# The Taxpayer's Third Personality: Comments on *Redlark v. Commissioner*

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## INTRODUCTION

Some cases force us to think about basic income tax principles in unfamiliar ways.[1] *Redlark*[2] is such a case. It deals specifically with the deduction of interest on overdue federal income taxes based on adjustments to business income as a business expense. But it does more. *Redlark* also forces us to think about the traditional two-personality approach to defining the income tax base, derived from *United States v. Gilmore*.[3] In the traditional analysis, taxpayers have two personalities—a business and personal personality—concerned respectively with profit-seeking and pleasure-seeking. But efforts to analyze income taxes and related payments from a two-personality perspective work very poorly. It turns out that taxpayers have a third personality—concerned with group redistribution of wealth—which has its own criteria for deductibility, and that income taxes (and perhaps some other payments, such as gifts, alimony, and personal insurance) fall within this third category. *Redlark* is an occasion to think about these issues.

*Redlark* also addresses several specific income tax issues of general interest—whether or not income taxes on business income and payments related to such taxes (such as interest on overdue taxes, litigation costs, and insurance premiums paid to cover such obligations) are deductible business expenses. Explicit statutory rules do not resolve these issues, leaving them to be resolved by basic income tax principles. Sometimes these payments are (or were) deductible as itemized deductions under specific provisions of the Internal Revenue Code ("Code"), such as the deduction for state income taxes,[4] the deduction of personal interest (before 1986),[5] and the deduction of tax litigation costs.[6] But these specific statutory rules leave open the question whether the payments are deductible business expenses, which is important for the following

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1. A recent example is Zarin v. Commissioner, 92 T.C. 1084 (1989), *rev'd*, 916 F.2d 110 (3d Cir. 1990) (where the downward adjustment of a gambler's debt raised questions about identifying taxable personal consumption).

2. Redlark v. Commissioner, 106 T.C. 31 (1996).

3. 372 U.S. 39 (1963).

4. I.R.C. § 164(a)(3) (West 1988). Before the War Revenue Act in 1917, federal income taxes were deductible. J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAW 1938-1861, at 943-44 (1938).

5. I.R.C. § 163(a), before amendment by Tax Reform Act of 1986, Pub. L. No. 99-514, § 511(b), 100 Stat. 2085, 2246 (adding § 163(h) (current version at § 163(h) (West Supp. 1996))).

6. I.R.C. § 212(3) (West 1988).

reasons: (1) computing adjusted gross income (AGI);[7] (2) computing net operating loss carry overs (NOL);[8] and (3) computing alternative minimum taxable income.[9]

The courts and the IRS have not always agreed on how to characterize income taxes on business income and related interest and litigation expenses. (Insurance premiums surfaced as an issue in 1983, but received no attention from courts or the IRS.[10]) There was (eventually) agreement on three points. First, the courts[11] and the IRS (in 1970),[12] agreed that state income taxes, and litigation and interest expenses related to federal and state income taxes, were deductible in computing NOL, if the tax was on business income. Second, there was agreement that state income taxes were *never* deductible as business expenses in computing AGI, based on specific 1944 legislative history.[13] Third, in 1992, the government agreed with case law that litigation expenses related to state and federal income tax on business income *were* business expenses for computing AGI.[14]

There has not been similar agreement about the interest expense. Before the 1986 law disallowed a deduction for "personal interest," case law disagreed with the IRS and allowed the deduction in computing AGI.[15] After the 1986 law disallowed the deduction of "personal interest" (currently defined not to include interest "properly allocable to a trade or business"),[16] the case law has split. The Eighth Circuit in *Miller* upheld the Temporary Regulation treating interest on

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7. I.R.C. § 62 (West 1988). If expenses do not reduce AGI, they may be useless because of the 2% floor on itemized deductions, I.R.C. § 67 (West 1988), or be replaced by the standard deduction, I.R.C. § 63(b)(2), (e) (West 1988), or be reduced if AGI is too large, I.R.C. § 68 (West 1988).

8. I.R.C. § 172 (West 1988).

9. I.R.C. § 56(b) (West 1988). With exceptions not relevant here, the minimum tax uses AGI to define its tax base. The itemized deductions for state income taxes and tax litigation costs are not deductible.

10. *See* N.Y. State Bar Ass'n Tax Section, *A Report on Tax Audit Insurance, reprinted in* 22 TAX NOTES 53 (1984); William D. Popkin, *Taxing Personal Insurance: The Case of Tax Audit Insurance*, 4 VA. TAX REV. 379 (1985).

11. Reise v. Commissioner, 35 T.C. 571 (1961), *aff'd*, 299 F.2d 380 (7th Cir. 1962) (holding that state income taxes, litigation costs, and interest were business expenses deductible under the tax code); Polk v. Commissioner, 31 T.C. 412 (1958), *aff'd*, 276 F.2d 601 (10th Cir. 1960) (interest related to income taxes).

12. Rev. Rul. 70-40, 1970-1 C.B. 50.

13. Tanner v. Commissioner, 45 T.C. 145 (1965), *aff'd per curiam*, 363 F.2d 36 (4th Cir. 1966) (legislative history found at S. REP. NO. 885, 78th Cong., 2d Sess. 877-78 (1944)).

14. Standing v. Commissioner, 28 T.C. 789 (1957), *aff'd*, 259 F.2d 450 (4th Cir. 1958); Rev. Rul. 92-29, 1992-1 C.B. 20 (Schedule C (sole proprietor), Part I of Schedule E (rents and royalties), and Schedule F (farming) (modifying Rev. Rul. 70-40, 1970-1 C.B. 50)).

15. *Standing*, 28 T.C. at 789. *But see* True v. United States, 35 F.3d 574 (10th Cir. 1994) (Interest is not deductible business expense for computing alternative minimum taxable income for taxable period prior to effective date of Tax Reform Act of 1986.).

16. I.R.C. § 163(h) (West Supp. 1996). The 1986 law initially excluded interest "incurred or continued in connection with the conduct of a trade or business." Tax Reform Act of 1986, Pub. L. No. 99-514, § 511(b), 100 Stat. 2085, 2246 (adding § 163(h)).

unpaid taxes related to business income as nondeductible personal interest.[17] In *Redlark*, the Tax Court disagreed, allowing the deduction as a business expense in computing AGI.[18] Now that personal interest is not deductible at all, a decision that the interest is allocable to a trade or business is necessary to support both an NOL carryover and a deduction in computing AGI.[19]

In this essay, I will first review the origin test (Part I) and explain how *Redlark* is an application of that test (Part II). I then turn to a discussion of the taxpayer's third personality—first in the context of gifts and alimony (Part III), then personal insurance (Part IV), and, finally, by applying the third personality approach to the income tax and related expenses (Part V).

## I. TAX PERSONALITIES: THE ORIGIN TEST

The contrast between two personalities—business and personal—comes from Justice Harlan's opinion in *Gilmore*.[20] Usually, it is easy to attribute expenses between the two personalities. Just look and see whether the taxpayer's purpose in incurring the expense is to obtain business receipts or reduce costs needed to acquire those receipts; if so, it is a deductible business expense. The problem in *Gilmore* arose when the taxpayer was defending property from a claim that arose out of personal activity (a divorce proceeding). Harlan adopted an origin test to characterize the expense—looking at whether the dispute originated in personal activities.

The origin test has always had a mechanically reassuring surface attraction. It sounds as though you can look back in time to see whether the events which gave rise to the expense were personal or business. The trouble is that nothing in the

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17. Miller v. United States, 65 F.3d 687 (8th Cir. 1995). The court of appeals rejected the district court's decision in Miller v. United States, 841 F. Supp. 305 (D.N.D. 1993), that the Regulation was invalid. The district court had, however, found for the government on the ground that the particular interest expense was not a busincss expense, having arisen because of "an obviously impropcr income deferral scheme." 95-1 USTC ¶ 50,068 (D.N.D. 1994).

18. Redlark v. Commissioner, 106 T.C. 31 (1996), allowed the interest deduction, rejecting the agcncy Rcgulation defining the intercst as personal.

19. The reader will notiee that I am simplifying the discussion in one respect—by characterizing business as the only profit-secking activity. The tax code also recognizes deductions related to nonbusincss income-producing activities (generally, investment activities) in I.R.C. § 212(1), (2) (West 1988). In the contcxt of deductions for income taxes and related payments, however, this refincment is an unnecessary complication beeause the nonbusiness deduction is conditioned on proving a connection to income production, just as a business expense deduction is eonditioned on demonstrating a relation to business activity. The same argumcnts which would justify a business expense deduction would support a dcduction as a nonbusiness income-producing expense if the expenses were related to such activities.

It is important for an expense to be a nonbusiness income-producing deduction in two situations. First, it might be the only route to deduetion. Second, in a few instances, a deduction for a nonbusiness income-producing expense is allowed in computing AGI. *See* I.R.C. § 62(a)(4) (West 1988) (expenses related to rent and royalties); § 67(e) (expenses incurred by estates and trusts which would not have becn incurred if the property were not held in a trust or estate; *see* O'Neill v. Commissioner, 994 F.2d 302 (6th Cir. 1993) (investment advisory fees)).

20. United States v. Gilmore, 372 U.S. 39 (1963).

origin test tells you when to stop running the clock backwards to decide what prior event characterizes a later expense to which it can be traced. Is a commuting expense traceable to the job decision or to a personal decision about where to live; is child care the result of a decision to work or a personal decision to have a child; are education expenses the result of a work choice or a personal choice about how to spend one's life?[21] These are difficult questions which take the business versus personal distinction to its limits. Not surprisingly, when underlying theory is uncertain, policies which have nothing to do with defining the fair tax base are influential. It is hard to decide how to characterize commuting expenses without considering the impact of a deduction on the comparative treatment of suburban versus inner-city commuters; or how to treat child care expenses without considering the impact on middle class female workers;[22] or how to characterize education expenses without thinking about how the poor and the well-off would fare if education expenses were depreciable.

The *Gilmore* case itself involved litigation expenses to defend against a divorce proceeding where the taxpayer's property might be lost to his wife. Although relying primarily on the origin test to define the expense as personal, Harlan also alluded to important policy concerns. Was it fair to allow litigation costs to be deducted depending on whether the taxpayer had business or other assets or to vary the value of the deduction depending on the tax bracket? The person seeking the property might be in a much lower bracket or be forced to add litigation payments to the basis of acquired assets. One of the puzzles growing out of *Gilmore*, highlighted by this analysis, is why the income-seeker of taxable alimony can get a deduction[23] but the person defending his assets cannot. Both expenses originate in the personal dispute and the unequal treatment has a potential impact on the litigants.

In some settings, however, the two-personality approach fails to provide any guidance at all. Some expenses are expressions of a third personality—derived from shared membership in a group and resulting in wealth redistribution within that group. When payments are group redistributions of wealth, the dominant consideration is whether there is overall gain to the group, not characterization as a business or personal expense. Absent such gain, the total income of the group should be zero. Whether the payer should deduct or the payee should report income to record the overall net zero result remains important for reasons of revenue and economic efficiency, but the issue cannot be resolved within the confines of the traditional two-personality approach.

This Article argues that focusing on a group-redistribution personality can do a better job of explaining how certain expenses, including income taxes and related payments, should be taxed. A good part of the argument dwells on how inadequate the two-personality approach is in such cases. There is less certainty

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21. *Cf.* Hantzis v. Commissioner, 38 T.C.M. 1169 (1979), *rev'd and remanded*, 638 F.2d 248 (1st Cir. 1981) (A law student cannot deduct living expenses at a New York summer job while away from her residence in Cambridge, Massachusetts.).

22. *See* Symes v. Canada, [1993] 4 S.C.R. 695, [1994] 1 C.T.C. 40 (holding that child care expense, even if required in order to engage in an occupation, is not a deductible business expense).

23. Wild v. Commissioner, 42 T.C. 706 (1964), *acq.*, 1967-2 C.B. 4.

about what the proper treatment of group redistribution expenses should be, but that uncertainty is one of the major lessons to be learned from taking account of a third group redistribution personality. The fundamental theoretical issue in taxation is to define what wealth taxpayers can fairly be asked to share with the government. Fairness concerns properly focus on the concept of personal consumption as at least one component of the fair tax base, tending to overshadow other concerns, such as economic efficiency or other policies unconcerned with tax fairness. But fairness issues remain in the forefront only if we can confidently identify personal consumption. When that becomes very difficult, other policy concerns become more important. Such policies are, however, difficult for courts to resolve without legislative guidance. No wonder the deductibility of income taxes and related payments is so contested and the existing efforts to rationalize the judicial and statutory rules so difficult to justify.

## II. *REDLARK* AS A TWO-PERSONALITY OPINION

The Tax Court's *Redlark* opinion illustrates the difficulty of trying to force income taxes and related payments into the two-personality mold. The technical issue was whether the interest on late federal income taxes was, to quote the statute, "properly allocable to a trade or business."[24] If not, the interest was (since 1986) nondeductible "personal interest."[25] The court held that, because the tax dispute arose from defining business income, the interest on late income taxes was allocable to a business debt, just as the business origin of any dispute would characterize related payments as business expenses.[26] This is the origin test, pure and simple, although the court did not cite *Gilmore*. Judge Halpern's dissent also adopted a two-personality approach, but would have disallowed the deduction. He argued that the nondeductiblity of federal income taxes meant that the taxes were personal consumption and, consequently, that the interest on late income tax payments was not allocable to a business.

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24. I.R.C. § 163(h)(2)(A) (West Supp. 1996).

25. "Personal interest" is a residual statutory category, defiued as any interest other than a specific list of deductible interest payments, including business interest. I.R.C. § 163(h)(1), (2) (West Supp. 1996), adopted by Pub. L. No. 99-514, § 511(b), 100 Stat. 2085, 2246 (1986). The current language—"properly allocable to a trade or business"—was a 1988 amendment to the original 1986 text. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1005(c)(4), 102 Stat. 3342, 3390 (1986). The 1986 text had traced interest to a business if the loan was "incurred or continued" in connection with the conduct of a trade or business, which was also the text of § 265(a)(2) (dealing with borrowing related to tax exempt bonds). However, before 1988, the "properly allocable" language applied to define investment interest and interest traceable to passive business activities, and the 1988 amendment conformed the language defining business loans to that used for investment and passive business activity. H. REP. NO. 795-816, 100th Cong., 2d Sess. 35 (1988) ("[C]hange results in consistency in the language of several significant provisions under which interest is likely to be allocated, and permits consistent application of a standard for allocation of interest."). No change in law was intended by the 1988 amendment, according to *Redlark*, 106 T.C. at 31.

26. *Cf.* Kornhauser v. United States, 276 U.S. 145 (1928) (discussing expenses to defend against suit by former partner regarding prior partnership business activities).

The Tax Court also discussed the Temporary Regulations, one section of which flatly defined interest on back taxes as nondeductible personal interest.[27] Another section of the Regulations dealt generally with tracing debt and adopted a "use" test for determining whether debt could be traced to a business.[28] Under the Regulation's use test, the only question is the specific use to which debt is put. If cash does not change hands between lender and borrower, use is traced as follows:

> If a taxpayer incurs or assumes a debt in consideration for the sale or use of property, for services, or for any other purpose, . . . and no debt proceeds are disbursed to the taxpayer, the debt is treated for purposes of this section as if the taxpayer used an amount of the debt proceeds equal to the balance of the debt outstanding at such time to make an expenditure for such property, services, or other purpose.[29]

A seller-financed purchase is the most obvious example of incurring a debt without cash changing hands. The Tax Court suggested that an income tax debt arising from a dispute over business income was "properly allocable to business activity" under the tracing rule applicable when cash does not change hands. But saying so does not make it so, as the dissent noted. An individual who keeps unpaid taxes and incurs interest charges retains assets available for business *or* personal use.

The court's problem was trying to force analysis of income taxes and related payments into a two-personality approach, by applying the origin test. But the two-personality test is itself an inadequate guide to analyzing these expenses, which are an expression of a third group redistribution personality. Before specifically discussing income taxes and related payments as examples of a group redistribution approach, let us examine other possible illustrations of this approach—specifically, gifts and alimony, and personal insurance.

## III. GIFTS AND ALIMONY

The correct income tax treatment of gifts has always seemed a puzzle, as Bill Klein noted some years ago.[30] The donee was not taxed by the 1913 income tax, even though the donee gets cash. Early explanations for the exclusion could rely on the *Eisner v. Macomber*[31] definition of income as the "fruits" from capital or

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27. Temp. Reg. § 1.163-9T(b)(2)(i)(A), 52 Fed. Reg. 48,409 (Dec. 22, 1987).

28. Temp. Reg. § 1.163-8T(c)(1), 52 Fed. Reg. 25,000 (July 2, 1987). The "use" test rejected two alternative approaches. One alternative supplements the "use" test by specifically tracing debt to property pledged as security or to property retained in lieu of borrowing. This is the I.R.C. § 265(a)(2) (West 1988) test for tracing loans to tax exempt bonds ("incurred or continued to purchase or carry" the bond). A second alternative to the use test is a pro rata approach, tracing all debt to the retention and acquisition of all property or a subset of the taxpayer's property. A pro rata test is used to allocate interest expenses between assets producing tax exempt interest and other assets, once the loan is indirectly traced to carrying a tax exempt bond. Rev. Proc. 72-18, 1972-1 C.B. 740, 743 (§ 7.02).

29. Temp. Reg. § 1.163-8T(e)(ii), 52 Fed. Reg. 25,001 (July 2, 1987).

30. William A. Klein, *An Enigma in the Federal Income Tax: The Meaning of the Word "Gift"*, 48 MINN. L. REV. 215 (1963).

31. 252 U.S. 189, 206 (1920).

labor "trees." But *Glenshaw Glass* looks for accession to wealth and the donee's cash is certainly that.[32] Moreover, after *Horst*,[33] the satisfaction of giving could justify taxing the donor as well.

The Code does not tax both donor and donee,[34] however, and we are inclined to think that taxing both would amount to double taxation. But double taxation is a pejorative term, stating rather than guiding us to a conclusion. If there are two items of personal consumption, there is no double tax. The best answer to the puzzle of taxing gifts lies in a group redistribution approach, which treats the donor and donee as members of a group, redistributing a single item of income.[35] The only question is what rate should apply to the income. Should it be the donor's or donee's tax rate? If we assume that the donor and donee are members of the same family, and that the donor is likely to be in the higher bracket, we might conclude that the donor's tax bracket should apply to the family's consumption. The Code elsewhere prevents donors from choosing where in the family tax losses can be best utilized[36] and, more recently, prevents shifting investment income to young children,[37] in effect treating donors and donees as a single taxable group for certain purposes.[38] The no-deduction no-inclusion approach for gifts also assumes that one item of income is redistributed within a single family group, but prevents shifting the income from which the gift was made to a lower bracket.

Alimony is also taxed once, though usually at the transferee's rate. Before 1942, alimony was excluded from the transferee's income, based on the Court's decision in *Gould v. Gould*,[39] though the explanation was a bit murky. The Court implied that alimony was not income because it was a "portion of the husband's estate," did "not arise from any . . . business transaction," and was "not founded on contract."[40] These rationales would presumably give way, however, to the modern "accession to wealth" approach to defining income. The better reason for exclusion of alimony, hinted at by the Court, was that only one tax was appropriate within a group split by marital discord—"net income of the divorced husband . . . was not decreased by the payment of alimony . . . and . . . the sum received by the wife . . . cannot be regarded as income . . . ."[41]

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32. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

33. Helvering v. Horst, 311 U.S. 112 (1940).

34. Unless the gift tax, despite its own set of exclusions and exemptions, is thought of as taxing the donor.

35. *See* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 348-49 (1972).

36. I.R.C. § 1015(a) (West 1988) (Donee's basis is lower of donor's basis or value at time of gift, preventing donor from shifting losses to donee.); I.R.C. § 267(a)(1) (West 1988) (Seller cannot recognize loss on sale to family member.).

37. I.R.C. § 1(g) (West Supp. 1996) ("kiddie tax").

38. The "kiddie tax" rule allows an election to aggregate parent and child income as the parent's income. I.R.C. § 1(g)(7) (West Supp. 1996).

39. 245 U.S. 151 (1917).

40. *Gould*, 245 U.S. at 153 (quoting Audobon v. Shufeldt, 181 U.S. 575, 577, 578 (1901)).

41. *Id.* at 154.

In 1942, Congress continued the "one income" approach to alimony but taxed the transferee.[42] Case law introduced some variations on this pattern. Property splits under state law were taxed the old way—no-deduction and no-inclusion;[43] gain or loss on property transfers were sometimes taxed to the transferor and not to the transferee,[44] but in that case the transferee got a basis equal to value at the time of the transfer.[45] The latest rules, adopted in 1984,[46] let the parties in the split unit decide which tax rate to apply on cash payments and require basis transfer from transferor to transferee when property is conveyed.[47] The one common thread throughout the case law and statutory permutations is one tax on the group.

## IV. INSURANCE AGAINST INCOME LOSS

### *A. Introduction*

Insurance against personal losses is another area of income tax law which can be usefully analyzed from a group redistribution perspective. I focus here on insurance against income loss because it avoids some of the more complex issues raised by other types of personal insurance. Daniel Halperin's sophisticated study of valuing personal consumption, insofar as it deals with insurance,[48] focuses primarily on insuring against risks to personal use property, where the issues are complicated by several possibilities not present in the case of insurance against income loss: specifically—basis in the lost property; the fact that insurance recoveries may not provide the insured with new consumption opportunities; and the presence of untaxed gain when the insured property does *not* suffer a casualty. As Halperin notes in his "preliminary" remarks about insurance against income loss,[49] such insurance involves no basis in lost property, no limits on spending the proceeds for personal consumption, and no difficulty in taxing income when the risk does *not* occur and the taxpayer's income flow continues. The dominant question, Halperin notes, is whether the insurance premiums provide the insured with taxable personal consumption. Does the taxpayer who insures acquire taxable personal consumption in the form of security?

42. Pub. L. No. 77-753, § 120, 56 Stat. 798, 816 (1942), codified as I.R.C. §§ 22(k) (requiring the inclusion of alimony in the payee's income) and 22(u) (allowing an alimony deduction to the payer).

43. Imel v. United States, 523 F.2d 853 (10th Cir. 1975).

44. Davis v. United States, 370 U.S. 65 (1962).

45. Farid-es-Sultaneh v. Commissioner, 160 F.2d 812 (2d Cir. 1947).

46. Pub. L. No. 98-369, §§ 421-422, 98 Stat. 494, 793, 795 (1984) (codified in scattered sections of I.R.C.).

47. I.R.C. § 71(b)(1)(B) (West 1988) (Payer and payee can elect to have payment taxed at payer's tax rate.); §§ 1015(e) (West 1988), 1041(b)(2) (West Supp. 1996) (basis of property transferred from payer to payee).

48. Daniel I. Halperin, *Valuing Personal Consumption: Cost Versus Value and the Impact of Insurance*, 1 FLA. TAX REV. 1 (1992).

49. *Id.* at 45-49.

The tax treatment of insurance against income loss also raises fewer economic efficiency problems. The comparison between deductible uninsured casualty losses and nondeductible casualty insurance premiums might influence people to underinsure and purchase less durable property or take more risks when using the property.[50] But disability and death are sufficiently unpleasant that people are unlikely to increase these risks based on how the insurance premiums or proceeds are taxed. I do not mean that the impact of the tax law on insuring against income loss raises no public policy concerns, especially if the government feels the need to replace the lost income. Such concerns may even lead to tax subsidies for purchasing insurance. But the amount of risky behavior is not likely to increase or decrease depending on how the insurance is taxed.

### *B. Two-Personality Analysis*

There are two ways to analyze the taxation of insurance premiums and the proceeds covering income loss based on a conventional two-personality approach. One approach treats the premiums and proceeds as related in the same way that any expenditure might be related to the production of future income and asks whether the expense is for income production or personal satisfaction. Another two-personality approach adopts the origin test.

#### 1. Premiums to Produce Income

If the premiums are incurred to produce future income and the income should be taxable (because, under *Glenshaw Glass*,[51] the income is an accession to wealth replacing lost taxable income), then related expenses should be deductible. On this theory, the premiums would be deductible whether or not the proceeds were collected, just as expenses are deductible when they exceed gross income in any income-producing activity.

If we isolate the insurance as the only relevant activity, this tax result seems strange. The premium, unlike a lottery ticket, is not paid in an effort to win the gamble with the insurance company—it is not incurred to generate the income. The premium is like a wager that the wagerer would rather lose. But that takes too narrow a view of the insurance against income loss. The insurance premium is better thought of as analogous to maintenance expenses, like repairs on a factory, incurred to preserve income flow. Although income in the form of insurance proceeds is not the taxpayer's preferred objective, the premiums are incurred to maintain income. This suggests deducting the premiums and taxing the proceeds.

The difficulty with this approach is that it fails to recognize the personal satisfaction element in acquiring secure protection from income loss. This income guarantee is arguably a nondeductible personal consumption item like

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50. *See generally* Louis Kaplow, *The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums*, 79 CAL. L. REV. 1485 (1991).

51. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

any other personal satisfaction. As Halperin notes, there is an argument *against* taxing this personal satisfaction (and for deducting the insurance premiums) based on a comparison of the risk averse taxpayer who insures and the risk neutral taxpayer who does not. The risk averse taxpayer who insures does not increase his expectations beyond that of the uninsured risk neutral taxpayer, who does not insure and accepts the reality that future income might not be realized.[52] He gives the following example. Assuming a 1% risk that $10,101 of income will not be realized because of death, the expected value to the uninsured risk neutral taxpayer is $10,000. The risk *averse* taxpayer who buys life insurance for $101 (1% times $10,101) to assure a certainty of $10,000 (a guarantee of $10,101 minus the $101 premium) also has a $10,000 expectation. Should the risk averse taxpayer have $10,101 income (despite the $101 premium) when the risk neutral taxpayer has that income *only if* the risk of loss does not occur?

The problem with this argument for deducting personal insurance premiums is that it would reduce tax because some taxpayers are led by their psychological predispositions—risk averseness—to make purchases that others do not make. But differences in individual psychology are not usually taken into account to reduce taxable income (except perhaps for a compulsive gambler like Zarin).

Halperin also suggests another argument in favor of deducting personal insurance premiums—that disallowing the premium deduction is inconsistent with allowing the deduction of premiums for insurance which protects against business interruption.[53] There are two reasons for rejecting this argument. First, there is indeed no reason why premiums for business interruption insurance protecting against personal risks should be deductible if personal insurance premiums are not, but the inconsistency argues as much for disallowing the deduction of business insurance premiums as for deducting premiums for personal insurance. Second, one argument presented by Halperin to support the deduction of premiums for business interruption insurance (and, by inference, for personal insurance) is troublesome. He notes that disallowing a deduction for premiums for business interruption insurance would discriminate between buying insurance and other purchases to protect the business, such as security guards, the cost of which is surely deductible. That may be true. But the same point can be made to *object* to deducting personal insurance premiums. Why should personal insurance premiums be deductible if expenses to take greater precautions while engaged in personal activity to prevent disability or death are not deductible (for example, the cost of a safer car)?

The personal satisfaction rationale for nondeductibility of personal insurance premiums, though plausible when we compare the risk averse insurer to the uninsured risk neutral taxpayer, nonetheless produces a troubling conclusion when we look just at the group of insured taxpayers. For example, assumc two people each with a prospect of $1000 income, but a threat of a $100 loss from disability. The risk of loss is 50%, and premiums are $50 each. Absent insurance, the loss lowers total income to $1900 ($900 for the loser plus $1000 for the taxpayer who suffers no loss). Does insurance increase income? If the premiums

52. Halperin, *supra* note 48, at 48-49.
53. *Id.* at 48.

are nondeductible personal expenses and the proceeds are taxable, total income is $2000 ($900 plus $100 proceeds for the loser, without a deduction for premiums; plus $1000 for the taxpayer who suffers a loss, without a deduction for premiums). Does the group really have $2000 income when one of the two taxpayers with a prospect of $1000 income earns $100 less because of disability? Isn't the value of security, like the enjoyment of giving, too insubstantial to support inclusion in the tax base, at least when we adopt the perspective of the *entire* group within which the cash is redistributed?

### 2. Origin Test

A second two-personality approach focuses not on what the insurance premiums buy, but on the origin of the risky activity. The deductibility of the premiums would depend on the origin of the activity giving rise to the covered risk. If the risk is a business risk, the premium is deductible; otherwise it is a nondeductible personal expense. This appears to be the analysis under current law. Thus, premiums paid for nonoccupational disability insurance are nondeductible personal expenses,[54] but payments by employees to a union-financed unemployment fund are deductible business expenses.[55] The same distinction was reaffirmed in a series of rulings which allowed employees a deduction for taxes to fund government unemployment insurance,[56] but not taxes to pay for nonoccupational disability insurance,[57] based on a provision that allowed a deduction for state taxes paid or incurred in carrying on a trade or business.[58]

But the origin test is as unsatisfactory in explaining how personal insurance should be taxed as an approach which tries to decide whether the premiums are for income production or personal satisfaction. For example, why is the entire premium nondeductible because *some* of the covered risks arise from personal activity, instead of being allocated between nondeductible personal and deductible business risks? And why are the premiums deductible if the insurance compensates for business overhead costs incurred while the business is not functioning (thereby increasing net income), even though the insured risks

54. Blaess v. Commissioner, 28 T.C. 710 (1957) (proteeting from loss of body part or its use); Rev. Rul. 58-480, 1958-2 C.B. (same); Rev. Rul. 55-331, 1955-1 C.B. 271 (same); 62 Rev. Rul. 70-394, 1970-2 C.B. 34 (insuring pilot against inability to fly). *But see* I.T. 3607, 1943 C.B. 110 (allowing business expense deduetion for state-mandated employee payments to cash sickness compensation fund).

55. I.T. 2888, XIV-1 C.B. 54 (1935).

56. Rev. Rul. 75-48, 1975-1 C.B. 62 (unemployment insurance).

57. Rev. Rul. 75-149, 1975-1 C.B. 65-66 (nonoccupational disability insurance); Rev. Rul. 75-148, 1975-1 C.B. 64 (same); Rev. Rul. 75-48, 1975-1 C.B. 62 (same); Rev. Rul. 71-73, 1971-1 C.B. 52 (same). Later rulings allowed the deduction as a state *income* tax under I.R.C. § 164(a)(3) (West Supp. 1996). Rev. Rul. 81-193, 1981-2 C.B. 52; Rev. Rul. 81-194, 1981-2 C.B. 55. These rulings probably respond to the decision in McGowan v. Commissioner, 67 T.C. 599 (1976) (treating mandatory withholding of disability insurance premiums under state law as an income tax).

58. The current seetion is I.R.C. § 164(a) (West 1988) (flush paragraph).

include those from personal activity.[59] Moreover, there is no explanation why the business, rather than the personal origin of the risk, should justify a deduction when the result in both cases is personal income security. Perhaps we are supposed to assume that the insurance is a cost of the underlying personal activity, when the insurance covers risks from personal behavior. But that is plausible only if the purchase of the insurance is an expression of underlying life style choices—for example, on the theory that the taxpayer is more careless in personal activities because of the security of income replacement. I doubt, however, that insurance against income loss is an expression of life style choices in the same way that insurance on personal use property or personal liability insurance might influence personal behavior to increase the underlying risk. One can, of course, characterize an insured taxpayer as engaged in personal behavior secure in the knowledge that the activity will not cause income loss. But that sounds more like an argument that insurance provides personal satisfaction (discussed earlier) than that the insurance originates from an underlying personal life style.

In sum, two-personality approaches are not very successful in explaining how personal insurance against income loss should be taxed. The personal satisfaction rationale is troubling but sufficiently plausible to call into question the maintenance expense justification for deduction. And the origin test has a mechanical sounding simplicity which is too simplistic.

### *C. The Group Redistribution Personality: A Description*

The difficulties encountered by a two-personality approach to taxing personal insurance against income loss suggest that we look for another way to conceptualize the tax treatment of premiums and proceeds. The group redistribution approach asks whether the group has an increase in income as a result of the premiums and proceeds, or whether there is simply a redistribution of wealth. Because the premiums paid by group members equal the proceeds (leaving aside insurance company expenses, profits, and investment earned by the premiums before payment of proceeds), there is no income from the group's perspective. Those who do not suffer the loss pay those who do suffer. The net result for society is zero and the net result for measuring income should therefore be zero.

The only question posed by the group redistribution approach is whether to deduct premiums and include proceeds, or disallow deduction of the premiums and exclude the proceeds. The rationale for taxing the payer in the gift setting—the donor's rate seemed appropriate to prevent income shifting to avoid high progressive rates—is inapt for insurance. There is not likely to be a systematic shifting of wealth from high to low bracket taxpayers. The alimony analogy—tax the person receiving cash—suggests taxing the payee (the insured who receives proceeds after suffering a loss). But that, too, seems questionable. For humanitarian reasons, the time of recovery seems a bad time for the government to appear to be extracting its pound of flesh. Moreover, the correct

59. Rev. Rul. 55-264, 1955-1 C.B. 11.

method of taxation would allow the taxpayer to reinvest any lump sum awards to receive an annuity over the period when the lost income would have been received, on the theory that the taxpayer should be free to treat the income as not freely available for current consumption (a modern but less extensive version of the older view that income *had* to be periodic). Absent the opportunity to defer tax by investing lump sum insurance recoveries in an annuity, analogous to § 1033 for casualty losses, the better approach is to disallow the deduction of the premiums and exclude the recoveries.[60]

Under the group redistribution approach, the critical point is that nondeductibility of premiums follows from not taxing the proceeds, rather than from any independent judgment that the premiums are personal consumption under a personal satisfaction or personal origin approach. Similarly, if the proceeds were taxable, the premiums would be deductible, but not because the premiums are incurred to produce the income.

The group redistribution perspective also helps to justify the existing statutory pattern (though I would not argue that lawmakers selfconsciously pursued that objective). When individuals buy disability or life insurance, the proceeds are excluded from income,[61] but premiums are not deductible, assuming the risks are personal. More generous rules—deducting premiums (or excluding them when they are employee fringe benefits) *and* excluding proceeds—must be justified either on social policy grounds or because the proceeds do not provide income (compensating for personal loss rather than replacing income). Social policy reasons might justify the exclusion of premiums and proceeds for group-term life insurance up to $50,000[62] and for Workers' Compensation.[63] Disability insurance funded by employers is treated with similar generosity (not taxing either premiums or proceeds) only if the proceeds are paid without regard to the period the employee is out of work and are either for permanent loss of bodily function or disfigurement,[64] conditions which suggest that the proceeds compensate in part for personal losses rather than loss of wages.[65]

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60. As Halperin notes, disallowing the deduction for premiums is not an exact equivalent of taxing proceeds because premiums are likely to exceed proceeds on account of insurance company expenses and profits. Halperin, *supra* note 48, at 36-37. There is, however, no obvious answer to how this excess should be treated under the group redistribution approach. To the extent the excess premiums equal the insurance company's *taxable* profits and any expenses the company pays to others as *taxable* income, a deduction for the excess premiums nets out to zero. However, nondeductibility of the excess premiums might still be the better course, to compensate for the undertaxation of the interest income accruing on the premiums. *See id.*, at 36 n.132.

61. I.R.C. § 101(a)(1) (West 1988) (life insurance); I.R.C. § 104(a)(3) (West Supp. 1996) (disability).

62. I.R.C. § 79(a) (West Supp. 1996).

63. I.R.C. § 104(a)(1) (West Supp. 1996) (proceeds); I.R.C. § 106 (West Supp. 1996) (premiums).

64. I.R.C. § 105(a), (c) (West Supp. 1996) (proceeds); § 106 (premiums).

65. The exclusion of medical insurance premiums and proceeds from the tax base can be similarly justified on the ground that the underlying expenses do not provide the taxpayer with taxable personal satisfaction. I.R.C. § 105(a), (b), (h) (West Supp. 1996) (proceeds); § 106, I.R.C. § 213(d)(1)(C) (West Supp. 1996) (premiums).

It seems unlikely that we will get a case law test of the group redistribution approach for personal insurance because current case law and statutory rules settle most issues. One setting where the issue could arise without statutory guidance is legal insurance to cover personal legal expenses. Legal insurance became a moderately popular employee fringe benefit some years ago, and the 1976 tax law provided an exclusion for both premiums and proceeds for the insured employee if there was a "qualified" plan (e.g., the benefits had to be provided to a group of employees on a nondiscriminatory basis and, in 1988, the statute was amended to limit the exclusion to plans worth no more than $70 per month).[66] Those exclusions were allowed to expire on July 1, 1992, however, leaving the issue to be resolved under general tax principles. There is some legislative history to the 1976 tax law suggesting that the premiums are nondeductible and the proceeds excludible in the absence of a specific statutory rule,[67] a result which can be justified on group redistribution grounds. The problem with this argument is that it neglects the policy consequences of encouraging legal insurance. As the tax issue becomes more difficult to resolve by conventional two-personality analysis, policies unrelated to tax fairness carry more weight. Although the Code could explicitly tailor tax breaks to plans with favorable policy consequences, a case law no-deduction-with-exclusion approach cannot be so precisely tailored, and the result might be excessive litigation and/or a litigation bias in favor of those able to afford the insurance.

### *D. The Group Redistribution Personality: A Justification*

The ability of the group redistribution approach to explain the taxation of personal insurance against income loss is a plus in its favor, but that does not prove its validity. There is, in fact, no way to "prove" the validity of a group personality approach, any more than the income tax base can be "proven" better than a consumption tax base. Such issues entail fundamental questions about the relationship of the individual to the political community to determine what wealth the individual should share for the public good. This is apparent in the argument by early advocates of a consumption tax that people should be

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66. *See* 5 EXEMPT ORG. TAX REV. 917 (1992) (recounting history in Congressional Research Service Report).

67. H.R. CONF. REP. NO. 1515, 94th Cong., 2d Sess. 536 (1976) ("Under present law, depending on the structure of the specific group legal services plan, an employee must pay tax on either (1) his share of employer contributions to the plan on his behalf, or (2) the value of legal services or reimbursements received by him under the plan."). *But see* CRS Report *in* EXEMPT ORG. TAX REV., *supra* note 66, at 917 (Prior to the statutory exclusion, "the plan structure caused the employee either to include the pro rata share contributed by the employer in his wages or the value of legal services or reimbursement of legal services expenses received under the plan (or both)."). Private Letter Rulings appear to have ducked the issue. In Private Letter Rulings 81-29-095 (April 24, 1981) and 81-42-136 (July 24, 1981), the employer paid premiums which funded legal services, but the plan did not qualify because it discriminated in favor of highly compensated employees. The rulings held that "the value of legal services provided, or amounts paid for legal services, under the group legal services plan to, or with respect to, an employee, his spouse, or his dependents is not excluded from gross income as provided by section 120(a) of the Code."

politically committed to sharing only that wealth which they took out of the society (through consumption), not the wealth they recommitted to investment.[68] As long as spending capital seemed strange (especially in an agricultural land-centered economy) and building up wealth through investment was a dominant concern, it made sense to define the obligation to share private wealth in consumption terms.

Income tax advocates view people differently. The opportunity to consume (including savings) is sufficient to justify forcing people to share wealth with others—consequently, income is the tax base. And, once wealth creation became less critical and wealth seemed to provide an independent basis of power and satisfaction, taxation of savings as well as consumption (that is, income) seemed more appropriate.

The group redistribution perspective insists that there is yet another way to think about taxpayers, recognizing that people not only seek pleasure or profit, but also share wealth in the social and political community. That seems especially appropriate in the contemporary political environment, where sharing wealth is integral to the conception of the modern welfare state. It therefore seems reasonable to suggest that community sharing of wealth is an aspect of an individual's political personality and that the tax law should recognize this as something different from the kind of personal consumption activity that is routinely subject to income tax.[69]

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68. THOMAS HOBBES, LEVIATHAN 238-39 (Richard Tuck ed., Cambridge Univ. Press 1991) (1651). A modern discussion of this justification for a consumption tax appears in William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1165-67 (1974).

69. William Andrews's argument in favor of the charitable deduction rests on assumptions which underlie the group redistribution approach. William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 355-56, 359-63, 368-69 (1972). In his view, the personal satisfaction of giving is not a reason for taxing the donor, in part because the gifts shift wealth around within the community. Although he ultimately rejects even a single tax on charitable gifts—because public goods ought not to be taxed on policy grounds and the donor's rate is inappropriate when the donees are poor—the community perspective on charitable wealth transfers recognizes group redistribution as a third tax personality.

The rigid separation of business expenses and charitable deductions by I.R.C. § 162(b) (West Supp. 1996)—no business expense deduction if charitable gifts exceed percentage floors—might reflect the view that charitable wealth transfers should not be analyzed in conventional business versus personal expense terms. Section 162(b) originated in § 23(a)(2) of the Revenue Act of 1938, ch. 289, 52 Stat. 447, 460. According to the legislative history, H.R. REP. NO. 1860, 75th Cong., 3d Sess. 17-18 (1938), *reprinted in* 1939-1 C.B. Part II, 728, 740, the problem was that "a corporation may claim it is entitled to obtain the benefit of deductions for . . . gifts and contributions, as business expenses, the effect of which would be that the amount of the deductions for contributions or gifts would exceed the . . . percent limitation contained in [the predecessor of § 170]." There was no further explanation of why that was a problem requiring legislative solution. This rule was extended to individuals in 1954. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 20 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 22 (1954).

## V. INCOME TAX AND RELATED EXPENSES

### A. Introduction

A group redistribution perspective is controversial in the context of personal insurance. The expenditures are voluntary and it is therefore arguable that we should not work so hard to develop an analysis other than the conventional two-personality approach. Deciding whether the expenses are to maintain income flow or buy personal satisfaction may be difficult but that does not necessarily mean that we should abandon the conventional analytical framework. At most, the group redistribution perspective might supplement but not replace the conventional approach, just as economic efficiency and other policy concerns play a role when the two-personality approach is problematic.[70]

Income tax payments, however, are involuntary and would seem to be a prime candidate for an unalloyed group redistribution analysis. What else is the income tax but a payment which redistributes wealth within the community? The involuntary nature of the payment makes it less plausible to argue that it provides satisfaction to the payer, unlike insurance. Nor is the benefit-burden relationship close enough to make the involuntary tax payment a measure of taxable enjoyment, as might be true with special assessment taxes on property owners to pay for sewers, etc. The group redistribution perspective was hinted at in Judge Halpern's dissent in *Redlark* when he appealed to Holmes's statement that taxes are the price we pay for civilized society.[71] Judge Halpern meant this as support for the view that income tax payments are personal consumption but a better view is that payments for civilization are contributions by which the group redistributes wealth within the political family.

The prior discussion suggested that group redistribution payments should net out to zero, *either* deduction-inclusion *or* nondeduction-exclusion. However, income taxes do not as a practical matter provide a choice of tax techniques. Benefits from income tax payments cannot usually be traced and valued to specific taxpayers because they are public goods enjoyed by a group. For example, assume two taxpayers with $1000 income, each of whom pays $50 in income taxes. If the taxes purchase $100 of group benefits (e.g., defense spending or environmental clean-up), there remains $1900 of potential private consumption, for a total of $2000. The $100 of group benefits cannot easily be taxed to the beneficiaries but the $100 remains in the tax base if it is not deductible.

Three objections might be made to this analysis of income taxes. First, a person earning business income can deduct sales taxes as a business expense. Why should income and sales taxes be different? Because the business taxpayer does not bear the sales tax burden, or at least that is the accepted operational principle.

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70. *See supra* text accompanying notes 21-22, about child care, commuting, and education.

71. *Redlark*, 106 T.C. at 31 (quoting Compania General de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting)).

The sales tax is not the business taxpayer's share of private wealth committed to public use; it is a cost of doing business shifted to the consumer. The consumer who bears the tax burden is the one who is denied the deduction.

Second, some government payments out of collected taxes are easily traced to the recipient and, in some cases, are taxable. Does that mean that the taxes should be deducted under a zero-sum group redistribution approach? Not really. If the government payments are to purchase input for products and services the government produces, the correct question is whether the value of those products and services can be taxed. Even though the wages of a government employee who builds an airplane or cleans up a polluted lake are taxable, the group benefits produced with those wages are not taxed to members of the general public.

The current rules about taxing transfer payments are also consistent with a group redistribution analysis. Needs-tested welfare benefits are financed out of income taxes, whose nondeductibility by the taxpayer[72] parallels the payee's exclusion from income.[73] The partial exclusion of social security benefits is consistent with the nondeductibility of the employee's portion of the social security tax (the employer's portion is deducted and the investment income should be taxed).[74] And the full taxation of unemployment insurance benefits[75] is consistent with the employer's and employee's deduction of the premiums.

Third, the federal income tax law allows a deduction for state income taxes despite the exclusion of government benefits from income. Does this "double" benefit undermine the claim that the tax treatment of income taxes is an example of the zero-sum group redistribution approach? No, it doesn't. Rather than undermine the group redistribution approach, current tax law supports it by relegating deductibility of state income taxes to itemized deduction status to provide state governments with fiscal assistance.

### *B. Applying a Group Redistribution Approach*

How then *should* a court determine whether the deduction of income taxes and related expenses are business deductions once it assumes that the income tax payments are best understood as group redistribution expenses. The statutory texts, providing deductions for "trade or business expenses" and for interest "properly allocable to a trade or business," do not produce a clear answer; and traditional two-personality approaches to distinguishing between business and personal expenses do not resolve the issue. Faced with such doubt, a court would normally rely on agency regulations and legislative history, subject to any policies it can derive from the statute or from principles about which the court

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72. State income taxes *are* deductible, I.R.C. § 164(a)(3) (West Supp. 1996), but not as business expenses. The deduction is a tax expenditure to help the states. *See supra* notes 11-14 and accompanying text.

73. Rev. Rul. 57-102, 1957-1 C.B. 26 (excluding welfare benefits from income).

74. I.R.C. § 86 (West Supp. 1996) (social security). *See also* I.R.C. § 164(f) (West Supp. 1996) (A self-employed taxpayer can deduct one-half of the social security taxes, which parallels the deduction by employers of their share of the social security tax to fund employee benefits.).

75. I.R.C. § 85 (West 1988) (unemployment insurance).

can be independently confident. These criteria would apply to the income tax and related expenses in the following way.

1. Income Taxes

The current treatment of state income taxes—allowing the deduction for net operating losses, but not in computing adjusted gross income—fits this pattern.[76] The rule disallowing a business deduction in computing AGI is based on explicit legislative history. A more pro-taxpayer rule allowing the deduction in computing NOL reflects both the lack of contrary legislative history and a heavy dose of economic policy, rather than tax fairness. The NOL deduction is limited primarily to business losses and is intended to smooth out total income over fluctuating business cycles and to help beginning businesses with loss carryforwards. Allowing a deduction of state income taxes related to business income implements that policy. The clincher is the fact that doing business in corporate form permits the taxpayer to deduct state income taxes when computing NOLs. Discriminating between businesses run in corporate and individual form seems especially arbitrary where NOLs are concerned. This is still a close call. Corporations often have an income-computation advantage, probably because the retained assets are available only for savings and not personal consumption.[77]

2. Payments Related to Income Taxes

It is more difficult to decide how to treat expenses related to income tax payments (interest, litigation expenses, and insurance premiums). It might seem plausible to analyze such expenses using a conventional two-personality origin test, even if the income taxes themselves cannot be viewed that way. But the origin test refers back to the underlying expense to determine the deductibility of related expenses. If the underlying expense is for business, then premiums to insure against incurring the expense, interest to defer making the expense, and litigation expenses to determine what the expense is, would be traceable to the business and would be a deductible business expense under the origin test. However, if the underlying expense is not a business expense, but a group redistribution of wealth, the origin test provides no analytical foundation for allocating related expenses to the business sphere of activity.

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76. *See supra* notes 13-14 and accompanying text.

77. The at-risk and passive business activity loss rules do not apply to widely owned corporations and have only limited impact on closely held corporations. I.R.C. § 465(a)(1)(B), (c)(7) (West Supp. 1996) (Only closely held corporations are subject to at-risk rules and, then, not even on "active businesses."); I.R.C. § 469(a)(2)(B), (C) (West Supp. 1996) (Only closely held corporations are subject to passive business activity loss rules and, then, not even to prevent the losses from offsetting business income in some situations.); *see also* I.R.C. § 1372 (West 1988) (depriving Subchapter S corporation of the opportunity to compute income with a deduction for expenses providing 2% shareholders with fringe benefits, but not other corporations).

It is easier to say how *not* to analyze expenses related to the income tax than to explain the appropriate analysis. If the origin test is unavailing, can we still rely on the "personal satisfaction" version of the two-personality approach to determine deductibility? Should policy considerations unrelated to tax fairness predominate, and, if so, how can the court identify those policies?

a. Tax Audit Insurance

First, consider tax audit insurance. I argued earlier that the potential personal satisfaction provided by insurance premiums was probably too thin a reed on which to tax the premiums. But what of policy concerns unrelated to issues of tax fairness? Policy considerations disfavor a business expense deduction for the premiums. The tax audit insurance proposals commented on by the New York State Bar Association were carefully circumscribed to discourage issuing insurance which would encourage taxpayers to play the "audit lottery."[78] The return had to be prepared or reviewed by a CPA or attorney engaged in tax practice. Interest and penalties were not insured, unless they were due to the insurer's actions. No more than $1000 could be paid for professional tax assistance. And coverage excluded transactions which lacked economic substance or where the principal purpose was tax avoidance or evasion. If tax audit insurance premiums were deductible, however, it would be difficult for courts to draw lines limiting the deduction in the event that insurers abandoned these coverage limitations. The better course is to disallow a deduction for tax audit insurance premiums unless Congress defines the limits, as it did with the now-expired tax-free fringe benefit for legal insurance.[79] This means that no deduction would be allowed for the premiums in computing AGI or NOL, even if the audit insurance covered disputes over business income.[80]

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78. MICHELLE P. SCOTT, COMM. ON UNREPORTED INCOME AND COMPLIANCE OF THE N.Y. STATE BAR ASS'N TAX SECTION, A REPORT ON TAX AUDIT INSURANCE, *reprinted in* 22 TAX NOTES 53, 53-55 (1984). The Bar Association also recommended legislation requiring disclosure on the tax return that the taxpayer was insured.

79. *See supra* notes 66-67 and accompanying text.

80. The New York State Bar Association's proposal for dealing with tax audit insurance tied deduction of premiums to the deduction of the underlying expense. SCOTT, *supra* note 78, at 55. Consequently, the portion of the premiums allocable to federal income taxes was not deductible, because the taxes were not deductible; but the portion allocable to litigation costs was deductible because the costs were deductible under § 212(3). Though the Report did not say so, the implication is to allow a business expense deduction for premiums to the extent the underlying litigation expenses could be business deductions.

The Bar Association's linkage between deducting premiums and the deductibility of the underlying expense is questionable. If the deduction of the underlying expense properly measures income—that is, if it does not provide personal consumption—then it is reasonable to allow a deduction of the premiums *because* the expenses are deductible. A society with two $1000 incomes, a $100 deductible loss, and no insurance has $1900 of income. If both taxpayers buy insurance for $50 to insure against a 50% risk of loss, the total income in society should still be $1900 after one taxpayer experiences the loss. That is achieved if each taxpayer deducts $50, and the $100 insurance recovery is offset by the $100 loss (no loss—$1000 minus $50 = $950; loss—$1000 minus $50 plus $100 minus $100 = $950). Employer funded medical insurance is an example of this approach (excluding both the premiums and proceeds from

### b. Interest

The deduction of interest related to unpaid income taxes must also be analyzed without guidance from personal satisfaction considerations. There is no way to agree a priori on how to trace the underlying loan to business or personal use. Moreover, interest is a difficult expense to characterize in the first place. Even when the loan is used for personal purposes, it only accelerates personal consumption, rather than provide consumption that would not otherwise occur. It is arguable that "personal interest" is nondeductible because the cost of acquiring earlier consumption is itself a personal consumption item, but confidence in this conclusion is shaken by the resulting implication that deferring (rather than accelerating) consumption might then create a loss, and that compensation for that deferral (that is, interest income) should therefore be excludible.[81] Given uncertainty about how the income tax should fairly account for accelerating or deferring personal consumption, a court would properly shy away from using the rules applicable to interest on unpaid income taxes as a setting in which to resolve that dispute.

The judge required to decide about deduction of interest on unpaid income taxes is therefore left with a difficult decision based on policy concerns uncomplicated by issues of tax fairness. Should taxpayers be encouraged to retain tax payments and litigate the obligation by allowing a deduction of interest? The federal statute already speaks to this issue by imposing higher interest rates on deficiencies than refunds.[82] A court might take this either as a legislative expression of concern over unpaid taxes (at least federal taxes), which the court could extend by expansively interpreting nondeductible personal interest, or as exhausting the extent of that concern, leaving the interest deduction to be determined on other grounds.

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income). (Nondeductibility of personal casualty insurance premiums despite deducting uninsured losses is not a counterexample, because the premiums maintain enjoyment of untaxed "imputed" income from the personal use property.)

However, the better view of § 212(3) justifies the deduction on policy grounds—leveling the tax litigation playing field between taxpayer and government—and policy considerations should therefore be given free rein to determine whether insurance premiums are equally deserving of a tax subsidy. As argued in the text, policy considerations do not favor deduction of tax audit insurance premiums, even under § 212(3).

Policy considerations also suggest that the proceeds be included in gross income whether or not the premiums are deductible, without adopting a zero-sum approach. These are not the kinds of risks that should be subject to voluntary group redistribution through insurance. Consequently, the proceeds should be taxable, even if this results in taxing both the premiums and proceeds. The proceeds produce a net increase in taxable income when they pay for nondeductible income tax payments and when they compensate for litigation expenses whose deduction under § 212(3) is useless as an itemized deduction. The Bar Association argued for this result but without any reference to policy considerations.

81. *See* Mark Kelman, *Time Preference and Tax Equity*, 35 STAN. L. REV. 649, 658-70 (1983).

82. I.R.C. § 6601(a) (West Supp. 1996); I.R.C. § 6611(a) (West Supp. 1996); I.R.C. § 6621(a) (West Supp. 1996).

In this uncertain setting, the Temporary Regulations and legislative history defining such interest as nondeductible personal interest should be dispositive. The *Redlark* majority worked very hard to avoid relying on these sources. The section of the Regulations defining interest on unpaid income taxes as nondeductible personal interest was rejected, in part because another section of the Regulations traced loan proceeds on the basis of their use and could be interpreted (implausibly, in my view) to allow the deduction.[83] The legislative history from legislative committees was deflected because it said that "personal interest . . . *generally* includes interest on tax deficiencies."[84] The court argued that the word "generally" left open the possibility that interest on taxes related to disputes about business income *could* be allocable to a business. The Blue Book was clear that the interest was personal[85]—there was no reference to "generally"—but the Tax Court rejected this legislative history because it was written by staff, not legislative committees, and was written after the law was passed.

The Tax Court worked too hard to reject these sources of law. Without tax fairness principles as a guide and absent strong indications from Congress that other policies favor the taxpayer, agency regulations and legislative history should be dispositive (recall that legislative history was dispositive to reject a business expense deduction for state income taxes in computing AGI).[86] Even if contemporary skepticism about legislative history[87] leads to rejection of the Blue Book, there should be enough teeth left in the *Chevron* doctrine[88] to favor deference to agency Regulations. Interest related to unpaid income taxes would therefore be personal interest, not deductible in computing AGI or NOL.

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83. *See supra* notes 24-25 and accompanying text.

84. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-154 (1986), *reprinted in* 1986-3 C.B. 4, 154 (emphasis added).

85. STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 266 (Jt. Comm. Print 1987). *See generally* Michael Livingston, *What's Blue and White and Not Quite as Good as a Committee Report: General Explanations and the Role of "Subsequent" Tax Legislative History*, 11 AM. J. TAX POL'Y 91 (1994).

86. *See supra* note 13.

87. Suspicion of legislative history also surfaced in recent cases allowing unused investment interest to be carried over to later years even though it exceeded taxable income, despite contrary legislative history. Flood v. United States, 33 F.3d 1174, 1178 (9th Cir. 1994) (Blue Book); Sharp v. United States, 14 F.3d 583, 589 (Fed. Cir. 1993) (Use legislative history to overcome clear text only in exceptional circumstances.); Beyer v. Commissioner, 916 F.2d 153, 156 (4th Cir. 1990) (Blue Book); Lenz v. Commissioner, 101 T.C. 260, 267 (1993).

88. Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984). *But see* Richard J. Pierce Jr., *The Supreme Court's New Hypertextualism: An Invitation to Cacophony and Incoherence in the Administrative State*, 95 COLUM. L. REV. 749 (1995) (suggesting that the current Supreme Court does not apply *Chevron*-deference consistently). Discussions of *Chevron* in the tax setting appear in Paul L. Caron, *Tax Myopia, or Mamas Don't Let Your Babies Grow Up To Be Tax Lawyers*, 13 VA. TAX REV. 517 (1994); Linda Galler, *Judicial Deference to Revenue Rulings: Reconciling Divergent Standards*, 56 OHIO ST. L.J. 1037 (1995); Linda Galler, *Emerging Standards for Judicial Review of IRS Revenue Rulings*, 72 B.U. L. REV. 841 (1992).

c. Litigation Costs

Can litigation expenses related to the income tax be business deductions? This issue is more difficult to determine because there are no regulations, legislative history, or more or less clear policy signals to determine the answer. It is hard to argue in favor of discouraging the litigation expenses after *Tellier*.[89] However, if the deduction extended to tax planning expenses and not just litigation (and § 212(3) has been so extended),[90] we might give a different answer. At least some of this advice will deal with tax schemes that are not economically viable in the absence of the tax law and it is hard to determine when that is true on a case by case basis. It is better to leave deductions for tax planning as itemized deductions without running the risk of further encouraging advice related to tax avoidance schemes.[91]

The reference to § 212(3) raises another argument against allowing business expense deductions even for litigation expenses. Congress has spoken on whether some litigation expenses should be deducted and has placed them in the itemized deduction category, suggesting that more generous deductions are inappropriate. I am *not* arguing that existing statutory rules forbid a business expense deduction. That would require a spurious inference that Congress intended to exclude business deductions for *some* tax-related expenses when it assured an itemized deduction for a larger all-inclusive category of expenses. But sometimes the fact that Congress has addressed an issue suggests that the court, as a matter of sound judicial judgment, should refrain from making decisions that would extend the results beyond those Congress has explicitly provided,[92] at least when there are policy arguments against that result and no general principles favor the deduction. When the issue is not amenable to readily discernible principles accessible to a court, specific legislative benefits suggest that Congress should be left to work out answers without further judicial extension.

Absent regulations or legislative history, however, the deduction of tax litigation expenses is a very close call. People might view litigation expenses (especially tax litigation expenses) as providing very little personal satisfaction, which might argue for the most favorable interpretation of the tax law (allowing

89. Commissioner v. Tellier, 383 U.S. 687 (1966) (allowing deduction for legal expenses to defend criminal charge arising from business activity).

90. Merians v. Commissioner, 60 T.C. 187, 188 (1973).

91. The IRS has argued that § 212(3) is limited to "legitimate tax advice and tax planning." Epp v. Commissioner, 78 T.C. 801, 803 (1982) (Commissioner's suggestion). A few cases support this limit. Hoye v. Commissioner, 58 T.C.M. (CCH) 1338, 1344-45 (1990); Kitcher v. Commissioner, 51 T.C.M. (CCH) 372, 381 (1986); Crowder v. Commissioner, 48 T.C.M. (CCH) 1359, 1361 (1984), *aff'd no opinion*, 802 F.2d 466 (9th Cir. 1986). The court in *Redlark* suggested that the dispute in *Miller v. United States*, 65 F.3d 687 (8th Cir. 1995), where the interest deduction was disallowed, involved a tax avoidance scheme.

92. The Canadian Supreme Court, for example, has ruled that the detailed rules providing tax breaks for child care preclude revisiting an old case denying a business expense deduction for child care (over two dissents). Symes v. Canada 4 S.C.R. 695, 744-51 (1993), *reprinted in* 1 C.T.C. 40, 62-66 (1994). United States courts would undoubtedly take the same position today.

a business expense deduction where plausible). That may explain why a 1992 Revenue Ruling[93] conceded the deduction in computing AGI and would justify retaining the older concession that the litigation expenses could increase NOLs.

## CONCLUSION

The lesson to be learned from this discussion is that the current hodge-podge of rules regarding the deductibility of income taxes and related payments as business expenses is a consequence of the breakdown of conventional two-personality approaches to defining taxable income. Once income taxes are recognized as group redistribution payments, not personal or business expenses, courts are at a loss to know how to treat related expenses, such as litigation costs, interest, and insurance premiums. This simply reveals what any good legal realist knew already—that there are fundamental principles lurking beneath any judicial effort to decide specific cases. Frequently, those principles are given to a court by authoritative legal sources so that the court can apply them in a "definitional" way—for example, deciding what is or is not personal consumption.[94] But once general principles of tax fairness or policies discernible either in existing legislation or the legal landscape lose their ability to guide judges, the normative standards become difficult to discern and the results often appear erratic.

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

94. Kaplow argues broadly against a "definitional" approach to determining the tax base. Kaplow, *supra* note 50.