked the requisite profit motive.[2] Fed.R.Civ.P. 52(a); Commissioner v. Duberstein, 363 U.S. 278 (1960). This standard of review applies although the only dispute is over the proper interpretation of uncontested facts. Commissioner v. Duberstein, 363 U.S. at 291. It is not enough, then, that we would have reached a different conclusion had the decision been ours to make. . . . This is one of those rare cases in which we are convinced that a mistake has been made.

Our basic disagreement with the tax court stems from our belief that the court improperly evaluated petitioners' actions from the perspective of whether they sincerely believed that they could make a profit from their current level of activity at the farm. On the contrary, petitioners need only prove that their current actions were motivated by the expectation that they would later reap a profit, in this case when they finished renovating the farm and began full-time operations. It is well established that a taxpayer need not expect an immediate profit; the existence of "start up" losses does not preclude a bona fide profit motive.

. . . The tax court was apparently of the view that petitioners' decision to spread these start-up losses over a period of years before starting full-time operation of the farm was inconsistent with a bona fide intention to make a profit. It is uncontested, however, that substantial time, effort, and money were needed to return the farm to a profitable operation, petitioners' only choice being when they would make this investment. We see no basis for distinguishing petitioners' actions from a situation in which one absorbs larger losses over a shorter period of time by beginning full-time operations immediately. In either situation the taxpayer stands an equal chance of recouping start-up losses. In fact, it seems to us a reasonable decision by petitioners to prepare the farm before becoming dependent upon it for sustenance. Keeping in mind that petitioners were not seeking to supplement their existing incomes with their current work on the farm, but rather were laying the ground work for a contemplated career switch, we will examine the factors relied upon by the tax court.

The tax court found that the amount of time petitioners devoted to the farm was inadequate. In reaching this conclusion the court ignored petitioners' agreement with the tenant-farmer under which he would convert 10 acres a year to profitable crops in exchange for the right to farm the land. In this situation the limited amount of time spent by petitioners, who were fully employed in Chicago, is not inconsistent with an expectation of profit. "The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity." Treas. Reg. §. 1.183-2(b)(3). There is no indication in the record that the tenant-farmer was not qualified to convert the land, or that 10 acres a year was an unreasonable amount. In these circumstances the tax court erred in inferring a lack of profit motive from the amount of time personally spent by petitioners on renovating the farm.

The court also rested its decision on the lack of a concrete plan to put the farm in operable condition. Once again, this ignores petitioners' agreement with the tenant-farmer concerning reclamation of the land. Under this agreement the majority of the land would be tillable by the time petitioners were prepared to begin full-time farming. The tax court also believed that petitioners' decision to renovate the farm house and orchard prior to obtaining farm equipment evidenced a lack of profit motive. As petitioners planned to live on the farm when they switched careers refurbishing the house would seem to be a necessary first step. The court also failed to consider the uncontradicted testimony regarding repairs made to the hay barn and equipment shed, which supported petitioners' contention that they were interested in operating a farm rather than just living on the land. Additionally, we fail to understand how renovating the orchard, a potential source of food and income, is inconsistent with an expectation of profit.

The tax court took into account the history of losses in considering petitioners' intentions. While a history of losses is relevant, in this case little weight should be accorded this factor. Petitioners did not expect to make a profit for a number of years, and it was clear from the condition of the farm that a financial investment would be required before the farm could be profitable. Accordingly, that petitioners lost money, as they expected, does not cast doubt upon the sincerity of their motivation. In this regard, the tax court should have also considered the fact that petitioners were reaping what profit they could through leasing the land to a local farmer.

The court believed that most of petitioners' problems were attributable to their lack of expertise. While lack of expertise is relevant, efforts at gaining experience and a willingness to follow expert advice should also be considered. Treas. Reg. 1.183-2(b)(2). The court here failed to consider the uncontradicted evidence that Melvin Nickerson read trade journals and Government-sponsored agricultural newsletters, sought advice from a state horticultural agent regarding renovation of the orchard and gained experience by working on neighboring farms. In addition, petitioners' agreement with the tenant-farmer was entered into on the advice of the area agricultural extension agent. To weigh petitioners' lack of expertise against them without giving consideration to these efforts effectively precludes a bona fide attempt to change careers. We are unwilling to restrict petitioners in this manner and believe that a proper interpretation of these facts supports petitioners' claims.

The tax court recognized that the farm was not used for entertainment and lacked any recreational facilities, and that petitioners' efforts at the farm were "prodigious," but felt that this was of little importance. While the Commissioner need not prove that petitioners were motivated by goals other than making a profit, we think that more weight should be given to the absence of any alternative explanation for petitioners' actions. As we previously noted the standard set out by the statute is to be applied with the insight gained from a lifetime of experience as well as an understanding of the statutory scheme. Common sense indicates to us that rational people do not perform hard manual labor for no reason, and if the possibility that petitioners

performed these labors for pleasure is eliminated the only remaining motivation is profit. The Commissioner has argued that petitioner was motivated by a love of farming that stems from his childhood. We find it difficult to believe that he drove five hours in order to spend his weekends working on a dilapidated farm solely for fun, or that his family derived much pleasure from the experience. Furthermore, there is no support for this contention in the record. At any rate, that petitioner may have chosen farming over some other career because of fond memories of his youth does not preclude a bona fide profit motive. Treas. Reg. Sec. 1.183-2(b)(9). We believe that the absence of any recreational purpose strongly counsels in favor of finding that petitioners' prodigious efforts were directed at making a profit.

. . . .

If this were a case in which wealthy taxpayers were seeking to obtain tax benefits through the creation of paper losses we would hesitate to reverse. Before us today, however, is a family of modest means attempting to prepare for a stable financial future. The amount of time and hard work invested by petitioners belies any claim that allowing these deductions would thwart Congress's primary purpose, that of excluding "hobby" losses from permissible deductions. Accordingly, we hold that the tax court's finding was clearly erroneous and reverse.

Notes

1. The taxpayer's litigation strategy. The issue in *Nickerson* was whether the taxpayer's primary purpose in restoring the dairy farm was to make a profit or for personal enjoyment. The taxpayer addressed both prongs: (1) he adduced evidence showing that he was restoring the farm in a business-like way; and (2) he established that the work he performed had no entertainment value. Should the government have emphasized that the taxpayer intended to enjoy the restored farm in the future, perhaps as a retirement home?

2. Section 183. The court in *Nickerson* quoted regulations promulgated under §183 for rules determining when an activity should be treated as a trade or business as compared with a not-for-profit hobby. Section 183 was enacted when Congress had become dissatisfied with the courts' willingness to accept taxpayer's often fanciful explanations for why activities that appeared to be purely personal should be classified as profit-seeking. One of the most extreme cases involved a family that owned a dairy farm and took an African safari, claiming that the primary purpose of the trip was advertising the dairy farm to the local citizenry (in Pennsylvania). The taxpayer posted photographs taken during the safari in the dairy farm's headquarters, and neighbors were invited to stop by and view them. And that, so the taxpayer argued, was the primary purpose for the taxpayer and the taxpayer's entire family to go on the safari. The Tax Court agreed. Sanitary Farms Dairy v. Commissioner, 25 T.C. 463 (1955).

It would be more logical for the regulations promulgated under §183 to have been promulgated under §162 or 212, but because §183(c) references §§162 and 212 for the definition of an activity "not engaged in for profit," no real harm was done shoehorning for-profit regulations into the §183 rules.

2. Sections 162, 165 and 167

We covered the most important deductions associated with trades and businesses earlier: §162(a) allows a deduction for all the ordinary and necessary expenses incurred in carrying on a trade or business. Similarly, §165(a) and (c)(1) allow a deduction for losses incurred in a trade or business. Finally, §167(a)(1) authorizes a deduction for the exhaustion, wear and tear of property used in a trade or business (with the amount of the deduction determined under the detailed MACRS rules of §168).

3. Section 199A

A major feature of the TCJA of 2017 was a reduction in the corporate tax rate from 35% to 21%. In a partial attempt to offer similar relief to certain noncorporate taxpayers, §199A was added to the Code. Section 199A offers a 20% deduction for certain "qualified business income." Here is an overview of §199A.

First, note that the 20% deduction does not arise from an expenditure but from a receipt: the deduction provided by §199A equals 20% of the qualified business income received by the taxpayer, §199A(a)(1), though limited to 20% of the taxpayer's ordinary income if that is less than the taxpayer qualified business income, §100A(a)(2).

The 20% deduction is based on a taxpayer's "qualified income," §199A(c), from the taxpayer's "qualified trade[s] and business[es]," §199A(d). Income received from the trade or business of performing services as an employee never can qualify for the §199A deduction. §199A(d)(1)(A).

For taxpayers whose taxable income (*not* qualified business income) is less than or equal to the "threshold amount," each trade and business (other than the trade or business of being an employee) is treated as a "qualified trade or business." §199A(d)(3)(A). The threshold amount is $157,500 except for married taxpayers filing a joint return: for such taxpayers, the threshold amount is $315,000. §199A(e)(2).

For taxpayers whose taxable income exceeds the applicable threshold amount by more than $50,000, there are additional hurdles. First, all specified trades and businesses are excluded from the definition of a qualified trade or business. §199A(d)(2). Specified trades or business are the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services. §199A(d)(2)(A). Also excluded are services that consist of investing and investment manage, trading, or dealing in securities, partnership interests, or commodities. §199A(d)(2)(B).[15]

[15] Also excluded are trades or businesses where the principal asset is the reputation or skill of one or more employees or owners. §§1202(e)(3)(A), 199A(d)(2)(A).

Second, the taxpayer's 20% deduction is based on the lesser of (1) the taxpayer's qualified business income, or (2) the greater of (a) 50% of wages paid by the taxpayer in connection with the taxpayer's qualified trades or businesses, and (b) 25% of the wages paid by the taxpayer in connection with the taxpayer's qualified trades and business plus 5% of the basis (not the adjusted basis) of tangible depreciable property used by the taxpayer in connection with the taxpayer's qualified trades or businesses. See §199A(b)(2). This limitation has been justified as limiting the §199A deduction for high-bracket taxpayers to those who contribute to the economy by creating jobs or encouraging manufacturing.

4. The Business Interest Deduction and Its Limitation

Interest paid by a taxpayer is deductible, §163(a), except that if the underlying debt is allocable to non-profit-seeking activity, the deduction generally is disallowed, §163(h). Such interest is called "personal interest." See §163(b)(2).

Interest that is not "personal interest" can be further divided into trade or business interest and investment interest. For interest on indebtedness allocable to a taxpayer's trades or business (called "business interest, §163(j)(5)), the interest deduction under §163(a) is limited to the sum of the taxpayer's business interest income (if any) plus 30% of the taxpayer's adjusted taxable income. §163(j)(1).[16] Interest paid in excess of this limitation can be carried forward and deducted as interest subject to the same dollar limitation. §163(j)(2). Note that for small businesses, the limitation in §163(j) on the interest deduction under §163(a) does not apply. §163(j)(3).

Investment interest, though not subject to the limitation in §163(j), is subject to its own limitation, discussed below. See §163(d).

5. Employee Business Expenses

Employee business expenses are described in §162 because being an employee is considered a trade or business. Historically, employee business expenses were subject to the 2% haircut applicable to miscellaneous deductions, see §67(a), but since the 2017 Act, miscellaneous deductions have been disallowed in full. §67(g).

C. Non-Business Profit-Seeking Deductions

1. Sections 212, 165 and 167

In an income tax, all costs incurred with a profit-seeking motive should be immediately deductible if the anticipated benefit is short term (i.e., if they are "ordinary"). For non-business expenditures (i.e., for investments), §§212(1) and (2) generally provide that deduction, and for longer-term investments that waste over time, section 167(a)(2) authorizes recovery of basis over time. Finally, for investment assets that generate a loss, §165(c)(2) authorizes a deduction. Thus, investment expenditures in many ways are

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[16] The interest deduction limitation in §163(j) is further increased by the taxpayer's "floor plan financing," §§163(j)(1)(C), 163(j)(90, a technical term we will not consider.

treated, as they should be, equivalently to trade or business expenses. As discussed above, some investment expenditures are subject to special limitations.

2. The Origin of the Claim Doctrine

United States v. Gilmore

372 U.S. 39 (1963)

MR. JUSTICE HARLAN delivered the opinion of the Court.

In 1955, the California Supreme Court confirmed the award to the respondent taxpayer of a decree of absolute divorce, without alimony, against his wife Dixie Gilmore. The case before us involves the deductibility for federal income tax purposes of that part of the husband's legal expense incurred in such proceedings as is attributable to his successful resistance of his wife's claims to certain of his assets asserted by her to be community property under California law. The claim to such deduction, which has been upheld by the Court of Claims, 290 F.2d 942, is founded on [the predecessor of §162] of the Internal Revenue Code which allows as deductions from gross income

> ". . . ordinary and necessary expenses . . . incurred during the taxable year . . . for the . . . conservation . . . of property held for the production of income."

. . . .

At the time of the divorce proceedings, instituted by the wife but in which the husband also cross-claimed for divorce, respondent's property consisted primarily of controlling stock interests in three corporations, each of which was a franchised General Motors automobile dealer. As president and principal managing officer of the three corporations, he received salaries from them aggregating about $66,800 annually, and in recent years his total annual dividends had averaged about $83,000. His total annual income derived from the corporations was thus approximately $150,000. His income from other sources was negligible.

As found by the Court of Claims, the husband's overriding concern in the divorce litigation was to protect these assets against the claims of his wife. Those claims had two aspects: first, that the earnings accumulated and retained by these three corporations during the Gilmores' marriage (representing an aggregate increase in corporate net worth of some $600,000) were the product of respondent's personal services, and not the result of accretion in capital values, thus rendering respondent's stockholdings in the enterprises *pro tanto* community property under California law; second, that, to the extent that such stockholdings were community property, the wife, allegedly the innocent party in the divorce proceeding, was entitled under California law to more than a one-half interest in such property.

The respondent wished to defeat those claims for two important reasons. First, the loss of his controlling stock interests, particularly in the event of their transfer in substantial part to his hostile wife, might well cost him the loss of his corporate positions, his principal

means of livelihood. Second, there was also danger that if he were found guilty of his wife's sensational and reputation-damaging charges of marital infidelity, General Motors Corporation might find it expedient to exercise its right to cancel these dealer franchises.

The end result of this bitterly fought divorce case was a complete victory for the husband. He, not the wife, was granted a divorce on his cross-claim; the wife's community property claims were denied in their entirety; and she was held entitled to no alimony.

Respondent's legal expenses in connection with this litigation amounted to $32,537.15 in 1953 and $8,074.21 in 1954 -- a total of $40,611.36 for the two taxable years in question. The Commissioner of Internal Revenue found all of these expenditures "personal" or "family" expenses, and, as such, none of them deductible.

In the ensuing refund suit, however, the Court of Claims held that 80% of such expense (some $32,500) was attributable to respondent's defense against his wife's community property claims respecting his stockholdings, and hence deductible [under the predecessor of §212] as an expense "incurred . . . for the . . . conservation . . . of property held for the production of income.". . . .

The Government does not question the amount or formula for the expense allocation made by the Court of Claims. Its sole contention here is that the court below misconceived the test governing [§212] deductions, in that the deductibility of these expenses turns, so it is argued, not upon the consequences to respondent of a failure to defeat his wife's community property claims, but upon the origin and nature of the claims themselves. So viewing Dixie Gilmore's claims, whether relating to the existence or division of community property, it is contended that the expense of resisting them must be deemed nondeductible "personal" or "family" expense under [the predecessor of § 262], not deductible expense under [§212]. For reasons given hereafter we think the Government's position is sound, and that it must be sustained.

I

For income tax purposes, Congress has seen fit to regard an individual as having two personalities:

> "one is [as] a seeker after profit who can deduct the expenses incurred in that search; the other is [as] a creature satisfying his needs as a human and those of his family but who cannot deduct such consumption and related expenditures."

The Government regards [§212] as embodying a category of the expenses embraced in the first of these roles.

Initially, it may be observed that the wording of [§212] more readily fits the Government's view of the provision than that of the Court of Claims. For, in context, "conservation of property" seems to refer to operations performed with respect to the property itself, such as safeguarding or upkeep, rather than to a taxpayer's retention of ownership in it. But more illuminating than the mere language . . . is the history of the provision.

Prior to 1942, [§162] allowed deductions only for expenses incurred "in carrying on any trade or business" . . . . In *Higgins v. Commissioner,* 312 U. S. 212, this Court gave that provision a narrow construction, holding that the activities of an individual in supervising his own securities investments did not constitute the "carrying on of trade or business," and hence that expenses incurred in connection with such activities were not tax deductible. . . . The Revenue Act of 1942, by adding what is now §212, sought to remedy the inequity inherent in the disallowance of expense deductions in respect of such profit-seeking activities, the income from which was nonetheless taxable.

As noted in *McDonald v. Commissioner,* 323 U. S. 57, 323 U. S. 62, the purpose of the 1942 amendment was merely to enlarge "the category of incomes with reference to which expenses were deductible." And committee reports make clear that deductions under the new section were subject to the same limitations and restrictions that are applicable to those allowable under [§162]. Further, this Court has said that]§212] "is comparable and *in pari materia* with [§ 162]," providing for a class of deductions "coextensive with the business deductions allowed by [162], except for" the requirement that the income-producing activity qualify as a trade or business. .

A basic restriction upon the availability of a [§162] deduction is that the expense item involved must be one that has a business origin. That restriction not only inheres in the language of [§ 162] itself, confining such deductions to "expenses . . . incurred . . . in carrying on any trade or business," but also follows from [§ 262], expressly rendering nondeductible "in any case . . . [p]ersonal, living, or family expenses." In light of what has already been said with respect to the advent and thrust of [§ 212], it is clear that the "[p]ersonal . . . or family expenses" restriction of [§ 262] must impose the same limitation upon the reach of [§ 212] -- in other words, that the only kind of expenses deductible under [§ 212] are those that relate to a "business," that is, profit-seeking, purpose. The pivotal issue in this case then becomes: was this part of respondent's litigation costs a "business," rather than a "personal" or "family," expense?

The answer to this question has already been indicated in prior cases. In *Lykes v. United States,* 343 U. S. 118, the Court rejected the contention that legal expenses incurred in contesting the assessment of a gift tax liability were deductible. The taxpayer argued that, if he had been required to pay the original deficiency, he would have been forced to liquidate his stockholdings, which were his main source of income, and that his legal expenses were therefore incurred in the "conservation" of income-producing property, and hence deductible under § 23(a)(2). The Court first noted that the "deductibility [of the expenses] turns wholly upon the nature of the activities to which they relate" (343 U.S. at 343 U. S. 123), and then stated:

> "Legal expenses do not become deductible merely because they are paid for services which relieve a taxpayer of liability. That argument would carry us too far. It would mean that the expense of defending almost any claim would be deductible by a taxpayer on the ground that such defense was made to help him keep clear of liens whatever income-producing property he might have. For example, it suggests that the expense of

> defending an action based upon personal injuries caused by a taxpayer's negligence while driving an automobile for pleasure should be deductible. Section 23(a)(2) never has been so interpreted by us. . . ."
>
> "While the threatened deficiency assessment . . . added urgency to petitioner's resistance of it, neither its size nor its urgency determined its character. It related to the tax payable on petitioner's gifts. . . . The expense of contesting the amount of the deficiency was thus at all times attributable to the gifts, as such, and accordingly was not deductible."
>
> "If, as suggested, the relative size of each claim, in proportion to the income-producing resources of a defendant, were to be a touchstone of the deductibility of the expense of resisting the claim, substantial uncertainty and inequity would inhere in the rule. . . . It is not a ground for [deduction] that the claim, if justified, will consume income-producing property of the defendant."

343 U.S. at 343 U. S. 125-126.

. . . .

The principle we derive from these cases is that the characterization, as "business" or "personal," of the litigation costs of resisting a claim depends on whether or not the claim arises in connection with the taxpayer's profit-seeking activities. It does not depend on the consequences that might result to a taxpayer's income-producing property from a failure to defeat the claim, for, as *Lykes* teaches, that "would carry us too far," and would not be compatible with the basic lines of expense deductibility drawn by Congress. Moreover, such a rule would lead to capricious results. If two taxpayers are each sued for an automobile accident while driving for pleasure, deductibility of their litigation costs would turn on the mere circumstance of the character of the assets each happened to possess, that is, whether the judgments against them stood to be satisfied out of income- or nonincome-producing property. We should be slow to attribute to Congress a purpose producing such unequal treatment among taxpayers, resting on no rational foundation.

. . . .

For these reasons, we resolve the conflict among the lower courts on the question before us in favor of the view that the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was "business" or "personal," and hence whether it is deductible or not under [§ 212]. We find the reasoning underlying the cases taking the "consequences" view unpersuasive.

. . . .

We turn then to the determinative question in this case: did the wife's claims respecting respondent's stockholdings arise in connection with his profit-seeking activities?

II

In classifying respondent's legal expenses, the court below did not distinguish between those relating to the claims of the wife with respect to the existence of community property and those involving the division of any such property. Nor is such a breakdown necessary for a disposition of the present case. It is enough to say that in both aspects the wife's claims stemmed entirely from the marital relationship, and not, under any tenable view of things, from income-producing activity. This is obviously so as regards the claim to more than an equal division of any community property found to exist. For any such right depended entirely on the wife's making good her charges of marital infidelity on the part of the husband. The same conclusion is no less true respecting the claim relating to the existence of community property. For no such property could have existed but for the marriage relationship. Thus, none of respondent's expenditures in resisting these claims can be deemed "business" expenses, and they are therefore not deductible under § 23(a)(2).

In view of this conclusion, it is unnecessary to consider the further question suggested by the Government: whether that portion of respondent's payments attributable to litigating the issue of the existence of community property was a capital expenditure or a personal expense. In neither event would these payments be deductible from gross income.

The judgment of the Court of Claims is reversed, and the case is remanded to that court for further proceedings consistent with this opinion.

It is so ordered.

Note

1. *The holding of* Gilmore. The holding of *Gilmore* appears to be part of the line-drawing between business and personal expenditures. Note that for expenditures that produce long-term benefits, such expenditures are not immediately deductible whether incurred in connection with profit-seeking activity or for purely personal reasons. Rather, such expenditures must be capitalized. Can the taxpayer in *Gilmore* add the litigation costs to his stock basis and thereby obtain a tax benefit from the litigation costs? In Gilmore v. United States, 245 F. Supp. 383 (N.D. CA 1965), the trial court held that the taxpayer could add the litigation costs to his stock basis. Is that result consistent with the reasoning by the Supreme Court in *Gilmore*? Or is a better reading of what the Supreme Court that the litigation costs should be treated as allocable to the divorce proceeding rather than to the assets held by the taxpayer?

3. The Investment Interest Deduction and Its Limitation

Investment interest (that is, interest on indebtedness incurred in connection with profit-seeking activity that does not rise to the level of a "trade or business, §163(d)(3)), generally is deductible, §163(a). However, such interest is subject to a special limitation: investment interest is only deductible by a taxpayer to the extent of the taxpayer's net investment income for the year. §163(d)(1). Any investment interest in excess of this

limitation can be carried forward and treated as investment interest in subsequent years. §163(d)(2).

Question

Q-2. What might be the rationale underlying this investment interest deduction? Consider the case of an investment made with borrowed funds that appreciates in the hands of the taxpayer but remains unsold so that the gain remains unrealized. Then consider the case of a taxpayer whose debt-financed investment does poorly and eventually is sold at a loss.

D. Personal Deductions

The term "personal deductions" generally is understood to mean deductions allowable despite the absence of a profit-seeking motive, although it sometimes is used to include all itemized deductions including, for example, investment expenses and employee business expenses.

1. Personal Interest

While §163(a) generally provides that all interest paid or accrued is deductible, §163(h)(1) eliminates this deduction for personal interest where personal interest generally means interest on indebtedness incurred other than in connection with the taxpayer's trade or business or investment activity, §163(h)(2). However, certain "qualified residence interest" is not treated as personal despite the absence of a profit-seeking motive underlying the indebtedness, where "qualified residence interest" is defined in §163(h)(3). In general, qualified residence interest is interest on acquisition indebtedness with respect to any qualified residence of the taxpayer, §163(h)(3)(A), subject to certain limitations, discussed in the Notes below.[17]

Notes

1. *Qualified Residence*. A "qualified residence" of a taxpayer is the taxpayer's principal residence, §163(h)(4)(A)(i)(I), and, if the taxpayer owns two or more personal residences, one other residence of the taxpayer selected by the taxpayer, §163(h)(4)(A)(i)II). Note that acquisition indebtedness must be secured by the personal residence acquired, constructed, or improved. §163(h)(3)(B)(i)(II).

2. *Acquisition Indebtedness*. "Acquisition indebtedness" is indebtedness incurred in "acquiring, constructing, or substantially improving" and qualified residence of the taxpayer. §163(h)(3)(B). It also includes debt incurred to refinance acquisition indebtedness, but only to the extent of the refinanced acquisition indebtedness. §163(h)(3)(B) (final flush language). Thus, a cash-out refinancing of acquisition indebtedness will only partially qualify.

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[17] While certain home equity indebtedness also seems to qualify under §163(h)(3), that allowance has been eliminated by the 2017 Tax Act, see §163(h)(3)(F)(i)(I).

3. *Points Paid to Obtain Acquisition Indebtedness*. In general, points on a acquisition indebtedness are deductible as provided in §461(g)(2). However, points paid on a refinancing loan cannot be deducted but rather must be capitalized and deducted over the life of the loan pursuant to §461(g)(1).

Question

Q-2. *Closing Costs*. When a taxpayer purchases a home using debt from a commercial lender, the taxpayer will be presented with a statement describing the terms of the loan and the uses to which it (and the taxpayer's equity) have been put. One line on this form might list amount paid to the lender's attorney while another might list the cost incurred by the lender to run a credit check on the taxpayer. In addition, there may be a general category labeled "origination fee" or something similar. It is the government's position that only the origination fees qualify as interest. If interest is an amount paid by one person for the use of another's money, Deputy v. Du Pont, 308 U.S. 488 (1940), should other closing costs be treated as interest? Consider the cost of title insurance, with one policy protecting the lender interest in the property and a second policy protecting the borrower's interest in the property.

2. The Charitable Deduction

Section 170 authorizes a deduction for all "contributions" to organizations described in §170(c). The list of organizations in §170(c) is almost the same as the definition of charitable organizations in §501(c)(3) that are exempt from taxation under §501(a). However, the overlap is not complete: organizations formed for testing for public safety (such as Union Laboratories) are described in §501(c)(3) but are omitted from §170(c). In addition, states and political subdivisions are covered by §170(c) but are not included in §501(c)(3).

When the contribution consists of cash, the amount of the contribution is clear. But if the contribution consists of appreciated property, the proper amount of the deduction is adjusted basis: appreciation that has not yet been taxed should not be deductible. However, the statute has never provided a rule for determining the amount of a charitable contribution, and the government long ago determined that the amount should equal the fair market value of any contributed property, a result now found in the regulations. Reg. §1.170A-1(c)(1). Note that this means that if loss property is contributed to a charitable organization, the amount of the deduction is only the value (rather than the higher adjusted basis) of the property. As a result, a taxpayer who is contemplating making a contribution of loss property to a charity generally would be better off selling the property (thereby recognizing the loss) and then contributing the sales proceeds. Note also that the contribution of services to a charitable organization by the service provider does not generate a deduction, Reg. §1.170A-1(g), a result that can be justified only by treating the amount of the contribution as equal to the taxpayer's $0 adjusted basis.

The charitable deduction is one of the clearest examples of a tax expenditure. Can this tax expenditure be justified? To be sure, support of institutions doing charitable work is

important, but is it clear that this support should be provided as a tax expenditure rather than as a direct expenditure? To be sure, the charitable deduction allows each individual to direct some of the government's charitable support. Thus, charitable support will better reflect society's diverse charitable goals.

Why should the wealthy have a greater say in the allocation of charitable support than the less wealthy? Indeed, most charitable contributions given to churches in this country are made by non-itemizers, so that these contributions go unmatched by the government. Contributions to private universities and to the arts almost always are deducted, so it is these contributions which obtain partial government matching contributions. Surely a direct expenditure would not emphasize such high-brow activities so greatly. Further, a relatively few exceptionally wealthy individuals contribute massive amounts to charity, so that these individuals obtain massive government subsidies for their pet projects. Is this democracy in action?

a. *The Contribution Requirement*

A “contribution” is a transfer to a charitable organization without the expectation of return value. While it largely is the same as a “gift,” the court have held that the terms “contribution” and “gift” are not synonymous. Here is why: transfers made with a subjective intention to profit are not gifts. For example, the transfer of property to a museum will not be a “gift” if made with the expectation that it will generate goodwill for the transferor. But it can still be a charitable contribution because no value was received in exchange. Thus, while the definition of a “gift” turns on the transferor’s subjective intention, the definition of a “contribution” turns on more objective criteria.

Consider, for example, Singer Co. v. United States, 449 F.2d 413 (Ct. Cl. 1971). The court held that transfers of Singer sewing machines to schools where students learned to sew could not constitute charitable “contributions” because the Singer Co. anticipated that the students would become purchasers after graduation. However, transfers of sewing machines by the Singer Co. to other charitable organizations could constitute “contributions” so long as no quid pro quo was expected.

In Hernandez v. Commissioner, 490 U.S. 680 (1989), the Supreme Court upheld the disallowance of a deduction for payments made to the Church of Scientology in exchange for "training" and "auditing" from the church. In Powell v. United States 945 F.2d 374 (11th Cir. 1991), the Circuit Court held that a member of the Church of Scientology who was denied a deduction under *Hernandez* could nonetheless bring a claim alleging unequal treatment if members of other religious organizations were allowed deductions for similar expenditures. Based on *Powell*, the I.R.S. has reversed itself with respect to members of the Church of Scientology, now allowing them a deduction for "auditing" expenses. Rev. Rul. 93-73, 1993-2 C. B. 75. Should we be bothered that the I.R.S. has allowed a deduction that the Supreme Court explicitly ruled is not allowable?

b. The Statutory Limitations

The deduction provided by §170(a) for property contributed to a charity equals the fair market value of the property contributed. However, that deduction is reduced under §170(e)(1) in two ways. First, under §170(e)(1)(A), the charitable deduction under §170(a) is reduced to the extent that gain from sale of the contributed property would be other than long-term capital gain (i.e., to the extent it would be short-term capital gain or ordinary income). Thus, for example, there will be a reduction for any recapture amount under §1245.

Second, under §170(e)(1)(B), there is also a reduction the extent a sale of the property would produce long-term capital gain if the property is tangible personal property and the use of the property by the charitable organization is "unrelated to the purpose or function constituting the basis for its [charitable] exemption." Note that this limitation never applies to contributions of real estate or of intangible property such as stocks and bonds.

Section 170 imposes specific written documentation restrictions on charitable contributions of property (including cash) of more than $500. If the taxpayer fails to meet these substantiation requirements prior to filing her tax return, the charitable deduction is denied. §170(f)(11)(A). The substantiation requirements increase as the value of the contribution increases. See §170(f)(11)(B)-(D). All contributions in excess of $500 must be substantiated by a written acknowledgement from the donee organization that specifies the value, if any, provided to the donor in exchange for the transfer. If no such value is transferred to the donor, the written acknowledgement must state that.

c. The Percentage Limitations

The universe of charitable organizations is divided into two groups: private foundations and public charities. Private foundations are charitable organizations that are funded by one person or a small group of people (often a family).[18] Contributions to private foundations remain deductible but most are subjected to a special limitation: a taxpayer cannot deduct more than 30% of the taxpayer's "contribution base" for the year, §170(b)(1)(B)(i), where a taxpayer's contribution base generally means the taxpayer's adjusted gross income for the year, §170(b)(1)(H). For public charities, the limitation is 50% of the taxpayer's contribution base, §170(b)(1)(A). For a taxpayer who makes contributions to both private foundations and public charities in a single year, the percentage limitations are combined in accordance with the rule in §170(b)(1)(B)(ii). For corporate taxpayer's, the percentage limitation is 10% of taxable income. §170(b)(2)(A). Contributions by any taxpayer in excess of the percentage limitation can be carried forward for 5 years where they are again treated as charitable contributions and so subject to the percentage limitations. §170(d).

[18] See §509.

d. Policy Limits

Bob Jones University v. United States

461 U.S. 574 (1982)

CHIEF JUSTICE BURGER delivered the opinion of the Court.

We granted certiorari to decide whether petitioners, nonprofit private schools that prescribe and enforce racially discriminatory admissions standards on the basis of religious doctrine, qualify as tax-exempt organizations under § 501(c)(3) of the Internal Revenue Code of 1954.

I

A

Until 1970, the Internal Revenue Service granted tax-exempt status to private schools, without regard to their racial admissions policies, under § 501(c)(3) of the Internal Revenue Code, and granted charitable deductions for contributions to such schools under § 170 of the Code.

On January 12, 1970, a three-judge District Court for the District of Columbia issued a preliminary injunction prohibiting the IRS from according tax-exempt status to private schools in Mississippi that discriminated as to admissions on the basis of race. *Green v. Kennedy,* 309 F.Supp. 1127 (1970). Thereafter, in July, 1970, the IRS concluded that it could "no longer legally justify allowing tax-exempt status [under § 501(c)(3)] to private schools which practice racial discrimination." At the same time, the IRS announced that it could not "treat gifts to such schools as charitable deductions for income tax purposes [under § 170]." *Ibid.* By letter dated November 30, 1970, the IRS formally notified private schools, including those involved in this litigation, of this change in policy, "applicable to all private schools in the United States at all levels of education."

On June 30, 1971, the three-judge District Court issued its opinion on the merits of the Mississippi challenge. *Green v. Connally,* 330 F.Supp. 1150 (1971). That court approved the IRS's amended construction of the Tax Code. The court also held that racially discriminatory private schools were not entitled to exemption under § 501(c)(3) and that donors were not entitled to deductions for contributions to such schools under § 170. The court permanently enjoined the Commissioner of Internal Revenue from approving tax-exempt status for any school in Mississippi that did not publicly maintain a policy of nondiscrimination.

The revised policy on discrimination was formalized in Revenue Ruling 71-447, 1971-2 Cum.Bull. 230:

> Both the courts and the Internal Revenue Service have long recognized that the statutory requirement of being "organized and operated exclusively for religious, charitable, . . . or educational purposes" was intended to express the basic common law concept [of "charity"]. . . . All charitable trusts, educational or otherwise, are subject to the

> requirement that the purpose of the trust may not be illegal or contrary to public policy.
>
> Based on the "national policy to discourage racial discrimination in education," the IRS ruled that “a [private] school not having a racially nondiscriminatory policy as to students is not 'charitable' within the common law concepts reflected in sections 170 and 501(c)(3) of the Code.”

Id. at 231.

The application of the IRS construction of these provisions to petitioners, two private schools with racially discriminatory admissions policies, is now before us.

B

No. 81-3, Bob Jones University v. United States

Bob Jones University is a nonprofit corporation located in Greenville, S.C. Its purpose is "to conduct an institution of learning . . giving special emphasis to the Christian religion and the ethics revealed in the Holy Scriptures." The corporation operates a school with an enrollment of approximately 5,000 students, from kindergarten through college and graduate school. Bob Jones University is not affiliated with any religious denomination, but is dedicated to the teaching and propagation of its fundamentalist Christian religious beliefs. It is both a religious and educational institution. Its teachers are required to be devout Christians, and all courses at the University are taught according to the Bible. Entering students are screened as to their religious beliefs, and their public and private conduct is strictly regulated by standards promulgated by University authorities.

The sponsors of the University genuinely believe that the Bible forbids interracial dating and marriage. To effectuate these views, Negroes were completely excluded until 1971. From 1971 to May, 1975, the University accepted no applications from unmarried Negroes, but did accept applications from Negroes married within their race.

Following the decision of the United States Court of Appeals for the Fourth Circuit in *McCrary v. Runyon,* 515 F.2d 1082 (1975), *aff'd,* 427 U.S. 160 (1976), prohibiting racial exclusion from private schools, the University revised its policy. Since May 29, 1975, the University has permitted unmarried Negroes to enroll; but a disciplinary rule prohibits interracial dating and marriage. That rule reads:

There is to be no interracial dating.

> 1. Students who are partners in an interracial marriage will be expelled.
>
> 2. Students who are members of or affiliated with any group or organization which holds as one of its goals or advocates interracial marriage will be expelled.
>
> 3. Students who date outside of their own race will be expelled.

> 4. Students who espouse, promote, or encourage others to violate the University's dating rules and regulations will be expelled.

The University continues to deny admission to applicants engaged in an interracial marriage or known to advocate interracial marriage or dating.

Until 1970, the IRS extended tax-exempt status to Bob Jones University under § 501(c)(3). By the letter of November 30, 1970, that followed the injunction issued in *Green v. Kennedy,* 309 F.Supp. 1127 (DC 1970), the IRS formally notified the University of the change in IRS policy, and announced its intention to challenge the tax-exempt status of private schools practicing racial discrimination in their admissions policies.

After failing to obtain an assurance of tax exemption through administrative means, the University instituted an action in 1971 seeking to enjoin the IRS from revoking the school's tax-exempt status. That suit culminated in *Bob Jones University v. Simon,* 416 U.S. 725 (1974), in which this Court held that the Anti-Injunction Act of the Internal Revenue Code, 26 U.S.C. § 7421(a), prohibited the University from obtaining judicial review by way of injunctive action before the assessment or collection of any tax.

Thereafter, on April 16, 1975, the IRS notified the University of the proposed revocation of its tax-exempt status. On January 19, 1976, the IRS officially revoked the University's tax-exempt status, effective as of December 1, 1970, the day after the University was formally notified of the change in IRS policy. The University subsequently filed returns under the Federal Unemployment Tax Act for the period from December 1, 1970, to December 31, 1975, and paid a tax totalling $21 on one employee for the calendar year of 1975. After its request for a refund was denied, the University instituted the present action, seeking to recover the $21 it had paid to the IRS. The Government counterclaimed for unpaid federal unemployment taxes for the taxable years 1971 through 1975, in the amount of $489,675.59, plus interest.

The United States District Court for the District of South Carolina held that revocation of the University's tax-exempt status exceeded the delegated powers of the IRS, was improper under the IRS rulings and procedures, and violated the University's rights under the Religion Clauses of the First Amendment. 468 F.Supp. 890, 907 (1978). The court accordingly ordered the IRS to pay the University the $21 refund it claimed and rejected the IRS's counterclaim.

The Court of Appeals for the Fourth Circuit, in a divided opinion, reversed. 639 F.2d 147 (1980). Citing *Green v. Connally,* 330 F.Supp. 1150 (DC 1971), with approval, the Court of Appeals concluded that § 501(c)(3) must be read against the background of charitable trust law. To be eligible for an exemption under that section, an institution must be "charitable" in the common law sense, and therefore must not be contrary to public policy. In the court's view, Bob Jones University did not meet this requirement, since its

> racial policies violated the clearly defined public policy, rooted in our Constitution, condemning racial discrimination and, more specifically,

> the government policy against subsidizing racial discrimination in education, public or private.

639 F.2d at 151. The court held that the IRS acted within its statutory authority in revoking the University's tax-exempt status. Finally, the Court of Appeals rejected petitioner's arguments that the revocation of the tax exemption violated the Free Exercise and Establishment Clauses of the First Amendment. The case was remanded to the District Court with instructions to dismiss the University's claim for a refund and to reinstate the IRS's counterclaim.

. . . .

II

A

In Revenue Ruling 71-447, the IRS formalized the policy, first announced in 1970, that § 170 and § 501(c)(3) embrace the common law "charity" concept. Under that view, to qualify for a tax exemption pursuant to § 501(c)(3), an institution must show, first, that it falls within one of the eight categories expressly set forth in that section, and second, that its activity is not contrary to settled public policy.

Section 501(c)(3) provides that "[c]orporations . . . organized and operated exclusively for religious, charitable . . . or educational purposes" are entitled to tax exemption. Petitioners argue that the plain language of the statute guarantees them tax-exempt status. They emphasize the absence of any language in the statute expressly requiring all exempt organizations to be "charitable" in the common law sense, and they contend that the disjunctive "or" separating the categories in § 501(c)(3) precludes such a reading. Instead, they argue that, if an institution falls within one or more of the specified categories it is automatically entitled to exemption, without regard to whether it also qualifies as "charitable." The Court of Appeals rejected that contention and concluded that petitioners' interpretation of the statute "tears section 501(c)(3) from its roots." 639 F.2d at 151.

. . . .

Section 501(c)(3) therefore must be.analyzed and construed within the framework of the Internal Revenue Code and against the background of the congressional purposes. Such an examination reveals unmistakable evidence that, underlying all relevant parts of the Code, is the intent that entitlement to tax exemption depends on meeting certain common law standards of charity -- namely, that an institution seeking tax-exempt status must serve a public purpose and not be contrary to established public policy.

This "charitable" concept appears explicitly in § 170 of the Code. That section contains a list of organizations virtually identical to that contained in § 501(c)(3). It is apparent that Congress intended that list to have the same meaning in both sections. In § 170, Congress used the list of organizations in defining the term "charitable contributions." On its face, therefore, § 170 reveals that Congress' intention was to provide tax benefits to

organizations serving charitable purposes. The form of § 170 simply makes plain what common sense and history tell us: in enacting both § 170 and § 501(c)(3), Congress sought to provide tax benefits to charitable organizations, to encourage the development of private institutions that serve a useful public purpose or supplement or take the place of public institutions of the same kind.

Tax exemptions for certain institutions thought beneficial to the social order of the country as a whole, or to a particular community, are deeply rooted in our history, as in that of England. The origins of such exemptions lie in the special privileges that have long been extended to charitable trusts.

More than a century ago, this Court announced the caveat that is critical in this case:

[I]t has now become an established principle of American law that courts of chancery will sustain and protect . . . a gift . . . to public charitable uses, *provided the same is consistent with local laws and public policy. . . .*

Perin v. Carey, 24 How. 465, 501 (1861) (emphasis added).

. . . .

In enacting the Revenue Act of 1938, ch. 289, Congress expressly reconfirmed this view with respect to the charitable deduction provision:

> The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burdens which would otherwise have to be met by appropriations from other public funds, and by the benefits resulting from the promotion of the general welfare.

H.R.Rep. No. 1860, 75th Cong., 3d Sess., 19 (1938).

A corollary to the public benefit principle is the requirement, long recognized in the law of trusts, that the purpose of a charitable trust may not be illegal or violate established public policy. In 1861, this Court stated that a public charitable use must be "consistent with local laws and public policy," *Perin v. Carey,*24 How. at 501. Modern commentators and courts have echoed that view. *See, e.g.,* Restatement (Second) of Trusts § 377, Comment *c* (1959); 4 Scott § 377, and cases cited therein; Bogert § 378, at 191-192.

When the Government grants exemptions or allows deductions all taxpayers are affected; the very fact of the exemption or deduction for the donor means that other taxpayers can be said to be indirect and vicarious "donors." Charitable exemptions are justified on the basis that the exempt entity confers a public benefit -- a benefit which the society or the community may not itself choose or be able to provide, or which supplements and advances the work of public institutions already supported by tax revenues. History buttresses logic to make clear that, to warrant exemption under § 501(c)(3), an institution must fall within a category specified in that section and must demonstrably serve and be in harmony with the public interest. The institution's purpose must not be so at odds with

the common community conscience as to undermine any public benefit that might otherwise be conferred.

B

We are bound to approach these questions with full awareness that determinations of public benefit and public policy are sensitive matters with serious implications for the institutions affected; a declaration that a given institution is not "charitable" should be made only where there can be no doubt that the activity involved is contrary to a fundamental public policy. But there can no longer be any doubt that racial discrimination in education violates deeply and widely accepted views of elementary justice. Prior to 1954, public education in many places still was conducted under the pall of *Plessy v. Ferguson,* 163 U.S. 537 (1896); racial segregation in primary and secondary education prevailed in many parts of the country. . . .This Court's decision in *Brown v. Board of Education,* 347 U.S. 483 (1954), signalled an end to that era. Over the past quarter of a century, every pronouncement of this Court and myriad Acts of Congress and Executive Orders attest a firm national policy to prohibit racial segregation and discrimination in public education.

An unbroken line of cases following *Brown v. Board of Education* establishes beyond doubt this Court's view that racial discrimination in education violates a most fundamental national public policy, as well as rights of individuals.

The right of a student not to be segregated on racial grounds in schools . . . is indeed so fundamental and pervasive that it is embraced in the concept of due process of law.

Cooper v. Aaron, 358 U.S. 1, 19 (1958). In *Norwood v. Harrison,* 413 U.S. 455, 468-469 (1973), we dealt with a nonpublic institution:

> [A] private school -- even one that discriminates -- fulfills an important educational function; *however, . . . [that] legitimate educational function cannot be isolated from discriminatory practices. . . . [D]iscriminatory treatment exerts a pervasive influence on the entire educational process.*

(Emphasis added.) *See also Runyon v. McCrary,* 427 U.S. 160 (1976); *Griffin v. County School Board,* 377 U.S. 218 (1964).

Congress, in Titles IV and VI of the Civil Rights Act of 1964, Pub.L. 88-352, 78 Stat. 241, 42 U.S.C. §§ 2000c 2000c-6, 2000d, clearly expressed its agreement that racial discrimination in education violates a fundamental public policy. Other sections of that Act, and numerous enactments since then, testify to the public policy against racial discrimination. *See, e.g.,* the Voting Rights Act of 1965, Pub.L. 89-110, 79 Stat. 437, 42 U.S.C. § 1973 *et seq.*(1976 ed. and Supp. V); Title VIII of the Civil Rights Act of 1968, Pub.L. 90-284, 82 Stat. 81, 42 U.S.C. § 3601 *et seq.* (1976 ed. and Supp. V); the Emergency School Aid Act of 1972, Pub.L. 92-318, 86 Stat. 354 (repealed effective Sept. 30, 1979; replaced by similar provisions in the Emergency School Aid Act of 1978, Pub.L. 95-561, 92 Stat. 2252, 20 U.S.C. §§ 3191-3207 (1976 ed., Supp. V)).

. . . .

Few social or political issues in our history have been more vigorously debated and more extensively ventilated than the issue of racial discrimination, particularly in education. Given the stress and anguish of the history of efforts to escape from the shackles of the "separate but equal" doctrine of *Plessy v. Ferguson,* 163 U.S. 537 (1896), it cannot be said that educational institutions that, for whatever reasons, practice racial discrimination, are institutions exercising "beneficial and stabilizing influences in community life," 163 U.S. 537 (1896), it cannot be said that educational institutions that, for whatever reasons, practice racial discrimination, are institutions exercising "beneficial and stabilizing influences in community life," *Walz v. Tax Comm'n,*397 U.S. 664, 673 (1970), or should be encouraged by having all taxpayers share in their support by way of special tax status.

There can thus be no question that the interpretation of § 170 and § 501(c)(3) announced by the IRS in 1970 was correct. That it may be seen as belated does not undermine its soundness. It would be wholly incompatible with the concepts underlying tax exemption to grant the benefit of tax-exempt status to racially discriminatory educational entities, which "exer[t] a pervasive influence on the entire educational process." *Norwood v. Harrison, supra,* at 469. Whatever may be the rationale for such private schools' policies, and however sincere the rationale may be, racial discrimination in education is contrary to public policy. Racially discriminatory educational institutions cannot be viewed as conferring a public benefit within the "charitable" concept discussed earlier, or within the congressional intent underlying § 170 and § 501(c)(3).

C

Petitioners contend that, regardless of whether the IRS properly concluded that racially discriminatory private schools violate public policy, only Congress can alter the scope of § 170 and § 501(c)(3). Petitioners accordingly argue that the IRS overstepped its lawful bounds in issuing its 1970 and 1971 rulings.

Yet ever since the inception of the Tax Code, Congress has seen fit to vest in those administering the tax laws very broad authority to interpret those laws. In an area as complex as the tax system, the agency Congress vests with administrative responsibility must be able to exercise its authority to meet changing conditions and new problems. Indeed, as early as 1918, Congress expressly authorized the Commissioner "to make all needful rules and regulations for the enforcement" of the tax laws. Revenue Act of 1918, ch. 18, § 1309, 40 Stat. 1143. The same provision, so essential to efficient and fair administration of the tax laws, has appeared in Tax Codes ever since, *see* 26 U.S.C. § 7805(a); and this Court has long recognized the primary authority of the IRS and its predecessors in construing the Internal Revenue Code.

Congress, the source of IRS authority, can modify IRS rulings it considers improper; and courts exercise review over IRS actions. In the first instance, however, the responsibility for construing the Code falls to the IRS. Since Congress cannot be expected to anticipate every conceivable problem that can arise or to carry out day-to-day

oversight, it relies on the administrators and on the courts to implement the legislative will. Administrators, like judges, are under oath to do so.

. . . .

Guided, of course, by the Code, the IRS has the responsibility, in the first instance, to determine whether a particular entity is "charitable" for purposes of § 170 and § 501(c)(3). This in turn may necessitate later determinations of whether given activities so violate public policy that the entities involved cannot be deemed to provide a public benefit worthy of "charitable" status. We emphasize, however, that these sensitive determinations should be made only where there is no doubt that the organization's activities violate fundamental public policy.

On the record before us, there can be no doubt as to the national policy. In 1970, when the IRS first issued the ruling challenged here, the position of all three branches of the Federal Government was unmistakably clear. The correctness of the Commissioner's conclusion that a racially discriminatory private school "is not ‘charitable' within the common law concepts reflected in . . . the Code," Rev. Rul. 71-447, 1971-2 Cum.Bull., at 231, is wholly consistent with what Congress, the Executive, and the courts had repeatedly declared before 1970. Indeed, it would be anomalous for the Executive, Legislative, and Judicial Branches to reach conclusions that add up to a firm public policy on racial discrimination, and at the same time have the IRS blissfully ignore what all three branches of the Federal Government had declared. Clearly an educational institution engaging in**[p599]** practices affirmatively at odds with this declared position of the whole Government cannot be seen as exercising a "beneficial and stabilizing influenc[e] in community life," *Walz v. Tax Comm'n,* 397 U.S. at 673, and is not "charitable," within the meaning of § 170 and § 501(c)(3). We therefore hold that the IRS did not exceed its authority when it announced its interpretation of § 170 and § 501(c)(3) in 1970 and 1971.

D

The actions of Congress since 1970 leave no doubt that the IRS reached the correct conclusion in exercising its authority. It is, of course, not unknown for independent agencies or the Executive Branch to misconstrue the intent of a statute; Congress can and often does correct such misconceptions, if the courts have not done so. Yet, for a dozen years, Congress has been made aware -- acutely aware -- of the IRS rulings of 1970 and 1971. As we noted earlier, few issues have been the subject of more vigorous and widespread debate and discussion in and out of Congress than those related to racial segregation in education. Sincere adherents advocating contrary views have ventilated the subject for well over three decades. Failure of Congress to modify the IRS rulings of 1970 and 1971, of which Congress was, by its own studies and by public discourse, constantly reminded, and Congress' awareness of the denial of tax-exempt status for racially discriminatory schools when enacting other and related legislation make out an unusually strong case of legislative acquiescence in and ratification by implication of the 1970 and 1971 rulings.

Ordinarily, and quite appropriately, courts are slow to attribute significance to the failure of Congress to act on particular legislation. We have observed that "unsuccessful attempts at legislation are not the best of guides to legislative intent," *Red Lion Broadcasting Co. v. FCC,* 395 U.S. 367, 382, n. 11 (1969). Here, however, we do not have an ordinary claim of legislative acquiescence. Only one month after the IRS announced its position in 1970, Congress held its first hearings on this precise issue. Equal Educational Opportunity: Hearings before the Senate Select Committee on Equal Educational Opportunity, 91st Cong., 2d Sess., 1991 (1970). Exhaustive hearings have been held on the issue at various times since then. These include hearings in February. 1982, after we granted review in this case. Administration's Change in Federal Policy Regarding the Tax Status of Racially Discriminatory Private Schools: Hearing before the House Committee on Ways and Means, 97th Cong., 2d Sess. (1982).

Nonaction by Congress is not often a useful guide, but the nonaction here is significant. During the past 12 years. there have been no fewer than 13 bills introduced to overturn the IRS interpretation of § 501(c)(3). Not one of these bills has emerged from any committee, although Congress has enacted numerous other amendments to § 501 during this same period, including an amendment to § 501(c)(3) itself. Tax Reform Act of 1976, Pub.L. 94-455, § 1313(a), 90 Stat. 1730. It is hardly conceivable that Congress -- and in this setting, any Member of Congress -- was not abundantly aware of what was going on. In view of its prolonged and acute awareness of so important an issue, Congress' failure to act on the bills proposed on this subject provides added support for concluding that Congress acquiesced in the IRS rulings of 1970 and 1971.

The evidence of congressional approval of the policy embodied in Revenue Ruling 71-447 goes well beyond the failure of Congress to act on legislative proposals. Congress affirmatively manifested its acquiescence in the IRS policy when it enacted the present § 501(i) of the Code, Act of Oct. 20, 1976, Pub.L. 94-568, 90 Stat. 2697. That provision denies tax-exempt status to social clubs whose charters or policy statements provide for "discrimination against any person on the basis of race, color, or religion." Both the House and Senate Committee Reports on that bill articulated the national policy against granting tax exemptions to racially discriminatory private clubs. S.Rep. No. 94-1318, p. 8 (1976); H.R.Rep. No. 94-1353, p. 8 (1976).

Even more significant is the fact that both Reports focus on this Court's affirmance of *Green v. Connally,* 330 F.Supp. 1150 (DC 1971), as having established that "discrimination on account of race is inconsistent with an *educational institution's* tax-exempt status." S.Rep. No. 94-1318, *supra,* at 7-8, and n. 5; H.R.Rep. No. 94-1353, *supra* at 7-8, and n. 5 (emphasis added). These references in congressional Committee Reports on an enactment denying tax exemptions to racially discriminatory private social clubs cannot be read other than as indicating approval of the standards applied to racially discriminatory private schools by the IRS subsequent to 1970, and specifically of Revenue Ruling 71-447.

III

Petitioners contend that, even if the Commissioner's policy is valid as to nonreligious private schools, that policy cannot constitutionally be applied to schools that engage in racial discrimination on the basis of sincerely held religious beliefs. As to such schools, it is argued that the IRS construction of § 170 and § 501(c)(3) violates their free exercise rights under the Religion Clauses of the First Amendment. This contention presents claims not heretofore considered by this Court in precisely this context.

This Court has long held the Free Exercise Clause of the First Amendment to be an absolute prohibition against governmental regulation of religious beliefs. As interpreted by this Court, moreover, the Free Exercise Clause provides substantial protection for lawful conduct grounded in religious belief. However,

> [n]ot all burdens on religion are unconstitutional. . . . The state may justify a limitation on religious liberty by showing that it is essential to accomplish an overriding governmental interest.

United States v. Lee, 455 U.S. 252, 257-258 (1982).

On occasion, this Court has found certain governmental interests so compelling as to allow even regulations prohibiting religiously based conduct. In *Prince v. Massachusetts,* 321 U.S. 158 (1944), for example, the Court held that neutrally cast child labor laws prohibiting sale of printed materials on public streets could be applied to prohibit children from dispensing religious literature. The Court found no constitutional infirmity in "excluding [Jehovah's Witness children] from doing there what no other children may do." *Id.* at 171. Denial of tax benefits will inevitably have a substantial impact on the operation of private religious schools, but will not prevent those schools from observing their religious tenets.

The governmental interest at stake here is compelling. As discussed in Part II-B, *supra,* the Government has a fundamental, overriding interest in eradicating racial discrimination in education -- discrimination that prevailed, with official approval, for the first 165 years of this Nation's constitutional history. That governmental interest substantially outweighs whatever burden denial of tax benefits places on petitioners' exercise of their religious beliefs. The interests asserted by petitioners cannot be accommodated with that compelling governmental interest, *see United States v. Lee, supra,* at 259-260; and no "less restrictive means," *see Thomas v. Review Board of Indiana Employment Security Div., supra,* at 718, are available to achieve the governmental interest.

IV

. . . .

Petitioner Bob Jones University, however, contends that it is not racially discriminatory. It emphasizes that it now allows all races to enroll, subject only to its restrictions on the conduct of all students, including its prohibitions of association between men and women of different races, and of interracial marriage. Although a ban on intermarriage or

interracial dating applies to all races, decisions of this Court firmly establish that discrimination on the basis of racial affiliation and association is a form of racial discrimination, *see, e.g., Loving v. Virginia,* 388 U.S. 1 (1967); *McLaughlin v. Florida,* 379 U.S. 184(1964); *Tillman v. Wheaton-Haven Recreation Assn.,* 410 U.S. 431 (1973). We therefore find that the IRS properly applied Revenue Ruling 71-447 to Bob Jones University.

The judgments of the Court of Appeals are, accordingly,

Affirmed.

Notes

1. *The Limit of* Bob Jones University. The Court held in *Bob Jones University* that Congress could deny (and tacitly had denied) tax exempt status to a religious educational institution that discriminated on the basis of race even if the discrimination is mandated by the religious dictates of the organization. *Bob Jones University* has never been extended beyond this limited context. For example, it has not been extended to non-educational institutions nor has it been extended to discrimination other than that based on race.[19]

2. *The Relationship of the charitable deduction to the First Amendment.* In Regan v. Taxation with Representation of Washington, 461 U.S. 540 (1983), the taxpayer lost its tax-exempt status for engaging in political lobbying. Since the First Amendment protects the right to lobby, this organization argued that it had been punished for exercising a constitutional right. The Supreme Court denied the taxpayer's challenge, holding that tax-exemption is a subsidy and Congress is not obligated to subsidize lobbying.

In Walz v. Tax Commissioner, 397 U.S. 664 (1969), the Supreme Court held that giving a tax-exemption to churches does not violate the establishment clause of the First Amendment, thereby holding that exemption from taxes is not equivalent to a direct subsidy. Is this consistent with the view expressed in *Taxation with Representation of Washington* of tax-preferred status as a subsidy? On a related topic, see Abrams, *Systemic Coercion: Unconstitutional Conditions in the Criminal Law*, 72 J. CRIM. L. & CRIM. 128 (1981), and a subsequent piece, Abrams, *Economic Analysis and Unconstitutional Conditions: A Reply to Professor Epstein*, 27 SAN DIEGO L. REV. 359 (1990).

3. State and Local income and Property Taxes

To what extent should state and local taxes be deductible? To the extent that funds are unavailable for consumption, they should be deductible just like theft losses.[20] However, to the extent that state and local taxes pay for services (like garbage collection) provided to the taxpayer, they are properly considered to be part of consumption. Of course, just like when we were looking at meals and lodging provided by an employer, we are uncertain in this case if the taxpayer would voluntarily pay what the state charges in taxes

[19] Note that the government's position in Bob Jones University was that the racial discrimination precluded both tax exempt status for the institution and the §170 deduction for the donors.
[20] Recall that the deduction for theft and other casualty losses in §165(c)(3) has been eliminated. §165(h)(5).

for the services. Note that the personal deduction for state and local taxes is now capped at $10,000 per year. Of course, state and local taxes incurred in connection with profit-seeking activity remain deducible in full.

E. Mixed-Motive Expenditures

1. Commuting Expenses

Commissioner v. Flowers

326 U.S. 465 (19846)

MR. JUSTICE MURPHY delivered the opinion of the Court.

This case presents a problem as to the meaning and application of the provision of [§162(a)(2)] of the Internal Revenue Code, allowing a deduction for income tax purposes of "traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business."

The taxpayer, a lawyer, has resided with his family in Jackson, Mississippi, since 1903. There, he has paid taxes, voted, schooled his children, and established social and religious connections. He built a house in Jackson nearly thirty years ago, and at all times has maintained it for himself and his family. He has been connected with several law firms in Jackson, one of which he formed and which has borne his name since 1922.

In 1906, the taxpayer began to represent the predecessor of the Gulf, Mobile & Ohio Railroad, his present employer. He acted as trial counsel for the railroad throughout Mississippi. From 1918 until 1927, he acted as special counsel for the railroad in Mississippi. He was elected general solicitor in 1927, and continued to be elected to that position each year until 1930, when he was elected general counsel. Thereafter, he was annually elected general counsel until September, 1940, when the properties of the predecessor company and another railroad were merged and he was elected vice-president and general counsel of the newly formed Gulf, Mobile & Ohio Railroad.

The main office of the Gulf, Mobile & Ohio Railroad is in Mobile, Alabama, as was also the main office of its predecessor. When offered the position of general solicitor in 1927, the taxpayer was unwilling to accept it if it required him to move from Jackson to Mobile. He had established himself in Jackson both professionally and personally, and was not desirous of moving away. As a result, an arrangement was made between him and the railroad whereby he could accept the position and continue to reside in Jackson on condition that he pay his traveling expenses between Mobile and Jackson and pay his living expenses in both places. This arrangement permitted the taxpayer to determine for himself the amount of time he would spend in each of the two cities, and was in effect during 1939 and 1940, the taxable years in question.

The railroad company provided an office for the taxpayer in Mobile, but not in Jackson. When he worked in Jackson, his law firm provided him with office space, although he no longer participated in the firm's business or shared in its profits. He used his own office furniture and fixtures at this office. The railroad, however,

furnished telephone service and a typewriter and desk for his secretary. It also paid the secretary's expenses while in Jackson. Most of the legal business of the railroad was centered in or conducted from Jackson, but this business was handled by local counsel for the railroad. The taxpayer's participation was advisory only, and was no different from his participation in the railroad's legal business in other areas.

The taxpayer's principal post of business was at the main office in Mobile. However, during the taxable years of 1939 and 1940, he devoted nearly all of his time to matters relating to the merger of the railroads. Since it was left to him where he would do his work, he spent most of his time in Jackson during this period. In connection with the merger, one of the companies was involved in certain litigation in the federal court in Jackson, and the taxpayer participated in that litigation.

During 1939, he spent 203 days in Jackson and 66 in Mobile, making 33 trips between the two cities. During 1940, he spent 168 days in Jackson and 102 in Mobile, making 40 trips between the two cities. The railroad paid all of his traveling expenses when he went on business trips to points other than Jackson or Mobile. But it paid none of his expenses in traveling between these two points or while he was at either of them.

The taxpayer deducted $900 in his 1939 income tax return and $1,620 in his 1940 return as traveling expenses incurred in making trips from Jackson to Mobile and as expenditures for meals and hotel accommodations while in Mobile. . . .

[Under applicable treasury regulations, three conditions must] be satisfied before a traveling expense deduction may be made under [§162(a)(2)]:

> (1) The expense must be a reasonable and necessary traveling expense, as that term is generally understood. This includes such items as transportation fares and food and lodging expenses incurred while traveling.
>
> (2) The expense must be incurred "while away from home."
>
> (3) The expense must be incurred in pursuit of business. This means that there must be a direct connection between the expenditure and the carrying on of the trade or business of the taxpayer or of his employer. Moreover, such an expenditure must be necessary or appropriate to the development and pursuit of the business or trade.

In this instance, the Tax Court, without detailed elaboration, concluded that

> "The situation presented in this proceeding is, in principle, no different from that in which a taxpayer's place of employment is in one city and, for reasons satisfactory to himself, he resides in another."

It accordingly disallowed the deductions on the ground that they represent living and personal expenses, rather than traveling expenses incurred while away from home in the pursuit of business. The court below accepted the Tax Court's findings of fact, but reversed its judgment on the basis that it had improperly construed the word "home"

. . . . The Tax Court, it was said, erroneously construed the word to mean the post, station, or place of business where the taxpayer was employed -- in this instance, Mobile -- and thus erred in concluding that the expenditures in issue were not incurred "while away from home." The Court below felt that the word was to be given no such "unusual" or "extraordinary" meaning in this statute, that it simply meant "that place where one in fact resides" or "the principal place of abode of one who has the intention to live there permanently." 148 F.2d at 164. Since the taxpayer here admittedly had his home, as thus defined, in Jackson, and since the expenses were incurred while he was away from Jackson, the deduction was permissible.

The meaning of the word "home" in [§162(a)(2)] with reference to a taxpayer residing in one city and working in another has engendered much difficulty and litigation. 4 Mertens, Law of Federal Income Taxation (1942) § 25.82. The Tax Court and the administrative rulings have consistently defined it as the equivalent of the taxpayer's place of business. On the other hand, the decision below and *Wallace v. Commissioner,* 144 F.2d 407, have flatly rejected that view, and have confined the term to the taxpayer's actual residence. *See also Coburn v. Commissioner,* 138 F.2d 763.

We deem it unnecessary here to enter into or to decide this conflict. The Tax Court's opinion, as we read it, was grounded neither solely nor primarily upon that agency's conception of the word "home." Its discussion was directed mainly toward the relation of the expenditures to the railroad's business, a relationship required by the third condition of the deduction. Thus, even if the Tax Court's definition of the word "home" was implicit in its decision, and even if that definition was erroneous, its judgment must be sustained here if it properly concluded that the necessary relationship between the expenditures and the railroad's business was lacking. Failure to satisfy any one of the three conditions destroys the traveling expense deduction.

Turning our attention to the third condition, this case is disposed of quickly. There is no claim that the Tax Court misconstrued this condition or used improper standards in applying it. And it is readily apparent from the facts that its inferences were supported by evidence and that its conclusion that the expenditures in issue were nondeductible living and personal expenses was fully justified.

The facts demonstrate clearly that the expenses were not incurred in the pursuit of the business of the taxpayer's employer, the railroad. Jackson was his regular home. Had his post of duty been in that city, the cost of maintaining his home there and of commuting or driving to work concededly would be nondeductible living and personal expenses lacking the necessary direct relation to the prosecution of the business. The character of such expenses is unaltered by the circumstance that the taxpayer's post of duty was in Mobile, thereby increasing the costs of transportation, food, and lodging. Whether he maintained one abode or two, whether he traveled three blocks or three hundred miles to work, the nature of these expenditures remained the same.

The added costs in issue, moreover, were as unnecessary and inappropriate to the development of the railroad's business as were his personal and living costs in Jackson. They were incurred solely as the result of the taxpayer's desire to maintain a home in Jackson while working in Mobile, a factor irrelevant to the maintenance and prosecution of the railroad's legal business. The railroad did not require him to travel on business from Jackson to Mobile, or to maintain living quarters in both cities. Nor did it compel him, save in one instance, to perform tasks for it in Jackson. It simply asked him to be at his principal post in Mobile as business demanded and as his personal convenience was served, allowing him to divide his business time between Mobile and Jackson as he saw fit. Except for the federal court litigation, all of the taxpayer's work in Jackson would normally have been performed in the headquarters at Mobile. The fact that he traveled frequently between the two cities and incurred extra living expenses in Mobile, while doing much of his work in Jackson, was occasioned solely by his personal propensities. The railroad gained nothing from this arrangement except the personal satisfaction of the taxpayer.

Travel expenses in pursuit of business within the meaning of [§162(a)(2) could arise only when the railroad's business forced the taxpayer to travel and to live temporarily at some place other than Mobile, thereby advancing the interests of the railroad. Business trips are to be identified in relation to business demands and the traveler's business headquarters. The exigencies of business, rather than the personal conveniences and necessities of the traveler, must be the motivating factors. Such was not the case here.

It follows that the court below erred in reversing the judgment of the Tax Court.

Reversed.

2. Business Expenses for Entertainment

Many ordinary and necessary expenditures described in §162 may have a significant personal component because §162 requires only that the taxpayer's primary purpose be that the expenditure is appropriate and helpful in the taxpayer's trade or business. See, e.g., Reg. §1.162-2(b)(1). So, for example, if a taxpayer travels for the primary purpose of conducting business with a client but uses the occasion to spend time with an out-of-state relative who resides near the client, the cost of the travel will be deductible under §162. *Id*. Of course, to the extent that the taxpayer spends extra funds to spend an additional night (or nights) in a hotel to visit with the family, such extra costs are not described in §162 because the primary purpose for such expenditures was wholly personal. *Id.*

How should the cost of business meals be treated? How should the cost of business entertainment be treated? While the cost of meals generally is treated as personal and so nondeductible, see §262, the cost of business meals while traveling away from home on business are deductible so long as they are not lavish or extravagant under the circumstances. §162(a)(2). Note that for this provision, "away from home" requires the taxpayer to have spent at least one night away from home. United States v. Correll, 398 U.S. 299 (1967). Thus, the cost of meals incurred on day trips will not

qualify for the deduction. And even as to the cost of meals that do qualify, only 50% of the costs is deductible. §274(k).