TAX MANAGEMENT
PORTFOLIOS™

U.S. INCOME

Principles of Income Tax Deductions

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TAX MANAGEMENT
PORTFOLIOS™

U.S. INCOME

Principles of Income Tax Deductions

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Principles of Income Tax Deductions*, No. 503-4th, analyzes in depth what income tax deductions are, how they function, and how they interact with other tax items. After examining the legal principles of general applicability to deductions, the Portfolio organizes the deductions into logical categories, including those allowed in computing adjusted taxable income, deductions for personal expenses, deductions allowed to corporations, etc. Deductions not discussed elsewhere in the Portfolios are analyzed thoroughly in this Portfolio and deductions that are discussed elsewhere in the U.S. Income series are organized into relevant categories but not discussed.

This Portfolio may be cited as Gutting, 503-4th T.M., *Principles of Income Tax Deductions*.

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DETAILED ANALYSIS

DETAILED ANALYSIS

I. Definition and Function of Deductions

A. Introduction

Deductions represent one of the most significant concepts of the federal income tax system. Aside from exclusions from gross income, deductions represent the only step in the computation of income tax liability that reduce taxable income and, thus, reduce income tax liability.[1] Deductions are an element in the computation of taxable income for every type of person or entity, except for nonresident aliens and foreign corporations subject to the flat 30% tax.[2] For example, deductions are available to individuals,[3] corporations,[4] exempt organizations,[5] banks and common trust funds,[6] trusts and estates,[7] life insurance companies,[8] other insurance companies,[9] regulated investment companies,[10] and real estate investment trusts.[11] Deductions are taken into account even with respect to partnerships and real estate mortgage investment conduits, which are not subject to taxation.[12] However, certain types of deductions are limited to individuals,[13] and others are limited to corporations.[14]

A deduction lowers a taxpayer's taxable income, so the ultimate tax savings depends on the taxpayer's marginal tax rate. A deduction is unlike a tax credit, which provides a dollar-for-dollar reduction to a taxpayer's tax liability.[15] For example, if an individual taxpayer has a marginal tax rate of 30%, then a $1,000 deduction would generate a tax savings of $300 ($1,000 × 30%). But, if an individual taxpayer had a $15,000 tax liability, a $1,000 tax credit would reduce a taxpayer's tax liability down to $14,000. Ultimately, in this example, the $1,000 credit offers the taxpayer $700 more in tax savings than a $1,000 deduction.

Deductions are not only a major step in the computation of federal taxable income, but they also are, either individually or in the aggregate, an element in the computation of other deductions or deduction limitations. For example, deductions are used as a computational base for certain exclusions or other deductions and as an eligibility factor for particular tax benefits. Deductions also are used as a measure for other steps in the taxable income and tax liability computation. For instance, some deductions reduce adjusted gross income[16] (AGI) and, in some instances, AGI is used to determine availability or amount for a specific deduction.

More importantly, deductions are a matter of legislative grace.[17] In contrast to the determination of gross income, with respect to which courts must determine whether an item is income without the benefit of a statutory definition of income, courts have no recourse but to the statutory language in determining whether a deduction is allowable.[18] The scope of transactions that generate deductions is a narrow slice of the much wider band of transactions that reduce the taxpayer's economic wealth. Thus, unlike gross income, which is a concept that includes all potential realized accessions to wealth that are not the subject of a specific statutory exclusion, a transaction does not generate a deduction unless there is a specific statutory provision allowing the deduction.[19] The deduction is allowed only to the extent permitted by the statute, and only to the extent another statutory provision does not disallow the otherwise allowable deduction.[20] The courts have no power to change the language of a statute or to create a new deduction to make a situation more equitable for the taxpayer.[21] Accordingly, a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms.[22] Consequent-

[1] All section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, unless otherwise indicated. *See generally* §63.

[2] *See* §871(a), §881(a).

[3] §63(a), §63(b).

[4] §63(a).

[5] §512(a)(1).

[6] §584(d), §585, §591.

[7] §641(b), §642, §651, §661.

[8] §804–§810.

[9] §832(c).

[10] §852(b).

[11] §857(b).

[12] §703, §860C(b).

[13] *See* §211–§223.

[14] *See* §241–§249.

[15] *See* 506 T.M., *Principles of Income Tax Credits.*

[16] For individuals, deductions that reduce AGI are commonly known as "above the line deductions." *See generally* §62.

[17] *See INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992) (quoting *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943)); *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) ("[A]n income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer."). *See also New Colonial Ice Co.*, 292 U.S. at 440 ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefore can any particular deduction be allowed.").

[18] *Nat'l Life Ins. Co. v. United States*, 63 Ct. Cl. 256, 264–65 (1927), *rev'd*, 277 U.S. 508 (1928), *later proceeding*, 66 Ct. Cl. 740 (1928).

[19] *See* §162–§249.

[20] *See* §261.

[21] *See Abdalla v. Commissioner*, 647 F.2d 487, 503 (5th Cir. 1981), *aff'g* 69 T.C. 697, 704 (1978).

[22] *New Colonial Ice Co., v. Helvering*, 292, U.S. 435, 440 (1934). The IRS considers deductions claimed because of opposition to particular government programs or policies to be frivolous. Rev. Rul. 2005-20. Therefore, no deduction is allowed for slavery reparations or for "black investment taxes." *Wilkins v. Commissioner*, 120 T.C. 109 (2003). Nor are taxpayers allowed "inflation factor" deductions, because there is no statutory provision authorizing such a deduction. *Daugherty v. United States*, 1 Cl. Ct. 216, 217 (Cl. Ct. 1983). Taxpayers are not allowed a "military deduction" to reflect their disagreement with federal military spending. *Monsky v. Commissioner*, 36 T.C.M. 525, 526 (1977). Taxpayers are not entitled to an alternative deduction to reflect their disagreement with federal spending based on their religious beliefs. *Bowman v. Commissioner*, 35 T.C.M. 881, 884 (1976). *See also Collett v. United States*, 781 F.2d 53, 54 (6th Cir. 1985), *aff'g* 85-1 USTC ¶9266 (S.D. Ohio 1984) (denying "war tax" deductions); *Gruber v. Commissioner*, 46 T.C.M. 112, 113 (1983) (denying "world peace" deductions); *Scott v. United States*, 84-1 USTC ¶9325 (W.D. Wis. 1984) (denying "conscience/disarmament" deductions); *Lull v. Commissioner*, 37 T.C.M. 364 (1978), *aff'd*, 602 F.2d 1166 (4th Cir. 1979), *cert. denied*, 444 U.S. 1014 (1980) (denying "war crimes" deductions); *Monsky v. Commissioner*, 36 T.C.M. 1046 (1977) (denying military deductions);

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ly, in a wide variety of circumstances, transactions do not generate deductions even though the taxpayer's wealth has been reduced.

The types of expenses for which Congress permits deductions range from those directly connected with generating gross income to those for which deductions are provided as a matter of social or other policy. However, deductions for trade or business expenses[23] and income-producing activity expenses[24] are the most common. Congress also has determined that some or all of a taxpayer's expenditures for items such as interest, taxes, charitable contributions, and medical expenses should be deductible.[25] Thus, in any particular area of activity, some transactions generate deductions and some do not. Generally, the closer the activity is to a trade or business, the more likely it is that the expenses of a particular transaction will be deductible.[26] Conversely, the closer an activity is to a personal endeavor, the more likely it is that the expenses of a particular transaction will not be deductible.[27] However, there are exceptions to these general principles. For example, unreasonable business compensation is not deductible[28] but real estate taxes paid on a personal residence are deductible subject to limitations.[29]

B. Definition of Deduction

Although the Internal Revenue Code contains specific definitions of each allowable deduction,[30] it does not contain a general definition of deduction. Instead, the clear implication of the statutory language provides a commonly accepted definition.[31] Implicitly, a deduction is any amount that is allowable as a subtraction from gross income for the purpose of computing taxable income. In contrast, an amount that is not included in gross income is not a deduction, but is an exclusion.[32]

C. Impact on Tax Account

1. Introduction

Federal income tax liability is determined as a percentage of taxable income,[33] which is derived by subtracting deductions from gross income.[34] Thus, in general, amounts allowable as deductions generate decreases in tax liability and amounts disallowed as deductions generate increases in tax liability. However, when considering a particular taxpayer's specific circumstances, it can be misleading to rely on the generalization about the impact of deductions on income tax liability. This arises in part from the impact of the resulting change in a deduction on the other deductions and credits that are measured, in whole or in part, by reference to deductions or an amount based in part on some or all of the taxpayer's deductions. It also arises because the impact of a deduction on alternative minimum tax liability may differ from its impact on regular tax liability, a phenomenon that reflects the different treatment of certain deductions for purposes of computing regular taxable income and alternative minimum taxable income. In some instances, a deduction can cause a taxpayer's tax liability to increase, and whether a taxpayer can ignore a deduction on account of this phenomenon has triggered an intense debate.[35] The treatment of deductions for alternative minimum tax purposes is described in I.C.3., below, and is discussed in detail in 587 T.M., *Noncorporate Alternative Minimum Tax*, and 752 T.M., *Corporate Alternative Minimum Tax*.

2. Tax Element Computations

a. Deductions Used in Computational Base

In many instances, some or all of a taxpayer's deductions are used as an element in the computation of a gross income inclusion or exclusion, another deduction, a credit, or another amount. Important examples include:

- Certain deductions or deduction disallowances are ignored, redefined, or recomputed in determining earnings and profits of a corporation.[36]
- Certain deductions are allowed in determining earned income for purposes of self-employed qualified plans.[37]
- Certain deductions are allowed in annualizing taxable income for the period of change when an accounting period shifts to or from a 52–53 week year.[38]
- Certain deductions are allowed in computing modified taxable income for purposes of annualizing the tax liability for a short accounting period resulting from a change in the taxpayer's accounting period.[39]
- Certain deductions are allowed in computing distributable net income.[40]
- Certain deductions are disallowed or recomputed in determining an investment company's earnings and profits.[41]

Hecht v. Commissioner, 35 T.C.M. 6, 7 (1976) (denying "war tax protest" deductions).

[23] *E.g.*, §162, §167, §168, §169, §172, §173, §174A, §175, §179.

[24] *E.g.*, §167, §168, §212.

[25] §163, §164, §170, §213.

[26] *See, e.g.*, §162.

[27] *See, e.g.*, §262.

[28] *See* §162(a)(1).

[29] *See* §164. For tax years beginning after 2017, the deduction of real estate taxes for a personal residence is limited. The following deduction limits apply to state and local income tax (or, if elected, sales tax) and state and local property tax or personal property tax: tax years 2018 through 2024, $10,000 ($5,000 married filing separate); tax year 2025, $40,000 ($20,000 married filing separate); tax year 2026, $40,400 ($20,200 married filing separate); tax years 2027 through 2029, 101% of the preceding calendar year limit (half for married filing separate); and tax years after 2029, $10,000 ($5,000 married filing separate). No deduction for foreign real property is allowed. This limitation does not apply to any taxes paid or accrued in carrying on a trade or business, for the production or collection of income, management or maintenance of property held for production of income, or in connection with the determination, collection, or refund of any tax. §164(b)(6), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70120, §164(b)(7), added by the OBBBA, §70120.

[30] *See, e.g.*, §63(c), §151, §161 *et seq.*, §211 *et seq.*, §241 *et seq.*

[31] *See, e.g.*, §63(a), §63(b).

[32] *Compare* §101 *et seq. with* §162 *et seq.*

[33] §1, §11, §512.

[34] §63(a).

[35] Maule, *No Thanks, Uncle Sam, You Can Keep Your Tax Break*, 31 Seton Hall Legis. J. 1 (2007).

[36] §312(f), §312(k), §312(m), §312(n).

[37] §401(c)(2)(A).

[38] *See* §441(f)(2)(B).

[39] §443(b)(3), §443(c).

[40] §643(a).

[41] §852(c).

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• Certain deductions are used in determining taxable income from sources without the United States.[42]

• Certain deductions are used in determining the source of income from sources partly within and partly without the United States.[43]

• Certain deductions are allowed in computing taxable income for purposes of calculating limitations on the foreign tax credit.[44]

• Certain deductions are allowed in computing various categories of foreign income for purposes of foreign tax credit limitations.[45]

• Certain deductions are allowed in computing Virgin Islands adjusted gross income.[46]

• Certain deductions are allowed in computing subpart F income.[47]

• Certain deductions are allowed in the computation of the unrelated business taxable income of a tax-exempt organization[48] and in the computation of the organization's unrelated debt-financed income.[49]

• Certain deductions are allowed in the computation of a political organization's taxable income.[50]

• Certain deductions are allowed in the computation of homeowners' association taxable income.[51]

• Certain deductions are allowed in computing hedging losses subject to the §1256(e)(4)(A) limitation.[52]

• Certain deductions are allowed in computing an S corporation's net passive income.[53]

• Certain deductions are allowed in computing the taxable income of the estate of a bankrupt.[54]

• Certain deductions are allowed in computing Merchant Marine capital construction funds.[55]

• Certain deductions are used in computing foreign personal holding company income, foreign base company sales income, foreign base company services income, and foreign base company oil-related income for subpart F purposes.[56]

• Certain deductions are allowed in computing the tax on expatriated nonresident aliens.[57]

• Certain deductions connected with certain investment-type activities are allowed in the computation of adjusted ordinary gross income for the §541 personal holding company tax.[58]

• Certain deductions are allowed in the computation of accumulated taxable income for purposes of the accumulated earnings tax.[59]

• Certain deductions are allowed in the computation of undistributed personal holding company income.[60]

• Certain deductions are allowed in the computation of common trust fund taxable income.[61]

• Certain deductions are allowing in computing the taxable income of a Real Estate Mortgage Investment Conduit (REMIC)[62] Likewise, certain deductions are allowed in computing net income from prohibited transactions for a REMIC.[63]

• Certain life insurance deductions are allowed in the computation of life insurance company taxable income.[64]

• Certain deductions are allowed in the computation of investment company taxable income.[65]

• Only certain deductions are allowed in computing adjusted taxable income, which is one of the elements in computing the capital loss carryforwards.[66]

• Deductions for depreciation and similar allowances are used in determining the amount of recapture income with respect to personal property and property treated as personal property.[67]

• Deductions for depreciation and similar allowances are used in determining the amount of recapture income with respect to real property.[68]

• Deductions for soil and water conservation expenditures[69] and for land-clearing expenditures[70] are used in determining the amount of recapture income with respect to the disposition of farm land.[71]

[42] §862(b).
[43] §863(b).
[44] §904.
[45] §907(a).
[46] §932(b)(2)(B).
[47] §952(a).
[48] §512(a), §512(b), §514(a). *See also* 450 T.M., *Tax-Exempt Organizations — Organizational and Operational Requirements.*
[49] §514.
[50] §527(b), §527(c). *See also* 453 T.M., *Tax-Exempt Organizations — Lobbying and Political Expenditures* .
[51] §528(b), §528(d). *See also* 596 T.M., *Residential Cooperative and Condominiums.*
[52] §1256(e)(4)(D).
[53] §1375(b)(2).
[54] §1398(e)(3).
[55] §7518.
[56] §954(b)(5).
[57] §877(b). Section 877 applies only to individuals whose expatriation date (as defined in §877A(g)(3)) is before June 17, 2008. §877(h), added by Pub. L. No. 110-245, §301. *But see* §877(a) (applies for a "10-year period immediately preceding the close of the taxable year" from the expatriation date).
[58] §543(a), §543(b).
[59] §535.
[60] §545.
[61] §584(d).
[62] §860C(b).
[63] §860F(a)(3).
[64] §801(a), §801(b), §804, §805, former §806, §807, §808, former §810. *See also* §831(a), §832 (imposing similar rules on other insurance companies).
[65] §852(b).
[66] §1212(b)(2)(B).
[67] §1245.
[68] §1250.
[69] *See* §175.
[70] *See* former §182, struck by Pub. L. No. 99-514, Title IV, §402(a), effective October 22, 1986.
[71] §1252(a)(2).

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• Deductions for intangible drilling and development costs,[72] for development expenditures,[73] and for certain mining exploration expenditures[74] are used in determining the amount of recapture income with respect to the disposition of an interest in oil, gas, geothermal, or other mineral property.[75]

b. Deductions Used as an Eligibility Factor

(1) Gross Income Inclusions and Exclusions

In certain instances, deductions are used as a factor for eligibility for an exclusion from gross income or for the application of a specific gross income inclusion provision. Important examples include:

• The exclusion for employee achievement awards is based on the employer's deduction[76] amount.[77]

• Certain deductions are a factor in determining whether the exclusion for dealers in tax-exempt securities applies.[78]

• The loss deduction[79] is a factor in determining whether the gross income inclusion for restoration of value of certain securities applies.[80]

• Previous medical expense deductions[81] limit the application of the exclusion for damages.[82]

• Previous medical expense deductions[83] limit the exclusion for medical plan benefits.[84]

• An exception to the inclusion of discharge of indebtedness income in gross income applies if the discharged indebtedness would have generated a deduction if paid.[85]

• Amounts included in gross income under the tax benefit rule depend in part on amounts previously deducted.[86]

• The exclusion for cost-sharing payments does not apply to amounts properly deductible.[87]

• The definition of working condition fringes eligible for exclusion from gross income is based on the deductibility of the equivalent expenditure.[88]

• Qualified higher education expenses, for purposes of the exclusion, are defined, in part, by the allowance to the taxpayer of a dependency exemption deduction[89] for certain dependents.[90]

• An individual retirement account (IRA) distribution is not taxed if, among other things, no §219 deduction was allowed for the amount distributed.[91]

• The amount deducted under §219 is a factor in determining the taxation of IRA distributions of excess contributions.[92]

• The exclusion of charitable gift annuities from the amount on which certain organizations providing commercial-type insurance are taxed applies if, among other things, a deduction is allowed under §170 or §2055.[93]

(2) Deductions

In certain instances, deductions are used as a factor for eligibility for another deduction. For example, in the former §812, the life insurance company 100% dividend was defined by reference to the deductions for dividends paid.[94]

(3) Tax Credits

In certain instances, deductions are used as a factor for eligibility for tax credits. Important examples include:

• Allowance of the dependent care credit requires, among other things, that the payment not be made to a person with respect to whom the taxpayer is entitled to the dependency exemption[95] deduction for certain dependents.[96]

• Allowance of the hope and lifetime learning credits for persons other than the taxpayer or the taxpayer's spouse requires, among other things, that the taxpayer be entitled to the dependency exemption deduction[97] for certain dependents.[98]

• A married individual is not taken into account in determining a taxpayer's qualification for the earned income credit, unless the taxpayer is allowed the dependency exemption deduction[99] for that individual.[100]

• In calculating basic research payments taken into account for purposes of the credit for increasing research activities, the taxpayer must compute a qualified organization base period amount, and one of the elements in that computation is the maintenance-of-effort amount, of which non-designated university contributions is in turn an element, which is based in part on the taxpayer's charitable contribution deduction.[101]

[72] *See* §263(c), §263(i).
[73] §616.
[74] §617.
[75] §1254.
[76] *See* §274(j).
[77] §74(c).
[78] §75(a).
[79] *See* §165.
[80] §80(a).
[81] *See* §213.
[82] §104(a).
[83] *See* §213.
[84] §105(b).
[85] §108(e)(2).
[86] §111.
[87] §126(b)(2).
[88] §132(d).
[89] *See* §151. *But see* §151(d)(5), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70103 (personal exemption deduction is zero beginning in 2018).
[90] §135(c)(2)(A)(iii).
[91] §408(d)(4).
[92] §408(d)(5).
[93] §501(m)(5).
[94] Former §812(e)(2) (references to §243, §245(b)).
[95] *See* §151.
[96] §21(e)(6).
[97] *See* §151.
[98] §25A(f)(1)(A)(iii).
[99] *See* §151.
[100] §32(c)(3)(B).
[101] §41(e)(5)(B)(i).

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• The deduction for tertiary injectants[102] is one way of defining qualified enhanced oil recovery costs for purposes of the enhanced oil recovery credit.[103]

• Foreign taxes paid with respect to corporate distributions that, among other things, qualify for the dividends received deduction[104] are not eligible for the foreign tax credit.[105]

(4) Tax Attributes and Definitions

In certain instances, deductions are used as a factor for eligibility for tax attributes, such as status and character, or for the definition of certain amounts. Important examples include:

• Qualification for head of household filing status requires, among other things, that the taxpayer be entitled to the dependency exemption deduction for certain dependents.[106]

• Whether the taxpayer is claiming the standard deduction or itemized deductions determines the type of tax table provided for the taxpayer.[107]

• The availability of the dividends paid deduction[108] is a factor in the definition of distributee corporation, for purposes of the special earnings and profits rule.[109]

• The character of distributions in redemption of stock to pay death taxes is determined in part by the amount of §2053 estate tax deductions.[110]

• The transfer of a liability that would generate a deduction is excluded from the §357 assumption of liability rules.[111]

• The former active trade or business exception to the §367 exception to §351 nonrecognition does not apply to the extent certain deducted losses, among other things, exceed certain other amounts.[112]

• The application of the deduction limitations of §219(b)(3) to an employee-funded pension trust is used as one of many qualification tests for the trust's tax-exempt status.[113]

• The total of certain deductions is used in determining whether personal holding company classification is avoided.[114]

• The determination of the status of a regulated investment company is made in part by the relative amount of §561 deductions.[115]

• The gross receipts element of the §1244 stock definition does not apply if certain allowable deductions exceed gross income.[116]

(5) Nontax Financial Benefits

In certain instances, deductions are used as an eligibility factor for financial benefit not directly related to taxes. Important examples include:

• Amounts that can be recovered under the War Claims Act[117] are reduced by any federal income tax liability reduction arising from any deduction allowed with respect to the losses for which the claim is filed.[118]

• The computation of net earnings from self-employment for purposes of determining federal old age, survivors, and disability insurance benefits includes the subtraction of some, but not all, deductions allowed for federal income tax purposes.[119]

• The computation of wages for purposes of determining federal old age, survivors, and disability insurance benefits excludes amounts paid as reimbursement for deductible moving expenses.[120]

• One factor in computing deemed average total wages for purposes of determining federal old age, survivors, and disability insurance benefits is deferred compensation amounts, but calculated without including any amount for which a federal income tax deduction is allowed by reason of a contribution to a §501(c)(18) plan.[121]

(6) Nontax Attributes and Definitions

In certain instances, deductions are used as a factor for eligibility for nontax attributes, such as status and character, or for the definition of certain amounts. Important examples include:

• The Securities Act of 1933[122] does not apply to an annuity plan that meets the requirements for the deduction of the employer's contributions[123] for income tax purposes.[124]

• The Securities Exchange Act of 1934[125] does not apply to an annuity plan that meets the requirements for the deduction of the employer's contributions[126] for income tax purposes.[127]

• The registration requirements for securities under the Securities Exchange Act of 1934[128] does not apply to an annuity plan which meets the requirements for the deduction

[102] §193(b).
[103] §43(c)(1)(C).
[104] *See* §243, §245, §246.
[105] §901(g)(1).
[106] §2(b)(1).
[107] §3(a).
[108] §243, §245.
[109] §301(e)(2).
[110] §303(a)(2).
[111] §357(c)(3)(A)(i).
[112] Former §367(a)(3)(C)(i)(II), effective for transfers before January 1, 2018.
[113] §501(c)(18)(D)(i).
[114] §542(c)(6).
[115] §852(a).
[116] §1244(c)(2)(C).
[117] 50 U.S.C. §4101–§4147.
[118] 50 U.S.C. §4136(b).
[119] 42 U.S.C. §411(a), §411(i).
[120] 42 U.S.C. §409(a)(9). For discussion of moving expenses deduction, see 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses.*
[121] 42 U.S.C. §409(k)(2).
[122] 15 U.S.C. §77a–§77aa.
[123] *See* §404(a)(2).
[124] 15 U.S.C. §77c(a)(2)(B).
[125] 15 U.S.C. §78a–§78nn.
[126] *See* §404(a)(2).
[127] 15 U.S.C. §78c(a)(12)(C)(ii).
[128] 15 U.S.C. §78a–§78nn.

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of the employer's contributions[129] for income tax purposes.[130]

• An investment company subject to the Investment Advisers Act of 1940[131] does not include an annuity plan which meets the requirements for the deduction of the employer's contributions[132] for income tax purposes.[133]

• The prohibition in the Employee Retirement Income Security Act of 1974[134] against permitting assets of a covered plan to inure to the benefit of an employer does not apply to the return of an employer contribution if the contribution was conditioned on the deductibility of the contribution for federal income tax purposes.[135]

• The prohibition against reduction by the board of directors of the capital of a system institution subject to Farm Credit Administration regulation through the payment of patronage refunds or dividends or the retirement of stock does not apply if, among other things, the system institution is subject to federal income taxation and the cash portion is the minimum amount required to qualify the refund as a deductible patronage dividend[136] for federal income tax purposes.[137]

• One element in the computation of the limitation on the amount deposited into a capital construction fund with respect to eligible vessels is the depreciation deduction[138] with respect to those vessels.[139]

• One element in the capital account portion of the capital construction fund with respect to eligible vessels is the amount that would be deductible as a dividends received deduction[140] by the person maintaining the fund if the deduction were not otherwise precluded by the rules applicable to capital construction funds.[141]

c. *Deductions Not Taken into Account for Certain Purposes*

(1) *Computational Purposes*

Amounts allowable as deductions generally are treated as deductions for all computational purposes, subject to certain exceptions, including:

• For purposes of computing the special small bond issue limit that is part of the determination of whether interest on a particular bond is tax-exempt, research and experimental expenditures for which a §174A deduction is allowed are not taken into account.[142]

• In computing taxable income for purposes of the taxable income limitation on the amount of the taxpayer's §179 expensing deduction, the §179 deduction is not taken into account.[143]

• The limitation on the taxpayer's aggregate dividends received deduction is based on a percentage of taxable income computed without regard to the net operating loss deduction, the domestic production activities deduction, the dividends received deduction, and the capital loss carryback deduction for the tax year.[144]

• In computing the earned income limitation on a self-employed taxpayer's deferred compensation contributions, the deduction for those contributions is not taken into account.[145]

• In determining the aggregate tax benefit resulting from the tax-exempt status of a terminated private foundation, an amount that must be calculated as part of computing the tax on a terminated private foundation, there must be computed the tax increases that would have resulted in the tax liabilities of all substantial contributors to the foundation had all their §170, §2055, §2522, and similar charitable contribution deductions for transfers to the foundation been disallowed.[146]

• In computing taxable income for purposes of the formula used to calculate a taxpayer's deduction for bad debt reserves under §593, the deduction for additions to bad debt reserves is not taken into account.[147]

• The limitation on an insurance company's dividends received deduction is based on a percentage of life insurance company taxable income computed without regard to the small life insurance company deduction,[148] the operations loss deduction, the dividends received deduction, and the capital loss carryback deduction for the tax year.[149]

• The special deduction for Blue Cross and Blue Shield organizations is limited to taxable income computed without regard to that deduction.[150]

• In computing taxable income for purposes of doubling rates on citizens and residents of certain foreign countries, the deduction for personal and dependency exemptions under §151 and the special deductions solely for corporations under §241 through §249 are not taken into account.[151]

• In determining the amount of tax that would be computed on foreign mineral income for purposes of the reduction in the foreign tax credit for taxes paid on foreign mineral income, the deduction under §613 for percentage depletion is not taken into account.[152]

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[129] *See* §404(a)(2).
[130] 15 U.S.C. §77c(a)(2).
[131] 15 U.S.C. §80a-1–§80a-64.
[132] *See* §404(a)(2).
[133] 15 U.S.C. §80a-3(c)(11)(A).
[134] 29 U.S.C. §1001–§1461.
[135] 29 U.S.C. §1103(c)(2)(C).
[136] *See* §1388.
[137] 12 U.S.C. §2154a(d)(2).
[138] *See* §167, §168.
[139] 46 U.S.C. §1177(b)(1)(B).
[140] *See* §243.
[141] 46 U.S.C. §1177(e)(2)(C).
[142] §144(a)(4)(C)(iv).
[143] §179(b)(3)(C).
[144] §246(b)(1).
[145] §404(a)(8)(C).
[146] §507(d)(1)(A).
[147] §593(b)(2)(D)(ii).
[148] Former §806.
[149] §805(a)(4)(B).
[150] §833(b)(2).
[151] §891.
[152] §901(e)(1).

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• In computing the taxable income component of the formula used to set the §904 tax-based limitation on the foreign tax credit, the taxable income of individuals, trusts, and estates is computed without regard to the personal exemption deduction.[153]

• In computing overall foreign loss for purposes of the recapture of overall foreign loss under §904(f), the deductions for net operating losses, foreign expropriation losses, and casualty losses are not taken into account.[154]

• In computing housing expenses for purposes of the §911 exclusion, the §163 interest deduction, the §164 deduction for taxes, and the §216(a) tenant-shareholder cooperative housing deductions are not taken into account to the extent they are attributable to the taxpayer's housing.[155]

• In computing the limitation on the amount treated as a dividend under §1248(a), the foreign income tax deduction is not taken into account.[156]

• In computing an S corporation's excess net passive income, the net §172 operating loss deduction and the special deductions for corporations under §241 through §249, other than the §248 organizational expenditure amortization deduction, are not taken into account.[157]

(2) Characterization and Classification Purposes

Generally, an amount that is allowable as a deduction is treated as a deduction for all purposes of characterization and classification. An amount that is allowable as a deduction under one Code provision generally is not classified as an amount allowable as a deduction under another Code provision. However, there are exceptions to this principle; examples include:

• In computing the earned income credit, the deduction under §164(f) for self-employment taxes paid by self-employed individuals is taken into account in determining self-employment income,[158] even though it is not taken into account in determining self-employment income for purposes of the computing the self-employment tax.[159]

• The basis reduction required if an investment credit is allowable is treated as a deduction subject to §1245 or §1250 depreciation recapture.[160]

• Amortization deductions under §291(b)(2) for §263(c), §616(a), and §617(a) deductions disallowed under §291(a) are treated as deductions subject to §1254 recapture.[161]

• Life insurance company deductions under §808(c) for policyholder dividends, under §807 for reserve adjustments, and under §805(a)(1) for death benefits and other amounts are classified as unallocable to any item or class of gross income for purposes of determining the amount of income from sources within and without the United States.[162]

• Any tax not allowed as a foreign tax credit by application of the §901(j)(2) ineligible country rule is not treated as a nondeductible tax under §78 and §275.[163]

• Certain basis reductions made as a condition for the exclusion from gross income of income from the discharge of indebtedness are treated as deductions subject to §1245 or §1250 depreciation recapture.[164]

• The tax computation mitigation provision for restoration of an item previously included in gross income under the claim of right doctrine is available only if, inter alia, the restoration qualifies the taxpayer for a deduction.[165]

• For purposes of determining a taxpayer's foreign expropriation loss under §1351, a worthless debt is treated as a foreign expropriation loss to the extent it is deductible under §166.[166]

d. Deductions Used in Special Tax Liability Computations

In some instances, some or all of a taxpayer's deductions are used as an element in computing a taxpayer's tax liability under a special provision. Important examples include:

• In determining the tax liability of a child under age 18, and for tax years beginning after May 25, 2005, children age 18, who have earned income that does not exceed one-half of the amount of their support, or full-time students ages 19 through 23, who have earned income that does not exceed one-half of the amount of their support[167] with respect to unearned income, the child's itemized deductions directly connected with the unearned income and the child's standard deduction are subtracted from gross unearned income to determine net unearned income, which is then in effect taxed at the marginal tax rates of the child's parents under certain circumstances.[168]

• Certain deductions are allowed in computing the tax on accumulation distributions made by trusts.[169]

• The computation of excess distributions subject to the §1291(a) tax is adjusted to reflect any §642(c) charitable deduction by a trust.[170]

• The net operating loss deduction is taken into account in calculating an S corporation's built-in gains tax.[171]

• Certain deductions are allowed in computing the tax on certain cooperatives.[172]

[153] §904(b)(1). *But see* §151(d)(5), amended by the OBBBA, §70103 (personal exemption deduction is zero beginning in 2018).
[154] §904(f)(2).
[155] §911(c)(3).
[156] §1248(b)(1).
[157] §1375(b)(1)(B).
[158] §32(c)(2)(A)(ii).
[159] *See* §1402(a)(12) (alternatively computed subtraction).
[160] §50(c)(4)(A).
[161] §291(b)(3).
[162] §818(f)(1).
[163] §901(j)(3).
[164] §1017(d).
[165] §1341(a)(2).
[166] §1351(b).
[167] §1(g)(2).
[168] §1(g)(4).
[169] §667.
[170] §1291(b)(3)(G).
[171] §1374(b)(2).
[172] §1383(a).

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3. *Alternative Minimum Tax*

a. *In General*

The alternative minimum tax (AMT) is an income tax that supplements the regular income tax.[173] Certain taxpayers are required to calculate their tax liability under both the regular income tax and the AMT, and then pay the higher amount. After the repeal of the corporate alternative minimum tax by the 2017 TCJA,[174] the Inflation Reduction Act[175] imposes a corporate alternative minimum tax equal to the excess of 15% of the corporation's adjusted financial statement income (AFSI) over its corporate AMT foreign tax credit, effective for tax years beginning after December 31, 2022. Unlike the former corporate AMT, which was based on taxable income, the post-2022 corporate AMT is based on adjusted financial statement income.[176] The determination of whether an amount is deductible and the manner in which the deduction is computed for AMT purposes differs in many instances from the determination for regular income tax purposes.[177] Rather than recomputing alternative minimum taxable income deductions separately, the IRC provides a series of adjustments and preferences that are added to, or subtracted from, taxable income to determine alternative minimum taxable income.[178] The adjustments and preferences relevant to deductions are described immediately below. The alternative minimum tax is discussed in detail in 587 T.M., *Noncorporate Alternative Minimum Tax*, and 752 T.M., *Corporate Alternative Minimum Tax.*

b. *Adjustments*

In many instances, some of a taxpayer's deductions are adjusted for AMT purposes, usually resulting in a smaller allowable deduction. Important examples of the adjustments and differing treatments include:

- Depreciation deductions are treated differently, generally resulting in a smaller deduction.[179]
- Mining exploration and development costs are deducted though amortization deductions over a specified period, rather than as deductions in the year incurred.[180]
- The net operating loss deduction is adjusted.[181]
- Pollution control facility costs are deducted under the alternative depreciation system of §168(g) or, for property placed in service after 1998, under the straight-line method of §168, rather than as amortization deductions under §169.[182]
- Miscellaneous itemized deductions are disallowed.[183]
- The itemized deduction for most taxes is disallowed.[184]
- The medical expense deduction is currently calculated in the same manner for all taxpayers.[185] Historically, the preferred lower AGI limit for taxpayers 65 years of age and older was lost for AMT purposes.
- The interest deduction is computed differently, generally resulting in a smaller deduction.[186]
- The standard deduction and deduction for personal and dependency exemptions are not allowed.[187]
- Circulation expenditures and research and experimental expenditures are deducted through amortization deductions over a specified period, rather than as deductions in the year incurred.[188]
- Tax shelter farm activity losses are not allowed.[189]
- Disallowed passive losses are computed differently.[190]

c. *Tax Preference Items*

In other instances, certain deductions are treated as tax preference items and, thus, are redefined, allowed, disallowed, or remeasured for AMT purposes. Important examples include:

- the depletion deduction;[191]
- intangible drilling costs;[192] and
- accelerated depreciation on certain property.[193]

4. *Other Federal Taxes*

Because there are other federal taxes based on a derivative of gross income reduced by deductions, the determination of deductions is significant beyond mere income tax liability. For example, moving expense reimbursements are not subject to Federal Income Contributions Act (FICA) taxation to the extent a corresponding deduction is allowable to the employee.[194] However, income tax deductions and deductions allowable for some other tax liability computations are not identical.[195] FICA taxation is discussed in detail in 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation.*

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[173] §55.
[174] §55.
[175] §55(b)(2), Pub. L. No. 117-169, §10101(a).
[176] *See* §55(a), §55(b)(2), §56A.
[177] §56, §57.
[178] §55(b)(2).
[179] §56(a)(1).
[180] §56(a)(2).
[181] §56(a)(4), §56(d).
[182] §56(a)(5).
[183] §56(b)(1)(A). For tax years beginning after 2017, miscellaneous itemized deductions are not available for regular tax purposes. §67(h), added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70110.
[184] §56(b)(1)(A).
[185] §56(b)(1).
[186] §56(b)(1)(B).
[187] §56(b)(1)(D). Under prior law, this disallowance did not apply to the portion of the standard deduction that consisted of the disaster loss deduction. §56(b)(1)(D) (reference to former §63(c)(1)(D)), pursuant to which the standard deduction included the disaster loss deduction. Under prior law, the disallowance also did not apply to the portion of the standard deduction that consisted of the qualified motor vehicle sales tax deduction. §56(b)(1)(D) (reference to former §63(c)(1)(E)), pursuant to which the standard deduction included the motor vehicle sales tax deduction.
[188] §56(b)(2).
[189] §58(a).
[190] §58(b).
[191] §57(a)(1).
[192] §57(a)(2).
[193] §57(a)(6).
[194] §3121(a)(11).
[195] *See, e.g.*, §1402(a).

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5. State and Local Income Taxes

The significance of deductions as an element in the computation of tax liability extends beyond the federal income tax. Most state and local income tax liability computations include the allowance of deductions, usually based on deductions allowed for federal income tax purposes modified to reflect the tax policy decisions of a particular state.[196] Even in most of the few states that independently define the income tax base, the statutory provisions closely resemble some or all of the federal provisions, and federal judicial and other analysis receives significant weight in state administrative and judicial analysis of the corresponding state provision.[197]

D. Administrative Impacts

1. Return Filing Requirements

Certain deductions are elements in determining whether a person or entity is required to file an income tax return.[198] For example, in the case of tax years beginning after December 31, 2017, and before January 1, 2026, an individual who is not married and whose gross income for the tax year does not exceed the standard deduction is not required to file a tax return.[199] Return filing requirements are discussed in detail in 623 T.M., *IRS Procedures: Examinations and Appeals.*

2. IRS Computation of Tax

Whether a taxpayer itemizes deductions or claims the standard deduction is a factor in determining whether the taxpayer can elect to require the IRS to compute the income tax liability.[200]

E. Constitutional Concerns

1. In General

Income tax deductions are not constitutional rights.[201] The Supreme Court specifically rejected an argument to the contrary in *New Colonial Ice Co. v. Helvering*.[202] In *INDOPCO v. Commissioner*,[203] *Deputy v. DuPont*[204] and *Interstate Transit Lines v. Commissioner*,[205] the Supreme Court held that deductions are a matter of legislative grace.[206] This maxim has been repeated by the lower courts many times.[207]

Note: Under the Sixteenth Amendment, Congress has the power to tax incomes, from whatever source derived, without apportionment.[208] The Sixteenth Amendment, however, does not define the concept of incomes nor does it indicate whether unapportioned taxes may be imposed on gross income, in contrast to net income. The issue has never arisen because deductions, including trade or business deductions, have always been a significant element in the computation of taxable income. The concepts of income and gross income are discussed in detail in 501 T.M., *Gross Income: Overview and Conceptual Aspects.*

Congress has the discretion to provide or to not provide any deductions or any particular deduction.[209] Thus, Congress could, if it chose, allow deductions for trade or business expenses and for no other expenditures.[210] The courts have no power to provide for a deduction for which Congress has not provided.[211] Congress also has the power to terminate a deduction.[212]

The Supreme Court has stated that Congress is not required to subsidize constitutional rights through deductions, but that it may selectively subsidize them.[213] Thus, Congress is not constitutionally required to provide an alternative deduction for taxpayers whose religious beliefs cause them to dis-

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[196] *See, e.g.*, as of 2017, Ala. Code §40-18-1.1, Ariz. Rev. Stat. Ann. §43-102, §43-105, §43-1001, §43-1121, §43-1122; Cal. Rev. & Tax Code §17024.5; Colo. Rev. Stat. §39-22-103, §39-22-104; Conn. Stat. Ann. §12-701; Del. Code Ann. tit. 30, §1101, §1105, §1121; D.C. Code Ann. §47-1801.04; Fla. Stat. §220.03, §220.12, §220.13; Ga. Code Ann. §48-7-2, §48-7-27; Haw. Rev. Stat. §235-1; Idaho Code §63-3004, §63-3022, §63-3027A; Ill. Cons. Stat. tit. 35, §5-102, §5-103; Ind. Code §6-3-1-11; Iowa Code §422.3, §422.7; Kan. Stat. Ann. §79-32,109, §79-32,117; Ky. Rev. Stat. Ann. §141.010; Me. Rev. Stat. Ann. tit. 36, §5102; Md. Code Ann. [Tax-Gen.] §1-101, §10-203 through 10-210; Mass. Gen. L. ch. 62, §1, §2, §3, §6F; Mich. Stat. Ann. §206.2, §206.30; Minn. Stat. §289A.02, §290.01(19), §290.21; Mo. Rev. Stat. §143.121, §143.181; Mont. Code Ann. §15-30-2101, §15-30-2111 (individuals); Neb. Rev. Stat. §77-2715; N.M. Stat. Ann. §7-2-2, §7-2A-2; N.Y. Tax Law §607, §612; N.C. Gen. Stat. §105-228.90, §105-130.2; N.D. Cent. Code §57-38-01; Ohio Rev. Code Ann. §5701.11, §5747.01; Okla. Stat. tit. 68, §2353, §2358; Or. Rev. Stat. §314.011, §316.007, §316.012, §316.013, §317.010, §317.259; Pa. Stat. Ann. tit. 72, §7301, §7401 (corporations); R.I. Gen. Laws §44-11-11, §44-30-6, §44-30-12, §44-30-32; S.C. Code Ann. §12-6-30, §12-6-40, §12-6-50; Utah Code Ann. §59-7-101, §59-10-103, §59-10-114, §59-10-116; Vt. Stat. Ann. tit. 32, §5811, §5824; Va. Code Ann. §58.1-301, §58.1-322; W.Va. Code §11-21-9, §11-21-12, §11-21-32; Wis. Stat. Ann. §71.01, §71.05.

[197] *See, e.g.*, as of 2017, Ark. Code Ann. §26-51-415–§26-51-417, §26-51-419, and §26-51-423–§26-51-430; Miss. Code Ann. §27-7-17; Mont. Code Ann. §15-31-114 (corporations).

[198] §6012(a).

[199] §6012(f), added by the TCJA, Pub. L. No. 115-97, §11041(e). For tax years beginning on or after January 1, 2026, an individual who is not married and whose gross income for the tax year does not exceed the sum of the standard deduction and the personal exemption amount is not required to file a tax return. §6012(a)(1)(A)(i)–§6012(a)(1)(A)(iii).

[200] *See* §6014(a).

[201] *Graham v. Commissioner*, 822 F.2d 844, 850 (9th Cir. 1987), *aff'g* 83 T.C. 575 (1984), *aff'd sub nom., Hernandez v. Commissioner*, 490 U.S. 680 (1989); *Commissioner v. First State Bank of Stratford*, 168 F.2d 1004, 1011 (5th Cir. 1948) (Sibley, J., concurring), *cert. denied*, 335 U.S. 867 (1948).

[202] 292 U.S. 435, 440 (1934).

[203] 503 U.S. 79 (1992), *quoting Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943).

[204] 308 U.S. 488 (1940).

[205] 319 U.S. 590 (1943).

[206] 319 U.S. at 593; 308 U.S. at 493.

[207] *E.g., Commissioner v. First State Bank of Stratford*, 168 F.2d 1004 (5th Cir. 1948) (Sibley, J., concurring), *cert. denied*, 335 U.S. 867 (1948); *Budget Credits, Inc. v. Commissioner*, 50 T.C. 52, 56 (1968), *aff'd per curiam*, 417 F.2d 1108 (6th Cir. 1969); *Estate of Fahnestock v. Commissioner*, 2 T.C. 756, 759 (1943); *George W. Helme Co. v. United States*, 23 F. Supp. 787, 792 (Ct. Cl. 1938) (per curiam), *cert. denied*, 305 U.S. 645 (1938); *Campbell v. United States*, 2001-2 USTC ¶50,716 (S.D.N.Y. 2001), *aff'd*, 45 Fed. App'x 50 (2d Cir. 2002), *cert. denied*, 537 U.S. 1171 (2003).

[208] United States Constitution, amend. XVI.

[209] *George W. Helme Co. v. United States*, 23 F. Supp. 787, 792 (Ct. Cl. 1938) (per curiam), *cert. denied*, 305 U.S. 645 (1938).

[210] *Ditunno v. Commissioner*, 80 T.C. 362, 377 (1983) (Tannenwald, J., dissenting); *High Plains Agric. Credit Corp. v. Commissioner*, 63 T.C. 118, 127 (1974).

[211] *Nat'l Life Ins. Co. v. United States*, 63 Ct. Cl. 256, 264–65 (1927), *rev'd on other grounds*, 277 U.S. 508 (1928).

[212] *See Am. Soc'y of Ass'n Execs. v. United States*, 23 F. Supp. 2d 64 (D.D.C. 1998).

[213] *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 548–49 (1983), *rev'g & rem'g* 676 F.2d 715 (D.C. Cir. 1982).

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agree with some of the uses to which tax revenues are put, and its failure to do so does not violate the First Amendment.[214] Similarly, the denial of deductions for personal exemptions in the computation of the AMT does not unconstitutionally infringe the free exercise rights of a taxpayer who, for religious reasons, chose to have many children.[215]

Several courts have stated that there may be a constitutional right "to deduct" the cost of goods sold from gross receipts.[216]

2. *Limitations on Congressional Power to Enact Deductions*

a. *In General*

The only limitation on the exercise by Congress of its discretion to provide or not provide deductions is that it not act so arbitrarily so as to create, in effect, a classification so unreasonable that it violates the Fifth Amendment.[217] Thus, a deduction is invalid only if it is arbitrary and capricious or results in a gross and patent inequality.[218] The Tax Court has held that the Equal Protection and Due Process Clauses of the Fourteenth Amendment do not affect the taxing power of the federal government.[219]

b. *Classification of Taxpayers for Deduction Purposes*

Congress is permitted to establish classes of taxpayers who are and are not entitled to a deduction, provided that all the members of a class are treated alike.[220] Thus, the denial of IRA deductions for those taxpayers who are participants in qualified plans (or for those taxpayers who are not participants, but whose spouses are active participants) does not violate the due process clauses of the Fifth Amendment.[221] Similarly, the denial of home office deductions for professors does not violate the Fifth Amendment equal protection clause because professors are allowed home office deductions to the same extent as other taxpayers.[222] Bringing the challenge under the Fourteenth Amendment and arguing that the denial of deductions treats home workers differently from other taxpayers is fruitless.[223] Establishing a presumption in favor of custodial parents for purposes of the dependency exemption deduction with respect to a child of divorced parents is not a bill of attainder nor is it a violation of equal protection.[224]

One of the most litigated provisions in this respect was the former dependent care deduction.[225] The Tax Court held that the statutory denial of the deduction for payments to the taxpayer's relatives in exchange for dependent care services did not violate the taxpayer's constitutional rights.[226] The Tax Court also consistently held that the limitation of the deduction to women, widowers, and husbands with incapacitated wives did not violate the constitutional rights of unmarried male taxpayers who were not widowers.[227] In *Moritz v. Commissioner*,[228] the Tenth Circuit reversed the Tax Court holding that the denial of the deduction to unmarried men violated the due process clause and that the appropriate relief was to extend the provision to include those taxpayers.[229] Shortly after Moritz was decided, Congress removed the restrictions that limited the deduction to women, widowers, and husbands with incapacitated wives.[230] In 1976, the deduction was repealed and replaced by a credit.[231]

The Supreme Court also held that the allowance of personal exemptions and the different treatment of married and unmarried individuals with respect to the predecessor of the standard deduction does not violate the Constitution.[232]

The Eleventh Circuit has held that denial of a deduction for in vitro fertilization-related expenses of a gestational surrogate claimed by a homosexual male taxpayer does not violate his right to equal protection of the laws because there is not fundamental right to IVF and surrogacy-assisted reproduction and no discrimination on the basis of sexual orientation where IVF expenses are not deductible by either homosexual or heterosexual taxpayers.[233]

c. *Charitable Contribution Deductions*

In *Taxation with Representation of Wash. v. Regan*,[234] the District of Columbia Circuit held that denying charitable contribution deductions for contributions to an exempt organization that represents the general public on tax matters, on the grounds of excessive lobbying, while allowing deductions for charitable contributions to veterans' organizations that lobby

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[214] *Bowman v. Commissioner*, 35 T.C.M. 881, 884 (1976).

[215] *See Klaassen v. Commissioner*, 76 T.C.M. 20 (1998), *aff'd in unpub. op.*, 182 F.3d 932 (10th Cir. 1999).

[216] *E.g., Hagen Advert. Displays, Inc. v. Commissioner*, 47 T.C. 139, 153 (1966) (Hoyt, J., dissenting), *aff'd*, 407 F.2d 1105 (6th Cir. 1969); *Estate of Johnson v. Commissioner*, 42 T.C. 441, 444–45 (1964), *aff'd without op.*, 355 F.2d 931 (6th Cir. 1965); *Sullenger v. Commissioner*, 11 T.C. 1076, 1077 (1948).

[217] *E.g., Davis v. United States*, 87 F.2d 323, 325 (2d Cir. 1937), *cert. denied*, 301 U.S. 704 (1937); *Hamilton v. Commissioner*, 68 T.C. 603 (1977).

[218] *George W. Helme Co. v. United States*, 23 F. Supp. 787, 792 (Ct. Cl. 1938) (citing *Brushaber v. Union Pac. R.R.*, 240 U.S. 1 (1916)), *cert. denied*, 305 U.S. 645 (1938).

[219] *E.g., Labay v. Commissioner*, 55 T.C. 6 (1970), *aff'd per curiam*, 450 F.2d 280 (5th Cir. 1971).

[220] *High Plains Agric. Credit Corp. v. Commissioner*, 63 T.C. 118, 127 (1974) (citing *Brushaber v. Union Pac. R.R.*, 240 U.S. 1 (1916)); *Holmes v. Commissioner*, 30 T.C.M. 1426, 1428 (1971).

[221] *Guest v. Commissioner*, 72 T.C. 768, 771 (1979). *See Shankar v. Commissioner*, 143 T.C. 140 (2014) (whether individual, spouse, or both, are active participants, economic family unit has ability to save in tax-favored manner as much as Congress thinks proper through active participation in employer-sponsored plan (or plans) and to extent IRA contribution deductions allowed).

[222] *Storzer v. Commissioner*, 44 T.C.M. 100, 102–03 (1982).

[223] *See Cook v. Commissioner*, 74 T.C.M. 339 (1997).

[224] *See Knight v. Commissioner*, 29 F.3d 632 (9th Cir. 1994), *aff'g* 64 T.C.M. 1519 (1992), *cert. denied*, 513 U.S. 878 (1994). *See also* §151(d)(5), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70103 (personal exemption deduction is zero beginning in 2018).

[225] §214 (as in effect for tax years beginning before 1976).

[226] *Bryant v. Commissioner*, 72 T.C. 757, 759 (1979).

[227] *Keeler v. Commissioner*, 70 T.C. 279, 282–86 (1978); *Nammack v. Commissioner*, 56 T.C. 1379 (1971), *aff'd per curiam*, 459 F.2d 1045 (2d Cir. 1972), *cert. denied*, 409 U.S. 991 (1972); *Moritz v. Commissioner*, 55 T.C. 113, 114–15 (1970), *rev'd*, 469 F.2d 466 (10th Cir. 1972), *cert. denied*, 412 U.S. 906 (1973); *Shonkwiler v. Commissioner*, 37 T.C.M. 546, 548 (1978); *Holmes v. Commissioner*, 30 T.C.M. 1426, 1428 (1971).

[228] 469 F.2d 466 (10th Cir. 1972), *rev'g* 55 T.C. 113, 114–15 (1970), *cert. denied*, 412 U.S. 906 (1973).

[229] 469 F.2d at 470.

[230] Revenue Act of 1971, Pub. L. No. 92-178, §210(a).

[231] Tax Reform Act of 1976, Pub. L. No. 94-455, §504 (adding the credit at current §21).

[232] *Stanton v. Baltic Mining Co.*, 240 U.S. 103, 111 (1916); *Brushaber v. Union Pac. R.R.*, 240 U.S. 1, 21, 23–24 (1916).

[233] *Morrissey v. United States*, 871 F.3d 1260 (11th Cir. 2017).

[234] 676 F.2d 715 (D.C. Cir. 1982), *rev'g* 79-1 USTC ¶9185 (D.D.C. 1979), *rev'd and rem'd*, 461 U.S. 540 (1983).

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extensively, violates the equal protection clause of the Fifth Amendment, because there was insufficient legitimate justification for distinguishing between the organizations to justify even indirect free speech infringement.[235] However, in a related case, the Supreme Court reversed and held that a rational basis for granting additional benefits to veterans' organizations existed and, thus, the equal protection clause was not violated.[236] It also held that the denial of charitable contribution deductions for contributions to organizations that do substantial lobbying does not violate the contributors' rights to freedom of speech.[237]

Note: Since the case was decided, Congress enacted legislation extending the disallowance of lobbying expense deductions to all taxpayers.[238] That decision in turn sparked challenges on constitutional grounds by other taxpayers.[239]

In *Hernandez v. Commissioner*,[240] the Supreme Court held that the allowance of a charitable contribution deduction for contributions to specified religious organizations does not violate the establishment clause of the First Amendment.[241] The allowance of charitable contribution deductions for contributions to churches does not violate the establishment clause[242] or any other provision.[243]

3. Failure to Provide or Continue Specific Deductions

The denial of deductions for personal expenditures does not violate the Constitution.[244] Nor is it a violation of a minister's First Amendment rights to deny a deduction for commuting expenses between home and church.[245] No constitutional rights are violated by the denial of deductions for commuting expenses paid by a carpenter.[246] The decision by Congress to prohibit deductions for lobbying expenses does not violate the taxpayers' First or Fifth Amendment rights.[247]

Denial of deductions for adoption expenses, even though medical expenses are deductible, is not a denial of equal protection.[248] However, several years after the unsuccessful challenge to the constitutionality of a medical expense deduction that excluded adoption expenses, Congress enacted a deduction for adoption expenses,[249] subsequently repealed it, and then, almost two decades after the unsuccessful challenge, enacted a limited credit for adoption expenses.[250]

[235] 676 F.2d at 740.
[236] *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 550 (1983), *rev'g and rem'g* 676 F.2d 715 (D.C. Cir. 1982).
[237] *Regan*, 461 U.S. at 549–50.
[238] *See* §162(e).
[239] *E.g., Am. Soc'y of Ass'n Execs. v. United States*, 23 F. Supp. 2d 64 (D.D.C. 1998).
[240] 490 U.S. 680 (1989).
[241] 490 U.S. at 695.
[242] *Graham v. Commissioner*, 822 F.2d 844, 851–53 (9th Cir. 1987), *aff'g* 83 T.C. 575 (1984), *aff'd sub nom., Hernandez v. Commissioner*, 490 U.S. 680 (1989).
[243] *Kessler v. Commissioner*, 87 T.C. 1285, 1293–94 (1986), *aff'd without op.*, 838 F.2d 1215 (6th Cir. 1988).
[244] *Reading v. Commissioner*, 70 T.C. 730, 734 (1978), *aff'd per curiam*, 614 F.2d 159 (8th Cir. 1980).
[245] *Hamblen v. Commissioner*, 78 T.C. 53, 54–55 (1982).
[246] *Lohr v. Commissioner*, 35 T.C.M. 1382, 1384–85 (1976).
[247] *Am. Soc'y of Ass'n Execs. v. United States*, 23 F. Supp. 2d 64 (D.D.C. 1998).
[248] *Kozlowski v. Commissioner*, 38 T.C.M. 744, 745–46 (1979).
[249] *See* former §222.
[250] *See* §23.

The provision allowing a deduction for some or all of the cost of business tangible personal property[251] does not violate the Constitution by precluding the deduction with respect to real property, because the application of the deduction to personal property is a reasonable classification.[252]

The Tax Court has rejected constitutional arguments against the denial of deductions for social security taxes paid by an employee.[253] It is not unconstitutional to deny deductions for compensation paid to employees in excess of compensation permitted by other laws.[254]

Denying deductions for losses of anticipated earnings and allowing deductions for losses of existing capital is a reasonable distinction that does not violate the Constitution.[255] Nor is the disallowance of "cost of living" deductions a violation of the taxpayer's constitutional rights.[256]

4. Imposition of Limitations or Restrictions on Deductions

a. In General

Congress may place limitations on deductions, provided the limitations do not go beyond the permissible Constitutional power described in I.E.2., above. It is within Congress's power to deny the deduction in its entirety.[257] Thus, application of the former §68 limitation on itemized deductions discussed in V.C.8.j.(2), below, to deductions for state and local taxes does not violate the Sixteenth Amendment or the Tenth Amendment, and limitations under §162(l) and §163(h), does not reflect an unconstitutional delegation of the taxing power to private entities such as employers and mortgage lenders.[258] Similarly, the substantiation requirements and limitations in §274 do not violate the Fifth, Thirteenth, or Fourteenth Amendments, nor do they impinge on a taxpayer's civil rights or freedom of travel.[259]

b. Requirement that Deductions Be Substantiated

The denial of medical expense deductions and state and local income tax deductions not substantiated by the taxpayer does not unconstitutionally favor one economic group over another.[260] Requiring a taxpayer who is an author to substantiate deductions for the expenses of writing does not constitute a prior restraint in violation of the taxpayer's First Amendment rights, because the substantiation requirements are imposed under statutes of general applicability that further substantial pub-

[251] §179.
[252] *Lasiter v. Commissioner*, 24 T.C.M. 52, 54 (1965).
[253] *See Pollard v. Commissioner*, 48 T.C.M. 1303 (1984).
[254] *N.A. Woodworth Co. v. Kavanagh*, 102 F. Supp. 9, 13–14 (E.D. Mich. 1952), *aff'd per curiam*, 202 F.2d 154 (6th Cir. 1953); *Oak Mfg. Co. v. United States*, 193 F. Supp. 514, 520 (N.D. Ill. 1961); *Pedone v. United States*, 151 F. Supp. 288, 291–92 (Ct. Cl. 1957), *cert. denied*, 355 U.S. 829 (1957).
[255] *Marks v. Commissioner*, 390 F.2d 598, 599 (9th Cir. 1968), *aff'g* 25 T.C.M. 338 (1966), *cert. denied*, 393 U.S. 883 (1968).
[256] *See Sjoroos v. Commissioner*, 81 T.C. 971 (1983).
[257] *Harrison v. N. Tr. Co.*, 317 U.S. 476, 480–81 (1943).
[258] *Campbell v. United States*, 2001-2 USTC ¶50,716 (S.D.N.Y. 2001), *aff'd*, 45 Fed. App'x 50 (2d Cir. 2002), *cert. denied*, 537 U.S. 1171 (2003).
[259] *Ranheim v. Commissioner*, 39 T.C.M. 720 (1979); *Vernaccini v. Commissioner*, 33 T.C.M. 321 (1974).
[260] *Majeske v. Commissioner*, 34 T.C.M. 915, 916 (1975).

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lic interests.[261] Imposing on taxpayers the obligation to provide a social security number for dependents with respect to whom dependency exemption deductions are claimed, a requirement designed to assist the IRS in identifying inappropriate deductions, does not violate that taxpayer's constitutional right to free exercise of religion nor does it violate their Religious Freedom Restoration Act.[262]

c. Requirement that There Be a Reduction in Wealth

It is not a violation of due process to deny deductions for expenditures for which the taxpayer receives reimbursement.[263] For example, the denial of charitable contribution deductions for taxpayers who receive consideration for their transfers to the charitable organization does not violate the taxpayers' rights of freedom of religion or equal protection.[264]

d. Imposition of Conditions Precedent to Deduction

Allowing a charitable contribution deduction only for transfers to qualified charitable donees does not prevent the taxpayer from engaging in the constitutionally protected activity of belonging to an organization that is not a qualified donee, merely because the taxpayer must fund the activities entirely with after-tax income.[265] Limitations on the personal exemption deduction do not force the taxpayer into involuntary servitude,[266] and the presumption favoring the custodial parent with the dependency deduction for a child whose parents are divorced does not violate the uniformity clause,[267] is not an unconstitutional irrebuttable presumption,[268] is not a bill of attainder,[269] does not violate equal protection,[270] and does not violate due process.[271] Congress may allow deductions only for expenses relating to taxable income, and thus the §265(a)(2) limitation precluding interest deductions with respect to indebtedness incurred or continued to purchase or carry tax-exempt obligations does not violate the Constitution.[272] Similarly, limiting the §274 deduction for travel, entertainment, and similar expenses does not violate the taxpayer's civil rights, freedom of travel right, or Fifth, Thirteenth, or Fourteenth Amendment rights.[273]

Also, Congress can set the condition that a taxpayer must be currently married to take a personal exemption deduction for a spouse.[274] The denial is not a violation of the Fifth Amendment because it is not arbitrary or capricious to deny a dependency exemption deduction for a taxpayer's former spouse in the year of divorce.[275]

e. Restrictions Related to Timing

Congress may impose timing restrictions, and so the use of an annual, rather than transactional, basis for income taxation is not constitutionally arbitrary.[276]

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[261] *Irwin v. Commissioner*, 131 F.3d 146 (9th Cir. 1997), *aff'g* 72 T.C.M. 1148 (1996).

[262] *Cansino v. Commissioner*, 81 T.C.M. 1729 (2001); *Miller v. Commissioner*, 114 T.C. 511 (2000).

[263] *Zamora v. Commissioner*, 47 T.C.M. 215, 218 (1983).

[264] *Miller v. IRS*, 829 F.2d 500, 505–06 (4th Cir. 1987), *cert. denied*, 490 U.S. 1113 (1989); *Graham v. Commissioner*, 822 F.2d 844, 851–53 (9th Cir. 1987), *aff'g* 83 T.C. 575 (1984), *aff'd sub nom., Hernandez v. Commissioner*, 490 U.S. 680 (1989).

[265] *Graham v. Commissioner*, 83 T.C. 575, 581 (1984), *aff'd*, 822 F.2d 844 (9th Cir. 1987), *aff'd sub nom., Hernandez v. Commissioner*, 490 U.S. 680 (1989).

[266] *Crowe v. Commissioner*, 26 T.C.M. 784, 785 (1967), *aff'd per curiam*, 396 F.2d 766 (8th Cir. 1968).

[267] *Tarbet v. Commissioner*, 36 T.C.M. 955 (1977).

[268] *Knight v. Commissioner*, 64 T.C.M. 1519 (1992), *aff'd*, 29 F.3d 632 (9th Cir. 1994), *cert. denied*, 513 U.S. 878 (1994).

[269] *Knight*, 64 T.C.M. 1519.

[270] *Knight*, 64 T.C.M. 1519.

[271] *Caputi v. Commissioner*, 88 T.C.M. 619 (2004).

[272] *Wynn v. United States*, 288 F. Supp. 797, 803 (E.D. Pa. 1968), *aff'd per curiam*, 411 F.2d 614 (3d Cir. 1969), *cert. denied*, 396 U.S. 1008 (1970).

[273] *Vernaccini v. Commissioner*, 33 T.C.M. 321, 325–26 (1974).

[274] *Hamilton v. Commissioner*, 68 T.C. 603, 606 (1977).

[275] *Hamilton*, 68 T.C. at 608.

[276] *Mannette v. Commissioner*, 69 T.C. 990, 994–95 (1978) (not a due process violation to deny a deduction to an embezzler for embezzled amounts included in gross income in one year and repaid in a later year).

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II. Applicable Principles

A. Introduction

As the tax law evolved, certain general principles developed that apply to deductions generally. One significant concept, discussed in II.B., below, is that of the tax benefit rule. Another, discussed in II.C., below, is that an expenditure or similar outlay generally is required. In II.D., below, the impact of reimbursement is discussed. Another principle is that that a deduction must be properly substantiated, as discussed in II.E., below. Finally, the timing principle of deductions is discussed in II.F., below.

B. Tax Benefit Rule

Generally, the tax benefit rule provides that the amount of an expense recovered shall be included in income in the year of recovery to the extent the expense resulted in a tax benefit to the taxpayer.[277] Conversely, if the taxpayer did not receive a tax benefit when the expense was paid, then the taxpayer does not have to include an amount in income when the expense is later recovered. The tax benefit rule is substantially judicial in origin and nature, but has been codified, in part, in §111. Under the tax benefit rule, the recovery of a previously paid expense must be included in income if four requirements are met:

> (1) The amount was deducted in a year prior to the current year, (2) the deduction resulted in a tax benefit, (3) an event occurs in the current year that is fundamentally inconsistent with the premises on which the deduction was originally based, and (4) a nonrecognition provision of the Internal Revenue Code does not prevent the inclusion in gross income. A current event is considered fundamentally inconsistent with the premises on which the deduction was originally based when the current event would have foreclosed the deduction if that event had occurred within the year that the deduction was taken.[278]

Thus, for example, if a taxpayer deducted state income tax in the prior tax year (thus, receiving a tax benefit), then the taxpayer must include any state income tax refund as income in the year of recovery that provided the tax benefit.[279] However, if the taxpayer had state income tax expenses in a previous tax year, but did not deduct the expenses, then the taxpayer does not have to include the subsequent state income tax refund in income.

Example: A single taxpayer, S, pays state income tax of $5,000 in the previous tax year and claimed itemized deductions totaling $25,000. In the current year, S receives a state income tax refund for the previous tax year in the amount of $2,000. When the $2,000 state income tax refund was deducted in the previous year, S received a tax benefit as a result of the deduction. Furthermore, if S would have paid $5,000 in state income taxes in the previous year, but also had been refunded the $2,000 dollars in the same year, S would have only been allowed a deduction of $3,000 for state income taxes paid. Additionally, there is not a nonrecognition provision preventing the inclusion in gross income. Thus, S must include the $2,000 in income in the current year.

Example: A single taxpayer, T, pays state income tax of $5,000 in the previous tax year and claimed itemized deductions totaling $6,500. In the current year, T receives a state income tax refund for the previous tax year in the amount of $2,000. When the $2,000 state income tax refunded was deducted in the previous year, T received a tax benefit as a result of the deduction. Furthermore, if T would have paid $5,000 in state income taxes in the previous year, but also had been refunded the $2,000 dollars in the same year, T would have only been allowed a deduction of $3,000 for state income taxes paid. Also, there is not a nonrecognition provision preventing the inclusion in gross income. Thus, T must include in income the amount of the $2,000 state income tax recovered that resulted in a tax benefit in the previous year to T. Here, if T would have only been allowed to deduct $3,000 for state income tax paid, T's total itemized deductions would have been $4,500 resulting in T claiming the standard deduction (in 2016, $6,300 for singles) instead of itemizing his deductions. As a result, the tax benefit to T for deducting the $2,000 state income tax recovered was only $200 ($6,500 – $6,300); and, T must only include $200 in income in the current year.

Example: If a single taxpayer, R, pays state income tax of $5,000 in the previous tax year, but did not itemize deductions, because R's total itemized deductions did not exceed the standard deduction amount, then R did not receive a tax benefit for the state income tax expense. Thus, if R receives a state income tax refund for the previous tax year, R does not have to include the amount in income.

A more detailed discussion on the tax benefit rule is provided in 502 T.M., *Gross Income: Tax Benefit, Claim of Right and Assignment of Income.*

C. Expenditure or Outlay

1. In General

Generally, a deduction represents a decrease in the taxpayer's economic wealth that is allowable in computing taxable income. Thus, in *Block v. Commissioner*,[280] the Tax Court disallowed a deduction to a law firm that placed funds in escrow to

[277] §111 (providing that the taxpayer only has to include in income the amount of the deduction that caused the tax benefit). *See, e.g., Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370 (1983); *Estate of Backemeyer v. Commissioner*, 147 T.C. No. 17 (2016) (discussing the inclusionary and exclusionary components of the tax benefit rule); *Elbaz v. Commissioner*, 109 T.C.M. 1229 (2015) (applying the tax benefit rule to a state income tax refund).

[278] *Frederick v. Commissioner*, 101 T.C. 35, 40–41 (1993). Most recently the four part-test was applied in *Estate of Backemeyer v. Commissioner*, 147 T.C. No. 17 (2016).

[279] §164. For further discussion, *see* 502 T.M., *Gross Income: Tax Benefit, Claim of Right and Assignment of Income.*

[280] 31 T.C.M. 579 (1972), *aff'd per curiam*, 482 F.2d 1342 (6th Cir. 1973).

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protect a client against possible third-party claims arising from the firm's erroneous advice, because the firm intended to retrieve the funds after the statute of limitations expired with respect to the third-party claims.[281]

2. Economic Wealth

a. Anticipated but Unrealized Income

No deduction is allowable with respect to income that the taxpayer anticipates, but does not realize.[282] In *Hort v. Commissioner*,[283] the Supreme Court held that no deduction was allowed for the difference between rent that a landlord would have received under a canceled lease and the amount paid by the tenant for having canceled the lease.[284] The Court reasoned that, because the unrealized rent was not includible in the taxpayer's gross income, the taxpayer had no grounds for a deduction.[285]

This principle applies to every type of income, including lost wages,[286] lost interest,[287] uncollected receivables,[288] uncollected business income,[289] uncollected condemnation proceeds,[290] unrealized anticipated investment profits,[291] lost rents,[292] and lost royalties.[293] Thus, no deduction is allowed for the difference between the amount realized by the taxpayer from the sale of property and greater amounts received by others from the sale of similar property.[294]

It does not matter that the income is not realized because of injury or illness,[295] unemployment,[296] employment termination due to criminal charges,[297] criminal conviction,[298] employment for fewer than the maximum possible hours,[299] loss of tools of the trade,[300] forfeiture of equipment,[301] employment in a lower-paying position than the one previously held,[302] devotion of time to other matters,[303] damage to property,[304] another person's breach of contract,[305] cancellation of contracts,[306] or another person's bankruptcy.[307] Similarly, no deduction is allowed for anticipated but unrealized rents, regardless of whether the cause is cancellation of a lease,[308] damage to the rental property,[309] or deterioration of the rental property.[310] No deduction is allowed for income not realized because the contingency on which it is based does not occur.[311]

In contrast, if the taxpayer does not receive income already included in gross income under the taxpayer's method of accounting, then a loss deduction is not precluded by the principle disallowing deductions for anticipated but unrealized income.[312] The rationale is that the taxpayer who includes an amount in gross income before it is collected acquires basis in that collectible, and the nonpayment of the collectible is tantamount to the taxpayer's relinquishment of the economic value reflected in that basis.[313]

b. Uncompensated Services

In *O'Connor v. Commissioner*,[314] the Tax Court held that a taxpayer was not allowed to deduct the value of services rendered to an organization on a voluntary, uncompensated basis, because there was no income from the activity.[315] A deduction is also not allowed for services performed if the taxpayer issues a check to an employee, but does not have the funds to properly pay the check.[316] Similarly, no deduction is allowed for the value of uncompensated performed by taxpayer for others even if the impact is not unlike that procured through spending money on advertising.[317] Furthermore, no deduction is allowed for the difference between what a taxpayer is paid and what a taxpayer believes his or her services are worth.[318] The arm's-length employment agreement establishes the value of the services.[319]

Similarly, taxpayers are not allowed to deduct the value of services that they render to themselves, because individuals

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[281] 31 T.C.M. at 586.

[282] *E.g., Carroll v. Commissioner*, 42 T.C.M. 326, 328 (1981); *Stephens v. Commissioner*, 40 T.C.M. 220, 221 (1980).

[283] 313 U.S. 28 (1941), *aff'g* 112 F.2d 167 (2d Cir. 1940), *aff'g per curiam* 39 B.T.A. 922 (1939).

[284] 313 U.S. at 33.

[285] 313 U.S. at 32–33.

[286] *E.g., Kukes v. Commissioner*, 72 T.C.M. 333 (1996); *Savignano v. Commissioner*, 38 T.C.M. 1, 2 (1979).

[287] *E.g.*, Rev. Rul. 55-405.

[288] *See Holman v. Commissioner*, 66 T.C. 809, 816–17 (1976), *aff'd on other grounds*, 564 F.2d 283 (9th Cir. 1977).

[289] *E.g., Hendricks v. Commissioner*, 26 T.C.M. 636, 638 (1967), *aff'd*, 406 F.2d 269, 272 (5th Cir. 1969).

[290] *E.g., Ratcliff v. Commissioner*, 39 T.C.M. 886, 890 (1980), *aff'd by unpub. op.* 636 F.2d 1203 (2d Cir. 1980), *cert. denied*, 452 U.S. 906 (1981).

[291] *Stilwell v. United States*, 585 F. Supp. 130, 133 (W.D. Mo. 1984).

[292] *E.g., Warren Serv. Corp. v. Commissioner*, 110 F.2d 723, 724 (2d Cir. 1940), *aff'g on this issue & rev'g & rem'g on other grounds* 39 B.T.A. 856, 860 (1939); *Oliver v. Commissioner*, 364 F.2d 575, 580 (8th Cir. 1966), *aff'g on other grounds* T.C. Memo 1965-83 (1965).

[293] *E.g., Fisher v. Commissioner*, T.C. Memo 1986-141.

[294] In re *Neustadt*, 3 B.T.A. 491 (1926).

[295] *E.g., Greenway v. Commissioner*, T.C. Memo 1980-97; *Andrews v. Commissioner*, T.C. Memo 1978-174; *Brennan v. Commissioner*, T.C. Memo 1971-176.

[296] *E.g., Kukes v. Commissioner*, T.C. Memo. 1996-363; *Greenfield v. Commissioner*, T.C. Memo 1965-203.

[297] *E.g., Johnson v. Commissioner*, T.C. Memo 1978-395.

[298] *E.g., Schiers v. Commissioner*, T.C. Memo 1976-37.

[299] *E.g., Bostick v. Commissioner*, T.C. Memo 1957-220.

[300] *E.g., Rice v. Commissioner*, T.C. Memo 1967-54.

[301] *E.g., Escofil v. Commissioner*, T.C. Memo 1971-131, *aff'd*, 464 F.2d 358, 359 (3d Cir. 1972), *cert. denied*, 409 U.S. 1112 (1973).

[302] *E.g., Marks v. Commissioner*, 390 F.2d 598, 599 (9th Cir. 1968), *aff'g* T.C. Memo 1966-62, *cert. denied*, 393 U.S. 883 (1968).

[303] *Brennan v. Commissioner*, 30 T.C.M. 751, 752 (1971).

[304] *E.g., J.G. Boswell Co. v. Commissioner*, 302 F.2d 682, 685–86 (9th Cir. 1962), *aff'g* 34 T.C. 539, 545 (1960), *cert. denied*, 371 U.S. 860 (1962). *See* Rev. Rul. 73-51.

[305] *E.g., Ratcliff v. Commissioner*, T.C. Memo 1986-457; *Ratcliff v. Commissioner*, T.C. Memo 1983-636.

[306] *E.g., Nicola v. Commissioner*, 1 B.T.A. 487, 490 (1925).

[307] *E.g., Fisher v. Commissioner*, T.C. Memo 1986-141.

[308] *E.g., Kokjer v. United States*, 70-1 USTC ¶9385 (N.D. Cal. 1970).

[309] *E.g., Kerr v. Commissioner*, T.C. Memo 1973-109.

[310] *E.g., Brady v. Commissioner*, T.C. Memo 1983-163; *Brady v. Commissioner*, T.C. Memo 1974-171, *aff'd without op.*, 513 F.2d 625 (3d Cir. 1975), *cert. denied*, 423 U.S. 912 (1975).

[311] *E.g., Blanchard v. Commissioner*, 17 B.T.A. 1271, 1276–79 (1929).

[312] *E.g., Royster v. Commissioner*, T.C. Memo 1985-258, *aff'd per curiam on other grounds*, 820 F.2d 1156 (11th Cir. 1987); Rev. Rul. 73-511, *clarified*, Rev. Rul. 75-21.

[313] *See Carroll v. Commissioner*, T.C. Memo 1981-347.

[314] 41 T.C.M. 1191 (1981).

[315] 41 T.C.M. at 1193. *See also* Reg. §1.170A-1(g) ("No deduction is allowable under section 170 for contribution of services.").

[316] *Vanney Assocs., Inc. v. Commissioner*, T.C. Memo 2014-184.

[317] *Remy v. Commissioner*, 73 T.C.M. 1976 (1997) (medical services).

[318] *Bostick v. Commissioner*, 15 T.C.M. 742 (1956).

[319] *Bostick*, 15 T.C.M. 742. *See also Stuart v. Commissioner*, 54 T.C.M. 70, 71 (1987) (no deduction is allowed for the value of vacation time used by a taxpayer to appear in Tax Court to contest a tax liability).

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are not required to include in income the value of services they provide to themselves.[320] This concept of excluding imputed income from gross income is discussed in detail in 501 T.M., *Gross Income: Overview and Conceptual Aspects.*

c. Unrented Property

No deduction is allowed for the amount of rent a taxpayer would receive from renting property to others that is not received, because the taxpayer does not attempt to rent the property.[321] The rationale of denying a deduction for the rental value of unrented property reflects the fact that the taxpayers are not required to include in gross income the value of their own property that they use themselves.[322] This concept of excluding imputed rental income from gross income is discussed in detail in 501 T.M., *Gross Income: Overview and Conceptual Aspects.*

D. Reimbursement

1. Effect on Deduction

a. In General

Generally, the impact of reimbursement on the allowance of a deduction depends on whether the reimbursement is includible in gross income. For reporting purposes, the IRS allows employees to report reimbursements net of deductible employee business expenses or deductible employee business expenses net of reimbursements.[323] These special rules are discussed in detail in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses.*

b. Reimbursement Includible in Gross Income

If a reimbursement is includible in gross income, the expenditure is deductible to the extent it satisfies the conditions of a particular deduction provision.[324] For example, deductible reforestation expenditures exclude reimbursed amounts unless the reimbursement has been included in gross income.[325] Similarly, §597 disallows banks and domestic savings and loan associations a deduction effectively reimbursed by nontaxable federal financial assistance.[326]

Note: The fact that an expenditure is reimbursed and the reimbursement is included in gross income does not necessarily mean that the expenditure is deductible. The expenditure must still satisfy the conditions of a specific provision allowing a deduction. Thus, for example, a taxpayer who receives reimbursement for all moving expenses that are incurred must include the entire reimbursement in gross income, even if some of the moving expenses are not deductible under §217. Moving expenses are discussed in 594 T.M., *Tax Implications of Home Ownership.*

Observation: If the expenditure is not deductible because it must be capitalized, any reimbursement reduces the amount that is capitalized and, thus, reduces any ensuing depreciation, depletion, or amortization deduction.[327]

The extent to which reimbursements are included in gross income is discussed in 501 T.M., *Gross Income: Overview and Conceptual Aspects.*

c. Reimbursement Not Includible in Gross Income

If the reimbursement is not includible in gross income, generally it reduces the amount of the deduction, because, to the extent of the reimbursement, the taxpayer has not made an expenditure or outlay.[328] This principle has been applied, for example, to otherwise deductible educational expenses,[329] costs of moving business property,[330] and rent expenses.[331]

2. Failure to Seek Reimbursement

a. In General

If the taxpayer has a right to reimbursement, but does not seek it, the deduction is disallowed to the extent of the reimbursement to which the taxpayer is entitled.[332] In some instances, the disallowance is based on the ground that it is not ordinary and necessary to incur an expenditure that another person is obligated to bear.[333] In other instances, the deduction has been disallowed on the ground that it is not reasonable to incur an expenditure payable by another.[334] In a third approach,

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[320] *Clark v. Commissioner*, 25 T.C.M. 118, 119 (1966).

[321] *Brady v. Commissioner*, 45 T.C.M. 1079, 1080 (1983). *See also* Reg. §1.170A-7 (disallowing a charitable deduction for rent-free leases and below market leases).

[322] *See Helvering v. Indep. Life Ins. Co.*, 292 U.S. 371, 379 (1934) (dictum).

[323] *See* Reg. §1.162-17.

[324] *See, e.g.*, §82, §217.

[325] §194(c)(3)(B).

[326] §597(b)(3).

[327] *See, e.g., Levy v. Commissioner*, 212 F.2d 552, 554 (5th Cir. 1954), *aff'g* 12 T.C.M. 235, 238 (1953); *379 Madison Ave., Inc. v. Commissioner*, 23 B.T.A. 29, 42 (1931), *rev'd on other grounds*, 60 F.2d 68 (2d Cir. 1932).

[328] *See, e.g., Manocchio v. Commissioner*, 710 F.2d 1400, 1402 (9th Cir. 1983), *aff'g* 78 T.C. 989, 997–98 (1982); *Wolfers v. Commissioner*, 69 T.C. 975, 983–85 (1978).

[329] *Manocchio v. Commissioner*, 710 F.2d 1400, 1402 (9th Cir. 1983), *aff'g* 78 T.C. 989, 995 (1982); *Olszewski v. Commissioner*, 45 T.C.M. 659, 660 (1983), *aff'd in unpub. op.* (1st Cir. 1983); *Allen v. Commissioner*, 51 T.C.M. 427, 428 (1986); *Walley v. Commissioner*, 49 T.C.M. 904, 905–06 (1985); *Grigsby v. Commissioner*, 47 T.C.M. 620, 621 (1983); *Rivers v. Commissioner*, 46 T.C.M. 1387, 1388 (1983), *aff'd in unpub. op.* (4th Cir. 1984); *Moran v. Commissioner*, 46 T.C.M. 445, 446 (1983); *Franks v. Commissioner*, 46 T.C.M. 307, 308–09 (1983); *Wilson v. Commissioner*, 46 T.C.M. 182, 183 (1983); *Forrest v. Commissioner*, 45 T.C.M. 1156, 1158 (1983); *Densch v. Commissioner*, 45 T.C.M. 783, 784 (1983); Rev. Rul. 83-3, *obsoleted on other issues*, Rev. Rul. 87-32, Rev. Rul. 80-173; PLR 201401001.

[330] *E.g., Charles Baloian Co. v. Commissioner*, 68 T.C. 620, 625–26 (1977), *nonacq.*, 1978-2 C.B. 3, *aff'd by unpub. op.* (9th Cir. 1982); Rev. Rul. 78-388.

[331] *E.g., Friedlaender v. Commissioner*, 26 T.C. 1005, 1019 (1956).

[332] *Spielbauer v. Commissioner*, 75 T.C.M. 1865 (1998) (travel expenses); *Richards v. Commissioner*, T.C. Memo 2014-88 (taxpayer did not request reimbursement for any claimed expenses (advertising, vehicle, supplies, travel, meals, and entertainment) even though she may have been entitled to reimbursement; taxpayer may not deduct such expenses as employee business expenses); *Putnam v. Commissioner*, 76 T.C.M. 238 (1998) (meal, entertainment, travel, and computer expenses); *Meeks v. Commissioner*, 75 T.C.M. 1997 (1998) (office supplies and other business expenses).

[333] *E.g., Orvis v. Commissioner*, 788 F.2d 1406, 1408 (9th Cir. 1986), *aff'g* 48 T.C.M. 1295, 1299 (1984) (§162); *Estate of Boyd v. Commissioner*, 28 T.C. 564, 566 (1957) (§212); *Podems v. Commissioner*, 24 T.C. 21, 23 (1955) (§162); *Kerr v. Commissioner*, 59 T.C.M. 193, 199 (1990); *McGuire v. Commissioner*, 24 T.C.M. 1174, 1175 (1965) (§162). *See Horne v. Commissioner*, 59 T.C. 319, 336–37 (1972), *aff'd*, 523 F.2d 1363 (9th Cir. 1975), *cert. denied*, 439 U.S. 892 (1978) (§212).

[334] *E.g., Campbell v. Commissioner*, 54 T.C.M. 632, 634 (1987).

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the disallowance is based on a specific statutory provision.[335] A fourth justification rests on the fact that the taxpayer could have avoided the expenditure by accepting in kind assistance from the other party.[336] It does not matter that the taxpayer fails to seek reimbursement through error,[337] through failure to submit the reimbursement claim before the employer's deadline,[338] failure to maintain records,[339] or recordkeeping complexities,[340] because of the other party's precarious financial condition,[341] or because the other party is unable to pay.[342]

b. Business Purpose Exception

If a taxpayer has a business purpose for not seeking reimbursement, the deduction may not be denied. For example, if there is a compelling business reason not to seek reimbursement for repairs to business property, the deduction is not necessarily denied.[343] Also, if waiver of the right to reimbursement is a condition of the taxpayer's employment, the failure to seek reimbursement does not reduce the amount otherwise deductible.[344] Nonetheless, a change in the employment contract made long after the expenditures are paid by the employee is disregarded, particularly if the employee is employed by a wholly owned corporation.[345] However, if the employee does not seek reimbursement because the corporation's reimbursement policy is unclear, there is doubt that there would be reimbursement, and the employee's relationship with the corporation is discordant, the deduction is not reduced.[346] Similarly, if the employer limits the reimbursement, the amount not reimbursed is not treated as voluntarily relinquished by the taxpayer and does not reduce the amount otherwise deductible.[347]

3. Indeterminable Right to Reimbursement

If the taxpayer does not have a reasonable prospect of reimbursement at the time the deduction is claimed, the fact that reimbursement subsequently is received does not make the deduction erroneous.[348] Instead, the taxpayer includes the reimbursement in gross income in the year received to the extent required to do so under the tax benefit doctrine, discussed at II.B., above. In other words, if the deduction generated a tax benefit, the reimbursement is included in gross income to the extent of the tax benefit.[349] The tax benefit doctrine is discussed in 502 T.M., *Gross Income: Tax Benefit, Claim of Right and Assignment of Income*. In contrast, if the right to reimbursement is fixed, the fact that it has not yet been received by the taxpayer does not matter.[350]

E. Substantiation

1. In General

Generally, a deduction is not allowed unless, in addition to all of the other requirements, the taxpayer substantiates the expense.[351] In *Harrell v. Tomlinson*,[352] the Florida district court, citing the Supreme Court's analysis in *Welch v. Helvering*,[353] stated, "[i]t is likewise important for a taxpayer claiming deductions to be in a position to establish proof of the correctness of the claimed amounts because the Commissioner's determination has the presumption of correctness and taxpayer has the burden of proving it to be wrong."[354]

Note: Special substantiation rules apply with respect to employee business expenses.[355] These rules are discussed in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*. Special substantiation rules also apply with respect to certain charitable contributions.[356] These rules are described in 521 T.M., *Charitable Contributions: Income Tax Aspects*.

Comment: Typically, the IRS has three years from the date a taxpayer files a return to audit and assess additional taxes.[357] However, in the case of a 25% omission of gross income, the IRS has six years from the date a return is filed to audit and assess additional taxes.[358] Finally, in the case of a fraudulent return, the IRS has an indefinite period to audit and assess additional taxes.[359] Thus, a taxpayer should retain records to substantiate his deductions for at least three years, and, longer if any of the exceptions to the three year rule may apply. The statute of limitations on assessment by the IRS is discussed in 627 T.M., *Limitations Periods, Interest on Underpayments and Overpayments, and Mitigation*.

Note: Generally, a return filed prior to its due date (without extensions) is deemed filed on the due date;[360] and a return filed after the due date is deemed filed upon receipt by the IRS.[361] The filing date of a return is discussed in 627 T.M., *Limita-*

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[335] *See, e.g.*, §165(h)(4)(E) (no deduction for losses to the extent covered by insurance and no timely filed insurance claim submitted). *But see* §165(h)(5)(A), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70109, applicable to tax years beginning after December 31, 2025 (limiting personal casualty and theft loss deduction to losses incurred in a federally declared disaster for tax years beginning after 2017 and before 2026, and to losses incurred in a federally declared disaster or a state declared disaster for tax years beginning after 2025). However, a taxpayer can still use a personal casualty loss to offset a personal casualty gain. §165(h)(5)(B), amended by the OBBBA, §70109.

[336] *E.g.*, *Heidt v. Commissioner*, 18 T.C.M. 149, 151 (1959), *aff'd*, 274 F.2d 25, 28 (7th Cir. 1959) (failure to use employer's vehicles).

[337] *See Krych v. Commissioner*, 20 T.C.M. 44, 46 (1961).

[338] *See Dixon v. Commissioner*, 78 T.C.M. 462 (1999), *aff'd on other issues*, 15 Fed. App'x 469 (9th Cir. 2001).

[339] *Morgan v. Commissioner*, 24 T.C.M. 644, 646 (1965).

[340] *Coplon v. Commissioner*, 18 T.C.M. 166, 167 (1959), *aff'd per curiam on other grounds*, 277 F.2d 534 (6th Cir. 1960).

[341] *E.g.*, *Berner v. Commissioner*, 20 T.C.M. 107, 110 (1961).

[342] *Worth v. Commissioner*, 20 T.C.M. 216, 223 (1961).

[343] *See Waxler Towing Co. v. United States*, 510 F. Supp. 297, 300 (W.D. Tenn. 1980).

[344] *Neal v. Commissioner*, 41 T.C.M. 1247, 1249 (1981).

[345] *Thomas v. Commissioner*, 56 T.C.M. 532, 533 (1988).

[346] *Jetty v. Commissioner*, 44 T.C.M. 373, 376 (1982).

[347] *Phillips v. Commissioner*, 32 T.C.M. 255, 258 (1973).

[348] *See, e.g.*, Reg. §1.165-1(d)(2)(iii), §1.213-1(g).

[349] *See* §111.

[350] *E.g.*, Rev. Rul. 78-388.

[351] *E.g.*, *Barnes v. Commissioner*, 408 F.2d 65, 69 (7th Cir. 1969), *aff'g Barnes Theatre Ticket Serv., Inc. v. Commissioner*, 26 T.C.M. 1290, 1294 (1967), *cert. denied*, 396 U.S. 836 (1969); *Lillis v. Commissioner*, 45 T.C.M. 1000, 1011–12 (1983), *aff'd by unpub. op.* (9th Cir. 1984).

[352] 63-1 USTC ¶9120 (M.D. Fla. 1962).

[353] 290 U.S. 111 (1933).

[354] 63-1 USTC ¶9120, at 87, 149 (citing *Welch v. Helvering*, 290 U.S. 111 (1933)).

[355] *See* Reg. §1.162-17.

[356] §170(f)(8). Note that the donee organization return exception (former §170(f)(8)(D)) was repealed.

[357] §6501(a).

[358] §6501(e).

[359] §6501(c)(1) (false return); §6501(c)(2) (willful attempt to evade tax).

[360] §6501(b)(1).

[361] *See* §7502; §7503.

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tions Periods, Interest on Underpayments and Overpayments, and Mitigation.

2. Strict Substantiation Requirements

If a deduction is one to which the §274(d) strict substantiation requirements apply,[362] the deduction is not allowed unless the taxpayer establishes certain information by adequate records or by sufficient evidence corroborating the taxpayer's own statement.[363] The required information includes:

- the amount of the item,[364]
- the time and place the travel item occurred, or the date and description of the gift,[365]
- the business purpose of the item,[366] and
- the business relationship to the taxpayer of the recipient of the benefit.[367]

The §274(d) substantiation requirements are discussed in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses.*

The §274(d) substantiation requirements apply to traveling expenses, entertainment items, business gifts, and expenses with respect to §280F(d)(4) listed property.[368] For tax years beginning before January 1, 2018, the §274(d) substantiation requirements applies to entertainment items.[369] However, for tax years beginning after December 31, 2017, deductions for entertainment expenses are disallowed.[370] An entertainment item is any item with respect to an activity of a type generally considered to constitute entertainment, amusement, or recreation,[371] or any item with respect to a facility used in connection with an entertainment activity.[372] Generally, listed property is:

- any passenger automobile,[373]
- any other property used as a means of transportation,[374]
- any property of a type generally used for purposes of entertainment, recreation, or amusement,[375]
- any computer or peripheral equipment (for tax years beginning before January 1, 2018).[376]
- any other property of a type specified by the IRS in regulations.[377]

Listed property is discussed in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses.*

3. Less Strict Substantiation Requirements

If the §274(d) substantiation requirements do not apply, the courts have permitted taxpayers to prove the existence and amount of an expenditure not only through documentary evidence[378] and third-party testimony[379] but also through the taxpayer's testimony.[380] The question is ultimately one of fact.[381] In some instances, deductions have been allowed even though no records were produced and the taxpayer's testimony was unconvincing and unsatisfactory.[382] In other instances, deductions have been disallowed because the court ruled as inadmissible the only documentation or testimony that would establish the taxpayer's claims.[383]

However, in the absence of complete or exact records, the courts have permitted the approximation of the amount, but not the fact of the taxpayer's expenditure.[384] In the leading decision, *Cohan v. Commissioner*,[385] the Second Circuit held that absolute certainty is not necessary because it often is impossible, but that as close an approximation as is possible suffices.[386] The Supreme Court has added that the record must at least establish the possibility of approximating the amount[387] and provide a method for doing so.[388] Thus, if the taxpayer fails to present any evidence from which the court can make an estimate, the taxpayer's claimed deduction cannot be upheld.[389]

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[362] §274(d). The TCJA amended §274 to reflect new limitations on deductions by employers of expenses for fringe benefits. For example, deduction for entertainment expenses, qualified transportation fringe benefits, and transportation and commuter benefits are eliminated, effective for tax years beginning after December 31, 2017. The deduction for meals provided at the convenience of the employer is eliminated for expenses paid or incurred after December 31, 2025. Substantiation requirements in §274(d) have been modified to reflect these changes, including repealing §274(d)(2) and redesignation of the listed property substantiation requirement §274(d)(4) as §274(d)(3).

[363] §274(d); Reg. §1.274-5T. The TCJA amended the substantiation requirements in §274(d) to reflect changes made to §274, including repealing §274(d)(2) and redesignation of the listed property substantiation requirement §274(d)(4) as §274(d)(3).

[364] §274(d)(3)(A), redesignated by the TCJA, §13304(a)(2)(A)(i); Reg. §1.274-5T.

[365] §274(d)(3)(B), redesignated by the TCJA, §13304(a)(2)(A)(i); Reg. §1.274-5T.

[366] §274(d)(3)(C), redesignated by the TCJA, §13304(a)(2)(A)(i); Reg. §1.274-5T.

[367] §274(d)(3)(D); Reg. §1.274-5T.

[368] §274(d).

[369] Former §274(d)(2).

[370] *See* §274(a).

[371] §274(a)(1)(A). *See* Reg. §1.274-2(b).

[372] §274(a)(1)(B).

[373] §280F(d)(4)(A)(i). *See* Reg. §1.280F-6(b)(1)(i).

[374] §280F(d)(4)(A)(ii). *See* Reg. §1.280F-6(b)(1)(ii), §1.280F-6(b)(2).

[375] §280F(d)(4)(A)(iii). *See* Reg. §1.280F-6(b)(1)(iii), §1.280F-6(b)(3).

[376] Former §280F(d)(4)(A)(iv) (reference to §168(i)(2)(B)). *See* Reg. §1.280F-6(b)(1)(iv). The TCJA amended §280F(d)(4) to remove computer or peripheral equipment from listed property, effective for property placed in service in tax years ending after December 31, 2017.

[377] §280F(d)(4)(A)(v), redesignated by the TCJA, §13202(b)(1)(C).

[378] *E.g., Hendrickson v. Commissioner*, 46 T.C.M. 1363, 1367 (1983); *Brothers v. Commissioner*, 33 T.C.M. 269, 274 (1974).

[379] *E.g., Ferrer v. Commissioner*, 50 T.C. 177, 185 (1968), *aff'd per curiam*, 409 F.2d 1359 (2d Cir. 1969); *Munafo v. Commissioner*, 24 T.C.M. 155, 156 (1965).

[380] *E.g., Riordan v. Commissioner*, 37 T.C.M. 839, 842 (1978); *Cheyne v. Commissioner*, 36 T.C.M. 1439, 1458–59 (1977); *Adler v. Commissioner*, 18 T.C.M. 520, 521 (1959).

[381] *E.g., Harris v. Commissioner*, 51 T.C.M. 635, 641 (1986).

[382] *E.g., Feinstein v. Commissioner*, 29 T.C.M. 1338, 1340 (1970).

[383] *E.g., Owen v. United States*, 34 F. Supp. 2d 1071 (W.D. Tenn. 1998).

[384] *See, e.g., Chesbro v. Commissioner*, 21 T.C. 123, 129 (1953), *aff'd per curiam*, 225 F.2d 674 (2d Cir. 1955), *cert. denied*, 350 U.S. 995 (1956); *Belser v. Commissioner*, 10 T.C. 1031, 1042–43 (1948), *aff'd*, 174 F.2d 386 (4th Cir. 1949), *cert. denied*, 338 U.S. 893 (1949); *West v. Commissioner*, T.C. Memo 2011-272.

[385] 39 F.2d 540 (2d Cir. 1930).

[386] 39 F.2d 540, 543–44; *see also Blossom Day Care Ctrs., Inc. v. Commissioner*, T.C. Memo 2021-87 (for day care center operation, court allowed deduction for credit card charges from businesses specializing in education or childcare-related supplies, but disallowed charges from stores that could have personal element (e.g., K-Mart, Walmart)); *United States v. Chambers*, No. 3:09-cv-00961-MMH-JRK, 2014 BL 145336 (M.D. Fla. May 22, 2014).

[387] *Humes v. United States*, 276 U.S. 487, 494 (1928).

[388] *Robinette v. Helvering*, 318 U.S. 184, 188 (1943).

[389] *E.g., Estate of Reinke v. Commissioner*, 46 F.3d 760 (8th Cir. 1995), *aff'g* 65 T.C.M. 2570 (1993).

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Application of the Cohan rule is discussed in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses.*

F. Timing

1. In General

Timing also plays an important role in the analysis of a deduction. Once a taxpayer determines that an item is allowable as a deduction, the tax year in which the deduction is allowable must also be determined.[390] Thus, the determination of the taxpayer's deductions involves not only whether an item is deductible, but when the item is deductible.

Generally, the timing rules are dependent on the taxpayer's method of accounting.[391] While there are many methods of accounting, the vast majority of taxpayers use only a few methods.[392] An allowable deduction is taken for the tax year that is the proper tax year under the method of accounting used in computing the taxpayer's taxable income.[393] The method of accounting used for tax purposes is the same method the taxpayer regularly uses to compute income in keeping the books.[394] If there is no regularly used book method, or if the method used does not clearly reflect income, the taxpayer must use the method the IRS prescribes.[395] Subject to those general principles, taxpayers are permitted to use the cash method, the accrual method, any other method permitted by statute, or any combination of these methods the IRS permits.[396] Special exceptions exist for amounts accrued by reason of the death of an accrual-method taxpayer,[397] real property taxes incurred by accrual-method taxpayers,[398] dividends and interest paid by specified financial institutions on certain deposits and similar amounts,[399] contested liabilities,[400] and certain prepaid interest.[401] Special rules, generally making acceleration unavailable, are provided for tax shelters.[402] There is a limitation on excess farm losses by noncorporate taxpayers who receive an applicable subsidy.[403] However, for tax years beginning after 2017, the limitation on excess farm losses does not apply.[404] In addition, for tax years beginning after 2020, excess business losses are not allowed.[405]

Comment: Timing affects not only the allowance of deductions, but also the recognition of gross income. For most taxpayers, it is advantageous to defer the recognition of income. Conversely, one of the principal consequences of timing determinations is the availability of acceleration; for most taxpayers it is advantageous to accelerate the deduction of an item to the earliest tax year permitted under the tax law. Some of the timing rules involve elections by the taxpayer that control, to a limited extent, the tax year of the deduction.[406] Although acceleration generally is beneficial, not all taxpayers in every situation benefit from the acceleration of a deduction, so careful analysis must be made before a taxpayer makes an election that affects timing and acceleration.

The deduction timing rules, including the special rules, are discussed in detail in 525 T.M., *State, Local, and Federal Taxes*; 536 T.M., *Interest Expense Deductions*; 565 T.M., *Installment Sales*; 570 T.M., *Accounting Methods — General Principles*; 572 T.M., *Accounting Methods — Adoption and Changes*; 576 T.M., *Uniform Capitalization Rules: Inventory; Self-Constructed Assets; Real Estate*; 577 T.M., *Uniform Capitalization Rules: Method Change Rules and Special Topics;* 578 T.M., *Inventories: General Principles; LIFO Method*; and 608 T.M., *Reporting Farm Income.*

2. Other Factors

There are other factors that must be considered in determining the tax year in which the deduction is allowable, including generally applicable exceptions, listed in II.F.2.a., below, specially applicable exceptions, listed in II.F.2.b., below, and capital expenditures, listed in II.F.2.c., below.

a. Generally Applicable Exceptions

The following exceptions are generally applicable to deductions, which should be considered in determining the tax year in which the deduction is allowable:

- The §465 at-risk limitation[407] discussed in detail in 550 T.M., *At-Risk Rules*; and
- The §469 passive loss limitation[408] discussed in detail in 549 T.M., *Passive Loss Rules.*

b. Specifically Applicable Exceptions

The following exceptions are specifically applicable to deductions, which should be considered, as applicable, in determining the tax year in which the deduction is allowable:

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390 *See generally* §451.
391 *E.g.*, §451(a).
392 *See* §446(c).
393 §461(a).
394 §446(a).
395 §446(b).
396 §446(c). Under the cash method of accounting, transactions are taken into account when cash or its equivalent is actually or constructively received and when cash or its equivalent is paid. Under the accrual method of accounting, transactions are taken into account when all events have occurred that fix, with reasonable certainty, the taxpayer's rights or obligations with respect to the transaction. In addition, for the deduction of certain expenses, economic performance of the transaction must have occurred. *See* Poswolsky, *The Line Between the Cash and Accrual Methods Has Narrowed, but the Choices Remain Important*, 44 Tax'n for Acct. 210 (1990)). The restrictions on the choice of methods of accounting and their selection are discussed in detail in 570 T.M., *Accounting Methods — General Principles*, 565 T.M., *Installment Sales,* and 572 T.M., *Accounting Methods — Adoption and Changes.*
397 §461(b).
398 §461(c), §461(d).
399 §461(e).
400 §461(f); Reg. §1.461-2.
401 §461(g).
402 §461(i).
403 §461(j).
404 §461(l)(1)(A).
405 §461(l)(1)(B).
406 *See, e.g.*, §461(c), §468(a), §468A(a).
407 §465(a)(1), §465(a)(2). A taxpayer's loss arising from an applicable activity during a tax year is deductible in that tax year only to the extent of the taxpayer's aggregate amount at-risk for the activity as of the end of the tax year; the excess is treated as a potential deduction in the succeeding tax year.
408 §469(a)(1), §469(b). *See* Reg. §1.469-1T(f). The passive activity losses incurred by covered taxpayers in a tax year are deductible in that tax year only to the extent of the aggregate income from passive activities for that tax year; the excess is treated as a potential deduction in the succeeding tax year.

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• The §464 limitation on deductions for certain farming expenses[409] discussed in detail in 607 T.M., *Farm and Ranch Expenses and Credits*, and 608 T.M., *Reporting Farm Income.*

• The tax treatment of employee stock options[410] discussed in detail in 381 T.M., *Statutory Stock Options.*

• The §468 special rules for mining and solid waste reclamation and closing cost and the election thereunder[411] discussed in detail in 603 T.M., *Mineral Properties Other Than Gas & Oil — Operation.*

• The §468A special rules for nuclear decommissioning costs,[412] discussed in 570 T.M., *Accounting Methods — General Principles.*

• The §468B special rules for designated settlement funds,[413] discussed in detail in 522 T.M., *Tax Aspects of Settlements and Judgments.*

• The §451(g)(3) deferral rule for frozen deposits in certain financial institutions[414] discussed in 570 T.M., *Accounting Methods — General Principles.*

c. Capital Expenditures

(1) In General

Under §263(a), no deduction is allowed for amounts that must be properly charged to a capital account.[415] Despite the descriptive nature of the statutory, judicial, and regulatory tests, the actual determination of whether an amount is a capital expenditure depends on the circumstances of each particular case.[416] The analysis of specific transactions is discussed in 509 T.M., *Principles of Capitalization.* The impact of the capitalization requirement on specific types of trade or business or for-profit activity deductions, such as insurance, advertising, relocation expenses, supplies, education, professional expenses, dues, professional service fees, depositors' guaranty fund set asides, or governmental impositions, is discussed in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.* Whether a capitalized amount can generate a depreciation, amortization, or depletion deduction is discussed in 531 T.M., *Depreciation: MACRS and ACRS*, 532 T.M., *First-Year Expensing and Additional Depreciation*, 533 T.M., *Amortization of Intangibles*, and 601 T.M., *Mineral Properties — Exploration, Acquisition, Development and Disposition.*

(2) Exceptions

(a) Deduction for Tax Year Paid or Incurred

Under certain provisions of the IRC, taxpayers may elect to treat capital expenditures as deductible expenses or deferred expenses, or to treat deductible expenses as capital expenditures.[417] This exception applies to the following expenditures:

• Circulation expenditures to the extent deductible under §173, discussed in detail in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*

• Research and development expenditures to the extent deductible under §174A, discussed in detail in 556 T.M., *Research and Development Expenditures.*[418]

• Soil and water conservation expenditures to the extent deductible under §175, discussed in detail in 607 T.M., *Farm and Ranch Expenses and Credits.*[419]

• Certain asset expensing to the extent deductible under §179, discussed in detail in 532 T.M., *First-Year Expensing and Additional Depreciation.*[420]

• Expenditures for qualified clean-fuel vehicle property and qualified clean-fuel vehicle refueling property to the extent deductible under former §179A, discussed in detail

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[409] §464(a) (reference to §464(d) (providing that certain prepaid farming expenses paid by covered taxpayers for feed, seed, fertilizer, or similar supplies or for poultry are allowed only for the later of the tax year in which the supplies are actually used or consumed or the tax year for which the deduction be allowable if §464 were disregarded).

[410] *See* §421(b), §422(a)(1), §423(a)(1). Under §421(b), if an employer corporation is entitled to deduct compensation on account of a transfer of stock to an employee pursuant to the exercise of a stock option that fails to qualify for gross income exclusion treatment by the employee because the employee fails to hold the stock for the requisite holding period, then the employer corporation's deduction is allowable in the tax year in which the employee disposes of the stock and not in the tax year in which the exercise of the option occurs.

[411] §468(a), §468(d). The taxpayer may elect to deduct the amount the taxpayer would be required to pay for qualified reclamation costs and for qualified closing costs if the reclamation or closing activities were performed currently, rather than waiting until the tax year in which economic performance occurs.

[412] §468A(a); Reg. §1.468A-1(a); Reg. §1.468A-2(a). An eligible taxpayer may elect to deduct the amount of cash payments made by the taxpayer to a Nuclear Decommissioning Reserve Fund during the tax year, even though under the applicable method of accounting the taxpayer would otherwise not be permitted to claim the deduction until a later tax year.

[413] §468B(a); Reg. §1.468B-3(c). Qualified payments to a designated settlement fund are deemed to satisfy the economic performance requirement for deduction by accrual method taxpayers even though economic performance otherwise has not yet occurred. *See also* §468B(d)(1) (defining a qualified payment as "any money or property transferred to a designated settlement fund pursuant to a court order, other than amounts which may be transferred from the fund to the taxpayer (or any related person) and other than the transfer of any stock or indebtedness of the taxpayer (or any related person)").

[414] §451(i)(3), redesignated by the TCJA, Pub. L. No. 115-97, §13221(a). No deduction is allowed to any qualified financial institution for interest paid to a depositor on a frozen deposit in that institution that is excluded from the depositor's gross income under §451(i)(1), redesignated by the TCJA, §13221(a), until the tax year in which the interest is includible in the depositor's gross income.

[415] §263(a). *See* Reg. §1.212-1(n). In some situations, a facts-and-circumstances analysis may be necessary to determine whether or not an item must be capitalized. *See, e.g.*, CCA 201036009 (Chief Counsel's Office rejected taxpayer's argument that payments on certain liabilities assumed in connection with purchase of assets from seller undergoing bankruptcy proceedings should fall under "bright-line" rule precluding capitalization; fact-and-circumstances analysis of such liabilities is necessary to determine whether capitalization is required).

[416] *W.P. Brown & Sons Lumber Co. v. Commissioner*, 26 B.T.A. 1192, 1198 (1932).

[417] Reg. §1.263(a)-6, T.D. 9636, 78 Fed. Reg. 57,685 (Sept. 19, 2013); Reg. §1.263(a)-6T, T.D. 9564, 76 Fed. Reg. 81,060 (Dec. 27, 2011). The final regulations issued under T.D. 9636, generally applicable to tax years beginning on or after January 1, 2014, replaced and removed temporary regulations issued in T.D. 9564. Taxpayers generally may elect to apply the final regulations to tax years beginning on or after January 1, 2012, or may elect to apply the temporary regulations to tax years beginning on or after January 1, 2012, and before January 1, 2014.

[418] *See* §263(a)(1)(B).

[419] *See* §263(a)(1)(C).

[420] *See* §263(a)(1)(G).

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in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses.*[421]

• Expenditures to comply with EPA sulfur regulations for which a deduction is allowed under §179B, discussed in detail in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*[422]

• Expenditures for petroleum refining assets for which a deduction is allowed under §179C, discussed in detail in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*[423]

• Expenditures for energy-efficient commercial building property to the extent deductible under §179D, discussed in detail in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*[424]

• Expenditures for qualified advanced mine safety equipment to the extent deductible under §179E, discussed in detail in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*[425]

• Farmers' land-conditioning expenditures to the extent deductible under §180, discussed in detail in 607 T.M., *Farm and Ranch Expenses and Credits.*[426]

• Certain qualified film, television, and live theatrical production expenses to the extent deductible under §181, discussed in detail in 599 T.M., *The Taxation of Filmed Entertainment Content Production & Distribution.*

• Architectural barrier removal expenses to the extent deductible under §190, discussed in detail in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*[427]

• Tertiary injectant expenses to the extent deductible under §193, discussed in detail in 605 T.M., *Oil and Gas Transactions.*[428]

• Reforestation expenditures allowed under §194, discussed in detail in 610 T.M., *Timber Transactions.*[429]

• Start-up expenditures to the extent deductible under §195, discussed in 534 T.M., *Start-Up Expenditures.*[430]

• Environmental remediation costs allowed under §198, discussed in 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources.*

• Qualified disaster expenses allowed under former §198A.

• Corporation organizational expenditures deducted under §248, discussed in detail in 534 T.M., *Start-Up Expenditures.*[431]

• Intangible drilling and development costs to the extent deductible under §263(c), and discussed in detail in 605 T.M., *Oil and Gas Transactions.*[432]

• Railroad rolling stock rehabilitation expenditures to the extent deductible under §263(d), discussed in detail in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*[433]

• Special temporary rule for citrus plants lost by reason of casualty under §263A(d)(2)(C), discussed in detail in 607 T.M., *Farm and Ranch Expenses and Credits.*[434]

• Capitalization limitation applied to qualified interest cost under §263A(f)(1), discussed in detail in 576 T.M., *Uniform Capitalization Rules: Inventory; Self-Constructed Assets; Real Estate*, and 577 T.M., *Uniform Capitalization Rules: Method Change Rules and Special Topics.*

• Exemption for the aging process of beer, wine, and distilled spirits under §263A(f)(4), discussed in detail in 576 T.M., *Uniform Capitalization Rules: Inventory; Self-Constructed Assets; Real Estate.*[435]

• Qualified creative expenses to the extend deductible under §263A(h), discussed in detail in 597 T.M., *Tax Incentives for Economically Distressed Areas.*

• Carrying charges to the extent deductible under §266, discussed in detail in 536 T.M., *Interest Expense Deductions.*

• Expenditures for the development of mines or deposits to the extent deductible under §616, discussed in detail in 601 T.M., *Mineral Properties — Exploration, Acquisition, Development and Disposition.*[436]

• Mining exploration expenditures to the extent deductible under §617, discussed in detail in 601 T.M., *Mineral Properties — Exploration, Acquisition, Development and Disposition.*

• Partnership organizational expenditures deducted under §709, described in 534 T.M., *Start-Up Expenditures.*[437]

• Contingent serial payments made in connection with franchise, trademark, and trade name acquisition to the extent deductible under §1253(d)(1), described in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*[438]

(b) Deferral of Deduction

In certain instances, the amount chargeable to a capital account, though not deductible for the tax year in which it is paid

[421] Former §179A, former §263(a)(1)(H).
[422] *See* §263(a)(1)(I).
[423] *See* §263(a)(1)(J).
[424] *See* §263(a)(1)(K).
[425] *See* §263(a)(1)(L).
[426] *See* §263(a)(1)(D).
[427] *See* §263(a)(1)(E).
[428] *See* §263(a)(1)(F).
[429] §194(b).
[430] §195(b); *see* Reg. §1.195-1.
[431] *See* Reg. §1.248-1.
[432] *See* Reg. §1.263(c)-1.
[433] *See* Reg. §1.263(e)-1.
[434] §263A(d)(2)(C), added by the TCJA, §13207(a).
[435] §263A(f)(4), as amended by the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Pub. L. No. 116-260, Div. EE, Title I, Subtitle A, §106, effective for interest costs paid or accrued after December 31, 2020.
[436] *See* §263(a)(1)(A).
[437] §709(b); *see* Reg. §1.709-1.
[438] §1253(d)(1).

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or incurred, is deductible over a period of tax years.[439] In these situations, technically the deduction is not disallowed, but is merely deferred from the tax year in which it is paid or incurred to one or more subsequent tax years.

The expenditures to which the deferral exception applies are those to which the following deductions apply:

- Accelerated cost recovery deductions under §168, discussed in detail in 531 T.M., *Depreciation: MACRS and ACRS* and 532 T.M., *First-Year Expensing and Additional Depreciation.*
- Amortization deductions for goodwill and other qualified intangible expenditures under §197, discussed in detail in 533 T.M., *Amortization of Intangibles.*
- Corporation organizational expenditures amortized under §248, discussed in detail in 534 T.M., *Start-Up Expenditures.*
- Depletion deductions under §611, discussed in detail in 603 T.M., *Mineral Properties Other Than Gas and Oil — Operation.*
- Depreciation deductions under §167, discussed in detail in 530 T.M., *Depreciation: General Concepts; Non-ACRS Rules*, and 533 T.M., *Amortization of Intangibles.*[440]
- Partnership organizational expenditures amortized under §709, described in 534 T.M., *Start-Up Expenditures.*
- Percentage depletion deductions under §613, discussed in detail in 603 T.M., *Mineral Properties Other Than Gas and Oil — Operation* and 605 T.M., *Oil and Gas Transactions.*
- Pollution control facility expenditures amortized under §169, discussed in detail in 530 T.M., *Depreciation: General Concepts; Non-ACRS Rules.*
- Reforestation expenditures amortized under §194, discussed in detail in 610 T.M., *Timber Transactions.*
- Start-up expenses amortized under §195, discussed in detail in 534 T.M., *Start-Up Expenditures.*

G. Deductions Passed Through to Another

1. In General

A taxpayer can incur deductions not only from the taxpayer's direct activities and transactions, but also from the taxpayer's membership in a pass-through entity[441] or relationship to an individual or entity. In some instances, net amounts are included in the taxpayer's taxable income, so the deductions passed through are taken into account by the taxpayer. In several instances, the net amounts are included in the taxpayer's gross income, but as a practical matter the taxpayer is given the benefit of the deductions.

[439] *E.g.*, §167, §168, §195, §248, §611, §613, §709.

[440] *See also* §197.

[441] *See, e.g.*, §671, §691, §702(a), §1366(a), §1398. *See also* §199A (providing a deduction for qualified business income of pass-through entities). For a detailed description of qualified business income, see 537 T.M., *Qualified Business Income Deduction: Section 199A.*

2. Pass-Through Entities

Typically, pass-through entities are not subject to income tax; and, instead, the owners are directly taxed on the income. For example, a partnership is a pass-through entity. The partnership does not pay income taxes.[442] Instead, the profits and losses from the partnership flow through to the individual partners based on the partner's distributive share.[443] Pass-through entities include:

- Partnerships (which, generally, included Limited Liability Companies), discussed in detail in 712 T.M., *Partnerships — Taxable Income; Allocation of Distributive Shares; Capital Accounts.*
- S corporation,[444] discussed in detail in 731 T.M., *S Corporations: Corporate Tax Issues.*

Additionally, in certain situations, foreign corporations are treated as pass-through entities with respect to their U.S. shareholders. These situations are as follows:

- Controlled foreign corporations,[445] discussed in detail in 6200 T.M., *CFCs — General Overview*, 6220 T.M., *CFCs — Foreign Personal Holding Company Income*, 928 T.M., *CFCs — Foreign Base Company Income (Other Than FPHCI)*, 6260 T.M., *CFCs — Investment of Earnings in United States Property*, and 6280 T.M., *CFCs — Sections 959–965 and 1248* (each of which is in the Foreign Income Series).
- Domestic international sales corporations,[446] discussed in detail in 6640 T.M., *The Allocation and Apportionment of Deductions* (Foreign Income Series).
- Qualified electing funds,[447] discussed in detail in 6300 T.M., *PFICs* (Foreign Income Series).

3. Pass-Through Relationships

Additionally, in certain instances, deductions from a trust, an estate, or a decedent can be passed through to other taxpayers. Some important situations are as follows:

- Estate or trust deductions to beneficiaries through the inclusion of estate and trust income in the beneficiaries' gross income from their interest in an estate or trust,[448] discussed in 860 T.M., *Revocable Inter Vivos Trusts* (Estates, Gifts, and Trusts Series), and 856 T.M., *Subchapter J — Throwback Rules* (Estates, Gifts, and Trusts Series).
- Owners of grantor trusts and the deduction by them of the trust's expenses, and the taxation of foreign trusts with U.S. beneficiaries and the deduction of those trust's expenses by persons making transfers to those trusts, discussed in detail in 819 T.M., *Grantor Trusts (Sections 671–679)* (Estates, Gifts, and Trusts Series).

[442] §701.

[443] §701, §704.

[444] §1366(a).

[445] §951.

[446] §991.

[447] §1293.

[448] §61(a)(15); Reg. §1.61-13(a).

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• The allowance of unused loss carryovers and excess deductions to beneficiaries on the termination of an estate or trust, discussed in detail in 852 T.M., *Income Taxation of Trusts and Estates* (Estates, Gifts, and Trusts Series).

• The deductions of bankrupts and their estates, and the tax consequences of bankruptcy, discussed in detail in 540 T.M., *Bankruptcy and Insolvency Restructurings; Discharge of Indebtedness.*

• A taxpayer is allowed to deduct the taxpayer's share of deductions in respect of a decedent (DRD),[449] discussed at V.C.4.h., below, and in detail in 862 T.M., *Income in Respect of a Decedent (Section 691)* (Estates, Gifts, and Trusts Series).

[449] §691(b).

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III. Taxpayer Entitled to Deduction

A. Introduction

The determination of which taxpayer is entitled to claim a deduction has been discussed in numerous cases and is the subject of many statutory provisions; yet, it has never evolved into an "assignment of deductions" doctrine analogous to the assignment of income doctrine.[450] The assignment of income doctrine is discussed in detail in 502 T.M., *Gross Income: Tax Benefit, Claim of Right and Assignment of Income.*

Generally, deductions attributable to property are allowable to the taxpayer who owns the property.[451] Further, deductions attributable to expenditures are generally allowable to the taxpayer who bears the economic burdens and receives the benefits of the expenditures.[452] The application of these general principles to specific situations is discussed in III.B., below.

Under §269, §269A, §482, and §845, the IRS has the power to disallow a deduction to one taxpayer and allow it to another taxpayer if the reallocation is determined by the IRS to be necessary to prevent the evasion or avoidance of federal income tax by securing the benefit of the deduction. Additionally, many statutory provisions have been enacted to resolve the question of which taxpayer is entitled to claim the deductions arising from a specific transaction. These are discussed in III.C., below.

B. Nonstatutory Principles

1. In General

The case law that addresses the issue of which taxpayer is allowed to claim a deduction is a mosaic of relatively few opinions scattered across a wide range of deductions. When compared with the numerous opinions with respect to the assignment of income doctrine, several basic principles have emerged that provide some guidance.

Generally, no deduction is allowed for the voluntary payment of another person's expenses even if the expense would be allowable as a deduction had it been the taxpayer's own obligation.[453] The taxpayer must be legally obligated to pay or incur the other person's expense.[454] It does not matter if the payment is made to satisfy a moral obligation[455] or because it is expedient to do so.[456] However, in *Reade Mfg. Co. v. United States*,[457] the Third Circuit suggested that a corporation that paid a partnership's tort liability would have been allowed to deduct the payment had there been sufficient moral compulsion.[458]

Observation: In the context of trade or business deductions, some courts have treated the lack of legal obligation to make any payment, whether of the taxpayer's own expenses or of another person's expenses, as automatically precluding satisfaction of the ordinary and necessary requirement.[459] Other courts, though, permit a showing that a legal obligation would have been imposed on the taxpayer had the payment not been made or that such a payment is customary in the taxpayer's trade or business. The issue of voluntariness in the context of "ordinary and necessary" is discussed in detail in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*

Generally, no deduction is allowed for the taxpayer's payment of property ownership expenses, such as maintenance, insurance, and taxes, unless the taxpayer owns the property or an interest in it.[460] Thus, a taxpayer who transfers property to a trust is not allowed to deduct expenses connected with the property that arise after the transfer.[461]

2. Constructive Deductions

a. In General

The notion that a taxpayer is allowed to deduct otherwise deductible amounts paid or incurred by another person has not been articulated by the IRS or the courts in those terms. However, just as a taxpayer can be considered to have received under the assignment of income doctrine amounts received by another person, so, too, a deduction that is disallowed to one person under the assignment of deduction doctrine ought to be allowable to the taxpayer whose deduction it actually is. The allowance of what are in effect constructive deductions occurs not only in situations involving one person's gratuitous payment of the taxpayer's expense, but also in agency, reimbursement, and corporate situations. These situations are discussed below.

b. Agency

(1) In General

Amounts paid by another person on behalf of the taxpayer are deductible by the taxpayer if the other person is acting as

[450] *See Blair v. Commissioner*, 300 U.S. 5, 12 (1937) (assignment of income); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440–41 (1934) (assignment of deductions); *Lucas v. Earl*, 281 U.S. 111, 114–15 (1930) (assignment of income); *Davis v. United States*, 861 F.2d 558 (9th Cir. 1988) (assignment of deductions).

[451] *E.g.*, *Railey v. Commissioner*, 36 B.T.A. 543, 548–49 (1937); *D.H. Willey Lumber Co. v. Commissioner*, 7 T.C.M. 454, 471 (1948), *aff'd per curiam*, 199 F.2d 375 (6th Cir. 1952).

[452] *E.g.*, *Case v. Commissioner*, 50 T.C.M. 1291, 1295 (1985); *Bordo Prods. Co. v. United States*, 476 F.2d 1312, 1327 (Ct. Cl. 1973).

[453] *E.g.*, *Williams v. Commissioner*, 19 T.C.M. 106, 112 (1960). *See also Polak's Frutal Works, Inc. v. United States*, 281 F.2d 261, 263–64 (2d Cir. 1960), *aff'g* 176 F. Supp. 521 (S.D.N.Y. 1959). *But see Old Colony Tr. Co. v. Commissioner*, 279 U.S. 716 (1929), codified in Reg. §1.61-14 (holding that payment by an employer of an employee's taxes was income to the employee). Thus, since the taxes were paid as compensation, the employer should be allowed to deduct the taxes paid, as long as the compensation was reasonable. *See* §162(a)(1).

[454] *E.g.*, *Sharon Herald Co. v. Granger*, 195 F.2d 890, 895 (3d Cir. 1952), *aff'g* 97 F. Supp. 295 (W.D. Pa. 1951); *Shoholm v. Commissioner*, 30 T.C.M. 1070, 1071 (1971).

[455] *E.g.*, *Williams v. Commissioner*, 19 T.C.M. 106, 113 (1960); *Welch v. Helvering*, 290 U.S. 111 (1983). *But see Jenkins v. Commissioner*, 47 T.C.M. 238 (1983), *nonacq.*, AOD 1984-22.

[456] *Ky. Util. v. Glenn*, 394 F.2d 631, 633 (6th Cir. 1968), *aff'g in part & rev'g in part on other issues*, 250 F. Supp. 265 (W.D. Ky. 1965), *overruled on other issues*, *Miller v. Commissioner*, 733 F.2d 399 (6th Cir. 1984).

[457] 301 F.2d 803 (3d Cir. 1962), *aff'g* 192 F. Supp. 749 (D.N.J. 1961).

[458] 301 F.2d at 806.

[459] *E.g.*, *Welch v. Helvering*, 290 U.S. 111 (1983). *But see Jenkins v. Commissioner*, 47 T.C.M. 238 (1983), *nonacq.*, AOD 1984-22.

[460] *E.g.*, *Brock v. Commissioner*, 44 T.C.M. 128, 145 (1982); *Brooks v. Commissioner*, 63 T.C.M. 1973 (1992).

[461] *In re Prather*, 5 B.T.A. 623, 625 (1926).

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the taxpayer's agent.[462] Thus, in *Kohlsaat v. Commissioner*,[463] the Board of Tax Appeals held that a husband was allowed to deduct mortgage interest paid by his former spouse from funds provided by him for that purpose because he was primarily liable on the mortgage and she was acting as an agent.[464] In another situation, the IRS Chief Counsel advised that a taxpayer on whose behalf a city government paid interest not only was required to include the payment in gross income, but also was permitted to deduct the amount paid as though the city had made the payment to the taxpayer and the taxpayer had then transferred the money to the creditor.[465]

In contrast, a taxpayer is not allowed to deduct amounts expended by an agent acting in its own right and as a principal rather than as an agent.[466] A taxpayer is not allowed to deduct amounts paid by its surety to creditors if the payments are made under the surety's direct obligation on its bond, are not loans to the taxpayer, and are not reimbursed by the taxpayer.[467]

(2) Relationship to Assignment of Income Doctrine

If under the assignment of income doctrine a taxpayer must include amounts in gross income that are paid to another person, the taxpayer is allowed to deduct the otherwise deductible expenses of earning that income that are paid by the other person.[468] This conclusion rests on the principle that otherwise deductible amounts paid by an agent on behalf of the taxpayer are deductible by the taxpayer.[469] If amounts are received by shareholders in their capacity as shareholders and are not included in the corporation's gross income, then the corporation is not allowed to deduct the amounts paid to the shareholders.[470]

Thus, in *Home Juice Co. v. Commissioner*,[471] the court held that a corporation was allowed to deduct the portion of rebates received by its sole shareholder from the corporation's supplier but treated as received on behalf of the corporation, to the extent otherwise deductible as reasonable compensation.[472] However, in *Plimpton Tool Co. v. Commissioner*,[473] the Tax Court held that commissions paid to a corporate employee by an unrelated sales agency were not includible in the corporation's gross income and were not deductible as compensation because the amounts were received by the employee in his individual capacity.[474]

Interest reduction payments to a mortgagee made by a governmental agency on behalf of a corporation formed to acquire and lease low income housing units are deductible by the homeowner as interest on the mortgage.[475] Furthermore, the interest reduction payments are included in the corporation's gross income and are treated as though constructively paid by the corporation to the mortgagee.[476] Similarly, payments made by a mortgage loan servicer to a mortgagee as part of a program that effectively reduces the interest rate on mortgage loans owed by members of the armed services are deductible by the service member.[477]

(3) Specific Situations

(a) Partnerships

In *Morton v. Commissioner*,[478] the Board of Tax Appeals held that a member of a syndicate primarily liable on a note was allowed to deduct his proportionate share of interest on the note even though the payment was made by a corporation organized by the syndicate.[479] Similarly, partners are allowed to deduct interest paid by the partnership on debt for which the partners are liable provided the interest is charged to the partners' capital accounts.[480] If the debt is not one for which the partners can prove they are liable, they are not allowed to deduct the interest paid by the partnership.[481]

(b) Corporations and Shareholders

If a shareholder pays interest on the corporation's indebtedness, the corporation is allowed to deduct the payment because it is treated as a contribution by the shareholder to the corporation[482] and a payment of the interest by the corporation.[483] Similarly, a shareholder is allowed to deduct interest paid by a controlled corporation that is charged to the shareholder's account[484] or credited by the shareholder to the corporation.[485] The interest deducted by the shareholder otherwise is treated as a constructive dividend.[486] Although one case has held that consideration in some form must be provided by the shareholder,[487] that conclusion has been questioned.[488]

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[462] *E.g.*, *State Pipe & Nipple Corp. v. Commissioner*, 46 T.C.M. 415, 421 (1983).

[463] 40 B.T.A. 528 (1939).

[464] 40 B.T.A. at 534–35.

[465] CCA 199919007.

[466] *E.g.*, *Joffe v. United States*, 73-2 USTC ¶9599 (D. Mass. 1973), *aff'd by unpub. op.* (1st Cir. 1973).

[467] *Zoby v. United States*, 364 F.2d 216, 219 (4th Cir. 1966).

[468] *E.g.*, *McEnaney v. Commissioner*, 3 T.C. 552, 559 (1944).

[469] *E.g.*, *Beer v. United States*, 132 F. Supp. 282, 285 (S.D. Ala. 1955); *Pierce Oil Co. v. United States*, 77 F. Supp. 273–74 (E.D. Va. 1947), *rev'd on other issues sub nom. United States v. Riely*, 169 F.2d 542 (4th Cir. 1948), *cert. denied*, 335 U.S. 908 (1949).

[470] *X-L Serv., Inc. v. Commissioner*, 32 T.C.M. 701, 706–07 (1973).

[471] 36 T.C.M. 1566 (1977), *aff'd by unpub. op.* 601 F.2d 599 (7th Cir. 1979).

[472] 36 T.C.M. at 1572–73.

[473] 31 T.C.M. 612 (1972).

[474] 31 T.C.M. at 615.

[475] *Graff v. Commissioner*, 74 T.C. 743, 760 (1980), *aff'd*, 673 F.2d 784 (5th Cir. 1982); Rev. Rul. 76-75. *See* Rev. Rul. 77-135.

[476] *Graff*, 74 T.C. at 760.

[477] PLR 201139003 (*citing* Rev. Rul. 76-75). The subsidy amount is considered income to the service member. PLR 201139003.

[478] 38 B.T.A. 1270 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940).

[479] 38 B.T.A. at 1275.

[480] *Marcello v. Commissioner*, 28 T.C.M. 1011, 1021–22 (1969), *aff'd on other issues sub nom*., *Bayou Verret Land Co. v. Commissioner*, 450 F.2d 850 (5th Cir. 1971); *Occhipinti v. Commissioner*, 28 T.C.M. 978, 989 (1969), *aff'd on other issues, sub nom*., *Bayou Verret Land Co. v. Commissioner*, 450 F.2d 850 (5th Cir. 1971).

[481] *Cimini v. Commissioner*, 39 T.C.M. 1170, 1172 (1980).

[482] *See Reese v. Commissioner*, 35 T.C.M. 1228, 1230 (1976), *aff'd on other issues*, 615 F.2d 226 (5th Cir. 1980).

[483] *Stofflet & Tillotson v. Commissioner*, 32 T.C. 1031, 1038 (1959).

[484] *Mann v. Commissioner*, 33 B.T.A. 281, 290 (1935), *nonacq*., VI-1 C.B. 37 (1936).

[485] *United States v. Collier*, 104 F.2d 420, 422 (5th Cir. 1939).

[486] *Berlin v. Commissioner*, 20 T.C.M. 969, 975 (1961).

[487] *Hanna Furnace Corp. v. Kavanagh*, 50-2 USTC ¶9443 (E.D. Mich. 1950).

[488] *Leward Cotton Mills, Inc. v. Commissioner*, 245 F.2d 314, 316 (4th Cir. 1957), *rev'g* 26 T.C. 885 (1956).

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(c) Sellers and Purchasers

A seller of property is allowed to deduct mortgage interest paid by the purchaser as part of the consideration for the sale, because the purchaser has in effect paid the amount in question to the seller as part of the purchase price and then received it back for transfer to the seller's mortgagee.[489] However, if the purchaser pays interest on the seller's indebtedness without a reduction in the purchase price and without the seller's agreement to reimburse the purchaser, the seller is not allowed to deduct the interest paid by the purchaser because the seller does not bear the economic burden of its payment.[490]

c. Reimbursement

A taxpayer is allowed to deduct otherwise deductible interest paid on the taxpayer's behalf by another person if the taxpayer reimburses the other person.[491] The same result applies if the other person's payment of the taxpayer's interest liability is a gift or loan, because the taxpayer is treated as having received the gift or loan proceeds and then using them to pay the interest.[492]

A taxpayer is allowed to deduct otherwise deductible expenses paid by an employee on behalf of the taxpayer for which the taxpayer reimburses the employee.[493] A corporation is allowed to deduct otherwise deductible expenses paid on its behalf by a shareholder.[494] The reimbursement can take the form of discharge of a debt owed to the taxpayer by the person acting as agent.[495]

d. Sham Entities

Otherwise deductible amounts paid by an entity that is treated as a sham for tax purposes are deductible by the taxpayer who is the actual owner of the funds used by the entity to make the payments, because the entity is treated as not existing for tax purposes.[496]

e. Corporate Capital Transactions

A corporation is not allowed to deduct an expense paid by its predecessor corporation before it was organized because the expense does not represent a liability incurred by the corporation.[497] However, a subsidiary is allowed to deduct otherwise deductible compensation paid to its employees by its parent because the payment is treated as a contribution to the subsidiary's capital and payment by the subsidiary to its employees.[498]

Note: A subsidiary should be allowed a deduction with respect to the exercise by its employees of nonqualified stock options for stock of its parent.

A predecessor corporation is allowed to deduct compensation paid to its employees on its behalf by its successor corporation for services rendered to the predecessor corporation before its assets are transferred to the successor.[499]

3. Trade or Business and For-Profit Activity Expenses

a. In General

One basic principle applicable in determining whether a deduction is allowed to a taxpayer who pays or incurs a deductible trade or business or for-profit activity expense is that the deduction is allowed only if, assuming the other requirements of the deduction are met, the expense relates to the taxpayer's trade or business or for-profit activity.[500] Thus, payments for services rendered to a trade or business are deductible only to the extent the services are rendered to the taxpayer's trade or business.[501] No deduction is allowed to a spouse who pays the other spouse's legal expenses of litigating claims as a beneficiary of a trust if there is no connection between the payor's trade or business and the legal expenses.[502] A parent who was the registered owner of a music business purchased equipment for the business and co-signed the checking account for the business was not allowed to deduct business deductions attributable to the music business because parent's children operated the business, gave the lessons, did the planning, and kept the records.[503]

A second principle is that payment of the expenses of a person with whom the taxpayer has a business relationship, even if made for business purposes, does not entitle the taxpayer to a deduction merely because the expenses would be deductible if paid by the other person, but if the payment is an ordinary and necessary business expense of the taxpayer because it is customary in the taxpayer's trade or business to pay the other person's expenses for business purposes, then the payment is deductible.[504] The issue of whether such a payment is ordinary and necessary is discussed in detail in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*

A third principle is that a taxpayer is not allowed to deduct an otherwise deductible amount if the taxpayer is entitled to reimbursement,[505] unless the reimbursement is included in gross income,[506] is worthless,[507] or is unlikely to be collected.[508] Thus,

[489] *Cooledge v. Commissioner*, 40 B.T.A. 1325, 1329 (1939).
[490] *Robbins Tire & Rubber Co. v. Commissioner*, 53 T.C. 275, 278–79 (1969), *supplementing* 52 T.C. 420 (1969).
[491] *Overbeck v. Commissioner*, 14 T.C.M. 967, 972 (1955).
[492] Rev. Rul. 57-481.
[493] *Westerhaus Co. v. Commissioner*, 16 T.C.M. 958, 976 (1957).
[494] *E.g., R.O.H. Hill, Inc. v. Commissioner*, 9 T.C. 153, 159 (1947); *Heymann Mercantile Co. v. Commissioner*, 7 T.C.M. 856 (1948); *Harrison v. United States*, 392 F. Supp. 1067, 1070 (E.D. La. 1975).
[495] *E.g., Royal Oak Apts., Inc. v. Commissioner*, 43 T.C. 243, 251 (1964).
[496] *Gibbs v. Commissioner*, 56 T.C.M. 459, 462 (1988).
[497] *Underwriters' Labs., Inc. v. Commissioner*, 46 B.T.A. 464, 480 (1942), *aff'd on other issues*, 135 F.2d 371 (7th Cir. 1943), *cert. denied*, 320 U.S. 756 (1943).
[498] Rev. Rul. 84-68.
[499] *Nekonegan Paper Co. v. Commissioner*, 16 B.T.A. 1000, 1005 (1929).
[500] *See S. Am. Gold & Platinum Co. v. Commissioner*, 8 T.C. 1297, 1301 (1947), *aff'd without op.*, 168 F.2d 71 (2d Cir. 1948); *Webb v. United States*, 560 F. Supp. 150, 157 (S.D. Miss. 1982).
[501] *Surloff v. Commissioner*, 81 T.C. 210, 244 (1983).
[502] *Brodeur v. Commissioner*, 10 T.C.M. 228, 232 (1951).
[503] *Malone v. Commissioner*, 89 T.C.M. 995 (2005).
[504] *See Spears v. United States*, 73-2 USTC ¶9261 (E.D. Tex. 1973).
[505] *Glendinning, McLeish & Co. v. Commissioner*, 61 F.2d 950, 952 (2d Cir. 1932), *aff'g* 24 B.T.A. 518 (1931); *Addressograph-Multigraph Corp. v. Commissioner*, 4 T.C.M. 147, 177 (1945).
[506] *Findley v. United States*, 28 F. Supp. 715, 719 (W.D. La. 1939). *See Weihrauch v. Commissioner*, 37 T.C.M. 28, 32 (1978).
[507] *Standard Oil Co. of N.J. v. Commissioner*, 11 T.C. 843, 848–49 (1948), *supplementing* 7 T.C. 1310 (1946).
[508] *Pittsburgh Indus. Eng'g Co. v. Commissioner*, 9 T.C.M. 1132, 1140 (1950). *See* Rev. Rul. 75-46.

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no deduction is allowable for litigation expenses for which reimbursement is due.[509] If reimbursement is due only under certain circumstances, the Claims Court[510] and Tax Court[511] have held that no immediate deduction is allowable, but the Ninth Circuit has reached the opposite conclusion.[512] The reimbursement principle applies to reimbursable amounts expended by employees for employers,[513] by sales representatives for principals,[514] by insurance agents for clients,[515] by attorneys for clients,[516] by engineers for clients,[517] by manufacturers for customers,[518] by contractors for subcontractors,[519] by shareholders for corporations,[520] by shareholders for other shareholders,[521] by officers for corporations,[522] by co-owners for co-owners,[523] by lessees for lessors,[524] by trustees for trusts,[525] and by patent licensees to owners.[526] If the taxpayer is not entitled to reimbursement, the principle does not apply.[527] Whether the taxpayer is entitled to reimbursement is a question of fact.[528]

The application of these general principles to specific situations is discussed below.

b. Employers and Employees

Employers are not allowed to deduct amounts paid for employees' personal expenses unless they are intended as compensation and satisfy the conditions for the deductibility of compensation, described in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions*.[529] Thus, no deduction is allowed to an employer for the amount of a bail bond advanced on behalf of an employee who has been arrested.[530] In *Scott & Assocs., Ltd. v. Commissioner*,[531] the court held that payment of rent for an employee's residence was not an ordinary and necessary expense because it was done merely for the convenience of the employee's spouse who shared office space with the employer.[532] In *J. Gordon Turnbull, Inc. v. Commissioner*, the Tax Court held that an employer is not allowed to deduct the cost of tax advice provided to employees with respect to personal matters.[533]

Note: Turnbull was decided before the enactment of §132. The IRS may treat the employer's payment as a taxable fringe benefit, includible in the employee's gross income, and deductible by the employer as compensation under §162. In years when miscellaneous itemized deductions are deductible, the employee arguably would be allowed to deduct the payment as a constructive §212 deduction, subject to the §67 2% limitation.[534]

In *Reis v. Commissioner*,[535] the court held that an employer was allowed to deduct payments made to the trustee in bankruptcy of an employee who was also the employer's spouse because allegations had been made that the employee spouse had transferred assets to the employer spouse and the payment was necessary to maintain the business reputation of the employer spouse.[536] But no deduction is allowed for an employer's payment of damages caused by an employee's spouse as director of an unrelated corporation.[537]

Generally, an employee is not allowed to deduct as a trade or business expense any amount paid solely for the purpose of

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[509] *Universal Oil Prods. Co. v. Campbell*, 181 F.2d 451, 474–75 (7th Cir. 1950), *cert. denied*, 340 U.S. 850 (1950), *rev'g* 49-1 USTC ¶9180 (N.D. Ill. 1948).

[510] *Boccardo v. United States*, 12 Cl. Ct. 184 (1987).

[511] *Humphrey, Farrington, McLain, PC v. Commissioner*, T.C. Memo 2013-23; *Boccardo v. Commissioner*, T.C. Memo 1993-224, *rev'd*, 56 F.3d 1016 (9th Cir. 1995).

[512] *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995), *rev'g* T.C. Memo 1993-224. The IRS will not follow this decision, except in the Ninth Circuit. 1997 FSA LEXIS 442 (June 2, 1997); IRS Info. Letter 2010-0218 (IRS has no plans to change litigation position announced in FSA). *See also Pace v. Commissioner*, T.C. Memo 2010-272.

[513] *Kravette v. Commissioner*, 53 T.C.M. 310, 313 (1987); *Graham v. Commissioner*, 39 T.C.M. 768 (1979); *Patterson v. Commissioner*, 36 T.C.M. 484, 486 (1977), *aff'd without op.*, 618 F.2d 117 (9th Cir. 1980); *Fairburn v. Commissioner*, 28 T.C.M. 438, 442–43 (1969); *Ellis v. Commissioner*, 26 T.C.M. 450, 452 (1967); *Johnson v. Commissioner*, 25 T.C.M. 858, 862 (1966); *Austin v. Commissioner*, 21 T.C.M. 102, 105 (1962); *Rogers v. Commissioner*, 18 T.C.M. 866, 867 (1959); *Treanor v. Commissioner*, 10 T.C.M. 336, 341 (1951).

[514] *Flower v. Commissioner*, 61 T.C. 140, 152 (1973), *aff'd without op.*, 505 F.2d 1302 (5th Cir. 1974); *Sickel v. Commissioner*, 40 T.C.M. 780, 781 (1980).

[515] *Albright v. Commissioner*, 16 B.T.A. 1228, 1230 (1929); *Tratner v. Commissioner*, 33 T.C.M. 21, 23 (1974).

[516] *Burnett v. Commissioner*, 356 F.2d 755, 759 (5th Cir. 1966), *cert. denied*, 385 U.S. 832 (1966), *aff'g* 42 T.C. 9 (1964); *Hearn v. Commissioner*, 309 F.2d 431, 433 (9th Cir. 1962), *aff'g* 36 T.C. 672 (1961), *cert. denied*, 373 U.S. 909 (1963); *Herrick v. Commissioner*, 63 T.C. 562, 566 (1975); *Canelo v. Commissioner*, 53 T.C. 217, 224 (1969), *aff'd*, 447 F.2d 484 (9th Cir. 1971), *nonacq.* in part, 1982-2 C.B. 2; *Cochrane v. Commissioner*, 23 B.T.A. 202, 207–08 (1931); *MacMillan v. Commissioner*, 14 B.T.A. 1367, 1370–71 (1929); *Wollesen v. Commissioner*, 54 T.C.M. 1315, 1319 (1987), *aff'd without op.*, 875 F.2d 317 (4th Cir. 1989); *Silverton v. Commissioner*, 36 T.C.M. 817, 827 (1977), *supp.*, 37 T.C.M. 1797 (1978), *aff'd without op.*, 647 F.2d 172 (9th Cir. 1981), *cert. denied*, 454 U.S. 1033 (1981); *Boccardo v. United States*, 12 Cl. Ct. 184, 188 (1987); *Milan, Miller, Berger, Brody & Miller, P.C. v. United States*, 679 F. Supp. 692, 695 (E.D. Mich. 1988).

[517] *See Patchen v. Commissioner*, 27 T.C. 592, 600 (1956), *rev'd in part & aff'd in part on other issues*, 258 F.2d 544 (5th Cir. 1958).

[518] *Jones v. Commissioner*, 25 T.C. 1100, 1103 (1956), *aff'd on other issues*, 259 F.2d 300 (5th Cir. 1958).

[519] *Dozier v. Commissioner*, 26 T.C.M. 467, 473 (1967).

[520] *Roussel v. Commissioner*, 37 T.C. 235, 242 (1961); *Drachman v. Commissioner*, 23 T.C. 558, 562–63 (1954); *Hessert v. Commissioner*, 1 T.C.M. 932, 934 (1943). *See also Alleghany Corp. v. Commissioner*, 28 T.C. 298, 303 (1957), *acq.*, 1957-2 C.B. 3 (deduction allowed because shareholder was in the trade or business of investing in corporations).

[521] *Busby v. United States*, 77-2 USTC ¶9652 (N.D. Tex. 1977), *aff'd by unpub. order* (5th Cir. 1980).

[522] *Stolk v. Commissioner*, 40 T.C. 345, 356 (1963), *aff'd*, 326 F.2d 760 (2d Cir. 1964); *Horowitz v. Commissioner*, 38 T.C.M. 108, 111 (1979).

[523] *Conte v. Commissioner*, 42 T.C.M. 1296, 1299 (1981), *aff'd without op.*, 722 F.2d 727 (2d Cir. 1983).

[524] *Levy v. Commissioner*, 212 F.2d 552 (5th Cir. 1954), *aff'g* 12 T.C.M. 235 (1953).

[525] *Estate of McJunkin v. Commissioner*, 25 T.C. 16, 21 (1955).

[526] *Grelck Condensed Buttermilk Co. v. Commissioner*, 7 B.T.A. 79, 84 (1927), *nonacq.*, VII-1 C.B. 37 (1928).

[527] *Ala. Hwy. Express, Inc. v. United States*, 57-1 USTC ¶9225 (N.D. Ala. 1956).

[528] *E.g., Mo. Valley Dredging Co. v. Commissioner*, 16 T.C.M. 166, 168 (1957).

[529] §162(a)(2); Reg. §1.162-7(a).

[530] *Banks v. Commissioner*, 20 T.C.M. 1165, 1202–03 (1961), *aff'd in part, rev'd in part on other issues*, 322 F.2d 530 (8th Cir. 1963).

[531] 43 T.C.M. 314 (1982).

[532] 43 T.C.M. at 316.

[533] 41 T.C. 358, 378 (1963), *aff'd on other issues*, 373 F.2d 87 (5th Cir. 1967), *cert. denied*, 389 U.S. 842 (1967).

[534] Miscellaneous itemized deductions are not allowable (not deductible) for tax years beginning after 2017. §67(h), amended and redesignated by the One Big Beautiful Bill Act (OBBBA), Pub. L. 119-21, §70110.

[535] 10 B.T.A.M. 194 (1941).

[536] 10 B.T.A.M. at 194–95.

[537] *Kenelm Corp. v. Commissioner*, 11 B.T.A.M. 750 (1942).

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advancing the business interests of the employer.[538] Thus, no deduction is allowed to an employee for the cost of a safe deposit box in which the employee, though not required to do so, stored certain papers of the employer.[539] No deduction is allowed for an employee's voluntary use of the employee's property in pursuit of the employer's business.[540]

However, an employee is allowed to deduct a fine withheld from a paycheck because of a violation by the employer.[541] In *Tyler v. Commissioner*,[542] the court held that an employee was allowed to deduct small amounts paid on behalf of the employer because the employee's salary had been established in contemplation of the employee being responsible to pay for these types of expenses.[543] In *Pickett v. Commissioner*,[544] the court held that a sales manager was allowed to deduct unreimbursed expenses paid to promote his employer's project.[545]

No deduction is allowed to an employee for the expense of purchasing a stock warrant to assist the employer in obtaining a loan, because incurring such an expense is not ordinary and necessary to the business of being an employee, so the expense must be capitalized.[546]

No deduction is allowed to the spouse of an employee who pays some of the employer's debts to protect the employee's business reputation.[547] These amounts are characterized as contributions to the employer's capital.[548]

c. Independent Contractors

In *Friedman v. Delaney*,[549] the First Circuit held that no deduction was allowable to an attorney who paid the obligations of a client after promising the client's creditors that they would be paid.[550] However, in *Pepper v. Commissioner*,[551] the Tax Court allowed an attorney to deduct payments to individuals who had invested in the client based on the attorney's recommendation and who incurred losses because of the client's fraud about which the attorney had no knowledge.[552] In *Delaney v. Commissioner*,[553] the Tax Court held that an attorney was allowed to deduct expenditures made on a client's behalf.[554] However, in *Greenspan v. Commissioner*,[555] the Tax Court held that an attorney was not allowed to deduct reimbursement of a relative's losses incurred on a sale erroneously made on the attorney's advice.[556]

In *Boyle, Flagg & Seaman, Inc. v. Commissioner*,[557] the Tax Court held that an insurance broker was allowed to deduct a client's premium increases paid by the broker when the broker moved the client's insurance to a new company and had made errors in quoting the premium rates.[558] The IRS has similarly ruled with respect to a broker's payment of a client's cost of obtaining new insurance after the insurance company with which the broker had written the client's insurance was suspended.[559]

The IRS has also ruled that a moving and storage company that reimburses losses incurred by its uninsured customers whose belongings were destroyed in a fire at the company's warehouse, is allowed to deduct the payments because they were made to protect the company's business reputation.[560] The same conclusion has been reached for the same reason with respect to a termite company's expenses in retreating certain substandard work performed by the corporation from which it acquired its business, even though the work was unguaranteed and thus the economic burden of the customers.[561] In *Canton Cotton Mills v. United States*,[562] the court held that a processor was allowed to deduct refunds made to customers who had been charged higher prices to reflect a processing tax that subsequently was invalidated.[563] However, no deduction is allowed for the payment of clients' business expansion expenses if the sole reason is to obtain future income from the expanded businesses.[564]

d. Corporations, Promoters, Shareholders and Officers

(1) Shareholder's Payment of Corporation's Expenses

(a) In General

Generally, shareholders are not allowed to deduct expenditures made on behalf of their corporation.[565] Many different reasons have been advanced. One is that the trade or business of the corporation is a separate activity from the activities of the shareholders as investors.[566] A second is that expenses that are the obligation of the corporation usually are not the oblig-

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[538] Rev. Rul. 72-192.

[539] *Crews v. Commissioner*, 11 T.C.M. 511, 514 (1952).

[540] *Westerman v. Commissioner*, 55 T.C. 478, 481 (1970).

[541] *Barone v. Commissioner*, 85 T.C. 462, 467 (1985), *aff'd without op.*, 807 F.2d 177 (9th Cir. 1986).

[542] 13 T.C. 186 (1949).

[543] 13 T.C. at 192.

[544] 34 T.C.M. 213 (1975).

[545] 34 T.C.M. at 223.

[546] *Mitchell v. Commissioner*, 60 T.C.M. 1368, 1374 (1990), *aff'd*, 992 F.2d 1219 (9th Cir. 1993), *cert. denied*, 510 U.S. 861 (1993).

[547] *Gilford v. Commissioner*, 24 T.C.M. 57, 61 (1965).

[548] *Gilford*, 24 T.C.M. at 61.

[549] 171 F.2d 269 (1st Cir. 1948), *aff'g* 75 F. Supp. 568 (D. Mass. 1948), *cert. denied*, 336 U.S. 936 (1949).

[550] 171 F.2d at 271.

[551] 36 T.C. 886 (1961).

[552] 36 T.C. at 893–94.

[553] 19 T.C.M. 151 (1960).

[554] 19 T.C.M. at 154.

[555] 39 T.C.M. 1000 (1980).

[556] 39 T.C.M. at 1004.

[557] 25 T.C. 43 (1955).

[558] 25 T.C. at 51.

[559] Rev. Rul. 56-359.

[560] Rev. Rul. 76-203.

[561] *United States v. E.L. Bruce Co.*, 180 F.2d 846, 848–49 (6th Cir. 1950), *aff'g* 49-1 USTC ¶9265 (W.D. Tenn. 1949).

[562] 94 F. Supp. 561 (Ct. Cl. 1951).

[563] 94 F. Supp. at 565.

[564] *Mountain Paper Prods. Corp. v. United States*, 287 F.2d 957, 959 (2d Cir. 1961), *aff'g* 60-2 USTC ¶9615 (D. Vt. 1960).

[565] *E.g.*, *Low v. Nunan*, 154 F.2d 261, 264 (2d Cir. 1946), *aff'g Low v. Commissioner*, 3 T.C.M. 859 (1944); *Das v. Commissioner*, 76 T.C.M. 594 (1998); *Morris v. Commissioner*, 59 T.C.M. 923, 928 (1990), *supp.*, 61 T.C.M. 2249 (1991), *aff'd by unpub. op.* (5th Cir. 1992); *Russell v. Commissioner*, 57 T.C.M. 292, 294 (1990); *Horowitz v. Commissioner*, 38 T.C.M. 108, 110 (1979); *Christie Coal & Coke Co. v. Commissioner*, 28 T.C.M. 498, 525 (1969); *Estate of Slater v. Commissioner*, 21 T.C.M. 1355, 1385 (1962); *Strasburger v. Commissioner*, 21 T.C.M. 1351, 1354 (1962), *aff'd*, 327 F.2d 236 (6th Cir. 1964); Rev. Rul. 71-36.

[566] *See S. Am. Gold & Platinum Co. v. Commissioner*, 8 T.C. 1297, 1301 (1947), *aff'd without op.*, 168 F.2d 71 (2d Cir. 1948); *Madden v. Commissioner*, 40 T.C.M. 1103, 1109 (1980); *Dunmire v. Commissioner*, 42 T.C.M. 438, 446 (1981); *Shoholm v. Commissioner*, 30 T.C.M. 1070, 1071 (1971); *Webb v. United States*, 560 F. Supp. 150, 157 (S.D. Miss. 1982).

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ation of the shareholder.[567] A third is that the expenses are not ordinary to the shareholders because the corporation is allowed to deduct them.[568] A fourth is that a shareholder who is not an officer or director is not in the trade or business of managing the corporation.[569] A fifth is the remoteness of the corporate expenses paid by the shareholder to the shareholder's investment.[570] A sixth is that the corporation is a separate entity and that its expenses are not the shareholders' expenses.[571] The fact that the corporation is financially unable to pay the expenses does not cause them to become expenses of the shareholder.[572] A shareholder's spouse who is not a shareholder but who pays otherwise deductible expenses of the corporation likewise is not allowed to deduct the payments.[573]

If the shareholder's payment of the corporation's expenses and debts causes the shareholder to acquire stock or securities of the corporation, no deduction is allowable because the shareholder's expenditure constitutes the cost of the stock or securities and must be capitalized.[574]

(b) Expenses Treated as Corporation's

In *Schrott v. Commissioner*,[575] the court held that amounts paid by shareholders to reimburse their corporation for legal expenses it incurred as a result of a contract fraud were not deductible by the shareholders because the legal expenses resulted from the corporation's trade or business and not from the shareholders' trade or business.[576] In *Eisenrod v. Commissioner*,[577] the court held that no deduction was allowable to a taxpayer for judgments rendered in the bankruptcy proceeding of a corporation controlled by the taxpayer.[578] In *Acree v. Commissioner*,[579] the court held that the principal shareholder and officer of a bank was not allowed to deduct his payment of the corporation's loan losses.[580]

No deduction is allowable to a shareholder for travel or other expenses paid or incurred in obtaining financing for the corporation.[581] No deduction is allowed for compensation paid by shareholders to employees for services rendered to the corporation.[582] The payment of premiums by shareholders for life insurance on their own lives is not deductible, even if required by the corporation's creditors.[583]

In *Gantner v. Commissioner*,[584] the court held that the controlling shareholder was not allowed to deduct the cost of computers purchased by the shareholder for use by the corporation.[585] A shareholder is not allowed to deduct rent paid with respect to premises used by a corporation if the lease is assigned to the corporation and the rent is the corporation's obligation.[586] No deduction is allowed for amounts paid in the nature of interest by shareholders on property borrowed and used to further corporate purposes.[587] The same principle applies to the shareholder's payment of the corporation's office expenses[588] and legal expenses.[589]

A shareholder is not allowed to deduct compensation paid to a corporate employee for services rendered to the corporation, even if the shareholder contractually agrees to do so.[590] However, a taxpayer whose closely-held corporation hired an employee is allowed to deduct compensation paid by the taxpayer to the employee for services performed for the taxpayer's sole proprietorship.[591]

Note: The prohibition against a shareholder's deduction of corporate expenses paid by the shareholder can be avoided if the shareholder can demonstrate that the expenses were the obligation of the shareholder and not the corporation.

(c) Treatment of Nondeductible Amounts Paid by Shareholders

The amount of corporate expenses paid by shareholders is treated as a contribution to capital.[592] The most that these additional investments can generate is a capital loss when the shareholder disposes of the stock.[593]

(d) Scope of Restriction

The prohibition against a shareholder's deduction of corporate expenses cannot be avoided if the corporation and shareholder merely agree that a corporate expense is the shareholder's expense.[594] Nor does it matter that the shareholder, by paying the corporation's expenses, avoids secondary lia-

[567] *E.g.*, *Gilman v. Commissioner*, 72 T.C. 730, 749–50 (1979); *Webb v. United States*, 560 F. Supp. 150, 158 (S.D. Miss. 1982); *Grant v. United States*, 399 F. Supp. 79, 80–81 (E.D. Ark. 1975).

[568] *Harrison v. United States*, 392 F. Supp. 1067, 1070 (E.D. La. 1975).

[569] *O'Connor v. Commissioner*, 13 T.C.M. 623, 631 (1954).

[570] *Grossman v. Commissioner*, 33 T.C.M. 1213, 1216 (1974).

[571] *E.g.*, *Kliethermes v. United States*, 27 Fed. Cl. 111 (1992); *Burstein v. Commissioner*, 35 T.C.M. 296, 302 (1976), *aff'd without op.*, 556 F.2d 564 (3d Cir. 1977); *Hudlow v. Commissioner*, 30 T.C.M. 894, 898 (1971).

[572] *See Kliethermes v. United States*, 27 Fed. Cl. 111 (1992).

[573] *Phillips v. Commissioner*, 75 T.C.M. 1754 (1998).

[574] *Hessert v. Commissioner*, 1 T.C.M. 932, 934 (1943). *See Roussel v. Commissioner*, 37 T.C. 235, 242 (1961).

[575] 57 T.C.M. 981 (1989).

[576] 57 T.C.M. at 998.

[577] 35 T.C.M. 1448 (1976).

[578] 35 T.C.M. at 1451.

[579] 35 T.C.M. 813 (1976).

[580] 35 T.C.M. at 818. *See Dunmire v. Commissioner*, 42 T.C.M. 438, 447 (1981).

[581] *Hawkins v. Commissioner*, 20 T.C. 1069, 1075 (1953); *Post v. Commissioner*, 39 T.C.M. 311, 333 (1979) (deduction allowable to corporation); *Kimball v. Commissioner*, 14 T.C.M. 1011, 1013 (1955).

[582] *Rand v. Commissioner*, 35 T.C. 956, 962 (1961).

[583] *Morison v. Commissioner*, 19 T.C.M. 1364, 1370 (1960).

[584] 905 F.2d 241 (8th Cir. 1990), *aff'g* 91 T.C. 713 (1988), *cert. denied*, 498 U.S. 921 (1990).

[585] 905 F.2d at 244.

[586] *Podlofsky v. Commissioner*, 43 T.C.M. 74, 76 (1981).

[587] *Deputy v. DuPont*, 308 U.S. 488, 494–95 (1940), *rev'g* 103 F.2d 257 (3d Cir. 1939), *aff'g* 22 F. Supp. 589 (D. Del. 1938); *DuPont v. Commissioner*, 37 B.T.A. 1198, 1273 (1938), *aff'd on other issues*, 118 F.2d 544 (3d Cir.), *cert. denied*, 314 U.S. 623 (1941).

[588] *Benton v. Commissioner*, 21 T.C.M. 1554, 1558 (1962), *aff'd per curiam*, 64-1 USTC ¶9323 (D.C. Cir. 1964).

[589] *Estate of Buder v. Commissioner*, 22 T.C.M. 300, 311 (1963), *aff'd on other issues*, 330 F.2d 441 (8th Cir. 1964).

[590] *Security-First Nat'l Bank of L.A. v. Commissioner*, 28 B.T.A. 289, 319 (1933).

[591] *Dietrick v. Commissioner*, 55 T.C.M. 706, 717 (1988), *aff'd*, 881 F.2d 336 (6th Cir.), *cert. denied*, 493 U.S. 1003 (1989).

[592] *Gantner v. Commissioner*, 905 F.2d 241, 244 (8th Cir. 1990), *aff'g* 91 T.C. 713 (1988), *cert. denied*, 498 U.S. 921 (1990); *Kout v. Commissioner*, 31 T.C.M. 1044, 1052 (1972).

[593] *Caudill v. Commissioner*, 33 T.C.M. 1025, 1029 (1974).

[594] *Gantner v. Commissioner*, 905 F.2d 241, 244 (8th Cir. 1990), *aff'g* 91 T.C. 713 (1988), *cert. denied*, 498 U.S. 921 (1990); *Harrison v. United States*, 392 F. Supp. 1067, 1069–70 (E.D. La. 1975).

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bility and prevents liquidation of the corporation.[595] The fact that the shareholder is not reimbursed or does not seek reimbursement does not convert the corporation's expenses into the shareholder's expenses.[596] The result is not changed if the shareholder charges the corporation for the shareholder's services if the amount charged is insufficient to permit the shareholder to make a profit and the shareholder is not otherwise in the trade or business of rendering such services to corporations generally.[597] It does not matter if the shareholder is a landlord of the corporation and pays the corporation's expenses to keep its tenant afloat.[598]

(e) Payment to Protect Shareholder

(i) In General

A shareholder's payment of the corporation's expenses or debts is deductible by the shareholder if the payment is made to protect the reputation or standing of some other business or job of the shareholder, in which case the payment is an ordinary and necessary expense of that other business and is not merely the expense of the corporation.[599] Thus, if the shareholder has no other trade or business, no deduction is allowed.[600]

In *Allen v. Commissioner*,[601] the Seventh Circuit reversed the Tax Court and held that a major shareholder was allowed to deduct payment of the corporation's debt because it was made to protect the reputation and credit standing of the shareholder's sole proprietorship.[602] The National Office has advised that the corporate parent of a foreign subsidiary could deduct amounts advanced to repay its subsidiary's creditors, because the parent's intent was to protect its own reputation within the international banking community, rather than restoring the failed subsidiaries financial health.[603] In *Lutz v. Commissioner*,[604] the Fifth Circuit did likewise, holding that payments of a corporation's expenses made to maintain the shareholder's credit and business license were deductible.[605] In *Milbank v. Commissioner*,[606] the Tax Court allowed a similar deduction[607] and in *Gould v. Commissioner*,[608] the Tax Court allowed a deduction for a shareholder's payment of a corporation's debt that was made in order to protect the shareholder's job at another corporation.[609]

Observation: The distinction is between payment by the shareholder of the corporation's expenses or debts on behalf of the corporation and payment by the shareholder on behalf of the shareholder's own business.

No deduction is allowed if the payment is made merely to protect the shareholder's investment[610] or to expand another business of the shareholder.[611] A shareholder is not allowed to deduct advertising and promotion expenses paid for two newly organized savings associations in order to obtain insurance business that would have been obtained in any event.[612]

(ii) Determination of Purpose for Payment

The question of whether the payment is made to protect business reputation or credit standing is one of fact.[613] In *Jenkins v. Commissioner*,[614] the Tax Court allowed a singer who was the sole shareholder of a corporation operating a restaurant to deduct payment of the corporation's debts, because failure to do so would have harmed the singing career.[615] In *Modell v. Commissioner*,[616] the Tax Court denied a deduction to an accountant for payment of his corporation's expenses, because the corporation was in the business of removing rust and thus the payments were not made to protect the accountant's reputation as an accountant.[617]

(f) Payments by Shareholder as Promoter

Expenses paid by a shareholder before the formation of the corporation are not deductible.[618] These amounts are treated as contributions to capital.[619]

In *Bing v. Helvering*,[620] the court held that a shareholder who paid a commission for assistance in obtaining financing used to organize the corporation was not allowed to deduct the amount paid.[621] In *Milne v. Commissioner*,[622] the court held that expenses paid by a shareholder to resume a corporation's busi-

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[595] *Ihrig v. Commissioner*, 26 T.C. 73, 76 (1956).

[596] *Gantner v. Commissioner*, 905 F.2d 241, 244 (8th Cir. 1990), *aff'g* 91 T.C. 713 (1988), *cert. denied*, 498 U.S. 921 (1990); *Eckles v. Commissioner*, 21 T.C.M. 1614, 1622 (1962).

[597] *See Bullock's Dep't Store, Inc. v. Commissioner*, 32 T.C.M. 1168, 1183 (1973).

[598] *Winn v. Commissioner*, 34 T.C.M. 916, 922 (1975), *aff'd without op.*, 546 F.2d 423 (4th Cir. 1976), *cert. denied*, 430 U.S. 945 (1977).

[599] *E.g., Lohrke v. Commissioner*, 48 T.C. 679, 688 (1967); *Conley v. Commissioner*, 36 T.C.M. 1644, 1648–49 (1977); *Frazier v. Commissioner*, 34 T.C.M. 951, 964 (1975).

[600] *Bronston v. Commissioner*, 34 T.C.M. 27, 31 (1975); *Canterbury Holdings, LLC v. Commissioner*, 98 T.C.M. 60 (2009).

[601] 283 F.2d 785 (7th Cir. 1960), *aff'g* the order (in part), *rev'g* the order (in part) and *rem'g* 18 T.C.M. 1101 (1959).

[602] 283 F.2d at 790–91.

[603] TAM 9522003.

[604] 282 F.2d 614 (5th Cir. 1960), *rev'g* 18 T.C.M. 152 (1959).

[605] 282 F.2d at 620.

[606] 51 T.C. 805 (1969).

[607] 51 T.C. at 818. *See also Thompson v. Commissioner*, 46 T.C.M. 1109, 1112 (1983).

[608] 64 T.C. 132 (1975).

[609] 64 T.C. at 135.

[610] *E.g., Madden v. Commissioner*, 40 T.C.M. 1103, 1109 (1980); *Reece v. Commissioner*, 36 T.C.M. 299, 304 (1977); *Estate of Cole v. Commissioner*, 32 T.C.M. 313, 331 (1973).

[611] *Dodd v. Commissioner*, 298 F.2d 570, 576 (4th Cir. 1962).

[612] *Mensik v. Commissioner*, 328 F.2d 147, 149 (7th Cir.), *aff'g* 37 T.C. 703 (1962), *cert. denied*, 379 U.S. 827 (1964).

[613] *E.g., Dietrick v. Commissioner*, 881 F.2d 336, 339–40 (6th Cir. 1989), *aff'g* 55 T.C.M. 706 (1988), *cert. denied*, 493 U.S. 1003 (1989); *Morgan v. Commissioner*, 46 T.C. 878, 894–95 (1966); *Rollins v. Commissioner*, 38 T.C.M. 1274, 1279 (1979), *aff'd without op.*, 668 F.2d 530 (5th Cir. 1982); *Orrell v. Commissioner*, 38 T.C.M. 577, 582 (1979); *Spitz v. United States*, 432 F. Supp. 148, 150 (E.D. Wis. 1977).

[614] T.C. Memo 1983-667, *nonacq.*, AOD 1984-22. *But see Welch v. Helvering*, 290 U.S. 111 (1933).

[615] *Jenkins v. Commissioner* at 246–47. *Cf. Boone v. Commissioner*, 33 T.C.M. 663, 667 (1974).

[616] 47 T.C.M. 706 (1983).

[617] 47 T.C.M. at 711. *See also Schneiderman v. Commissioner*, 54 T.C.M. 1006, 1009 (1987).

[618] *Ward v. Commissioner*, 20 T.C. 332, 344 (1953), *aff'd on other issues*, 224 F.2d 547 (9th Cir. 1955); *Post v. Commissioner*, 39 T.C.M. 311, 331 (1979).

[619] *Evans v. Commissioner*, 33 T.C.M. 1192, 1201–02 (1974), *supp.*, 34 T.C.M. 783 (1975), *aff'd on other issues*, 557 F.2d 1095 (5th Cir. 1977).

[620] 76 F.2d 941 (2d Cir. 1935), *aff'g* 30 B.T.A. 429 (1934).

[621] 76 F.2d at 942–43.

[622] 8 T.C.M. 858 (1949), *aff'd per curiam,*, 181 F.2d 503 (3d Cir. 1950).

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ness after a war ended were not deductible by the shareholder.[623]

(g) Payments After Corporate Liquidation

In *In re Ames*,[624] the court held that corporation business expenses paid by the sole shareholder after the corporation was liquidated were deductible by the shareholder who was continuing the corporation's business.[625] In *Goldner v. Commissioner*,[626] the court held that the shareholders were not allowed to deduct litigation expenses against a liquidated corporation of which they were transferees.[627]

(h) Payments While Corporate Charter Is in Suspense

Payment by a shareholder of the corporation's otherwise deductible expenses while the corporation's charter is in suspense does not make those expenses deductible by the shareholder.[628] So long as the corporation has not been liquidated, its business does not become the shareholder's sole proprietorship.[629] It is irrelevant that under state law the shareholder is obligated to pay the expenses.[630]

(i) Former Shareholders

In *Kaufmann v. Commissioner*,[631] the court held that no deduction was allowed for the payment, pursuant to an agreement, of a corporation's debts by individuals who had been its shareholders.[632]

(2) Officer's Payment of Corporation's Expenses

(a) In General

Generally, an officer's payment of the corporation's expenses or debts is not deductible by the officer.[633] Thus, no deduction is allowed for an officer's payment of expenses of a corporation engaged in liquor sales if the officer is a physician not in the liquor business and the officer's reputation as a physician would not be harmed by the failure of the corporation.[634] Likewise, an officer is not allowed to deduct as a trade or business expense any amount paid solely for the purpose of advancing the business interests of the corporation.[635] The expense of repurchasing shares of the corporation's stock that had been sold in possible violation of federal securities laws must be capitalized.[636]

However, if the officer is required by the corporation to bear the burden of expenses paid that exceed the corporation's reimbursement, the officer is allowed to deduct those expenses because the officer is not voluntarily paying a corporate obligation.[637] It does not matter that the officer was influential in establishing the corporation's reimbursement policy.[638]

(b) Expenses Treated as Corporation's

An officer is not allowed to deduct compensation paid to an employee of the corporation because the officer is not the employer.[639] However, an officer is allowed to deduct compensation paid to an individual hired by the officer to assist the officer in performing corporate duties provided that the officer, and not the corporation, compensates the individual and provided that the individual is the employee of the officer.[640] In contrast, in *In re Titus*,[641] the Board of Tax Appeals allowed an officer to deduct compensation paid to a corporate employee for services rendered directly to the corporation because the officer wanted to retain the employee to work on the officer's individual ventures.[642]

In *Acree v. Commissioner*,[643] the court held that the principal shareholder and officer of a bank was not allowed to deduct his payment of the corporation's loan losses.[644] In *Hickey v. Chahoon*,[645] the court held that a bank president was not allowed to deduct the bank's losses even though the president was contractually obligated to indemnify the bank against the losses under an agreement purportedly imposing the obligation on the president to preserve his income, because the bank had sufficient assets to pay its own losses.[646]

(c) Scope of Restriction

The prohibition against an officer's deduction of corporate expenses cannot be avoided by charging the corporation for the officer's activities if the amount charged is insufficient to permit the officer to make a profit and the officer is not otherwise in the trade or business of rendering such services to corporations generally.[647]

(d) Payments to Protect Officer

If an officer's payment of a corporate expense is made to protect the reputation or standing of some other business or job of the officer, the payment is deductible because it is an ordinary and necessary expense of that other business and is not merely the expense of the corporation.[648]

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[623] 8 T.C.M. at 860.
[624] 1 B.T.A. 63 (1924).
[625] 1 B.T.A. at 71–72.
[626] 27 T.C. 455 (1956).
[627] 27 T.C. at 463.
[628] *Stewart v. Commissioner*, 63 T.C.M. 2707 (1992), *aff'd without pub. op.*, 986 F.2d 1429 (10th Cir. 1993).
[629] *Stewart*, 63 T.C.M. at 2708–9.
[630] *Stewart*, 63 T.C.M. at 2709.
[631] 10 T.C.M. 790 (1951).
[632] 10 T.C.M. at 792.
[633] *Harding v. Commissioner*, 29 T.C.M. 789, 792 (1970).
[634] *Betson v. Commissioner*, 802 F.2d 365, 368–69 (9th Cir. 1986), *aff'g in part & rev'g in part* 48 T.C.M. 113 (1984).
[635] Rev. Rul. 72-192. *See Kliethermes v. United States*, 27 Fed. Cl. 111 (1992) (travel and other expenses).
[636] *Jordan v. Commissioner*, 60 T.C. 872, 882 (1973), *aff'd*, 514 F.2d 1209 (8th Cir. 1975).
[637] *Noyce v. Commissioner*, 97 T.C. 670 (1991).
[638] *Noyce*, 97 T.C. 670.
[639] *Robinson v. Commissioner*, 45 B.T.A. 39, 43 (1941).
[640] *Thompson v. Commissioner*, 9 T.C.M. 694, 696 (1950).
[641] 2 B.T.A. 582 (1925).
[642] 2 B.T.A. at 583–84.
[643] 35 T.C.M. 813 (1976).
[644] 35 T.C.M. at 817. *See Dunmire v. Commissioner*, 42 T.C.M. 438, 447 (1981).
[645] 153 F.2d 107 (2d Cir. 1946), *cert. denied*, 328 U.S. 843 (1946), *rev'g* 60 F. Supp. 409 (N.D.N.Y. 1944).
[646] 153 F.2d at 108.
[647] *See Bullock's Dep't Store, Inc. v. Commissioner*, 32 T.C.M. 1168, 1183 (1973).
[648] *Conley v. Commissioner*, 36 T.C.M. 1644, 1648–49 (1977). For a discussion of the deductibility of such payments, see FSA 200206005 (Chief Counsel's Office examines deductibility under §162 of a corporation's payment in redemption of stock as part of judgment against its shareholders/directors).

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(3) Corporation's Payment of Shareholder's Expenses

(a) In General

Generally, it is not ordinary and necessary for a corporation to pay its shareholders' expenses and obligations.[649] Thus, no deduction is allowed for amounts paid by the corporation for services that are rendered to its shareholders in their individual capacities.[650] This principle applies to legal fees and expenses incurred in connection with disputes between shareholders and their spouses,[651] even if it involves a spouse's attempt to obtain management input that would be detrimental to the corporation,[652] and to amounts transferred to a spouse on behalf of a shareholder.[653] It also applies to expenses of litigating the shareholder's personal tax matters,[654] even if connected with ownership of the stock[655] or with a business subsequently transferred by the shareholder to the corporation,[656] legal and accounting fees allocable to the shareholder's interests in other corporations,[657] the shareholder's personal medical expenses,[658] personal accounting services,[659] personal legal services,[660] personal recreational activities,[661] and the childcare expenses of the shareholder's child.[662] No deduction is allowed for the corporation's payment of the shareholder's tax liabilities on distributions loaned by them to the corporation.[663] A corporation that pays legal fees for defending its sole shareholder against criminal bribery and income tax evasion charges is not allowed to deduct those fees even though they are paid from the corporation's funds.[664]

Note: If the shareholder is an employee, the payment might be treated as deductible compensation.[665]

[649] *E.g.*, *Justice Steel, Inc. v. Commissioner*, 41 T.C.M. 209, 212 (1980); *Heim v. Commissioner*, 37 T.C.M. 584, 589 (1978).

[650] *Belmont Lumber Co. v. Commissioner*, 15 T.C.M. 88, 90 (1956). *See Nw. Ind. Tel. Co. v. Commissioner*, 127 F.3d 643 (7th Cir. 1997), *aff'g* 71 T.C.M. 2674 (1996), *cert. denied*, 525 U.S. 810 (1998) (payments made on behalf of controlling shareholder's son).

[651] *E.g.*, *Delaware Corp. v. Commissioner*, 88 T.C.M. 589 (2004); *Mann v. Commissioner*, 33 B.T.A. 281, 290 (1935) *nonacq.*, VI-1 C.B. 37 (1936).

[652] *E.g.*, *Hartwell v. Commissioner*, 24 T.C.M. 278, 282 (1965).

[653] *E.g.*, *Greenwood v. Commissioner*, 57 T.C.M. 1058, 1062 (1989).

[654] *E.g.*, *Ringmaster, Inc. v. Commissioner*, 21 T.C.M. 1024, 1033 (1962).

[655] *E.g.*, *Baxter D. Whitney & Son, Inc. v. Commissioner*, 20 B.T.A. 380, 383 (1930).

[656] *E.g.*, *Harrison Lumber & Hardware Co. v. Commissioner*, 15 T.C.M. 281, 284 (1956).

[657] *E.g.*, *Mun. Secs. Co. v. Commissioner*, 4 T.C.M. 120, 128 (1945).

[658] *E.g.*, *Wilson-Smith Veneer Co. v. Commissioner*, 11 B.T.A.M. 109, 111 (1942).

[659] *E.g.*, *Forcum-James Co. v. Commissioner*, 7 T.C. 1195, 1219 (1946), *rem'd* per stipulation on other issues, 176 F.2d 311 (6th Cir. 1949); *George Haiss Mfg. Co. v. Commissioner*, 16 T.C.M. 1106, 1117 (1957); *Pac. Mut. Door Co. v. United States*, 56-2 USTC ¶9762 (W.D. Wash. 1956).

[660] *E.g.*, *Royal Cotton Mill Co. v. Commissioner*, 29 T.C. 761, 788–89 (1958).

[661] *E.g.*, *Midwest Indus. Supply, Inc. v. Commissioner*, 71 T.C.M. 2446 (1996), *aff'd* without bub. op., 125 F.3d 855 (6th Cir. 1997).

[662] *E.g.*, *Delaware Corp. v. Commissioner*, 88 T.C.M. 589 (2004).

[663] *Inland Asphalt Co. v. Commissioner*, 756 F.2d 1425, 1429 (9th Cir. 1985), *aff'g* 44 T.C.M. 765 (1982).

[664] *Capital Video Corp. v. Commissioner*, 311 F.3d 458 (1st Cir. 2002), *aff'g* 83 T.C.M. 1229 (2002).

[665] *See* 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*

(b) Shareholder Property

In *D. H. Willey Lumber Co. v. Commissioner*,[666] and in *Magnon v. Commissioner*,[667] the court held that a corporation was not allowed to deduct expenses that it paid with respect to the maintenance of property belonging to a shareholder.[668] The same result has been reached with respect to improvements to the shareholder's property.[669] It also has been reached with respect to the corporation's payment of expenses of corporate property used as a residence by a shareholder[670] and to the corporation's payment of expenses allocable to the shareholder's personal use of a corporate vehicle.[671] No deduction is allowed for expenses paid by the corporation in connection with the condemnation of property previously transferred to the shareholder.[672]

(c) Shareholder Stock Transfers

No deduction is allowed to a corporation for payments to one shareholder for that shareholder's transfer of stock to another shareholder.[673] Nor is a corporation allowed to deduct amounts paid with respect to a shareholder's obligation to purchase another shareholder's stock in the corporation merely because it voluntarily assumes that obligation.[674] However, if the shareholder agrees to sell the stock to an employee on behalf of the corporation and the employee is discharged, the corporation's payment to the employee to settle the employee's breach of contract action against the shareholder is deductible.[675]

A corporation is not allowed to deduct the expenses of redeeming a shareholder's stock and selling that stock to another shareholder if the redemption and transfer is made for the shareholder's, rather than the corporation's, benefit;[676] nor is the corporation allowed to deduct the expenses of a shareholder's sale of stock to another shareholder or to the corporation.[677] No deduction is allowed for payments to settle a shareholder's alleged right to purchase newly issued stock if the dispute is in substance one among the shareholders with respect to their proportionate interests.[678]

A corporation is not allowed to deduct as a trade or business expense interest that it pays on a loan obtained by it and a shareholder to finance the shareholder's purchase of stock from a third person.[679]

[666] 7 T.C.M. 454 (1948), *aff'd*, 177 F.2d 200 (6th Cir. 1949).

[667] 73 T.C. 980 (1980).

[668] 7 T.C.M. at 471; 73 T.C. at 1002.

[669] *E.g.*, *Atlanta Biltmore Hotel Corp. v. Commissioner*, 349 F.2d 677, 680 (5th Cir. 1965), *aff'g* 22 T.C.M. 1266 (1963). *See Loftin & Woodard, Inc. v. United States*, 577 F.2d 1206, 1216 (5th Cir. 1978), *rev'g & rem'g* 78-1 USTC ¶9444 (W.D. La. 1975).

[670] *Lanteen Med. Labs., Inc. v. Commissioner*, 10 T.C. 279, 290 (1948).

[671] *Egan v. Commissioner*, 43 T.C.M. 1284, 1286 (1982).

[672] *Rodebaugh v. Commissioner*, 33 T.C.M. 169, 178 (1974), *aff'd*, 518 F.2d 73 (6th Cir. 1975).

[673] *Mid-State Prods. Co. v. Commissioner*, 21 T.C. 696, 725 (1954).

[674] *Schalk Chem. Co. v. Commissioner*, 304 F.2d 48, 52 (9th Cir. 1962), *aff'g* 32 T.C. 879 (1959).

[675] *Driskill Hotel Co. v. Commissioner*, 12 T.C.M. 565, 568 (1953).

[676] *Snyder Bros. Co. v. Commissioner*, 40 T.C.M. 762, 772 (1980).

[677] *S. Eng'g & Metal Prods. Corp. v. Commissioner*, 9 T.C.M. 93, 96 (1950).

[678] *105 W. 55th St., Inc. v. Commissioner*, 42 F.2d 849, 852 (2d Cir. 1930), *aff'g* 15 B.T.A. 210 (1929).

[679] *Miles v. Commissioner*, 25 T.C.M. 1278, 1284 (1966).

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(d) Expenses of Predecessor Partnership of Shareholders

In *Reade Mfg. Co. v. United States*,[680] the Third Circuit held that a corporation was not allowed to deduct tort liability incurred by a partnership whose partners had subsequently formed the corporation because there was insufficient moral compulsion to make the payment.[681] In *United States v. Smith*,[682] the Fifth Circuit held that the deductibility by a corporation of a predecessor partnership's expenses depended on whether the corporation assumed the obligation to do so and on the nature of the assumption.[683]

(e) Jointly Incurred Expenses

If the corporation pays otherwise deductible expenses that benefit both the corporation's interests and the shareholder's individual interests, the determination of whether the expense is an expense of the corporation is a question of fact.[684] Thus, in *Blackwell Oil & Gas Co. v. Commissioner*,[685] the court held that the corporation was not allowed to deduct amounts paid to settle claims against the shareholders and directors that they conspired to prevent exercise of purchase options on the corporation's stock.[686] A similar result was reached with respect to the corporation's payment to settle a threatened action against it and its shareholders to enforce an option to purchase the corporation's business.[687] In *Dolese v. United States*,[688] the court held that a corporation was allowed to deduct legal expenses incurred in connection with a shareholder's divorce in which the shareholder's spouse sued the corporation and succeeded in placing the corporation's activities under the supervision of the court.[689] In contrast, the expenses paid by the corporation for audits and record reconstructions required by the divorce court were held not to be deductible, even though the corporation obtained incidental benefits, because they were performed to value marital property.[690]

In *Old Town Corp. v. Commissioner*,[691] the court held that the corporation was allowed to deduct amounts paid to settle an action brought against it and the shareholders for an alleged breach of an employment contract, considering that the shareholders threatened to sue the corporation for reimbursement and the corporation reasonably believed they would succeed.[692] A corporation's payment of expenses in defending a lawsuit against a shareholder in connection with the shareholder's representation of the corporation was held to be deductible because the corporation had reason to conclude it was legally obligated to make the payments.[693] Likewise, a corporation's payment of legal fees to defend itself and its president against charges of antitrust violations were deductible because reversal of the president's conviction benefited the corporation.[694]

(f) Shareholder Derivative Suits

A corporation is allowed to deduct the expenses of a shareholder's derivative suit.[695] This applies whether the court orders the corporation to pay the expenses[696] or the corporation is obligated under local law to do so.[697]

(4) Corporation's Payment of Officer's Expenses

Generally, it is not necessary for a corporation to pay its officers' expenses and obligations.[698] Thus, the corporation is not allowed to deduct an officer's selling expenses that it pays.[699] Nor is a corporation permitted to deduct expenses of building homes on land owned by its president that the president subsequently sells through another corporation, because the expenses are those of the president and not the corporation.[700]

(5) Corporation's Payment of Bondholder's Expenses

In *Sharon Herald Co. v. Granger*,[701] the court held that a corporation was not allowed to deduct corporate loan taxes imposed on bondholders on whom the tax was imposed, because the corporation had not made itself legally obligated to pay those taxes on behalf of the bondholders.[702]

(6) Corporation's Payment of Subsidiary's and Affiliate's Expenses

(a) Operating Expenses

In *Interstate Transit Lines v. Commissioner*,[703] the Supreme Court held that a corporation was not allowed to deduct the operating deficit of a subsidiary that it had paid.[704] The same result has been reached with respect to the payment of advances to a wholly-owned foreign subsidiary[705] and to pay-

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[680] 301 F.2d 803 (3d Cir. 1962), *aff'g* 192 F. Supp. 749 (D.N.J. 1961).

[681] *Reade Mfg. Co.*, 301 F.2d at 806–07.

[682] 418 F.2d 589 (5th Cir. 1969), *rev'g and rem'g* 266 F. Supp. 814 (S.D. Tex. 1967).

[683] *Smith*, 418 F.2d at 596–97.

[684] *E.g., Okemah Nat'l Bank v. Wiseman*, 253 F.2d 223, 225–26 (10th Cir. 1958), *aff'g* 57-2 USTC ¶9930 (W.D. Okla. 1957), *cert. denied*, 358 U.S. 821 (1958); *Ecco High Frequency Corp. v. Commissioner*, 167 F.2d 583, 585 (2d Cir. 1948), *aff'g* 5 T.C.M. 688, 692 (1946), *cert. denied*, 335 U.S. 825 (1948).

[685] 60 F.2d 257 (10th Cir. 1932), *aff'g* 20 B.T.A. 661 (1930).

[686] 60 F.2d at 258.

[687] *Beer v. United States*, 132 F. Supp. 282, 285 (S.D. Ala. 1955).

[688] 605 F.2d 1146 (10th Cir. 1979), *cert. denied*, 445 U.S. 961 (1980).

[689] 605 F.2d at 1151–52.

[690] *Estate of Colley v. Commissioner*, 40 T.C.M. 81, 94 (1980).

[691] 37 T.C. 845 (1962).

[692] 37 T.C. at 861.

[693] *Standard Galvanizing Co. v. Commissioner*, 202 F.2d 736, 738–40 (7th Cir. 1953), *rev'g* 11 T.C.M. 170 (1952).

[694] *Central Coat, Apron & Linen Serv., Inc. v. United States*, 298 F. Supp. 1201, 1204–05 (S.D.N.Y. 1969).

[695] *B.T. Harris Corp. v. Commissioner*, 30 T.C. 635, 641 (1958).

[696] *E.g., Shoe Corp. of Am. v. Commissioner*, 29 T.C. 297, 306 (1957).

[697] *E.g., Ingalls v. Patterson*, 158 F. Supp. 627, 641 (N.D. Ala. 1958).

[698] *E.g., Evans-Winter-Hebb, Inc. v. Commissioner*, 11 B.T.A.M. 1048, 1052 (1942).

[699] *Liberty City Dev. Corp. v. Commissioner*, 9 T.C.M. 347, 351 (1950).

[700] *Jim Wood Land Clearing Co v. Commissioner*, 77 T.C.M. 1588 (1999).

[701] 195 F.2d 890 (3d Cir. 1952), *aff'g* 97 F. Supp. 295 (W.D. Pa. 1951).

[702] 195 F.2d at 895.

[703] 319 U.S. 590 (1943), *aff'g* 130 F.2d 136 (8th Cir. 1942), *aff'g* 44 B.T.A. 957 (1941).

[704] 319 U.S. at 594. *See S. Am. Gold & Platinum Co. v. Commissioner*, 8 T.C. 1297, 1302 (1947), *aff'd without op.*, 168 F.2d 71 (2d Cir. 1948); *L.A. & Salt Lake R.R. Co. v. Commissioner*, 4 T.C. 634, 651 (1945); *Meadville Corp. v. Commissioner*, 3 T.C.M. 466 (1944); *Morris Plan Co. of Phila. v. Commissioner*, 11 B.T.A.M. 61, 63 (1942); *In re J.C. Invs. Inc.*, 81-2 USTC ¶9775 (Bankr. M.D. Fla. 1981).

[705] *Post v. Commissioner*, 39 T.C.M. 311, 330 (1979); *Nalco Chem. Co. & Subs. v. United States*, 561 F. Supp. 1274, 1288–89 (N.D. Ill. 1983); FSA 200047015.

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ments to depositors of an affiliated bank whose assets were acquired by the taxpayer when the bank failed.[706] It does not matter that the subsidiary is the corporation's principal asset.[707] It does not matter that the corporation agreed to pay the claims before it made payment.[708]

However, in *Texas & Pacific Ry. Co. v. Commissioner*,[709] the Tax Court held that the Interstate Transit principle did not apply to a corporation that paid the operating expenses of a subsidiary that was formed to provide service to the corporation.[710] Deductions also have been allowed in cases in which the subsidiary was the sole source of supply for the payor.[711]

In *L. Heller & Son, Inc. v. Commissioner*,[712] the Tax Court held that payment of a subsidiary's debts after the subsidiary underwent bankruptcy reorganization was deductible because it was made to restore the credit standing of a subsidiary whose name, business, and creditors were substantially similar to those of the taxpayer.[713] No such deduction is allowed if the subsidiary's business and credit standing are not closely related to the taxpayer's,[714] if the payment is not made to improve the corporation's business relations with third parties,[715] or if the payment is not made to protect the taxpayer's reputation or credit standing.[716] No deduction is allowed if the payment is made to protect the corporation's investment in the subsidiary's stock,[717] if the payment is made to expand the payor's business,[718] or if the payment is made to protect another business owned by shareholders and their relatives.[719]

A corporation that has the right to set the amount of its affiliate's cost of goods purchased from the corporation, thus affecting the amount of the affiliate's income or loss, is not permitted to deduct the affiliate's expenses on the ground that it has entered into a contract with the affiliate to pay the affiliate's losses.[720] However, a corporation is allowed to deduct expenses of affiliated corporations that are no longer in existence if payment of those expenses is required as a condition of obtaining a bona fide loan from a creditor that had loaned money to the affiliated corporations.[721]

Amounts paid by a corporation on behalf of its subsidiary that are not deductible because they are expenses of the subsidiary must be treated as a capital contribution to the subsidiary.[722]

(b) Compensation

Amounts paid by a corporation to its employees that are charged on the books to the corporation's foreign subsidiaries for cost-control purposes are deductible by the corporation if the employees are performing services for the corporation and not for the subsidiaries.[723] Amounts paid by a corporation to employees performing services for foreign subsidiaries are deductible by the corporation only to the extent the corporation directly benefits from those services,[724] but the IRS takes the position that this principle does not apply to stock options granted by a corporation to its subsidiary's employees because §83 overrides §162, preventing the application of a "direct benefit" exception to the requirement in §83 that the options be granted to the taxpayer's employees if the taxpayer is to have a deduction.[725] However, amounts paid by the corporation merely to assist its subsidiary are not deductible by the corporation.[726]

In *Austin Co. v. Commissioner*,[727] the Tax Court held that a corporation was not allowed to deduct employment taxes paid by it with respect to employees loaned to a subsidiary because the payment did not directly and proximately benefit the corporation and was made merely to assist the subsidiary, even though the corporation's business reason for paying the taxes was to reduce its annual personnel maintenance overhead expenses.[728] No deduction is allowed for a parent corporation's compensation of security guards hired to protect the property of a subsidiary.[729]

No deduction is allowed for stock bonuses paid to employees and surviving spouses of deceased employees of the taxpayer's subsidiary.[730] The same conclusion applies to cash bonuses.[731]

(c) Warranty Expenses

In *Coulter Elecs., Inc. v. Commissioner*,[732] the Tax Court held that a corporation was allowed to deduct warranty expenses incurred by a subsidiary because the subsidiary's failure to provide services of the same quality as those provided by the corporation would diminish the corporation's reputation.[733] The

[706] *Mitten Mgmt., Inc. v. Commissioner*, 29 B.T.A. 569, 576–77 (1933).

[707] *Mo.-Kan. Pipe Line Co. v. Commissioner*, 148 F.2d 460, 461 (3d Cir. 1945), *aff'g* 3 T.C.M. 15 (1944).

[708] FSA 200147013.

[709] 1 T.C.M. 863 (1943).

[710] 1 T.C.M. at 869.

[711] *Fishing Tackle Prods. Co. v. Commissioner*, 27 T.C. 638, 644 (1957).

[712] 12 T.C. 1109 (1949).

[713] 12 T.C. at 1112.

[714] *W.F. Young, Inc. v. Commissioner*, 120 F.2d 159, 165 (1st Cir. 1941), *rev'g* and *rem'g* 9 B.T.A.M. 305 (1940).

[715] *Cal-Farm Ins. Co. v. United States*, 647 F. Supp. 1083, 1090 (E.D. Cal. 1986), *aff'd without op.*, 820 F.2d 1227 (9th Cir. 1987).

[716] *Fancy Foods of Va., Inc. v. United States*, 73-1 USTC ¶9372 (E.D. Va. 1973).

[717] *Eskimo Pie Corp. v. Commissioner*, 4 T.C. 669, 676 (1945), *aff'd*, 153 F.2d 301 (3d Cir. 1946).

[718] *Midland Distribs., Inc. v. United States*, 481 F.2d 730, 735 (5th Cir. 1973), *aff'g* 72-2 USTC ¶9606 (M.D. Fla. 1972).

[719] *Se. Aviation Underwriters, Inc. v. Commissioner*, 25 T.C.M. 412, 427 (1966).

[720] *Miracle Span Corp. v. United States*, 82-1 USTC ¶9365 (D.S.D. 1982).

[721] *Metro Land Co. v. Commissioner*, 42 T.C.M. 263, 266–67 (1981).

[722] *Koppers United Co. v. Commissioner*, 2 T.C.M. 103, 107 (1943); Rev. Rul. 84-68. *See* FAA 20132801F (payments that parent corporation agreed to make for subsidiary's liabilities as part of negotiations for sale of subsidiary are deemed contribution of capital and cannot be deducted as ordinary and necessary business expenses).

[723] *Columbian Rope Co. v. Commissioner*, 42 T.C. 800, 814 (1964); T.I.R. 839, 1966 P-H ¶45999.

[724] *Young & Rubicam, Inc. v. United States*, 410 F.2d 1233, 1238–39 (Ct. Cl. 1969).

[725] FAA 20032902F.

[726] *Columbian Rope Co. v. Commissioner*, 42 T.C. 800, 816 (1964).

[727] 71 T.C. 955 (1979).

[728] 71 T.C. at 959.

[729] *Coosa Land Co. v. Commissioner*, 29 B.T.A. 389, 393–94 (1933), *aff'd on other issues*, 103 F.2d 555 (5th Cir. 1939).

[730] *Koppers United Co. v. Commissioner*, 2 T.C.M. 103, 107–08 (1943).

[731] Rev. Rul. 84-68.

[732] 59 T.C.M. 350 (1990), *aff'd in unpub. op.*, 943 F.2d 1318 (11th Cir. 1991).

[733] *Coulter Elecs., Inc. v. Commissioner*, 59 T.C.M. 350 (1990), *aff'd* in without pub. op., 943 F.2d 1318 (11th Cir. 1991).

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court applied the ordinary and necessary test to support this conclusion.[734]

(d) Equity Transactions

The loss incurred by a corporation by converting its subsidiary's debentures into its own stock is not a trade or business deduction of the corporation.[735] No deduction is allowed for assets transferred by a corporation to a corporation controlled by its shareholder, particularly if the two corporations are engaged in different types of business.[736]

No deduction is allowed for the legal expenses of restructuring a subsidiary under an antitrust decree requiring severance of the parent's interests.[737] No deduction is allowed for the cost of an audit of a liquidating corporation that is paid by the corporation if the audit primarily benefits the shareholders of the successor corporation.[738]

(7) Subsidiary's Payments to Parent

In *Smith-Bridgman & Co. v. Commissioner*,[739] the court held that a subsidiary was allowed to deduct compensation paid to its parent for management services rendered to it by an officer of the parent, even though the officer was directly compensated by the subsidiary for other services rendered to it by the officer in his capacity as officer of the subsidiary.[740]

(8) Corporation's Payment of Predecessor's Expenses

No deduction is allowed to a corporation for the payment of expenses of a business that it acquires.[741] The rationale for the disallowance is that the payment is part of the purchase price of the predecessor's assets or stock, and thus must be capitalized.[742] The capitalization rules are discussed in 509 T.M., *Principles of Capitalization.*

A corporation is not allowed to deduct payments made on the debt of a predecessor, whether or not incorporated.[743] Likewise, no deduction is allowed for a corporation's payment of a debt with respect to which its predecessor was guarantor.[744] The same principle applies to the payment of contingent claims for which the corporation assumed liability when it acquired the assets of its predecessor[745] and to liabilities that had not been asserted at the time of the acquisition of the predecessor's assets.[746]

Note: The cases do not address the issue of whether the payments should be treated as additional purchase price that, to the extent allocated to depreciable or amortizable assets, would generate additional depreciation or amortization deductions.

In *Scovill Mfg. Co. v. Fitzpatrick*,[747] the court held that a corporation was allowed to deduct contributions to a pension trust established by another corporation before the taxpayer acquired all of its stock.[748] In *United States v. Minneapolis & St. Louis Ry.*,[749] the court held that a corporation was allowed to deduct retroactive wage increases for periods its employees were employed by its predecessor corporation, because the liability for making those payments was not approved by the receivership court until after the predecessor's assets had been acquired by the corporation.[750] The IRS has ruled that the surviving corporation in a merger is allowed to deduct severance payments and supplemental allowances paid by the corporation to former employees of the corporation that was absorbed in the merger.[751] The IRS has also ruled that severance payment deductions were allowable to the surviving corporation in a §338 asset acquisition because the obligation to make the payments arose after the assets were acquired.[752]

It does not matter that the predecessor has the same name as the corporation.[753] Nor does it matter that a court has ordered that the payment be made.[754]

(9) Corporation's Payment of Another Corporation's Expenses

Generally, a corporation's payment of another corporation's expenses is not deductible. However, if the payment is made to protect the payor's business interests and is ordinary and necessary in the context of the payor's industry, it is deductible as an expense of the payor.[755] Thus, a corporation in the business of delivering products abroad was allowed to deduct the expenses it paid for a Guatemalan company in the business of delivering products to the United States, because the Guatemalan company included promotional material for the taxpayer in its shipments, generating increased revenue for the taxpayer.[756] The exception does not apply to expenses paid by an S corporation with respect to partially completed contracts

[734] *Coulter Elecs., Inc.*, 59 T.C.M. 350.

[735] *Nat'l Can Corp. v. United States*, 687 F.2d 1107, 1116–17 (7th Cir. 1982), *aff'g* 520 F. Supp. 567 (N.D. Ill. 1981).

[736] *E.g.*, *John J. Wells, Inc. v. Commissioner*, 47 T.C.M. 1114, 1118 (1984).

[737] *E.I. du Pont de Nemours & Co. v. United States*, 432 F.2d 1052, 1059 (3d Cir. 1970), *rev'g* 296 F. Supp. 823 (D. Del. 1969).

[738] *Kingsford Co. v. Commissioner*, 41 T.C. 646, 662 (1964).

[739] 16 T.C. 287 (1951).

[740] 16 T.C. at 295.

[741] *E.g.*, *In re F. Tinker & Sons Co.*, 1 B.T.A. 799, 803 (1925); *Pa. Forge Corp. v. Commissioner*, 2 T.C.M. 723, 727 (1943).

[742] *E.g.*, *Illinois Tool Works Inc. v. Commissioner*, 355 F.3d 997 (7th Cir. 2004); *David R. Webb Co. v. Commissioner*, 708 F.2d 1254, 1256–58 (7th Cir. 1983), *aff'g* 77 T.C. 1134 (1981); *Gaines v. Commissioner*, 45 T.C.M. 363, 371 (1982); *Leavitt v. Commissioner*, 31 T.C.M. 453, 456 (1972); *Foster v. Commissioner*, 25 T.C.M. 1390, 1422 (1966), *aff'd in part & rev'd in part on other issues sub nom.*; *Likins-Foster Honolulu Corp. v. Commissioner*, 417 F.2d 285 (10th Cir. 1969), *cert. denied*, 397 U.S. 987 (1970).

[743] *Birmingham Bus. Coll., Inc. v. Commissioner*, 276 F.2d 476, 481 (5th Cir. 1960); *Intermed, Inc. v. Commissioner*, 36 T.C.M. 1209, 1213 (1977); *Egg-Safety Carton Corp. v. Commissioner*, 5 B.T.A.M. 441, 442 (1936).

[744] *Portland Gasoline Co. v. Commissioner*, 181 F.2d 538, 540–41 (5th Cir. 1950); *W.D. Haden Co. v. Commissioner*, 165 F.2d 588, 591 (5th Cir. 1948).

[745] *Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323, 324–25 (8th Cir. 1946).

[746] *Meeks Motor Freight, Inc. v. Commissioner*, 8 T.C.M. 838, 840 (1949).

[747] 215 F.2d 567 (2d Cir. 1954), *rev'g* 53-1 USTC ¶9429 (D. Conn. 1953).

[748] 215 F.2d at 568.

[749] 260 F.2d 663 (8th Cir. 1958), *aff'g* 57-2 USTC ¶9964 (D. Minn. 1957).

[750] 260 F.2d at 669–70.

[751] Rev. Rul. 67-408.

[752] TAM 9721002.

[753] *Athol Mfg. Co. v. Commissioner*, 54 F.2d 230, 231 (1st Cir.), *aff'g* 22 B.T.A. 105 (1931).

[754] *Pac. Gas & Elec. Co. v. Commissioner*, 7 T.C. 1142, 1146–48 (1946).

[755] *E.g.*, *Moloney Elec. Co. v. Commissioner*, 42 B.T.A. 78, 83 (1940), *modified on other issues*, 120 F.2d 617 (8th Cir.), *cert. denied*, 314 U.S. 682 (1941); *First Nat'l Bank of Skowhegan v. Commissioner*, 35 B.T.A. 876, 884–86 (1937); *Va. Eng'g Co. v. United States*, 43-1 USTC ¶9495 (E.D. Va. 1943); *St. Louis Union Tr. Co. v. Sheehan*, 40-2 USTC ¶9585 (E.D. Mo. 1940).

[756] *JRJ Express, Inc. v. Commissioner*, 75 T.C.M. 2397 (1998).

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transferred to C corporations if those expenses are paid after the transfer and do not benefit the S corporation.[757]

The IRS has ruled that contributions by utilities owning nuclear generating plants towards the cleanup of damage at a nuclear generating plant owned by an unrelated utility are deductible because they reduce the utilities' financing costs, improve the public's perception of the industry, and are an acceptable means of dealing with an industry-wide problem.[758] The IRS has extended this conclusion to contributions by utilities not owning nuclear generating plants[759] and to contributions by utility holding companies.[760]

A corporation's payment of another corporation's dividends pursuant to a guaranty made as part of a sales promotion is deductible.[761] The same result has been reached when the purpose was to raise capital through sale of the other corporation's stock.[762]

Payments made by a corporation to the creditors of another corporation in order to protect the payor's reputation or credit have been allowed as deductions when the two corporations were considered one business by the public[763] or were both entirely owned by the same shareholder.[764] However, a deduction was disallowed to a bank that paid half of a judgment against the shareholders of a second bank, because there was no obligation to make the payment, there was no particular business benefit connected to the second bank, there was no business practice in the banking industry of making such payments, and the relationship between the banks would not have deteriorated if the payment were not made.[765]

A corporation that pays the income taxes of another company without being contractually obligated to do so is not allowed to deduct those taxes as a cost of earning income from a contract with that other company to sell and service its products.[766] A corporation that pays debts of another corporation without obtaining an economic benefit from doing so is not allowed to deduct those payments, even if the paying corporation regularly makes purchases from the debtor corporation and even if the debtor corporation is owned by relatives of the paying corporation's shareholders.[767]

e. Unincorporated Association

The deductible expenses of a trust established by an unincorporated association are not allowed to the unincorporated association.[768] Policyholders in mutual aid associations are not allowed to deduct amounts paid to advertise businesses after those businesses are transferred to the association.[769]

f. Partnerships and Partners

A partnership is not allowed to deduct, and thus the partners are not allowed to deduct, amounts paid in settlement of litigation brought against one partner in that partner's individual capacity.[770] This principle applies to amounts paid to prevent financial damage to a partnership by a partner's spouse's demands in a divorce action.[771]

Nor is a partnership allowed to deduct amounts paid to an investment advisor for advice given to its limited partners before they invested in the partnership.[772]

The mere fact that an expense is to be borne by, and allocated to, fewer than all of the partners does not preclude the partnership from taking into account the expense in determining its taxable income.[773] If one partner pays partnership employees additional compensation that is otherwise deductible, the partner is allowed to deduct the amount paid.[774] However, if the compensation is paid by the partner for services rendered directly to the partner for personal purposes, no deduction is allowed.[775] Likewise, payments by a partner to a relative who is employed by the partnership and that do not represent compensation are not deductible.[776]

Note: In the partnership context, the question of whether the partnership or the partner "deducts" the expense is actually an aspect of the manner in which partnership expenses are allocated among the partners.[777] Payment of a partnership expense by a partner who is not reimbursed is, assuming no facts to the contrary, prima facie proof that the partner bears the economic burden of that expense. Partnership allocations are described in III.C.4.a., below, and are discussed in detail in 712 T.M., *Partnerships — Taxable Income; Allocation of Distributive Shares; Capital Accounts.*

A partner is not allowed to deduct the entire amount of unreimbursed expenses paid on behalf of the partnership and for which the partner is entitled to reimbursement.[778] However, if the partner agrees to be responsible for the expenditure, the deduction is allowable.[779]

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[757] *Bone v. Commissioner*, 324 F.3d 1289 (11th Cir. 2003).

[758] PLR 8413050.

[759] PLR 8413061.

[760] PLR 8413072.

[761] *Standard Oil Co. of N.J. v. Commissioner*, 11 T.C. 843, 854 (1948), *supplementing* 7 T.C. 1310 (1946).

[762] *Camp Mfg. Co. v. Commissioner*, 3 T.C. 467, 472 (1944).

[763] *Scruggs-Vandervoort-Barney, Inc. v. Commissioner*, 7 T.C. 779, 787–88 (1946).

[764] *Hudlow v. Commissioner*, 30 T.C.M. 894, 924 (1971).

[765] *First Nat'l Bank of Bellaire v. Commissioner*, 68 T.C.M. 35 (1994).

[766] *Nat'l Piano Mfg. Co. v. Burnet*, 50 F.2d 310, 311 (D.C. Cir. 1931), *aff'g* 11 B.T.A. 46 (1928).

[767] *A. Giurlani & Bro., Inc. v. Commissioner*, 119 F.2d 852, 856–57 (9th Cir. 1941), *aff'g* 41 B.T.A. 403 (1940).

[768] *E.g., Phila.-Balt. Stock Exchange v. Commissioner*, 19 T.C. 355, 359 (1952).

[769] *Crowder v. Commissioner*, 19 T.C. 329, 335 (1952).

[770] *Estate of Korr v. Commissioner*, 13 T.C.M. 238, 239 (1954).

[771] *Estate of Walsh v. Commissioner*, 28 T.C. 1274, 1277 (1957).

[772] *Surloff v. Commissioner*, 81 T.C. 210, 244 (1983).

[773] *Decker v. United States*, 71 F.2d 685, 686 (7th Cir. 1934), *rev'g* 15 AFTR2d 882 (N.D. Ill. 1933).

[774] *E.g., Noble v. Commissioner*, 7 T.C. 960, 965 (1946); *Herndon v. Commissioner*, 7 T.C.M. 125, 129 (1948), *aff'd*, 175 F.2d 55 (5th Cir. 1949), 177 F.2d 145 (5th Cir. 1949); *Siarto v. Commissioner*, 6 T.C.M. 3, 9 (1947), *aff'd*, 171 F.2d 293 (6th Cir. 1948); Rev. Rul. 70-253. *See Jackson v. Commissioner*, 4 T.C.M. 503, 506 (1945).

[775] *Edwards v. Commissioner*, 3 T.C.M. 1098, 1106 (1944).

[776] *Dalton v. Commissioner*, 4 T.C.M. 33, 36 (1945).

[777] *See* §704(b).

[778] *McLauchlan v. Commissioner,* 558 Fed. App'x 374 (5th Cir. 2014); *Magruder v. Commissioner*, 57 T.C.M. 117, 124 (1989); *Dollord v. Commissioner*, 53 T.C.M. 1335, 1337 (1987); *Johnson v. Commissioner*, 49 T.C.M. 81, 88–89 (1984); *Wilson v. United States*, 376 F.2d 280, 297–98 (Ct. Cl. 1967).

[779] *Dodd v. United States*, 56-2 USTC ¶9673 (N.D. Ga. 1956), *aff'd on other issues*, 243 F.2d 944 (5th Cir. 1957).

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In *Fihe v. Commissioner*,[780] the court held that a taxpayer who revealed his partner's fraud was not allowed to deduct legal fees paid for the partner's defense.[781] A corporation is not allowed to deduct compensation paid to shareholder-officers for services rendered to a joint venture in which the corporation is a venturer.[782]

A former partner who pays for the determination of a dissolved partnership's state tax liabilities is allowed to deduct those amounts to the extent the determination reduces the partner's penalties for failure of the partnership to pay the taxes, if the benefit to the other former partners is merely incidental.[783] When a partnership dissolves, payments to one partner in the nature of retirement pay are deductible by the other partners who make the payments.[784]

g. Partnership's Payment of Corporation's Expenses

Deductions have been allowed to a law firm for payments made under an agreement to reimburse the losses of a newly formed savings and loan association because the payments were made to protect the firm's title abstract business.[785] Likewise, deductions have been allowed for a partnership's payment of the expenses of a nonprofit corporation formed by the partners in order to maintain the medical fees being collected by the partnership from the hospital.[786]

h. Landlords and Tenants

In *Hennepin Holding Co. v. Commissioner*,[787] the Board of Tax Appeals allowed a landlord to deduct expenses incurred in advertising and rehabilitating a tenant's business in order to prevent loss of the rental income being generated for the landlord by the tenant.[788]

Comment: The allowance of the landlord's deduction in *Hennepin* is consistent with the allowance of a rent rebate or a decrease in gross income from a rent reduction. All three are methods of easing the tenant's economic burden for a purpose related to the landlord's rental activities.

i. Tenants in Common

A taxpayer who is entitled to reimbursement from co-owners of rental property is not allowed to deduct more than the taxpayer's share of the expenses.[789] It does not matter if the taxpayer provided all of the funds for the purchase or regularly paid all of the expenses, because the reimbursement right precluded characterization of the reimbursable expenses as ordinary and necessary with respect to the taxpayer.[790]

j. Trusts, Grantors, and Beneficiaries

As a general proposition, trust beneficiaries are not allowed to deduct the trust's business and for-profit activity expenses.[791] In *Bernheim v. Commissioner*,[792] the court held that a beneficiary who owned a remainder interest in a trust was not allowed to deduct business expenses of the trust that he paid.[793] The same principle has been applied to the attempt by the owner of the remainder to deduct amounts paid by the trustee in final settlement of litigation with respect to distributions from the trust.[794] Nor is a sole beneficiary allowed to deduct compensation paid to the trustees for services performed for the trust.[795]

A grantor of a trust treated as a grantor trust is allowed to deduct for-profit activity expenses of the trust, such as trustee commissions and administrative expenses.[796] However, a grantor is not allowed to deduct amounts paid by a trust merely because the trust is not recognized as a partner of the grantor for income tax purposes.[797] The allocation of grantor trust deductions to grantors under §671 is described in III.C.3., below, and is discussed in detail in 819 T.M., *Grantor Trusts: Income Taxation Under Subpart E* (Estates, Gifts, and Trusts Series).

k. Estates, Fiduciaries, and Beneficiaries

In *Estate of Windsberg v. Commissioner*,[798] the court held that the executor of his parent's estate was not allowed to deduct on his individual income tax return as trade or business expenses the administration expenses of the estate, because the deductions were those of the estate.[799] The IRS has similarly ruled with respect to the deduction by the administrator of administration expenses as for-profit activity expenses.[800] The same principle applies to the fiduciary's deduction of the estate's litigation expenses[801] and the expense of contesting deficiencies asserted with respect to the decedent's income tax liability.[802]

l. Individual's Payment of Another Person's Expenses

(1) In General

Generally, an individual is not allowed to deduct the trade or business expenses of another individual or unrelated corporation.[803] Thus, a taxpayer is not allowed to deduct for-profit ac-

[780] 15 T.C.M. 696 (1956), *aff'd*, 265 F.2d 511 (9th Cir. 1958).
[781] 15 T.C.M. at 700.
[782] *Cropland Chem. Corp. v. Commissioner*, 75 T.C. 288, 297 (1980), *aff'd without pub. op.* (7th Cir. 1981).
[783] *Farnsworth v. Commissioner*, 29 T.C. 1131, 1140 (1958), *aff'd on other issues*, 270 F.2d 660 (3d Cir. 1959), *cert. denied*, 362 U.S. 902 (1960).
[784] *Sloan v. Commissioner*, 42 T.C.M. 1606, 1612 (1981).
[785] *Snow v. Commissioner*, 31 T.C. 585, 596 (1958).
[786] *Dinardo v. Commissioner*, 22 T.C. 430, 439 (1954).
[787] 23 B.T.A. 119 (1931).
[788] 23 B.T.A. at 123.
[789] *James v. Commissioner*, 70 T.C.M. 1420 (1995).
[790] *James*, 70 T.C.M. at 1422.
[791] *E.g., Bergin v. Commissioner*, 20 B.T.A. 1002, 1104–05 (1930).
[792] 9 T.C.M. 1021 (1950).
[793] 9 T.C.M. at 1024.
[794] *Carrington v. United States*, 66-2 USTC ¶9626 (M.D. Fla. 1966).
[795] *Kenan v. Bowers*, 50 F.2d 112, 113 (2d Cir. 1931).
[796] *Mallinckrodt v. Commissioner*, 2 T.C. 1128, 1148 (1943), *aff'd on other issues*, 146 F.2d 1 (8th Cir. 1945), *cert. denied*, 324 U.S. 781 (1945), *acq.*, 1944 C.B. 18; *Rentschler v. Commissioner*, 1 T.C. 814, 820 (1943), *distinguished by* TAM 200733024. *See Vest v. Commissioner*, 57 T.C. 128, 149 (1971), *aff'd in part & rev'd in part on other issues*, 481 F.2d 238 (5th Cir. 1973), *cert. denied*, 414 U.S. 1092 (1973).
[797] *Moore v. Commissioner*, 7 T.C. 1250, 1270 (1946), *rem'd* pursuant to stipulation in compromise, 176 F.2d 311 (6th Cir. 1949).
[798] 37 T.C.M. 455 (1978).
[799] 37 T.C.M. at 459–60.
[800] Rev. Rul. 55-190.
[801] *See Henderson v. Commissioner*, 11 T.C.M. 419, 420 (1952).
[802] *Estate of Henderson v. Commissioner*, 2 T.C.M. 1089, 1091–92 (1943), *rev'd on other issues*, 147 F.2d 619 (5th Cir. 1945).
[803] *E.g., Grauman v. Commissioner*, 357 F.2d 504, 506 (9th Cir. 1966), *aff'g* 23 T.C.M. 1368 (1964).

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tivity expenses paid on behalf of a friend.[804] An individual is not allowed to deduct the expenses of operating rental property, the title to which is in the names of the individual's children because the individual is not obligated to pay those expenses.[805]

However, in one case a proprietor was allowed to deduct expenses of the proprietorship paid after the business was incorporated.[806] In another case, a funeral home was allowed to deduct voluntary payment of the deficits of an insurance company formed to advertise the funeral home's business.[807]

(2) Expenses of Contesting Taxes

A taxpayer is allowed to deduct the expenses of contesting income tax deficiencies asserted against the taxpayer and a former spouse with respect to community income, but the taxpayer's current spouse is not allowed to deduct the expenses because the expenses relate to the community between the taxpayer and the former spouse and not the one between the taxpayer and the current spouse.[808] A taxpayer is not allowed to deduct the expense of contesting a tax liability asserted against a former spouse, even if the taxpayer agrees to pay any liability and contest any deficiency.[809]

4. Interest

a. In General

Mortgage interest paid by a taxpayer is not deductible if the taxpayer is not liable on the loan secured by the mortgage and does not own any of the property on which the mortgage was given.[810] The taxpayer must prove the existence of personal liability or ownership of the property securing the mortgage.[811] In *Wusich v. Commissioner*,[812] the Tax Court rejected an IRS argument that no deduction should be allowed for interest paid by the taxpayer on principal payments made to a bonding company under an agreement by which the taxpayer agreed to indemnify the bonding company for payments made by the bonding company to a bank under the indemnity bond.[813]

b. Personal Liability

(1) In General

Otherwise deductible interest paid by the taxpayer on a loan with respect to which the taxpayer alone is personally liable is deductible by the taxpayer.[814] Otherwise deductible interest paid by a parent on a loan made to a child is deductible by the parent if the parent cosigned the note,[815] but not if the parents do not make, co-make, or endorse the note.[816] The parent's mere promise to the borrower to make the payments is insufficient.[817] However, a taxpayer who is not obligated to the lender but who assumes liability on the mortgage in exchange for a part interest in the property securing the mortgage is allowed to deduct otherwise deductible interest.[818]

If the taxpayer does not prove personal liability on a loan nor the use of his or her property to secure the loan, no deduction is allowed.[819] No deduction is allowed for the payment of interest by the taxpayer on a loan secured by another person's property and on which the taxpayer is not liable.[820] However, in *Belden v. Commissioner*,[821] the Tax Court held that a taxpayer was allowed to deduct interest paid to a builder to cover a construction loan even though the taxpayer did not yet have legal title to the property and was not directly obligated on the loan.

It does not matter that the taxpayer pays the interest with funds provided by another person for that purpose.[822] This principle has been applied to disallow a deduction by a child of interest paid on a mortgage on which the parent but not the child was liable.[823]

A tenant is allowed to deduct otherwise deductible interest paid on a loan made to the tenant by the landlord even after the tenant assigns the lease to a corporation, if the assignment does not relieve the tenant of liability on the loan.[824] In *Thomas v. Commissioner*,[825] the Board of Tax Appeals held that the taxpayer was not allowed to deduct interest on a loan secured by property purchased by the taxpayer for relatives because the taxpayer was not liable on the loan and did not have title to the property.[826]

Taxpayers who pay interest on loans secured by property transferred by the taxpayers to trustees, but who are not relieved of their personal liability on the loans, are allowed to deduct the interest if under state law they remain primarily liable on the loans.[827]

(2) Guarantees

A taxpayer who pays interest on a loan made to another person is not allowed to deduct the interest merely because the taxpayer guarantees the loan.[828] However, if the taxpayer be-

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[804] *Sparks v. Commissioner*, 19 T.C.M. 807, 810 (1960).
[805] *Harlow v. Commissioner*, 48 T.C.M. 661, 663 (1984).
[806] *McCaffrey v. Enochs*, 62-2 USTC ¶9727 (S.D. Miss. 1962).
[807] *Crowder v. Commissioner*, 19 T.C. 329, 334–35 (1952).
[808] *Marshall v. Commissioner*, 5 T.C. 1032, 1034–35 (1945), *acq.*, 1946-1 C.B. 3.
[809] *Jergens v. Commissioner*, 17 T.C. 806, 811 (1951).
[810] *E.g., Blunt v. Commissioner*, 25 T.C.M. 1445, 1463 (1966). *See Bonkowski v. Commissioner*, 458 F.2d 709, 711–12 (7th Cir. 1972), *cert. denied*, 409 U.S. 874 (1972), *aff'g* 29 T.C.M. 1645 (1970). *See also Loria v. Commissioner*, 70 T.C.M. 553 (1995).
[811] *Song v. Commissioner*, 70 T.C.M. 745 (1995).
[812] 35 T.C. 279 (1960).
[813] 35 T.C. at 288.
[814] *See Machen v. Commissioner*, 25 T.C.M. 990, 992 (1966).
[815] Rev. Rul. 71-179.
[816] *Prendergast v. Commissioner*, 46 T.C.M. 787, 788 (1983); *Secunda v. Commissioner*, 36 T.C.M. 763, 764 (1977).
[817] *Secunda v. Commissioner*, 36 T.C.M. 763, 765 (1977).
[818] *Amundson v. Commissioner*, 60 T.C.M. 39, 42 (1990).
[819] *See Grubbs v. Commissioner*, 59 T.C.M. 933 (1990).
[820] *Seale v. Commissioner*, 9 T.C.M. 48, 50 (1950).
[821] 70 T.C.M. 274 (1995).
[822] Rev. Rul. 70-282.
[823] *Brooks v. Commissioner*, 63 T.C.M. 3046 (1992); *Tuer v. Commissioner*, 46 T.C.M. 870, 871 (1983); *Schrayter v. Commissioner*, 39 T.C.M. 205, 207 (1979); *Feeney v. Commissioner*, 25 T.C.M. 40, 41 (1966); *Emmons v. Commissioner*, 20 T.C.M. 1513, 1515 (1961).
[824] *McNaghten v. Commissioner*, 13 B.T.A. 871, 876 (1928).
[825] 8 B.T.A.M. 186 (1939).
[826] 8 B.T.A.M. at 191.
[827] *Walther v. Commissioner*, 316 F.2d 708, 710 (7th Cir. 1963), *rev'g* 21 T.C.M. 1119 (1962).
[828] *Simon v. Commissioner*, 36 B.T.A. 184, 186 (1937). *See Abdalla v. Commissioner*, 647 F.2d 487, 503–04 (5th Cir. 1981), *aff'g* 69 T.C. 697 (1978).

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comes personally liable on the debt, otherwise deductible interest accruing thereafter and paid by the taxpayer is deductible.[829]

(3) Transferee Liability Situations

A taxpayer who is liable as a transferee for a tax liability is allowed to deduct otherwise deductible interest that accrues on the liability after the transfer of the transferor's assets to the transferee.[830] Similarly, the transferees are not allowed an interest deduction for their payment of interest accruing before the transfer, because that interest is the obligation of the transferor and its payment by the transferees is treated as a capital loss as is the payment of the underlying tax obligation.[831]

It does not matter that the transferee agreed with the transferor to pay the deficiency, without specific mention of the interest, if the interest accrues after the transfer of the assets.[832] It does not matter that the transferor pays on behalf of the transferee the interest accruing after the transfer, because the transferor in that situation is acting as the transferee's agent.[833]

Otherwise deductible interest on an estate tax deficiency that accrues after the estate distributes its assets and that is paid by the distributee is deductible by the distributee.[834] If the distributees are not liable for a tax deficiency because it is only a lien against the property, no deduction is allowed to them when they pay the interest.[835]

The transferee liability principle does not apply to a spouse who is sole heir of the decedent spouse and personal representative of the decedent spouse's estate if the surviving spouse is not a transferee.[836]

(4) Joint Liability

The fact that the taxpayer is jointly liable on a debt does not preclude the taxpayer from deducting all otherwise deductible interest paid by the taxpayer on the debt.[837] Thus, a co-maker of a note is allowed to deduct otherwise deductible interest paid with respect to the note.[838] A taxpayer who is jointly responsible for the payment of withholding taxes is allowed to deduct otherwise deductible interest on unpaid taxes.[839]

If the taxpayer remains personally liable on a mortgage bond, the fact that the transferee of the property securing the mortgage executes a new bond and becomes jointly liable does not make the taxpayer's otherwise deductible interest nondeductible.[840] Equal partners who guarantee a note are allowed to deduct their proportionate shares of otherwise deductible interest that they pay.[841] Each of several affiliated corporations jointly and severally liable on a tax deficiency arising from a consolidated return is allowed to deduct the interest on the deficiency to the extent allocated among themselves in a reasonable, fair, and equitable manner.[842]

(5) Spouses

A spouse is not allowed to deduct on a separate return interest paid on the debt of the other spouse.[843] However, if the liability is joint, either spouse who pays otherwise deductible interest with respect to the liability is allowed to deduct it.[844] If payment is made with community funds, each spouse is treated as having paid one-half of the interest.[845]

If joint property is used to pay otherwise deductible interest on a loan on which the spouses are jointly liable, each spouse is entitled to deduct one-half of the interest.[846] If one spouse pays the interest with his or her own funds,[847] that spouse is entitled to any deduction.[848] It does not matter that the loan is secured by the other spouse's property.[849] In a state in which one spouse is entitled to possession of, and proceeds from the sale of, property held as tenants by the entirety, that spouse is allowed to deduct all of the otherwise deductible accrued interest paid by a purchaser of the property who agrees to transfer a portion of the sales proceeds directly to the mortgagee.[850]

A spouse cannot make interest paid on the other spouse's debt deductible merely by becoming a guarantor with respect to the debt.[851] A taxpayer is not allowed to deduct interest paid by a former spouse on a debt for which the taxpayer remains

[829] *Sherman v. Commissioner*, 18 T.C. 746, 753 (1952), *nonacq.* on other issues, 1964-2 C.B. 9. *See Tolzman v. Commissioner*, 43 T.C.M. 1, 7 (1981).

[830] *Johnson v. Commissioner*, 19 T.C. 465, 468–69 (1952); *Timken v. Commissioner*, 6 T.C. 483, 484 (1946); *Armour v. Commissioner*, 6 T.C. 359, 362 (1946); *Smith v. Commissioner*, 6 T.C. 255, 257–58 (1946); *Koppers Co. v. Commissioner*, 3 T.C. 62, 64–65 (1944), *aff'd sub nom., Commissioner v. Breyer*, 151 F.2d 267 (3d Cir. 1945); W. D. *Haden Co. v. Commissioner*, 5 T.C.M. 250, 268 (1946), *aff'd in part & rev'd in part on other issues*, 165 F.2d 588 (5th Cir. 1948); *Gulf Oil Corp. v. Commissioner*, 3 T.C.M. 496 (1944), *aff'd by unpub. op.* (3d Cir. 1946); *Koppers Co. v. Commissioner*, 3 T.C.M. 204, 205 (1944), *aff'd without pub. op.*, 46-1 USTC ¶9206 (3d Cir. 1946); *Driscoll v. Commissioner*, 3 T.C.M. 73, 76 (1944), *modified on other issues*, 147 F.2d 493 (5th Cir. 1945); *Breyer v. Commissioner*, 3 T.C.M. 48, 51 (1944), *aff'd*, 151 F.2d 267 (3d Cir. 1945); *Webster v. Maloney*, 114 F. Supp. 726, 730 (D.N.J. 1953), *aff'd*, 213 F.2d 152 (3d Cir. 1954).

[831] *United States v. Norton*, 250 F.2d 902, 905–06 (5th Cir. 1958), *rev'g* 144 F. Supp. 425 (W.D. La. 1956); *Ewing v. Commissioner*, 27 T.C. 406, 412–13 (1956), *aff'd*, 254 F.2d 600 (6th Cir. 1958). *See* Rev. Rul. 58-374, *clarified*, Rev. Rul. 83-73.

[832] *Jergens v. Commissioner*, 17 T.C. 806, 809–10 (1951).

[833] *Central Elec. & Gas Co. v. United States*, 159 F. Supp. 353, 358 (Ct. Cl. 1958).

[834] Rev. Rul. 72-544.

[835] *Thompson v. United States*, 78-1 USTC ¶9193 (N.D. Okla. 1977).

[836] *Merritt v. Commissioner*, 23 T.C.M. 960, 964 (1964).

[837] *Williams v. Commissioner*, 3 T.C. 200, 202 (1944); *Sparks Farm, Inc. v. Commissioner*, 56 T.C.M. 464, 479 (1988); *Marcello v. Commissioner*, 23 T.C.M. 1847, 1862 (1964), *aff'd in part & rev'd in part on other issues*, 380 F.2d 499 (5th Cir. 1967), *cert. denied*, 389 U.S. 1044 (1968).

[838] *Larson v. Commissioner*, 44 B.T.A. 1094, 1104 (1941), *aff'd on other issues*, 131 F.2d 85 (9th Cir. 1942); *Grubbs v. Commissioner*, 59 T.C.M. 933, 937 (1990); *Halleran v. Commissioner*, 11 B.T.A.M. 1143, 1147 (1942); Rev. Rul. 71-179.

[839] *Arrigoni v. Commissioner*, 73 T.C. 792, 806 (1980).

[840] *Ligget v. Commissioner*, 4 T.C.M. 598, 601 (1945).

[841] *Marcello v. Commissioner*, 28 T.C.M. 959, 961–62 (1969).

[842] *Koppers Co. v. Commissioner*, 11 T.C. 894, 902–03 (1948), *modifying* 8 T.C. 886 (1947).

[843] *E.g., Teitelbaum v. Commissioner*, 346 F.2d 266, 270 (7th Cir. 1965), *aff'g* 23 T.C.M. 847 (1964); *Colston v. Commissioner*, 21 B.T.A. 396, 399 (1930), *aff'd*, 59 F.2d 867 (D.C. Cir. 1932), *cert. denied*, 287 U.S. 640 (1932); *Stewart v. Commissioner*, 8 B.T.A.M. 66, 68 (1939). *See Miller v. Commissioner*, 150 F.2d 823 (2d Cir. 1945), *aff'g* 3 T.C.M. 1079 (1944).

[844] Rev. Rul. 71-268. *See Castanedas-Benitez v. Commissioner*, 41 T.C.M. 1213, 1214–15 (1981).

[845] *See Keeter v. United States*, 957 F. Supp. 1160 (E.D. Cal. 1997).

[846] *Higgins v. Commissioner*, 16 T.C. 140, 143–44 (1951).

[847] *See Sachs v. Commissioner*, 14 T.C.M. 703, 706 (1955).

[848] *Evans v. Commissioner*, 5 T.C.M. 336, 345 (1946).

[849] *Neracher v. Commissioner*, 32 B.T.A. 236, 237 (1935).

[850] *Milgroom v. Commissioner*, 31 T.C. 1256, 1259 (1959) (applying provision of Massachusetts law repealed in 1979).

[851] *Johnson v. Commissioner*, 39 T.C.M. 868, 873 (1980), *aff'd without pub. op.* 652 F.2d 54 (2d Cir. 1981).

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jointly and severally liable merely by alleging that funds provided by the taxpayer to the former spouse were used to make the payment.[852] Also, no deduction is allowed to the taxpayer if the former spouse is liable for the debt and the taxpayer provides funds from which the former spouse pays the interest.[853] The deduction is allowed if the taxpayer is primarily liable on the debt and the divorce decree requires the taxpayer to provide the funds for that purpose.[854] The Tax Court has allowed a former husband to deduct a portion of his former wife's share of interest on a joint debt that he paid using his separate funds, even though community funds remained, because the former wife's bankruptcy made it unlikely the taxpayer would be reimbursed.[855]

c. Indebtedness Secured by Taxpayer's Property

(1) In General

A taxpayer is allowed to deduct otherwise deductible interest on a loan secured by a mortgage on the taxpayer's property even if the taxpayer is not otherwise liable on the note.[856] The taxpayer's method of accounting does not matter.[857] This principle applies even if the taxpayer transfers title to secure the loan instead of granting a mortgage.[858] Interest paid to release a lien on the taxpayer's condemned real property is deductible by the taxpayer.[859]

(2) Beneficial or Equitable Ownership

A taxpayer is allowed to deduct otherwise deductible interest on a mortgage secured by property that the taxpayer transfers to another person if the taxpayer can demonstrate that the taxpayer has retained a beneficial interest in the property.[860] The same conclusion applies to a taxpayer who acquires equitable or beneficial interest in property, but not legal title, and who pays interest on a loan secured by the taxpayer's interest in the property.[861] In *Uslu v. Commissioner*,[862] a married couple was held to have acquired an equitable interest in property legally owned by the husband's brother and his wife, because they made all of the interest payments, lived in the home, paid for all the other expenses without contribution from the brother and his wife, were the donees of an unrecorded quitclaim deed for the property, and would be liable if the brother and his wife sued them for not making interest payments. In *Hodgkins v. Commissioner*,[863] the Tax Court held that no deduction was available to taxpayers who held legal title, but who made no payments and who transferred the benefits and burdens of ownership in exchange for consideration.

A taxpayer obtains beneficial ownership when the taxpayer takes possession and assumes the benefits and burdens of ownership.[864] Thus, if the seller retains legal title to secure installment payments of the purchase price by the purchaser, the purchaser is allowed to deduct otherwise deductible interest on the indebtedness owed to the seller.[865] A taxpayer does not become equitable owner merely by making an earnest money deposit on the property.[866] However, a purchaser who assumes liability on a land sales contract and takes legal title after making all of the contractually required payments can readily demonstrate acquisition of beneficial ownership.[867] The Fourth Circuit reversed a Tax Court decision holding that benefits and burdens do not shift to a purchaser if the seller retains primary responsibility for making the interest payments, even though those payments correlate to the additional interest payments that the seller must make and even though at final settlement the purchaser is responsible for reimbursing the seller for taxes accrued from the original settlement date.[868]

No deduction is allowed for advances made by the taxpayer to the owner of record to pay the interest.[869]

(3) Condominiums

Owners of units in a condominium are allowed to deduct otherwise deductible interest paid on loans secured by mortgages on their interests in the condominium even though they do not own the property in fee simple.[870]

(4) Life Insurance Policies

An assignee of a life insurance policy is not allowed to deduct interest paid by the assignee which accrued on a policy loan made to the assignor before the assignment.[871] Interest paid by the assignee and accruing after the assignment is deductible by the assignee if it is otherwise deductible.[872] The assignors are not allowed to deduct interest on policy loans paid by the assignors and accruing after the assignment, if the assignors' obligations with respect to the loans terminate when the policies are assigned.[873]

d. Sellers and Purchasers

A seller is not allowed to deduct a loan discount paid to a money lender in order to assist the purchaser in obtaining a mortgage to finance the purchase, because the purchaser and not the seller is liable on the mortgage.[874] Likewise, a purchaser of property is not allowed to deduct mortgage interest ac-

[852] *Kazupski v. Commissioner*, 43 T.C.M. 1024, 1026 (1982).

[853] *See Colston v. Commissioner*, 21 B.T.A. 396, 399 (1930), *aff'd*, 59 F.2d 867 (D.C. Cir. 1932), *cert. denied*, 287 U.S. 640 (1932).

[854] *See Kohlsaat v. Commissioner*, 40 B.T.A. 528, 534–35 (1939). *See also Finney v. Commissioner*, 35 T.C.M. 1504, 1507–08 (1976).

[855] *See Ewell v. Commissioner*, 71 T.C.M. 3134 (1996).

[856] Reg. §1.163-1(b).

[857] *New McDermott, Inc. v. Commissioner*, 44 B.T.A. 1035, 1041 (1941), *nonacq.*, 1954-1 C.B. 8.

[858] *Lewis v. Commissioner*, 6 B.T.A.M. 182, 183 (1937).

[859] *Schoen v. Commissioner*, 30 B.T.A. 1075, 1079–80 (1934).

[860] *Conroy v. Commissioner*, 17 T.C.M. 21, 25 (1958).

[861] *E.g., Markward v. Commissioner*, 37 T.C.M. 1306, 1307 (1978); *Jacqueline, Inc. v. Commissioner*, 37 T.C.M. 937, 940 (1978), *supplementing* 36 T.C.M. 1363 (1977).

[862] 74 T.C.M. 1376 (1997).

[863] 71 T.C.M. 2017 (1996).

[864] *E.g., Riordan v. Commissioner*, 37 T.C.M. 839, 841–42 (1978).

[865] *Kindschi v. Commissioner*, 39 T.C.M. 638, 649 (1979).

[866] *Koehler v. Commissioner*, 37 T.C.M. 1563, 1566–67 (1978).

[867] *See Nelson v. Commissioner*, 66 T.C.M. 691 (1993).

[868] *See Kingstowne L.P. v. Commissioner*, 68 T.C.M. 1497 (1994), *rev'd sub nom. Halle v. Commissioner*, 83 F.3d 649 (4th Cir. 1996).

[869] *In re Farmers & Traders Bank*, 4 B.T.A. 753, 755 (1926).

[870] Rev. Rul. 64-31.

[871] *Fox v. Commissioner*, 43 B.T.A. 895, 899 (1941).

[872] *Fox*, 43 B.T.A. at 899.

[873] *Dean v. Commissioner*, 35 T.C. 1083, 1086 (1961), *nonacq.*, 1973-2 C.B. 4.

[874] *Gladu v. Commissioner*, 45 T.C.M. 269, 270 (1982); *Hunt v. Commissioner*, 24 T.C.M. 915, 916 (1965).

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crued before legal or equitable title passes, because the interest accrued on the seller's liability.[875] A second mortgagee is not allowed to deduct interest paid on the first mortgage after the commencement of foreclosure proceedings on the second mortgage and before the foreclosure sale, because the payments are made to acquire title.[876]

e. Corporations and Shareholders

(1) Corporation's Interest Paid by Shareholder

Shareholders are not allowed to deduct interest paid by them on the corporation's indebtedness.[877] It does not matter, with respect to interest attributable to the period during which only the corporation is liable, that the shareholder guarantees the loan for the period during which only the corporation is liable,[878] or becomes personally liable to the creditor when the corporation defaults.[879] Nor does it matter that the loan proceeds are used for the shareholder's personal benefit.[880] The same principles apply to any discount on a corporate draft drawn on the shareholder.[881] Nor can a shareholder deduct interest owed by the corporation as a trade or business expense if there is no relationship between the shareholder's trade or business and the interest payment.[882]

Whether the indebtedness is an indebtedness of the corporation, rather than that of the shareholder, is a question of fact.[883] Thus, interest payments made by a shareholder on a mortgage owed by the corporation are not deductible by the shareholder.[884] Indebtedness of the corporation guaranteed by the shareholders is not indebtedness of the shareholders.[885] However, if in substance the loan is the primary responsibility of the shareholders, though made directly to the corporation by the lender, the interest paid by the shareholders is interest on their own indebtedness.[886]

Generally, the indebtedness is not treated as the shareholders' merely by disregarding the corporation's existence.[887] Thus, the shareholder is not allowed to deduct interest on the corporation's indebtedness even if the corporation is formed only to obtain financing for the shareholder's projects, because the corporation's separate existence and its business activity of obtaining financing must be recognized.[888] The same result is reached even if the corporation is formed solely to limit the shareholder's liability and to permit proportionate property ownership.[889]

However, the Tax Court has held that if the corporation is formed solely to avoid usury laws and immediately reloans the amount it borrows to the shareholder, the shareholder is allowed to deduct the interest paid on the loan from the corporation.[890] If there is no loan from the corporation to the shareholder, interest paid by the shareholder on the loan to the corporation is not deductible by the shareholder.[891] The corporation is not treated as a shell if it continues to own and operate its assets after the financing transaction.[892]

In one case, the court allowed the shareholder to deduct interest on residential property placed in the name of a corporation solely for title transfer convenience purposes.[893] In another case, the court reached the same result principally because the shareholder and the corporation treated the property as belonging to the shareholder in their transactions with other persons.[894]

In *Stoneking v. Commissioner*,[895] the Tax Court allowed a shareholder to deduct interest on money borrowed by the shareholder from a third party and used to pay loans of the corporation on which she was a guarantor, because the loan was actually made to the shareholder and its proceeds constructively contributed by her to the corporation.[896] If the shareholders become personally liable on a debt of the corporation that they guaranteed, otherwise deductible interest accruing after they become liable and that is paid by them is deductible,[897] but interest attributable to before they become liable is not.[898] Thus, if after the bankruptcy of the corporation, the shareholders have a direct and fixed obligation to pay the loan, without recourse against the corporation, the otherwise deductible interest paid by the shareholders is deductible by them.[899]

Similarly, in *Leward Cotton Mills, Inc. v. Commissioner*,[900] the court held that shareholders who sold their stock and agreed to indemnify the corporation and the purchasers against any undisclosed liability were allowed to deduct interest on taxes subsequently assessed against the corporation.[901] Shareholders who become primarily liable under transferee liability provisions for the payment of taxes not paid by the corporation are allowed to deduct otherwise deductible interest on those taxes that they pay.[902]

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[875] *Koehler v. Commissioner*, 37 T.C.M. 1563, 1566 (1978).

[876] *Estate of Broadhead v. Commissioner*, 391 F.2d 841, 848 (5th Cir. 1968), *aff'g* 25 T.C.M. 133 (1966).

[877] *E.g.*, *Griffin v. Commissioner*, 7 B.T.A. 1094, 1095 (1927); *Boshwit Bros., Inc. v. Commissioner*, 43 T.C.M. 906, 910 (1982).

[878] *Scallen v. Commissioner*, 54 T.C.M. 177, 201 (1987), *aff'd on other issues*, 877 F.2d 1364 (8th Cir. 1989).

[879] *Hamrick v. Commissioner*, 40 T.C.M. 276, 277–78 (1980). *See* Rev. Rul. 74-592.

[880] *Reese v. Commissioner*, 35 T.C.M. 1228, 1230 (1976), *aff'd on other issues*, 615 F.2d 226 (5th Cir. 1980).

[881] *United States v. Collier*, 104 F.2d 420, 423–24 (5th Cir. 1939).

[882] *Cloud v. Commissioner*, 35 T.C.M. 95, 100–01 (1976).

[883] *E.g.*, *Post v. Commissioner*, 39 T.C.M. 311 (1979).

[884] *Golder v. Commissioner*, 604 F.2d 34, 36 (9th Cir. 1979).

[885] *Nelson v. Commissioner*, 281 F.2d 1, 6 (5th Cir. 1960).

[886] *Hawkins v. Commissioner*, 53 T.C.M. 138, 151 (1987).

[887] *E.g.*, *U.S. Fidelity & Guaranty Co. v. Commissioner*, 40 B.T.A. 1010, 1017 (1939).

[888] *Rogers v. Commissioner*, 34 T.C.M. 1254, 1257 (1975).

[889] *Munroe v. Commissioner*, 61 T.C.M. 1797, 1800 (1991).

[890] *Beran v. Commissioner*, 40 T.C.M. 163, 168 (1980).

[891] *See Byram v. United States*, 705 F.2d 1418, 1425–26 (5th Cir. 1983).

[892] *Crouch v. United States*, 692 F.2d 97, 100 (10th Cir. 1982).

[893] *Watson v. Commissioner*, 42 B.T.A. 52, 59–60 (1940), *nonacq.*, 1940-2 C.B. 14, *aff'd on other issues*, 124 F.2d 437 (2d Cir. 1942).

[894] *Lang v. Commissioner*, 46 T.C.M. 335, 343 (1983).

[895] 50 T.C.M. 1301 (1985).

[896] 50 T.C.M. at 1306.

[897] *See B.B. Rider Corp. v. Commissioner*, 725 F.2d 945, 951 (3d Cir. 1984), *aff'g in part & rem'g in part on other issues* 43 T.C.M. 637 (1982), *on remand*, 48 T.C.M. 1369 (1984), *rev'd sub nom Stratmore v. Commissioner*, 785 F.2d 419 (3d Cir. 1986).

[898] *Hamrick v. Commissioner*, 40 T.C.M. 276, 277–78 (1980). *See* Rev. Rul. 74-592.

[899] *Stratmore v. Commissioner*, 785 F.2d 419, 423 (3d Cir. 1986), *rev'g* 48 T.C.M. 1369 (1984).

[900] 245 F.2d 314 (4th Cir. 1957), *rev'g* 26 T.C. 885 (1956).

[901] 245 F.2d at 316.

[902] *Arrigoni v. Commissioner*, 73 T.C. 792, 806 (1980).

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Interest on corporate indebtedness paid by the shareholders is treated as a contribution by them to the capital of the corporation.[903]

(2) Shareholder's Interest Paid by Corporation

A corporation is not allowed to deduct interest paid on the shareholder's indebtedness.[904] This principle applies even if the shareholder incurred the loan in order to purchase the corporation's property.[905] However, a corporation is allowed to deduct otherwise deductible interest on its own indebtedness.[906]

Whether indebtedness is the corporation's or shareholder's is a question of fact.[907] Thus, a corporation was allowed to deduct interest on a loan incurred by the corporation in its name and in its capacity, the security for which was some or all of the corporation's assets, even though the corporation loaned the borrowed proceeds to its shareholders.[908] Likewise, a corporation is allowed to deduct otherwise deductible interest on a loan secured by a mortgage on property titled in the name of a shareholder if the corporation is equitable owner of the property and the shareholder holds title as an accommodation.[909] If a corporation is recognized as an independent entity, it, and not the shareholder, is allowed to deduct the interest on debt for which the corporation is liable because the debt is a debt of the corporation.[910]

In contrast, interest paid by a corporation on a shareholder's obligation to a former spouse incurred as part of a property settlement is not deductible by the corporation.[911] Similarly, a corporation is not allowed to deduct as a trade or business expense interest that it pays on a loan obtained by it and a shareholder to finance the shareholder's purchase of stock from a third person.[912]

In *United States v. Barwin Realty Co.*,[913] the U.S. District Court for the Eastern District of New York rejected an attempt to create an interest deduction for a corporation through a series of circular transactions that ostensibly created indebtedness secured by the corporation's property but with respect to which the corporation was not liable.[914] The court held that the corporation was a dummy formed to evade state laws for the convenience of the shareholders, that no valid corporate indebtedness was created by the transactions, and that amounts paid as interest to the shareholders on the alleged corporate debt were not deductible even though creditors were entitled to otherwise deductible interest payments with respect to the debts secured by the property and with respect to which the shareholders were personally liable.[915]

(3) Officer's Interest Paid by Corporation

A corporation is not allowed to deduct interest that it pays on a loan made to one of its officers by a third party, even though it promised to pay the interest when the officer transferred to it property acquired with the proceeds of the loan.[916]

(4) Corporation's Payment of Interest on Subsidiary's Debt

A corporation is not allowed to deduct its payment of interest owed by its subsidiary, because the payment is a capital expenditure[917] by the corporation to protect its investment in the subsidiary.[918] The same result is reached even if the interest is paid with respect to a debt of the subsidiary that the parent corporation guaranteed.[919] However, if the parent becomes liable with respect to the debt, such as assuming the debt when the subsidiary is merged into it, the parent is allowed to deduct the interest that it pays.[920]

(5) Subsidiary's Payment of Parent Corporation's Debt

A subsidiary is allowed to deduct otherwise deductible interest paid with respect to a loan made to the subsidiary but subsequently assumed by the parent under conditions obligating the subsidiary to continue paying the interest.[921]

(6) Corporation's Payment of Interest on Predecessor's Debt

A corporation is allowed to deduct otherwise deductible interest on a debt of its predecessor with respect to which it assumes liability.[922]

f. Landlords and Tenants

A lessee is not allowed to deduct interest paid on outstanding installment obligations incurred by the lessor when the lessor acquired the property under lease because the lessee is not obligated to make the interest payments.[923]

g. Trusts, Fiduciaries, and Beneficiaries

Trust beneficiaries are not allowed to deduct interest paid on the trust's debts if they are not liable on the debt and their property does not secure the debt.[924] It does not matter if the beneficiary is a guarantor of the debt.[925]

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[903] *Reese v. Commissioner*, 35 T.C.M. 1228, 1230 (1976), *aff'd on other issues*, 615 F.2d 226 (5th Cir. 1980).

[904] *E.g., Mann v. Commissioner*, 33 B.T.A. 281, 290 (1935), *nonacq.*, 1936 C.B. 37; *Compressed Paper Box Corp. v. Commissioner*, 6 B.T.A.M. 515, 517 (1937).

[905] *Enoch v. Commissioner*, 57 T.C. 781, 794 (1972).

[906] *Arcade Realty Co. v. Commissioner*, 35 T.C. 256, 263 (1960).

[907] *E.g., Murphy Logging Co. v. United States*, 378 F.2d 222, 224 (9th Cir. 1967), *rev'g* 239 F. Supp. 794 (D. Or. 1965).

[908] *Arcade Realty Co. v. Commissioner*, 35 T.C. 256, 263 (1960).

[909] *Republic Petroleum Corp. v. United States*, 397 F. Supp. 900, 923 (E.D. La. 1975), *aff'd in part & rev'd in part on other issues*, 613 F.2d 518 (5th Cir. 1980).

[910] *See Jouvaud v. Commissioner*, 1 T.C.M. 287 (1942).

[911] *House of Carpets, Inc. v. Commissioner*, 32 T.C.M. 1239, 1244 (1973).

[912] *Miles v. Commissioner*, 25 T.C.M. 1278, 1283–84 (1966).

[913] 25 F.2d 1003 (E.D.N.Y. 1928), *aff'd*, 29 F.2d 1019 (2d Cir. 1928).

[914] 25 F.2d at 1004.

[915] 25 F.2d at 1004.

[916] *Orange Sec. Corp. v. Commissioner*, 45 B.T.A. 24, 31 (1941), *aff'd on other issues*, 131 F.2d 662 (5th Cir. 1942).

[917] Capital expenditures are discussed in 509 T.M., *Principles of Capitalization*.

[918] *Pa. Forge Co. v. Commissioner*, 2 T.C.M. 723, 726–27 (1943).

[919] *Eskimo Pie Corp. v. Commissioner*, 4 T.C. 669, 675 (1945), *aff'd*, 153 F.2d 301 (3d Cir. 1946).

[920] Rev. Rul. 78-230.

[921] *Peerless Realty Co. v. Commissioner*, 6 B.T.A.M. 341, 343 (1937).

[922] *See Princess Coals, Inc. v. United States*, 239 F. Supp. 401, 413 (S.D. W. Va. 1965).

[923] *Anderson Dairy, Inc. v. Commissioner*, 39 T.C. 1027, 1044 (1963).

[924] *O'Brien v. Commissioner*, 47 B.T.A. 561, 564 (1942).

[925] *Hynes v. Commissioner*, 74 T.C. 1266, 1288 (1980).

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h. Partners and Partnerships

Partners are allowed to deduct their allocable portion of otherwise deductible interest payments made on a loan to the partnership, even though the partnership distributed the loan proceeds to a corporation of which the partners were shareholders.[926] Advances to a syndicate for purposes of its paying interest are not deductible by the person making the advance.[927]

5. Taxes

a. In General

(1) Imposition of Economic Burden of the Tax

Generally, taxes are deductible only by the taxpayer upon whom they are imposed.[928] The critical determination is not whether the taxpayer is the person on whom the tax is nominally imposed, but whether the burden of the tax is borne by the taxpayer.[929] In *Peterman v. Commissioner*,[930] for example, a taxi driver was not permitted to deduct taxes collected from passengers and remitted to the driver's employer because the taxes were not imposed on the driver.[931] In a similar type of case, *Arrigoni v. Commissioner*,[932] the court held that an employer is not entitled to deduct state income taxes withheld from employees' pay because the tax is imposed on the employee and not the employer, who is acting as the state's "collection agent" in withholding the taxes.[933]

In *Farnsworth v. Commissioner*,[934] the Third Circuit held that a former partner of a dissolved partnership was not allowed to deduct state taxes imposed on the partnership to the extent of the fractional shares of the other partners because the partner voluntarily renounced the right to contribution from the other partners of a tax for which they were jointly and severally liable.[935]

(2) Effect of Contract

A taxpayer who pays the income taxes of another company without being contractually obligated to do so is not allowed to deduct those taxes as a cost of earning income from a contract with that other company to sell and service its products.[936]

b. Payment Through Agent

The tax may be paid through an agent. Thus, in *Hradesky v. Commissioner*,[937] the court held that a mortgagor who paid amounts into escrow with the mortgagee was entitled to deduct real estate taxes paid by the mortgagee on the mortgagor's behalf when the mortgagee paid the taxes; the fact that the mortgagor was contractually compelled to pay the taxes to the mortgagee did not make the tax deductible when paid to the mortgagee.[938] In *Galt v. Commissioner*,[939] the same result was reached with respect to voluntary payments into an escrow account.[940] In *Peters v. Commissioner*,[941] the court permitted the taxpayer to deduct real estate taxes paid by third party intermediaries because the taxes were the taxpayer's obligation and the payments were made specifically for the purpose of paying the taxes.[942]

Comment: A taxpayer may lose the deduction if the documentation fails to demonstrate that the taxpayer's agent paid the taxes on behalf of the taxpayer.

In *Howlett v. Commissioner*,[943] the taxpayer was not permitted to deduct purported tax payments made to a company managing properties that the taxpayer had an option to purchase because the taxpayer failed to show that the payments were made for real estate tax purposes or that the manager ever paid any part of the payments to the taxing jurisdiction.[944] Similarly, in *Schultz v. Commissioner*,[945] the taxpayer prepaid Kentucky ad valorem taxes incident to the purchase of bulk whiskey, but made the payment to the seller and did not prove that the funds were remitted to the state.[946]

In *Johnson v. Commissioner*,[947] the court held that a husband was not permitted, under §164, to deduct real estate taxes paid by his estranged wife, who was the sole owner of the property.[948]

c. Payment on Behalf of Corporations

Under the general rule, a parent corporation is not permitted to deduct taxes it pays on behalf of a subsidiary.[949] In *El Paso Nat'l Bank v. United States*,[950] a parent corporation was not permitted to deduct property taxes paid by it but which were imposed on the property of its subsidiary even though it was paying the taxes on behalf of itself as a shareholder.[951] Similarly, in *Rink v. Commissioner*,[952] a shareholder was not permitted to deduct the corporation's taxes paid by the shareholder.[953]

In *Young v. Commissioner*,[954] the court held that no deduction was allowed for a taxpayer who paid real property taxes owed by an unrelated corporation, even though the corporation

[926] *Marcello v. Commissioner*, 28 T.C.M. 959, 961–62 (1969).
[927] *Mendelsohn v. Commissioner*, 8 B.T.A.M. 234, 241–42 (1939).
[928] Reg. §1.164-1(a).
[929] Rev. Rul. 69-497.
[930] 23 T.C.M. 388 (1964).
[931] 23 T.C.M. at 390.
[932] 73 T.C. 792 (1980).
[933] 73 T.C. at 802.
[934] 270 F.2d 660 (3d Cir. 1959), *aff'g* 29 T.C. 1131 (1958), *cert. denied*, 362 U.S. 902 (1960).
[935] 270 F.2d at 666.
[936] *Nat'l Piano Mfg. Co. v. Burnet*, 50 F.2d 310, 311 (D.C. Cir. 1931), *aff'g* 11 B.T.A. 46 (1928).
[937] 65 T.C. 87 (1975), *aff'd per curiam*, 540 F.2d 821 (5th Cir. 1976).
[938] 65 T.C. at 91.
[939] 31 B.T.A. 930 (1934).
[940] 31 B.T.A. at 931–32.
[941] 29 T.C.M. 1440 (1970).
[942] 29 T.C.M. at 1441–42.
[943] 56 T.C. 951 (1971).
[944] 56 T.C. at 961.
[945] 50 T.C. 688 (1968), *aff'd per curiam*, 420 F.2d 490 (3d Cir. 1970).
[946] 50 T.C. at 697.
[947] 39 T.C.M. 868 (1980), *aff'd without op.*, 652 F.2d 54 (2d Cir. 1981).
[948] 39 T.C.M. at 873.
[949] *Cooperstown Corp. of Md. v. Commissioner*, 4 T.C.M. 819, 820 (1945).
[950] 335 F. Supp. 490 (W.D. Tex. 1971), *aff'd per curiam*, 453 F.2d 1313 (5th Cir. 1972).
[951] 335 F. Supp. at 492.
[952] 51 T.C. 746 (1969), *acq.*, 1969-2 C.B. XXIII.
[953] 51 T.C. at 751–52. *Accord*, *Vesey v. Commissioner*, 33 T.C.M. 697, 702 (1974); *Cloud v. Commissioner*, 33 T.C.M. 597, 599 (1974).
[954] 49 T.C.M. 981 (1985).

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subsequently transferred the properties to business entities in which the taxpayer had interests.[955]

d. Real Property

Generally, only the owner of real property is entitled to deduct real property taxes[956] on the property because those taxes are the liability[957] of the owner.[958] In *Cramer v. Commissioner*,[959] the court denied the deduction to a taxpayer who paid real estate taxes on property in which the taxpayer had no present interest.[960] However, it should be noted that where one taxpayer gratuitously pays the real property taxes for another taxpayer who actually owns the real property, the taxpayer who owns the property would be entitled to the deduction for the real estate taxes paid on the property.[961]

In order to deduct real property taxes, the obligation for the payment must arise from an interest in the property and not from a contractual relationship with a third party. In *Macdonald v. Commissioner*,[962] the court held that the taxpayer could not deduct real estate taxes on his aunt's property paid under court order, because the taxpayer's obligation being enforced by the court order was an agreement to let him live rent-free in the property provided he paid the expenses, and the taxpayer did not own the property.[963] In contrast, in *Willamette Valley Lumber Co. v. United States*,[964] the court held that the taxpayer could deduct ad valorem taxes on land and timber which it had obligated itself to pay under a contract to purchase the timber, because under state law the contractual obligation justified regarding the taxpayer as "owner" of the land even though the taxes were paid by the seller and billed to the taxpayer.[965] However, in *Small v. Commissioner*,[966] the court held that the taxpayer's obligation under an agreement with the taxpayer's mortgagee-creditor to guarantee payment of the taxes was insufficient to permit the taxpayer to deduct the taxes,[967] and in *Kohlsaat v. Commissioner*,[968] the same result was reached with respect to a taxpayer who agreed in a separation agreement to pay taxes imposed on property owned by the taxpayer's spouse.[969]

Two revenue rulings demonstrate the significance of the legal incidence of the tax. In Rev. Rul. 64-327, the IRS ruled that Hawaii real estate taxes imposed on a lessee of Hawaiian real property who holds the property under a lease of at least 15 years are deductible by the lessee; the Hawaii statutes were subsequently amended to provide that the tax was the liability of the lessee.[970] In Rev. Rul. 75-301, the IRS ruled that even though a landlord was permitted to pass real estate tax increases onto tenants under a rent control ordinance, the tenants were not allowed to deduct the "tax surcharge" because the real estate taxes remained the liability of the landlord, and the tenants were not paying the taxes as such to preserve their beneficial interests.

However, a taxpayer who owns a beneficial interest in property and who pays taxes thereon to protect that interest may deduct the taxes, assuming they are deductible taxes, even though legal title is in another.[971] In Rev. Rul. 67-21, the IRS ruled that a taxpayer who transferred his residence to a church, reserving a term interest and agreeing to pay real property taxes during the term, was permitted to deduct the taxes paid by him during the term.[972] In Rev. Rul. 73-531, the IRS ruled that real estate taxes imposed on and paid by a taxpayer with a terminable life estate in certain real property of his employer were deductible by the taxpayer.[973] In Rev. Rul. 74-408, the IRS ruled that foreign real property taxes imposed on the taxpayer entitled to the beneficial but not legal ownership of a condominium were deductible by the taxpayer even though legal title was in a trust.[974] In *Powell v. Commissioner*,[975] the court held that a taxpayer owning an undivided one-sixth interest in property owned in tenancy-in-common with her siblings and paying the entire real property tax imposed on the property was entitled to deduct the tax because under Texas law the taxpayer's interest would be extinguished if only one-sixth of the tax were paid. The court described the test as whether the taxpayer by paying the tax satisfied a personal liability or protected a personal right or beneficial interest in the property.[976] In Rev. Rul. 68-84, the IRS ruled that a lessee of real property whose name is placed on the tax rolls as co-assessee with the owner may deduct real estate taxes paid by the lessee.[977]

Statutory provisions affecting the deduction of real property taxes by sellers and purchasers of real estate are described in III.C.5., below.

e. Spouses

In *Buff v. Commissioner*,[978] the court held that a real estate tax paid by a taxpayer on a home owned solely by the taxpayer's spouse was not deductible by the taxpayer on a separate return.[979] In Rev. Rul. 71-268, the IRS had ruled that if property is held by spouses as tenants by the entirety and they file separate returns, each may deduct only that portion he or she actually pays.[980] The Tax Court has allowed a former husband to

[955] 49 T.C.M. at 982–83.
[956] Reg. §1.164-3(b).
[957] *See* Reg. §1.164-6 (apportionment of taxes on real property between seller and purchaser).
[958] *See DeVere v. Commissioner*, 35 T.C.M. 28, 29 (1976); *Anderson v. Commissioner*, 33 T.C.M. 234, 238 (1974), *aff'd per curiam*, 527 F.2d 198 (9th Cir. 1975).
[959] 55 T.C. 1125 (1971), *acq.*, 1971-2 C.B. 2.
[960] 55 T.C. at 1127–28.
[961] *See Lang v. Commissioner*, 100 T.C.M. 603 (2010) (where mother paid the real property taxes for daughter, Tax Court applied substance-over-form doctrine to treat taxpayer as having received from her mother a gift of the amount paid for the real estate taxes with which the taxpayer paid to the city in satisfaction of her own real estate taxes).
[962] 35 T.C.M. 346 (1976).
[963] 35 T.C.M. at 347–48.
[964] 252 F. Supp. 199 (D. Ore. 1966).
[965] 252 F. Supp. at 206.
[966] 27 B.T.A. 1219 (1933).
[967] 27 B.T.A. at 1223.
[968] 40 B.T.A. 528 (1939).
[969] 40 B.T.A. at 535–36.
[970] 40 B.T.A. at 57.
[971] *Estate of Movius v. Commissioner*, 22 T.C. 391, 394–95 (1954), *acq.*, 1954-2 C.B. 5.
[972] Rev. Rul. 67-21.
[973] Rev. Rul. 73-531.
[974] Rev. Rul. 74-408.
[975] 26 T.C.M. 161 (1967).
[976] 26 T.C.M. at 165–67.
[977] Rev. Rul. 68-84.
[978] 58 T.C. 224 (1972), *rev'd on other issues*, 469 F.2d 847 (2d Cir. 1974).
[979] 58 T.C. at 233.
[980] Rev. Rul. 71-268.

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deduct a portion of his former wife's share of property taxes that he paid using his separate funds, even though community funds remained, because the former wife's bankruptcy made it unlikely the taxpayer would be reimbursed.[981]

With respect to state income taxes, the IRS in Rev. Rul. 74-486,[982] set forth three principles concerning the deduction of state income taxes by spouses who file separate federal or state income tax returns. First, if the spouses file separate federal and state income tax returns, each spouse deducts on his or her federal return the state income tax he or she pays.[983] Second, if the spouses file separate state income tax returns and a joint federal income tax return, the spouses deduct the sum of the state income taxes each pays.[984] In Rev. Rul. 75-47, the IRS amplified this principle by ruling that it does not matter which spouse actually pays the state income taxes.[985] Third, if the spouses file a joint state income tax return and separate federal income tax returns, each spouse deducts the portion of the state income tax paid that the gross income of each spouse bears to combined gross income, but not more than the tax actually paid by the spouse.[986] However, if the spouses are jointly and severally liable for the state income tax, the amount paid by each spouse is deductible by each spouse.[987]

f. Trusts and Estates

In *Clough v. Commissioner*,[988] the court held that an income tax imposed on an estate was not deductible by the testamentary trust that paid it.[989] In *Goldberg v. Commissioner*,[990] the court held that an income tax imposed on an estate was not deductible by the legatee who paid it.[991]

g. Banks and Depositors

In Rev. Rul. 69-497, the IRS ruled that a Rhode Island tax imposed on customer deposits in banks is deductible by the depositor, assuming the account is used in carrying on a trade or business or in a for-profit activity, if the bank elects to pay the tax without seeking reimbursement; the depositor, of course, also must recognize gross income as a consequence of the bank's decision to forego reimbursement, and the bank is entitled to a §162 deduction.[992] In Rev. Rul. 77-418,[993] the IRS ruled that a bank paying the taxes of a depositor must waive its right to reimbursement in order to deduct the tax under §162, and that the depositor must recognize gross income and is allowed a deduction under §164.[994] The IRS suspended this ruling in 1979 when the state law was changed to impose the tax on the financial institution, thus permitting a §164 deduction by the institution.[995]

Observation: In view of the ruling in Rev. Rul. 77-418, it appears that the corporation should formally waive any right to reimbursement by the shareholder even though the statute and the regulations do not so require.

h. Substantiation

In order to sustain the deduction of a tax paid by the taxpayer, the taxpayer must prove that the tax was imposed on the taxpayer or borne by the taxpayer and not by some other person. In *Buff v. Commissioner*[996] and *Moyer v. Commissioner*,[997] the courts denied a deduction for taxes, because the taxpayer failed to demonstrate that he paid the taxes or was legally responsible for their payment.[998] In *Johnson v. Commissioner*,[999] the Tax Court extended the principle in holding that the taxpayer did not prove that the taxes were imposed on him merely because his separation agreement with his wife required him to pay real estate taxes on a home solely owned by her.[1000] In *Von Tersch v. Commissioner*,[1001] the court denied a deduction for personal property taxes despite the taxpayer's testimony that he paid them; the court had advised the taxpayer during the trial to write to the tax assessor for the records, but the court never received any information from the taxpayer.[1002]

6. Losses

a. In General

Losses that are otherwise deductible are deductible only by the taxpayer who incurs the loss.[1003] Thus, in *Medeiros v. Commissioner*,[1004] a taxpayer who entered into a conditional oral agreement to acquire the stock of a corporation, and who paid the corporation's penalty for failure to withhold employment taxes, was not allowed to deduct the payment as a loss, because the taxpayer was not an officer, director, employee, or shareholder of the corporation and thus did not have a relationship that imposed any obligation on the taxpayer to bear the burden of the loss.[1005]

b. Lack of Ownership

(1) In General

A taxpayer is not allowed to deduct losses arising from the destruction of property or damage to property unless the taxpayer owns the property.[1006] Thus, one spouse is not allowed to deduct losses arising with respect to the other spouse's proper-

[981] *See Ewell v. Commissioner*, 71 T.C.M. 3134 (1996). *See Ritter v. Commissioner*, 71 T.C.M. 1748 (1996) (husband allowed deduction for taxes paid with separate funds).

[982] *Clarified*, Rev. Rul. 75-47.

[983] Rev. Rul. 74-486.

[984] Rev. Rul. 74-486.

[985] Rev. Rul. 75-47.

[986] Rev. Rul. 75-47.

[987] Rev. Rul. 75-47.

[988] 45 B.T.A. 97 (1941).

[989] 45 B.T.A. at 98.

[990] 15 T.C. 696 (1950).

[991] 15 T.C. at 697.

[992] Rev. Rul. 69-497.

[993] *Clarified*, Rev. Rul. 78-337.

[994] Rev. Rul. 77-418.

[995] Rev. Rul. 79-357.

[996] 58 T.C. 224 (1972), *rev'd on other grounds*, 469 F.2d 847 (2d Cir. 1974).

[997] 35 T.C.M. 304 (1976), *aff'd without pub. op.*, 565 F.2d 152 (3d Cir. 1977).

[998] 58 T.C. at 233; 35 T.C.M. at 315.

[999] 39 T.C.M. 868 (1980), *aff'd without pub. op.*, 652 F.2d 54 (2d Cir. 1981).

[1000] 39 T.C.M. at 873.

[1001] 31 T.C.M. 938 (1972).

[1002] 31 T.C.M. at 939.

[1003] *See, e.g.*, *Messenger Corp. v. Smith*, 136 F.2d 172, 174 (7th Cir. 1943), *rev'g* 42 USTC ¶9641 (N.D. Ind. 1942).

[1004] 77 T.C. 1255 (1981).

[1005] 77 T.C. at 1262.

[1006] *E.g.*, *Glasgow Village Dev. Corp. v. Commissioner*, 36 T.C. 691, 702 (1961). *See Feistman v. Commissioner*, 44 T.C.M. 30 (1982); *Kennedy v. Commissioner*, 32 T.C.M. 52, 57 (1973).

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ty.[1007] Similarly, a parent is not allowed to deduct losses with respect to a child's property.[1008] However, the Fourth Circuit and the Tax Court have held that this restriction does not apply to a parent for losses with respect to property necessary for the support of a child whom the parent has a legal obligation to support.[1009]

A taxpayer is not allowed to deduct as a loss the amount of damages caused by the taxpayer to another person's property.[1010] An S corporation shareholder is not allowed to deduct losses arising from damage to property not owned by the shareholder or by the S corporation.[1011]

A taxpayer who knowingly purchases stolen property, and thus is not the legal owner, is not entitled to claim a loss deduction when the property is confiscated by authorities.[1012] Losses with respect to property owned by a shareholder and purportedly included in the inventory of a corporation owned by the shareholder, but which does not deal in the type of property involved, are not deductible by the corporation.[1013]

(2) Property Under Contract of Sale

A taxpayer who owns legal title to property that is destroyed and who has entered into a contract to sell the property is allowed to deduct otherwise deductible losses arising from its destruction, because the taxpayer had the right to repossess the property if the purchaser breached the contract.[1014] Similarly, the purchaser is allowed to deduct the portion of the loss borne by the purchaser to the extent the purchaser assumes the risk of loss and has an equitable interest in the property.[1015]

(3) Determination of Ownership

The issue of whether the taxpayer owns the property is a factual one.[1016] Otherwise deductible losses with respect to investments owned and controlled by the taxpayer, but placed into the names of the taxpayer's children, are deductible by the taxpayer.[1017] A taxpayer to whom another person owes money does not own that other person's property absent a conveyance to the taxpayer, and thus the taxpayer is not allowed to deduct losses with respect to that property.[1018]

c. Corporations and Shareholders

(1) Corporate Activities

(a) Separate Business Operations

Shareholders are not allowed to deduct losses incurred by a corporation that is conducting its own business on its own behalf, except to the extent the losses pass through from an S corporation.[1019] It does not matter that the losses are financed with loans advanced by the shareholders.[1020] A corporation that has its own bank account, uses its own name, holds itself out as a corporation, and conducts business activities is operating in a manner that strongly suggests the shareholders are not operating the business as partners,[1021] and it does not matter that the corporation failed to file returns.[1022] The same principles apply to losses incurred by a trust classified as an association for tax purposes.[1023]

Otherwise deductible losses incurred by a corporation that is properly organized and operated as a separate entity are deductible by the corporation and not by those who form and own it.[1024] Thus, the shareholders of a corporation are not allowed to claim a loss deduction arising from the corporation's purchase of notes fraudulently made by third parties who did not intend to pay the notes, even though the corporation purchased the notes with money loaned to it by the shareholders.[1025] A shareholder is not permitted to claim a bad debt deduction for payments made on a corporate note on which the shareholder was not liable.[1026]

(b) Separate Property and Assets

Shareholders are not allowed to claim a theft loss deduction arising from an officer's theft of corporate property[1027] or an officer's misappropriation of corporate funds.[1028] No deduction is allowed to the shareholder even if the theft of the corporate property causes a decline in the value of the shareholders' stock.[1029] Members of a tax- exempt incorporated club are not allowed to deduct a casualty loss arising from damage to the club's property.[1030]

Shareholders are not allowed to deduct losses arising from the breach of a covenant not to compete executed in favor of

[1007] *Loewenstein v. Commissioner*, 27 T.C.M. 1112, 1113 (1968).

[1008] *Draper v. Commissioner*, 15 T.C. 135 (1950); *White v. Commissioner*, 41 T.C.M. 1429, 1430 (1981); *Smith v. Commissioner*, 38 T.C.M. 322, 326 (1979); *Sukenick v. Commissioner*, 14 T.C.M. 95, 96 (1955). *See Roman v. Commissioner*, 73 T.C.M. 2375 (1997), *aff'd without published op.*, 149 F.3d 1191 (10th Cir. 1998) (taxpayer was custodian, not owner).

[1009] *Scharf v. Commissioner*, 32 T.C.M. 1281, 1283–84 (1973), *aff'd without published op.*, 535 F.2d 1250 (4th Cir. 1976).

[1010] *Dosher v. United States*, 730 F.2d 375, 377 (5th Cir. 1984).

[1011] *DuPont v. United States*, 234 F. Supp. 681, 691 (D. Del. 1964).

[1012] *Gutierrez v. Commissioner*, 42 T.C.M. 1108, 1111 (1981).

[1013] *J.S.M. Enters. v. Commissioner*, 48 T.C.M. 138, 142 (1984).

[1014] *Randall v. Commissioner*, 37 T.C.M. 950, 951 (1978).

[1015] *Collins v. United States*, 193 F. Supp. 602, 610 (D. Mass. 1961), *rev'd on other issues*, 300 F.2d 821 (1st Cir. 1962); *modified by R.P. Collins & Co. v. United States*, 303 F.2d 142 (1st Cir. 1962).

[1016] *E.g., Silverman v. Commissioner*, 50 T.C.M. 1226, 1229 (1985).

[1017] *Silverman*, 50 T.C.M. at 1229.

[1018] *Ratcliff v. Commissioner*, 39 T.C.M. 886, 889 (1980), *aff'd in unpub. op.* 636 F.2d 1203 (2d Cir. 1980), *cert. denied*, 452 U.S. 906 (1981).

[1019] *Watson v. Commissioner*, 124 F.2d 437, 439 (2d Cir. 1942).

[1020] *Weigman v. Commissioner*, 47 T.C. 596, 606 (1967), *aff'd per curiam*, 400 F.2d 584 (9th Cir. 1968).

[1021] *Brints v. Commissioner*, 57 T.C.M. 1405, 1407 (1989).

[1022] *Reed v. Commissioner*, 74 T.C.M. 1300 (1997).

[1023] *Wenger v. Commissioner*, 13 T.C.M. 24, 28 (1954).

[1024] *Nixon v. Lucas*, 42 F.2d 833, 834 (2d Cir. 1930).

[1025] *Silverman v. Commissioner*, 34 T.C.M. 1094 (1975), *aff'd without pub. op.* 538 F.2d 320 (3d Cir. 1976).

[1026] *See Yei v. Commissioner*, 73 T.C.M. 1891 (1997).

[1027] *Jasinski v. Commissioner*, 37 T.C.M. 1, 2 (1978).

[1028] *Jensen v. Commissioner*, 39 T.C.M. 163, 167 (1979).

[1029] *Munson v. Commissioner*, 39 T.C.M. 1101, 1105 (1980).

[1030] *Orr v. Commissioner*, 19 T.C.M. 789, 790 (1960); *Hine v. Tomlinson*, 63-1 USTC ¶9142 (M.D. Fla. 1962), *rev'd on other issues*, 329 F.2d 462 (5th Cir. 1964); *West v. United States*, 163 F. Supp. 739, 740 (E.D. Pa. 1958), *aff'd per curiam*, 259 F.2d 704 (3d Cir. 1958).

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the corporation.[1031] Nor are they allowed to deduct losses arising from the expiration of an option held by the corporation.[1032]

A corporation that assumes liability for a contract is allowed to deduct otherwise deductible losses arising from the contract.[1033] This is so even though the shareholders originally enter into the contract, provided the shareholders transfer the contract to the corporation and are relieved of all liability with respect to it.[1034]

The dissolution of a corporation is not the same as the distribution of its assets, and until the distribution occurs, any deductible losses are those of the corporation.[1035]

(c) Formalities of Incorporation

A shareholder is not allowed to deduct losses arising from the operation of a business by a corporation that fails to hold organizational meetings, if the corporation is incorporated and functioning as a separate entity before the losses are incurred.[1036] Technical noncompliance with incorporation statutes does not make a corporation's loss deductible by the shareholders if the corporation functions and operates as a viable separate entity.[1037] It does not matter that the corporation was formed merely to avoid usury laws.[1038] In contrast, if no assets of the business are transferred to the corporation and the corporation's name is not used in the daily operations of the business, the business is that of the shareholders and not of the corporation, and any otherwise deductible losses are deductible by the shareholders.[1039]

(2) Shareholder Activities

(a) In General

A corporation is not allowed to deduct losses arising from the separate conduct of a trade or business by its shareholders.[1040] The fact that the trade or business is conducted on the corporation's premises does not in and of itself make the trade or business the corporation's or the loss deductible by the corporation.[1041]

A corporation is not allowed to deduct a loss arising from its payment of a third party's debt guaranteed by its shareholders.[1042] Nor is a corporation allowed to deduct losses arising from the payment of a note endorsed by its shareholder in the shareholder's individual capacity.[1043] A corporation is not allowed to deduct a casualty loss arising from the destruction of property owned by a shareholder, even if the corporation advanced funds for its purchase.[1044]

(b) Corporation as Conduit

If the corporation is a mere conduit for the conduct of the shareholder's activities, otherwise deductible losses are deductible by the shareholder and not the corporation.[1045] If the shareholder conducts the business, and the corporation's participation is minimal at best, any otherwise deductible loss is deductible by the shareholder.[1046] Likewise, if the corporation merely holds title to real property used by the shareholder in the shareholder's trade or business, the otherwise deductible losses from that business are deductible by the shareholder.[1047]

Similar principles apply if the corporation is inactive and the shareholder does not transfer any of the business assets to it.[1048] If the shareholder continues to retain ownership of the assets and continues to operate the business, it does not matter that the corporate name is used.[1049]

(c) Shareholder Assumption of Corporate Business

If a shareholder agrees to assume the corporation's business by assuming its obligations and acquiring rights to the income, the losses are deductible by the shareholder in carrying on the trade or business of performing services under the contract with the corporation.[1050] However, if the shareholder acts as an agent for the corporation, the shareholder is not entitled to deduct losses incurred by the corporation.[1051]

(3) Related Corporations

(a) Subsidiaries

A parent corporation is not allowed to deduct a loss arising from the sale of an asset by its wholly owned subsidiary.[1052] It does not matter if the subsidiary is liquidated after incurring the loss.[1053] However, an otherwise deductible loss that arises after the liquidation is deductible by the parent if the parent is legally required to make the payment that generates the loss.[1054]

If the subsidiary is formed merely to hold title to real property, then any deduction is the parent's.[1055] However, if the subsidiary is acting on its own behalf through the conduct of busi-

[1031] *Markwardt v. Commissioner*, 64 T.C. 989, 995 (1975).
[1032] *Leuthold v. Commissioner*, 54 T.C.M. 1308, 1314–15 (1987).
[1033] *Robert G. Lassiter & Co. v. Commissioner*, 16 B.T.A. 1151, 1157 (1929), *acq.*, 1931-1 C.B. 40.
[1034] *Robert G. Lassiter & Co.*, 16 B.T.A. at 1157.
[1035] *Krome v. Commissioner*, 9 T.C.M. 178, 195 (1950).
[1036] *Richards v. Commissioner*, 53 T.C.M. 1016, 1019–20 (1987).
[1037] *Hvidsten v. United States*, 185 F. Supp. 856, 865 (D.N.D. 1960).
[1038] *Jones v. Commissioner*, 640 F.2d 745, 754 (5th Cir. 1981).
[1039] *Bystry v. United States*, 596 F. Supp. 574, 580 (W.D. Wis. 1984).
[1040] *Blue Flame Gas Co. v. Commissioner*, 54 T.C. 584, 600 (1970); *Angier v. Commissioner*, 17 B.T.A. 1081, 1083 (1929), *acq.*, 1931-1 C.B. 2.
[1041] *Rota-Cone Oil Field Operating Co. v. Commissioner*, 171 F.2d 219, 222 (10th Cir. 1948), *aff'g* 6 T.C.M. 892 (1947).
[1042] *Tennessee Sec., Inc. v. Commissioner*, 674 F.2d 570, 574 (6th Cir. 1982), *aff'g* 37 T.C.M. 1803 (1978).
[1043] *United States v. Ward*, 15 AFTR 498 (D. Idaho 1925).
[1044] *Von Hessert v. Commissioner*, 20 T.C.M. 1119, 1126 (1961).
[1045] *Stringfellow v. United States*, 246 F. Supp. 474, 475 (W.D. Wash. 1965). *See McGinley Corp. v. Commissioner*, 82 F.2d 56, 57 (5th Cir. 1936), *aff'g* 31 B.T.A. 266 (1934); *Juniper Inv. Co. v. United States*, 338 F.2d 356, 360 (Ct. Cl. 1964).
[1046] *Estate of Faris v. Commissioner*, 14 T.C.M. 1061, 1064–65 (1955).
[1047] *Roberts v. Commissioner*, 7 T.C.M. 599, 606–07 (1948).
[1048] *De Vore v. Commissioner*, 13 B.T.A. 1376, 1379 (1928), *acq.*, VII-1 C.B. 12 (1931).
[1049] *In re Barry*, 48 B.R. 600 (Bankr. M.D. Tenn. 1985), *aff'd by unpub. order* (6th Cir. 1987).
[1050] *Wiggin v. Commissioner*, 46 F.2d 743, 745 (1st Cir. 1931), *rev'g* 19 B.T.A. 282 (1930); *Ripley v. Commissioner*, 26 T.C. 1203, 1209 (1956).
[1051] *Estate of Rosset v. Commissioner*, 13 T.C.M. 1193, 1200 (1954).
[1052] *Thomas J. Corcoran Lamp Co. v. Commissioner*, 24 B.T.A. 284, 286–87 (1931), *appeal dismissed*, 61 F.2d 1041 (6th Cir. 1932).
[1053] *Patten Fine Papers, Inc. v. Commissioner*, 249 F.2d 776, 781 (7th Cir. 1957), *aff'g in part & rev'g in part* 27 T.C. 772 (1957).
[1054] *Avco Mfg. v. Commissioner*, 25 T.C. 975, 989 (1956), *rem'd by* stipulation, 57-2 USTC ¶10,021 (2d Cir. 1957), *acq.*, 1957-1 C.B. 3.
[1055] *North Jersey Title Ins. Co. v. Commissioner*, 84 F.2d 898, 901 (3d Cir. 1936), *rev'g* 3 B.T.A.M. 34–166 (1934).

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ness activity in its own name, the parent is not allowed the deduction.[1056]

If a subsidiary is acting as the parent's agent, then any otherwise deductible loss is deductible by the parent.[1057] However, this is not the case if the subsidiary is acting on its own behalf.[1058]

(b) Reorganizations

In *Prudential Loan Co. v. Commissioner*,[1059] the Board of Tax Appeals held that a corporation was allowed to deduct a loss from the sale of an asset acquired in a reorganization, even though the corporation from which it acquired the asset had contracted for its sale.[1060] In *Federation Bank & Trust Co. v. Commissioner*,[1061] the Tax Court held that a reorganized bank was allowed to deduct losses arising from the sale of assets acquired by the bank in the reorganization.[1062]

d. Trusts and Estates

(1) Beneficiaries

The beneficiaries of a trust are not allowed to deduct losses incurred by the trust.[1063] The rationale is that the beneficiaries do not own the trust property, even though they have an interest in it.[1064] Until the trust terminates, the trust is entitled to any loss deductions.[1065]

Note: Under §642(h), the termination of a trust or estate entitles the beneficiaries to deduct certain unused deductions of the trust or estate.[1066] The §642(h) deduction allowance is discussed in 852 T.M., *Income Taxation of Trusts and Estates* (Estates, Gifts, and Trusts Series).

(2) Grantors

Generally, grantors are not allowed to deduct losses incurred by a trust with respect to property conveyed to the trust.[1067] This principle does not apply to taxpayers who are, or who are treated as, grantors of grantor trusts.[1068] Grantor trusts are described in III.C.3.a., below, and are discussed in detail in 819 T.M., *Grantor Trusts: Income Taxation Under Subpart E* (Estates, Gifts, and Trusts Series).

(3) Decedents

Losses incurred in a business conducted by a taxpayer while alive are deducted on the taxpayer's final income tax return and not by the estate.[1069]

e. Life Tenants

In *Steinert v. Commissioner*,[1070] the Tax Court held that a life tenant was allowed to deduct losses arising from a casualty to the property, to the extent of cleaning-up expenses and the portion of the loss allocable to the life interest.[1071] In *Bliss v. Commissioner*,[1072] the Second Circuit, in reversing the Tax Court, held that the entire amount of a casualty loss to the property was deductible by the life tenant because the facts and the will of the grantor demonstrated that no portion of the loss was borne by the holder of the remainder interest.[1073]

f. Joint Owners

An otherwise deductible loss arising with respect to property held by taxpayers as joint owners is allocated among them in proportion to their ownership interests.[1074] Joint ownership does not exist if property is purchased by and held solely in the name of another taxpayer;[1075] nor does it exist if one of the two owners endorses it to the other owner before the taxable year in which the loss arises.[1076] An ownership arrangement that is in the form of joint ownership is not treated in that manner for tax purposes if the property is acquired by, operated by, and controlled by one person and the other person is named as owner merely for convenience.[1077]

Otherwise deductible losses with respect to property that is held by spouses as tenants by the entirety are allocated one-half to each spouse.[1078] The fact that one spouse provided all the funds to acquire the property does not change this result.[1079]

g. Lessors and Lessees

Generally, a lessee is not allowed to deduct a loss arising with respect to the leased property because the lessor is the owner.[1080] However, to the extent the lessee is obligated to bear the burden of the loss under the lease, the lessee is allowed to deduct the loss assuming it is otherwise deductible.[1081] Thus, if a lessee, who is under an obligation to return the property in good order and condition, is held liable to the lessor for the amount

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[1056] *Sarkisian v. Commissioner*, 43 T.C.M. 1074, 1081 (1982).

[1057] *Custom Casing Co. v. Commissioner*, 2 T.C.M. 58, 76 (1943), *aff'd per curiam on other issues sub nom. Hygrade Food Prods. Corp. v. Commissioner*, 144 F.2d 115 (2d Cir. 1944).

[1058] *Mills v. Commissioner*, 132 F.2d 753, 756 (1st Cir. 1943), *cert. denied*, 319 U.S. 770 (1943), *aff'g Smithfield Co. v. Commissioner*, 11 B.T.A.M. 845 (1942).

[1059] 37 B.T.A. 975 (1938), *acq.* 1939-2 C.B. 30.

[1060] 37 B.T.A. at 982.

[1061] 27 T.C. 960 (1957), *aff'd per curiam*, 256 F.2d 764 (2d Cir. 1958), *acq.* 1969-2 C.B. xxiii.

[1062] 27 T.C. at 972.

[1063] *Widener v. Commissioner*, 8 B.T.A. 651, 659 (1927), *aff'd*, 33 F.2d 833 (3d Cir. 1929); *Haley v. Commissioner*, 6 B.T.A. 782, 784 (1927); *Studebaker v. Commissioner*, 2 B.T.A. 1020, 1027 (1925).

[1064] *See Smietanka v. Commissioner*, 41 T.C.M. 451, 455 (1980).

[1065] *Swoboda v. United States*, 258 F.2d 848, 850 (3d Cir. 1958).

[1066] §642(h); Reg. §1.642(h)-1.

[1067] *E.g., Watkins v. Commissioner*, 38 T.C.M. 1062, 1064 (1979); *Hays v. Commissioner*, 11 T.C.M. 461, 466 (1952); *Kalm v. Commissioner*, 5 T.C.M. 728, 729 (1946).

[1068] §671–§679.

[1069] Rev. Rul. 74-175.

[1070] 33 T.C. 447 (1959).

[1071] 33 T.C. at 450–51.

[1072] 256 F.2d 533 (2d Cir. 1958), *rev'g* 27 T.C. 770 (1957).

[1073] 256 F.2d at 535.

[1074] *See Kincheloe v. Commissioner*, 41 T.C.M. 437, 444 (1980).

[1075] *DuBois v. Commissioner*, 51 T.C.M. 895, 901 (1986).

[1076] *See Bloch v. Commissioner*, 6 B.T.A. 563, 564 (1927), *acq.* 1931-X-1 C.B. 6.

[1077] *Parker v. Commissioner*, 39 B.T.A. 423, 428–29 (1939), *acq.* 1939-2 C.B. 28.

[1078] *Kraus v. Commissioner*, 10 T.C.M. 1071, 1077 (1951); *Anderson v. Commissioner*, 7 T.C.M. 811, 812 (1948); Rev. Rul. 75-347.

[1079] *Reynolds v. Commissioner*, 26 T.C. 1225, 1240 (1956), *aff'd on other issues*, 249 F.2d 259 (4th Cir. 1957); *Morley v. Commissioner*, 8 T.C. 904, 918 (1947); *Finney v. Commissioner*, 35 T.C.M. 1504, 1508 (1976).

[1080] *E.g., Orlando Three Inc. v. Commissioner*, 45 T.C.M. 687, 690 (1983).

[1081] *Gyro Eng'g Corp. v. Commissioner*, 33 T.C.M. 1343, 1351 (1974).

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of damage to the property, the lessee is allowed to deduct the loss to the extent it is otherwise deductible.[1082]

7. Depreciation and §179 Expense Deductions

a. In General

(1) Burden of Risk of Economic Loss

The Supreme Court has held, in *Weiss v. Weiner*,[1083] that any otherwise deductible depreciation is allowable only to the taxpayer who is in a position to bear any economic loss that arises from any decrease in the value of the property.[1084] The Court noted that mere ownership under local law is insufficient in and of itself to entitle the owner to any depreciation deduction.[1085] The same principle applies to §179 expense deductions.[1086]

(2) Capital Investment

No deduction for depreciation is allowed to a taxpayer if the taxpayer does not have a capital investment in the depreciable property.[1087] It does not matter that the taxpayer uses borrowed money to make the investment.[1088] A creditor with a security interest in property has not made a capital investment in that property,[1089] and this result is not changed even if the creditor becomes a mortgagee in possession.[1090] An owner of property that is stolen is not allowed to deduct depreciation because the property is not used by the owner in a trade or business or profit-seeking activity.[1091]

Comment: Because depreciation is allowed only to the taxpayer who bears the risk of loss and has made an investment in the property, the thief should not be allowed to claim depreciation deductions with respect to the stolen property.

(3) Rights to Income from Another's Property

In *Miller v. Commissioner*,[1092] the Tax Court held that a taxpayer who acquired a development corporation's rights to payment under a leaseback of property leased by the corporation to a third party was not allowed to deduct depreciation with respect to the property because the capital investment was made by the third party, which bore the burden of any loss from depreciation.[1093] A taxpayer who acquires a right to net profits from a property is purchasing an intangible contractual right and not the property, and thus is precluded from claiming depreciation with respect to the property.[1094]

A taxpayer who acquires a right to payments contingent on the success of property protected by copyright does not acquire the copyright and is not the taxpayer allowed to depreciate the copyright.[1095] The deduction is allowed to the seller, if the seller retains complete and exclusive control[1096] or if the ownership rights are immediately retransferred to the seller,[1097] and to a creditor if the copyright is assigned to the creditor.[1098] The purchaser is allowed to deduct depreciation with respect to the intangible contract right to the extent of the actual investment made in it.[1099]

b. Loss of Ownership

(1) Governmental Seizure

No depreciation is allowed to the owner of record of property for the period between the date of condemnation and the date on which the governmental authority paid the condemnation proceeds.[1100] No depreciation is allowed to a taxpayer for taxable years during which the property is in the possession of a governmental unit following a requisition order.[1101] Likewise, no depreciation deduction is allowed with respect to property forfeited to a governmental unit because it was used in illegal activities.[1102]

(2) Property Transferred to Public Use

No depreciation is allowed to a taxpayer with respect to property dedicated to public use.[1103] However, a taxpayer is allowed to depreciate improvements made on its property even though it grants a right of way in the improvements to a governmental unit, provided the expenditures for the improvements benefit the taxpayer's other property.[1104] Amounts paid for special assessments for public improvements are not depreciable by the taxpayer because the taxpayer has no ownership rights in the improvements.[1105]

[1082] Rev. Rul. 73-41.

[1083] 279 U.S. 333 (1929), *rev'g* 27 F.2d 200 (6th Cir. 1928), *rev'g* 17 F.2d 650 (N.D. Ohio 1926).

[1084] 279 U.S. at 336.

[1085] 279 U.S. at 337.

[1086] *See Duaine v. Commissioner*, 49 T.C.M. 588, 591–92 (1985).

[1087] *Commissioner v. Revere Land Co.*, 169 F.2d 469, 475 (3d Cir. 1948), *rev'g* 7 T.C. 1061 (1946), *cert. denied*, 335 U.S. 853 (1948). *See Railey v. Commissioner*, 36 B.T.A. 543, 548 (1937).

[1088] *Machen v. Commissioner*, 25 T.C.M. 990, 991 (1966).

[1089] *Villa v. Commissioner*, 40 T.C.M. 938, 941 (1980).

[1090] *See Murray v. Commissioner*, 21 T.C. 1049, 1062 (1954), *aff'd on other issues*, 232 F.2d 742 (9th Cir. 1956), *cert. denied*, 352 U.S. 872 (1956).

[1091] *See Francis v. Commissioner*, 8 T.C.M. 346, 352 (1949) (depreciation denied if ownership not proven).

[1092] 68 T.C. 767 (1977).

[1093] 68 T.C. at 776.

[1094] *Bailey v. Commissioner*, 912 F.2d 44, 47–51 (2d Cir. 1990), *aff'g in part & vac'g in part* 90 T.C. 558 (1988); *Markin v. Commissioner*, 58 T.C.M. 994, 1001–02 (1989); *Meister v. Commissioner*, 56 T.C.M. 440, 447 (1988); *Schwartz v. Commissioner*, 54 T.C.M. 11, 25 (1987), *aff'd without op.*, 930 F.2d 920 (9th Cir. 1991).

[1095] *Durkin v. Commissioner*, 872 F.2d 1271, 1275–76 (7th Cir. 1989), *aff'g* 87 T.C. 1329, 1368–70 (1986), *cert. denied*, 493 U.S. 824 (1989); *Law v. Commissioner*, 86 T.C. 1065, 1100 (1986); *Tolwinsky v. Commissioner*, 86 T.C. 1009, 1041–42 (1986); *Carnegie Prods., Inc. v. Commissioner*, 59 T.C. 642, 653 (1973). *See Leahy v. Commissioner*, 87 T.C. 56, 67 (1986).

[1096] *E.g.*, *Law v. Commissioner*, 86 T.C. 1065, 1100 (1986).

[1097] *Durkin v. Commissioner*, 872 F.2d 1271, 1275–76 (7th Cir. 1989), *aff'g* 87 T.C. 1329 (1986), *cert. denied*, 493 U.S. 824 (1989).

[1098] *E.g.*, *Carnegie Prods., Inc. v. Commissioner*, 59 T.C. 642, 653 (1973).

[1099] *E.g.*, *Brown v. Commissioner*, 56 T.C.M. 638, 651 (1988), *aff'd by unpub. op.* (9th Cir. 1990).

[1100] *Barbour v. Commissioner*, 44 B.T.A. 1117, 1121–22 (1941), *rev'd on other issues*, 136 F.2d 486 (6th Cir. 1943), *cert. denied*, 320 U.S. 778 (1943); *Covered Wagon, Inc. v. Commissioner*, 24 T.C.M. 427, 431 (1965), *supp.* on other issues, 24 T.C.M. 641 (1965), *aff'd in part & rem'd in part on other issues*, 369 F.2d 629 (8th Cir. 1966).

[1101] *Cohn v. Westover*, 125 F. Supp. 184 (S.D. Cal. 1954).

[1102] *Holmes Enters. v. Commissioner*, 69 T.C. 114, 118 (1977).

[1103] *Algernon Blair, Inc. v. Commissioner*, 29 T.C. 1205, 1221 (1958).

[1104] *Clinton Cotton Mills, Inc. v. Commissioner*, 78 F.2d 292, 296 (4th Cir. 1935), *rev'g* 28 B.T.A. 1312 (1933), *on remand*, 5 B.T.A.M. 284, 286 (1936).

[1105] *F.M. Hubbell Son & Co. v. Burnet*, 51 F.2d 644 (8th Cir. 1931), *cert. denied*, 284 U.S. 664 (1931), *aff'g* 19 B.T.A. 612 (1930).

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c. Use by Others

The owner of record is not precluded from claiming any otherwise allowable depreciation deduction merely because other persons are using the property, if the owner bears the burden of any loss from the property's decline in value.[1106] However, if the owner acquires the property in a transaction that includes a leaseback to the seller and the transaction is disregarded as a sham, the alleged owner is not allowed to claim the depreciation deduction.[1107] The tax treatment of sales and leasebacks is discussed in detail in 593 T.M., *Real Estate Leases.*

A taxpayer who acquires property subject to a lease is allowed to deduct depreciation with respect to the property, even though not entitled to possession, because the benefits and burdens of ownership pass from the selling landlord to the taxpayer, but this principle does not apply if the taxpayer negotiates a purchase price that reflects the depreciated value of the property at the end of the existing lease.[1108] Depreciation with respect to returnable containers is deductible by the seller of the goods shipped therein until the purchaser's failure to return the containers within the designated period is treated as a loss, provided title to the containers does not pass to the purchaser, deposits are accounted for separately, and sales invoices clearly state that the containers are the seller's property.[1109]

d. Placement on Property of Others

The owner of property is not precluded from claiming any otherwise allowable depreciation deduction merely because the property is located on land owned by another person.[1110]

e. Property Owned by Others

A taxpayer who expects to purchase property in a subsequent taxable year is not allowed to deduct depreciation with respect to that property before the purchase.[1111] A taxpayer who leases property with an option to purchase is not allowed to deduct depreciation with respect to that property before the option is exercised.[1112] A taxpayer who has a contractual right to purchase property but who is not liable for the purchase price until the satisfaction or waiver of all conditions precedent is not allowed to deduct depreciation with respect to the property until the sale contract is executed.[1113] Accommodation purchasers are not allowed to claim depreciation because there is no intent to shift the benefits and burdens of ownership to them.[1114] A purchase has not occurred if the property is not transferred to the taxpayer, the taxpayer does not make payments to the seller, and the property has not yet been produced.[1115]

In *Hodgkins v. Commissioner*,[1116] the Tax Court held that depreciation deductions were not allowable to taxpayers who held legal title, but who made no payments and who transferred the benefits and burdens of ownership in exchange for consideration. Similarly, a corporation is not permitted to deduct depreciation on properties that it transfers to purchasers because legal title was transferred, the transaction was structured as a sale, the purchasers paid taxes and insurance, the purchasers had the right to transfer or lease the properties, and the corporation's repurchase obligation did not cause it to retain the benefits and burdens of ownership.[1117]

f. Corporations, Shareholders, and Subsidiaries

No depreciation deduction is allowed to a corporate shareholder with respect to corporate property used exclusively for corporate business,[1118] even if the shareholders hold security interests in the property.[1119] Likewise, the shareholder of a corporation is not allowed to deduct §179 expense deductions with respect to property acquired by and owned by the corporation.[1120] A corporation is not allowed to deduct depreciation with respect to property owned by its shareholders.[1121] Merely providing funds to the shareholder does not cause the corporation to have a capital investment in property acquired by the shareholder with those funds.[1122] Likewise, making contributions toward the shareholder's expenses in operating the property does not give the corporation a capital investment in the property.[1123]

A subsidiary is allowed to deduct depreciation with respect to property owned by it, even though its parent may have received income from the subsidiary's business.[1124] A successor corporation is not allowed to deduct depreciation with respect to leasehold improvements that it occupies and that were constructed by a predecessor corporation, if it does not acquire the

[1106] *Moyer v. Commissioner*, 9 T.C.M. 1043, 1047 (1950), *aff'd per curiam*, 193 F.2d 876 (3d Cir. 1952).

[1107] *W.H. Armston Co. v. Commissioner*, 188 F.2d 531, 534 (5th Cir. 1951), *aff'g* 12 T.C. 539 (1949).

[1108] *Wagner v. Commissioner*, 518 F.2d 655, 659 (10th Cir. 1975), *rev'g* 33 T.C.M. 201 (1974).

[1109] *See* Rev. Rul. 75-34, *revoking* Rev. Rul. 58-77; Rev. Proc. 79-44. *See also Buck v. Commissioner*, 83 F.2d 627, 629 (9th Cir. 1936); *U.S. Indus. Alcohol Co. v. Commissioner*, 42 B.T.A. 1323, 1354–57 (1940), *aff'd in part & rev'd in part on other grounds*, 137 F.2d 511 (2d Cir. 1943).

[1110] Rev. Rul. 54-579.

[1111] *Seale v. Commissioner*, 9 T.C.M. 48, 50 (1950).

[1112] *Lambert v. United States*, 409 F. Supp. 1015, 1018 (W.D. Va. 1976). *See* Rev. Rul. 78-411.

[1113] *Walter v. Commissioner*, 753 F.2d 35, 39 (6th Cir. 1985).

[1114] *Kinzler v. Commissioner*, 21 T.C.M. 341, 344 (1962).

[1115] *See Schwartz v. Commissioner*, 68 T.C.M. 63 (1994), *aff'd*, 80 F.3d 558 (D.C. Cir. 1996).

[1116] 71 T.C.M. 2017 (1996).

[1117] *Highland Farms, Inc. v. Commissioner*, 106 T.C. 237 (1996).

[1118] *E.g., Evans v. Commissioner*, 557 F.2d 1095, 1100 (5th Cir. 1977), *aff'g* 33 T.C.M. 1192 (1974), *supp.* on other issues, 34 T.C.M. 783 (1975); *Rink v. Commissioner*, 51 T.C. 746, 753 (1969); *Hunter v. Commissioner*, 46 T.C. 477, 490–92 (1966); *Estate of Cady v. Commissioner*, 60 T.C.M. 685, 686 (1990); *Bistrup v. Commissioner*, 40 T.C.M. 1289, 1291 (1980); *Am. Rolbal Corp. v. Commissioner*, 13 T.C.M. 540, 547 (1954), *aff'd per curiam*, 220 F.2d 749 (2d Cir. 1955).

[1119] *See Bowden v. Commissioner*, 72 T.C.M. 96 (1996).

[1120] *Duaine v. Commissioner*, 49 T.C.M. 588, 592 (1985).

[1121] *Greenspoon v. Commissioner*, 23 T.C. 138, 152 (1954), *aff'd in part & rev'd in part on other grounds*, 229 F.2d 947 (8th Cir. 1956); *Borkowski v. Commissioner*, 43 T.C.M. 593, 602 (1982); *Von Hessert v. Commissioner*, 20 T.C.M. 1119, 1126 (1961).

[1122] *Extrusions Div., Inc. v. Commissioner*, 68 T.C.M. 1423 (1994). *See also Extrusions Div., Inc. v. Commissioner*, 70 T.C.M. 314 (1995), *aff'd without pub. op.*, 100 F.3d 956 (6th Cir. 1996) (same).

[1123] *Allied Marine Sys., Inc. v. Commissioner*, 73 T.C.M. 2124 (1997), *aff'd per curiam sub nom., Gibbons v. Commissioner*, 155 F.3d 558 (4th Cir. 1998).

[1124] *Ry. Express Agency, Inc. v. Commissioner*, 8 T.C. 991, 1011 (1947), *aff'd on other grounds*, 169 F.2d 193 (2d Cir. 1948), *cert. denied*, 336 U.S. 944 (1949).

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leasehold, because it has not made any investment in the improvements.[1125]

g. Purchasers and Sellers

(1) In General

If the purchaser of property assumes the benefits and burdens of ownership, the purchaser, and not the seller, is entitled to any depreciation deduction, even if the seller retains title as security[1126] or for advertising and promotional reasons.[1127] If benefits and burdens are not transferred until the final closing, any depreciation deduction for the period between the preliminary closing and the final closing is allowable to the seller and not to the purchaser.[1128]

Thus, a taxpayer who acquires property, makes payments on the purchase mortgage, and is treated as owner is allowed to claim depreciation with respect to the property even though passage of title is delayed for legal reasons.[1129] A taxpayer who obtains equitable ownership in property for substantially all of its entire life is allowed to deduct depreciation with respect to the property.[1130]

A taxpayer who leases property to another person under the terms of which the benefits and burdens of ownership pass to the tenant is not allowed to deduct depreciation with respect to the property because the transaction is treated as a sale.[1131]

(2) Default and Rescission

However, if the purchaser defaults and abandons the property to the seller, the seller may claim any otherwise allowable depreciation deductions.[1132] If the purchaser sues for rescission, the seller cannot claim depreciation so long as the purchaser retains the benefits and burdens of ownership.[1133]

(3) Period Preceding Ownership

Similarly, no depreciation is allowed to a purchaser of property for the period preceding the date on which the property is transferred, in depreciated condition, to the purchaser.[1134] No depreciation is allowed for the period before the benefits and burdens of ownership pass, even though the purchaser is in possession, because use and maintenance of property are incidents of possessory rights and not of ownership.[1135]

h. Lessors and Lessees

(1) In General

Generally, lessors and not lessees are the taxpayers entitled to claim depreciation deductions with respect to the leased property.[1136] It does not matter that the lessee is required to maintain the property in good and safe condition.[1137]

(2) Shifting of Burden of Loss Risk to Lessee

However, the lessor is not allowed to claim depreciation deductions if the lessee is required to return the property in a condition that is the physical equivalent of the leased property at the inception of the lease.[1138] Nor is the lessor allowed depreciation deductions if the lessee is required to return the property in first-class condition.[1139]

(3) Leasehold Improvements

Lessors are not allowed to deduct depreciation with respect to leasehold improvements of which they take possession at the end of a lease because they have not made any investment in them.[1140] It does not matter that the lessor loans to the lessee the funds needed to pay for the improvements.[1141]

Lessees are allowed to deduct depreciation with respect to improvements made by them so long as they retain an economic interest in the improvements, even if the property has been condemned.[1142] It does not matter if the lease is canceled if the lessee has possession of the improvements.[1143]

Note: Permitting the lessee to continue depreciating the improvements after the property has been condemned appears inconsistent with the weight of authority denying deductions to

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[1125] *Bonwit Teller, Inc. v. Commissioner*, 46 B.T.A. 978, 984–85 (1942), *aff'd*, 136 F.2d 978 (2d Cir. 1943), *cert. denied*, 320 U.S. 794 (1943).

[1126] *J.I. Morgan, Inc. v. Commissioner*, 30 T.C. 881, 893 (1958), *rev'd on other grounds*, 272 F.2d 936 (9th Cir. 1959); *T.K. Harris Co. v. Commissioner*, 38 B.T.A. 383, 387 (1938), *aff'd on other grounds*, 112 F.2d 76 (6th Cir. 1940); *Proctor v. Commissioner*, 42 T.C.M. 725, 759 (1981); *Exolon Co. v. United States*, 15 AFTR 719 (D. Mass. 1931); Rev. Rul. 69-89.

[1127] *Persson v. Commissioner*, 58 T.C.M. 409, 423 (1989).

[1128] *See Derr v. Commissioner*, 77 T.C. 708, 726 (1981).

[1129] *Jacqueline, Inc. v. Commissioner*, 37 T.C.M. 937, 940 (1978), *supplementing* 36 T.C.M. 1363 (1977).

[1130] Rev. Rul. 60-122; Rev. Rul. 55-542; Rev. Rul. 55-541; Rev. Rul. 55-540.

[1131] *Calbom v. Commissioner*, 41 T.C.M. 1009, 1014 (1981).

[1132] *Kohinoor Coal Co. v. Commissioner*, 15 T.C.M. 403, 406 (1956).

[1133] *Maier Brewing Co. v. Commissioner*, 54 T.C.M. 46, 63 (1987), *aff'd by unpub. op.*, 916 F.2d 716 (9th Cir. 1990).

[1134] *Fox River Paper Co. v. Commissioner*, 28 B.T.A. 1184, 1204 (1933).

[1135] *Barker v. United States*, 668 F. Supp. 1199, 1204–05 (C.D. Ill. 1987).

[1136] *E.g.*, *Nw. Acceptance Corp. v. Commissioner*, 58 T.C. 836, 850 (1972), *aff'd per curiam*, 500 F.2d 1222 (9th Cir. 1974); *Lake Forest, Inc. v. Commissioner*, 22 T.C.M. 156, 159 (1963). *See Trustees of Graceland Cemetery Improvement Fund v. United States*, 515 F.2d 763, 778–79 (Ct. Cl. 1975).

[1137] *Alaska Realty Co. v. Commissioner*, 141 F.2d 675, 676–78 (6th Cir. 1944), *rev'g* in part & *rem'd in part* 2 T.C.M. 190 (1943); *Gulf, Mobile & N. R.R. Co. v. Commissioner*, 83 F.2d 788, 791 (5th Cir. 1936), *cert. denied*, 299 U.S. 574 (1936), *rev'g* in part & *rem'd in part* 4 B.T.A.M. 313 (1935); *Terminal Realty Corp. v. Commissioner*, 32 B.T.A. 623, 629–30 (1935), *nonacq.*, 1939-2 C.B. 65; *N.C. Midland Ry. Co. v. United States*, 163 F. Supp. 610, 613 (Ct. Cl. 1958).

[1138] *Ga. Ry. & Elec. Co. v. Commissioner*, 77 F.2d 897, 898 (5th Cir. 1935), *cert. denied*, 296 U.S. 601 (1935); *Commissioner v. Terre Haute Elec. Co.*, 71 F.2d 1001 (7th Cir. 1934); *Miss. River & Bonne Terre Ry. v. Commissioner*, 39 B.T.A. 995, 1003 (1939); *Terre Haute Elec. Co. v. Commissioner*, 33 B.T.A. 975 (1934), *aff'd in part & rem'd in part* 96 F.2d 383 (7th 1938); *Terre Haute, Indianapolis & E. Traction Co. v. Commissioner*, 24 B.T.A. 197, 211–12 (1931), *rev'd on other issues sub nom.*, *Commissioner v. Terre Haute Elec. Co.*, 67 F.2d 697 (7th Cir. 1933), *cert. denied*, 292 U.S. 624 (1934).

[1139] *Royal St. Louis, Inc. v. United States*, 578 F.2d 1017, 1019–20 (5th Cir. 1978), *aff'g* 76-2 USTC ¶9698 (E.D. La. 1976). *See Hibernia Nat'l Bank v. United States*, 740 F.2d 382, 387 (5th Cir. 1984), *rev'g* 569 F. Supp. 5 (E.D. La. 1983).

[1140] *Reisinger v. Commissioner*, 2 T.C.M. 163, 167 (1943), *aff'd*, 144 F.2d 475 (2d Cir. 1944); *Halleran v. Commissioner*, 11 B.T.A.M. 1143, 1150 (1942); *First Nat'l Bank of Kansas City v. Nee*, 85 F. Supp. 840, 843 (W.D. Mo. 1949), *aff'd*, 190 F.2d 61 (8th Cir. 1951).

[1141] *Buzzell v. United States*, 326 F.2d 825, 826 (1st Cir. 1964), *aff'g Barnes v. United States*, 222 F. Supp. 960 (D. Mass. 1963); *Currier v. Commissioner*, 51 T.C. 488, 493 (1968).

[1142] *Moses Lake Homes, Inc. v. Commissioner*, 23 T.C.M. 1756, 1764 (1964).

[1143] *Glazer Steel Corp. v. United States*, 388 F.2d 990, 993 (Ct. Cl. 1967) (per curiam).

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the owner after the date of condemnation.[1144] The only possible distinction is that the lessee has full use of the improvements until settlement, whereas the owner loses the right to sell or lease as of the date of condemnation.

(4) Acquisition of Lessor's Interest by Lessee

If the lessee acquires the lessor's interest, the lessee is allowed to deduct any otherwise allowable depreciation with respect to the interest acquired.[1145] Otherwise, the lessee has no capital investment in the property on which to base depreciation deductions.[1146]

i. Life Estates and Remainders

Under §167(d), depreciation deductions allowable with respect to property held by a life tenant with remainder to another person are allowed to the life tenant.[1147] The holder of the remainder is not allowed to claim depreciation until the life tenant dies and the holder of the remainder becomes a fee simple owner.[1148]

Note: In contrast, for purposes of determining gain or loss from the disposition of the life estate, the life tenant is treated as though the adjusted basis in the life estate is zero.[1149]

If the life tenant transfers the life estate to the holder of the remainder, the life tenant is not allowed to claim depreciation deductions with respect to the transferred interest.[1150] Otherwise allowable depreciation deductions with respect to improvements constructed by the life tenant are allowed to the life tenant.[1151]

j. Trusts and Estates

Under §167(d), depreciation with respect to property held in trust must be apportioned between the income beneficiaries and the trustee in accordance with the terms of the governing instrument[1152] or, if there are no such terms, in proportion to the trust income allocated to the beneficiaries and trustee.[1153] Depreciation with respect to property held by an estate must be apportioned between the estate and the heirs, legatees, and devisees in proportion to the estate income allocated to them.[1154] Depreciation with respect to property transferred to a trust, the income from which is included in the gross income of the transferor under the grantor trust rules[1155] must be apportioned to the transferor.[1156]

The depreciation allocated to a beneficiary may exceed the beneficiary's share of trust or estate income.[1157] If all income is payable to the beneficiary, the depreciation deduction is allocated to the beneficiary even if in a particular year the trust has no income from the property.[1158] It does not matter whether the beneficiary's share of the income is distributed or not.[1159]

The apportionment of depreciation between trustees and trust beneficiaries and between estates and beneficiaries is discussed in 856 T.M., *Subchapter J — Throwback Rules* (Estates, Gifts, and Trusts Series).

k. Determination of Taxpayer Entitled to Depreciation

The question of whether the taxpayer is the person entitled to depreciation with respect to a particular property is a question of fact.[1160] Taxpayers claiming depreciation deductions bear the burden of showing that the burdens of ownership have passed to them[1161] and the burden of proving when that passage occurred.[1162] Thus, if a transfer of property to the taxpayer is a sham because there is no intent to transfer the benefits and burdens of ownership, the taxpayer is not allowed to deduct depreciation with respect to the property.[1163]

If the taxpayer does not have legal title to property, there is prima facie evidence that the taxpayer does not bear the burdens of ownership, and the taxpayer is not allowed to claim depreciation with respect to the property unless the taxpayer proves actual ownership.[1164] A taxpayer who bears construction, insurance, and financing responsibilities can demonstrate actual ownership despite not having legal title.[1165]

If title to property is in the name of another person, who also has possession and use of the property, the taxpayer's burden of demonstrating actual ownership is almost impossible to satisfy.[1166]

Note: The IRS will usually not issue advance rulings on the question of who is entitled to claim depreciation on property if title is held by a party other than the formal owner, unless the holding of title is for security purposes.[1167]

8. Charitable Contribution Deductions

a. In General

A taxpayer is not allowed to deduct charitable contributions made by a dependent from gifts provided to the dependent by the taxpayer, because the contribution is a result of the de-

[1144] *See* III.B.7.b.(1), above.

[1145] *Wilshire Med. Props., Inc. v. United States*, 314 F.2d 333 (9th Cir. 1963) (per curiam), *rem'g* 61-1 USTC ¶9446 (D. Cal. 1961).

[1146] *See Dab v. Commissioner*, 255 F.2d 788, 790 (2d Cir. 1958), *aff'g* 28 T.C. 933 (1957).

[1147] §167(d); Reg. §1.167(h)-1(a).

[1148] *Lone Pine Lawn Corp. v. Commissioner*, 41 B.T.A. 638, 642 (1940), *aff'd on other grounds*, 121 F.2d 935 (2d Cir. 1941); *Odom v. Commissioner*, 38 T.C.M. 217, 219 (1979).

[1149] *See* §1001(e)(1).

[1150] *Sohosky v. Commissioner*, 473 F.2d 810, 813 (8th Cir. 1973), *aff'g* 57 T.C. 403 (1971).

[1151] *E.g., Penn v. Commissioner*, 16 T.C. 1497, 1499 (1951), *aff'd*, 199 F.2d 210 (8th Cir. 1952), *cert. denied*, 344 U.S. 927 (1953).

[1152] *See Estate of Little v. Commissioner*, 274 F.2d 718, 729 (9th Cir. 1960), *rev'g on other grounds* 30 T.C. 936 (1958).

[1153] §167(d); Reg. §1.167(h)-1(b).

[1154] §167(d); Reg. §1.167(h)-1(c).

[1155] *See* §671–§679.

[1156] *Brown v. Commissioner*, 25 B.T.A. 814, 821 (1932).

[1157] Rev. Rul. 74-530.

[1158] *Carol v. Commissioner*, 30 B.T.A. 443, 448–49 (1934).

[1159] *Gutman v. Commissioner*, 1 T.C. 365, 367 (1942), *aff'd on other grounds*, 143 F.2d 201 (2d Cir. 1944).

[1160] *E.g., Gilmartin v. Commissioner*, 47 T.C.M. 1532, 1543–45 (1984); *Kittle v. United States*, 67-1 USTC ¶9241 (W.D. Tenn. 1966).

[1161] *Eppley v. Commissioner*, 25 B.T.A. 300, 304 (1932); *Salzman v. Commissioner*, 55 T.C.M. 278, 285 (1988); *Arevalo v. Commissioner*, 124 T.C. 244 (2005).

[1162] *Smith v. Commissioner*, 38 T.C.M. 322, 325 (1979).

[1163] *Hager v. Commissioner*, 76 T.C. 759, 781 (1981); *Milbrew, Inc. v. Commissioner*, 42 T.C.M. 1467, 1481 (1981), *aff'd*, 83-2 USTC ¶9467 (7th Cir. 1983).

[1164] *Coleman v. Commissioner*, 87 T.C. 178, 201 (1986).

[1165] *See Energy Res. Ltd. P'ship v. Commissioner*, 64 T.C.M. 80 (1992).

[1166] *E.g., Hyde v. Commissioner*, 42 T.C.M. 954, 962 (1981).

[1167] Rev. Proc. 2026-3, §4.01(15).

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pendent's independent determination with respect to the use of the funds.[1168] The same principle applies to charitable contributions made by a spouse with funds provided by the taxpayer for the spouse's discretionary use.[1169]

b. Property Contributions

A taxpayer is allowed to deduct an otherwise eligible charitable contribution of property only if the taxpayer owns the donated property.[1170] Thus, in *Estate of Wasie v. Commissioner*,[1171] the Tax Court held that a charitable contribution deduction for a contribution of trees to a qualified organization was allowed to a taxpayer who sold the land on which the trees stood, because the parties to the land sale contract did not intend that the trees be transferred to the land purchaser.[1172]

The taxpayer need not be in physical possession of the donated property nor is a formal conveyance at the time of donation required.[1173] A taxpayer who acquires property and causes it to be transferred directly to the donee is not precluded from claiming an otherwise allowable deduction,[1174] but the deduction is disallowed if the evidence suggests the taxpayer never owned the property and the donee acquired it other than through transfer by the taxpayer.[1175] A taxpayer who sells property to a third party and retains title for security is allowed a charitable contribution deduction if the purchaser defaults and the property is donated to a qualified organization, because the taxpayer has legal and equitable title to the property.[1176]

c. Corporate Contributions

The shareholders of a corporation that makes a charitable contribution are not allowed to deduct it,[1177] even if they signed the pledge card for the contribution, except to the extent the deduction flows through from an S corporation to the shareholders.[1178]

Note: The IRS takes the position that the shareholder is treated as having received a distribution only if property or economic benefit is received by the shareholder or family members.[1179]

A corporation is allowed to deduct otherwise deductible charitable contributions that it makes even if they are made pursuant to a plan permitting employees to designate the donee.[1180]

Note: The IRS takes the position that the employee does not realize gross income as a consequence of the donee designation.[1181]

9. Medical Expense Deductions

A taxpayer whose transfer of income and expenses to a family trust is disregarded for federal income tax purposes is allowed to treat medical expenses paid by the trust as paid by the taxpayer.[1182] Otherwise deductible medical expenses paid by spouses out of separate funds are deductible by the spouse making the payment, but medical expenses paid out of community funds are deductible one-half by each spouse.[1183] The spouse seeking the deduction bears the burden of demonstrating that the funds used were separate funds.[1184]

Where a mother directly paid the medical expenses of her daughter, the Tax Court held that the daughter is entitled to the medical expense deduction.[1185] The court noted that pursuant to §2503(e)(1) and (2)(B), the mother did not have any gift tax consequences on the payment of these expenses because these payments were made to a "person who provides medical care … with respect to [a donee]." However, according to the court, the income tax treatment is not controlled by the gift tax consequences. The court then applied the substance over form doctrine to treat the taxpayer as having received from her mother a gift of the amount paid for her medical expenses with which the taxpayer paid her own medical expenses.[1186]

10. Legal and Professional Fees

Parents who paid legal and professional fees incurred by their daughter in seeking a divorce are not deductible by the parents because the fees had no connection with the father's consulting activities, his agreement with his daughter concerning the fees did not shift the obligation to him, a portion of the fees related to the parents' attempt to obtain custody of their grandchild, and the expenses were nondeductible personal expenses regardless of who was obligated to pay the fees.[1187]

C. Statutory Provisions Relating to Assignment of Deductions

1. Related-Party Reallocation

a. IRS Reallocation of Deductions Among Related Parties

Under §482, the IRS has the power to distribute, apportion, or allocate deductions and other items between or among any two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, if it determines that distribution, apportionment, or allocation is necessary to prevent evasion of taxes or to reflect clearly the income

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[1168] *Wilson v. Commissioner*, 11 T.C.M. 159, 161 (1952). *See Feinstein v. Commissioner*, 29 T.C.M. 1338, 1339 (1970).

[1169] *Herring v. Commissioner*, 66 T.C. 308, 312 (1976).

[1170] *See Furstenberg v. United States*, 78-1 USTC ¶9267 (Ct. Cl. 1978), *aff'd, modified, and remanded per curiam*, 595 F.2d 603 (Ct. Cl. 1979).

[1171] 36 T.C.M. 1302 (1977).

[1172] 36 T.C.M. at 1304–05.

[1173] *Hunter v. Commissioner*, 51 T.C.M. 1533, 1536 (1986).

[1174] *See Weiss v. Commissioner*, 65 T.C.M. 2768 (1993); *Klavan v. Commissioner*, 66 T.C.M. 68 (1993).

[1175] *Oughton v. Commissioner*, 67 T.C.M. 2271 (1994).

[1176] *Randall v. Commissioner*, 37 T.C.M. 950, 951 (1978).

[1177] PLR 8211127.

[1178] *G and R Corp. v. Commissioner*, 8 T.C.M. 970, 972 (1949).

[1179] Rev. Rul. 79-9.

[1180] Rev. Rul. 67-137.

[1181] *G & R Corp. v. Commissioner*, 8 T.C.M. 970, 972 (1949).

[1182] *Damm v. Commissioner*, 36 T.C.M. 793, 797–98 (1977).

[1183] Rev. Rul. 55-479. *See Haseltine v. Commissioner*, 38 T.C.M. 1259, 1264 (1979).

[1184] *Clemens v. Commissioner*, 8 T.C. 121, 125 (1947).

[1185] *Lang v. Commissioner*, T.C. Memo 2010-286.

[1186] Of course, had the mother actually given her daughter the money to pay the medical expenses or had merely reimbursed her daughter for those medical expenses, the mother would have been subject to the gift tax (to the extent that all of the mother's gifts to the daughter for that year exceeded the annual gift tax exclusion) as the exception for the payment of medical expenses applies only where the donor pays the medical expenses directly to the medical service provider. *See* Reg. §25.2503-6(c) *Ex.* 4.

[1187] *Rupert v. Commissioner*, 82 T.C.M. 197 (2001), *aff'd*, 57 Fed. App'x 212 (5th Cir. 2003).

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of any of those organizations, trades, or businesses.[1188] It does not matter whether the organizations, trades, or businesses are incorporated, organized in the United States, or affiliated.[1189]

The §482 adjustment power is discussed in detail in the Tax Management Transfer Pricing Portfolios (Foreign Income Series).

b. IRS Reallocation of Deductions of Personal Service Corporations

Under §269A, the IRS has the power to allocate deductions and other items between a personal service corporation[1190] and its employee-owners, if three conditions are satisfied.[1191] First, substantially all of the services of the personal service corporation must be performed for or on behalf of one other corporation, partnership, or other entity.[1192] Second, the principal purpose for forming, or availing of, the personal service corporation must be the avoidance or evasion of federal income tax by reducing the income of, or securing the benefit of any expense, deduction, credit, exclusion, or other allowance for, any employee-owner which would not otherwise be available.[1193] Third, the allocation must be necessary to prevent avoidance or evasion of federal income tax or to reflect clearly the income of the personal service corporation or any of its employee-owners.[1194]

c. IRS Reallocation of Reinsurance Agreement Deductions

Under §845, the IRS has the power to allocate deductions and other items related to a reinsurance agreement between or among two or more related persons if it determines the allocation is necessary to reflect the proper amount, source, or character of the taxable income or any other item of one or more of the related persons.[1195] Persons are related if they are related for purposes of the §482 adjustment, as described above.[1196] The §845 adjustment power can also be invoked if one of the parties to a reinsurance agreement is, with respect to any contract covered by the agreement, in effect an agent of another party to the agreement or a conduit between related persons.[1197]

The IRS also has the authority to reallocate deductions between unrelated parties when a reinsurance contract between them has a significant tax avoidance effect.[1198] Legislative history suggests that a tax avoidance effect is significant if the transaction is designed so that the tax benefits enjoyed by one or both parties to the contract are disproportionate to the risk transferred between the parties.[1199] According to the legislative history, this test focuses on the economic substance of the contract.[1200] The legislative history lists the following nonexclusive factors to be used in applying this test, namely, the duration or age of the business reinsured, the character of the business reinsured, the structure for determining the potential profits of each of the parties and any experience rating, the duration of the reinsurance agreement between the parties, the parties' right to terminate the reinsurance agreement and the consequences of termination, the relative tax positions of the parties, and the general financial situations of the parties.[1201] In *Trans City Life Insurance Co. v. Commissioner*,[1202] the Tax Court held that the IRS abused its discretion in applying this provision to reinsurance agreements between the taxpayer and another, unrelated insurance company, resting its conclusion on an analysis not only on the factors listed in the legislative history, but also two other factors, namely, the risk transferred versus the tax benefits derived and state determinations on risk transfers.[1203] The IRS has issued a nonacquiescence in this decision,[1204] stating that it disagrees with the court's characterization and application of these two additional factors.

2. Corporate Transactions

a. Deductions Transferable in Certain Corporate Acquisitions

Under §381, a corporation that acquires the assets of another corporation in a qualified acquisition succeeds to, and must take into account, specified deductions and other items of the transferor corporation.[1205] A variety of special rules and limitations apply to the transfer of the deductions to the acquiring corporation.[1206] The §381 deduction succession provision is discussed in detail in 780 T.M., *Net Operating Losses and Other Tax Attributes — Sections 381, 382, 383, 384, and 269.*

b. Limitation on Transfer of Deductions Following Ownership Change

Under §382, certain deductions that a corporation otherwise would be entitled to claim after there has been a change in its ownership are limited to a specified amount.[1207] The §382 limitation in effect prevents the shifting of the benefit of the deduction from one group of corporate owners to another.[1208] The §382 limitation is discussed in detail in 780 T.M., *Net Operating Losses and Other Tax Attributes — Sections 381, 382, 383, 384, and 269.*

[1188] §482. *See* Reg. §1.482-1, §1.482-2.

[1189] §482.

[1190] §269A(b)(2); Prop. Reg. §1.269A-1(b)(2). A personal service corporation is a corporation that has as its principal activity the performance of personal services that are substantially performed by employee-owners. Generally, employee-owners are employees who, on any day during the taxable year, own more than 10% of the outstanding stock of the personal service corporation.

[1191] §269A(a); Prop. Reg. §1.269A-1(a).

[1192] §269A(a)(1); Prop. Reg. §1.269A-1(a)(1).

[1193] §269A(a)(2); Prop. Reg. §1.269A-1(a)(2).

[1194] §269A(a) (flush language); Prop. Reg. §1.269A-1(a).

[1195] §845(a).

[1196] §845(a).

[1197] §845(a).

[1198] §845(b).

[1199] *See* Conference Report to the Deficit Reduction Act of 1984, H.R. Rep. No. 861, 98th Cong., 2d Sess. 1061–1065 (1984).

[1200] Conference Report to the Deficit Reduction Act of 1984, H.R. Rep. No. 861, 98th Cong., 2d Sess. 1061–1065 (1984).

[1201] Conference Report to the Deficit Reduction Act of 1984, H.R. Rep. No. 861, 98th Cong., 2d Sess. 1061–1065 (1984).

[1202] 106 T.C. 274 (1996), *nonacq.*, 1997-2 C.B. 1.

[1203] 106 T.C. at 308.

[1204] AOD 1997-11.

[1205] §381(a); Reg. §1.381(a)-1(a).

[1206] §381(b); Reg. §1.381(b)-1.

[1207] §382(a).

[1208] *See* §382.

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c. Limitation on Use of Preacquisition Losses

Under §384, loss corporations are not permitted to deduct their preacquisition losses against built-in gains of acquired corporations recognized within five years of the acquisition.[1209] The §384 limitation is discussed in detail in 780 T.M., *Net Operating Losses and Other Tax Attributes — Sections 381, 382, 383, 384, and 269.*

d. Qualified Subsidiary of Tax-Exempt Real Property Entity

Deductions and other items of a qualified subsidiary of a tax-exempt real property entity are treated as belonging to that entity.[1210] The §501(c)(25)(E)(i)(II) adjustment is discussed in 591 T.M., *Real Estate Transactions by Tax-Exempt Entities* (Estates, Gifts, and Trusts Series).

e. Qualified Real Estate Investment Trust Subsidiaries

Under §856, deductions and other items of a qualified real estate investment trust (REIT) subsidiary are treated as belonging to the real estate investment trust.[1211] A qualified REIT subsidiary is any corporation that is owned entirely by a real estate investment trust, but does not include taxable REIT subsidiaries.[1212] The §856(i)(1)(B) adjustment is discussed in 742 T.M., *Real Estate Investment Trusts.*

3. Trusts and Estates

a. Deduction of Grantor Trusts

Under certain circumstances specified in §672 through §679, the deductions of a trust are allowed to the person who is treated as owner of the trust, and are not allowed to the trust or its beneficiaries.[1213] However, in these cases, the person who is treated as owner must also include in gross income the amounts that otherwise would have been included in the gross income of the trust.[1214] Generally, the deductions allowed to the person treated as owner are the amounts that would be deductible had that person directly engaged in the trust's activities and transactions that are attributable to the portion of the trust of which the person is treated as owner.[1215] A taxpayer is treated as the owner of a trust (grantor trust) if, generally, the taxpayer is the grantor and retained certain substantial powers or if the taxpayer is not the grantor but has certain equivalent substantial powers.[1216]

> *Example:* G created T Trust, but retained substantial powers with respect to one-half of the trust income. Assume that the trust is a grantor trust on account of those powers. G is the grantor of the trust to the extent of one-half of its income and one-half of its deductions. G is allowed to deduct one-half of the amounts that would have been deductible had G directly engaged in the activities and transactions of T Trust from which it derived its income and deductions.

The taxation of owners of grantor trusts and the deduction by them of the trust's expenses, and the taxation of foreign trusts with United States beneficiaries and the deduction of those trust's expenses by persons making transfers to those trusts, are discussed in detail in 819 T.M., *Grantor Trusts: Income Taxation Under Subpart E* (Estates, Gifts, and Trusts Series).

b. Excess Deductions of Trusts and Estates

Under §642(h), certain deductions of a trust or estate that terminates are allowable to the beneficiaries that succeed to the property of the trust or estate.[1217] This rule applies to the trust's or estate's unused net operating loss carryovers and unused capital loss carryovers.[1218] It also applies to the excess of the trust's or estate's deductions for its last taxable year over its gross income for the year, without taking into account its personal exemption deduction and its charitable contribution deduction.[1219] The §642(h) excess deductions of a trust and estate are discussed in 852 T.M., *Income Taxation of Trusts and Estates* (Estates, Gifts, and Trusts Series).

4. Entities and Members

a. Partnerships

(1) In General

There are four specific statutory provisions that impose the assignment of deductions doctrine in the partnership context.[1220] These provisions stand in contrast to the general principle that the sharing of profits by a partnership need not necessarily reflect the capital advanced to, or services rendered on behalf of, the partnership,[1221] provided the partnership agreement is bona fide.[1222]

(2) Substantial Economic Effect

Under §704(b), allocations of partnership deductions to a partner that do not have substantial economic effect are disregarded, and the deductions are allocated pursuant to the partner's interest in the partnership.[1223] Although determining whether an allocation has economic effect involves objective tests, substantiality involves comparing both the difference between after-tax consequences with and without the allocation and the difference between before-tax consequences with and without the allocation.[1224] Factors taken into account in deter-

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[1209] §384(a), §384(c)(8) (reference to §382(h) for the definition of recognition period taxable year).

[1210] §501(c)(25)(E)(i)(II).

[1211] §856(i)(1)(B).

[1212] §856(i)(2).

[1213] §671. *See, e.g., Catlin v. Commissioner*, 25 B.T.A. 834, 840 (1932), *acq.*, 1939-2 C.B. 6; *Chamberlain v. Commissioner*, 19 B.T.A. 126, 134 (1930), *nonacq.*, 1931 C.B. 83.

[1214] §671.

[1215] *See* §671.

[1216] *See* §672–§679.

[1217] §642(h).

[1218] §642(h)(1).

[1219] §642(h)(2). See also *Estate or Trust: Excess Deductions on Termination Calculation (§642(h)(2))* in the Tax Elections & Compliance Statements Library.

[1220] §704(b), §704(c), §704(e), §706(d).

[1221] *See, e.g., Hartz v. Commissioner*, 170 F.2d 313, 318 (8th Cir. 1948), *cert. denied*, 337 U.S. 959 (1949).

[1222] *See* Mim. 6767, 1952-1 C.B. 111.

[1223] §704(b). *See* Reg. §1.704-1(b)(3).

[1224] *See* Reg. §1.704-1(b)(2)(iii).

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mining the partners' interests in the partnership include the partners' relative contributions, their interests in economic profits and losses, their interests in cash flow and other nonliquidating distributions, and their rights to distributions of capital if there is a liquidation,[1225] all of which are factors analyzed in applying the judicial assignment of deductions doctrine. If a partner is itself a look-through entity, the tax consequences with and without the allocation must be examined for the owner of that partner.[1226]

The validity of partnership allocations is discussed in detail in 712 T.M., *Partnerships — Taxable Income; Allocation of Distributive Shares; Capital Accounts.*

(3) Contributed Property

Under §704(c), income, gain, loss, and deductions attributable to property contributed to a partnership by a partner must be allocated in a manner that takes into account any difference between the fair market value of the property and its adjusted basis at the time of the contribution.[1227] Although application of §704(c) to depreciation and other issues is complex, the provision primarily prevents assignment of income and deductions.

> *Example:* B, C, and D form a partnership in which each has a one-third interest in capital and profits. B and C contribute $100 in cash. D contributes land with a fair market value of $100 and in which D's adjusted basis is $160. Absent §704(c), the $60 of loss that would arise if the partnership sold the land for $100 would be allocated $20 to each partner. Under §704(c), the $60 loss must be allocated to D, preventing its assignment to B and C.

The §704(c) rule also applies if the partnership distributes the contributed property to a partner other than the one who contributed it.[1228] A related provision requires the partnership, under certain circumstances, to determine the character of loss or deduction by reference to the state of the property in the hands of the contributing partner immediately before its contribution, in order to prevent the contribution to the partnership from providing opportunities to alter the character of loss or deduction.[1229] Another related provision requires the contributing partner to recognize the built-in gain or loss when receiving a distribution from the partnership, to the extent that the §704(c) provision has not yet applied.[1230]

The treatment of property contributed to a partnership is discussed in detail in 712 T.M., *Partnerships — Taxable Income; Allocation of Distributive Shares; Capital Accounts.*

(4) Partnership Interests Created by Gift

Under §704(e), special rules apply to partnership interests created by gift to prevent partnerships from taking advantage of circumstances which generally would provide, in the absence of the rules, opportunities to avoid the assignment of deductions doctrine.[1231] These rules are discussed in detail in 722 T.M., *Family Limited Partnerships and Limited Liability Companies.*

(5) The Varying Interest Rule

Under §706(d), if the interests of the partners vary during the taxable year, allocations of deductions and other items of the partnership must take the varying interests into account.[1232] In addition, certain items of a cash method partnership, such as interest, taxes, compensation, and rent, must be assigned proportionately to each day to which it is attributable, and the portion assigned to each day can be allocated only to those who are partners on that day.[1233]

Note: In effect, this rule prohibits "retroactive" allocation of deductions and other items to persons who are not partners during the period in which the deductions arose; as such, it reflects the judicial assignment of deductions doctrine.

> *Example:* A, B, and C are one-third partners in ABC Partnership. During the current taxable year the partnership generates $730,000 in rental expenses. On November 1, the partners admit D to the partnership; thereafter each is a one-fourth partner. Of the $730,000, $2,000 is assigned to each day in the year. For the first 304 days, $608,000 is assigned, and none is permitted to be allocated to D. In effect, A, B, and C are prevented from allocating any of the $608,000 in deductions to D.

The §706(d) varying interest rule is discussed in detail in 712 T.M., *Partnerships — Taxable Income; Allocation of Distributive Shares; Capital Accounts.*

b. S Corporations

Under §1366(e), if an individual who is a member of the family of one or more of the shareholders in an S corporation renders services for, or furnishes capital to, the corporation without receiving adequate compensation, the IRS must make adjustments to the deductions and other items taken into account by the individual and the shareholders in order to reflect the value of those services or capital.[1234] Family includes only spouses, ancestors, lineal descendants, and trusts created for the primary benefit of such persons.[1235]

The application of this statutory codification of the assignment of deductions doctrine in the S corporation context is discussed in detail in 732 T.M., *S Corporations: Shareholder Tax Issues.*

[1225] *See* Reg. §1.704-1(b)(3)(ii).
[1226] T.D. 9398, 73 Fed. Reg. 28,699 (May 19, 2008).
[1227] §704(c).
[1228] §704(c)(2).
[1229] §724.
[1230] §737.

[1231] Section 704(e) was reorganized by the Bipartisan Budget Act of 2015 (2015 BBA), Pub. L. No. 114-74, §1102, effective January 1, 2016, by moving the definition in §704(e)(1) to the general definition of "partner" in §761(b), redesignating §704(e)(2) and §704(e)(3) as §704(e)(1) and §704(e)(2), respectively, and retitling §704(e) "Partnership Interests Created By Gift."
[1232] §706(d)(1).
[1233] §706(d)(2). *See* Reg. §1.706-4 and §1.706-5 for rules for determining the partners' distributive shares of partnership items when a partner's interest in a partnership varies during the taxable year as a result of the disposition of a partial or entire interest in a partnership, or with respect to a partner whose interest in a partnership is reduced, including by the entry of a new partner, and for rules on exceptions to the varying interest rule for certain partnerships with contemporaneous partners and for certain service partnerships.
[1234] §1366(e).
[1235] §1366(e) (referring to §704(e)(3)), as amended by the Tax Technical Corrections Act of 2018, Pub. L. No. 115-141, Div. U, §401(a)(192).

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5. *Provisions Relating to Deduction of Taxes*

a. *Apportionment of Real Property Taxes*

Under §164(d), a special real property tax apportionment rule applies and is used to determine the amount of the taxes imposed on a purchaser and seller of real estate, regardless of how they decide to allocate the real estate taxes for the year of sale or for prior or subsequent years.[1236] No taxpayer is permitted to deduct the taxes that are treated under the apportionment rule as being imposed on the other taxpayer.[1237] If one party pays the taxes treated as imposed on the other, they are treated as additional cost if paid by the purchaser and as a reduction of amount realized if paid by the seller.[1238]

Note: Beginning in 2018, itemized deductions for the aggregate of state and local real estate taxes not paid or accrued in carrying on a trade or business or investment activity described in §212, and state and local income, war profits, and excess profits taxes (or sales taxes in lieu of these taxes) paid or accrued in the tax year, are limited to:

- tax years 2018 through 2024, $10,000 ($5,000 married filing separate);
- tax years 2025, $40,000 ($20,000 married filing separate);
- tax years 2026, $40,400 ($20,200 married filing separate);
- tax years 2027 through 2029, 101% of the preceding calendar year limit (half for married filing separate);
- tax years after 2029, $10,000 ($5,000 married filing separate).[1239]

The §164(d) real property tax apportionment rule is discussed in detail in 525 T.M., *State, Local, and Federal Taxes.*

b. *Taxes of Shareholder Paid by Corporation*

Under §164(e), if a corporation pays a tax imposed on a shareholder on the shareholder's interest as a shareholder and is not reimbursed by the shareholder, the corporation is allowed to deduct the tax and the shareholder is not allowed to deduct the tax.[1240] The amount paid on behalf of the shareholder is not included in the shareholder's gross income.[1241]

The §164(e) provision is discussed in detail in 525 T.M., *State, Local, and Federal Taxes.*

c. *Cooperative Housing Corporation Shareholders*

Under §216(a)(1), tenant-stockholders of cooperative housing corporations are permitted to deduct their proportionate share of real property taxes paid by the corporation.[1242] The §216(a)(1) provision is discussed in detail in 596 T.M., *Residential Cooperative and Condominiums.*

[1236] §164(d)(1); Reg. §1.164-6(a). *See Aagaard v. Commissioner*, 56 T.C. 191, 208 (1971). *See also* §164(b)(6), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70120.

[1237] §164(c)(2); Reg. §1.164-6(a).

[1238] Reg. §1.1001-1(b)(1).

[1239] §164(b)(6), amended by the OBBBA, §70120, §164(b)(7), added by the OBBBA, §70120. Former §164(b)(6) (tax years 2018 through 2024).

[1240] §164(e); Reg. §1.164-7.

[1241] Reg. §1.164-7.

[1242] *See also* Reg. §1.216-1(a)(1).

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IV. Deduction Limitations and Allowances

A. Introduction

1. In General

One of the more confusing aspects of deductions, at least to those exploring federal income tax law for the first time, is that Congress not only has selected only certain transactions as justifying the allowance of deductions, but also has imposed limitations or restrictions on the allowance of some deductions.[1243] Deduction limitations are not unconstitutional, because the Constitution does not guarantee to all taxpayers the same economically equivalent deductions under all circumstances.[1244] Different types of limitations and restrictions, discussed below, are used for different policy goals. The limitations and restrictions reflect several general approaches. In some instances, the restriction provides, in effect, that although a transaction meets the tests for a particular deduction, the deduction nonetheless is not allowable.[1245] In other instances, the restriction provides additional tests for the deduction.[1246] In still other instances, the restriction limits the amount of an otherwise available deduction.[1247] Thus, an amount that is otherwise deductible under a deduction provision nonetheless may not be deductible in full if a deduction restriction or limitation applies. Generally, restrictions and limitations that apply to a specific deduction are described in connection with the explanation of that deduction, but restrictions and limitations that apply to groups of deductions are discussed in IV.B., below through IV.G., below. Trade or business deductions are discussed in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*

2. Types of Limitations and Restrictions

a. Computational Limitations

Certain limitations are computational in nature. Some deduction limitations further a policy of directing the benefits of a deduction to taxpayers with lower income. Other limitations further a policy of allowing deductions only for extraordinary expenses. For example, otherwise deductible medical expenses[1248] and casualty losses[1249] are allowed only for expenses exceeding a specified percentage of the taxpayer's adjusted gross income. Certain limitations further a policy of not permitting the excess of deductions over gross income from an activity, or group of activities, to offset gross income from other sources. For example, passive losses generally are deductible only to the extent of passive income,[1250] capital losses are deductible only to the extent of capital gains, plus, for individuals, an additional amount,[1251] and losses from the rental of personal dwellings cannot, in effect, offset other income.[1252]

Computational limitations on deductions are described in IV.B., below.

b. Double Benefit Restrictions

Certain restrictions apply when the taxpayer has the advantage of some other tax benefit. For example, if a taxpayer receives assistance in meeting an otherwise deductible expenditure and the assistance is excludible from gross income, the taxpayer may not deduct the expenditure.[1253] The benefit can be the exclusion of an amount from gross income,[1254] the allowance of a credit,[1255] or advantageous characterization of expenses.[1256]

Generally, taxpayes are prohibited from claiming multiple deductions for the same economic loss. Under the principle sometimes referred to as the *Ilfeld* doctrine, a double deduction is permissible only if the taxpayer can assert a statutory or regulatory provision that may fairly be read to authorize the double deduction.[1257] The Tax Court has stated that this requires a specific statutory provision, not just a general allowance provision.[1258] If a statute is silent, a double deduction is not authorized. Similarly, taxpayers generally are prohibited from claiming deductions for amounts that are the basis for the claiming of a credit.[1259] Double benefit restrictions are described in IV.C., below.

[1243] *See* §261–§291.

[1244] *Campbell v. United States*, 2001-2 USTC ¶50,716 (S.D.N.Y. 2001), *aff'd per curiam*, 45 Fed. App'x 50 (2d Cir. 2002) (unpub. op.), *cert. denied*, 537 U.S. 1171 (2003).

[1245] *E.g.*, §162(c), §162(e), §162(f).

[1246] *E.g.*, §274.

[1247] *E.g.*, §162(m), §183(b), §280A(c)(5).

[1248] §213(a).

[1249] §165(h)(5)(A), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70109 (limiting personal casualty and theft loss deductions to losses incurred in federally declared disasters in tax years beginning after 2017 and before 2026, and to losses incurred in federally declared disasters or state declared disasters in tax years beginning after 2025). However, a taxpayer can still use a personal casualty loss to offset a personal casualty gain. §165(h)(5)(B), amended by the OBBBA, §70109.

[1250] *See* §469.

[1251] *See* §1211.

[1252] *See* §280A.

[1253] *E.g.*, §127(c)(7) (educational assistance), §129(e)(7) (dependent care assistance).

[1254] *E.g.*, §127(c)(7), §129(e)(7), §171(a)(2), §265, §421(a)(2), §931(b), §932(c), §933, §7701(k)(2).

[1255] *E.g.*, §43(d)(1), §44(d)(7)(A), §280C, §905(a), §960(c)(3).

[1256] *E.g.*, §268, §272.

[1257] *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934) (denied loss to parent company that subsidiary had previously claimed). *Duquesne Light Holdings, Inc. v. Commissioner*, 861 F.3d 396 (3d Cir. 2017) (denied loss under *Ilfeld* doctrine when consolidated group claimed deduction for loss that duplicated another deduction already taken by group for the same loss), *cert. denied*, 138 S. Ct. 2651 (2018). *See also Marwais Steel Co. v. Commissioner*, 354 F.2d 997 (9th Cir. 1965) (double deduction denied); *CSI Hydrostatic Testers, Inc. v. Commissioner*, 103 T.C. 398 (1994) (double deduction allowed); CCA 200431014 (*Ilfeld* doctrine has continuing vitality; duplicative losses on disposition of subsidiary stock not disallowed under consolidated return regulations may be disallowed under *Ilfeld* doctrine).

[1258] *Thrifty Oil Co. v. Commissioner*, 139 T.C. 198 (2012) (deduction for environmental remediation expenses denied after the losses were previously claimed as a capital loss).

[1259] *E.g.*, §43(d)(1) (enhanced oil recovery credit); §44(d)(7)(A) (expenditures to provide access to the disabled); §45B(c) (credit for employer social security taxes on employee cash tips); §45E(e)(2) (small-employer pension plan startup cost credit); §45F(f)(2) (employer-provided child care credit); §280C (certain expenses for which credits are allowable); §905(a) (credits relating to foreign income); §960(b)(4) (foreign tax credits). *Cf.* §25A(g)(5) (no credit for expenses for which deduction allowed); *O'Brien v. Commissioner*, 79 T.C. 776 (1982) (taxpayers could not claim both the new jobs credit and investment credit), *aff'd in part and remanded by O'Brien v. Commissioner*, 771 F.2d 476 (10th Cir. 1985).

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c. Public Policy Restrictions

Some amounts otherwise deductible are disallowed to support nontax public policy. Thus, deductions are not allowed for illegal bribes,[1260] fines and similar penalties,[1261] certain lobbying expenses,[1262] settlements subject to nondisclosure agreements paid in connection with sexual harassment or sexual abuse,[1263] and the expenses of illegal drug sales.[1264] Other restrictions reflect a variety of public policy concerns. Public policy restrictions are described in IV.D., below.

d. Timing Matter Restrictions

Some deduction restrictions reflect a policy of matching a deduction to the tax year to which it most appropriately belongs. Thus, for example, otherwise deductible expenditures for assets reasonably expected to generate economic benefits for more than one year may not be deducted in the year paid, but must be capitalized and deducted over an appropriate time period through depreciation, cost recovery, or amortization deductions or used as a basis adjustment to reduce the gain or increase the loss on the disposition of the asset.[1265] Certain restrictions on deductions reflect the nature of the expenditure as amounts that are properly chargeable to a capital account. These include capital expenditures,[1266] capitalized inventory costs,[1267] and demolition expenses.[1268] Capitalization restrictions are described in II.F.2.c., above, and 509 T.M., *Principles of Capitalization.*

e. Compliance Failure Restrictions

There are restrictions on deductions for failure to continue to comply with conditions for tax benefits.[1269] These restrictions are described in IV.E., below.

f. Personal Expenditure Limitations and Restrictions

Some limitations and restrictions on deductions reflect the basic concept that personal expenditures are generally not deductible.[1270] For example, the expense for painting a room in an individual's personal residence is not deductible. These limitations and restrictions are described in IV.F., below.

g. Miscellaneous Limitations and Restrictions

There are approximately a dozen miscellaneous limitations and restrictions.[1271] These restrictions and limitations are described in IV.G., below.

B. Computational Limitations

1. Limitation Based on a Percentage of Income

a. Overall Limitation on Itemized Deductions

Under §68, taxpayers must reduce the amount of otherwise allowable itemized deductions by 2/37 of the lesser of two amounts: (1) such amount of itemized deductions or (2) the taxable income of the taxpayer for the tax year (determined without regard to §68 and increased by such amount of itemized deductions) that exceeds the dollar amount under §1 at which the 37% rate bracket begins for the taxpayer.[1272]

The overall limitation on itemized deductions is discussed further in V.C., below.

b. Dividends Received Deduction Limitation

Under §246(b), the aggregate amount of limited dividends received deductions that may be available to corporations is limited to the dividends received limitation amount, which is based on a percentage of the corporate shareholder's taxable income.[1273] The dividends received deduction limitation is discussed in detail in 764 T.M., *Current Distributions — Cash and Property.*

2. Limitations Equal to Income or Similar Amount

a. Hobby Loss Limitation

Under §183, deductions attributable to activities not engaged in for profit by individuals, trusts, estates, or S corporations[1274] are generally limited to the gross income from the activity.[1275] This limitation is commonly referred to as the "hobby loss limitation." However, a taxpayer can deduct expenses in excess of gross income if the expenses are allowable without regard to a taxpayer's profit motive, such as home mortgages, casualty and theft losses, and taxes.[1276]

In determining if an activity is subject to the hobby loss limitation, a facts-and-circumstances test applies, with the main focus being on "an honest profit objective."[1277] An activity is presumed to be engaged in for profit if the activity produces income in excess of deductions in three or more tax years during a period of five consecutive tax years that ends with the tax year.[1278] Activities that are scrutinized as possible hobbies

[1260] *See* §162(c).

[1261] See §162(f), which generally denies a deduction for fines, penalties, and other amounts paid to or at the direction of a government or government entity in relation to the violation of any law or the investigation by a government or governmental entity into the potential violation of any law. Note that there are exceptions for payments that are characterized as restitution (including remediation of property) or legal compliance costs. §162(f)(2).

[1262] §162(e) (repealing former §162(e)(2) and former §162(e)(7), local counsel or similar governing body lobby expense deductions).

[1263] §162(q).

[1264] *See* §280E.

[1265] *E.g.*, §263, §263A.

[1266] *E.g.*, §263.

[1267] *E.g.*, §263A.

[1268] *E.g.*, §280B.

[1269] *E.g.*, §150(b)(1)–§150(b)(6).

[1270] *E.g.*, §262, §264, §273, §274, §275, §280A(e).

[1271] *E.g.*, §83(b)(1), §90(c), §162(j), §246(a), §246(c)–§246(e), §266, §271, §420(d), §508(d), §668(c), §807(d)(3)(C), §1091(a).

[1272] §68(a), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70111, effective for tax years beginning after Dec. 31, 2025.

[1273] *See* §246(b)(1); Reg. §1.246-2(a).

[1274] *See* §183(a); Reg. §1.183-1(a).

[1275] §183(b); Reg. §1.183-1(b).

[1276] §183(b)(1).

[1277] *Stettner v. Commissioner*, 113 T.C.M. 1503 (2017), *citing Keating v. Commissioner*, 544 F.3d 900, 904 (8th Cir. 2008), *aff'g* 94 T.C.M. 383. *See also* Reg. §1.183-2(b) (providing factors the IRS considers in determining if the activity is engaged in for profit).

[1278] §183(d). *See also* §183(e) (allowing a taxpayer to elect to defer the application of the §183(d) presumption until the close of the fifth tax year of the activity). A different presumption applies in the case of the breeding, training, showing, or racing of horses. For the specified horse activity, the presumption of profit motive is met if the activity produces income in excess of deductions in two or more tax years during a period of seven consecutive tax years that ends within the tax year.

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include fishing, horse racing, horse breeding, farming, motorcross racing, auto racing, craft sales, bowling, stamp collecting, dog breeding, yacht charter, artists, gambling, direct sales, photography, writing, entertainers, airplane charter, and rentals.[1279]

Note: Section 183 has effectively been rendered superfluous because miscellaneous itemized deductions are disallowed for tax years after 2017.[1280] However, a taxpayer can still deduct expenses in excess of gross income if the expenses are allowable without regard to a taxpayer's profit motive and are not miscellaneous itemized deductions, such as home mortgages[1281] and taxes.[1282]

> *Example (1):* In 2017, an individual taxpayer is an artist who occasionally sells her paintings. The taxpayer's gross income from her paintings has never exceeded her expenses. In the current year, the taxpayer has $100 of income from the sale of her paintings. She also has the following expenses: $100 supplies and $150 in home mortgage and real estate taxes allocable to her home studio. Assuming the taxpayer's painting activity is held to be not engaged in for profit, the taxpayer is subject to the hobby loss limitation and can deduct only $150. If the expenses were incurred in 2018, the taxpayer still would be subject to the hobby loss limitation and could still deduct only $150.

> *Example (2):* In 2017, an individual taxpayer is an artist that occasionally sells her paintings. The taxpayer's gross income from her paintings has never exceeded her expenses. In the current year, the taxpayer has $100 of income from the sale of her paintings. She also has the following expenses: $100 supplies and $75 in home mortgage and real estate taxes allocable to her home studio. Assuming the taxpayer's painting activity is held to be not engaged in for profit, the taxpayer is subject to the hobby loss limitation and can deduct only $100 ($75 for the home mortgage and taxes and $25 for the supplies). If the expenses were incurred in 2018, the taxpayer still would be subject to the hobby loss limitation but could deduct only the $75 home mortgage and taxes. The deduction for the supplies would be disallowed, because it would be considered a miscellaneous itemized deduction.

The §183 hobby loss limitation is discussed in detail in 548 T.M., *Hobby Losses.*

b. Passive Loss Limitation

To prevent taxpayers from using losses generated from activities in which the taxpayer did not materially participate, §469 suspends the use of such losses from sheltering other sources of active income, such as compensation.[1283] This limitation is commonly referred to as the "passive loss limitation." Under §469, an individual, estate, trust, closely held C corporation,[1284] or any personal-service corporation[1285] may not deduct losses[1286] from passive activities that exceed the income from such passive activities.[1287] Thus, a taxpayer may not use losses from passive activities to offset income from non-passive activities, such as salaries. A taxpayer may carry forward any disallowed passive-activity losses and use her excess losses in subsequent years to offset passive income.[1288] A taxpayer may also carry forward disallowed passive-activity losses when there is a disposition of the passive activity that generated the passive loss. For example, if a taxpayer participates in a passive activity and has a loss of $100, the taxpayer cannot use the $100 loss to offset the taxpayer's salary. Instead, the taxpayer would carry forward the $100 loss for use in subsequent years.[1289] Therefore, the passive loss limitation does not permanently disallow the use of excess passive-activity losses; rather, it defers such use.

An activity qualifies as "passive" if it involves a trade or business in which "the taxpayer does not materially participate."[1290] A taxpayer "materially participates" only by regularly,

[1279] IRS Pub. 5558, *Activities Not Engaged in for Profit — Audit Technique Guide — Internal Revenue Code Section 183.*

[1280] §67(h), amended and redesignated by the One Big Beautiful Bill Act (OBBBA), Pub. L. 119-21, §70110.

[1281] §183(b)(1). For tax years beginning after 2017, the mortgage interest deduction is limited to underlying indebtedness of $750,000 ($375,000 for married taxpayers filing separately), and the deduction for interest on home equity indebtedness is not available. §163(h)(3)(F), amended by the OBBBA, §70108(a).

[1282] §183(b)(1). For tax years after 2017, the deduction of real estate taxes for a personal residence for the aggregate of state and local real estate taxes not paid or accrued in carrying on a trade or business or investment activity described in §212, and state and local income, war profits, and excess profits taxes (or sales taxes in lieu of these taxes) paid or accrued in the tax year, is limited as follows: tax years 2018 through 2024, $10,000 ($5,000 married filing separate); tax year 2025, $40,000 ($20,000 married filing separate); tax year 2026, $40,400 ($20,200 married filing separate); tax years 2027 through 2029, 101% of the preceding calendar year limit (half for married filing separate); and tax years after 2029, $10,000 ($5,000 married filing separate). §164(b)(6), amended by the OBBBA, §70120, §164(b)(7), added by the OBBBA, §70120.

[1283] Staff of the J. Comm. on Taxation, 100th Cong., General Explanation of the Tax Reform Act of 1986, at 215 (Joint Comm. Print 1987); S. Rep. No. 99-313, at 718–19 ("The bill provides that deductions from passive trade or business activities ... generally may not be deducted against other income ... . Under the bill, an activity generally is a passive activity if it involves the conduct of any trade or business, and if the taxpayer does not materially participate in the activity.").

[1284] §469(j)(1), §465(a)(1)(B), §542(a)(2) (defining a closely held C corporation as a corporation that is more than 50% owned, directly or indirectly, by five or fewer persons at any time during the last half of the tax year). The passive-loss rules of §469 apply on a limited basis to closely held C corporations.

[1285] §469(j)(2), §269A(b)(1)–(2) (defining a "personal service corporation" as a corporation in which at least 10% of the stock, by value, is held by employee-owners and whose principal activity is providing personal services that its employees substantially perform). Special rules exist regarding the application of the passive-loss rules of §469 to personal service corporations.

[1286] §469(a)(1)(B). A similar limitation exists for passive-activity tax credits. While a taxpayer may carry over disallowed passive credits to offset future passive income, the disposition of a passive activity does not trigger the use of such credits.

[1287] §469(a)(1)(A), §469(d)(1). A taxpayer calculates and nets the income and loss generated from each of a taxpayer's passive activities. §469(d)(1)–(2). If the passive-activity loss exceeds the passive-activity gain, the remaining passive-activity loss cannot be deducted in the current tax year. §469(3)(2)(A).

[1288] §469(b).

[1289] §469(b).

[1290] §469(c)(1). *See* §469(c)(6)(B) (expanding the definition of a trade or business to include any activity in which §212 deductions are allowed); *see also* §469(c)(5) (expanding the typical definition of trade or business to also include "any activity involving research or experimentation"); Reg. §1.469-4(b)(1)(ii) (providing that the definition of trade or business also includes activities that "[a]re conducted in anticipation of the commencement of a trade or business"). *But see* §469(c)(2), §469(c)(7), §469(i) (providing that a rental activity is a "passive activity," but providing certain exceptions for taxpayers involved in real estate).

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continuously, and substantially participating in the activity.[1291] Treasury Regulation §1.469-5T sets out seven separate tests for proving material participation. To prevent a taxpayer from using passive losses to shelter income from the typical forms of investment, such as dividends, interests, and capital gains from the sale of securities, Congress prohibited the consideration of net portfolio income when calculating income or loss arising from a passive activity.[1292]

The passive loss limitation is discussed in detail in 549 T.M., *Passive Loss Rules.*

c. Capital Loss Limitations

Under §1211(a), a corporation's capital losses that are otherwise deductible are allowed only to the extent of capital gains.[1293] Under §1211(b), capital losses of taxpayers other than corporations that are otherwise deductible are allowed only to the extent of capital gains plus the lesser of $3,000 or the excess of capital losses over capital gains.[1294] For married individuals filing separate returns, the $3,000 limitation is reduced to $1,500.[1295] For individuals, capital loss deductions that are unused in a tax year due to the limitation are carried over to the next tax year and retains their character as short-term or long-term.[1296] For a corporation, special rules apply to any capital loss that is unused in a tax year due to the limitation allowing the capital loss to be carried back and carried forward subject to limitations.[1297]

> *Example:* An individual taxpayer has long-term capital loss of $10,000 and long-term capital gain of $6,000. The capital loss reduces the taxpayer's capital gain to $0. The taxpayer can claim $3,000 of the remaining $4,000 capital loss as a deduction against her ordinary income. The remaining $1,000 capital loss will carryforward to the next tax year.

The capital loss limitations are discussed in detail in 562 T.M., *Capital Assets — Related Issues.*

d. Other Limitations

Examples of other limitations equal to an income or similar amount include:

- The §199A qualified business income deduction limitation discussed in detail in 537 T.M., *Qualified Business Income Deduction: Section 199A*;[1298]
- The §163(j) limitation on the deduction of business interest discussed in detail in 536 T.M., *Interest Expense Deductions*;[1299]
- The §461(l) limitation of excess business losses of noncorporate taxpayers discussed in detail in 527 T.M., *Loss Deductions*;[1300]
- The §280A dwelling unit limitation discussed in detail in 547 T.M., *Home Office, Vacation Home, and Home Rental Deductions*;
- The §1237 subdivision characterization provision discussed in detail in 561 T.M., *Capital Assets*;
- The §277 social club and membership organization deduction limitation discussed in detail in 596 T.M., *Residential Cooperative and Condominiums* (Real Estate Series) and 744 T.M., *Taxation of Cooperatives*;
- The §422(c)(2) disqualifying incentive stock option stock disposition employer deduction limitation discussed in detail in 381 T.M., *Statutory Stock Options*; and
- The §470 tax-exempt use loss limitation discussed in 593 T.M., *Real Estate Leases.*

3. Limitations Equal to Specified Amount

a. At-Risk Limitation

Generally, under §465, any loss of an individual[1301] or a closely held C corporation[1302] arising from a business or investment-related activity is limited to the taxpayer's aggregate amount at risk for the activity as of the end of the tax year.[1303] This limitation is commonly referred to as the "at-risk limitation." A taxpayer may carry forward any amount disallowed under the at-risk limitation and use her excess losses in subsequent years to offset at-risk amounts.[1304] A loss is the excess of deductions for the tax year allocable to an activity[1305] that are otherwise allowable over the income received or accrued by the taxpayer[1306] during the tax year from the activity.[1307] A taxpayer's amount at risk includes the amount of money and adjusted basis of other property that the taxpayer contributes to the activity.[1308] Certain amounts borrowed with respect to such activity are included in the at-risk amount[1309] to the extent the taxpayer is personally liable for the repayment of the amount borrowed or the taxpayer has pledged property, other than the

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[1291] §469(h)(1).

[1292] §469(e)(1)(A)(i)(I)–§469(e)(1)(A)(i)(III). *See* S. Rep. No. 99-313, at 728 (1985) ("To permit portfolio income to be offset by passive losses ... would create the inequitable result of restricting sheltering by individuals dependent for support on wages or active business income, while permitting sheltering by those whose income is derived from an investment portfolio."); *see also* Reg. §1.469-2T(c)(3) ("Passive activity gross income does not include portfolio income.").

[1293] §1211(a).

[1294] §1211(b).

[1295] §1211(b)(1).

[1296] §1212(b).

[1297] §1212(a).

[1298] §199A (providing a deduction for qualified business income of taxpayers other than corporations). See Form 8995, *Qualified Business Income Deduction Simplified Computation*, or Form 8995-A, *Qualified Business Income Deduction*, to determine the qualified business income deduction.

[1299] §163(j).

[1300] §461(l).

[1301] §465(a)(1)(A). *See* Prop. Reg. §1.465-1(d).

[1302] §465(a)(1)(B). *See also* §542(a)(2) (defining a closely held C corporation as a corporation that is more than 50% owned, directly or indirectly, by five or fewer persons at any time during the last half of the tax year). However, the at-risk rules do not apply to a "qualified C corporation." §465(c)(7). *See also* Prop. Reg. §1.465-10 (applying the at-risk limitation to S Corporations and their shareholders on a limited basis).

[1303] §465(a)(1). *See* Prop. Reg. §1.465-1, §1.465-2, §1.465-38.

[1304] §465(a)(2).

[1305] *See* Prop. Reg. §1.465-13.

[1306] *See* Prop. Reg. §1.465-13.

[1307] §465(d). *See* Prop. Reg. §1.465-2, §1.465-11.

[1308] §465(b)(1)(A).

[1309] §465(b)(1)(B).

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property used in the activity, as security for the debt.[1310] However, a taxpayer is not considered at risk for amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.[1311] Notwithstanding, a taxpayer will be considered at risk for "qualified nonrecourse financing" in the activity of holding real property.[1312]

> *Example:* An individual taxpayer materially participates in an activity for profit. The taxpayer donated $100 cash and other property with an adjusted basis of $200 to the activity. Thus, the taxpayer is at risk for $300. The taxpayer has $500 of loss in the current year from the activity. Under the at-risk rules only $300 is currently deductible. The remaining $200 is carried forward to the following year.

The at-risk limitation is discussed in detail in 550 T.M., *At-Risk Rules*.

b. Repurchased Bond Premium Deduction Limitation

A corporation's deductions for any repurchase premium paid or incurred on the repurchase of a convertible obligation are limited to the adjusted issue price plus a normal call premium on nonconvertible obligations.[1313]

> *Example:* A corporation issues a callable 20-year convertible bond at face for $2,000 bearing interest at 10% per annum. The bond is convertible at any time into two shares of the common stock of the corporation. Under the terms of the bond, the applicable call price is $2,200. The corporation calls the bond for $2,200. Since the repurchase premium, $200 ($2,200 – $2,000), was specified in dollars in the obligation and does not exceed one year's interest at the rate fixed in the obligation, the $200 is considered to be a normal call premium on a comparable nonconvertible obligation. Accordingly, the corporation may deduct the $200.[1314]

The repurchased bond premium deduction limitation is discussed in 181 T.M., *Time Value of Money — Holders of Debt Instruments*, 182 T.M., *Time Value of Money — Issuers of Debt Instruments*, and 188 T.M., *Taxation of Equity Derivatives*.

c. Reciprocal Insurance Company Attorney-in-Fact Deduction Limitation

(1) In General

Under §835, a reciprocal insurance company can elect to subject its attorney-in-fact deductions to the attorney-in-fact deduction limitation.[1315] The §835 attorney-in-fact deduction limitation is described in IV.B.3.c.(3), below.

(2) Reciprocal Insurance Company

A reciprocal insurance company is any mutual insurance company that is an interinsurer or reciprocal underwriter subject to taxation as an insurance company other than a life insurance company.[1316]

(3) Attorney-in-Fact Deduction Limitation

If a taxpayer elects for the attorney-in-fact deduction limitation to apply, the deductions otherwise allowable for amounts paid or incurred during the tax year to the attorney-in-fact by the reciprocal is limited to, but not increased by, the deductions of the attorney-in-fact allocable, to the extent specified by the IRS in regulations, to the income received by the attorney-in-fact from the reciprocal.[1317] Any increase in the reciprocal's taxable income attributable to the limitation is taxed at the highest rate of tax applicable to corporations.[1318]

The reciprocal is credited with so much of the tax paid by the attorney-in-fact as is attributable to the income received by the attorney-in-fact from the reciprocal in that tax year, to the extent specified by the IRS in regulations.[1319] The reciprocal's taxes must be adjusted for any credit or refund for taxes allowed to the attorney-in-fact with respect to taxes credited to the reciprocal.[1320] The §835 attorney-in-fact deduction limitation has no effect on the tax liability of the attorney-in-fact.[1321]

(4) Election

The election is effective for the tax year for which made and for all succeeding tax years.[1322] The election can be revoked only with the consent of the IRS.[1323]

(5) Exception

The election may not be made unless the attorney-in-fact of the reciprocal satisfies four conditions.[1324] First, the attorney-in-fact must be subject to the federal corporate income tax.[1325] Second, the attorney-in-fact must consent in the manner specified by the IRS in regulations to make available whatever information is required, as specified by the IRS in regulations, during the period for which the election is in effect.[1326] Third, the attorney-in-fact must report the income received from the reciprocal and the deductions allocable to that income under the same method of accounting under which the reciprocal reports deductions for amounts paid to the attorney-in-fact.[1327] Fourth, the attorney-in-fact must file its return on the calendar year basis.[1328]

[1310] §465(b)(2).
[1311] §465(b)(4).
[1312] §465(b)(6).
[1313] §249(a). *See* Reg. §1.249-1(a)(1). *E.g., Clark Equip. Co. v. United States*, 912 F.2d 113, 116, 118 (6th Cir. 1990).
[1314] *See* Reg. §1.249-1(g) (example adapted from).
[1315] §835(a), §835(b).
[1316] §835(a) (reference to §831(a)).
[1317] §835(b).
[1318] §835(e) (reference to §11(b)).
[1319] §835(d).
[1320] §835(f).
[1321] §835(g).
[1322] §835(a).
[1323] §835(a).
[1324] §835(c).
[1325] §835(c)(1) (reference to §11).
[1326] §835(c)(2).
[1327] §835(c)(3).
[1328] §835(c)(4).

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d. Other Limitations

Examples of other limitations equal to a specified amount include:

- The §280F automobile and listed property deduction limitations discussed in detail in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*;
- The §280G parachute payment limitation discussed in detail in 396 T.M., *Golden Parachutes*;
- The §681 trust charitable contribution deduction limitation discussed in 462 T.M., *Unrelated Business Income Tax* (Estate, Gifts, and Trusts Series) and 866 T.M., *Charitable Lead Trusts* (Estate, Gifts, and Trusts Series);
- The §704(d) partner's adjusted basis loss limitation discussed in detail in 714 T.M., *Partnerships — Allocation of Liabilities; Basis Rules*; and
- The S corporation shareholder's §1366(d) adjusted basis loss limitation discussed in detail in 731 T.M., *S Corporations: Operations.*

4. Limitations Based on Specified Reductions

a. Reduction of Financial Institution Preference Item Deductions

(1) In General

Under §291(a)(3), an amount otherwise allowable as a deduction with respect to a financial institution preference item is reduced by 20%.[1329] For a detailed discussion of §291 financial preference institution items, see 536 T.M., *Interest Expense.*

(2) Financial Institution Preference Items

(a) In General

Financial institution preference items consist of interest paid or incurred by a bank[1330] on indebtedness incurred or continued to purchase or carry specified obligations, to the extent the interest would be deductible were it not for the fact that the §265 limitation, described in 536 T.M., *Interest Expense*, applies.[1331] Specified obligations are obligations acquired after December 31, 1982, and before August 8, 1986, the interest on which is exempt from federal income taxes.[1332] Specified obligations also include those acquired after August 7, 1986, if it is a qualified tax-exempt obligation for purposes of the §265(b) limitation, described in 536 T.M., *Interest Expense.*[1333] A limited de minimis safe harbor rule applies to the allocation rules of §265(b)(2). This rule provides that in calculating the taxpayer's average adjusted bases in tax-exempt obligations under §265(b)(2)(A), tax-exempt obligations issued during 2009 or 2010 are not considered, but only up to the amount that is equal to 2% of the taxpayer's average adjusted bases for all assets under §265(b)(2)(B).[1334] For purposes of this rule, a current refunding bond or advance refunding bond is treated as issued on the date of the refunded bond. If there are a series of refunding bonds, the date of the original bond controls.[1335]

(b) Interest Paid or Incurred on Indebtedness

The amount of interest paid or incurred on the indebtedness is determined by multiplying the aggregate amount allowable as interest deductions for the tax year determined without regard to the §291(a)(3) reduction or the §265(b) limitation, by a fraction.[1336] The numerator of the fraction is the taxpayer's average adjusted basis[1337] of the specified obligations.[1338] The denominator of the fraction is the average adjusted basis of all of the taxpayer's assets.[1339] The taxpayer may establish a different formula to the extent specified by the IRS in regulations.[1340]

(c) Interest

Interest includes amounts, whether designated interest, paid in respect of deposits, investments certificates, and withdrawable or purchasable shares.[1341]

b. Other Limitations

Examples of other limitations based on specified reductions include:

- The §291(a)(2) percentage depletion reduction discussed in detail in 601 T.M., *Mineral Properties — Exploration, Acquisition, Development and Disposition*, and 605 T.M., *Oil and Gas Transactions*;
- The §291(a)(4) percentage pollution control facility amortization deduction reduction, which the amortizable basis of any certified pollution control facility with respect to which the election under §169 is made to deduct amortization of that basis is reduced by 20%, discussed in detail in 530 T.M., *Depreciation: General Concepts; Non-ACRS Rules*; and
- The §291(b) reduction of mineral limitation, which provides that certain mineral deductions otherwise allowable are reduced by 30%, discussed in detail in 605 T.M., *Oil and Gas Transactions.*

5. Compensation-Related Limitations

Examples of computational limitations applying compensation-related limitations include:

- The §406(d) specified foreign affiliate employees §404 deduction limitation discussed in in detail 371 T.M., *Employee Plans — Deductions, Contributions and Funding*;
- The §407(d) specified domestic subsidiary employees §404 deduction limitation discussed in detail in 371 T.M., *Employee Plans — Deductions, Contributions and Funding*;

[1329] §291(a)(3).
[1330] *See* §585(a)(2).
[1331] §291(e)(1)(B)(i).
[1332] §291(e)(1)(B)(i).
[1333] §291(e)(1)(B)(iv) (reference to §265(b)(3)). *See* §265(b)(3)(A).
[1334] §265(b)(7)(A), §265(b)(7)(B).
[1335] §265(b)(7)(C).
[1336] §291(e)(1)(B)(ii).
[1337] *See* §1016.
[1338] §291(e)(1)(B)(ii)(I).
[1339] §291(e)(1)(B)(ii)(II).
[1340] §291(e)(1)(B)(ii).
[1341] §291(e)(1)(B)(iii).

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• The §280H personal service company employee-owner compensation deduction limitation discussed in detail in 574 T.M., *Accounting Periods*;

• The §162(m)(1) $1 million limitation discussed in detail in 390 T.M., *Reasonable Compensation*;

• The §162(m)(5) limitation applying to employers from whom any troubled assets, aggregating over $300 million for all tax years, are acquired by the Department of Treasury under the Emergency Economic Stabilization Act of 2008 discussed in detail in 390 T.M., *Reasonable Compensation*; and

• The §162(m)(6) limitation applying to remuneration exceeding $500,000 attributable to services performed by an applicable individual for a covered health insurance provider during an applicable tax year discussed in detail in 385 T.M., *Deferred Compensation Arrangements*.

C. Double Benefit Restrictions

1. Deductions Attributable to Excluded Income

a. Congressional Allowances

No deduction is allowed for expenses paid or incurred by designated congressional officials with respect to which they receive reimbursement that is excluded from gross income.[1342] Designated congressional officials consist of the Majority and Minority Leaders of the Senate,[1343] the President Pro Tempore of the Senate,[1344] the Chairs of the Majority and Minority Conference Committees,[1345] the Secretary for the Majority of the Senate and the Secretary for the Minority of the Senate,[1346] and the Secretary, Sergeant at Arms, and Doorkeeper of the Senate.[1347]

b. Expenses Attributable to Conrail Reorganization

No deduction is allowed to Conrail[1348] for any amount paid after the date of the public sale of its stock[1349] for services paid on or before the date of the public sale.[1350] This disallowance reflects certain tax benefits accorded Conrail as a consequence of the public sale.[1351]

c. Expenses Attributable to Federal Financial Assistance

Under §597(b)(3), no deduction is allowed for any expenditure for which, in effect, the taxpayer is reimbursed through nontaxable federal financial assistance.[1352] Federal financial assistance is money or other property provided with respect to a domestic building and loan association by the Federal Savings and Loan Insurance Corporation or the Resolution Trust Corporation under §406(f) of the National Housing Act, §21A of the Federal Home Loan Bank Act, or under any other similar law.[1353] It also includes any money or other property provided with respect to a bank or domestic building and loan association by the Federal Deposit Insurance Corporation under §11(f) or §13(c) of the Federal Deposit Insurance Act, or any other similar law.[1354] Certain federal financial assistance is nontaxable.[1355] The IRS stated that until further guidance is issued, amounts furnished by the Department of the Treasury to financial institutions pursuant to the Troubled Assets Relief Program (TARP) established under the Emergency Economic Stabilization Act of 2008[1356] will not be treated as the provision of federal financial assistance within the meaning of §597. The IRS also stated that if any future guidance provides to the contrary, that guidance will not apply retroactively to transactions with the Department of the Treasury, or to securities issued by financial institutions to the Department of the Treasury, before the publication of such guidance, or pursuant to a written binding contract entered into before that date.[1357]

d. Other Deductions Disallowed

Examples of other deductions attributable to excluded income include:

• The §127(c)(7) educational assistance exclusion, providing no deduction is allowed for amounts excluded from gross income under the §127 educational assistance exclusion,[1358] discussed in detail in 517 T.M., *Educational Expenses and Credits*;

• The §129(e)(7) dependent care assistance exclusion, providing no deduction is allowed for amounts excluded from gross income under the §129 dependent care assistance exclusion, discussed in detail in 394 T.M., *Employee Fringe Benefits*;

• The §421(a)(2) stock option exclusion, providing no deduction is allowed with respect to a transfer of stock that qualifies for the §421(a)(1) exclusion due to qualifying as a §422 incentive stock option or as a §423 employee stock purchase plan option,[1359] discussed in detail in 381 T.M., *Statutory Stock Options*;

[1342] 2 U.S.C. §6102, §32b, §65c(a), §69a.
[1343] 2 U.S.C. §6102.
[1344] 2 U.S.C. §6115.
[1345] 2 U.S.C. §6102.
[1346] 2 U.S.C. §6512(a).
[1347] 2 U.S.C. §6512(a); 2 U.S.C. §6514.
[1348] *See* 45 U.S.C. §1347(e)(1).
[1349] *See* 45 U.S.C. §1347(e)(2).
[1350] 45 U.S.C. §1347(c).
[1351] *See* 45 U.S.C. §1347(a), §1347(b), §1347(d).
[1352] §597(b)(3).
[1353] §597(c)(1).
[1354] §597(c)(2).
[1355] *See* Reg. §1.597-2(c)(2), §1.597-2(c)(3), T.D. 9825, 82 Fed. Reg. 48,618, effective on October 19, 2017.
[1356] Pub. L. No. 110-343, Div. A.
[1357] Notice 2008-101.
[1358] Reg. §1.127-1(b).
[1359] Reg. §1.421-2(a)(1)(ii). The §421(a)(2) disallowance applies to the employer corporation, any parent or subsidiary of the employer corporation, and any corporation issuing or assuming a stock option in a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation to which the §424 stock option transfer rules apply.

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• The §265(a) disallowance, providing that no deduction is allowed for expenses and interest related to tax-exempt income,[1360] discussed in detail in 536 T.M., *Interest Expense Deductions*;

• The §265(b) disallowance, providing that no deduction is allowed for the portion of a financial institution's interest expense that is allocable to tax-exempt interest, discussed in detail in 536 T.M., *Interest Expense Deductions*;

• The §171(a)(2) tax-exempt bond disallowance, providing no deduction is allowed with respect to the amortization of bond premium with respect to a bond if interest on the bond is excludible from gross income, discussed in 536 T.M., *Interest Expense Deductions*;

• The §530(d)(2)(B) disallowance, providing if the aggregate distributions exceed the qualified education expenses, a proportionate part of the distribution is excluded from gross income and the §530(d)(2)(D) disallowance, providing no deduction is allowed for any qualified education expenses to the extent they are taken into account in computing the exclusion from gross income of distributions from a Coverdell education savings account discussed in 517 T.M., *Educational Expenses and Credits*;

• The §931(b), §932(c), and §933 disallowances, providing no deduction[1361] is allowed for amounts otherwise deductible that are properly allocable or chargeable against amounts excluded from gross income as income from sources within, or effectively connected with the conduct of a trade or business within, a specified U.S. possession, discussed in 6080 T.M., *Section 911 and Other International Tax Rules Relating to U.S. Citizens and Residents* (Foreign Income Series);

• The §953(b) disallowance and limitations for expenses related to excluded Subpart F insurance company income, providing certain deductions are disallowed and others are limited in computing controlled foreign corporation insurance income subject to taxation under Subpart F, discussed in 926 T.M., *CFCs — General Overview* (Foreign Income Series);

• The §901(g)(1) possession corporation disallowance, providing no deduction is allowed for any tax of a foreign country or possession paid or accrued with respect to a possessions corporation distribution, discussed in 6020 T.M., *The Creditability of Foreign Taxes — General Issues* (Foreign Income Series);

• The §118(c)(4)[1362] exclusion for contributions in aid of construction, providing no deduction is allowed for, or by reason of, any expenditure constituting a contribution in aid of construction that is excluded by a regulated water or sewage disposal utility, discussed in 501 T.M., *Gross Income: Overview and Conceptual Aspects*; and

• The §136(b) energy conservation subsidy exclusion, providing a public utility customer who excludes from gross income an energy conservation subsidy provided by a public utility is not allowed to deduct any expenditure with respect to which the subsidy was granted, to the extent of the amount excluded, discussed in 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources.*

With respect to an alimony deduction, there is no double benefit if the amount deducted by one spouse is included in income by the other spouse.[1363] In *Leyh*, the Tax Court held that the taxpayer may deduct as alimony the amount of the premiums he paid to provide health insurance coverage for his then-wife under his employer's cafeteria plan, even though the value of the employer-provided health insurance was excludible from his income. The court reasoned that there was no double benefit because the amounts deducted by the taxpayer were included in his then-wife's income.[1364]

2. *Deductions Attributable to Amounts for Which Credit Allowed*

A taxpayer allowed a credit for an expenditure cannot claim a deduction for the same expenditure. Examples of this principle are as follows:

• Section 30B(h)(5)(A), §30B(h)(5)(B), disallowance of certain deductions for which a motor vehicle credit was claimed. For further discussion, see 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources*;

• Section §43(d)(1), providing any deduction allowable with respect to costs taken into account in computing the enhanced oil recovery credit[1365] is reduced by the amount of the credit attributable to those costs. For further discussion, see 605 T.M., *Oil and Gas Transactions*;

[1360] §265(a); Reg. §1.265-1(a)(1). *E.g.*, *Denman v. Slayton*, 282 U.S. 514, 519 (1931), *rev'g Nauts v. Slayton*, 36 F.2d 145 (6th Cir. 1929); *Manocchio v. Commissioner*, 78 T.C. 989 (1982) (Tax Court based its disallowance of expense deduction on §265, finding close connection between receipt of tax-exempt income and the claimed deduction for education expense claimed by taxpayer; court reasoned that right to reimbursement for expense arose only when the Veterans Administration received signed certification of training and cost of such training). *Cf. Leyh v. Commissioner*, 157 T.C. No. 7 (2021) (§265 does not apply to husband's alimony deduction; husband's alimony payments are not allocable to tax-exempt income because husband's spouse (recipient of the payments deducted) was required to include the payments in her income); CCA 200947035 (§265 does not prohibit an employer's deduction of compensation payments made to its disabled employee because deduction is not allocable to the insurance proceeds received from the disability policy; employer received the disability insurance payment on account of its employee's disability, not on account of its contractual obligation to pay the employee's salary; with no connection between the income and the expense, the requirement that the expense be allocable to the tax-exempt income is not met, and §265 does not disallow the deduction).

[1361] *See also* Reg. §1.931-1(b) (providing, in regards to Guam, American Samoa, or the Northern Mariana Islands sourced income, the §151 deduction for personal and dependency exemptions is allowed), Reg. §1.933-1(c) (providing, in regards to Puerto Rico sourced income, the §151 deduction for personal and dependency exemptions is allowed). *But see* §151(d)(5), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70103 (personal exemption deduction is zero beginning in 2018).

[1362] Added by the Infrastructure Investment and Jobs Act, Pub. L. No. 117-58, §80601, effective for contributions made after December 31, 2020.

[1363] *Leyh v. Commissioner*, 157 T.C. No. 7 (2021).

[1364] 157 T.C. No. 7 (2021).

[1365] *See* §43(a).

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• Section 44(d)(7)(A), providing no deduction is allowed for the amount of expenditures for which a disabled individual's access credit[1366] is allowed. For further discussion, see 506 T.M., *Principles of Income Tax Credits*;

• Section 45B(c), providing no deduction is allowed for excess social security taxes paid by an employer for which an excess employer social security tax credit is allowed, For further discussion, see 514 T.M., *Tax Incentives to Hire, Retain, or Compensate Employees*;

• Section 45E(e)(2), providing no deduction is allowed for the portion of qualified small employer pension plan startup costs paid or incurred during the tax year equal to the amount of the §45E small employer pension plan startup cost credit determined for that year. For further discussion, see 514 T.M., *Tax Incentives to Hire, Retain, or Compensate Employees*;

• Section 45F(f)(2), providing no deduction is allowed with respect to the amount of the employer-provided child care credit. For further discussion, see 514 T.M., *Tax Incentives to Hire, Retain, or Compensate Employees*;

• Section 45V(d)(2), providing no credit is allowed with respect to any qualified clean hydrogen produced at a facility which includes carbon capture equipment for which the 45Q credit is allowed. For further discussion, see 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources*;

• Section 280C(a), providing no deduction is allowed for the portion of wages or salaries paid or incurred during the tax year that equals the sum of the Indian employment credit,[1367] the employer differential wage payments credit,[1368] the employer credit for paid family and medical leave,[1369] the work opportunity credit,[1370] the empowerment zone employment credit,[1371] the Hurricane Katrina employer housing credit,[1372] and the employee retention credit[1373] allowable for the tax year.[1374] For further discussion, see 514 T.M., *Tax Incentives to Hire, Retain, or Compensate Employees*;

• Section 280C(b), providing no deduction is allowed for the portion of qualified clinical testing expenses[1375] otherwise allowable as a deduction for the tax year that equals the amount of the qualified clinical testing expenses credit[1376] allowable for the tax year,[1377] discussed in 506 T.M., *Principles of Income Tax Credits*;

• Section 280C(c),[1378] providing no deduction is allowed for the portion of qualified research expenses[1379] or basic research expenses[1380] otherwise allowable as a deduction for the tax year that equals the amount of the research credit[1381] allowable for the tax year,[1382] discussed in detail in 556 T.M., *Research and Development Expenditures*;

• Section 280C(d),[1383] providing deductions otherwise allowed under Chapter 1 of the Code are reduced by the amount of the §45H low-sulfur diesel fuel production credit, discussed in 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources*;

• Section 280C(e), providing no deduction is allowed for the portion of the expenses otherwise allowable as a deduction that equals the amount of the §45N mine-rescue team training credit, discussed in 506 T.M., *Principles of Income Tax Credits*;

• Section 280C(f), providing a taxpayer may not deduct the amount of the §45O agricultural chemicals security credit even if it otherwise would have been allowed as a deduction, discussed in 506 T.M., *Principles of Income Tax Credits*;

• Section 280C(g), providing no deduction is allowed for the portion of the premiums paid by the taxpayer for coverage of one or more individuals under a qualified health plan that is equal to the amount of the §36B health insurance premium credit, discussed in 513 T.M., *Family and Household Transactions*;

• Section 280C(h), providing no deduction is allowed for that portion of the premiums for qualified health plans, or for health insurance coverage in the case of tax years beginning in 2010 through 2013, paid by an employer that is equal to the amount of the small employer health insurance credit,[1384] discussed in 514 T.M., *Tax Incentives to Hire, Retain, or Compensate Employees*;

• Section 905(a), providing no deduction is allowed for the payment of any foreign income tax that accrued in an earlier tax year and with respect to which the taxpayer elected to claim the foreign tax credit[1385] by electing to treat the tax as paid in the tax year in which it accrued,[1386] discussed in detail in 6020 T.M., *The Creditability of Foreign Taxes — General Issues* (Foreign Income Series); and

• Section 960(c)(4),[1387] providing if the taxpayer elected to claim foreign tax credits for any tax year in which the taxpayer was required to include subpart F income in gross income under §951(a), no deduction is allowed for any foreign income tax on or with respect to any distribution from previously taxed subpart F earnings and profits of a controlled foreign corporation excluded from gross in-

[1366] *See* §44(a).
[1367] *See* §45A(a).
[1368] §45P(a).
[1369] §45S.
[1370] *See* §51(a).
[1371] *See* §1396(a).
[1372] *See* former §1400P(b).
[1373] *See* former §1400.
[1374] §280C(a). *See* Reg. §1.280C-1.
[1375] *See* §45C(b).
[1376] *See* §45C(b).
[1377] §280C(b)(1); Reg. §1.280C-3(a) (referring to former §28).
[1378] §280C(c).
[1379] *See* §41(b).
[1380] *See* §41(e)(2).
[1381] *See* §41(a).
[1382] §280C(c)(1).
[1383] As amended by the 2007 Tax Technical Corrections Act, Pub. L. No. 110-172, §7(a)(1)(B).
[1384] §45R.
[1385] *See* §901.
[1386] Reg. §1.905-1.
[1387] §960(c)(4).

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come under §959(a) and received in a tax year for which the taxpayer does not elect to claim foreign tax credits,[1388] discussed in 6280 T.M., *CFCs — Sections 959–965 and 1248* (Foreign Income Series).

In addition, where an eligible taxpayer elects to transfer all or a portion of an eligible credit to an unrelated taxpayer under the §6418 credit transfer election,[1389] with respect to any amount paid by the transferee taxpayer as consideration for such transfer, that amount is not deductible.[1390]

3. Deductions Attributed to Favorably Characterized Amounts

Examples of deduction attributed to favorable characterized amounts include:

• The §268 unharvested crop production expenses deduction disallowances[1391] discussed in detail in 607 T.M., *Farm and Ranch Expenses and Credit*; and

• The §272 coal and domestic iron ore disposition contract expenses disallowance[1392] discussed in detail in 603 T.M., *Mineral Properties Other Than Gas and Oil — Operation.*

4. Other Double Benefit Restrictions

a. Interrelationship with Previous Internal Revenue Codes

Under §7852(c), unless otherwise distinctly expressed or manifestly intended, the same item must not be taken into account both in computing an income tax under the Internal Revenue Code of 1986 and an income tax under the Internal Revenue Code of 1939.[1393]

b. Trusts and Estates

(1) Interrelationship with Estate Tax Deductions

Under §642(g), amounts allowable as estate tax deductions for expenses, debts, taxes, and losses[1394] are not allowed as income tax deductions, or offsets against amount realized, in computing the taxable income of the estate or any other person unless there is filed a statement[1395] that the amounts have not been allowed as estate tax deductions and that the right to claim the amounts as estate tax deductions is waived.[1396] Similar principles apply to amounts that are allowable as generation skipping tax deductions under §2621(a)(2) and §2622(b).[1397] The §642(g) disallowance is discussed in detail in 852 T.M., *Income Taxation of Trusts and Estates* (Estates, Gifts, and Trusts Series).

(2) Distributions Deductions

Under §663(a)(3), an estate or complex trust is not allowed to deduct an amount paid, credited, or distributed in the tax year if that amount was taken into account for a preceding tax year as a credit or required distribution.[1398] The §663(a)(3) disallowance is discussed in 852 T.M., *Income Taxation of Trusts and Estates* (Estates, Gifts, and Trusts Series).

c. Insurance Companies

Under §832(d), no item may be deducted more than once by an insurance company.[1399]

D. Public Policy Restrictions

1. Introduction

Some amounts otherwise deductible are disallowed to support nontax public policy. Thus, deductions are not allowed for illegal bribes,[1400] fines and similar penalties,[1401] certain lobbying expenses,[1402] settlements subject to nondisclosure agreements paid in connection with sexual harassment or sexual abuse,[1403] and the expenses of illegal drug sales.[1404] Additionally, the IRS has the broad authority, under §269, to disallow any deduction arising from a tainted acquisition if the principal purpose of the acquisition was to secure the benefit of the deduction.[1405] The §269 disallowance is discussed in detail in 780 T.M., *Net Operating Losses and Other Tax Attributes — Sections 381, 382, 383, 384, and 269.* Loss between related parties is also disallowed. Under §267(a)(1), no deduction otherwise allowable is allowed with respect to any loss from the sale or exchange of property, directly or indirectly, between related persons.[1406] Note that proposed rules issued in November 2023 would revise the regulations under §267 and §707 to reflect Congress's intent underlying these provisions that partnerships should be viewed as an entity rather than as an aggregate of its partners when applying the loss disallowance rules of §267(a)(1) and §707(b)(1).[1407]

If the §267(a)(1) disallowance applies to a transferor, the transferee is permitted to exclude certain gain from gross income when the transferee transfers the property.[1408] The §267(a)(1) disallowance is discussed in detail in 527 T.M., *Loss Deductions.* Under §267A, no deduction is allowed for any dis-

[1388] §960(c)(4); Reg. §1.960-5.

[1389] *See* §6418(f)(1) (eligible credits) §13801; *see also* Reg. §1.6418-1(c) (eligible credits), T.D. 9993, 89 Fed. Reg. 34,770 (Apr. 30, 2024).

[1390] §6418(b)(3), applicable to tax years beginning after December 31, 2022; *see* Reg. §1.6418-2(e)(3), T.D. 9993, 89 Fed. Reg. 34,770 (Apr. 30, 2024). For a detailed of the transfer election under §6418, see 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources*, at XI.B.

[1391] Reg. §1.268-1.

[1392] Reg. §1.272-1(a), §1.272-1(b)(1).

[1393] §7852(c).

[1394] *See* §2053, §2054.

[1395] *See* Reg. §1.642(g)-1.

[1396] §642(g); Reg. §1.642(g)-1, §1.642(g)-2.

[1397] §642(g).

[1398] §663(a)(3); Reg. §1.663(a)-3.

[1399] §832(d).

[1400] *See* §162(c).

[1401] *See* §162(f). Note that there are exceptions for payments that are characterized as restitution (including remediation of property) or legal compliance costs. §162(f)(2).

[1402] §162(e).

[1403] §162(q).

[1404] *See* §280E.

[1405] §269(a); Reg. §1.269-2. *See* Reg. §1.269-6 and §1.269-7.

[1406] §267(a)(1); Reg. §1.267(a)-1(a). E.g., *McWilliams v. Commissioner*, 331 U.S. 694, 699–700 (1947), *aff'g* 158 F.2d 637 (6th Cir. 1946), *rev'g* 5 T.C. 623 (1945).

[1407] *See* Prop. Reg. §1.267(a)-1, as amended by REG-131756-11, 88 Fed. Reg. 82,792 (Nov. 27, 2023). The changes would apply to tax years ending on or after the date final rules are published in the Federal Register.

[1408] §267(d); Reg. §1.267(d)-1.

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qualified related party amount paid or accrued pursuant to a hybrid transaction, or for any disqualified related party amount paid or accrued by, or to, a hybrid entity.[1409] The §267A disallowance is discussed in detail in 6000 T.M., *Foundations of U.S. International Taxation* (Foreign Income Series).

2. Deductions Disallowed for Nontax Policy Reasons

a. Judicially Developed Disallowances

(1) In General

The Code contains several statutory nontax policy disallowance provisions discussed in IV.D.2.b. through IV.D.2.e., below. For deductions not specifically disallowed by these provisions, the IRS, in regulations, takes the position that a deduction for an expense that would otherwise be allowable as a deduction under §162 is not disallowed on the grounds that its allowance would frustrate a sharply defined public policy.[1410] However, over the years, judicial doctrine has developed disallowing taxpayers to deduct an expense on the grounds that its allowance would frustrate a sharply defined public policy, discussed in IV.D.2.a.(2) through IV.D.2.a.(5), below.

(2) Scope of Application of Disallowance

Courts have taken the position that so long as a state statute is generally enforced, it can be the basis of a federal income tax deduction disallowance, even though it is not aggressively enforced.[1411] Courts have declined to impose a public policy disallowance if the taxpayer's actions were not a direct violation of a nontax law.[1412] Similarly, if the taxpayer's payment to another person is not violative of public policy, the fact that the payee, by accepting the payment, breaches a duty to a third party does not require that the taxpayer's deduction be disallowed.[1413]

(3) Illegal Business Activities

(a) Illegal Business

In *Commissioner v. Sullivan*,[1414] the Supreme Court held that wages and rental deductions paid by a taxpayer operating an illegal bookmaking business were deductible, because they were ordinary and necessary expenses of the business.[1415] The Court noted that the deductions would be disallowed if they were a device to avoid the consequences of violations of law or otherwise contravened federal policy.[1416] In an earlier decision, the Tax Court had held that a taxpayer illegally selling whiskey could not treat the cost of confiscated liquor either as part of cost of goods sold or as a loss, based on public policy grounds.[1417]

Since the *Sullivan* decision, the courts have been somewhat inconsistent with respect to deductions paid or incurred in the conduct of an illegal trade or business, sometimes not disallowing the deductions solely because of the illegality,[1418] and allowing deductions for otherwise deductible expenses paid or incurred by taxpayers engaged in operating illegal numbers games,[1419] illegal lotteries,[1420] and illegal gambling enterprises.[1421] The IRS has also refrained from disallowing deductions connected to an illegal activity, but that are not illegal in themselves,[1422] such as arms sales commissions paid to foreign agents by a taxpayer who illegally concealed the payments that were not in and of themselves illegal.[1423] Yet, the Tax Court denied a deduction for illegal gambling proceeds forfeited to authorities by a bar owner who illegally operated a gambling enterprise.[1424] This result is consistent with other decisions denying a loss deduction for the value of illegal gambling devices seized by authorities,[1425] and with a decision denying a deduction for payments made to the government under a plea bargain made in response to charges of illegally smuggling freon into the country.[1426]

Note: Under §280E, discussed in IV.D.2.b., below, the expenses paid or incurred in carrying on an illegal drug sale business are disallowed.[1427]

(b) Transacting Business in Illegal Manner

The cost of extra bottles given to customers who purchased illegally at posted prices is included in cost of goods sold.[1428] A taxpayer who loaned money at usurious rates in violation of state law was allowed to deduct losses that arose when the state made collection of the loans illegal.[1429]

[1409] §267A.

[1410] Reg. §1.162-1(a).

[1411] *E.g., Boucher v. Commissioner*, 77 T.C. 214, 220 (1981), *aff'd per curiam*, 693 F.2d 98 (9th Cir. 1982).

[1412] *See, e.g., RCA Commc'ns, Inc. v. United States*, 277 F.2d 164, 166 (Ct. Cl. 1960).

[1413] *McKissack v. Commissioner*, 28 T.C.M. 557, 566 (1969).

[1414] 356 U.S. 27 (1958), *aff'g* 241 F.2d 46 (7th Cir. 1957), *rev'g Ross v. Commissioner*, 15 T.C.M. 23, 28 (1956).

[1415] *Commissioner v. Sullivan*, 356 U.S. 27, 29 (1958). *See Mesi v. Commissioner*, 242 F.2d 558, 559 (7th Cir. 1957), *aff'd sub nom., Commissioner v. Sullivan*, 356 U.S. 27 (1958), *rev'g* 25 T.C. 513 (1955); *English v. Commissioner*, 249 F.2d 432, 433 (7th Cir. 1957), *rev'g* 15 T.C.M. 23 (1956); *Commissioner v. Doyle*, 231 F.2d 635, 636 (7th Cir. 1956), *aff'g* 13 T.C.M. 1171, 1175 (1954); *Accardo v. Commissioner*, 17 T.C.M. 322, 331 (1958).

[1416] *Commissioner v. Sullivan*, 356 U.S. 27, 29 (1958).

[1417] *Fuller v. Commissioner*, 20 T.C. 308, 318 (1953), *aff'd on other issues*, 213 F.2d 102 (10th Cir. 1954).

[1418] *E.g., Zouganiles v. Commissioner*, 19 T.C.M. 13, 18 (1960).

[1419] *Harbin v. Commissioner*, 17 T.C.M. 950, 952 (1958).

[1420] *Cohen v. Commissioner*, 17 T.C.M. 284, 286 (1958).

[1421] *Comeaux v. Commissioner*, 10 T.C. 201, 207–08 (1948), *aff'd sub nom., Cohen v. Commissioner*, 176 F.2d 394 (10th Cir. 1949); *Clemons v. Commissioner*, 7 T.C.M. 81, 84 (1948), *aff'd sub nom., Cohen v. Commissioner*, 176 F.2d 394 (10th Cir. 1949); *Polk v. Commissioner*, 7 T.C.M. 51, 54 (1948), *aff'd sub nom., Cohen v. Commissioner*, 176 F.2d 394 (10th Cir. 1949); *Cohen v.* Commissioner, 9 T.C. 1156 (1947), *aff'd sub nom., Cohen v. Commissioner*, 176 F.2d 394 (10th Cir. 1949); *Carahan v. Commissioner*, 9 T.C. 1206 (1947), *aff'd sub nom., Cohen v. Commissioner*, 176 F.2d 394 (10th Cir. 1949).

[1422] GCM 39813 (Mar. 19, 1990).

[1423] FSA 200128004.

[1424] *Hackworth v. Commissioner*, 88 T.C.M. 44 (2004), *aff'd per curiam*, 155 Fed. App'x 627 (4th Cir. 2005).

[1425] *Farris v. Commissioner*, 50 T.C.M. 412 (1985), *aff'd without op.*, 823 F.2d 1552 (9th Cir. 1987); *Hopka v. United States*, 195 F. Supp. 474 (N.D. Iowa 1961).

[1426] *Wood v. United States*, 2003-1 USTC ¶50,193 (S.D. Fla. 2002).

[1427] §280E.

[1428] *Max Sobel Wholesale Liquors v. Commissioner*, 630 F.2d 670, 673–74 (9th Cir. 1980), *aff'g* 69 T.C. 477 (1977), *acq.*, 1982-2 C.B. 2.

[1429] *Tharp v. Commissioner*, 31 T.C.M. 22, 26 (1972).

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(c) Rebates

No deduction is allowed for rebates and discounts illegally paid by a life insurance agent to policy buyers.[1430] In contrast, a deduction has been allowed for an insurance broker's illegal payment of the policy buyer's first-year premium, because the state insurance authority was aware of the taxpayer's practice.[1431] The IRS has also ruled that price rebates granted by a taxpayer in order to meet competitor's prices while engaged in an illegal price-fixing conspiracy were included in cost of goods sold even though the taxpayer was convicted.[1432] Additionally, incidental expenses paid or incurred to make illegal rebates were not disallowed on public policy grounds.[1433] Illegal cash payments to customers are adjustments to the sales price of merchandise.[1434]

(d) Compensation in Furtherance of Illegal Purpose

The IRS has ruled that compensation paid to an arsonist to burn down a building is not deductible.[1435] The Tax Court has denied deductions for blackmail payments made to an employee who threatened to reveal information to customers who would have ceased doing business with the corporation had they known the information, noting that blackmail payments were not ordinary in the taxpayer's line of business.[1436]

(e) Illegal Equipment

The IRS has ruled that depreciation deductions are allowable with respect to coin-operated gaming machines subsequently confiscated for the taxpayer's failure to register them.[1437]

(4) Other Illegal Activities

The IRS and Tax Court have taken the position that no casualty loss deduction is allowed if the casualty is a fire started by the taxpayer's grossly negligent or intentional behavior.[1438] Similarly, no deduction is allowable for payments made by a taxpayer to a former lover under the threat by the former lover to inform the taxpayer's spouse about an affair, reflecting a public policy against government financing of failed extramarital affairs.[1439]

(5) Racial Discrimination

(a) Contributions to Schools

The IRS takes the position that no charitable contribution deduction is allowed with respect to contributions to private schools that have racially discriminatory policies.[1440] In 1979, Congress enacted legislation that prohibited the IRS from implementing any proposed revenue procedure that would have set up guidelines for reviewing the tax-exempt status of private schools to determine if they have racially discriminatory policies and that prohibited the IRS from spending money to revoke the tax-exempt status of, and thus make nondeductible, charitable contributions to private schools.[1441]

Injunctions had been issued suspending the charitable contribution deduction for contributions to certain schools[1442] and requiring suspension of advance assurance of the deductibility of contributions to certain schools.[1443] The Supreme Court had held that a university could not obtain an injunction preventing the IRS from revoking its tax-exempt status on the grounds that it had racially discriminatory policies.[1444]

The impact of public policy on the charitable contribution deduction is discussed in detail in 521 T.M., *Charitable Contributions: Income Tax Aspects.*

(b) Contributions to Governments

No deduction is allowable for a contribution of land to a government for use as a public recreational area that would otherwise be deductible if the donor restricts the use on a racially discriminatory basis.[1445]

b. Expenses of Illegal Drug Sale Trade or Business

(1) In General

Under §280E, no deduction is allowed for any amount paid or incurred during the tax year in carrying on any illegal drug sale trade or business.[1446] The enactment of §280E overruled cases in which drug dealers, drug smugglers, and others engaged in illegal drug trafficking were allowed to deduct compensation, repairs, telephone, rent, vehicle, and similar expenses paid or incurred in connection with their trafficking businesses.[1447]

Section 280E disallows not only the deduction for trade or business expenses under §162, but all of the deductions specified in Part VI of Subchapter B of the Income Tax Subtitle of the Code, which includes the deductions under §162, §163,

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[1430] *Boucher v. Commissioner*, 77 T.C. 214, 220 (1981), *aff'd per curiam*, 693 F.2d 98 (9th Cir. 1982); *Alex v. Commissioner*, 70 T.C. 322, 326 (1978), *aff'd*, 628 F.2d 1222 (9th Cir. 1980); *Kriesberg v. Commissioner*, 39 T.C.M. 337, 345 (1979).

[1431] *Custis v. Commissioner*, 43 T.C.M. 1511, 1515 (1982).

[1432] Rev. Rul. 77-243, *modified by* Rev. Rul. 82-149.

[1433] *Harmony Dairy Co. v. Commissioner*, 19 T.C.M. 582, 587 (1960).

[1434] *E.g., Haas Bros. v. Commissioner*, 73 T.C. 1217, 1223 (1980), *acq.*, 1982-2 C.B. 1.

[1435] Rev. Rul. 82-74.

[1436] John J. *Wells, Inc. v. Commissioner*, 47 T.C.M. 1114, 1117 (1984).

[1437] Rev. Rul. 74-528.

[1438] *Blackman v. Commissioner*, 88 T.C. 677, 683 (1987), *aff'd without op.*, 867 F.2d 605 (1st Cir. 1988); Rev. Rul. 81-24.

[1439] *See Ing v. United States*, 94-1 USTC ¶50,031 (D. Haw. 1993).

[1440] Rev. Rul. 71-447. *See also* Rev. Proc. 75-50 (guidelines and recordkeeping requirements for determining whether a private school has adopted a racially nondiscriminatory policy regarding students and operates in accordance with that policy), *modified by* Rev. Proc. 2019-22, effective May 28, 2019.

[1441] Treasury, Postal Service, and General Government Appropriation Act of 1980, Pub. L. No. 96-74, §615, 93 Stat. 559, 577.

[1442] *Green v. Connally*, 330 F. Supp. 1150, 1179–80 (D.D.C. 1971), *aff'd without op. sub nom., Coit v. Green*, 404 U.S. 997 (1971), *supplemented* and *modified sub nom., Green v. Miller*, 80-1 USTC ¶9401 (D.D.C. 1980).

[1443] *Green v. Kennedy*, 70-2 USTC ¶9600 (D.D.C. 1970).

[1444] *Bob Jones Univ. v. Simon*, 416 U.S. 725, 739, 749 (1974), *aff'g* 476 F.2d 259 (4th Cir. 1973), *rev'g and rem'g* 341 F. Supp. 277 (D.S.C. 1971).

[1445] Rev. Rul. 67-325.

[1446] §280E. For example, §280E disallows all deductions or credits for a business that sells or otherwise traffics marijuana. *See IRS's Marijuana Industry Frequently Asked Questions.*

[1447] *E.g., N. Cal. Small Bus. Assistants, Inc. v. Commissioner*, 153 T.C. 65 (2019); *Holmes Enters., Inc. v. Commissioner*, 69 T.C. 114, 119 (1977); *Carter v. Commissioner*, 48 T.C.M. 909, 911 (1984); *Hossbach v. Commissioner*, 42 T.C.M. 80, 85 (1981); *Edmondson v. Commissioner*, 42 T.C.M. 1533 (1981).

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§164, §165, §166, §167, §168, §169, and §170.[1448] The fact that an expenditure does not qualify as a business expenditure is irrelevant under §280E, which applies to *any amount* paid or incurred during the tax year in carrying on a trade or business that consists of trafficking in certain defined controlled substances.[1449]

However, the §280E disallowance does not apply to the cost of goods sold,[1450] nor to exclusions from gross income.[1451] It applies to the expenses of the taxpayer's illegal drug sale trade or business, but not to other trades or businesses of the taxpayer.[1452]

The Tax Court has rejected taxpayer claims that, because a taxpayer's trade or business is not limited exclusively to the sale of cannabis items, its trade or business does not "consist of" trafficking in controlled substances within the meaning of §280E.[1453]

The Tax Court also has rejected a taxpayer's argument that §280E does not disallow deductions for depreciation because depreciation is not an amount "paid or incurred during the taxable year."[1454]

Similarly, the Tax Court has rejected a taxpayer's argument that §280E does not disallow deductions for charitable contributions made by a business because charitable contributions by a business are not paid or incurred "in carrying on" the trade or business.[1455]

Also, no deduction is allowable for the value of illegal drug-dealing proceeds, other currency, or other property forfeited to the government, on the rationale that there exists a public policy against drug trafficking and against deductions for property forfeited under forfeiture statutes.[1456] Moreover, the forfeiture is comparable to a governmental fine and, thus, is not deductible.[1457]

(2) Illegal Drug Sale Trade or Business

(a) In General

An illegal drug sale trade or business is any trade or business that satisfies two conditions.[1458] First, the trade or business, or the activities comprising the trade or business, must consist of trafficking in controlled substances.[1459] Second, that trafficking must be prohibited by federal law or the law of any state in which the trade or business is conducted.[1460] Trafficking in a controlled substance includes an organization's distribution of marijuana to its members for medical purposes.[1461]

States legalizing marijuana distribution businesses have caused conflict with the federal government pursuant to §280E. In *Feinberg v. Commissioner*,[1462] Colorado state authorized the taxpayer to operate a marijuana distribution business. Also, the Department of Justice had twice instructed field prosecutors that they should generally decline to enforce federal drug trafficking laws when states like Colorado license marijuana distribution operations. However, the IRS still refused to recognize the taxpayer's claimed business expense deductions on the ground that the company is an illegal drug sale trade or business under federal law. Another point of contention arose when, although the taxpayer relied on state law to legitimize his marijuana distribution business, the taxpayer also invoked federal law to avoid self-incrimination, because of that business. The taxpayer argued that the Fifth Amendment prevented him from producing documents the IRS requested about the nature of his business, which it claimed was for the disputed deduction reason, but the court recognized it was the agency's attempt to

[1448] §161 ("there shall be allowed as deductions the items specified in this [part VI of the Code], subject to the exceptions provided in part IX, sec. 261 and following, relating to items not deductible"); *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 17 (1974).

[1449] *San Jose Wellness v. Commissioner*, 156 T.C. No. 4 (Feb. 17, 2021).

[1450] *See* S. Rep. No. 494, 97th Cong., 2d Sess. 309 (1982); *Sundel v. Commissioner*, 75 T.C.M. 1853 (1998), *aff'd without op.*, 201 F.3d 428 (1st Cir. 1999) (IRS permitted subtraction of cost of drugs sold in computing taxable income). *See also Patients Mut. Assistance Collective Corp. v. Commissioner*, 151 T.C. 176 (2018) (marijuana dispensary may be able to use the capitalization rules of §471, which distinguish between resellers and producers, for costs of goods sold, but cannot use the more inclusive rules under §263); *Alt. Health Care Advocates v. Commissioner*, 151 T.C. 225 (2018); CCA 201504011 (taxpayer trafficking in marijuana is entitled to determine inventoriable costs using applicable inventory-costing regulations under §471 as they existed when §280E was enacted); *IRS's Marijuana Industry Frequently Asked Questions.*

[1451] *Franklin v. Commissioner*, 65 T.C.M. 2497 (1993). Federal courts have consistently upheld IRS determinations that state compliant marijuana dispensaries have taxable income. *See, e.g.*, *Feinberg v. Commissioner*, 916 F.3d 1330 (10th Cir. 2019); *Olive v. Commissioner*, 792 F.3d 1146 (9th Cir. 2015); *Beck v. Commissioner*, T.C. Memo 2015-149. *See also IRS's Marijuana Industry Frequently Asked Questions.*

[1452] In *Californians Helping to Alleviate Med. Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007), the Tax Court held that the provision of medical marijuana under California law is subject to §280E. However, the court also held that the taxpayer had two separate trades or business and was subject to the limitation only on the drug-trafficking one. *See also Olive v. Commissioner*, 139 T.C. 19 (2012), *aff'd*, 792 F.3d 1146 (9th Cir. 2015); *Canna Care, Inc. v. Commissioner*, T.C. Memo 2015-206, *aff'd*, 694 Fed. Appx. 570 (9th Cir. 2017) (all drug-trafficking expenses other than those used to determine cost of goods sold disallowed; *Californians Helping* distinguished because taxpayer had only one trade or business). See TIGTA Report 2020-30-017, *The Growth of the Marijuana Industry Warrants Increased Tax Compliance Efforts and Additional Guidance* (Mar. 30, 2020), for an overview of the nature and extent of tax compliance issues in the marijuana industry.

[1453] *San Jose Wellness v. Commissioner*, 156 T.C. No. 4 (Feb. 17, 2021); *Patients Mut. Assistance Collective Corp. v. Commissioner*, 151 T.C. 176, 190 (2018).

[1454] *San Jose Wellness v. Commissioner*, 156 T.C. No. 4 (Feb. 17, 2021) (reasoning that *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 11 (1974) leaves no doubt that, as a cost presently incurred, depreciation is an amount paid or incurred during the tax year).

[1455] *San Jose Wellness v. Commissioner*, 156 T.C. No. 4 (Feb. 17, 2021).

[1456] *Brown v. Commissioner*, 71 T.C.M. 3197 (1996); *Santilli v. Commissioner*, 69 T.C.M. 2974 (1995); *King v. United States*, 949 F. Supp. 787 (E.D. Wash. 1996), *aff'd*, 152 F.3d 1200 (9th Cir. 1998).

[1457] *See Nacchio v. United States*, 824 F.3d 1370 (Fed. Cir. 2016) (holding an amount that a taxpayer had to forfeit to the government as part of his sentence for insider trading was a fine or similar penalty and, thus, was not deductible).

[1458] §280E.

[1459] §280E.

[1460] §280E.

[1461] *Californians Helping to Alleviate Med. Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007); *Olive v. Commissioner*, 792 F.3d 1146 (9th Cir. 2015), *aff'g* 139 T.C. 19 (2012) (although use and sale of medical marijuana are legal under California state law, use and sale of medical marijuana still prohibited under federal law). For further discussion of the tax consequences related to the marijuana industry see the IRS's website for the *Marijuana Industry Frequently Asked Questions.*

[1462] 808 F.3d 813 (10th Cir. 2015). *See Californians Helping to Alleviate Med. Problems, Inc.*, 128 T.C. 173 (2007); *Olive v. Commissioner*, 792 F.3d 1146 (9th Cir. 2015) *aff'g* 139 T.C. 19 (2012).

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obtain proof for §280E purposes, that the taxpayer was indeed illegally trafficking in marijuana.[1463]

(b) Controlled Substance

Any substance that is a controlled substance within the meaning of Schedules I and II of the Controlled Substances Act[1464] is a controlled substance.[1465] For purposes of §280E, marijuana is a controlled substance.[1466]

Note: The Treasury Inspector General for Tax Administration (TIGTA)'s report 2020-30-017, *The Growth of the Marijuana Industry Warrants Increased Tax Compliance Efforts and Additional Guidance* (Mar. 30, 2020), includes evaluation results of the IRS' examination and education approach to certain cash-based industries with an emphasis on legal marijuana operations. TIGTA reviewed three statistical random samples of marijuana businesses with a 2016 tax year filing requirement with likely §280E adjustments. It found that marijuana businesses in California, Oregon, and Washington states have a high rate of noncompliance with IRC §280E. TIGTA recommended that the IRS develop a comprehensive compliance approach for the marijuana industry, including a method to identify businesses in this industry and track examination results; develop and publicize guidance specific to the marijuana industry; leverage publicly available information at the state level and expand use of existing federal/state agreements to identify nonfilers and unreported income in the marijuana industry; and increase educational outreach towards unbanked taxpayers making cash deposits regarding the unbanked and relief policies available.

(3) In Carrying On

In *Bratulich v. Commissioner*,[1467] the Tax Court disallowed the travel expenses of a taxpayer, because they were incurred in carrying on a drug-dealing business and not for a fictitious gemstone business that the taxpayer had established to disguise his activities.[1468]

c. Charitable Contributions on Behalf of Federal Employees

(1) In General

No deduction is allowable with respect to excludible amounts paid to a charitable organization[1469] on behalf of a federal government employee.[1470] The same provision also disallows any deduction under any state or local tax law.[1471] The §7701(k)(2) disallowance is effective as of January 1, 1991.[1472] It ceases to be effective if the provisions of §703 of the Ethics Reform Act of 1989[1473] are repealed.[1474]

(2) Excludible Amount

An excludible amount is a payment which, except for §501(b) of the Ethics in Government Act of 1978,[1475] might be made to a federal government employee, but which is instead paid to a charitable organization on behalf of the employee and is excludible from the employee's gross income.[1476]

(3) Federal Government Employee

A federal government employee is any officer or employee of the federal government, including a senator, a representative in the Congress, a delegate to the Congress, and a resident commissioner to the Congress.[1477]

d. Discriminatory Taxation of U.S. Persons

Under §896(b), the president has the power to disallow federal income tax deductions otherwise allowable to subjects, or a class of subjects, of a foreign country that is imposing discriminatory taxation on U.S. persons or a class of U.S. persons.[1478] This power is part of a broader power to disallow credits and exemptions and to increase tax rates on those subjects of a foreign country.[1479] For a detailed discussion of §896(b), see 506 T.M., *Principles of Income Tax Credits.*

e. Other Restrictions

Examples of other public policy restrictions include:

• The restrictions under §162 and §212,[1480] providing no deduction is allowable for any illegal government bribe or kickback,[1481] illegal payment,[1482] illegal Medicare payment,[1483] settlements subject to nondisclosure agreements paid in connection with sexual harassment or sexual abuse,[1484] or fine or similar penalty paid to a government for the violation of any law,[1485] discussed in detail in 524 T.M., *Deductibility of Illegal Payments, Fines, and Penalties.*

[1463] *See also The Green Sol. Retail, Inc. v. United States*, 855 F.3d 1111 (10th Cir. 2017); *High Desert Relief, Inc. v. United States*, No. 16-CV-469 MCA/SCY, 2017 BL 108288 (D.N.M. Mar. 31, 2017), *aff'd*, 917 F.3d 1170 (10th Cir. 2019).

[1464] 21 U.S.C. §801–§969.

[1465] §280E. *Note:* After passage of the Agriculture Improvement Act of 2018 (2018 Farm Bill), Pub. L. No. 115-334, hemp (with .3% or less THC) is no longer considered to be a Schedule I substance. Hemp was also removed from the Controlled Substances Act. *See IRS's Marijuana Industry Frequently Asked Questions.*

[1466] *Sundel v. Commissioner*, 75 T.C.M. 1853 (1998), *aff'd without op.*, 201 F.3d 428 (1st Cir. 1999); *Browning v. Commissioner*, 61 T.C.M. 2053 (1991).

[1467] 60 T.C.M. 1308 (1990).

[1468] 60 T.C.M. at 1309–10.

[1469] *See* §170(c).

[1470] §7701(k)(2).

[1471] §7701(k)(2).

[1472] Ethics Reform Act of 1989, Pub. L. No. 101-194, §603, 103 Stat. 1716.

[1473] Pub. L. No. 101-194, §603, 103 Stat. 1716.

[1474] Pub. L. No. 101-194, §603, 103 Stat. 1716.

[1475] 18 U.S.C. §207.

[1476] §7701(k)(1).

[1477] §7701(k) (flush language).

[1478] §896(b).

[1479] §896(b).

[1480] Reg. §1.212-1(p).

[1481] §162(c)(1); Reg. §1.162-18(a)(1).

[1482] §162(c)(2); Reg. §1.162-18(b)(1).

[1483] §162(c)(3); Reg. §1.162-18(c).

[1484] §162(q).

[1485] §162(f); Reg. §1.162-21(a). *See Nacchio v. United States*, 824 F.3d 1370 (Fed. Cir. 2016) (holding an amount that a taxpayer had to forfeit to the government as part of his sentence for insider trading was a fine or similar penalty and, thus, was not deductible).

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• The restrictions under §162[1486] and §212,[1487] providing no deduction is allowable for two-thirds of any antitrust treble damage payment, discussed in detail in 522 T.M., *Tax Aspects of Settlements and Judgments.*

• The §162(e) restriction, providing no deduction is allowed for any amount paid or incurred in connection with any of the following: influencing legislation;[1488] participation or intervention in any political campaign on behalf of or in opposition to any candidate for public office;[1489] any attempt to influence the general public, or any segment, with respect to elections, legislative matters, or referendums;[1490] any direct communication with a covered executive branch official in an attempt to influence the official actions or positions of the official,[1491] discussed in 453 T.M., *Tax-Exempt Organizations — Lobbying and Political Expenditures*; and

• The §276 restriction, providing no deduction otherwise allowable is allowed for indirect political party contributions,[1492] discussed in detail in 453 T.M., *Tax-Exempt Organizations — Lobbying and Political Expenditures.*

E. Deductions Disallowed for Failure to Continue Compliance with Conditions for Tax Benefit

1. Interest on Mortgage Financed with Mortgage Revenue Bond Proceeds

Under §150(b)(1), no deduction is allowed for disqualified interest on a mortgage financed with the proceeds of a tax-exempt qualified mortgage bond or qualified veterans' mortgage bond.[1493] Interest is disqualified interest if it accrues on or after the date a disqualified use period begins and before the date the disqualified use period ends.[1494] A disqualified use period is any continuous period of at least one year during which the residence securing the mortgage is not the principal residence of at least one of the mortgagors who received the mortgage proceeds.[1495] The §150(b)(1) disallowance does not apply to the extent the IRS determines that its application would result in undue hardship and that the disqualified use period exists because of circumstances beyond the mortgagor's control.[1496] The exclusion from gross income of interest on qualified mortgage bonds[1497] and qualified veterans' mortgage bonds[1498] is described in 501 T.M., *Gross Income: Overview and Conceptual Aspects.*

2. Interest on Mortgage Financed with Qualified Residential Rental Project Private Activity Bond Proceeds

Under §150(b)(2), no deduction is allowed for disqualified interest on a mortgage financed with the proceeds of an apparent residential rental project private activity bond.[1499] An apparent residential rental project private activity bond is a bond which, when issued, purported to be a tax-exempt private activity bond by virtue of being a tax-exempt facility bond[1500] because its proceeds were to be used for a qualified residential rental project.[1501] Interest is disqualified interest if it accrues during the disqualified use period.[1502] The disqualified use period begins on the first day of the tax year in which the project securing the mortgage fails to meet the qualified residential rental project requirements[1503] and ends on the date the project meets those requirements.[1504] The exclusion from gross income of interest on private activity bonds used to finance qualified residential rental projects and the qualified residential rental project requirements are described in 183 T.M., *Tax-Advantaged Bonds.*

3. Interest on Mortgage Financed with Qualified §501(c)(3) Bond Proceeds

Under §150(b)(3)(B), no deduction is allowed for disqualified interest on a mortgage financed with the proceeds of an apparent §501(c)(3) bond.[1505] An apparent §501(c)(3) bond is a bond which, when issued, purported to be a tax-exempt qualified §501(c)(3) bond.[1506] Thus, deductions were disallowed when bonds were issued with purported tax-exempt status but the financed facility was never used in a manner qualifying for tax-exempt financing.[1507]

Interest is disqualified interest if it accrues during the disqualified use period.[1508] The disqualified use period begins on the date the facility securing the mortgage is used in a trade or business of any person other than a §501(c)(3) organization or governmental unit and ends on the date the facility is not so used.[1509]

The exclusion from gross income of interest on qualified §501(c)(3) bonds[1510] is described in 183 T.M., *Tax-Advantaged Bonds.*

4. Interest on Mortgages Financed with Private Activity Bond Proceeds

a. Failure to Continue Complying Use

Under §150(b)(4)(A), no deduction is allowed for disqualified interest on a mortgage financed with the proceeds of an

[1486] §162(g); Reg. §1.162-22(a).
[1487] Reg. §1.212-1(p).
[1488] §162(e)(1)(A).
[1489] §162(e)(1)(B).
[1490] §162(e)(1)(C).
[1491] §162(e)(1)(D).
[1492] §276(a); Reg. §1.276-1(a).
[1493] §150(b)(1)(A).
[1494] §150(b)(1)(A).
[1495] §150(b)(1)(A).
[1496] §150(b)(1)(B).
[1497] *See* §143(a).
[1498] *See* §143(b).
[1499] §150(b)(2).
[1500] *See* §142(a).
[1501] §150(b)(2)(A) (reference to §142(a)(7)).
[1502] §150(b)(2).
[1503] *See* §142(d).
[1504] §150(b)(2).
[1505] §150(b)(3)(B).
[1506] §150(b)(3)(A).
[1507] *See* FSA 199942007.
[1508] §150(b)(3)(B).
[1509] §150(b)(3)(B).
[1510] *See* §145.

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apparent private activity bond.[1511] An apparent private activity bond is a bond which, when issued, purported to be a tax-exempt private activity bond by virtue of being a tax-exempt facility bond[1512] because its proceeds were to be used for a qualified facility other than a qualified residential rental project or by virtue of being a qualified small issue bond.[1513] Interest is disqualified interest if it accrues during the disqualified use period.[1514] The disqualified use period begins on the date the facility securing the mortgage is not used for a purpose for which the tax-exempt private activity bond could be issued on the date of its issue, and ends when the facility is used for such a purpose.[1515] The exclusion from gross income of interest on tax-exempt private activity bonds[1516] is described in 183 T.M., *Tax-Advantaged Bonds.*

b. Failure to Continue Complying Ownership

Under §150(b)(5), no deduction is allowed for disqualified interest on a mortgage financed with the proceeds of an apparent private activity bond whose tax-exempt status depends, in part, on the facility securing the mortgage being owned by a governmental unit or a §501(c)(3) organization.[1517] An apparent private activity bond is a bond which, when issued, purported to be a tax-exempt private activity bond.[1518] Interest is disqualified interest if it accrues during the disqualified ownership period.[1519] The disqualified ownership period begins on the date the facility securing the mortgage is not owned by a governmental unit or a §501(c)(3) organization and ends on the date the facility is so owned.[1520] The exclusion from gross income of interest on tax-exempt private activity bonds[1521] is described in 183 T.M., *Tax-Advantaged Bonds.*

5. Interest on Mortgages Financed with Qualified Small Issue Bond Proceeds

Under §150(b)(6), no deduction is allowed for disqualified interest on a mortgage financed with the proceeds of an apparent qualified small issue bond.[1522] An apparent qualified small issue bond is a bond which, when issued, purported to be a tax-exempt qualified small issue bond.[1523] Interest is disqualified interest if it accrues during the disqualification period.[1524] The disqualification period begins on the date the bond is not a qualified small issue bond and ends on the date the bond is again a qualified small issue bond.[1525] The exclusion from gross income of interest on tax-exempt qualified small issue bonds[1526] is described in 183 T.M., *Tax-Advantaged Bonds.*

F. Disallowance of Personal Deductions

1. Introduction

Under §262, a taxpayer is not allowed to deduct personal, living, or family expenses.[1527] These types of expenses are nondeductible, unless another IRC provision allows the deduction.[1528] To be nondeductible, an expense need only be within the scope of one of the §262 categories. Thus, for example, although funeral expenses are not "living" expenses as such, they nonetheless are personal and thus nondeductible.[1529]

Observation: In many instances, the §262 deduction disallowance applies because the taxpayer has failed to persuade the IRS or the courts that the taxpayer is engaged in a trade or business or for-profit activity.[1530]

Some expenditures that otherwise would be nondeductible personal expenditures can be deductible if they are required by the employer and are related to the job. In *Sibla v. Commissioner*,[1531] the court stated that when conditions of employment restrict an employee's discretion in typically personal choices, "that which may be a personal expense under some circumstances can, when prescribed by company regulations, directives, and conditions, lose its character as a personal expense and take on the color of a business expense." For example, in PMTA 2009-068, the IRS National Office advised that costs incurred by employees to obtain the identification card required by the employer are deductible employee business expenses under §162 and that reimbursements made under the employer's arrangement to reimburse its employees for the expenses incurred by them to obtain the identification cards will be treated as made under an accountable plan and will be excluded from the employees' income and wages.

For a detailed discussion (including relevant case law) pertaining to the types of personal, living, or family expenses that are deductible, see 513 T.M., *Family and Household Transactions.*

[1511] §150(b)(4)(A).

[1512] *See* §142(a).

[1513] §150(b)(4)(B) (references to §142(a), §144(a)).

[1514] §150(b)(4)(A).

[1515] §150(b)(4)(A). Demolition of a facility financed with tax-exempt private facility bonds issued before May 16, 1997, does not necessarily result in the loss of tax-exempt status for bond interest, since the demolished facilities can no longer be put to any other use. PLR 200928018. *See also* PLR 201110007.

[1516] *See* §142.

[1517] §150(b)(5).

[1518] §150(b)(5)(A).

[1519] §150(b)(5).

[1520] §150(b)(5).

[1521] *See* §142.

[1522] §150(b)(6). Under §144(a)(1), a "qualified small issue bond" means any bond issued as part of an issue the aggregate authorized face amount is $1 million or less and 95% of the net proceeds are used for certain designated purposes. A taxpayer can elect under §144(a)(4) to increase the dollar limit from $1 million to $10 million.

[1523] §150(b)(6).

[1524] §150(b)(5).

[1525] §150(b)(6).

[1526] *See* §144(a).

[1527] §262(a); Reg. §1.262-1(a).

[1528] §262(a); Reg. §1.262-1(a).

[1529] *See, e.g., Schroeder v. Commissioner*, 74 T.C.M. 1213 (1997).

[1530] *See, e.g., Masat v. Commissioner*, 784 F.2d 573, 575 (5th Cir. 1986), *aff'g in part, rev'g in part* 48 T.C.M. 317 (1984); *Zell v. Commissioner*, 763 F.2d 1139, 1141 (10th Cir. 1985), *aff'g* 47 T.C.M. 1371 (1984); *Sabelis v. Commissioner*, 37 T.C. 1058, 1063 (1962); *Dunkelberger v. Commissioner*, 64 T.C.M. 1567 (1992); *DeVincent v. Commissioner*, 58 T.C.M. 179, 180 (1989), *aff'd by unpub. op.*, 923 F.2d 861 (9th Cir. 1991); *Gerber & Assocs., Inc. v. Commissioner*, 54 T.C.M. 420, 428 (1987), *aff'd by unpub. op.*, 876 F.2d 106 (7th Cir. 1989); *Burnett v. Commissioner*, 51 T.C.M. 147, 149 (1985); *Mueller v. Commissioner*, 50 T.C.M. 914, 916 (1985), *aff'd by* unpub. op., 813 F.2d 408 (9th Cir. 1987).

[1531] 611 F.2d 1260, 1262 (9th Cir. 1980).

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2. Insurance Policy Payments

a. In General

Subject to certain exceptions, no deduction is allowed for disqualified insurance policy payments that are otherwise deductible.[1532] A disqualified insurance policy payment includes disqualified life insurance policy premiums, single premium insurance contract indebtedness interest, cash value funded insurance contract indebtedness interest, disqualified life insurance policy indebtedness interest, and unborrowed policy cash value interest. The fact that a payment is not a disqualified insurance policy payment does not make it deductible, because the §264 disallowance merely disallows amounts otherwise deductible under some other provision.[1533] The denial of the insurance premium deduction has two exceptions.[1534] A deduction for premiums is not denied for annuity contracts, such as those under certain qualified pension plans, certain retirement annuities, individual retirement annuities, and qualified funding assets, described in §72(s)(5).[1535] Nor is the deduction disallowed for annuity contracts, essentially those not held by natural persons, to which §72(u) applies.[1536]

The §264 disallowance is described in IV.F.2.b., below, and is discussed, in part, in 386 T.M., *Insurance-Related Compensation.*

b. Types of Disqualified Insurance Policy Payments

(1) Disqualified Life Insurance Policy Premiums

Disqualified life insurance policy premiums are premiums paid on any life insurance policy, endowment contract, or annuity contract, with respect to which the taxpayer is, directly or indirectly, a beneficiary under the policy or contract.[1537] The IRS has advised that payments by a corporation to a Voluntary Employee Beneficiary Association (VEBA) that purchases life insurance to fund the VEBA's obligation to pay post-retirement benefits to the corporation's retirees are not payments by the corporation of life insurance premiums, leaving the corporation unaffected by §264.[1538]

(2) Single Premium Insurance Contract Indebtedness Interest

Single-premium insurance contract indebtedness interest is any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single-premium insurance contract.[1539] A single-premium insurance contract is any single-premium life insurance, endowment, or annuity contract.[1540] A contract is treated as a single-premium insurance contract if it satisfies either one of two conditions.[1541] The first condition is satisfied if substantially all[1542] the premiums on the contract are paid within a period of four years from the date on which the contract is purchased.[1543] The second condition is satisfied if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.[1544] The Tax Court has held that even if a policy is not treated as a single-premium policy under the predecessor of the first condition, the interest is nonetheless nondeductible if the policy is part of an arrangement through which the anticipated policy benefits fund the premium and interest costs, with the only economic value arising from tax savings, because the lack of economic substance and business purpose necessitates concluding that the arrangement is a sham transaction for which Congress has not indicated any intent to countenance.[1545]

Note: For this purpose, an annuity contract does not include an annuity contract purchased before March 2, 1954.[1546]

(3) Cash Value Funded Insurance Contract Indebtedness Interest

Cash value funded insurance contract indebtedness interest is any amount paid or accrued on indebtedness incurred or continued to purchase or carry a disqualified insurance contract pursuant to a disqualified borrowing plan.[1547] A disqualified insurance contract is any life insurance, endowment, or annuity contract that does not satisfy either one of two conditions.[1548] The first condition is satisfied if the contract is a single-premium insurance contract.[1549] The second condition is satisfied if the contract was purchased before August 7, 1963.[1550] A borrowing plan is a plan of purchase which contemplates the systematic direct or indirect[1551] borrowing,[1552] either from the insurer or otherwise, of part or all of the increases in the cash value of the contract.[1553] A disqualified borrowing plan is any borrowing plan that does not meet either the four-of-seven rule, or one of the other §264(d) exceptions to §264(a)(3),[1554] discussed in detail in 386 T.M., *Insurance-Related Compensation.*

(4) Disqualified Life Insurance Policy Indebtedness Interest

Disqualified life insurance policy indebtedness interest is any interest paid or accrued on any indebtedness with respect to one or more life insurance policies owned by the taxpayer

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1532 §264(a).

1533 *E.g., Arthur R. Womrath, Inc. v. Commissioner*, 22 B.T.A. 335, 336 (1931); *Semon Bache & Co. v. Commissioner*, 22 B.T.A. 200, 201 (1931), *aff'd per curiam*, 53 F.2d 1084 (2d Cir. 1931).

1534 §264(b).

1535 §264(b) (as in effect generally for contracts issued after June 8, 1997).

1536 §264(b) (as in effect generally for contracts issued after June 8, 1997).

1537 §264(a)(1).

1538 TAM 200511015.

1539 §264(a)(2); Reg. §1.264-2.

1540 §264(a)(2); Reg. §1.264-2.

1541 §264(c).

1542 *See Shirar v. Commissioner*, 916 F.2d 1414, 1420–21 (9th Cir. 1990), *rev'g* 54 T.C.M. 698 (1987); *Dudderar v. Commissioner*, 44 T.C. 632, 637–38 (1965), *acq.*, 1966-2 C.B. 4.

1543 §264(c)(1). *E.g.*, Rev. Rul. 72-609.

1544 §264(c)(2). *See* Rev. Rul. 79-41, *clarified and superseded by* Rev. Rul. 95-53.

1545 *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254 (1999), *aff'd*, 254 F.3d 1313 (11th Cir. 2001), *cert. denied* (per curiam) 535 U.S. 986 (2002). *See also* TAM 9812005 (overstated premium charge used to fund loading dividends).

1546 §264(a) (flush language); Reg. §1.264-2. *See* Reg. §1.264-3.

1547 §264(a)(3); Reg. §1.264-4(a), §1.264-4(b).

1548 §264(a)(3).

1549 §264(a)(3); Reg. §1.264-4(a).

1550 §264(a) (flush language); Reg. §1.264-4(a).

1551 *See* Reg. §1.264-4(c)(2).

1552 *See* Reg. §1.264-4(c)(1).

1553 §264(a)(3). *E.g., Mosko v. Commissioner*, 52 T.C.M. 520, 524 (1986).

1554 §264(a)(3), §264(d).

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and covering the life of any individual, any endowment contract owned by the taxpayer and covering any individual, or any annuity contract owned by the taxpayer and covering any individual.[1555] Disqualified life insurance policy indebtedness interest does not include any interest paid with respect to policies or contracts purchased before June 21, 1986.[1556] Disqualified life insurance policy indebtedness interest also does not include interest paid or accrued on indebtedness with respect to policies or contracts covering a key person to the extent that the aggregate amount of the indebtedness with respect to those policies and contracts does not exceed $50,000,[1557] discussed in detail in 386 T.M., *Insurance-Related Compensation.*

(5) Unborrowed Policy Cash Value Interest

(a) In General

The portion of interest expense allocable to unborrowed policy cash values is a disqualified insurance policy payment.[1558] Unborrowed policy cash value is the excess of the cash surrender value of a life insurance policy, endowment contract, or annuity contract, determined without regard to any surrender charge, over the amount of any loan with respect to that policy or contract.[1559] If the cash surrender value with respect to a policy or contract does not reasonably approximate its actual value, then, in lieu of that amount, the loan is subtracted from the greater of the insurance company liability or the insurance company reserve with respect to the policy or contract, as determined for purposes of the annual statement approved by the National Association of Insurance Commissioners or any other amount approved by the IRS.[1560]

The portion of the taxpayer's interest expense allocable to unborrowed policy cash values equals the interest expense multiplied by a fraction.[1561] The numerator of the fraction equals the taxpayer's average unborrowed policy cash values of life insurance policies, endowment contracts, and annuity contracts issued after June 8, 1997.[1562] The denominator of the fraction equals the sum of the unborrowed policy cash values of the taxpayer's life insurance policies, endowment contracts, and annuity contracts[1563] plus the average adjusted bases[1564] of the taxpayer's other assets.[1565] Policies or contracts with respect to which the interest is not unborrowed policy cash value interest by reason of the exceptions described in (b), below, are excluded from this fraction.[1566] The denominator of this fraction is reduced, but not below zero, by the amount of any interest disallowed under any of the other insurance policy limitations or under the §265 limitations on deductions for interest relating to tax-exempt income.[1567]

Interest expense equals the aggregate amount allowable as a deduction for interest without regard to the unborrowed policy cash value interest limitation, the §265(b) financial institution interest expense tax-exempt income allocation, or the §291 corporate preference item limitations.[1568] Interest disallowed under any of the other insurance policy limitations or under the §265 limitations on deductions for interest relating to tax-exempt income is not taken into account for purposes of the unborrowed policy cash value interest limitation.[1569] However, the unborrowed policy cash value interest limitation is applied before application of the produced property capitalization limitation.[1570]

The application of the unborrowed policy cash values deduction limitation with respect to partnerships and S corporations is determined and computed at the partnership and corporate levels, respectively, and not at the partner or shareholder levels.[1571] For purposes of applying the limitation, all members of a controlled group are treated as one taxpayer.[1572] All persons treated as a single employer under the rules applicable to compensation-related credits[1573] or under the affiliated service group or qualified compensation grouping rules[1574] are treated as members of a controlled group.[1575] The limitation does not apply to insurance companies taxable under the insurance company taxation rules, and these companies are excluded from the application of the limitation to controlled groups.[1576]

(b) Business Policy Exceptions

Unborrowed policy cash value interest does not include interest with respect to any policy or contract owned by an entity engaged in a trade or business if the policy or contract covers only one individual who, at the time first covered, is a 20% owner of the entity[1577] or is an officer, director, or employee of the trade or business.[1578] The fact that the policy or contract covers the joint lives of the individual and the individual's spouse does not prevent it from qualifying for this exception.[1579] For these purposes, any coverage under a master contract, other than group life insurance contracts, that is treated as a separate contract for purposes of §817(h), §7702, and §7702A is treated as a separate contract for purposes of determining whether this exception applies.[1580] If the insured under a new contract is no longer an employee, this exception does not apply.[1581]

For corporations, a 20% owner is any person who owns directly 20% or more of the outstanding stock of the corporation or stock possessing 20% or more of the total combined voting power of all the corporation's stock.[1582] Otherwise, a 20% own-

[1555] §264(a)(4).
[1556] §264(a) (flush language).
[1557] §264(e)(1).
[1558] §264(f)(1).
[1559] §264(f)(3).
[1560] §264(f)(3) (flush language).
[1561] §264(f)(2).
[1562] §264(f)(2)(A).
[1563] §264(f)(2)(B)(i).
[1564] *See* §1016.
[1565] §264(f)(2)(B)(ii).
[1566] §264(f)(4)(C).
[1567] §264(f)(6)(A)(ii).
[1568] §264(f)(7).
[1569] §264(f)(6)(A)(i).
[1570] §264(f)(6)(B).
[1571] §264(f)(5)(B).
[1572] §264(f)(8)(A).
[1573] *See* §52(a), §52(b).
[1574] *See* §414(m), §414(o).
[1575] §264(f)(8)(A) (reference to §264(e)(5)(B)).
[1576] §264(f)(8)(B).
[1577] §264(f)(4)(A)(i).
[1578] §264(f)(4)(A)(ii).
[1579] §264(f)(4)(A) (flush language).
[1580] §264(f)(4)(E).
[1581] *See* PLR 200627021.
[1582] §264(f)(4)(D) (reference to §264(e)(4)).

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er is any person who owns 20% or more of the capital or profits interest in the taxpayer.[1583]

Unborrowed policy cash value interest does not include interest with respect to annuity contracts, essentially those not held by natural persons, to which §72(u) applies.[1584]

(c) Natural Person Contracts

Unborrowed policy cash value interest does not include interest with respect to any policy or contract held by a natural person.[1585] A policy or contract which has a trade or business as a direct or indirect beneficiary is treated as held by that trade or business and not by a natural person.[1586] The preceding limitation does not apply to trades or businesses operated as sole proprietorships nor does it apply to the trade or business of performing services as an employee.[1587] The preceding limitation applies only to the extent of the benefit to which the trade or business is directly or indirectly entitled under the policy or contract.[1588]

(6) Shrinkage of Life or Terminable Interest Income

Under §273, no deduction against life or terminable interest holder income is allowed for shrinkage, by whatever name called, in the value of a life or terminable interest due to the lapse of time.[1589] Life or terminable interest holder income is income paid under the laws of a state, the District of Columbia, a U.S. possession, or a foreign country to the holder of a life or terminable interest acquired by gift, bequest, or inheritance.[1590]

The §273 disallowance does not apply to a life estate acquired by a spouse in exchange for relinquishing a remainder interest in community property, because that acquisition is by purchase.[1591] It does apply to a life estate acquired in settlement of a claim against an estate because the settlement was in lieu of a gift or bequest.[1592]

3. Other Disallowances

Personal deductions are disallowed for a variety of categories of expenditures, including entertainment, amusement, recreational activities, travel, food and beverage, certain business gifts, certain employee achievement awards, and certain taxes. Some important examples of these disallowances are listed below:

- Section 274(a), providing no deduction is allowed for expenses related to activities generally considered entertainment, amusement, or recreation, or for facilities used in connection with such activities,[1593] discussed in detail in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses.*

- Section 274(n), providing 50% of the amount that would otherwise be deductible for food and beverage items is disallowed (subject to certain exceptions).[1594] Before the TCJA, entertainment expenses were deductible, but limited to the 50% of the amount that would otherwise be deductible. Section 274(n) is discussed in detail in 520 T.M., *Entertainment, Meals, Gifts, and Lodging — Deduction and Recordkeeping Requirements*;

- Section 274(m)(1), providing no deduction is allowed for any luxury water transportation expenses that would otherwise[1595] be deductible,[1596] discussed in detail in 520 T.M., *Entertainment, Meals, Gifts, and Lodging — Deduction and Recordkeeping Requirements*;

- Section 274(h), providing no deduction is allowed for disqualified foreign convention expenses that would otherwise be deductible[1597] under §162,[1598] no deduction is allowed for disqualified cruise ship convention expenses that would otherwise be deductible[1599] under §162,[1600] and no deduction is allowed for any expense allocable to a convention, seminar, or similar meeting that would otherwise be allowable[1601] solely under §212,[1602] discussed in detail in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*;

- Section 274(c), providing no deduction is allowed under §162 or §212 for the portion of specified foreign travel by an individual that is not allocable to a trade or business or for-profit activity,[1603] discussed in detail in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*;

- Section 274(m)(2), providing no deduction is allowed for any expense of travel as a form of education that would otherwise[1604] be deductible,[1605] discussed in detail in 517 T.M., *Educational Expenses and Credits*;

- Section 274(k), providing no deduction is allowed for the expense of any food or beverages that would otherwise be deductible[1606] unless the expense is a qualified business meal expense,[1607] discussed in detail in 520 T.M., *Enter-*

[1583] §264(f)(4)(D) (reference to §264(e)(4)).
[1584] §264(f)(4)(B).
[1585] §264(f)(5)(A)(i).
[1586] §264(f)(5)(A)(ii).
[1587] §264(f)(5)(A)(iii)(I).
[1588] §264(f)(5)(A)(iii)(II).
[1589] §273; Reg. §1.273-1. *E.g., Early v. Commissioner*, 445 F.2d 166, 172 (5th Cir. 1971), *rev'g* 52 T.C. 560 (1969); *Codman v. Miles*, 28 F.2d 823, 824 (4th Cir. 1928).
[1590] §273; Reg. §1.273-1.
[1591] *Gist v. United States*, 423 F.2d 1118, 1120 (9th Cir. 1970), *aff'g* 296 F. Supp. 526 (S.D. Cal. 1968); *Kuhn v. United States*, 392 F. Supp. 1229, 1240 (S.D. Tex. 1975).
[1592] *Elrick v. Commissioner*, 485 F.2d 1049, 1058 (D.C. Cir. 1973), *rev'g* 56 T.C. 903 (1971), *nonacq.*, 1978-2 C.B. 3.
[1593] §274(a)(1); Reg. §1.274-2(a).
[1594] §274(n)(1)(B). *See Jacobs v. Commissioner*, 148 T.C. No. 24 (June 26, 2017) (holding that the owner of a National Hockey League franchise, the Boston Bruins, could deduct the full amount spent on meals for its employees at hotels during away games).
[1595] *See* Reg. §1.274-1.
[1596] §274(m)(1)(A).
[1597] *See* Reg. §1.274-1.
[1598] §274(h)(1), §274(4)(A).
[1599] *See* Reg. §1.274-1.
[1600] §274(h)(2), §274(4)(A).
[1601] *See* Reg. §1.274-1.
[1602] §274(h)(7).
[1603] §274(c)(1); Reg. §1.274-4(a), §1.274-4(f).
[1604] *See* Reg. §1.274-1.
[1605] §274(m)(2).
[1606] *See* Reg. §1.274-1.
[1607] §274(k)(1).

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tainment, Meals, Gifts, and Lodging — Deduction and Recordkeeping Requirements;

• Section 274(b), providing no deduction is allowed under §162 or §212 for excess gift expense that would otherwise[1608] be allowable,[1609] discussed in detail in 520 T.M., *Entertainment, Meals, Gifts, and Lodging — Deduction and Recordkeeping Requirements*;

• Section 274(j), providing no deduction is allowed under §162 or §212 for any excess employee achievement award cost that would otherwise[1610] be allowable,[1611] discussed in detail in 520 T.M., *Entertainment, Meals, Gifts, and Lodging — Deduction Recordkeeping Requirements*;

• Section 274(a)(4), providing that no deduction shall be allowed for the expense of any qualified transportation fringe[1612] provided to an employee of the taxpayer, discussed in detail in 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*;

• Section 274(o),[1613] for expenses paid or incurred before 2025, deduction disallowed employer-operated eating facility and meals excluded §119. Beginning in 2026, expenses described in subsection §274(e)(8) (entertainment sold to customers) or subsection §274(n)(2)(C) (commercial vessels) are excepted. For further discussion, see 520 T.M., *Entertainment, Meals, Gifts, and Lodging — Deduction and Recordkeeping Requirement*; and

• Section 275(a), providing no deduction otherwise allowable is allowed for disqualified taxes, discussed in detail in 525 T.M., *State, Local, and Federal Taxes.*

G. Other Deduction Disallowances

1. Disallowance of Foreign Advertising Expenses

No deduction is allowed for any foreign advertising expenses otherwise deductible under §162(a).[1614] Foreign advertising expenses are the expenses of an advertisement carried by a foreign broadcast undertaking located in a reciprocating country and directed primarily to a market in the United States.[1615] A foreign broadcast undertaking includes, but is not limited to, radio and television stations.[1616] A reciprocating country is a country that denies a similar deduction for the cost of advertising directed primarily to a market in the foreign country when placed with a U.S. broadcast undertaking.[1617]

2. Other Disallowances

Examples of other deduction disallowances include:

• No deduction is allowed on losses from wash sales that otherwise would be allowable,[1618] discussed in detail in 186 T.M., *Financial Instruments: Special Rules*;

• No deduction otherwise allowable under §170, §545(b)(2), or §642(c),[1619] is allowed for disqualified charitable contributions to disqualified organizations,[1620] discussed in detail in 458 T.M., *Private Foundations and Public Charities — Termination and Special Rules (Sections 507 and 508)* (Estates, Gifts, and Trusts Series);

• No deduction is allowed for any amount otherwise deductible with respect to forfeited substantial restriction election property,[1621] discussed in detail in 384 T.M., *Restricted Property — Section 83*;

• No dividends received deduction otherwise allowable is allowed with respect to the receipt of disqualified dividends,[1622] discussed in detail in 764 T.M., *Current Distributions — Cash and Property*;

• No §166 bad debt deduction and no §165(g) worthless security loss deduction otherwise deductible is allowed by reason of the worthlessness of any debt owed by a political party,[1623] discussed in detail in 453 T.M., *Tax-Exempt Organizations — Lobbying and Political Expenditures*;

• No deduction is allowed by reason of any illegal federal irrigation subsidy included in gross income,[1624] discussed in 501 T.M., *Gross Income: Overview and Conceptual Aspects*;

• No deduction is allowed under any deduction provision for the interest charge on accumulation distributions from foreign trusts,[1625] discussed in 854 T.M., *U.S. Taxation of Foreign Estates, Trusts, and Beneficiaries* (Estates, Gifts, and Trusts Series);

• No deduction is allowed for any interest payable on unpaid estate tax attributable to the period during which an extension of time for payment of the tax is in effect on account of the estates assets consisting largely of an interest in a closely held business,[1626] discussed in 627 T.M., *Limitations Periods, Interest on Underpayments and Overpayments, and Mitigation*;

• No deduction is allowed for the interest component of the low-income housing credit recapture amount,[1627] discussed in 584 T.M., *Low-Income Housing Tax Credit*;

[1608] *See* Reg. §1.274-1.
[1609] §274(b)(1); Reg. §1.274-3(a).
[1610] *See* Reg. §1.274-1.
[1611] §274(j)(1); Prop. Reg. §1.274-8(a).
[1612] §132(f).
[1613] §274(o), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. 119-21, §70305(a).
[1614] §162(j)(1).
[1615] §162(j)(1).
[1616] §162(j)(2).
[1617] §162(j)(1).
[1618] §1091(a); Reg. §1.1091-1.
[1619] *See* §508(d)(1).
[1620] §508(d).
[1621] §83(b)(1) (flush language).
[1622] §246. *See* Reg. §1.246-1.
[1623] §271(a); Reg. §1.271-1(a).
[1624] §90(c).
[1625] §668(c).
[1626] §163(k) (reference to §6166).
[1627] §42(j)(2) (flush language).

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• No deduction is allowed for interest paid or accrued on a disqualified debt instrument,[1628] discussed in 536 T.M., *Interest Expense Deductions*; and

• No deduction is allowed for retiree health account amounts,[1629] discussed in detail in 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans.*

[1628] §163(l)(1).

[1629] §420(d)(1).

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V. Deductions Allowable to Individuals

A. Introduction

For individuals, certain deductions are allowed in the computation of adjusted gross income (AGI).[1630] All other deductions are itemized, except (1) the standard deduction, (2) the personal and dependency exemption deduction, (3) the qualified business income deduction, (4) the charitable contributions deduction for nonitemizers, (5) the no tax on tips deduction, (6) the no tax on overtime deduction, and (7) the no tax on car loan interest deduction.[1631] Deductions that are allowed in computing AGI are commonly referred to as above-the-line deductions. Typically, taxpayers prefer above-the-line deductions because they are not subject to the overall limitation on itemized deductions discussed in V.C.8.j.(2), below. Taxpayers also prefer above-the-line deductions because these deductions reduce AGI, which is used to limit various expenses or as a basis for determining other taxable amounts.

Important examples of the AGI limitations on deductions include:[1632]

- restriction on the deduction from AGI of employee expenses of certain performing artists;[1633]
- phaseout of the exclusion for interest on U.S. savings bonds used to pay higher-education tuition and fees;[1634]
- phaseout of the exclusion for employer-paid adoption expenses;[1635]
- limitations on the net casualty losses deduction;[1636]
- caps on an individual's charitable contribution deduction;[1637]
- limitation on the medical expense deduction;[1638]
- phaseout of the deduction for contributions to individual qualified retirement plans;[1639]
- phaseout of the deduction for education loan interest;[1640]
- phaseout of the amount that may be contributed to a Roth IRA;[1641]
- phaseout of the actively managed rental real estate exception to the passive loss deduction limitation;[1642] and
- phaseout of the amount that an individual may contribute to a Coverdell education savings account.[1643]

[1630] §62, §165(h)(4)(A), §402(e)(3), §911(c)(4).

[1631] *See* §63(b), §63(d). See V.B. and V.C., below, for certain above-the-line deductions that are available for itemizing and non-itemizing taxpayers.

[1632] *Cf.* Reg. §1.62-1T(a)(1)–§1.62-1T(a)(6).

[1633] §62(a)(2)(B), §62(b) (performing artist cannot qualify if AGI exceeds specified amount).

[1634] §135(b)(2).

[1635] §137(b)(2).

[1636] §165(h).

[1637] §170(b)(1).

[1638] §213(a).

[1639] §219(g)(2).

[1640] §221(b)(2).

[1641] §408A(c)(3).

[1642] §469(i)(3).

[1643] §530(c).

For a discussion of AGI, see 501 T.M., *Gross Income: Overview and Conceptual Aspects.*

B. Above-the-Line Deductions

1. Deductions Attributable to Carrying on a Trade or Business

a. In General

Deductions attributable to carrying on a trade or business[1644] are allowable in computing adjusted gross income.[1645] For example, under §162(a), a deduction is allowed for ordinary and necessary expenses attributable to carrying on a trade or business. Other sections allow deductions for trade or business interest,[1646] certain taxes paid,[1647] trade or business losses,[1648] and business bad debts.[1649] An individual taxpayer reports these allowable trade or business deductions incurred as a sole proprietor on Form 1040, Schedule C, Profit or Loss from Business. However, deductions attributable to carrying on a trade or business do not include those allowed under §211 through §223.[1650] They also do not include those paid or incurred in carrying on the trade or business of being an employee.[1651] But the practice of a profession, not as an employee, is the conduct of a trade or business.[1652] For a detailed discussion on trade or business expenses, see 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*

b. Direct Attribution

Expenses attributable to carrying on a trade or business are allowable as deductions in computing adjusted gross income (AGI) if they are directly attributable to the trade or business or to property from which rents or royalties are derived.[1653] Thus, wagering losses incurred by full-time gamblers who gamble for their own account are allowable in computing AGI, because they arise from the carrying on of a trade or business.[1654] However, if an individual is not carrying on a trade or business as a gambler, wagering losses are not deductible in computing AGI but instead are deductible as an itemized deduction.[1655] For tax years beginning in 2018 through 2025, all deductions for expenses incurred in carrying out wagering transactions, and not

[1644] *See Shaller v. Commissioner*, 49 T.C.M. 10, 12 (1984), *aff'd*, 813 F.2d 403 (4th Cir. 1986).

[1645] §62(a)(1); Reg. §1.62-1T(c)(1). *See Dorminey v. Commissioner*, 26 T.C. 940, 947 (1956), *nonacq.*, 1957-1 C.B. 4; *Melton v. Commissioner*, 11 T.C.M. 133, 140 (1952).

[1646] §163(a), §163(h)(1), §163(h)(2)(A). *But see* §163(j) (limiting the deduction on business interest).

[1647] §164(a). Regardless of §164, if a taxpayer incurred any of the taxes listed in §164 as a trade or business expense, then the tax would presumably be deductible under §162.

[1648] §165(a), §165(c)(1).

[1649] §166.

[1650] §62(a)(1); Reg. §1.62-1T(c)(1).

[1651] §62(a)(1); Reg. §1.62-1T(c)(1), §1.62-1T(d).

[1652] Reg. §1.62-1T(d).

[1653] Reg. §1.62-1T(d).

[1654] *Commissioner v. Groetzinger*, 480 U.S. 23, 36 (1987), *aff'g* 771 F.2d 269, 274 (7th Cir. 1985), *aff'g* 82 T.C. 793, 803 (1984); *Bathalter v. Commissioner*, 54 T.C.M. 902, 905 (1987); *Regan v. Commissioner*, 54 T.C.M. 846, 848 (1987). *See* Rev. Rul. 54-339.

[1655] *McQuarrie v. Commissioner*, 91 T.C.M. 1127 (2006); *Torpie v. Commissioner*, 79 T.C.M. 2064 (2000); Rev. Rul. 54-339.

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just gambling losses, are limited to the extent of gambling winnings.[1656] For tax years beginning after 2025, wagering loss deductions (including related expenses incurred in carrying out wagering transactions) are limited to 90% of wagering losses incurred during the tax year, and also limited to the extent of gambling winnings.[1657]

Rebates paid by a stockbroker to clients who generate commission gross income for the stockbroker are allowable in computing AGI.[1658]

c. Interest

Interest on a loan is allowable as a deduction in computing adjusted gross income if the proceeds are used in the taxpayer's business,[1659] but not if used to acquire a business[1660] or to make personal investments.[1661] The IRS takes the position that interest on state and federal income tax deficiencies is not allowable in computing adjusted gross income, even if the taxes relate to trade or business income.[1662] Thus, if a taxpayer incurs interest for the underpayment of his federal income taxes attributable to his business income, the taxpayer would not be allowed to deduct the interest paid to the federal government.[1663] For further discussion on the deduction of interest, see 536 T.M., *Interest Expense Deduction.*

d. Taxes

Certain taxes incurred in a trade or business are deductible.[1664] Sales and use taxes, other than those that must be capitalized,[1665] are allowable in computing adjusted gross income to the extent they relate to purchases made for items used in the taxpayer's trade or business.[1666] Also, state taxes on gross business income are allowable in computing adjusted gross income.[1667] This principle applies to the Indiana gross income tax, to the extent applicable to the receipt of business income.[1668] It also applies to the New Hampshire business profits tax, which is not a state tax on net income.[1669] However, state taxes on net income are not allowable in computing adjusted gross income, even though the income on which they are imposed is derived from the taxpayer's trade or business.[1670] This principle applies to the Cincinnati tax on net business profits,[1671] the Indiana adjusted gross income tax imposed on net income,[1672] and to income taxes imposed on residents of Nevada by Alabama, California, Colorado, Louisiana, Michigan, Mississippi, New Mexico, Oklahoma, and Utah with respect to net royalty income received by the Nevada residents from oil and gas wells located in those states.[1673] It applies to the Louisville, Kentucky, license fee on 1% of all business profits to the extent imposed on compensation, but not to the extent imposed on partnership or proprietorship profits, even though the fee is a tax.[1674] For further discussion of the deductibility of taxes, see 525 T.M., *State, Local, and Federal Taxes.*

e. Tax Litigation Expenses

Ordinary and necessary[1675] litigation expenses paid or incurred with respect to disputes over taxes imposed on business income are allowable in computing adjusted gross income.[1676] For a detailed discussion on the ordinary and necessary requirement, see 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*

f. Losses

Under §165(a), an individual can deduct a loss that is incurred in a trade or business.[1677] Net operating losses and deductions for the expense of worthless business property also are allowable in computing adjusted gross income.[1678] For a detailed discussion of the deductibility of trade or business losses, see 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*

g. Bad Debt

Individual taxpayers are allowed to deduct the amount of any business debt that becomes partially or wholly worthless during the tax year.[1679] Individual taxpayers are also allowed to deduct any nonbusiness bad debt only when it becomes wholly worthless.[1680] Unlike business bad debts that are allowable in computing adjusted gross income, nonbusiness bad debts are reported as a short-term capital loss on Form 8949, Sales and

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[1656] Former §165(d).

[1657] §165(d)(1), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70114, §165(d)(2), amended by the OBBBA, §70114.

[1658] *Corrigan v. Commissioner*, 89 T.C.M. 1313 (2005).

[1659] §163. *But see* §163(j) (limiting the deduction of business interest); *Dorminey v. Commissioner*, 26 T.C. 940, 947 (1956).

[1660] *Wallendal v. Commissioner*, 31 T.C. 1249, 1251 (1959); *Miller v. Commissioner*, 26 T.C. 151, 161 (1956), *rev'd on other grounds*, 247 F.2d 206 (7th Cir. 1957), *cert. denied*, 355 U.S. 939 (1958).

[1661] §163(h)(1); *Murphy v. Commissioner*, 92 T.C. 12, 15 (1989); *Ford v. Commissioner*, 29 T.C. 499, 505 (1957). *See Ingram v. Commissioner*, 20 T.C.M. 1447, 1465 (1961), *vac'd and rem'd on other grounds*, 63-2 USTC ¶9516 (5th Cir. 1963).

[1662] Reg. §1.163-9T(b)(2)(i)(A); Rev. Rul. 70-40.

[1663] *Robinson v. Commissioner*, 119 T.C. 44 (2002).

[1664] §164(a). Regardless of §164, if a taxpayer incurred any of the taxes listed in §164 as a trade or business expense, then the tax would presumably be deductible under §162.

[1665] *See* §164(a) (flush language). For a discussion of sales taxes that must be capitalized, see 525 T.M., *State, Local, and Federal Taxes.*

[1666] Rev. Rul. 70-39; Rev. Rul. 67-458.

[1667] Rev. Rul. 70-40, *superseding* Rev. Rul. 58-142, *modified*, Rev. Rul. 92-29.

[1668] Rev. Rul. 71-279.

[1669] Rev. Rul. 81-288.

[1670] Reg. §1.62-1T(d); *Tanner v. Commissioner*, 45 T.C. 145, 151 (1965), *aff'd per curiam*, 363 F.2d 36 (4th Cir. 1966); *Estate of Broadhead v. Commissioner*, 25 T.C.M. 133 (1966), *aff'd on other grounds*, 391 F.2d 841 (5th Cir. 1968); *Lutts v. United States*, 65-1 USTC ¶9313 (S.D. Cal. 1965); Rev. Rul. 70-40, *superseding* Rev. Rul. 58-142, *modified*, Rev. Rul. 92-29; *Strange v. Commissioner*, 270 F.3d 786 (9th Cir. 2001), *aff'g* 114 T.C. 206 (2000); *Cutler v. Commissioner*, 109 T.C.M. 1389 (2015).

[1671] Rev. Rul. 58-25.

[1672] Rev. Rul. 65-19.

[1673] *Strange v. Commissioner*, 114 T.C. 206 (2000), *aff'd*, 270 F.3d 786 (9th Cir. 2001).

[1674] Rev. Rul. 54-598.

[1675] *Commissioner v. Standing*, 259 F.2d 450, 456 (4th Cir. 1958), *aff'g* 28 T.C. 789, 795 (1957); *Thomas v. Commissioner*, 41 T.C. 614, 615–16 (1964).

[1676] Rev. Rul. 92-29, *modifying in part*, Rev. Rul. 70-40.

[1677] §165(c)(1).

[1678] §172 (limiting the net operating loss deduction and repealing the net operating loss carryback provision, except as otherwise provided, for losses arising in tax years beginning after December 31, 2017); *Wasson v. United States*, 56-2 USTC ¶9886 (N.D. Tex. 1956), *aff'd on other grounds*, 250 F.2d 826 (5th Cir. 1958), *cert. denied*, 358 U.S. 815 (1958).

[1679] §166(a)(1); Reg. §1.166-1(a)(1).

[1680] §166(d)(1)(B).

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Other Dispositions of Capital Assets. Bad debt deductions are discussed in detail in 538 T.M., *Bad Debts.*

2. *Reimbursed Employee Trade or Business Deductions*

a. *In General*

Generally, deductions allowed under §162 through §198 in connection with the performance of services as an employee, under a reimbursement or other expense allowance arrangement with the employer, are allowable in computing adjusted gross income (AGI).[1681] It does not matter that the reimbursement is provided by a third party, provided the employee performs a benefit for the third party as an employee of the employer.[1682]

Although the IRC establishes the structure of including reimbursed employee business expenses in the employee's gross income and then allowing a deduction in computing AGI,[1683] the regulations provide for a simplified reporting method that reaches the same result by excluding the reimbursement amounts from gross income and eliminating the need for a corresponding deduction.[1684] The regulations allow this simplified reporting method for "accountable" reimbursement plans.[1685]

> *Example:* An employee incurs a $1,000 business expense and the employer reimburses the employee as part of an accountable plan. If the employee includes the $1,000 in his gross income, the employee is allowed a $1,000 above-the-line deduction. However, under the simplified reporting method, the reimbursement is not reported as income to the employee and the employee does not take a deduction. Both approaches reach the same result.

For further discussion of employee reimbursement plans, see 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses.*

b. *Unreimbursed Employee Business Expenses*

If there is no reimbursement arrangement, the deductions are not allowable under §62(a)(2) in computing adjusted gross income.[1686] Otherwise deductible unreimbursed employee business expenses, which have been specifically identified as not allowable in computing adjusted gross income, include books,[1687] business gifts,[1688] cash register shortage repayments,[1689] dues for technical society memberships[1690] and professional associations,[1691] educational expenses,[1692] entertainment expenses,[1693] legal fees,[1694] license fees on wages and salaries,[1695] malpractice insurance premiums,[1696] medical examination costs,[1697] office expenses and supplies,[1698] postal supervisor expenses,[1699] professional fees[1700] and expenses,[1701] storage,[1702] subscriptions,[1703] technical journals and data,[1704] tools,[1705] tax preparation and legal fees,[1706] travel expenses,[1707] uniforms,[1708] union dues and assessments,[1709] and work clothing.[1710]

c. *Reimbursement or Other Expense Allowance Arrangement*

An accountable reimbursement plan is a reimbursement plan or arrangement that satisfies three conditions.[1711] First, the business connection condition requires advances, allowances, or reimbursements be made only for business expenses than are allowable as deductions and incurred by the employee in performance of services as an employee of the employer.[1712] Second, the substantiation condition requires the employee to substantiate, within a reasonable period of time, the expenses covered by the arrangement to the person providing the reimbursement.[1713] Third, the excess nonretention condition requires the employee to not retain any amount in excess of the substantiated expenses covered under the arrangement and must return the amount within a reasonable period of time.[1714]

[1681] §62(a)(2)(A), §62(c).
[1682] §62(a)(2)(A); Reg. §1.62-2(d)(1).
[1683] §62(a)(2).
[1684] §62(c); Reg. §1.62-2(c)(4).
[1685] Reg. §1.62-2(c)(1), §1.62-2(d), §1.62-2(e), §1.62-2(f).
[1686] *See Pelowski v. United States*, 605 F. Supp. 65, 69 (N.D. Ohio 1985).
[1687] *Williams v. Commissioner*, 39 T.C.M. 420, 421–22 (1979).
[1688] *Ward v. Commissioner*, 11 T.C.M. 340, 341 (1952).
[1689] *Butchko v. Commissioner*, 638 F.2d 1214, 1217 (9th Cir. 1981), *aff'g* 37 T.C.M. 894, 897 (1978).
[1690] *Williams v. Commissioner*, 39 T.C.M. 420, 421–22 (1979); *Groder v. Commissioner*, 19 T.C.M. 1142, 1148–49 (1960).
[1691] *Thompson v. Commissioner*, 16 T.C.M. 271, 272 (1957).
[1692] *Booth v. Commissioner*, 47 T.C.M. 774, 776 (1983); *Thompson v. Commissioner*, 16 T.C.M. 271, 272 (1957).
[1693] *Weinstein v. Commissioner*, 29 T.C. 142, 146 (1957).
[1694] *Alexander v. Commissioner*, 69 T.C.M. 1792 (1995), *aff'd*, 72 F.3d 938 (1st Cir. 1995).
[1695] Rev. Rul. 54-598.
[1696] Rev. Rul. 60-365.
[1697] *Booth v. Commissioner*, 47 T.C.M. 774, 776 (1983); *Bodholdt v. Commissioner*, 20 T.C.M. 390, 394 (1961).
[1698] *Blackburn v. Commissioner*, 44 T.C.M. 1121, 1123 (1982); *Byers v. Commissioner*, 14 T.C.M. 153, 156 (1955).
[1699] *Harris v. Commissioner*, 22 T.C. 1118, 1125–26 (1954); Rev. Rul. 55-579.
[1700] *Owen v. Commissioner*, 23 T.C. 377, 381 (1954).
[1701] Rev. Rul. 80-110.
[1702] *Williams v. Commissioner*, 39 T.C.M. 420, 421–22 (1979).
[1703] *Fisher v. Commissioner*, 24 T.C. 269, 272 (1955).
[1704] *Groder v. Commissioner*, 19 T.C.M. 1142, 1148–49 (1960); *Stahlin v. Commissioner*, 11 T.C.M. 996, 997 (1952).
[1705] *Disney v. Commissioner*, 20 T.C.M. 901, 903 (1961); *Auer v. Commissioner*, 11 T.C.M. 1141, 1143 (1952); *Stahlin v. Commissioner*, 11 T.C.M. 996, 997 (1952); *Lively v. Commissioner*, 11 T.C.M. 238, 239 (1952).
[1706] *Addington v. Commissioner*, 39 T.C.M. 1073, 1080 (1980), *aff'd by unpub. op.* (5th Cir. 1981).
[1707] *Weinstein v. Commissioner*, 29 T.C. 142, 146 (1957); *Williams v. Commissioner*, 39 T.C.M. 420, 421–22 (1979).
[1708] *Bodholdt v. Commissioner*, 20 T.C.M. 390, 394 (1961).
[1709] *Cashman v. Commissioner*, 9 T.C. 761, 762 (1947); *Dougherty v. Commissioner*, 51 T.C.M. 986, 988 (1986), *aff'd without op.*, 822 F.2d 1093 (8th Cir. 1987); *Osburn v. Commissioner*, 17 T.C.M. 310, 313 (1958); *Stahlin v. Commissioner*, 11 T.C.M. 996, 997 (1952); *Ward v. Commissioner*, 11 T.C.M. 340, 341 (1952); *Lively v. Commissioner*, 11 T.C.M. 238, 239 (1952); *Stuermer v. Commissioner*, 10 T.C.M. 1100 (1951).
[1710] *Winn v. Commissioner*, 32 T.C. 220, 225 (1959); *Cashman v. Commissioner*, 9 T.C. 761, 762 (1947); *Ward v. Commissioner*, 11 T.C.M. 340, 342 (1952); *Lively v. Commissioner*, 11 T.C.M. 238, 239 (1952); Rev. Rul. 55-235.
[1711] §62(c); Reg. §1.62-2(c)(1), §1.62-2(c)(2)(i). The IRS ordinarily will not rule whether amounts related to a salary reduction and paid under a reimbursement arrangement or other expense allowance arrangement will be treated as paid under an "accountable plan" under Reg. §1.62-2(c). Rev. Proc. 2026-3, §4.01(4).
[1712] Reg. §1.62-2(c)(1), §1.62-2(d).
[1713] §62(c)(1); Reg. §1.62-2(c)(1), §1.62-2(e).
[1714] §62(c)(2); Reg. §1.62-2(c)(1), §1.62-2(f).

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A reimbursement plan that does not satisfy all three conditions is classified as a nonaccountable plan.[1715] Employers are permitted to have more than one arrangement with any one employee.[1716] Determining whether a plan satisfies the three conditions is done on an employee-by-employee basis.[1717] An employer may be treated as having both an accountable and a nonaccountable plan.[1718] An employee receiving reimbursements under a nonaccountable plan cannot cause the plan to be recharacterized as an accountable plan with respect to that employee by voluntarily complying with the requirements for an accountable plan.[1719]

For an in-depth discussion of accountable and nonaccountable plans, see 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*.

3. Certain Performing Artist Deductions

a. In General

Deductions allowed under §162 that consist of expenses paid or incurred by a qualified performing artist in connection with the performance of services in the performing arts as an employee are allowable in computing adjusted gross income.[1720] An individual is not treated as performing services in the performing arts as an employee for an employer during any tax year unless the amount received by the individual from the employer for the performance is at least $200.[1721]

b. Qualified Performing Artist

(1) In General

A qualified performing artist is any individual who, for the tax year, satisfies three conditions.[1722] First, the individual must perform services in the performing arts as an employee during the tax year for at least two employers,[1723] but an employer cannot be considered unless the individual earns at least $200 during the tax year from that employer.[1724] Second, the aggregate amount of §162 trade or business expenses allowable in connection with the performance of the services must exceed 10% of the individual's gross income attributable to the performance of those services.[1725] Third, the individual's adjusted gross income, determined without regard to the performing artist deduction provision, must not exceed $16,000.[1726] For this purpose, adjusted gross income includes adjusted gross income from all sources and is not limited to adjusted gross income from acting activities.[1727]

(2) Application to Married Individuals

Married individuals[1728] are within the performing artist provision only if they file joint income tax returns.[1729] If the married individuals file a joint return, each spouse must separately meet the first condition of performing services in the performing arts for at least two employers.[1730] Each spouse also must separately meet the second condition that the amount allowable as a deduction must exceed 10% of his or her performing arts income.[1731] However, the $16,000 limit on adjusted gross income[1732] applies to the spouses' combined adjusted gross income.[1733]

> *Example:* B and C are married and file a joint return. B and C are performing artists and each are employed by two separate employers. Both B and C earn $2,000 with each employer. B's total §162 expense incurred as a performing artist is $500. C's total §162 expense incurred as a performing artist is $600. B and C's total adjusted gross income for the year is $15,900. Both B and C meet the first condition, because each of them are employed as a performing artist by at least two employers. The second condition is met because: (1) B's $500 performing artist expense exceeds 10% of his $4,000 gross income attributable to his performance of such services ($4,000 × 10% = $400) and (2) C's $600 performing artist expense exceeds 10% of her $4,000 gross income attributable to her performance of such services ($4,000 × 10% = $400). Finally, the third condition is met. B and C do not have in excess of $16,000 of combined adjusted gross income before taking into account their §162 deductions. Accordingly, B and C satisfy all three conditions; therefore, B and C are qualified performing artist and are allowed a $1,100 performing artist deduction.

Note: This limitation does not apply if the married individuals live apart at all times during the tax year.[1734]

4. Certain Public Official Expenses

Deductions under §162 that consist of expenses paid or incurred with respect to services performed by a public official in a position compensated in whole or in part on a fee basis are allowable in computing adjusted gross income.[1735] A public official is an official of a state government or a political subdivision of a state. In *Jones v. Commissioner*,[1736] the Tax Court determined what is meant for a public official to be "compensated

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[1715] Reg. §1.62-2(c)(3)(i).
[1716] Reg. §1.62-2(c)(1).
[1717] Reg. §1.62-2(i).
[1718] Reg. §1.62-2(d)(2).
[1719] Reg. §1.62-2(c)(3)(i).
[1720] §62(a)(2)(B).
[1721] §62(a)(2)(B), §62(b)(2); Reg. §1.62-1T(c)(3).
[1722] §62(b)(1).
[1723] §62(b)(1)(A).
[1724] §62(b)(2).
[1725] §62(b)(1)(B).
[1726] §62(b)(1)(C).
[1727] *Fleischli v. Commissioner*, 123 T.C. 59 (2004), *aff'd*, 135 Fed. App'x 975 (9th Cir. 2005).

[1728] §62(b)(3)(C) (reference to §7703(a)).
[1729] §62(b)(3).
[1730] §62(b)(3)(B)(i).
[1731] §62(b)(3)(B)(i).
[1732] §62(b)(1)(C).
[1733] §62(b)(3)(B)(ii).
[1734] §62(b)(3)(A).
[1735] §62(a)(2)(C).
[1736] 146 T.C. 39 (2016). The Tax Court in *Jones* noted that it could be reasonable to read §62(a)(2)(C) as permitting a segregation of expenses for public officials compensated in part on a fee basis, which would allow them to deduct above the line those expenses incurred to produce fee income, but treating them like all other employees when it comes to any other employee's business expenses. This interpretation did not apply to the judge, because he admitted to waiving fees that he could have collected for marrying couples.

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on a fee basis" pursuant to §62(a)(2)(C). The court referred to Rev. Rul. 74-608 and other federal laws for guidance, and ultimately agreed with the IRS's interpretation that a public official is compensated by fees if the official receives them directly from a member of the public, but not if it is paid from a government fund. By that definition, the taxpayer, a county judge, was not considered to be compensated on a fee basis, because he was not paid directly by the public for services he rendered. Accordingly, the court held that §62(a)(2)(C) was inapplicable and the judge could deduct his unreimbursed employee business expenses only as miscellaneous itemized deductions.[1737]

For further discussion of the deductibility of public official expenses, see 453 T.M., *Tax-Exempt Organizations — Lobbying and Political Expenditures.*

5. Certain Expenses of Elementary and Secondary School Teachers

a. In General

Deductions for qualified business expenses of teachers and other eligible educators are allowable in computing adjusted gross income,[1738] but only to the extent the amount of such expenses exceeds the amount excludible under §135 (income from U.S. savings bonds used to pay higher education tuition and fees), §529(c)(1) (qualified tuition program), or §530(d)(2) (Coverdell education savings accounts) for the tax year.[1739] The amount of the deduction that is allowable in computing adjusted gross income is limited to $250 each year, adjusted annually for inflation beginning in 2016.[1740]

b. Eligible Educator

An eligible educator is an individual who is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year.[1741] A school is any school which provides elementary education or secondary education, as determined under state law, with elementary or secondary education being defined as kindergarten through grade 12.[1742]

c. Qualified Business Expense

Qualified business expenses are amounts that satisfy three conditions.[1743] First, the expense must be paid or incurred in connection with professional development courses,[1744] books, supplies, computer equipment and related software and services, supplementary materials used in the classroom by the eligible educator,[1745] or personal protective equipment, disinfectant, and other supplies used for the prevention of the spread of COVID-19 in the classroom.[1746] Second, the expense must not be for nonathletic supplies for courses of instruction in health or physical education.[1747] Third, the expense must otherwise be deductible under §162 as a trade or business expense.[1748]

6. Overnight Travel Expenses of Military Reservists

a. In General

Qualified travel expenses paid or incurred by individuals in connection with qualified military reserve services are allowable in computing adjusted gross income.[1749]

b. Qualified Military Services

Qualified military reserve services are services that satisfy two conditions.[1750] First, they must be performed by a taxpayer who is a member of a reserve component of the United States Armed Forces.[1751] Second, their performance must occur for a period during which the taxpayer is more than 100 miles away from home in connection with the services.[1752]

c. Qualified Travel Expenses

Qualified travel expenses are amounts that satisfy two conditions.[1753] First, the amount of travel expenses that qualify for this above-the-line deduction may not exceed the federal per diem rate authorized for the locality of the travel.[1754] Second, the expenses must otherwise be deductible under §162 as trade or business expenses.[1755]

For an in-depth discussion on the deductibility of overnight travel expenses of military reservists, see 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses* .

7. Losses from Sales or Exchanges of Property

Deductions allowed under §162 through §198 as losses from the sale or exchange of property are allowable in computing adjusted gross income.[1756]

8. Deductions Attributable to Rents and Royalties

Deductions allowed under §162 through §198 for trade or business expenses, under §212 for expenses of producing income, and under §611 for depletion, which are attributable to property held for the production of rents or royalties are allow-

[1737] *But see* §67(h) (miscellaneous itemized deductions not allowable for tax years beginning after 2017), added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70110.

[1738] §62(a)(2)(D).

[1739] §62(d)(2).

[1740] §62(a)(2)(D), §62(d)(3). The annual inflation-adjusted limit is provided in Tables, Charts & Lists, *Eligible Expenses of Elementary and Secondary School Teachers by Year.*

[1741] §62(d)(1)(A).

[1742] §62(d)(1)(B).

[1743] §62(a)(2)(D).

[1744] §62(a)(2)(D)(i).

[1745] §62(a)(2)(D)(ii).

[1746] *See* COVID-related Tax Relief Act of 2020, Pub. L. No. 116-260, Div. N, Title II, Subtitle B, §275, effective for expenses paid or incurred after March 12, 2020. Such supplies include (among others) face masks, paint or chalk used to guide social distancing, hand soap, hand sanitizer, disposable gloves, physical barriers (e.g., clear plexiglass), and air purifiers. *See* Rev. Proc. 2021-15, §3.

[1747] §62(a)(2)(D)(ii).

[1748] §62(a)(2)(D)(ii).

[1749] §62(a)(2)(E).

[1750] §62(a)(2)(E).

[1751] §62(a)(2)(E).

[1752] §62(a)(2)(E).

[1753] §62(a)(2)(E).

[1754] §62(a)(2)(E).

[1755] §62(a)(2)(E).

[1756] §62(a)(3); Reg. §1.62-1T(c)(4).

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able in computing adjusted gross income.[1757] Interest on loans made to purchase rental property is deductible in computing adjusted gross income, even if the loans are not secured by a mortgage on the property.[1758] Similarly, interest on a loan secured by rental property is not deductible in computing adjusted gross income if the loan is not incurred nor its proceeds used for the rental property.[1759] According to the Tax Court and the Ninth Circuit, state income taxes paid on net oil and gas royalty income are not "attributable to property held for the production of rents or royalties," citing the legislative history and pointing out that the taxes are attributable to the royalty income and not the property generating the royalty.[1760]

9. Life Tenant and Income Beneficiary Deductions

Any deduction for depreciation under §167 or for depletion under §611 allowed to a life tenant of property or the income beneficiary of property held in trust or an heir, legatee, or devisee of an estate is allowable in computing adjusted gross income.[1761]

10. Self-Employed Individuals' Retirement Plan Deductions

Any deduction allowed under §404 with respect to a self-employed individual's pension, profit-sharing, annuity, or other qualified retirement plan is allowable in computing adjusted gross income.[1762] For an in-depth discussion on the §404 deduction, see 371 T.M., *Employee Plans — Deductions, Contributions and Funding* and 385 T.M., *Deferred Compensation Arrangements.*

11. Retirement Savings Deductions

Any deduction allowed under §219 with respect to retirement savings is allowable in computing adjusted gross income.[1763]

12. Premature Withdrawal Penalty Deductions

Any deduction allowed under §165 for a premature withdrawal penalty is allowable in computing adjusted gross income.[1764] A premature withdrawal penalty is a loss arising from a transaction entered into for profit, though not connected with a trade or business, to the extent that those losses include amounts forfeited to a financial institution as a penalty for premature withdrawal of funds from a time savings account, certificate of deposit, or similar class of deposit.[1765] A financial institution is any bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank, or homestead association.[1766]

13. Alimony and Alimony Recapture Deduction

For divorce or separation instruments executed after December 31, 2018 (or a modification of divorce or separation instruments executed before that date but modified after, where the modification expressly provides the new tax treatment shall apply), alimony paid is not deductible and alimony received is not income.[1767] For divorce or separation instruments executed before December 31, 2018 (or a modification of divorce or separation instruments executed before that date but modified after, where the modification does not expressly provides the new tax treatment shall apply), a deduction under §215 for alimony paid is allowed in computing adjusted gross income.[1768] Also, the deduction allowed to a payee who received alimony and with respect to whose payor the alimony recapture provisions apply is allowed in computing adjusted gross income.[1769] For an in-depth discussion on alimony and alimony recapture, see 515 T.M., *Divorce and Separation.*

14. Reforestation Expenditure Deductions

The deduction allowed under §194 for reforestation expenditures is allowable in computing adjusted gross income.[1770] For an in-depth discussion on the reforestation expenditure deduction, see 610 T.M., *Timber Transaction.*

15. Certain Supplemental Unemployment Compensation Benefit Repayment Deductions

Any deduction allowed under §165 for the repayment to a trust of supplemental unemployment compensation benefits is allowable in computing adjusted gross income.[1771] The deduction is allowed for a repayment to a §501(c)(9) or §501(c)(17) trust of supplemental unemployment benefits received from the trust that is required, because trade readjustment allowances under §231 or §232 of the Trade Act of 1974[1772] were received.[1773]

16. Remitted Jury Pay

In computing adjusted gross income, an employee may deduct jury pay that is remitted to the employer.[1774] This rule applies if the employee must remit the jury fees in exchange for the employer continuing to pay the employee wages or salary during the period of jury service.[1775] Jury pay is any payment received by an individual for the discharge of jury duty.[1776]

17. Clean Fuel Vehicle and Refueling Property Deduction

For tax years beginning before January 1, 2015, the deduction allowed under former §179A for the cost of any qualified

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[1757] §62(a)(4); Reg. §1.62-1T(c)(5). *See also Foster v. Commissioner*, 24 T.C.M. 1268, 1323 (1965), *aff'd in part and rev'd in part on other grounds*, 391 F.2d 727 (4th Cir. 1968); Rev. Rul. 75-14.

[1758] *Koshland v. Commissioner*, 19 T.C. 860, 864 (1953), *aff'd per curiam*, 216 F.2d 751 (9th Cir. 1954).

[1759] *United States v. Wharton*, 207 F.2d 526, 527 (5th Cir. 1953).

[1760] *Strange v. Commissioner*, 114 T.C. 206 (2000), *aff'd*, 270 F.3d 786 (9th Cir. 2001).

[1761] §62(a)(5); Reg. §1.62-1T(c)(6).

[1762] §62(a)(6); Reg. §1.62-1T(c)(7).

[1763] §62(a)(7); Reg. §1.62-1T(c)(8).

[1764] §62(a)(9); Reg. §1.62-1T(c)(10). *See* Rev. Rul. 75-20.

[1765] §62(a)(9); Reg. §1.62-1T(c)(10).

[1766] §62(a)(9); Reg. §1.62-1T(c)(10).

[1767] Former §61(a)(8), former §71, former §215.

[1768] Former §62(a)(10), former §71(g)(1); Reg. §1.62-1T(c)(11).

[1769] Former §71(f)(1)(B).

[1770] §62(a)(11); Reg. §1.62-1T(c)(12).

[1771] §62(a)(12); Reg. §1.62-1T(c)(13).

[1772] 19 U.S.C. §2291, §2292.

[1773] §62(a)(12); Reg. §1.62-1T(c)(13).

[1774] §62(a)(13).

[1775] §62(a)(13).

[1776] §62(a)(13).

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clean-fuel vehicle property or refueling property was formerly allowable in computing adjusted gross income.[1777]

18. Moving Expense Deduction

For any tax year beginning after 2017, the moving expense deduction is only available to active duty Armed Forces members who move pursuant to a military order and incident to a permanent change of station; and, for tax years beginning after 2025, to an employee or new appointee of the intelligence community who relocates due to a change in assignment.[1778] Otherwise, the deduction allowed under §217 for certain moving expenses is allowable in computing adjusted gross income.[1779] For further discussion of the moving expenses deduction, see 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses* .

19. Medical Savings Account Contributions Deduction

The deduction allowed under §220 for Archer medical savings account contributions is allowable in computing adjusted gross income.[1780] For a further discussion of the deductibility of Archer medical savings account contributions, see 330 T.M., *Tax and ERISA Implications of Employer-Provided Medical and Disability Benefits.*

20. Education Loan Interest Deduction

The deduction allowed under §221 for certain interest on education loans is allowable in computing adjusted gross income.[1781] For further discussion on the deductibility of education loan interest, see 517 T.M., *Educational Expenses and Credits.*

21. Former Higher Education Expense Deduction

The deduction allowed under former §222 for qualified tuition and related expenses was allowable in computing adjusted gross income.[1782] The deduction applies for tax years beginning before January 1, 2021.[1783] For further discussion on the deductibility of higher education expenses, see 517 T.M., *Educational Expenses and Credits.*

22. Health Savings Account Deductions

The deduction allowed under §223 for amounts paid to health savings accounts is allowable in computing adjusted gross income.[1784] For a further discussion of health saving account deductions, see 330 T.M., *Tax and ERISA Implications of Employer-Provided Medical and Disability Benefits.*

23. Certain Attorney Fee and Court Cost Deductions

Any deduction allowable under §1 through former §1400T for attorney fees and court costs that satisfy two conditions are allowable in computing adjusted gross income.[1785] First, the fees and costs must be paid by, or on behalf of, the taxpayer.[1786] Second, they must be paid in connection with any action involving a claim of unlawful discrimination, a claim of a violation of 31 U.S.C. §3721 *et seq.*, or a claim made under §1862(b)(3)(A) of the Social Security Act.[1787] Only the portion of the fees and costs that do not exceed the amount includible in the taxpayer's gross income for the tax year on account of a judgment or settlement, whether by suit or agreement and whether as lump sum or periodic payments, resulting from the claim are allowable in computing adjusted gross income.[1788]

A claim of unlawful discrimination is a claim that an act is unlawful under any of the following provisions:[1789]

- §302 of the Civil Rights Act of 1991;[1790]
- §201, §202, §203, §204, §205, §206, or §207 of the Congressional Accountability Act of 1995;[1791]
- The National Labor Relations Act;[1792]
- The Fair Labor Standards Act of 1938;[1793]
- §4 or §15 of the Age Discrimination in Employment Act of 1967;[1794]
- §501 or §504 of the Rehabilitation Act of 1973;[1795]
- §510 of the Employee Retirement Income Security Act of 1974 (ERISA);[1796]
- Title IX of the Education Amendments of 1972;[1797]
- The Employee Polygraph Protection Act of 1988;[1798]
- The Worker Adjustment and Retraining Notification Act;[1799]
- §105 of the Family and Medical Leave Act of 1993;[1800]
- Chapter 43 of title 38, United States Code, which relates to the employment and reemployment rights of members of the uniformed services;[1801]
- §1977, §1979, or §1980 of the Revised Statutes;[1802]
- §703, §704, or §717 of the Civil Rights Act of 1964;[1803]

[1777] Former §62(a)(14).
[1778] §217(g), §217(k), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70113(a); §217(k)(2), added by the OBBBA, §70113(b).
[1779] §62(a)(15).
[1780] §62(a)(16).
[1781] §62(a)(17).
[1782] Pre-2021 §62(a)(18).
[1783] Former §222(e).
[1784] §62(a)(19).
[1785] §62(a)(20).
[1786] §62(a)(20).
[1787] §62(a)(20). *See* 42 U.S.C. §1395y(b)(3)(A).
[1788] §62(a)(20).
[1789] §62(e).
[1790] §62(e)(1) (reference to 42 U.S.C. §2000e-16b).
[1791] §62(e)(2) (reference to 2 U.S.C. §1311, §1312, §1313, §1314, §1315, §1316, §1317).
[1792] §62(e)(3) (reference to 29 U.S.C. §151 *et seq.*).
[1793] §62(e)(4) (reference to 29 U.S.C. §201 *et seq.*).
[1794] §62(e)(5) (reference to 29 U.S.C. §623, §633a).
[1795] §62(e)(6) (reference to 29 U.S.C. §791, §794).
[1796] §62(e)(7) (reference to 29 U.S.C. §1140).
[1797] §62(e)(8) (reference to 20 U.S.C. §1681 *et seq.*).
[1798] §62(e)(9) (reference to 29 U.S.C. §2001 *et seq.*).
[1799] §62(e)(10) (reference to 29 U.S.C. §2102 *et seq.*).
[1800] §62(e)(11) (reference to 29 U.S.C. §2615).
[1801] §62(e)(12) (reference to 38 U.S.C. §4301 *et seq.*).
[1802] §62(e)(13) (reference to 42 U.S.C. §1981, §1983, §1985).
[1803] §62(e)(14) (reference to 42 U.S.C. §2000e-2, §2000e-3, §2000e-16).

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• §804, §805, §806, §808, or §818 of the Fair Housing Act;[1804]

• §102, §202, §302, or §503 of the Americans with Disabilities Act of 1990;[1805]

• Any provision of federal law prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law ("whistleblower protection provisions");[1806]

• Any provision of federal, state, or local law, or common law claims permitted under federal, state, or local law that provide for the enforcement of civil rights;[1807] or

• Any provision of federal, state, or local law, or common law claims permitted under federal, state, or local law that regulate any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.[1808]

Note: For amounts paid or incurred, after December 22, 2017, for settlements or payments or attorney's fees related to sexual harassment or sexual abuse no deduction is allowed if the settlement or payment is subject to a nondisclosure agreement.[1809]

Additionally, any attorney fees or court costs paid by, or on behalf of, the taxpayer in connection with an award under §7623(b), relating to tax whistleblower awards, are allowable in computing adjusted gross income.[1810] Only the portion of the fees and costs that do not exceed the amount includible in the taxpayer's gross income for the tax year on account such award, are allowable in computing adjusted gross income.[1811] For an in-depth discussion of the §7623(b) whistleblower award, see 632 T.M., *Tax Whistleblower Laws and Programs.*

Observation: The allowance of attorney fees and court costs as deductions in the computation of adjusted gross income is designed to prevent situations in which limitations on itemized deductions reduce the amount of the deduction and cause the taxpayer's taxable income to increase by more than the net award received by the taxpayer. Unfortunately, the same situation can arise when taxpayers are successful in other types of litigation, but in those situations the taxpayer is not permitted to use the deduction in computing adjusted gross income because they do not involve discrimination claims.

For further discussion on the deductibility of legal fees and cost, see 523 T.M., *Deductibility of Legal and Other Professional Fees.*

24. Charitable Contributions

For tax years beginning in 2020 only, an above-the-line deduction for the amount (not to exceed $300) of qualified charitable contributions made by an eligible individual during the tax year was allowed in computing adjusted gross income.[1812] An "eligible individual" is any individual who does not elect to itemize deductions.[1813] A "qualified charitable contribution" is any charitable contribution (as defined by §170(c)) which is made in cash, for which a deduction is allowed under §170, and which is made to an organization described in §170(b)(1)(A).[1814]

For discussion of charitable contribution deductions by non-itemizers as below-the-line deductions, see V.C.5., below. For further discussion of charitable deductions and contributions, see 521 T.M., *Charitable Contributions: Income Tax Aspects.*

25. Certain Personal Casualty Losses

Personal casualty losses in excess of personal casualty gains are deductible if attributable to a federally declared disaster in tax years beginning after 2017 and before 2026, and if attributable to a federally declared disaster or a state declared disaster in tax years beginning after 2025 — subject to a $100 per casualty floor, and to the extent that the amount of excess personal casualty losses exceeds 10% of the individual's AGI.[1815]

For a detailed discussion of the deductibility of personal casualty losses, the definition of "personal casualty loss," and the definition of "federally declared disaster," see 527 T.M., *Loss Deductions.*

26. Housing Cost While Living Abroad

The deduction for housing costs that are allowed with respect to a U.S. citizen or resident who is employed abroad and who does not receive a housing cost allowance from his or her employer is allowable in computing adjusted gross income.[1816] For further discussion of the deduction of housing cost while living abroad, see 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*

[1804] §62(e)(15) (reference to 42 U.S.C. §3605, 42 U.S.C. §3606, 42 U.S.C. §3608, 42 U.S.C. §3617).

[1805] §62(e)(16) (reference to 42 U.S.C. §12112, 42 U.S.C. §12132, 42 U.S.C. §12182, 42 U.S.C. §12203).

[1806] §62(e)(17).

[1807] §62(e)(18).

[1808] §62(e)(18).

[1809] §162(q).

[1810] §62(a)(21).

[1811] §62(a)(21).

[1812] Former §62(a)(22). *Editor's note*: former §62(a)(22) only treated charitable contributions not exceeding $300 in tax years beginning in 2020 as above-the-line deductions in computing adjusted gross income (AGI). Thus, charitable contributions in other tax years are not above-the-line deductions in computing AGI.

[1813] Former §62(f)(1).

[1814] Former §62(f)(2). Contributions made to §509(a)(3) organizations or made for the establishment of a new, or maintenance of an existing, donor advised fund (as defined in §4966(d)(2)), are not "qualified charitable contributions." Former §62(f)(2)(ii)(II).

[1815] §165(h)(5)(A), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70109, applicable to tax years beginning after December 31, 2025; §165(h)(1), §165(h)(2)(A). Personal casualty losses are deductible to the extent of personal casualty gains. §165(h)(5)(B), amended by the OBBBA, §70109.

[1816] §911(c)(4)(A).

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27. Deductions for Losses from Marketable Stock Subject to Mark-to-Market Rules

The deduction allowed under §1296(a)(2) with respect to annual losses on marketable stock in passive foreign investment companies and under §1296(c)(1)(B)(ii) for losses from the dispositions of that marketable stock are allowable in computing adjusted gross income.[1817] For further discussion of the deduction for losses from marketable stock subject to mark-to-market rules, see 6300 T.M., *PFICs* (Foreign Income Series).

28. Deduction for Qualified Overtime Compensation (2025–2028)

For tax years beginning in 2025–2028, taxpayers may deduct up to $12,500 ($25,000 joint return) in qualified overtime compensation.[1818] The annual deduction is phased out (but not below zero) by $100 for each $1,000 by which the taxpayer's modified adjusted gross income (MAGI) exceeds $150,000 ($300,000 joint return).[1819] Qualified overtime compensation does not include §224(d) qualified tips.[1820]

A valid social security number must be included on taxpayer's return.[1821] A married taxpayer must file a joint return to claim the deduction.[1822]

A transition rule applies to reporting periods before January 1, 2026, allowing qualified overtime compensation accounting by any reasonable method specified by the Secretary.[1823]

The deduction is available to both itemizers and non-itemizers.[1824]

The deduction for qualified overtime compensation is reported on Schedule 1-A (Form 1040, Form 1040-SR, or Form 1040-NR).

For a detailed discussion of the deduction for qualified overtime compensation, see V.C.7., below.

29. Deduction for Qualified Tips (2025–2028)

For tax years beginning in 2025–2028, individuals other than highly compensated employees may deduct up to $25,000 of qualified tips, subject to a phaseout of $100 for every $1,000 modified adjusted gross income exceeds $150,000 ($300,000 for joint filers).[1825]

The deduction for qualified tips is available to both itemizers and non-itemizers.[1826]

The deduction for qualified tips is reported on Schedule 1-A (Form 1040, Form 1040-SR, or Form 1040-NR).

For a detailed discussion of the deduction for qualified tips, see V.C.6., below.

30. Enhanced Deduction for Seniors (2025–2028)

For tax years 2025 through 2028, qualified seniors can deduct up to $6,000, subject to a 6% phaseout for the amount modified adjusted gross income (MAGI) exceeds $75,000 ($150,000 for joint filers).[1827] Married joint filers can each take the deduction if both individuals are at least 65 yerars old by the end of the year. The deduction is available to non-itemizing and itemizing taxpayers.[1828] The enhanced deduction for seniors is reported on Schedule 1-A (Form 1040, Form 1040-SR, or Form 1040-NR) and is discussed in detail in 513 T.M., *Family and Household Transactions.*

C. Below-the-Line Deductions

1. Introduction

In calculating taxable income, an individual is only allowed above-the-line deductions, discussed in V.B., above, and either the deductions listed in §63(b), discussed in V.C.3. through V.C.7., below, or itemized deductions, discussed in V.C.8., below. The standard deduction is not allowable if the taxpayer elects to itemize deductions.[1829] The election to itemize is made on the taxpayer's return by completing Schedule A.[1830] If the taxpayer fails to substantiate itemized deductions exceeding the standard deduction, the election is disregarded.[1831] A taxpayer who fails to file a return loses the opportunity to itemize deductions.[1832] A taxpayer may change the election to itemize deductions after filing the return.[1833] The change of election does not extend the statute of limitations for claiming a credit or refund of tax with respect to the tax year.[1834] Thus, a taxpayer who did not elect to itemize deductions, but later discovers additional itemized deductions, may make the election on any timely filed amended return. Likewise, a taxpayer who elected to itemize deductions whose return is audited and deductions disallowed may revoke the election and claim the standard deduction.[1835]

Additional rules apply if the taxpayer's spouse filed a separate return for the tax year.[1836] The taxpayer may not change his or her election to itemize unless two conditions are satisfied.[1837] First, the spouse must change the election for the tax year con-

[1817] §1296(c)(1)(B) (flush language).

[1818] §225(a)–§225(c), added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70202(a). Qualified overtime compensation is overtime pay required under the Fair Labor Standards Act, §7, in excess of the regular pay rate.

[1819] §225(b)(2), added by the OBBBA, §70202(a). MAGI under §225 equals adjusted gross income plus certain exclusions for living abroad, in a U.S. territory, or Puerto Rico.

[1820] §225(c)(2), added by the OBBBA, §70202(a).

[1821] §225(d), added by the OBBBA, §70202(a). SSN is defined by reference to §24(h)(7), which requires the SSN to be issued to a citizen before the tax return's due date.

[1822] §225(e), added by the OBBBA, §70202.

[1823] OBBBA, §70202(h).

[1824] §63(b)(6), added by the OBBBA, §70202(b).

[1825] §224, added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70201(a). Qualified tips must be reported on statements provided to the taxpayer under §6041(d)(3), §6041A(e)(3), §6050W(f)(2), or §6051(a)(18), or by the taxpayer on Form 4137, *Social Security and Medicare Tax On Unreported Tip Income.*

[1826] §63(b)(5), added by the OBBBA, §70201(b).

[1827] §151(d)(5)(C), added by the OBBBA, §70103.

[1828] *See* IRS Fact Sheet FS-2025-03 (July 14, 2025).

[1829] *See* §63(b).

[1830] §63(e)(2). *See also* IRS Publication 17, *Your Federal Income Tax (For Individuals).*

[1831] *See Cohen v. Commissioner*, 82 T.C.M. 627 (2001).

[1832] *See Lange v. Commissioner*, 90 T.C.M. 157 (2005); *Maxwell v. United States*, 80 F. Supp. 2d 1352 (N.D. Ga. 1999).

[1833] §63(e)(3); Reg. §1.63-1(a).

[1834] Reg. §1.63-1(b).

[1835] *See* Reg. §1.63-1(a).

[1836] §63(e)(3); Reg. §1.63-1(c).

[1837] §63(e)(3); Reg. §1.63-1(c).

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sistent with the taxpayer's change.[1838] Second, the taxpayer and spouse must consent in writing to the extension of the time for the assessment of any deficiency, to the extent attributable to the change of election, even though at the time the consent is filed the assessment would otherwise be prevented by the operation of any law or rule of law.[1839]

2. Personal and Dependency Exemptions

Beginning in 2018, the §151 personal and dependency deduction is zero,[1840] except for a temporary deduction for seniors (the "enhanced deduction for seniors") and when determining an allowable deduction or whether a tax-payer is entitled to a deduction.[1841] The enhanced deduction for seniors is available to non-itemizing and itemizing taxpayers and is discussed in V.B.30., above. The deduction for personal and dependency exemptions is discussed in detail in 513 T.M., *Family and Household Transactions.*

3. Standard Deduction

a. In General

An individual is given a choice between claiming the standard deduction or itemized deductions. Unlike other deductions, the standard deduction does not require the taxpayer to prove that expenditures have been made. The standard deduction is based, in part, on the notion that, even if they do not maintain records of deductible expenditures, all taxpayers are presumed to have made some expenditures that would be deductible. Thus, most individuals who do not elect to itemize deductions for the tax year may claim a standard deduction.[1842] However, a taxpayer may not claim both the standard deduction and itemized deductions.[1843] Thus, a taxpayer will claim the standard deduction, only if the taxpayer's itemized deductions are less.

> *Example:* S is an individual who has never been married and lives alone. In Year 1, S pays $3,250 in expenses that are categorized as itemized deductions. S's standard deduction is $6,350. Because the standard deduction is higher than S's itemized deductions, S claims the $6,350 standard deduction, but is not allowed to deduct the $3,250 in expenses as deductions.

b. Exceptions

Certain individuals may not claim the standard deduction.[1844] Technically, the standard deduction for ineligible individuals is zero. This is equivalent, however, to not allowing the standard deduction.

The standard deduction is not available to:

- a married individual who files a separate return and whose spouse elects to itemize deductions;[1845]
- a nonresident alien individual;[1846]
- an individual filing a return for a short period,[1847] because of a change in annual accounting period;[1848] and
- an estate, trust, common trust fund, or partnership.[1849]

The IRS has advised that if one spouse properly selects head of household filing status and elects to itemize deductions, the other spouse is treated as filing a separate return and is not eligible for the standard deduction.[1850] The IRS also advised that the spouse who properly selects head of household filing status may elect the standard deduction, even if the other spouse elects to itemize deductions.[1851]

c. Amount of Standard Deduction

(1) In General

The standard deduction consists of two elements: the basic standard deduction[1852] and the additional standard deduction.[1853] The basic standard deduction for married couples filing jointly and for surviving spouses is twice the basic standard deduction amount for unmarried taxpayers.[1854] Individual filers can find their standard deduction amount listed on Form 1040 or Form 1040-SR. Form 1040-SR, *Tax Return for Seniors*, is available for use by taxpayers age 65 and older. For more information on Form 1040-SR, see Instructions for Form 1040, which covers Form 1040-SR.

If an individual has a net disaster loss for the tax year, the basic standard deduction amount is increased by the net disaster loss. A net disaster loss is the excess of qualified disaster-related personal casualty losses for the tax year over personal casualty gains (as defined in §165(h)(3)(A)) for the tax year.[1855]

The basic standard deduction amounts for recent years are set forth in Tables, Charts & Lists, *Standard Deduction Tables by Year.*

(2) Limitation for Certain Taxpayers

The basic standard deduction for an individual's tax year is limited if another taxpayer is permitted to claim a dependency

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[1838] §63(e)(3)(A); Reg. §1.63-1(c)(1)(i). *See Boyd v. Commissioner*, 86 T.C.M. 440 (2003).

[1839] §63(e)(3)(B); Reg. §1.63-1(c)(1)(ii).

[1840] §151(d)(5), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70103.

[1841] *See* §151(d)(5)(C), §151(d)(5)(B).

[1842] §63(b)(1); Prop. Reg. §1.63-2.

[1843] *See George v. Commissioner*, 91 T.C.M. 1258 (2006) (taxpayer may not deduct itemized deductions in addition to standard deduction).

[1844] §63(c)(6).

[1845] §63(c)(6)(A). *See Peterson v. Commissioner*, 74 T.C.M. 890 (1997).

[1846] §63(c)(6)(B).

[1847] *See* §443(a)(1).

[1848] §63(c)(6)(C).

[1849] §63(c)(6)(D).

[1850] SCA 200030023 (applying §63(c)(6)(A)).

[1851] SCA 200030023 (applying §63(c)(6)(A)). *See also* §6695(g)(1) (imposing a $500 penalty on tax return preparers that do not use due diligence in determining head-of-household filing status for tax years beginning after December 31, 2017).

[1852] §63(c)(1)(A).

[1853] §63(c)(1)(B); Prop. Reg. §1.63-2, §1.63-3.

[1854] §63(c)(2)(A).

[1855] The One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70438, extending the special rules for qualified disaster-related personal casualty losses under the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Pub. L. No. 116-260, Div. EE, Title III, §304(b)(1)(C). For a detailed discussion of disaster-related tax legislation, see 597 T.M., *Tax Incentives for Economically Distressed Areas*. For a detailed discussion of the treatment of personal casualty losses, see 527 T.M., *Loss Deductions*, at V.

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exemption deduction for that individual.[1856] For these individuals, the basic standard deduction to which the individual would otherwise be entitled is limited to the greater of the general fixed amount[1857] or the individual's earned income increased by the supplemental fixed amount.[1858]

The general fixed amount is $500,[1859] adjusted for inflation.[1860] The supplemental fixed amount is $250,[1861] adjusted for inflation.[1862] The inflation-adjusted amounts for recent years are listed in Tables, Charts & Lists, *Standard Deduction Tables by Year*.

Comment: It does not matter whether the other taxpayer actually claims the dependency exemption deduction for the individual. What matters is that it is allowable. Thus, even if it appears otherwise advantageous to do so, there is no benefit in deliberately forgoing a dependency exemption deduction.

> *Example 1:* C, the 15-year-old child of M and D, recognizes gross income of $260 from compensation and $105 from interest. Assume the standard deduction is $6,350 and that the limited standard deduction for dependents is the greater of $1,050 ($500 statutory amount adjusted for inflation) or the sum of $350 ($250 statutory amount adjusted for inflation) and the individual's earned income. M and D provide almost all of C's support, and C's principal place of abode is the same as that of M and D. M and D may claim a dependency exemption deduction for C on their joint return. On C's return, which C files to obtain a refund of federal income taxes withheld from the compensation, C's standard deduction, which would otherwise be $6,350, is limited to the greater of $1,050 or $610 ($260 earned income increased by $350). C's standard deduction is $1,050.

> *Example 2:* The facts are the same as in *Example 1*, except that C's compensation gross income is $1,800. C's standard deduction, which would otherwise be $6,350, is limited to the greater of $1,050 or $2,150 ($1,800 earned income increased by $350). C's standard deduction is $2,150.

> *Example 3:* The facts are the same as in *Example 1*, except that C's compensation gross income is $6,180. C's standard deduction is $6,350. The limitation does not apply, because C's earned income increased by $350 is $6,530, which exceeds the $6,350 standard deduction to which C otherwise is entitled.

> *Example 4:* The facts are the same as in *Example 1*, except that C's compensation gross income is $7,500. C's standard deduction is $6,350. The limitation does not apply, because C's earned income exceeds the $6,350 standard deduction to which C otherwise is entitled.

[1856] §63(c)(5).
[1857] §63(c)(5)(A).
[1858] §63(c)(5)(B).
[1859] §63(c)(5)(A).
[1860] §63(c)(4)(A), §63(c)(4)(B)(i).
[1861] §63(c)(5)(B).
[1862] §63(c)(4)(A), §63(c)(4)(B)(ii).

(3) Additional Standard Deduction

(a) In General

The additional standard deduction is the sum of each additional amount to which the taxpayer is entitled to by qualifying through age, blindness, or both.[1863]

Each additional standard deduction amount for the aged and for the blind is $600,[1864] adjusted for inflation.[1865] The inflation-adjusted amounts for recent years are listed in Tables, Charts & Lists, *Standard Deduction Tables by Year*.

(b) Qualifying Through Age

The taxpayer is entitled to an additional standard deduction if the taxpayer attained age 65 before the close of the tax year.[1866] The taxpayer is entitled to another additional standard deduction if the taxpayer's spouse attained age 65, before the close of the tax year; and, the taxpayer is entitled to claim a personal exemption deduction[1867] for the spouse.[1868] If spouses, both of whom have attained age 65, file a joint return, each is entitled to an additional standard deduction and, thus, their total standard deduction reflects the basic standard deduction plus two additional standard deductions.[1869]

Note: Form 1040-SR, *Tax Return for Seniors*, is available to taxpayers age 65 and older. Form 1040-SR filers can find their standard deduction by using the chart provided on the form.[1870]

A taxpayer attains age 65 on the day preceding the taxpayer's 65th birthday.[1871]

> *Example:* T was born on January 1, 1952. T attains age 65 on December 31, 2016, the day before T's 65th birthday. Thus, T is entitled to an additional standard deduction for 2016.[1872]

> *Example:* T's spouse was born on January 15, 1951, and died on January 14, 2016. T's spouse is considered age 65 at the time of death. However, if T's spouse died on January 13, 2016, T's spouse is not considered age 65 at time of death.

[1863] §63(c)(3), §63(f).
[1864] §63(f)(1). Prop. Reg. §1.63-3 would provide new guidance on the additional standard deduction for the aged and blind. REG-137604-07, 82 Fed. Reg. 6370 (Jan. 19, 2017).
[1865] §63(c)(4)(A), §63(c)(4)(B)(i).
[1866] §63(f)(1)(A). Prop. Reg. §1.63-3(b)(2) would provide new guidance on the additional standard deduction for the aged and blind.
[1867] *See* §151(b). See also the temporary deduction for seniors discussed in 513 T.M., *Family and Household Transactions*.
[1868] §63(f)(1)(B); Prop. Reg. §1.63-3(b)(1).
[1869] *See* Prop. Reg. §1.63-3(b)(1).
[1870] Instructions for Form 1040 also covers Form 1040-SR.
[1871] IRS Pub. 501, *Dependents, Standard Deduction, and Filing Information. See also* Reg. §1.151-1(c)(2) (interpreting since-repealed additional personal exemption for taxpayers attaining age 65).
[1872] Reg. §1.151-1(c)(2).

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Observation: This rule differs from the one prescribed by the IRS for determining when a child attains a specific age for purposes of the dependent care, adoption, child, and earned income credits, the dependent care assistance, foster care, and adoption assistance exclusions, and the dependency exemption deduction.[1873] In these instances, a child attains a specific age on the anniversary of the date that the child was born, and not on the previous day. It is unknown why the IRS does not apply a uniform rule for purposes of determining when anyone attains a specified age.

(c) Qualifying Through Blindness

The taxpayer is entitled to an additional standard deduction if the taxpayer is blind at the close of the tax year.[1874] The taxpayer is entitled to another additional standard deduction if the taxpayer's spouse is blind at the close of the tax year and if the taxpayer may claim a personal exemption deduction[1875] for the spouse.[1876] If spouses, both of whom are blind, file a joint return, each is entitled to an additional standard deduction and, thus, their total standard deduction reflects the basic standard deduction plus two additional standard deductions.[1877]

Comment: It is possible for a married couple to be entitled to four additional standard deductions: two additional amounts for blindness and two additional amounts for age.[1878]

Note: If the taxpayer's spouse dies during the tax year, the determination of whether the spouse is blind is made as of the time of the spouse's death.[1879]

A taxpayer is blind if either one of two conditions is satisfied.[1880] First, the taxpayer's central visual acuity does not exceed 20/200 in the better eye with correcting lenses.[1881] Second, the taxpayer's visual acuity is greater than 20/200, but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends to an angle no greater than 20 degrees.[1882] The taxpayer must obtain, and maintain in their records, a statement from their eye doctor (e.g., ophthalmologist or optometrist) stating that the doctor has examined the taxpayer, or the taxpayer's spouse, and that, in the doctor's opinion, the taxpayer, or the taxpayer's spouse, meets at least one of the two conditions indicating blindness.[1883] The ophthalmologist's or optometrist's statement must document that the doctor examined the taxpayer or the taxpayer's spouse in the tax year for which the additional standard deduction for blindness is claimed, or that the doctor examined the person in an earlier year and that the visual impairment is irreversible.[1884]

Comment: Court decisions applying the regulations interpreting the additional personal exemption for blindness,[1885] which was repealed for tax years beginning after 1986 and replaced with the additional standard deduction, should apply to the additional standard deduction. Greatly impaired vision does not qualify as blindness if the statutory blindness conditions are not satisfied.[1886] If the vision can be corrected only with special contact lenses that cause severe pain, infection, and ulcers, and that can be worn only for short periods, the blindness conditions are satisfied.[1887]

4. Qualified Business Income Deduction

Individuals, trusts, and estates who invest in noncorporate businesses (i.e., sole proprietorships, partnerships, and S corporations) may be eligible to claim a deduction of up to 20% of the "qualified business income" earned by those businesses.[1888] The §199A qualified business income deduction is discussed in detail in 537 T.M., *Qualified Business Income Deduction: Section 199A.*

5. Charitable Contributions Deduction for Nonitemizers

For tax years beginning after 2025, individuals who do not elect to itemize deductions are permitted a charitable contribution deduction for qualified contributions up to $1,000 ($2,000 joint filers).[1889]

For tax years beginning in 2021, individuals who did not elect to itemize deductions were permitted a charitable contribution deduction for qualified contributions up to $300 ($600 joint filers).[1890]

For discussion of above-the-line deductions for charitable contributions in tax years beginning in 2020, see V.B.24., above. For further discussion of charitable deductions and contributions, see 521 T.M., *Charitable Contributions: Income Tax Aspects.*

6. Qualified Tip Deduction (2025–2028)

a. In General

For tax years beginning in 2025–2028, individuals other than highly compensated employees may deduct up to $25,000 of qualified tips, subject to a phaseout of $100 for every $1,000 modified adjusted gross income (MAGI) exceeds $150,000 ($300,000 for joint filers).[1891]

[1873] Rev. Rul. 2003-72.
[1874] §63(f)(2)(A); Prop. Reg. §1.63-3(c)(1).
[1875] *See* §151(b). Personal exemptions are further discussed in 513 T.M., *Family and Household Transactions.*
[1876] §63(f)(2)(B); Prop. Reg. §1.63-3(c)(1).
[1877] §63(f)(2)(B); Prop. Reg. §1.63-3(c)(1).
[1878] *See* Prop. Reg. §1.63-3(b)(1), §1.63-3(c)(1).
[1879] §63(f)(2) (flush language); Prop. Reg. §1.63-3(c)(1).
[1880] §63(f)(4); Prop. Reg. §1.63-3(c)(2).
[1881] §63(f)(4); Prop. Reg. §1.63-3(c)(2).
[1882] §63(f)(4); Prop. Reg. §1.63-3(c)(2).
[1883] Prop. Reg. §1.63-3(c)(2); IRS Pub. 17, *Your Federal Income Tax (For Individuals).*
[1884] Prop. Reg. §1.63-3(c)(2).
[1885] Reg. §1.151-1.
[1886] *Kub v. Commissioner*, 33 T.C.M. 1282 (1974), *aff'd by unpub. op.* 558 F.2d 1033 (7th Cir. 1977); *Rice v. Commissioner*, 26 T.C.M. 295, 297 (1967).
[1887] *Hollman v. Commissioner*, 38 T.C. 251, 262 (1962), *acq.*, 1964-2 C.B. 5.
[1888] §199A.
[1889] §170(p), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70424(a).
[1890] Former §170(p).
[1891] §224, added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70201(a). Qualified tips must be reported on statements provided to the taxpayer under §6041(d)(3), §6041A(e)(3), §6050W(f)(2), or §6051(a)(18), or by the taxpayer on Form 4137, *Social Security and Medicare Tax On Unreported Tip Income.* MAGI for §224 purposes is AGI plus certain exclusions related to living abroad, in a U.S. territory, or Puerto Rico under §911, §931, and §933.

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Example — High Income Single Taxpayer

An employee receiving more than $25,000 of qualified tips in 2025 files as a single taxpayer and has MAGI of $200,000. The employee's §224 qualified tip amount is reduced (but not below zero) by $100 for each $1,000 by which MAGI exceeds $150,000 (i.e., the threshold for a single filer). Because the employee's MAGI exceeds $150,000 by $50,000, the employee first divides $50,000 by $1,000 to get 50. The employee's §224 deduction is reduced by $5,000 ($100 × 50), from $25,000 to $20,000.[1892]

Taxpayers must provide a valid social security number and married taxpayers must file a joint return to claim the deduction.[1893]

Example — Qualified Tips Received by Both Spouses

Taxpayers X and Y are married, file a joint income tax return, and both work in occupations that customarily and regularly received tips before 2025. In 2025, X receives $15,000, and Y receives $20,000, in qualified tips. The maximum §224 deduction X and Y may claim on their joint return for 2025 is $25,000.[1894]

Self-employed taxpayers' gross income from the trade or business generating qualified tips must exceed the sum of deductions allocable to the trade or business other than §224 for the tips to be deductible.[1895] Generally, this means the §224 deduction is limited to trade or business net income before the §224 deduction is taken.

Example — Self-Employed Individual Not Limited by §224(c)

A self-employed manicurist owns a nail salon and does not have other employment. The manicurist's gross income is $100,000, consisting of $70,000 of fees for services at the nail salon and $30,000 of qualified tips. The manicurist's total deductible expenses (other than the deduction for qualified tips) equal $40,000. The manicurist's gross income of $100,000 from the trade or business exceeds the sum of trade or business deductions other than qualified tips by $60,000 ($100,000 – $40,000 = $60,000). The manicurist is permitted to deduct $25,000 under §224.[1896]

Example — Limited §224 Deduction for Self-Employed Individual

Assume the same facts as the prior example, except the manicurist has gross income of $75,000 ($55,000 of fees for services at the nail salon and $20,000 of qualified tips). The manicurist's total deductible expenses (other than the deduction for qualified tips) are $60,000; thus, gross income of $75,000 from the trade or business exceeds the sum of the deductions for that trade or business (other than qualified tips) by $15,000 ($75,000 – $60,000). Although the manicurist received $20,000 in qualified tips, the manicurist can only deduct $15,000 in qualified tips.[1897]

The deduction for qualified tips is available to both itemizers and non-itemizers.[1898]

Qualified tips allowed as a §224 deduction are excluded from Qualified Business Income.[1899]

Section 224 qualified tip reporting requirements are discussed in 643 T.M., *Information Reporting to U.S. Persons — Payments Subject to Backup Withholding*, at III.E. For tax year 2025, the IRS provided transitional relief in eight scenarios by not imposing §6721 or §6722 penalties for failure to file timely and correct information returns or failure to furnish timely and correct payee statements, respectively.[1900]

The deduction for qualified tips is reported on Schedule 1-A (Form 1040, Form 1040-SR, or Form 1040-NR).

b. Qualified Tips

Qualified tips are voluntary "cash" tips received by an individual in an occupation in which tips were customary and regularly received before 2025, and not in the course of a specified service trade or business (§199A(d)(2)).[1901] Tips received by anyone with an ownership interest in or employed by the payor of the tip are not qualified tips.[1902] For discussion of specified service trades or businesses, see V.C.6.c., below.

Occupations that customarily and regularly received tips before 2025 are listed in **Tables, Charts & Lists,** ***Occupations That Customarily Received Tips Before 2025.*** Cash tips include payments by credit card, debit card, gift card, or casino chips, and any other form of payment denominated in cash. Cash tips do not include items paid in any medium other than cash, such as event tickets, meals, services, or other assets not exchangeable for a fixed cash amount.[1903]

Qualified tips must not be negotiated or associated with adverse consequences if not paid. Service charges and automatic gratuities are not qualified tips, unless the customer may waive, recompute, or ignore.[1904]

Example — Restaurant Imposes Automatic Service Charge

A restaurant automatically adds an 18% charge to bills for parties of six or more. Customer's bill includes the 18% charge on the tip line, and the total bill includes this amount. The bill also has a line labeled "additional tip amount." Customer adds 2% of the food and beverage on the additional tip amount line. The 18% charge is not a

[1892] Prop. Reg. §1.224-1(b)(4) *Ex.*, REG-110032-25, 90 Fed. Reg. 45,340 (Sept. 22, 2025).

[1893] §224(e), added by the OBBBA, §70201(a), §224(f), added by the OBBBA, §70201(a). Spousal social security numbers are not required.

[1894] Prop. Reg. §1.224-1(e)(3) *Ex.*

[1895] §224(c), added by the OBBBA, §70201; Prop. Reg. §1.224-1(d)(1).

[1896] Prop. Reg. §1.224-1(d)(3) *Ex.* 1.

[1897] Prop. Reg. §1.224-1(d)(4) *Ex.* 2.

[1898] §63(b)(5), added by the OBBBA, §70201(b).

[1899] §199A(c)(4)(D), added by the OBBBA, §70201(d).

[1900] Notice 2025-62, §3.01, §5.

[1901] §224(d), added by the OBBBA, §70201; Prop. Reg. §1.224-1(c), Prop. Reg. §1.224-1(f).

[1902] Prop. Reg. §1.224-1(c)(9).

[1903] §224(d)(3), added by the OBBBA, §70201. Most digital assets are not exchangeable for a fixed amount in cash. Prop. Reg. §1.224-1(c)(2).

[1904] §224(d)(2)(A), added by the OBBBA, §70201; Prop. Reg. §1.224-1(c)(3).

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qualified tip because it is involuntary, but the voluntary 2% amount is a qualified tip.[1905]

Note: Employees who enter into a tip agreement as part of the Tip Rate Determination Agreement (TRDA) program or Gaming Industry Tip Compliance Agreement (GITCA) program may determine the amount of their qualified tips using the agreement's applicable tip rate (and amounts reported on Form 4137, *Social Security and Medicare Tax on Unreported Tip Income*) in lieu of reporting actual tips received.[1906]

Proposed regulations exclude tips received while performing a service that is a crime.[1907] Similarly, amounts received for prostitution services or pornographic activity would not be qualified tips.[1908]

c. *Specified Service Trade or Business (SSTB)*

Qualified tips do not include amounts received in the course of a specified service trade or business (SSTB).[1909] For employees, the relevant trade or business is the employer's trade or business.[1910]

Tips received by an employee performing services in the course of a SSTB operated by an employer are not qualified tips, even if the trade or business (or its owner) is eligible for a §199A deduction, or the employee is performing services in an otherwise qualifying occupation.[1911]

SSTBs include the following fields:

- health;
- law;
- accounting;
- actuarial science;
- performing arts;
- consulting;
- athletics;
- financial services;
- brokerage services;
- investing and investment management;
- trading;
- dealing in securities, partnership interests, or commodities; or
- any trade or business where the principal asset of the business is the reputation or skill of one or more of its employees or owners.[1912]

Until January 1 of the calendar year following the year final SSTB regulations are issued, the IRS will treat tips received in an occupation that customarily and regularly received tips before 2025 as being received in a non-SSTB trade or business.[1913]

Example — Trade or Business is a SSTB

Taxpayer is a self-employed comedian who receives cash tips after performing stand-up comedy routines. The tips are not qualified tips because the tips are received in the course of the taxpayer's trade or business, and that trade or business is a SSTB (i.e., performing arts), even though taxpayer's occupation is included in the Treasury Tipped Occupation Code (TTOC) category of "Entertainers and performers," on the list of occupations that customarily and regularly received tips before 2025.[1914]

Example — Employee is Pianist and Employer is Not Operating a SSTB

Pianist is an employee of a hotel that is not a SSTB. Pianist plays a piano in the hotel's lobby, and hotel patrons leave cash tips for the pianist. These tips are qualified tips, even though the tips are received for services in a SSTB (i.e., performing arts), because Pianist is performing services as an employee, Pianist's employer is not operating a SSTB, and Pianist's occupation (i.e., piano player) is included in the "Musicians and singers" category on the list of occupations that customarily and regularly received tips before 2025.[1915]

Example — Employee is Bartender and Employer is Not Operating a SSTB

Bartender is an employee of Company X, which does not operate a SSTB. A theater enters into a contract with X to provide bartending services at the theater, and Bartender receives cash tips from theater patrons. These cash tips are qualified tips because Bartender is performing services as an employee, X is not engaged in a SSTB, and the employee's occupation is included in the "Bartenders" category on the list of occupations that customarily and regularly received tips before 2025.[1916]

For a detailed discussion of the tax implications of SSTBs, see 537 T.M., *Qualified Business Income Deduction: Section 199A*.

d. *Transition Rules for Tax Year 2025*

Tax year 2025 Form W-2, Form 1099-NEC, Form 1099-MISC, and Form 1099-K will not be revised to account for new OBBBA information reporting requirements, including those related to the qualified tip deduction.[1917]

[1905] Prop. Reg. §1.224-1(c)(3)(iii) *Ex.* 2.

[1906] Prop. Reg. §1.224-1(c)(5). Using a TRDA or GITCA program to determine qualified tips does not affect audit protections otherwise applicable to the employee's agreement, and employees participating in the TRDA or GITCA program remain subject to §224 and Prop. Reg. §1.224-1(c)(5) requirements.

[1907] Prop. Reg. §1.224-1(c)(6).

[1908] Prop. Reg. §1.224-1(c)(7), Prop. Reg. §1.224-1(c)(8).

[1909] §224(d)(2)(B), added by the OBBBA, §70201(a), effective for tax years after Dec. 31, 2024, §199A(d)(2); Prop. Reg. §1.224-1(c)(4).

[1910] Prop. Reg. §1.224-1(c)(4).

[1911] Prop. Reg. §1.224-1(c)(4). *See also* **Tables, Charts & Lists, *Occupations That Customarily Received Tips Before 2025.***

[1912] Reg. §1.199A-5(b)(1).

[1913] Notice 2025-69, §III.A.1.

[1914] Prop. Reg. §1.224-1(c)(4)(ii) *Ex.* 1.

[1915] Prop. Reg. §1.224-1(c)(4)(iii) *Ex.* 2.

[1916] Prop. Reg. §1.224-1(c)(4)(iv) *Ex.* 3.

[1917] Notice 2025-69, §I (reference to Notice 2025-62). Section 224(a) allows a qualified tip deduction, subject to limitations, equal to the qualified tips documented on information reporting forms furnished to the individual under

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For tax year 2025, the requirement that qualified tips be included on a statement furnished to the employee is satisfied if the employee's cash tips are properly reported on Form W-2, without separately accounting for the tips as required by §6051(a)(18). Also for tax year 2025, employees may use the employee's cash tips reported on Form W-2, box 14 (or on a separate statement), or calculate qualified tips as the sum of social security tips reported on Form W-2 and tips reported by the employee on Form 4070, *Employee's Report of Tips to Employer* (or similar substitute form). Tip amounts treated as income and reported on a Form 4137 filed with the employee's 2025 income tax return may also be treated as cash tips.[1918]

Forms 1099 furnished to non-employees are not a separate cash tip accounting, and a non-employee may satisfy the requirement that qualified tips be furnished on a statement under §6041(d)(3), §6041A(e)(3), or §6050W(f)(2), if the non-employee's cash tips are included in the total amounts reported as other income:

- on Form 1099-MISC furnished to the non-employee;
- as nonemployee compensation on Form 1099-NEC furnished to the non-employee; or
- as payment card/third-party network transactions on Form 1099-K furnished to the non-employee.[1919]

Non-employees may calculate qualified tips (subject to §224 limitations) using earnings statements or other documentation such as receipts, point-of-sale system reports, daily tip logs, third party settlement organization records, or similar records.[1920]

Example 1 — Tax Year 2025: Tips Included on Form W-2 Employee A is a restaurant server. A's employer reports $18,000 of social security tips on A's 2025 Form W-2. A did not report any additional tips on Form 4137. A may use $18,000 to calculate qualified tips.[1921]

Example 2 — Tax Year 2025: Employee Reports Tips on Form 4070 and Form 4137 Employee B is a bartender. B reports $20,000 in 2025 tips to B's employer on Form 4070. B's 2025 Form W-2 reports $200,000 in box 1 (wages, tips, other compensation), an amount in excess of the social security wage base, and $15,000 in box 7 (social security tips). Additionally, B reports $4,000 of unreported tips on Form 4137 and includes this amount in income on B's Form 1040. B may use either the $15,000 from Form W-2, box 7, or the $20,000 reported on Form 4070 to calculate qualified tips. B may also include the $4,000 of unreported tips from Form 4137.[1922]

Example 3 — Tax Year 2025: Self-Employed Person Receives Tips From Third-Party Settlement Organizations D is a self-employed travel guide and sole proprietor. In 2025, D received $7,000 in tips from customers paid through a §6050W(b)(3) third-party settlement organization. D receives Form 1099-K showing $55,000 of total payments from an online booking platform that is also a third-party settlement organization. The Form 1099-K does not separately identify tips. However, D keeps a log of each tour that shows the date, customer, and tip amount received. Because D has daily tip logs substantiating the $7,000 tip amount, D may use the $7,000 tip amount to determine qualified tips.[1923]

7. *Qualified Overtime Compensation (2025–2028)*

a. *In general*

For tax years beginning after 2024 and before 2029, taxpayers may deduct up to $12,500 ($25,000 joint return) in qualified overtime compensation.[1924] The annual deduction is phased out (but not below zero) by $100 for each $1,000 by which the taxpayer's modified adjusted gross income (MAGI) exceeds $150,000 ($300,000 joint return).[1925] Qualified overtime compensation does not include §224(d) qualified tips. The deduction is available to both itemizers and non-itemizers.[1926]

A valid social security number must be included on the taxpayer's return.[1927] A married taxpayer must file a joint return to claim the deduction.[1928]

A transition rule applies to reporting periods before January 1, 2026, allowing qualified overtime compensation accounting by any reasonable method specified by the Secretary.[1929]

The deduction for qualified overtime compensation is reported on Schedule 1-A (Form 1040, Form 1040-SR, or Form 1040-NR).

b. *Transition Rules for Tax Year 2025*

Employers and other payors are not required to separately account for qualified overtime compensation for tax year 2025, so a separate accounting will only be furnished if entered on Form W-2, box 14 or provided on a separate statement.[1930] To claim a §225 deduction, individuals who are not furnished a

§6041(d)(3), §6041A(e)(3), §6050W(f)(2), or §6051(a)(18), or reported by the individual on Form 4137, *Social Security and Medicare Tax on Unreported Tip Income* (or successor).

[1918] Notice 2025-69, §III.A.1.

[1919] Notice 2025-69, §III.A.2.

[1920] Notice 2025-69, §III.A.2.

[1921] Notice 2025-69, §III.A.3. *Ex.* 1.

[1922] Notice 2025-69, §III.A.3. *Ex.* 2.

[1923] Notice 2025-69, §III.A.3. *Ex.* 3.

[1924] §225(a)–§225(c), added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70202(a). Qualified overtime compensation is overtime pay required under the Fair Labor Standards Act (FLSA), §7, in excess of the regular pay rate.

[1925] §225(b)(2), added by the OBBBA, §70202(a). MAGI under §225 equals adjusted gross income plus certain exclusions for living abroad, in a U.S. territory, or Puerto Rico.

[1926] §63(b)(6), added by the OBBBA, §70202(b).

[1927] §225(d), added by the OBBBA, §70202(a). SSN is defined by reference to §24(h)(7), which requires the SSN to be issued to a citizen before the tax return's due date.

[1928] §225(e), added by the OBBBA, §70202.

[1929] OBBBA, §70202(h).

[1930] Notice 2025-62, §3.02, Notice 2025-69, §III.B.1.

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separate accounting must make a reasonable effort to determine whether they are considered FLSA-eligible employees.[1931]

An FLSA-eligible employee may treat the separate accounting requirement as satisfied if qualified overtime compensation is reported on Form W-2, Form 1099-NEC, or Form 1099-MISC, without regard to §6051(a)(19)'s qualified overtime compensation separate accounting requirement. Qualified overtime compensation can be calculated using information from documentation such as earnings or pay statements, invoices, or similar statements that support the amount. In the case of multiple employers, a different method may be used for each employer.[1932] Notice 2025-69 provides seven reasonable methods for calculating §225(c) qualified overtime compensation.[1933]

Example 1 — Tax Year 2025 Payroll System Captures FLSA Overtime Premium A's payroll system shows totals of amounts paid to A in 2025, including the FLSA overtime premium. In 2025, Individual A was last paid wages on December 22, for the payroll period beginning on November 30, 2025, and ending on December 13, 2025. The payroll system shows $5,000 in "overtime premium" paid to A. To calculate 2025 qualified overtime compensation received, A may treat $5,000 as the FLSA overtime premium.[1934]

Example 2 — Tax Year 2025: Pay Stub Presents FLSA Overtime Premium Assume the same facts as Example 1, except A's pay stub shows total overtime of $15,000, representing the FLSA overtime premium combined with the individual's regular wages for hours worked over 40 in a work week. To calculate 2025 qualified overtime compensation received, A may include $5,000 as the FLSA overtime premium (computed by dividing $15,000 by three, using the method described in Notice 2025-69, §III.B.2.(B)).[1935]

Example 3 — Tax Year 2025: Employer Pays Overtime at Two Times Regular Rate of Pay B's employer pays overtime at a rate of two times regular pay, even though FLSA §7 only requires one and one-half times an employee's regular rate. B was paid $20,000 in overtime in 2025. B's last pay stub for 2025 shows "overtime premium" of $10,000, representing B's overtime premium paid at two times the regular rate. To calculate 2025 qualified overtime compensation received, B may include $5,000 as FLSA overtime premium ($10,000 divided by two, using the method described in Notice 2025-69, §III.B.2.(C)).[1936]

Example 4 — Tax Year 2025: Employer Pays Overtime at Two Times Regular Rate of Pay Assume the same facts as Example 3, but B's pay stub shows total overtime of $20,000, representing (B's overtime premium paid at two times the regular rate combined with B's regular wages for hours worked over 40 in a work week). To calculate 2025 qualified overtime compensation received, B may include $5,000 as FLSA overtime premium ($20,000 divided by four, using the method described in Notice 2025-69, §III.B.2.(D)).[1937]

8. *Itemized Deductions*

a. *In General*

As discussed in V.C.1., above, an individual is given a choice between claiming the standard deduction or itemized deductions. Itemized deductions for taxpayers include medical and dental expenses, taxes, interest, charitable contributions, casualty and theft losses.[1938]

Under §67(b), miscellaneous itemized deductions are defined as all itemized deductions *other than* the following:

- the §163 interest deduction;[1939]
- the §164 taxes deduction;[1940]
- the §165 casualty and theft deduction, and the §165 wagering loss deduction;[1941]

[1931] Notice 2025-69, §III.B.1. (reasonable effort may include inquiries about FLSA status).

[1932] Notice 2025-69, §III.B.1.

[1933] Notice 2025-69, §III.B.2.

[1934] Notice 2025-69, §III.B.3. *Ex.* 1.

[1935] Notice 2025-69, §III.B.3. *Ex.* 2; *see also* Notice 2025-69, §III.B.2.(B) ("If the individual is paid overtime compensation at a rate of one and one-half times the individual's regular rate for hours worked in excess of 40 hours in a workweek, as generally required by 29 USC §207(a), and receives a statement covering the entire 2025 tax year that does not separately account for the FLSA Overtime Premium, but does include an entry showing the aggregate dollar amount of the FLSA Overtime Premium combined with the portion of the individual's regular wages for the hours worked over 40 in a workweek, the individual may use one-third of that aggregate dollar amount.").

[1936] Notice 2025-69, §III.B.3. *Ex.* 3; *see also* Notice 2025-69, §III.B.2.(C) ("If the individual is paid overtime compensation at a rate in excess of one and one-half times the individual's regular rate for hours worked in excess of 40 hours in a workweek, as generally required by 29 USC §207(a) (for example, two times the individual's regular rate), and receives a statement covering the entire 2025 tax year that separately accounts for the portion in excess of the employee's regular rate, the individual may multiply that separate amount by an appropriate fraction to approximate the FLSA Overtime Premium (for example, if overtime is paid at a rate of two times the regular rate, the appropriate fraction is one-half) and use the product.").

[1937] Notice 2025-69, §III.B.3. *Ex.* 4; *see also* Notice 2025-69, §III.B.2.(D) ("If the individual is paid overtime compensation at a rate in excess of one and one-half times the individual's regular rate for hours worked in excess of 40 hours in a workweek, as generally required by 29 USC §207(a) (for example, two times the individual's regular rate), and receives a statement that does not separately account for the FLSA Overtime Premium but does include an entry showing the aggregate dollar amount of overtime compensation at that higher rate for the hours worked over 40 hours combined with the portion of the individual's regular wages for the hours worked over 40 in a workweek covering the entire 2025 tax year, then the individual may multiply the aggregate dollar amount by an appropriately smaller fraction (for example, if overtime is paid at a rate of two times the regular rate, the appropriate fraction is one-fourth) and use the product.").

[1938] *But see* §165(h)(5)(A), amended by the OBBBA, §70109 (personal casualty and theft losses in excess of personal casualty gains are deductible if attributable to a federally declared disaster in tax years beginning after 2017 and before 2026, and if attributable to a federally or state declared disaster in tax years beginning after 2025). Personal casualty losses are deductible to the extent of personal casualty gains. §165(h)(5)(B), amended by the OBBBA, §70109. For further discussion of personal casualty and theft losses, see V.C.8.f., below.

[1939] §67(b)(1); Reg. §1.67-1T(b)(5).

[1940] §67(b)(2); Reg. §1.67-1T(b)(6).

[1941] §67(b)(3); Reg. §1.67-1T(b)(7).

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• the §170 charitable contribution deduction;[1942]

• the §642(c) deduction for amounts paid or permanently set aside for a charitable purpose;[1943]

• the §213 medical expense deduction;[1944]

• any impairment-related work expense deduction, as described in V.C.4.j.(1)(b)(ii), below;[1945]

• the §691(c) deduction for estate tax paid with respect to any items of IRD;[1946]

• any deduction allowable in connection with personal property used in a short sale;[1947]

• the §1341 deduction allowable in connection with the computation of tax applicable to taxpayers who restore substantial amounts held under claim of right;[1948]

• the §72(b)(3) deduction for the investment in an annuity not recovered when the annuity payments cease;[1949]

• the §171 amortizable bond premium deduction;[1950]

• the §216 cooperative housing corporation deductions;[1951]

• the deductions allowed by §162 for educator expenses;[1952] and

• the §63(c) standard deduction.[1953]

b. Medical and Dental Expenses

An individual is allowed a deduction under §213 for medical expenses paid during the tax year to the extent that those expenses exceed 7.5% of the taxpayer's adjusted gross income for that year.[1954] After 2025, §213 deductions are subject to the §68(a) overall limitation on itemized deductions.[1955] The medical expense deduction is discussed in detail in 513 T.M., *Family and Household Transactions.*

c. Taxes

A taxpayer is allowed to deduct qualified taxes, regardless of whether the tax is paid or incurred in carrying on a trade or business or for the production of income.[1956] This deduction is discussed in detail in 525 T.M., *State, Local, and Federal Taxes.* For individuals, if the taxes are not incurred as part of a trade or business, then the deduction for qualified taxes is an itemized deduction. For further discussion of taxes incurred in carrying on a trade or business, see 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.*

Deductible taxes include:

• state, local, and foreign real property taxes;[1957]

• state and local personal property taxes;[1958]

• state, local, and foreign income, war profits, and excess profits taxes;[1959] and

• state and local sales taxes;[1960]

Limitations apply to tax years beginning after 2017. Taxpayers can claim an itemized deduction for the aggregate of:

(1) state and local real and personal property taxes not paid or accrued in carrying on a trade or business or investment activity described in §212; and

(2) state and local income, war profits, and excess profits taxes (or state and local sales taxes in lieu of these taxes) paid or accrued in the tax year, up to the following limits:

• tax years 2018 through 2024, $10,000 ($5,000 married filing separate);

• tax year 2025, $40,000 ($20,000 married filing separate);

• tax year 2026, $40,400 ($20,200 married filing separate);

• tax years 2027 through 2029, 101% of the preceding calendar year limit (half for married filing separate);

• tax years after 2029, $10,000 ($5,000 married filing separate).[1961]

In response to the limitation imposed by §164(b)(6), certain state and local governments created workarounds intended to allow taxpayers greater state and local tax deductions.[1962] To prevent taxpayers from circumventing the limitation under §164(b)(6), the IRS issued regulations providing that if a taxpayer makes a payment to, or transfers property to, or for the use of, a charitable organization, and the taxpayer receives, or expects to receive, a state or local tax credit in return for such payment, the state or local tax credit will constitute a return benefit, or quid pro quo, and will reduce the taxpayer's charitable contribution deduction.[1963] In addition, the §164 regulations provide a safe harbor for individuals that itemize their deductions and make payments to §170(c) entities in consideration for state or local tax credits. Such individuals may treat a payment for which a charitable deduction under §170 is disallowed under Reg. §1.170A-1(h)(3) as a payment of state or local tax under §164(a) in the tax year in which the payment is made to

[1942] §67(b)(4); Reg. §1.67-1T(b)(8).
[1943] §67(b)(4).
[1944] §67(b)(5); Reg. §1.67-1T(b)(10).
[1945] §67(b)(6); Reg. §1.67-1T(b)(2).
[1946] §67(b)(7); Reg. §1.67-1T(b)(13).
[1947] §67(b)(8); Reg. §1.67-1T(b)(15).
[1948] §67(b)(9); Reg. §1.67-1T(b)(14).
[1949] §67(b)(10); Reg. §1.67-1T(b)(3).
[1950] §67(b)(11); Reg. §1.67-1T(b)(9).
[1951] §67(b)(12); Reg. §1.67-1T(b)(11).
[1952] §67(b)(13), added by the One Big Beautiful Bill Act (OBBBA), Pub. L. 119-21, §70110, effective for tax years beginning after Dec. 31, 2025.
[1953] Reg. §1.67-1T(b)(1).
[1954] §213(a).
[1955] §213(a). *Compare* §68, amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70111.
[1956] §164(a)(1)–§164(a)(4); Reg. §1.164-1(a)(1)–§1.164-1(a)(5).
[1957] §164(a)(1); Reg. §1.164-2(g), §1.164-3(b), §1.164-4.
[1958] §164(a)(2), §164(b)(1).
[1959] §164(a)(3). Reg. §1.901-2(a) and §1.901-2(b) define foreign income taxes. *E.g.*, *Trujillo v. Commissioner*, 68 T.C. 670, 673 (1977); *McGowan v. Commissioner*, 67 T.C. 599, 610 (1976); Rev. Rul. 89-16, Rev. Rul. 85-115, Rev. Rul. 81-194, Rev. Rul. 81-191, Rev. Rul. 81-193, Rev. Rul. 81-192, Rev. Rul. 54-598.
[1960] §164(b)(5)(A).
[1961] §164(b)(6), amended by the OBBBA, §70120, §164(b)(7), added by the OBBBA, §70120.
[1962] *See* Notice 2018-54.
[1963] Reg. §1.170A-1(h)(3), §1.642(c)-3(g).

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the extent that the resulting credit is applied to offset the individual's state or local tax liability for that tax year, or the preceding tax year.[1964]

The limitation does not apply to state or local real and personal property taxes and foreign real property taxes when paid or accrued in carrying on a trade or business or investment activity described in §212. Additionally, the limitation does not apply to foreign income, war profits, and excess profits taxes regardless of whether paid or accrued in carrying on a trade or business or investment activity described in §212.[1965] Accordingly, foreign real property taxes not paid or accrued in carrying on a trade or business or investment activity described in §212 may not be deducted.[1966] Qualified self-employment taxes[1967] and qualified generation-skipping tax can be deducted.[1968]

The deductibility of taxes is discussed in detail in 525 T.M., *State, Local, and Federal Taxes.*

d. Interest

Certain types of interest can be deducted regardless of whether the interest is paid or incurred in carrying on a trade or business or for the production of income,[1969] discussed in detail in 536 T.M., *Interest Expense Deductions.*

Some important examples include:

- qualified residence interest,[1970] discussed in 594 T.M., *Tax Implications of Home Ownership*;
- qualified education loan interest,[1971] discussed in 517 T.M., *Educational Expenses and Credits*;
- interest attributable to contracts under which personal property or educational services are purchased if the contract provides that payment of part or all of the purchase price is to be made in installments and in which carrying charges are separately stated, but the interest charge cannot be ascertained,[1972] discussed in detail in 565 T.M., *Installment Sales*;
- interest on timeshare and residential lot installment sales,[1973] discussed in detail in 565 T.M., *Installment Sales*;
- interest on nondealer installment sales,[1974] discussed in detail in 565 T.M., *Installment Sales*;
- original issue discount (OID),[1975] discussed in detail, in 181 T.M., *Time Value of Money — Holders of Debt Instruments*, and 182 T.M., *Time Value of Money — Issuers of Debt Instruments*;
- amortizable bond premium,[1976] discussed in detail in 181 T.M., *Time Value of Money — Holders of Debt Instruments*;
- net direct interest expense with respect to any market discount bond[1977] and net direct interest expense with respect to any short-term obligation,[1978] discussed in detail in 181 T.M., *Time Value of Money — Holders of Debt Instruments*;
- investment interest to the extent of the taxpayer's net investment income;[1979] and
- qualified passenger vehicle interest on indebtedness incurred for tax years beginning in 2025–2028 for the purchase of an "applicable passenger vehicle" for personal use.[1980]

For individuals, if the interest is not incurred as part of a trade or business, the deduction for qualified interest is an itemized deduction. For a brief discussion of interest incurred in carrying on a trade or business see V.B.1.c., above.

e. Charitable Contributions

A deduction is allowed for any charitable contribution payment made within the tax year, regardless of whether the contribution is paid or incurred in carrying on a trade or business or for the production of income.[1981] For tax years beginning after 2025, otherwise allowable charitable contribution deductions will be allowed only to the extent the aggregate of such contributions exceeds 0.5% of the taxpayer's "contribution base" (adjusted gross income computed without regard to any §172 net operating loss carryback to the tax year) for the tax year. §170(b)(1)(I), added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70425. The charitable contribution deduction is discussed in 521 T.M., *Charitable Contributions: Income Tax Aspects* and 794 T.M., *Charitable Contributions by Corporations and Other Business Entities.*

f. Personal Casualty and Theft Losses

Taxpayers are allowed to deduct personal casualty and theft losses, subject to limitations.[1982] For tax years beginning after 2017 and before 2026, the personal casualty and theft loss deduction is disallowed, except for losses attributable to a federally-declared disaster, and for tax years beginning after 2025, for losses attributable to a federally-declared disaster or a state declared disaster.[1983] Under an exception, however, a taxpayer

[1964] Reg. §1.164-3(j). For a detailed discussion of the §164 regulations, see 525 T.M., *State, Local, and Federal Taxes.*

[1965] §164(b)(6) (flush language).

[1966] §164(b)(6).

[1967] §164(f)(1). *Note:* The additional hospital insurance tax imposed by §1401(b)(2) on high income taxpayers is not included within the scope of the deduction for one-half of self-employment taxes. §164(f)(1).

[1968] §164(a)(4), §164(b)(4)(A).

[1969] *See* §163.

[1970] §163(h)(3)(A). *But see* §163(h)(3)(F).

[1971] §221.

[1972] §163(b)(1); Reg. §1.163-2(a), §1.163-2(b). *E.g., Gilmore v. Commissioner*, 33 T.C.M. 196, 200 (1974).

[1973] §453(l)(3).

[1974] §453A.

[1975] §163(e)(1). *See also* Reg. §1.163-7(a), §1.163-7(b)(2), §1.1275-4.

[1976] §171(a)(1), §171(c)(1), §171(e); Reg. §1.171-1(a)(1), §1.171-1(c)(2), §1.171-2(a)(1), §1.171-4.

[1977] *See* §1277(c).

[1978] §1282(a).

[1979] *See* §163(d). After 2025, deductions for investment interest are subject to the §68(a) overall limitation on itemized deductions. *Compare* §68, amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70111, *with* pre-2026 §68. For further discussion of the deduction for investment interest, see 536 T.M., *Interest Expense Deductions.*

[1980] §163(h)(4), added by the OBBBA, §70203. For further discussion of the qualified passenger vehicle interest deduction, see 536 T.M., *Interest Expense Deductions.*

[1981] §170(a)(1); Reg. §1.170A-1(a). *See also* §170(b)(1)(G).

[1982] §165(a), §165(c)(3); Reg. §1.165-7(a)(1).

[1983] §165(h)(5)(A), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70109, applicable to tax years beginning after Dec. 31, 2025.

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can still use a personal casualty loss to offset a personal casualty gain.[1984]

After 2025, the deductions for personal casualty losses under §165(c)(2) or §165(c)(3) and for wagering losses under §165(d) are subject to the §68(a) overall limitation on itemized deductions.[1985]

For further discussion of personal casualty and theft losses, see 527 T.M., *Loss Deductions.*

g. Repayments of Previously Taxed Social Security Benefits

A taxpayer is allowed to deduct repayments of social security benefits only if two conditions are met. First, the deduction must be allowable under §165. Second, the deduction is only allowable to the extent the repayments exceed the social security benefits received by the taxpayer during the tax year and not repaid during the tax year.[1986] The amount of social security benefits received during the tax year that is considered in determining any inclusion of social security benefits in gross income is reduced by the amount of any repayment during the tax year of social security benefits previously received by the taxpayer, whether received in the same tax year.[1987] Thus, the deduction for any repayment is necessarily limited to situations in which the repayment exceeds the benefits received.

> *Example (1):* R receives $6,500 of social security benefits during the tax year. The $6,500 represents the $9,500 that R would ordinarily have received, reduced by $3,000 of repayments withheld from R's benefit checks, because of amounts received by R in an earlier tax year that were mistakenly paid by the agency. R is not allowed to deduct the $3,000, regardless of whether R included any social security benefits in gross income for that earlier tax year.

> *Example (2):* Assume the same facts as in Example (1) except that the amounts mistakenly paid in previous tax years aggregated $20,000. As a result, R received no checks for the year and was required to repay $10,500. Assume that had R not received the $10,500 in the earlier tax years, R would have included $10,500 less in gross income than R was required to include. R is allowed to deduct the $10,500. R is not allowed to deduct $20,000.

> *Example (3):* Assume the same facts as in Example (2), except that if R had not received the $10,500 in the earlier tax years, R would have included $4,200 less in gross income than R was required to include. R is allowed to deduct $4,200. R is not allowed to deduct $20,000, nor is R allowed to deduct $10,500.

If the amount of the allowed deduction is $3,000 or less, the deduction is an itemized deduction, subject to the 2% floor discussed in V.C.4.j.(1), below. If the amount of the allowed deduction is more than $3,000, then the taxpayer may be allowed a credit instead of an itemized deduction under the §1341 claim of right doctrine.[1988] The §1341 claim of right doctrine is discussed in detail in 502 T.M., *Gross Income: Tax Benefit, Claim of Right and Assignment of Income.*

The inclusion of social security benefits in gross income is discussed in detail in 501 T.M., *Gross Income: Overview and Conceptual Aspects.*

h. Estate Taxes Paid on Items of Income in Respect of Decedent

Under §691(c), a taxpayer who includes an item of income in respect of a decedent (IRD) in gross income is allowed to deduct an amount based on the estate tax paid with respect to the item of IRD.[1989] Examples of IRD include, but are not limited to, IRA distributions, retirement plan assets, salary, wages, unpaid interest and dividends, and sales commissions. The §691(c) deduction is discussed in detail, together with items of IRD, in 862 T.M., *Income in Respect of a Decedent* (*Section 691)* (Estates, Gifts, and Trusts Series).

i. Unrecovered Investment in Annuities

Unrecovered investment in an annuity contract is deductible under certain circumstances.[1990] Generally, if a taxpayer dies before the entire investment is recovered tax free, any unrecovered investment can be deducted on the taxpayer's final income tax return.[1991] The deductibility of unrecovered investment in annuities is discussed in detail in 821 T.M., *Tax Issues of Employee Plan and Commercial Annuities* (Estates, Gifts and Trusts Series).

j Educator Expenses

Section 67(b)(13) provides that a taxpayer is allowed to deduct certain educator expenses under §162. Section 67(g) defines educator expenses.[1992] The deduction for such educator expenses is discussed in 517 T.M., *Educational Expenses and Credits.*

k. Impairment-Related Work Expenses

Under §67(b)(6), a deduction allowable for impairment-related work expenses is not a miscellaneous itemized deduction. Impairment-related work expenses are expenses that satisfy two conditions.[1993] First, the expense must be incurred by a handicapped individual[1994] for attendant care services at the individual's place of employment or for other expenses in connection with that place of employment necessary for the indi-

[1984] §165(h)(5)(B), amended by the OBBBA, §70109.

[1985] *Compare* §68, amended by the OBBBA, §70111, *with* pre-2026 §68.

[1986] §86(d)(2)(B).

[1987] §86(d)(2)(A).

[1988] IRS Publication 915, Social Security and Equivalent Railroad Retirement Benefits.

[1989] §691(c)(1)(A); Reg. §1.691(c)-1(a).

[1990] §72(b)(3).

[1991] §72(b)(3). *See also* IRS Publication 17, Your Federal Income Tax (For Individuals).

[1992] *See* §67(g), redesignated and amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. 119-21, §70110, effective for tax years beginning after Dec. 31, 2025.

[1993] §67(d).

[1994] *See* §190(b)(3) (defining a "handicapped individual" as "any individual who has a physical or mental disability (including, but not limited to, blindness and deafness) which for such individual constitutes or results in a functional limitation to employment, or who has any physical or mental impairment (including, but not limited to, a sight or hearing impairment) which substantially limits one or more major activities of such individual).

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vidual to be able to work.[1995] Second, a §162 trade or business deduction must be allowable with respect to the expense.[1996]

l. Limitations

(1) Overall Limitation on Itemized Deductions

(a) Computation of Limitation

Under §68, individual taxpayers must reduce the amount of otherwise allowable itemized deductions by 2/37 of the lesser of two amounts: 1) such amount of itemized deductions; or 2) the taxable income of the taxpayer for the tax year (determined without regard to §68 and increased by such amount of itemized deductions) that exceeds the dollar amount under §1 at which the 37% rate bracket begins for the taxpayer.[1997]

> *Example:* A is a single taxpayer with taxable income in Year 6 of $500,000 and itemized deductions of $20,000. For Year 6 the 37% bracket threshold is $640,600. A's taxable income in Year 6 does not reach the 37% bracket threshold, so A's itemized deductions for Year 6 will be reduced by 2/37 of $20,000, or $1,081.

Note: For tax years 2018–2025, the §68 limitation on itemized deductions does not apply.[1998]

(b) Coordination with Other Limitations

All other statutory limitations on itemized deductions are applied before application of the overall limitation.[1999]

(c) Pease Limitation for Tax Years Before 2018

For tax years before 2018, the overall limitation on itemized deductions (Pease limitation) applied to certain individual taxpayers.[2000] The §68 limitation applied only to individual taxpayers whose adjusted gross incomes exceeded the applicable amount. Generally, taxpayers whose adjusted gross incomes exceeded the applicable amount had to reduce the amount of otherwise allowable itemized deductions by the lesser of 3% of the excess of adjusted gross income over the applicable amount, or 80% of the amount of otherwise allowable itemized deductions. Thus, because the phase-out of the value of itemized deductions was capped at 80%, a taxpayer was at least allowed to deduct 20% of the value of the taxpayer's itemized deductions.

> *Example:* B and C are married taxpayers who file a joint return for 2017. Their adjusted gross income for 2017 is $320,000. Their otherwise allowable itemized deductions for 2017 are $25,000. The excess of adjusted gross income over the applicable amount is $6,200 ($320,000 – $313,800). Three percent of that $6,200 excess is $186 ($6,200 × 3%). Eighty percent of the amount of otherwise allowable itemized deductions is $20,000 ($25,000 × 80%). The lesser of $186 and $20,000 is $186. B and C must reduce the amount of their otherwise allowable itemized deductions by $186. Assuming no other limitations apply, B and C may deduct $24,814 of itemized deductions in 2017 ($25,000 – $186).

(2) Miscellaneous Itemized Deductions for Tax Years Before 2018

Miscellaneous itemized deductions are not allowed for tax years beginning after 2017.[2001] When miscellaneous itemized deductions were available under §67, an individual could deduct miscellaneous itemized deductions only to the extent that the total of these deductions exceeded 2% of the individual's adjusted gross income.[2002] Generally, miscellaneous itemized deductions referred to most itemized deductions allowed in computing taxable income in contrast to above-the-line deductions, discussed in V.B., above.[2003]

[1995] §67(d)(1).

[1996] §67(d)(2).

[1997] §68(a), amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70111, effective for tax years beginning after Dec. 31, 2025.

[1998] *See* Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97, §11045(a).

[1999] §68(b), amended by the OBBBA, §70111, effective for tax years beginning after Dec. 31, 2025.

[2000] *See* Pub. L. No. 115-97, §11045(a). Applicable amounts are listed in Tables, Charts & Lists, *Inflation Adjusted Applicable Amounts for the Limitation on Miscellaneous Itemized Deductions (Pease Limitation).*

[2001] §67(h), added by the One Big Beautiful Bill Act (OBBBA), Pub. L. 119-21, §70110(b).

[2002] §67(a); Reg. §1.67-1T(a)(1).

[2003] Reg. §1.67-1T(a).

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VI. Deductions Allowable to Corporations

A. Introduction

Generally, a corporation is treated as a separate tax-paying entity from its shareholders.[2004] Thus, unlike other business entities, such as partnerships or single-member limited liability companies, corporations are generally taxed on their net income, for tax years beginning after December 31, 2017, at a flat rate of 21%[2005] and, for tax years beginning before January 1, 2018 at graduated rates up to 35%.[2006] Apart from certain special classes of corporations,[2007] the taxation of corporate income is generally based on taxable income. Taxable income begins with gross income, increased and decreased by various items. Generally, a corporation can deduct all ordinary and necessary expenses that are paid or incurred during the taxable year in carrying on a trade or business.[2008] These include reasonable compensation, repairs and maintenance, bad debts, rents, taxes and licenses, interest, charitable contributions, depreciation, depletion, advertising, contributions to pension and profit-sharing plans, contributions to employee benefit programs, and other specifically allowed deductions. To determine taxable income, corporations are subject to special rules regarding the timing and deductibility of certain types of expenses, and available accounting methods. For an overview of the taxation of corporations, see 750 T.M., *Corporate Overview*.

B. Specific Deductions Allowed to Corporations

1. Dividends Received Deductions

Under §243[2009] and §245,[2010] corporations are allowed a deduction for qualifying dividends received. The §243 and §245 dividends received deductions are discussed in detail in 764 T.M., *Current Distributions — Cash and Property*.

2. Dividends Paid Deductions

Several different code provisions allow corporations a deduction for qualifying dividends paid, such as:

- The §561 dividends paid deduction, discussed in detail in 797 T.M., *Personal Holding Companies*;
- The §547 personal holding company deficiency dividends deduction, discussed in detail in 797 T.M., *Personal Holding Companies*; and
- The §860 regulated investment company and real estate investment trust deficiency dividend deduction, discussed in detail in 740 T.M., *Taxation of Regulated Investment Companies and Their Shareholders*, and 742 T.M., *Real Estate Investment Trusts*.

3. Amortization of Disallowed Mineral Deductions

Under §291(b)(2), a corporation is allowed to deduct amortization with respect to the amount of mineral deductions disallowed under §291(b)(1).[2011] The §291(b)(1) disallowance is discussed in detail in 603 T.M., *Mineral Properties Other Than Gas and Oil — Operation*.

4. Transfer of a Residual Interest in a REMIC

Any tax imposed under §860E(e)(6)(A) on any excess inclusion with respect to a residual interest in a real estate mortgage investment conduit (REMIC) held by a pass-through entity of which a disqualified organization is a member is deductible in determining the gross income with respect to the residual interest.[2012] The §860E(e)(6)(A) tax is discussed in detail in 741 T.M., *REMICs, Mortgage REITs, Mortgage Trusts and Other Real Estate Mortgage Securitization Vehicles*.

C. Deductions Allowable to Specific Entities

1. Deductions Allowable to Terminal Railroad Corporations

a. In General

Under §281(a)(1)(B), no deduction otherwise allowable to a terminal railroad corporation is disallowed because of the discharge of liability exclusion of §281(a)(1)(A).[2013] Section 281 is to be construed and administered to accomplish relief to terminal railroads.[2014] Shareholders of terminal railroad corporations are treated consistent with this deduction preservation provision.[2015]

However, the §281(a)(1)(B) deduction preservation provision does not apply for a taxable year unless all the shareholders of the terminal railroad corporation agreed in writing before the beginning of that taxable year that the provision would apply.[2016] Additionally, this provision does not apply to the extent that it would otherwise create or increase a net operating loss for the terminal railroad corporation.[2017]

[2004] There are several statutory and judicial limitations to the general principle of treating a corporation as a separate taxable entity, such as §267, §269, §318, and §482; and the business purpose, substance over form, and step transaction doctrines. These limitations are typically designed to prevent the use of the corporate form for tax avoidance purposes and can result in the denial of corporate deductions or an allocation of additional income to a corporation.

[2005] §11(b), as amended by the TCJA, Pub. L. No. 115-97, §13001(a).

[2006] *See* §11. A 3% surcharge tax applies to corporations with taxable incomes greater than $15 million.

[2007] Such as, for example, regulated investment companies, real estate investment trusts, small business investment companies, cooperatives, and tax-exempt corporations.

[2008] §162.

[2009] §243(a). The TCJA reduced the 80% dividends received deduction to 65% and the 70% dividends received deduction to 50%. §243(c), as amended by the TCJA, Pub. L. No. 115-97, §13002(a). Reg. §1.243-1(a)(1).

[2010] The TCJA reduced the 80% dividends received deduction to 65% and the 70% dividends received deduction to 50%. §245, as amended by the TCJA, Pub. L. No. 115-97, §13002(b). *See* Reg. §1.245-1(a)(1).

[2011] §291(b)(2).

[2012] §860E(e)(6)(C).

[2013] §281(a)(1)(B); Reg. §1.281-1, §1.281-2(a)(2).

[2014] *United States v. Chicago & E. Ill. R.R. Co.*, 349 F. Supp. 1157, 1161 (N.D. Ill. 1972), *aff'd without op.*, 486 F.2d 1406 (7th Cir. 1973) (relying on legislative history, stating that §281 was promulgated "with an eye to the 'financial problems faced by the railroads.' The Committee felt it was 'undesirable to increase their overall tax burdens.'").

[2015] §281(b); Reg. §1.281-2(b).

[2016] §281(c); Reg. §1.281-3(d).

[2017] §281(a)(2); Reg. §1.281-2(c)(4).

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b. Discharge of Liability Exclusion

The discharge of liability exclusion provides that the terminal railroad corporation is not considered to have received or accrued as income the portion of any liability of a railroad corporation, with respect to related terminal services provided by the corporation, which is discharged by crediting the liability with an amount of related terminal income.[2018] The exclusion also provides that the corporation is not considered to have received or accrued as income the portion of any charge which would be made by the corporation for related terminal services provided by it, but which is not made as a result of taking related terminal income into account in computing the charge.[2019]

c. Terminal Railroad Corporation

A terminal railroad corporation is a corporation that satisfies six conditions.[2020] First, it must be a domestic[2021] railroad corporation. Second, it must not be a member, other than as a common parent corporation, of an affiliated group.[2022] Third, all of its shareholders must be rail carriers subject to part A of subtitle IV of title 49.[2023] Fourth, its primary business must be the providing of railroad terminal and switching facilities and services to rail carriers subject to part A of subtitle IV of title 49 and to the shippers and passengers of those railroad corporations.[2024] Fifth, a substantial part of its services for the taxable year must be rendered to one or more of its shareholders.[2025] Sixth, each shareholder must compute its taxable income on the basis of a taxable year beginning or ending on the same day that the corporation's taxable year begins or ends.[2026]

d. Related Terminal Income

Related terminal income is any of four types of income of a terminal railroad corporation derived directly by the corporation.[2027] The first type is income from services or facilities of a character ordinarily and regularly provided by terminal railroad corporations for railroad corporations or for the employees, passengers, or shippers of railroad corporations.[2028] The second type is income from the use by persons other than railroad corporations of portions of a facility, or a service, which is used primarily for railroad purposes.[2029] For these purposes, a substantial addition to a facility constructed after October 23, 1962, is treated as a separate facility.[2030] The third type is income from any railroad corporation for services or facilities provided by the terminal railroad corporation in connection with railroad operations.[2031] The fourth type is income from the United States in payment for facilities or services in connection with mail handling.[2032]

e. Related Terminal Services

Related terminal services include only services and the use of facilities taken into account in computing related terminal income.[2033]

2. Deductions Allowable to Financial Institutions

a. Reserves for Losses on Bank Loans

(1) In General

Under §585(a), banks, other than large banks, are allowed to deduct a reasonable addition to a reserve for bad debts.[2034] The deduction is in lieu of any §166 bad debt deduction.[2035] Essentially, an eligible bank is allowed to estimate its expected write-offs based on historical experience. In determining whether a debt is worthless for this purpose, and in computing the addition to a bad debt reserve with respect to the debt, Federal Savings and Loan Insurance Corporation (FSLIC) assistance with respect to the debt must be taken into account.[2036]

Note: the FSLIC was abolished by the Financial Institutions Reform, recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73. FIRREA created the FSLIC Resolution Fund (FRF), the Resolution Trust Corporation (RTC), and the Office of Thrift Supervision (OTS), and transferred the assets and liabilities and regulatory activities of the FSLIC to other agencies and funds, including the FRF and the RTC. FIRREA also designated the Federal Deposit Insurance Corporation (FDIC) as the administrator of funds formerly supervised by the FSLIC. The IRS has advised that in determining the §585 bad debt deduction, a bank that holds servicing rights to mortgages owned by others is not permitted to include those mortgages in its total loans outstanding.[2037]

(2) Bank

For purposes of the §585 deduction,[2038] a bank is a bank or trust company that satisfies three conditions.[2039] First, the bank or trust company must be incorporated and doing business under the laws of the United States, including laws relating to the District of Columbia, or of any state.[2040] Second, a substantial part of the bank's or trust company's business must consist of receiving deposits and making loans or discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency.[2041]

[2018] §281(a)(1)(A); Reg. §1.281-2(a)(1), §1.281-2(c). *See Chicago & W. Ind. R.R. Co. v. Commissioner*, 310 F.2d 380 (7th Cir. 1962), *rev'g* T.C. Memo 1961-103, *vac'g* 303 F.2d 796 (7th Cir. 1962).
[2019] *Chicago & W. Ind. R.R. Co.*, 310 F.2d 380.
[2020] §281(d)(1).
[2021] *See* Reg. §1.281-3(a)(1).
[2022] §281(d)(1) (reference to §1504); Reg. §1.281-3(a)(3).
[2023] §281(d)(1)(A).
[2024] §281(d)(1)(B).
[2025] §281(d)(1)(C) Reg. §1.281-3(a)(5).
[2026] §281(d)(1)(D); Reg. §1.281-3(a)(6).
[2027] §281(d)(2); Reg. §1.281-3(b)(1).
[2028] §281(d)(2)(A); Reg. §1.281-3(b)(2)(i).
[2029] §281(d)(2)(B); Reg. §1.281-3(b)(2)(iii).
[2030] §281(d)(2) (flush language); Reg. §1.281-3(b)(2)(iii).
[2031] §281(d)(2)(C); Reg. §1.281-3(b)(2)(ii).
[2032] §281(d)(2)(D); Reg. §1.281-3(b)(2)(iv).
[2033] §281(d)(3); Reg. §1.281-3(c).
[2034] §585(a)(1), §585(c); Reg. §1.585-1(a).
[2035] §585(a)(1), §585(c); Reg. §1.585-1(a).
[2036] Pub. L. No. 103-66, §13224(a)(2), 107 Stat. 312, 485 (1993). *See Bank of Kirksville v. United States*, 943 F. Supp. 1191 (W.D. Mo. 1996) (bank in rural community may deduct under §585 its additions to bad debt reserves for loans made mostly to farmers or farm suppliers during a period when the farm economy fell dramatically).
[2037] TAM 200439041.
[2038] §585(a)(2)(A) (reference to §581); Reg. §1.585-1(b)(1).
[2039] §581.
[2040] §581.
[2041] §581. *See MoneyGram Int'l, Inc. v. Commissioner*, 144 T.C. 1 (2015), *vacated and remanded by* 664 Fed. App'x 386 (5th Cir. 2016) (Tax Court re-

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Third, the bank or trust company must be subject by law to supervision and examination by state or federal authority having supervision over banking institutions.[2042] A bank includes a domestic building and loan association.[2043]

For purposes of the §585 deduction, a bank also includes any corporation that would otherwise be a bank but for the fact that it is a foreign corporation.[2044] However, the §585 deduction applies to such foreign banks only with respect to outstanding loans on which the interest is effectively connected with the conduct of a banking business within the United States.[2045]

(3) Addition to Reserve for Bad Debts

The reasonable addition to the reserve for bad debt allowed as a deduction under §585 is an amount determined by the taxpayer that does not exceed the amount computed under the experience method.[2046] The experience method involves the determination of the six-year moving average amount and the base year amount,[2047] with special rules for new financial institutions.[2048]

(4) Restrictions on Large Banks

The §585 deduction does not apply to large banks.[2049] No deduction for an addition to reserves for bad debts is allowed to a large bank under any other deduction provision.[2050] A large bank is a bank that for any taxable year beginning after 1986, satisfies either of two conditions.[2051] First, the average adjusted bases of all assets of the bank must exceed $500,000,000.[2052] Second, the bank must be a member of a parent-subsidiary controlled group[2053] and the average adjusted bases of all assets of the group exceed $500,000,000.[2054] Special rules apply to any bank that becomes a large bank in a taxable year following a taxable year in which it maintained a reserve for bad debts.[2055]

quirement that deposits be held for extended time period and interest be paid on loans too restrictive in its definition of bank; remand for reconsideration based on proper definition), *on remand*, 153 T.C. 185 (2019) (taxpayer was not bank for purposes of §581 and was not entitled to §582 ordinary loss deductions), *aff'd*, No. 20-60146, 2021 BL 203171 (5th Cir. June 1, 2021) (because money services business did not hold customers' funds for safekeeping and return it to them upon demand, it did not meet the "deposit" requirement and therefore that business was not bank).

[2042] *MoneyGram Int'l, Inc.*, 144 T.C. 1 (2015), *vacated and remanded by* 664 Fed. App'x 386 (5th Cir. 2016), *on remand*, 153 T.C. 185 (2019), *aff'd*, No. 20-60146, 2021 BL 203171 (5th Cir. June 1, 2021).

[2043] *MoneyGram Int'l, Inc.*, 144 T.C. 1 (2015), *vacated and remanded by* 664 Fed. App'x 386 (5th Cir. 2016), *on remand*, 153 T.C. 185 (2019), *aff'd*, No. 20-60146, 2021 BL 203171 (5th Cir. June 1, 2021).

[2044] §585(a)(2)(B); Reg. §1.585-1(b)(1)(ii).

[2045] §585(a)(2)(B); Reg. §1.585-1(b)(1)(ii).

[2046] §585(b)(1); Reg. §1.585-2(a)(1).

[2047] §585(b)(2); Reg. §1.585-2(c)(1).

[2048] *See* Reg. §1.585-2(c)(2).

[2049] §585(c)(1).

[2050] §585(c)(1).

[2051] §585(c)(2).

[2052] §585(c)(2)(A).

[2053] *See* §585(c)(5)(A).

[2054] §585(c)(2)(B).

[2055] §585(c)(3), §585(c)(4).

b. Interest and Dividends Paid on Deposits by Membership Banks

(1) In General

Under §591, membership banks are allowed to deduct depositor interest and dividends.[2056] The deduction is not disallowed merely because the depositor interest and dividends are subject to the terms of a pledge agreement between the bank and the depositor or holder of an account.[2057] Amounts deductible under §591 are not deductible under §163 even if a deduction under §163 would be more advantageous.[2058]

(2) Depositor Interest and Dividends

(a) In General

Depositor interest and dividends are amounts that satisfy two conditions.[2059] First, the amounts must be paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts.[2060] Second, the amounts paid or credited must be withdrawable on demand subject only to customary notice of intention to withdraw.[2061] Liquidating dividends are not deductible.[2062]

(b) Serial Association and Bonus Plan Amounts

The §591 deduction is not precluded merely because the bank operates in whole or in part as a serial association, maintains a bonus plan, or issues shares, or accepts deposits, subject to fines, penalties, forfeitures, or other withdrawal fees, and requires that amounts invested and credited to series shares must be withdrawn in multiples of even shares or has the right, pursuant to by-law, contract, or otherwise, to retain or recover a portion of the total amount invested in or credited to the shares or deposits, bonus account, or series of shares, as a fine, penalty, forfeiture, or other withdrawal fee.[2063] This provision does not apply if the original issue discount rules,[2064] discussed, in detail, in 181 T.M., *Time Value of Money — Holders of Debt Instruments*, and 182 T.M., *Time Value of Money — Issuers of Debt Instruments*; apply to deposits made with respect to a certificate of deposit, time deposit, bonus plan, or other deposit arrangement.[2065]

(3) Membership Banks

For purposes of the §591 deduction, a membership bank is any mutual savings bank, cooperative bank, domestic building and loan association, and any other savings institution chartered and supervised as a savings and loan or similar association under federal or state law.[2066] It also includes any bank that has capital stock represented by shares, and which is subject to,

[2056] §591(a); Reg. §1.591-1(a)(1).

[2057] Reg. §1.591-1(a)(2).

[2058] *Hudson City Sav. Bank v. Commissioner*, 53 T.C. 70, 75 (1969).

[2059] §591(a); Reg. §1.591-1(a)(1).

[2060] §591(a); Reg. §1.591-1(a)(1). *See* Rev. Rul. 55-391.

[2061] §591(a); Reg. §1.591-1(a)(1).

[2062] *See* Rev. Rul. 57-39.

[2063] Reg. §1.591-1(b).

[2064] *See* Reg. §1.163-4(a).

[2065] Reg. §1.591-1(b).

[2066] §591(a); Reg. §1.591-1(c)(1).

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and operates under, federal or state laws relating to mutual savings banks.[2067]

c. Other Deductions

Other deductions specific to financial institutions include:

• The §166 bad debt deduction is allowed to banks with respect to debts that are evidenced by a security.[2068] This deduction is allowed notwithstanding the limitations of §165(g)(1) and §166(e).[2069] For a detailed discussion of the §166 bad debt discussion, see 538 T.M., *Bad Debts.*

• Special assessments on insured depository institutions imposed by the Federal Deposit Insurance Corporation (FDIC) and designed to capitalize the Savings Association Insurance Fund[2070] are deductible under §162.[2071]

• Special assessments on insured depository institutions imposed by the FDIC and designed to capitalize the Deposit Insurance Fund are deductible in the taxable years in which the §461 all events test is met. In this context, the all events test is not treated as met any earlier than when the liability for the special assessments was established (i.e., November 29, 2023, when the FDIC adopted a final rule implementing the special assessments) and when economic performance occurs. The special assessments are not subject either to the §162(r) deduction limitations for FDIC premiums or to capitalization under §263(a).[2072]

3. Deductions Allowable to Health Insurance Organizations

a. In General

Health insurance organizations are allowed a health insurance deduction.[2073] In AM 2014-007, to determine if the eligible health organization could claim the deduction, the IRS decided the two main issues to resolve were whether the Blue Cross and Blue Shield (BCBS) organization had (1) a qualifying liability or expense in connection with a cost-plus contract under §833(b)(1)(A)(i) and (2) incurred expenses in connection with the administration of a claim under §833(b)(1)(A)(ii).[2074] The IRS described a cost-plus contract under §833(b)(1)(A)(i), as a self-insurance arrangement offered by BCBS organizations under which a BCBS organization will pay all of a self-insured plan's covered claims from its own bank account and the self-insured plan will, in turn, pay the BCBS organization for the claims plus a negotiated amount to cover the BCBS organization's administrative expenses and profit.[2075] The IRS also noted that a BCBS organization could not meet the second requirement under §833(b)(1)(A)(ii) if it was reimbursed for the expenses incurred in connection with the administration of a claim.[2076]

b. Health Insurance Organizations

(1) In General

Health insurance organizations are any existing Blue Cross/Blue Shield organization,[2077] any deemed Blue Cross/Blue Shield organization,[2078] and any other health insurance organization meeting certain requirements.[2079] However, a "health insurance organization" does not include any organization with a medical loss ratio less than 85%.[2080] An organization's medical loss ratio is calculated by dividing the total premium revenue expended on reimbursement for clinical services and activities that improve health care quality[2081] provided to enrollees under its policies during a tax year divided by the organization's total premium revenue for the taxable year. For taxable years beginning after December 31, 2015, the numerator and denominator compute the expenses using a 3-year period corresponding to the way those expenses are computed under §2718 of the Public Health Service Act (42 U.S.C. §201, *et. seq.*) and the regulations thereunder.[2082]

(2) Existing Blue Cross or Blue Shield Organization

An existing Blue Cross or Blue Shield organization is any Blue Cross or Blue Shield organization that satisfies three conditions:[2083]

• The organization must have been in existence on August 16, 1986;[2084]

• The organization must be exempt from tax for its last taxable year beginning before January 1, 1987;[2085] and

[2067] §591(b).
[2068] §582(a); Reg. §1.582-1(a).
[2069] §582(a); Reg. §1.582-1(a). *See, e.g.*, TAM 9522003 (parent corporation could take a §166 ordinary loss deduction on worthless subordinated debentures of its foreign banking subsidiary).
[2070] Pub. L. No. 104-208, §2702, 110 Stat. 3009, 3009-479 (1996).
[2071] Pub. L. No. 104-208, §2711, 110 Stat. 3009, 3009-397 (1996). *See* H.R. Rep. No. 863, 104th Cong., 2d Sess. 492 (1996).
[2072] AM 2024-003 (referencing 88 Fed. Reg. 83,329 (Nov. 29, 2023); §13(c)(4)(G) of the FDI Act (12 U.S.C. §1823(c))).
[2073] §833(a)(2), §833(b).
[2074] AM 2014-007. *See* §833(b)(1)(A)(i), §833(b)(1)(A)(ii); TAM 9803003.
[2075] AM 2014-007. *See* §833(b)(1)(A)(i); FAA 20101502F.
[2076] AM 2014-007. *See* §833(b)(1)(A)(ii). *See also Burnett v. Commissioner*, 356 F.2d 755 (5th Cir. 1966) (a deduction is not allowed for an amount that is reimbursed); FAA 20101502F.
[2077] §833(c)(1)(A).
[2078] §833(c)(4)(A).
[2079] §833(c)(1)(B), §833(c)(3).
[2080] §833(c)(5). *See* CCA 201519030, Q&A-1 (providing that satisfaction of the 85% requirement is computed on an aggregate basis for purposes of §833(c)(5)).
[2081] Reg. §1.833-1(c)(1), *added by* T.D. 9651 and *amended by* T.D. 9772 (providing for the retroactive inclusion of "activities that improve health care quality" in §833(c)(5)). *See* Reg. §1.833-1(b)(3), as *redesignated by* T.D. 9772 (defining "total premium revenue"). *See also* CCA 201519030 (questions and answers on permissible adjustments).
[2082] §833(c)(5). Use of the three-year period is phased in for the §833 computation so that medical loss ratio is computed on a one-year basis for the first tax year beginning after December 31, 2013, and on a two-year basis for the first tax year beginning after December 31, 2014. Reg. §1.833-1(c)(2). The medical loss ratio is calculated according to the rules in Reg. §1.833-1, discussed further in 201 T.M., *Taxation of Domestic Insurance Companies. See* AM 2016-002 for guidance on applying the §481(a) rules to changes in accounting methods for unearned premiums by Blue Cross/Blue Shield organizations by reason of failing, or subsequently meeting, the medical loss ratio requirement.
[2083] §833(c)(2).
[2084] §833(c)(2)(A).
[2085] §833(c)(2)(B).

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• No material change must have occurred in the operations of the organization or in its structure after August 16, 1986, and before the close of its taxable year.[2086]

To the extent permitted by the IRS, any successor to an existing Blue Cross or Blue Shield organization and any organization resulting from the merger or consolidation of existing Blue Cross or Blue Shield organizations is treated as an existing Blue Cross or Blue Shield organization.[2087]

(3) Deemed Blue Cross or Blue Shield Organization

A deemed Blue Cross or Blue Shield organization is an organization that satisfies five conditions:[2088]

• It is organized under and governed by state laws which are specifically and exclusively applicable to not-for-profit health insurance or health service type organizations;[2089]

• It is not a Blue Cross or Blue Shield organization or health maintenance organization;[2090]

• The organization must have been in existence on August 16, 1986;[2091]

• The organization must be exempt from tax for its last taxable year beginning before January 1, 1987;[2092] and

• No material change must have occurred in the operations of the organization or in its structure after August 16, 1986, and before the close of its taxable year.[2093]

(4) Other Health Insurance Organization

Any other organization is a health insurance organization for the taxable year if it satisfies six conditions:[2094]

• Substantially all of its activities must involve the providing of health insurance;[2095]

• At least 10% of the health insurance, other than Medicare supplemental coverage, provided by the organization must be provided to individuals and small groups.[2096] A small group is the lesser of 15 individuals[2097] or the number of individuals required for a small group under state law;[2098]

• The organization must provide continuous full-year open enrollment, including conversions, for individuals and small groups;[2099]

• The organization's policies covering individuals must provide full coverage of preexisting conditions of high-risk individuals without a price differential and with a reasonable waiting period, and coverage is provided without regard to age, income, or employment status of individuals under age 65;[2100]

• At least 35% of the organization's premiums must be determined on a community rated basis;[2101] and

• No part of the organization's earnings may inure to the benefit of any private shareholder or individual.[2102]

c. Computation of Deduction

(1) In General

The health insurance deduction equals the excess, if any, of 25% of the claims cost minus the adjusted surplus as of the beginning of the taxable year.[2103] The claims cost is the sum of the claims incurred during the taxable year,[2104] plus the liabilities incurred during the taxable year under cost-plus contracts,[2105] plus the expenses incurred during the taxable year in connection with the administration, adjustment, or settlement of claims.[2106]

(2) Adjusted Surplus

(a) In General

The adjusted surplus as of the beginning of the taxable year is the adjusted surplus as of the beginning of the preceding taxable year increased by the amount of any adjusted taxable income for that preceding taxable year or decreased by the amount of any adjusted net operating loss for that preceding taxable year.[2107] In computing adjusted surplus, only items attributable to the health-related business of the health insurance organization are taken into account.[2108]

(b) First Taxable Year

For existing Blue Cross and Blue Shield organizations and deemed Blue Cross or Blue Shield organizations, adjusted sur-

[2086] §833(c)(2)(C). Loss of eligibility for the deduction solely by reason of failing the §833(c)(5) 85% medical loss ratio requirement does not constitute a material change. Reg. §1.833-1(d)(2). Reg. §1.833-1(d)(2), added by T.D. 9651, 79 Fed. Reg. 755 (Jan. 7, 2014), applicable to taxable years beginning after December 31, 2013, and amended by T.D. 9772, 81 Fed. Reg. 40,518 (June 22, 2016) (incorporating retroactive legislative change reflecting that complete loss of BC/BS treatment does not result from failure to satisfy MLR ratio), applicable to taxable years beginning after December 31, 2016, but may be relied on for taxable years beginning after December 31, 2009.

[2087] §833(c)(2) (flush language). *See, e.g.*, PLR 201642026, PLR 201432013.

[2088] §833(c)(4)(B).

[2089] §833(c)(4)(B)(i).

[2090] §833(c)(4)(B)(ii).

[2091] §833(c)(4)(A) (implicit reference to §833(c)(2)(A)).

[2092] §833(c)(4)(A) (implicit reference to §833(c)(2)(B)).

[2093] §833(c)(4)(A) (implicit reference to §833(c)(2)(C)).

[2094] §833(c)(3)(A). *See also* FAA 20165301F (special treatment available to "other organizations" under §833(c)(3) is not limited to organizations that were in existence on August 16, 1986, but also applies to later-created organizations).

[2095] §833(c)(3)(A)(i).

[2096] §833(c)(3)(A)(ii). *See also* FAA 20165301F (insurance coverages for persons who obtained health insurance under government-sponsored programs are not included in 10% qualification test of §833(c)(3)(A)(ii)).

[2097] §833(c)(3)(B)(i).

[2098] §833(c)(3)(B)(ii).

[2099] §833(c)(3)(A)(iii).

[2100] §833(c)(3)(A)(iv).

[2101] §833(c)(3)(A)(v). *See also* FAA 20165301F (neither modified community-rating method nor community rating by class method constitutes community-rated basis for purposes of §833(c)(3)(A)(v); health insurance coverage provided to individuals under government-sponsored programs are not included in 35% qualification test).

[2102] §833(c)(3)(A)(vi).

[2103] §833(b)(1).

[2104] §833(b)(1)(A)(i).

[2105] §833(b)(1)(A)(i).

[2106] §833(b)(1)(A)(ii).

[2107] §833(b)(3)(A).

[2108] §833(b)(4).

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plus as of the beginning of the organization's first taxable year beginning after 1986 is its surplus at that time.[2109] If a newly formed corporation acquires the assets of existing Blue Cross/Blue Shield organizations in statutory mergers, it must combine the adjusted surplus of the acquired Blue Cross/Blue Shield organizations to arrive at its adjusted surplus for its first taxable year.[2110] For other health insurance organizations, the adjusted surplus as of the beginning of the organization's first taxable year in which it becomes an other health insurance organization is its surplus at that time.[2111] Surplus equals the excess of the organization's total assets over its total liabilities as shown on its annual statement.[2112]

(3) Adjusted Taxable Income and Net Operating Loss

Adjusted taxable income for a taxable year is taxable income for that taxable year determined without regard to the health insurance deduction,[2113] without regard to any carryforward or carryback to that taxable year,[2114] and by increasing gross income by an amount equal to the net exempt income for the taxable year.[2115]

Adjusted net operating loss for a taxable year is the net operating loss for that taxable year determined without regard to the health insurance deduction,[2116] without regard to any carryforward or carryback to that taxable year,[2117] and by increasing gross income by an amount equal to the net exempt income for the taxable year.[2118]

Net exempt income is the sum of two amounts.[2119] The first amount is any tax-exempt interest received or accrued during the taxable year, reduced by any amount not otherwise deductible that would have been allowable as a deduction if the interest were not tax-exempt.[2120] The second amount is the aggregate deductions under §243 and §245, reduced by the amount of any §832(b)(5)(B) loss reserve deductions attributable thereto.[2121] The §243 and §245 dividends received deductions are discussed in detail in 764 T.M., *Current Distributions — Cash and Property.*

Note: The deduction under §833(b) is not allowed for purposes of the Alternative Minimum Tax.[2122] The alternative minimum tax is discussed in I.C.3., above, and in detail in 587 T.M., *Noncorporate Alternative Minimum Tax* and 752 T.M., *Corporate Alternative Minimum Tax.*[2123]

d. Limitation

The deduction is limited to the health insurance organization's taxable income for the taxable year, determined without regard to the health insurance deduction.[2124]

4. Deductions Allowable to Cooperatives

Cooperatives are allowed five special deductions.[2125] These deductions are discussed in detail in 744 T.M., *Taxation of Cooperatives and Their Patrons.* These deductions are allowable to exempt farmers' cooperatives[2126] and any corporation operating on a cooperative basis other than tax-exempt organizations, mutual savings and similar banks, insurance companies, and providers of electric energy or telephone service to persons in rural areas.[2127] The five deductions are as follows:

- Under §1382(b)(1), cooperatives are allowed to deduct amounts paid during the payment period as patronage dividends,[2128] to the extent paid in money, qualified written notices of allocation,[2129] or other property, except nonqualified written notices of allocation[2130] with respect to patronage occurring during the taxable year.[2131]

- Under §1382(b)(2), cooperatives are allowed to deduct amounts paid during the payment period in money or other property, other than written notices of allocation, in redemption of a nonqualified written notice of allocation[2132] that was paid as a patronage dividend during the payment period for the taxable year during which patronage occurred.[2133]

- Under §1382(b)(3), cooperatives are allowed to deduct amounts paid during the payment period for the taxable year as per-unit retain allocations[2134] to the extent paid in money, qualified per-unit retain certificates,[2135] or property (except nonqualified per-unit retain certificates),[2136] with respect to marketing occurring during the taxable year.[2137]

- Under §1382(b)(4), cooperatives are allowed to deduct amounts paid during the payment period for the taxable

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[2109] §833(b)(3)(B).
[2110] TAM 200418009.
[2111] §833(c)(3)(C).
[2112] §833(b)(3)(B).
[2113] §833(b)(3)(C)(i).
[2114] §833(b)(3)(C)(ii).
[2115] §833(b)(3)(C)(iii).
[2116] §833(b)(3)(D) (reference to §833(b)(3)(C)(i)).
[2117] §833(b)(3)(D) (reference to §833(b)(3)(C)(ii)).
[2118] §833(b)(3)(D) (reference to §833(b)(3)(C)(iii)).
[2119] §833(b)(3)(E).
[2120] §833(b)(3)(E)(i).
[2121] §833(b)(3)(E)(ii). *See* §832(b)(5)(B), as amended by the TCJA, Pub. L. No. 115-97, §13515(a)(1) (providing that for tax years beginning after December 31, 2017, the other insurance company loss deduction computed under the general rule is reduced by the applicable percentage of the sum of three amounts), §832(b)(5)(B), as amended by the TCJA, Pub. L. No. 115-97, §13515(a)(2) (providing that the applicable percentage is 5.25% divided by the highest rate in effect under §11(b) corporate tax rate).
[2122] Former §56(c)(3), struck by the TCJA, Pub. L. No. 115-97, §12001(b)(8).
[2123] Note that the TCJA repealed the corporate alternative minimum tax for tax years beginning after December 31, 2017. §55, as amended by the TCJA, Pub. L. No. 115-97, §12001, however, another corporate AMT was enacted in 2022, applicable to tax years beginning after December 31, 2022. §55(b)(2), Pub. L. No. 117-169, §10101(a). Unlike the former corporate AMT, which was based on taxable income, the post-2022 corporate AMT is based on adjusted financial statement income. *See* §55(a), §55(b)(2), §56A, as amended by Pub. L. No. 117-169, §10101.
[2124] §833(b)(2).
[2125] *See* §1382(b), §1382(c).
[2126] §1381(a)(1) (referring to §521). *See* Reg. §1.1381-2(a).
[2127] §1381(a)(2); Reg. §1.1381-1.
[2128] *See* §1388(a); Reg. §1.1388-1(a).
[2129] *See* §1388(c); Reg. §1.1388-1(b), §1.1388-1(c).
[2130] *See* §1388(d); Reg. §1.1388-1(b), §1.1388-1(d).
[2131] §1382(b)(1). *See* Reg. §1.1382-2(b).
[2132] *See* §1388(d).
[2133] §1382(b)(2). *See* Reg. §1.1382-2(c).
[2134] *See* §1388(f).
[2135] *See* §1388(h).
[2136] *See* §1388(i).
[2137] §1382(b)(3).

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year in money or other property, other than per-unit retain certificates, in redemption of a nonqualified per-unit retain certificate that was paid as a per-unit retain allocation during the payment period for the taxable year during which the marketing occurred.[2138]

• Under §1382(c), exempt farmers' cooperatives are allowed to deduct amounts paid during the taxable year as dividends on its capital stock;[2139] amounts paid during the taxable year in money, qualified written notices of allocation, or other property, except nonqualified written notices of allocation, on a patronage basis to patrons with respect to its earnings during that taxable year derived from business done for the United States or any of its agencies or from sources other than patronage;[2140] and amounts paid during the taxable year in money or other property, except written notices of allocation, in redemption of a nonqualified written notice of allocation that was paid during the payment period for the taxable year during which earnings were derived, on a patronage basis to a patron with respect to earnings during that taxable year derived from business done for the United States or any of its agencies or from sources other than patronage.[2141]

[2138] §1382(b)(4).
[2139] §1382(c)(1); Reg. §1.1382-3(b).
[2140] §1382(c)(2)(A); Reg. §1.1382-3(c).
[2141] §1382(c)(2)(B); Reg. §1.1382-3(d).

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VII. Deductions Allowed to Trusts and Estates

A. Introduction

Generally, deductions allowable to individuals are also allowable to trusts and estates, such as trade or business expenses, interest, taxes, casualty and theft losses, bad debt, investment expenses.[2142] For further discussion of deductions allowed to individuals, see V., above. However, special rules apply to the allowance of certain deductions to trusts and estates.[2143] For example, a backup withholding credit deduction and a distributions deduction, not allowable to individuals, are allowable to trusts and estates.[2144] Specific trust and estate deductions are discussed in VII.B., below.

B. Specific Trust and Estate Deductions

1. Personal Exemption

Trusts and estates are allowed a personal exemption deduction.[2145] The personal exemption deduction for trusts and estates is discussed in 852 T.M., *Income Taxation of Trusts and Estates* (Estates, Gifts, and Trusts Series).

2. Charitable Contribution Deduction

Trusts and estates are allowed a deduction for amounts paid or permanently set aside for a charitable purpose.[2146] Charitable contribution deductions for trusts and estates are discussed in 852 T.M., *Income Taxation of Trusts and Estates* (Estates, Gifts, and Trusts Series).

3. Net Operating Loss Deduction

Trusts and estates are allowed the net operating loss deduction.[2147] The net operating loss deduction is described in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions*, and is discussed in detail in 539 T.M., *Net Operating Losses — Concepts and Computations.*

4. Depreciation and Depletion Deductions

Trusts and estates are allowed deductions for depreciation, cost recovery, and depletion,[2148] Depreciation and depletion allowable to beneficiaries is described in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions.* The depreciation deduction is discussed in detail in 530 T.M., *Depreciation: General Concepts; Non-ACRS Rules*, 533 T.M., *Amortization of Intangibles*, and 531 T.M., *Depreciation: MACRS and ACRS.* The depletion deduction is discussed in detail in 603 T.M., *Mineral Properties Other Than Gas & Oil — Operation,* and 605 T.M., *Oil and Gas Transactions.*

5. Pollution Control Facility Amortization Deduction

Trusts and estates are allowed deductions for pollution control facility amortization[2149] and for goodwill and intangibles amortization[2150] in the same manner as are individuals.[2151] The §169 pollution control facility amortization deduction is described in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions*, and is discussed in detail in 530 T.M., *Depreciation: General Concepts; Non-ACRS Rules.* The §197 goodwill and intangibles amortization deduction is described in 505 T.M., *Trade or Business Expenses and For-Profit Activity Deductions*, and is discussed in detail in 533 T.M., *Amortization of Intangibles.*

6. Backup Withholding Credit Deduction

Trusts and estates are allowed to deduct an amount equal to the backup withholding credit allocated to beneficiaries.[2152] The backup withholding credit deduction is discussed in detail in 852 T.M., *Income Taxation of Trusts and Estates* (Estates, Gifts, and Trusts Series).

7. Distributions Deduction

Simple trusts are allowed to deduct the amount of the income for the tax year that is required to be distributed currently.[2153] The distributions deduction for simple trusts is discussed in detail in 860 T.M., *Revocable Inter Vivos Trusts* (Estates, Gifts, and Trusts Series). Estates and complex trusts are allowed to deduct the sum of any amount of income for the tax year required to be distributed currently[2154] and any other amounts properly paid or credited or required to be distributed for that tax year.[2155] The distribution deduction for estates and complex trusts is discussed in detail in 852 T.M., *Income Taxation of Trusts and Estates* (Estates, Gifts, and Trusts Series).

8. Section 199A Qualified Business Income Deduction

Both trusts and estates are entitled to take advantage of the 20% qualified business income deduction.[2156] The §199A qualified business income deduction is discussed in detail in 537 T.M., *Qualified Business Income Deduction: Section 199A.*

C. Two Percent Floor on Miscellaneous Deductions for Trusts and Estates

Miscellaneous itemized deductions are not available for tax years beginning after 2017.[2157] The adjusted gross income of an estate or trust is computed in the same manner as for an individual, except that deductions for costs that are paid or incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in the trust or estate are allowable in arriving at adjusted gross income. That is, instead of being treated as miscellaneous itemized deductions, costs that qualify under §67(e) are deductible in full above-the-line. The IRS amended the regulations to clarify that §67(e) deductions are not miscellaneous itemized de-

[2142] §641(b); Reg. §1.641(a)-1.
[2143] *E.g.*, §642(b)–§642(f).
[2144] *See* §643(d)(3), §651, §661, §663.
[2145] §642(b); Reg. §1.642(b)-1.
[2146] §642(c).
[2147] §642(d); Reg. §1.642(d)-1. *See also* §172.
[2148] §642(e); Reg. §1.642(e)-1. *See also* §167, §168, §611.
[2149] *See* §169.
[2150] *See* §197.
[2151] §642(f). *See* Reg. §1.642(f)-1.
[2152] §643(d)(3).
[2153] §651(a); Reg. §1.651(a)-1.
[2154] §661(a)(1); Reg. §1.661(a)-2(a)(1), §1.661(a)-2(d), §1.661(a)-2(e).
[2155] §661(a)(2); Reg. §1.661(a)-2(a)(2), §1.661(a)-2(a)(2)(c), §1.661(a)-2(a)(2)(d), §1.661(a)-2(a)(2)(e).
[2156] §199A.
[2157] §67(h), added by the OBBBA, §70110.

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ductions and therefore are not disallowed under §67.[2158] For a detailed discussion of the application of §67 to trusts and estates, see 852 T.M., *Income Taxation of Trusts and Estates* (Estates, Gifts, and Trusts Series).

[2158] *See* Reg. §1.67-4(a)(1)(ii).

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Working Papers for this Portfolio can be found at https://bloombergtax.com.

Additional Resources:

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- Tables, Charts & Lists, *High Deductible Health Plan Annual Deductible Limits.*
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