

FEDERAL INCOME TAX: DEDUCTIBILITY OF STATE INCOME TAXES AS A BUSINESS EXPENSE FOR INDIVIDUALS IN COMPUTING NET OPERATING LOSS

THE 1954 INTERNAL REVENUE CODE¹ provides that expenses characterized as "attributable to a trade or business" may be deducted in computing a net operating loss for an individual, while personal expenses may be offset only against non-business income.² The general rule has been that state income taxes paid by an individual are not expenses attributable to a trade or business, but personal deductions only.³ However, some state income taxes have been held deductible; for example, a license fee based on gross receipts and a tax on gross income.⁴

¹ "SEC. 172. NET OPERATING LOSS DEDUCTION

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" (c) NET OPERATING LOSS DEFINED.—For purposes of this section, the term "net operating loss" means . . . the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

" (d) MODIFICATIONS.—The modifications referred to in this section are as follows:

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" (4) NONBUSINESS DEDUCTIONS OF TAXPAYERS OTHER THAN CORPORATIONS.—In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amounts of the gross income not derived from such trade or business. . . ."

See Treas. Reg. § 1.172-3(3) (1960); INT. REV. SER., TREASURY DEP'T, YOUR FEDERAL INCOME TAX 91 (Pub. No. 17, 1961). See generally Ayers, *How to Treat the Net Operating Loss Deduction*, N.Y.U. 10TH INST. ON FED. TAX 583 (1956); Susser, *Tax Consequences of the Net Operating Loss Deduction*, 5 TAX L. REV. 211 (1950); Whitehead, *Net Operating Loss Deductions*, TUL. 5TH TAX INST. 148 (1956).

² Actual computation of the net operating loss deduction is complex. See CCH 1961 STAND. FED. TAX REP. ¶ 1921. See generally Graichen, *The Net Operating Loss*, N.Y.U. 16TH INST. ON FED. TAX 865 (1958); Peterson, *What Is New and Important in Our Net Operating Loss Problems? How To Use the Allowance Most Effectively*, N.Y.U. 6TH INST. ON FED. TAX 870 (1948); Petta, *How To Treat the Net Operating Loss*, N.Y.U. 14TH INST. ON FED. TAX 1467 (1956); Welsch, *Planning To Get Full Tax Benefit from an Operating Loss Deduction*, 8 J. TAXATION 88 (1958).

³ Harry Schroeder, 16 CCH Tax Ct. Mem. 707 (1957); Wilma Aaron, 22 T.C. 1370 (1954); Rev. Rul. 58-142, 1958-1 CUM. BULL. 147; I.T. 3951, 1949-1 CUM. BULL. 84.

⁴ Rev. Rul. 58-142, 1958-1 CUM. BULL. 147; Rev. Rul. 54-598, 1954-2 CUM. BULL. 121; I.T. 3829, 1946-2 CUM. BULL. 38.

In *Elmer Reise*,⁵ a recent Tax Court decision, a sole proprietor treated as business expenses in computing his net operating loss for 1949.⁶ legal and accounting fees incurred in tax investigations; interest on federal income tax deficiencies; state income taxes for earlier years; and interest on the state tax deficiencies.⁷ Substantially all of the deficiencies arose from the Commissioner's determination that the taxpayer's income for the disputed period from the sale of hides and skins should have been reported on an accrual rather than a cash basis.⁸ The Commissioner, following the general rule announced by the Tax Court,⁹

⁵ 35 T.C. No. 61 (Jan. 18, 1961), (unanimous decision by the full Tax Court). *Appeal docketed* (7th Cir.), CCH 1961 STAND. FED. TAX REP. ¶ 7758 (June 28, 1961).

⁶ The payments involved were made in 1949, causing a loss which was carried back to 1947, the year for which the deficiency in the present case was redetermined.

Although the 1939 Code controls the years in question, it is believed that the same result would obtain under the 1954 Code.

The 1939 Code provided:

"Sec. 122 Net Operating Loss Deduction.

"(a) Definition of Net Operating Loss.—As used in this section, the term 'net operating loss' means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

"(d) Exceptions, Additions, and Limitations.—The exceptions, additions, and limitations referred to in subsection (a), . . .

"(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. . . ." Int. Rev. Code of 1939, § 122, added by ch. 247, § 211(b), 53 Stat. 867.

⁷ During 1949, the taxpayer paid his Wisconsin state income tax for 1948, deficiencies in his state income taxes for 1945 through 1947, interest on deficiencies in his state and federal income taxes for 1945 through 1947, and legal fees incurred in connection with state and federal investigations of his income tax liability to the respective governments for 1945 through 1947 which resulted in the determination of deficiencies in his state and federal income taxes for those years. 35 T.C. No. 61 (Jan. 18, 1961).

⁸ The taxpayer was engaged also in the management of apartment buildings and other dwellings which he held primarily for rental purposes and received other income in form of dividends and interest. He used and was permitted to continue to use a cash basis of accounting for non-business income. 35 T.C. No. 61 (Jan. 18, 1961).

⁹ *Wilma Aaron*, 22 T.C. 1370 (1954).

There, the taxpayer had paid in 1947 California state income taxes on income from two businesses acquired from her husband's estate. She contended that the taxes were deductible as attributable to the operations of a trade or business at least to the extent that they were based on income derived from that business.

In holding adversely to the taxpayer, the court relied on: (1) *Anna Harris*, 10 T.C. 818 (1948), a case involving taxes which were deductible in calculating Victory tax net income; and (2) Regulation 111, § 29.22(n)-1 as added by T.D. 5425, 1945 CUM. BULL. 10, 16 which interpreted "attributable to" for purposes of adjusted gross

took the position that, while all of these sums were deductible in computing net income, none were attributable to the taxpayer's trade or business for purposes of the net operating loss deduction.¹⁰

In allowing a deduction for the investigation fees and interest on federal tax deficiencies, the court relied on two similar cases and announced that it would no longer follow its previous ruling.¹¹ In *James J. Standing*,¹² a sole proprietor had been assessed a deficiency because he

income. This regulation was based on language found in the *Report of the Committee on Finance on the Individual Income Tax Bill of 1944*, S. REP. NO. 885, 78th Cong., 2d Sess., 1944 CUM. BULL. 858, 877-878.

In *Harris*, the court said:

"California income tax is a personal income tax which, like the Federal income tax, is imposed upon income derived from all sources. . . . The state income tax was not incurred 'in connection with the carrying on of the business.' [Language of the victory tax statute] Those words have a clear meaning, but, if it is necessary to undertake to clarify them, we think that the words mean a tax which is incurred as an incident to the carrying on of business in the sense that a business expense is incurred in carrying on a business; that is to say, something which must be paid in order to do business." Anna Harris, *supra* at 827.

In *Aaron*, the court went on to conclude:

"The fact that petitioner's State income taxes were affected by her business income does not compel the conclusion that they were 'attributable to' the business income. The State income tax is of a personal nature imposed on income received by petitioner from all sources, regardless of whether she operated a business. It does not have such a direct relation to the operation of a business as to entitle petitioner to deduct it in computing a net operating loss." Wilma Aaron, *supra* at 1377.

¹⁰ The Commissioner determined that the disputed deductions were not attributable to operations of taxpayer's trade or business and were allowable as deductions in computing the net operating loss only to the extent of the total dividends and interest, which was the reported gross income not derived from the petitioner's trade or business.

The Commissioner took the position that while in computing taxpayer's net income for 1949, the legal expenses were deductible under INT. REV. CODE OF 1939, ch. 1, § 23(a), 53 Stat. 12 [now INT. REV. CODE OF 1954, § 162(a)], the interest was deductible under § 23(b) [now § 163(a)], and the state income taxes were deductible under § 23(c) [now § 164(a)], none of the items were attributable to the operation of the taxpayer's business for purposes of the net operating loss deduction. Elmer Reise, 35 T.C. No. 61 (Jan. 18, 1961).

¹¹ The language of the opinion suggests that the court would have been willing to overrule *Wilma Aaron*, 22 T.C. 1370 (1954), on mere reconsideration of the construction of the statutory language:

"In view of our holding in the *Standing* and *Polk* cases, which we think are sound and correct, we no longer regard the language and holding in the *Aaron* case as a proper and correct construction of section 122(d)(5)." 35 T.C. No. 61 (Jan. 18, 1961).

¹² 28 T.C. 789 (1957), *aff'd* 259 F.2d 450 (4th Cir. 1958), *nonacq.*, 1958-1 CUM. BULL. 7. *Accord*, *International Trading Co.*, P-H TAX CT. REP. & MEM. DEC. ¶ 58, 104 (1958). *Contra*, *Guignard Maxcy*, 26 T.C. 526 (1956) (taxpayer failed to prove deduction).

had improperly reported business income on a cash basis.¹³ The court permitted the taxpayer to deduct as a business expense the interest on the deficiency and the related legal and accounting fees. In *Frank Polk*,¹⁴ the Commissioner assessed a deficiency after determining that inventories had been computed improperly.¹⁵ The taxpayer was allowed to deduct interest on the deficiency as an ordinary and necessary business expense in computing a net operating loss; the court reasoned that since the deficiency was connected with the business the same must be said for the interest. In *Reise* the court went a step further; analogizing the state income taxes and related interest to the federal tax deficiencies, the court held that the former were as much ordinary and necessary expenses of carrying on a business as were the latter in the *Polk* case.¹⁶

¹³ The taxpayer operated as sole proprietorships a retail lumber and building supply business and a business of building and selling houses. The deficiencies were based on adjustments of business income resulting from taxpayer's having improperly reported business income on the cash basis when it should have been reported on the accrual basis. The court reasoned that the deficiencies were based on adjustments of business income, thus the adjustments were proximately related to the business. Therefore, the fees and expenses and interest were deductible. 28 T.C. 789, 795.

Litigation expenses related to determination of tax liability are generally deductible as business expenses. *Green Motor Co.*, 5 T.C. 314 (1945) (corporation may deduct); *Estate of Henry N. Bawner, Jr.*, 36 B.T.A. 884 (1937) (sole proprietor); *Louise C. Slack*, 35 B.T.A. 271 (1937) (real estate held for income). Cf. *Trust of Bingham v. Commissioner*, 325 U.S. 365 (1945) (non-business expense); *Commissioner v. Heininger*, 320 U.S. 467 (1943) (suit proximately resulted from business); *Kornhauser v. United States*, 276 U.S. 145 (1928) (defense of suit by former partner).

¹⁴ 31 T.C. 412 (1958), *aff'd*, 276 F.2d 601 (10th Cir. 1960) *nonacq.*, 1959-2 CUM. BULL. 8 (Guignard Maxcy, *supra* note 12, distinguished).

¹⁵ The taxpayer was engaged in the business of raising and producing livestock. The Tax Court said the *Standing* case, *supra* note 14 was controlling.

The Court of Appeals took judicial notice that the value of livestock, raised as well as purchased, is a matter on which qualified minds differ. Upon analysis and examination of the tax return, a valuation considerably different from that adopted by taxpayer may be expected to arise. Such errors are an ordinary and unavoidable incident of conducting that type business. *Frank Polk*, *supra* note 14, at 607.

¹⁶ "With respect to the deficiency in Federal income tax involved in the *Polk* case and to which the interest there in question related, we said that the deficiency 'arose in connection with petitioner's business, and was proximately related thereto, and that the same must be said of the interest paid thereon.' On the basis of that situation and of the finding that the interest constituted an ordinary and necessary expense of carrying on the taxpayer's business, we held that the interest was deductible in computing the net operating loss carryover there involved. In view of the foregoing we are of the opinion that the State income taxes with interest thereon involved here just as much arose in connection with the petitioner's business and were as proximately related to it as the deficiency in Federal income tax involved in the *Polk* case, and that they were as much ordinary and necessary expenses of carrying on the business of the petitioner herein as was the interest involved in the *Polk* case in carrying on the business of the taxpayer there." 35 T.C. No. 61 (Jan. 18, 1961).

The *Reise* decision thus appears to stand for the rule that state income taxes and interest on deficiencies are deductible by the individual businessman¹⁷ in computing the net operating loss deduction. Some language to the contrary in *Polk*¹⁸ seems to be refuted by the holding in *Reise*; thus it would seem that these taxes and interest on deficiencies are deductible regardless of whether the basic deficiency was related to a change in business accounting methods. Certainly no practical purpose is served by relating deductibility to change in business procedures.

Proper determination of the question of whether state taxes should be allowed as a factor in computing net operating loss is not advanced by formulating precise definitions of such phrases as "attributable to" and "trade or business." Where a definitional approach has been used on similar phrases in other parts of the tax law,¹⁹ the courts have some-

¹⁷ An outside salesman would seem to be covered since he can deduct, in computing adjusted gross income, the expenses "which are attributable to" his business. INT. REV. CODE OF 1954, § 62(2)(D). See note 26, *infra*. Where the taxpayer has nonbusiness income, an allocation of state taxes attributable to the business income would seem to be required. See CCH 1961 STAND. FED. TAX REP. ¶ 8748 (March 8, 1961).

¹⁸ In *Reise*, the court said:

"[T]he factual situation in the instant case is in principle indistinguishable from that presented in the *Standing* and *Polk* cases. Accordingly, we think that the holdings in those cases are applicable and controlling here . . ." 35 T.C. No. 61 (Jan. 18, 1961).

In *Polk*, the Court of Appeals used the following language:

"Unless it can be said that the failure to properly evaluate inventories, which form a part of a taxpayer's return, arises because of the nature of the business, and is ordinarily and necessarily to be expected¹, interest on a deficit assessment does not arise out of the ordinary operation of the business and may not be deducted.

¹ Ordinary and necessary is used in the sense that it may be expected to occur on numerous occasions even where the taxpayer exercises good faith in preparing and evaluating inventories."

Polk v. Commissioner, 276 F.2d 601, 603 (1960). See note 15 *supra*.

¹⁹ See, e.g., *Higgins v. Commissioner*, 312 U.S. 212 (1941); *Deputy v. DuPont*, 308 U.S. 488 (1940). There the Court tried to distinguish between the business of a corporation and the private business of a major shareholder. Further, the Court held that expenses of a private financial arrangement were not deductible, for managing one's own investments was not a business. Such expenses are now deductible as expenses for production of income, INT. REV. CODE OF 1954, § 212(2).

In *Sic. v. Commissioner*, 177 F.2d 469 (8th Cir. 1949), *cert. denied*, 339 U.S. 913 (1950). Taxpayer could not deduct, for net operating loss, loss on sale of his farm, for he was in the business of farming not in the business of buying and selling farm land. This problem is covered by INT. REV. CODE OF 1954, § 172(d)(4)(A) (now deductible).

In *Fackler v. Commissioner*, 133 F.2d 509 (6th Cir. 1943), a full-time lawyer owned a long-term lease which he sold. Held, a sale of property used in a trade or business. The court attempted to define a trade or business and concluded that one may have both a profession and a business. See generally *Williams, Net Operating Loss Deduction*, 35 TAXES 93 (1957); Note, 59 HARV. L. REV. 119 (1945).

times fallen into dialectical confusion. "Business deduction" is not a metaphysical concept to be adduced by scholarly search through opinions and dictionaries.²⁰ A more realistic test of whether an expenditure is a business deduction is: "Was this expense necessary as a condition to conducting the business?" To the practical businessman, whether individual proprietor or corporate officer,²¹ state taxes are exacted because he is doing business and state income taxes on profits from his business are as much a necessary business expense as a state tax on gross income or a franchise tax measured by gross income—both of which are allowed.²² If the net operating loss deduction is conceded to be desirable to reduce inequities in taxation arising from cyclical and sporadic factors,²³ then a businessman's view of business expenses will further that policy by reducing discrimination arising from the phrasing of the state tax statute²⁴ or the form of enterprise.²⁵ The holding in *Reise* points the

²⁰ In *Reise*, the court quoted various authorities which had attempted to define "attributable"; then the court consulted Webster's Dictionary. 35 T.C. No. 61 (Jan. 18, 1961).

²¹ There seems to be no question of the deductibility of all types of state taxes, interest, and litigation expenses for a corporation, for the limitation on non-business deduction applies only to individuals. See INT. REV. CODE of 1954, § 172(d)(4). See generally Brody, *How To Take Advantage of the Corporate Net Operating Loss Deduction*, 2 P-H TAX IDEAS ¶ 7033 (1954) (examples); Graichen, *The Net Operating Loss Deduction as Applied to Corporations*, 33 TAXES 519 (1955) (a simplified method of computation); Rice, *Changes in the Net Operating Loss Carry-Back, Carry-Forward, And Acquisition of Loss Corporations*, U. SO. CAL. 1955 TAX INST. 433 (purpose and theory); Comment, 69 YALE L.J. 1201 (1960) (exhaustive treatment of loss corporations).

²² See note 4 *supra*.

²³ Four arguments in support of the net operating loss deduction are frequently advanced. It is contended that the deduction:

(1) removes tax discrimination which would exist between uniformly profitable businesses and unsteady ones.

(2) prevents taxation of capital which would otherwise result if unsteady businesses were unable to effectively deduct their expenses.

(3) contributes to business stability, for, knowing that expenses are deductible over a period of years, businessmen are less reluctant to incur a temporary loss.

(4) encourages venture capital. New businesses carry substantial risk of loss in early years but such losses can be used to reduce taxable profits in later years. See BURTON & BRADLEY, *CASES ON FEDERAL TAXATION* 232 (1955). See generally Brody, *Net Operating Loss Deduction*, 34 TAXES 325 (1956); Susser, note 1 *supra*.

²⁴ See note 4 *supra*.

²⁵ What rule would be followed in respect to close corporations that elect to be taxed as a partnership, or partnerships that elect to be taxed as corporations? See Gardner, *Tax Advantages in Corporations Treated as Partnerships*, 2 P-H TAX IDEAS ¶ 7038 (1960). See generally Peterson, note 2 *supra*.

way to a more rational application of the statutory language in determining business expenses.²⁶

²⁶ Because of the similarity of the statutory provisions, the holding in *Reise* should be applied also in computing adjusted gross income. See P-H TAX CT. REP. ¶ 32,072 (Feb. 2, 1961). Both sections of the Code provide for deductions "attributable to a trade or business." Compare INT. REV. CODE OF 1954, § 172(d)(4) with INT. REV. CODE OF 1954, § 62(1). The former section is quoted at note 1, *supra*; the latter is as follows:

"SEC. 62 ADJUSTED GROSS INCOME DEFINED

"[T]he term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

"(1) TRADE OR BUSINESS DEDUCTIONS.—The deductions allowed by this chapter . . . which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee."

INT. REV. CODE OF 1954, § 62(1).

Under this interpretation, individual businessmen may be able to deduct as a business expense that portion of their state income tax which is related to their business income. See note 17, *supra*. If this view is taken, interest on tax deficiencies assessed in connection with business income would be deductible as a business expense, contrary to the Government's present position that such interest is an itemized deduction. See INT. REV. SER., TREASURY DEP'T, YOUR FEDERAL INCOME TAX 110 (Pub. No. 17, 1961).

Since every tax return involves the computation of adjusted gross income, this application of the *Reise* rule would affect a greater number of taxpayers than the net operating loss application. See CCH 1961 STAND. FED. TAX REP. ¶ 8748 (Mar. 8, 1961) (examples of tax savings are given). There is also a possibility of refund claims for years still open under the statute of limitations. *Ibid.*