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No Thanks, Uncle Sam, You Can Keep Your Tax Break

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I. Introduction

It is a rather simple question. Is a taxpayer permitted to forego a deduction or credit for which the taxpayer otherwise qualifies? Even before it is answered, the question triggers another. Why would a taxpayer even dream of ignoring something so wonderful, from a tax perspective, as a deduction or credit? As explained in Part II of this article, tax deductions and credits sometimes are not as beneficial as one might expect, even to the point of being disadvantageous, for tax or other purposes.

The simple question can be asked more succinctly. Are tax deductions and credits, in the absence of a specific provision to the contrary, mandatory? Phrased in this fashion, the question might tempt some to see the answer in the very asking, much as one can with an almost-as-important query, "Is chocolate delicious?" The urge to begin with the words "Of course" is too much for many to resist. In this instance, though, it is dangerous to assume that deductions and credits are mandatory.

For some, the asking of the question is almost a surprise. One might expect that more than eight decades of federal income tax law history would leave no basic question unanswered. Yet the debate over the permissive or mandatory quality of deductions has twice cascaded through the American Bar Association's TAX-LAW listserv, generating two of the longest-lasting, deep, and intense discussions on that list, and attracting at least, if not more, participants than any other thread to have made its rounds among its members. Perhaps those two discussions, one in the spring of 2004 and the other in the spring of 2006, inspired the two short articles that appeared shortly thereafter, one in May of 2004[1] and the other in May of 2006.[2] Neither article, though, provides, nor perhaps was intended to provide, an extensive, in-depth analysis of the question.

When numerous tax practitioners invest meaningful amounts of time discussing an issue, it is safe to conclude that the issue matters. On that point, there is no disagreement. The issue, though periodically moving to the edges of the tax stage in years gone by, is ready to take the spotlight, principally because increasing tax complexity has changed the value of tax deductions and credits.

The practical relevance of the question is highlighted by the controversy swirling about a

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[1] Nicole E. Ballard, Cherie J. O'Neil & Donald P. Samelson, "Avoiding Taxes by Avoiding Deductions," 82 Taxes 45 (May 2004)

[2] See generally Joseph D. Beams & W. Eugene Seago, "Why Some Taxpayers Benefit from Not Claiming Deductions," 84 Taxes 43 (May 2006).

settlement that Boeing reached with the federal government. In July of 2006, Boeing announced that it would not deduct $615 million it agreed to pay the government to settle charges that it had violated ethical rules in obtaining documents from a rival manufacturer and that it had recruited a military weapons buyer in violation of other rules, even though it claims it is entitled to the deduction.[3] If, as some argue, deductions must be claimed, how can Boeing's decision to forego a deduction it claims is justified withstand scrutiny by the IRS? Does Boeing's attempt to score points in the arena of public relations justify its stance? It isn't just Boeing, because other companies reaching settlements with the government with respect to other types of disputes have accepted provisions in the settlement agreement by which they promise not to deduct the payments.[4] Do these provisions violate the tax law? The core issue addressed by this article has been moved into a national spotlight on account of the Boeing situation, and its analysis should help answer the specific questions raised in this paragraph, together with the others that arise in the course of exploring the matter.

After explaining why the issue exists and is becoming more important, this article will explore the various arguments that can be, and have been, raised in support of the proposition that all deductions are mandatory and in support of the proposition that only certain deductions, for specific purposes, are mandatory whereas the others are optional. The proposition that all deductions are optional is untenable under existing law, and thus is discussed only in the context of policy options available to legislators who choose to address the issue. The question of whether credits must be claimed is not treated separately, but is left to ride tandem with the arguments and discussion applicable to the claiming of deductions.

This article concludes that only certain deductions, for specific purposes, are mandatory, leaving taxpayers with an option with respect to other deductions and credits. For simplicity sake, this position is described as the "most deductions are optional" approach. The contrary position easily is tagged as the "all deductions are mandatory" approach, even though its adherents concede that deductions requiring an election are ipso facto optional.

II. Why Turn Down a Tax Break?

A. In General

It is widely believed that tax deductions and tax credits are tax "breaks," that is, they contribute to a reduction of a taxpayer's tax liability. Accordingly, deductions and credits are considered

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[3] See
http://www.nytimes.com/2006/07/27/business/27boeing.html?_r=2&ref=business&oref=slogin&oref=slogin (visited 31 July 2006).

[4] See United States Government Accountability Office, Report to the Committee on Finance, U.S. Senate, "Tax Administration: Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments 21 (Sept. 2005),
http://www.gao.gov/new.items/d05747.pdf (visited 31 July 2006).

beneficial to taxpayers, and items for which taxpayers aim some of their planning goals.[5] Considerable resources are devoted to making a taxpayer's transactions "fit" the definitional and other requirements of a deduction or credit.

Yet there are instances in which a tax deduction or credit either is worthless to the taxpayer or disadvantageous. Worthless deductions and credits are those for which a taxpayer has no use. For example, a taxpayer whose non-business deductions exceed gross income has no use for additional deductions, because those deductions would enlarge a loss that cannot be carried to other taxable years. That deductions and credits can be useless is demonstrated by the existence, in some states of statutory provisions permitting taxpayers with otherwise useless state income tax credits of one sort or another to sell those credits to other taxpayers who can make use of them.[6]

Sometimes, however, a tax deduction or credit can cause a taxpayer's tax liability to increase. Though seemingly counter-intuitive, the complex relationship among various federal income tax provisions can have that effect. For example, in some instances, decreases in adjusted gross income or taxable income reduce a credit and thus create an incentive to forego a deduction because the salvaged credit exceeds the tax savings generated by the deduction. Examples of these disadvantageous situations are explored in B through G of this Part II.

At other times, a tax deduction or credit can foreclose a taxpayer, or someone related or otherwise connected to the taxpayer, from qualifying for a non-tax benefit. For example, some benefit programs require that a person is ineligible if someone else claims a dependency exemption deduction for that person. Similarly, taxpayers may want to disregard deductions or credits because the cost and aggravation of anticipated routine audits involving these items are seen as out-weighing the putative tax benefit. Some taxpayers consider privacy more important than a deduction, and other taxpayers may seek beneficial publicity from declining to claim a deduction. These and similar situations are explored in H through K of this Part II.

The instances described in B through K of this article are but some of the situations in which a taxpayer would benefit in some way from declining to claim a tax deduction or credit. For purposes of analyzing the core question, it is not essential to identify every such instance. It is not unlikely that continued changes in the tax law not only will create more situations in which taxpayers would choose to ignore a deduction or credit, but also will cause some of the presently identified circumstances to become moot or obsolete.

B. Alternative Minimum Tax

Under certain circumstances, an itemized deduction can cause the taxpayer's alternative

[5] Other major tax planning goals include qualification for gross income exclusions, deferral of gross income, and shifting income to other taxpayers.

[6] See, e.g., Susan Kalinka, "Transferable State Income Tax Credits: Are They 'Property' or 'Tax Items' for Federal Tax Purposes?," 33 State Tax Notes 849 (2004).

minimum tax (AMT) to increase by an amount greater than the reduction in regular tax generated by the deduction. In this instance, from a tax planning perspective, a taxpayer is better off ignoring the deduction.[7] Whether, from a tax compliance perspective, the taxpayer should ignore the deduction is at the root of the question this article addresses.

One situation in which a taxpayer's total tax liability increases on account of a deduction arises when four factors are present: taxable income is less than the beginning of the 25 percent bracket; adjusted net capital gain exceeds taxable income; taxable income is less than AMTI less the AMT exemption; and items that are deductible for regular tax are not deductible for AMT.[8] Whether Congress should change this particular glitch is left for others to discuss.[9]
Another situation, described by an ABA-TAX listserv participant, involved a taxpayer whose total tax liability would decrease by $3,560 if the taxpayer ignored $35,600 of state tax payments.[10] If a deduction is not going to decrease the taxpayer's total tax liability, and might even increase it, is there any point in claiming the deduction?

C. Social Security Benefit Computations

Because social security benefits generally are higher if earned income during pre-retirement years is higher,[11] there is an incentive for self-employed individuals to understate business deductions if the tax reduction afforded by those deductions has less present value than that of the anticipated increases in post-retirement social security benefits.[12] The IRS takes a dim view of this particular strategy,[13] as discussed in IX, C, below.

D. Maximizing Deferred Compensation Contributions

Because in most instances the amount that can be set aside in a qualified tax-deferred

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[7] See Kris Hill, "In AMT? Even the Capital Gains Rate May Be Higher For You, 103 Tax Notes 119 (2004).

[8] Id.

[9] See id.

[10] Post by Philip Karpel to ABA-TAX listserv (Apr. 19, 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R44692&I=-3 (visited 31 July 2006).

[11] See Social Security Administration, Retirement Planner, http://www.ssa.gov/r&m6.htm (visited 31 July 2006) ("Higher lifetime earnings result in higher benefits").

[12] See Nicole E. Ballard, Cherie J. O'Neil & Donald P. Samelson, "Avoiding Taxes by Avoiding Deductions," 82 Taxes 45 (May 2004).

[13] Rev. Rul. 56-407, 1956-2 C.B. 564.

compensation plan by self-employed individuals reflects the taxpayer's net profit,[14] there is an incentive for self-employed individuals to understate business deductions if the tax reduction afforded by those deductions has less present value than that of the combined present value of the deduction for the contribution to the plan and the net present value of the after-tax retirement benefits generated by the plan.[15]

E. Avoiding Application of Section 183 Not-for-Profit Activity Deduction Limitations

Taxpayers engaging in activities that frequently fail to generate an annual profit sometimes will have good reason to forego a deduction so that the activity shows a profit in a sufficient number of years to qualify for the presumption in section 183(d) that treats an activity as for-profit if it shows a profit in at least three of five consecutive years.[16] For example, a taxpayer whose activity has shown a profit in two of the preceding four years and a loss in the other two needs to show a profit in the current, fifth year in order to avoid retroactive denial of the net loss deducted in the two previous loss-generating years. One way of showing that profit is to ignore sufficient deductions, and the resulting tax liability on the profit so generated most likely will be less than the tax savings generated by the net losses incurred in the two previous loss-generating years. Whether the taxpayer is permitted to so act is at the root of the question addressed in this article, though, as discussed in VIII, B, below, the IRS appears to foreclose this particular tax planning gambit.

F. Maximizing the Earned Income Tax Credit

Because the earned income tax credit reflects a percentage of the taxpayer's earned income,[17] there is an incentive for taxpayers to ignore deductions as a means to obtaining a much more valuable credit.[18] Deductions reduce tax liability by an amount equal to the deduction multiplied by the taxpayer's effective marginal income tax rate, but credits reduce tax liability dollar for dollar.[19] Although many taxpayers attempt to maximize the earned income tax credit by

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[14] See, e.g., §§403(b)(1), (3), 408(k)(3)(C), 415.

[15] See generally Joseph D. Beams & W. Eugene Seago, "Why Some Taxpayers Benefit from Not Claiming Deductions," 84 Taxes 43, 46-47 (May 2006).

[16] See §183(d); Regs. §1.183-1(c). See generally Joseph D. Beams & W. Eugene Seago, "Why Some Taxpayers Benefit from Not Claiming Deductions," 84 Taxes 43, 47 (May 2006); Nicole E. Ballard, Cherie J. O'Neil & Donald P. Samelson, "Avoiding Taxes by Avoiding Deductions," 82 Taxes 45 (May 2004) .

[17] §32(a)(1), (b).

[18] See Joseph D. Beams & W. Eugene Seago, "Why Some Taxpayers Benefit from Not Claiming Deductions," 84 Taxes 43, 44-46 (May 2006); Nicole E. Ballard, Cherie J. O'Neil & Donald P. Samelson, "Avoiding Taxes by Avoiding Deductions," 82 Taxes 45 (May 2004) .

[19] See, e.g., Joseph Isenbergh, "The Foreign Tax Credit: Royalties, Sunsidies, and Creditable

fabricating and report non-existing earned income,[20] the opportunity to increase earned income by choosing not to claim deductions is very real.[21] As it has with any attempt to maximize social security benefits by reducing self-employment deductions, the IRS has rejected this strategy because the earned income tax credit cross-references the definition of self-employment income,[22] as discussed in IX, D, below.

G. Qualifying for Education Credits

Because the section 25A Hope Scholarship[23] and Lifetime Learning Credits[24] cannot be claimed by a taxpayer with respect to whom a section 151 dependency exemption deduction is allowed to another taxpayer,[25] that other taxpayer can make the credits available to an otherwise qualifying taxpayer by choosing not to claim the dependency exemption deduction for that taxpayer. If the taxpayer who chooses to forego the dependency exemption deduction has an adjusted gross income high enough to reduce or eliminate the amount of his or her dependency exemption deduction because of the phase-out,[26] that taxpayer has nothing to lose, tax-wise, from foregoing what would be a zero or insignificant deduction. As discussed in VIII, A, below, the IRS has put its imprimatur on this particular strategy,[27] making it impossible to put the IRS into either the deductions are mandatory or deductions are optional camps because of its position with respect to omitted deductions in the self-employment income computation context.

H. Reducing the Chances of an Audit and Audit Tactics

It is generally believed that many of the taxpayers who choose to forego deductions and credits do so because they think that it will reduce the chances of an IRS audit of their tax returns.[28] One

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Taxes," 39 Tax L. Rev. 227, 230 n.8 (1984).

[20] See, e.g., Leslie Book, "The Poor and Tax Compliance: One Size Does Not Fit All," 51 Kan. L. Rev. 1145, 1172 (2003) ("taxpayers may be in the unusual position of creating income").

[21] Post by Cheryl Collins to ABA-TAX listserv (Apr. 16, 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R36923&I=-3 (visited 31 July 2006).

[22] CCA 200022051.

[23] §25A(a)(1), (b).

[24] §25A(a)(2), (c).

[25] §25A(g)(3)(A).

[26] See §151(d)(3).

[27] PLR 200236001.

[28] See, e.g, See Joseph D. Beams & W. Eugene Seago, "Why Some Taxpayers Benefit from Not

commentator references the matter thusly, “However, the results of taxpayer surveys suggest that a substantial number of taxpayers intentionally fail to take deductions to which they are entitled.”[29] Even though there is doubt that this taxpayer perception reflects the reality of audit selection,[30] this approach also triggers the question this article addresses.

For decades, tax practitioners have advised taxpayers and each other that amending a tax return to claim an overlooked deduction or to increase a claimed but miscalculated deduction should not be undertaken unless the amount involved is so substantial that the tax savings overwhelm the alleged increase in chances of audit supposedly caused by the filing of an amended return.[31] Again, regardless of the validity of the “amended return as red flag” warning, the question addressed in this article can be posed in alternative terms, namely, “Must a taxpayer who discovers an unintentionally overlooked or understated deduction amend his or her income tax return?”

Another practice involving audits that also relates to the core question is that of bringing previously unclaimed deductions to an audit to present to the auditor when the auditor disallows deductions that have been claimed on the return.[32] If doing so is somehow improper, no one

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Claiming Deductions,” 84 Taxes 43, 46 (May 2006) (“A taxpayer may choose not to claim a home office deduction or some other business deduction because she fears it will increase her likelihood of getting audited...”); Watson, “An Analysis of ‘Meeting or Dealing’ for Home Office Deductions,” 1984 U. Ill. L. Rev. 1075, n. 59 (“There are some negative tax ramifications that ... may persuade eligible taxpayers to forego home office deductions. ... For a general discussion, see Kennedy & Anderson, Recent Changes Make It Easier to Deduct Costs Related to an Office-at-Home 12 Tax'n for Law. 18, 21 (1983). See also Everett, Home Office Expense Deductions: More Trouble Than They are Worth?, 58 Taxes 589 (1980).”).

[29] Leandra Lederman, “Symposium: Tax Compliance: Should Congress Reform the 1998 Reform Act: Tax Compliance and the Reformed IRS,” 51 Kan. L. Rev. 971, 1001 n. 140 (2003) (citing Karyl A. Kinsey, Foreward to Survey Data on Noncompliance: A Compendium and Review, at 1, 21 (American Bar Foundation, Working Paper No. 8716)).

[30] Post by Jim Maule to ABA-TAX listserv (Apr. 18, 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R42210&I=-3 (visited 31 July 2006 (“My experience tells me that many of the taxpayers who forego deductions do so because of misguided notions that it will decrease the chances of IRS audit (something that many taxpayers literally fear).”)

[31] Post by Jim Maule to ABA-TAX listserv (Apr. 19, 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R48897&I=-3 (visited 31 July 2006) (“In reviewing a return, I discovered an omitted deduction (unintentional). Amending the return would have reduced tax liability by a few hundred dollars. The supervising partner told me, ‘Don't amend the return. It's like waving a red flag in front of a bull, and to get attention from the IRS for a few hundred dollars isn't worth it.’”).

[32] Id. (“Often, for whatever reason, taxpayers are cautious, and refrain from claiming deductions

seems to have encountered objections from the IRS.[33] Yet there does not exist any specific authority endorsing or prohibiting the practice.

I. Keeping Information Private

Taxpayers might refuse to claim a deduction because they do not want the information required for substantiating the deduction to be made available to a government agency[34] or to a private enterprise that examines a person's tax return as part of a process to determine if the person qualifies for a loan, to determine the financial health of a potential investor, or to achieve some similar purpose.[35] Taxpayers may want to keep private the identity of charitable gift recipients, the amount spent on a safe deposit box, the amount paid as alimony, the fact alimony has been paid, or the details of medical expenses.[36]

J. Public Relation Coups

As illustrated by the Boeing announcement that it would not deduct $615 million it agreed to pay the federal government to settle charges that it had violated ethical rules while engaged in several business activities, a corporation and perhaps even individuals can "score points" in the media by "sacrificing" deductions that public considers unsuitable, even though the tax law permits the deduction. Though in Boeing's case, giving up the deduction allegedly will increase its tax liability, the incentive to make such a "sacrifice" strengthens when the taxpayer has little or no need for the deduction.

K. Qualifying for Non-tax Benefits

Because a variety of non-tax benefits are denied to a potential recipient if a dependency exemption deduction is allowed to another person with respect to that potential recipient,[37] the

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that very likely would be allowed if claimed, challenged, and resolved by a court. Then, when audited on other issues, as the IRS "takes away" deductions, the taxpayers reach into their pocket and drag out some of the ones held in reserve. I don't like this approach, but I've never heard of the IRS proposing penalties on account of the deductions that were not claimed until the audit.").

[33] Id.

[34] See, e.g., Beatty v. Comr., 40 T.C.M. 438 (1980).

[35] See Joseph D. Beams & W. Eugene Seago, "Why Some Taxpayers Benefit from Not Claiming Deductions," 84 Taxes 43, 43-44 (May 2006).

[36] See Post by Jim Maule to ABA-TAX listserv (Apr. 19, 2004) (discussing Beatty v. Comr.), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R51929&I=-3 (visited 31 July 2006).

[37] E.g., Post by Cheryl Collins to ABA-TAX listserv (17 May 2006), http://mail.abanet.org/scripts/wa.exe?A2=ind0605&L=aba-tax&P=R27761&I=-3 (visited 31 July

taxpayer who would otherwise be entitled to claim the deduction often has a good reason to abandon the claim. As with the education credit qualification discussed in G, above, this is particularly true if the taxpayer who chooses to forego the dependency exemption deduction has an adjusted gross income high enough to reduce or eliminate the amount of his or her dependency exemption deduction because of the phase-out.[38]

The benefits that might be available to a taxpayer who chooses not to claim a dependency exemption or other deduction include those offered through programs for disaster relief, insurance settlements, bank loans, and sales of businesses.[39] Whether the tax law would require the taxpayer to claim the deduction is at the root of the question addressed in this article. Whether the agency administering the non-tax benefit would consider the foregoing of the deduction as valid is beyond the scope of this article.

III. Does "Shall Be Allowed" Mandate Deduction?

A. The Words of the Statute: A Road-Map to Nowhere

1. In General

It has been argued by advocates of the "all deductions are mandatory" approach that the Internal Revenue Code literally requires a taxpayer to claim all deductions for which the taxpayer otherwise qualifies because the term "shall be allowed" mandates taking the deduction into account in computing taxable income.[40] This argument rests on a sequential analysis of statutory terms ultimately defining taxable income. Predictably, the language of the Internal Revenue Code does not provide a definitive answer to the question of whether taxpayers are obligated to claim every deduction for which they otherwise are eligible. At best, the language provides some clues that assist in finding an answer through implication and inference.

2. Use of "Allowed" in Defining Taxable Income

a. Taxable Income

2006) (qualifying for Medi-Cal); "Texas Residency - FAQ", http://www.utdallas.edu/residency/fac.html#8 (visited 31 July 2006) (parents not residing in Texas and claiming child as dependent cause child not to qualify as Texas resident for tuition and other purposes, and thus have incentive to forego dependency exemption deduction).

[38] See §151(d)(3).

[39] See Joseph D. Beams & W. Eugene Seago, "Why Some Taxpayers Benefit from Not Claiming Deductions," 84 Taxes 43, 43 (May 2006).

[40] Post by Rod Goodwin to ABA-TAX listserv (16 Apr 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R37166&I=-3 (visited 31 July 2006 ("Therefore, the deductions which are allowed, must be taken.").

Section 63(a) defines taxable income, with one exception, as “gross income minus the deductions allowed by this chapter (other than the standard deduction).”[41] The exception defines taxable income for individuals who do not elect to itemize deductions, and provides that “taxable income means adjusted gross income minus the standard deduction and the deduction for personal exemptions.”[42] The adjusted gross income to which this definition refers is “gross income minus the following deductions:”[43] where “following deductions” is a list of deductions set forth in section 62(a). All but two of those deductions, in turn, are referred to as “The deductions allowed by” the particular provision for the selected item,[44] whereas two are described as “Any deduction allowable under this chapter ....”[45]

None of this language, though, answers the question. The definitions rest on the concept of “deductions allowed by this chapter” but that is a term for which no definition appears in the Code. Instead, the logical interpretation is that “deductions allowed by this chapter” means those items for which a provision in “this chapter” allows a deduction. There is no issue, of course, with “this chapter” because section 63 is in chapter 1, and thus “this chapter” means chapter 1 of subtitle A of the Internal Revenue Code, which deals with “Normal Taxes and Surtaxes.”

b. Allowing Deductions

There are numerous provisions in chapter 1 that allow deductions. The language of those provisions adds to the confusion surrounding the issue of whether deductions are mandatory.

A principal provision is section 161, which introduces the litany of deduction provisions contained in Part VI of subchapter B of chapter 1. Part VI is captioned “Itemized Deductions for Individuals and Corporations,” which is misleading because the word “itemized” is being used in the sense of “listing” and not in the sense of “itemized deductions” as defined in section 63(d). The latter provision defines itemized deductions as “deductions allowable under this chapter other than the deductions allowable in arriving at adjusted gross income, and the deduction for personal exemptions.” Clearly some of the deductions listed in Part VI are allowable in computing adjusted gross income and thus are not itemized deductions within the scope of section 63(d). This is one reason that section 7806(b) essentially demands that caption titles be ignored for purposes of substantive interpretation.[46] A similar definition exists in section 211,

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[41] §63(a).

[42] §63(b).

[43] §62(a),

[44] See id.

[45] §62(a)(13), (20).

[46] §7806(b).

which introduces the list of deduction provisions contained in Part VII of subchapter B of chapter 1. Part VII is captioned “Additional Itemized Deductions for Individuals” which by using the word itemized is no less misleading than is the caption for Part VI. Another definition based on the same pattern exists in section 241, which introduces the list of deduction provisions contained in Part VIII of subchapter B of chapter 1. Part VIII is captioned “Special Deductions for Corporations.”

Section 161 provides: “In computing taxable income under section 63, there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible).” Section 211 provides: “In computing taxable income under section 63, there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible).” Section 241 provides: “In addition to the deductions provided in Part VI (sec. 161 and following), there shall be allowed as deductions in computing taxable income the items specified in this part.” The phrase “shall be allowed” also appears in some, but not all, of the other deduction provisions in the Code, such as the section 611 deduction for depletion,[47] the section 642(b) personal exemption deduction for estates[48] and trusts,[49] the section 643(b) charitable deduction for estates and trusts,[50] the distributions deduction for estates and trusts,[51]

c. “Shall Be Allowed”

The critical element of these definitions is the introduction of the phrase “shall be allowed” into the tax lexicon. The term “shall be allowed” is not defined in the statute. Thus, even if the word “shall” means “must,” as some have argued,[52] the meaning of “allowed” remains determinative because whatever it is that must be done is whatever “allowed” means. If the word “allowed” means “claimed” then “shall be allowed” must be interpreted as “must be claimed,” making all deductions mandatory. In contrast, if “allowed” means “permitted,” then “shall be allowed” must be interpreted as “must be permitted,” which means that the claiming of the deduction is not required. In further contrast, if “allowed” means “accepted” or “approved,” then “shall be

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[47] §611(a).

[48] §642(b)(1).

[49] §642(b)(2).

[50] §642(c).

[51] §§651(a), 661(a).

[52] See Nicole E. Ballard, Cherie J. O'Neil & Donald P. Samelson, “Avoiding Taxes by Avoiding Deductions,” 82 Taxes 45 (May 2004) (“Generally, a taxpayer is required by established case law and rulings to take all allowable deductions”); Post by Rod Goodwin to ABA-TAX listserv (16 Apr 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R37166&I=-3 (visited 31 July 2006 (“Therefore, the deductions which are allowed, must be taken.”).

allowed" must be interpreted as "must be accepted" or "must be approved," making an otherwise eligible deduction unassailable if claimed by the taxpayer.

Put another way, the question is whether "shall be allowed" means "must be claimed on the return" or "must be allowed if it is claimed on the return." By phrasing the question in this manner, the issue becomes one of determining if the direction in the statute is an instruction to the IRS to allow the claim if it is made or is an instruction to taxpayers that the deduction must be claimed.

Complicating matters is the fact that the "shall be allowed" phrase does not always appear in taxable and other income definitions. Sometimes the term allowed is used without "shall be." For example, section 832(a) defines insurance company taxable income as "gross income as defined in section (b)(1) less the deductions allowed by subsection (c)."[53] Section 512(a) defines "unrelated business taxable income" as "gross income .... less the deductions allowed by this chapter ...." In other instances, the term "allowable" is used. For example, section 543(b) defines "adjusted ordinary gross income," a component of personal holding company income" as "ordinary gross income adjusted as follows: ... subtract the amount allowable as deductions for ..."[54] Sometimes the term "allowed" or "allowable" does not appear. For example, section 801(b) defines "life insurance taxable income" as "life insurance gross income, reduced by life insurance deductions."[55] Rather than supporting the argument that "shall be allowed" makes deductions mandatory, this potpourri of language formulations adds strength to the position that the particular words used to define various types of income do not inform the core question.

3. Impact of the Term "Allowable"

The statutory lexicon is complicated by use of the term "allowable" in describing deductions. There are numerous provisions using the term "allowable" to modify the word "deduction" or "deductions," though a description of a few is sufficient to illustrate the point.

In computing of the section 21 household and dependent care credit, taxpayers are not permitted to take into account payments to individuals for whom a dependency exemption deduction is allowable to the taxpayer or the taxpayer's spouse.[56] The exclusion for employer-provided dependent care assistance does not apply to payments made by the employer to individuals for whom a dependency exemption deduction is allowable to the employee or the employee's spouse.[57]

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[53] §832(a).

[54] §543(b)(2).

[55] §801(b).

[56] §21(e)(6)(A).

[57] §129(c)(1).

In computing adjusted gross income, eighteen enumerated deductions that are allowed to the taxpayer are subtracted from gross income, whereas two deductions, one for jury pay remitted to an employer and the other for attorney fees and costs arising from certain discrimination litigation recoveries, are subtracted if they are "allowable" to the taxpayer.[58] Itemized deductions, for purposes of computing taxable income, are defined as deductions allowable under chapter 1 other than deductions allowable in computing adjusted gross income and the personal exemption deduction.[59] Impairment-related work expenses, which are excepted from the section 67 two-percent floor on miscellaneous itemized deductions, are defined as certain expenses of handicapped individuals with respect to which a deduction is allowable under section 162.[60] The reduction of itemized deductions under section 68 applies to "itemized deductions otherwise allowable for the taxable year."[61]

Computation of the exclusion for employee achievement awards depends on whether the cost to the employer of the award exceeds or does not exceed the amount allowable to the employer as a deduction for the cost of the award.[62] Investment interest for purposes of the limitation on the deduction of investment interest is defined as "any interest allowable as a deduction" under chapter 1.[63]

The reduction in the adjusted basis of depreciable property is the amount of depreciation allowed as deductions but "not less than the amount allowable" under the tax law.[64] Depreciation recapture for personalty applies to "all adjustments reflected in ... adjusted basis on account of deductions ... allowed or allowable ... for depreciation or amortization,[65] but if the taxpayer can establish that the amount allowed for any period was less than the amount allowable, recapture is limited to the amount allowed.[66] A similar rule applies to depreciation recapture on real property.[67]

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[58] §62(a)(13), (20).

[59] §63(d).

[60] §67(d).

[61] §68(a).

[62] §74(c)(1), (2).

[63] §163(d)(3)(A).

[64] §1016(a)(2).

[65] §1245(a)(2)(A).

[66] §1016(a)(2)(B).

[67] §1250(b)(3).

The use of the term “allowable” suggests that the term means something other than “allowed.” For example, the statutory provision dealing with the impact of depreciation on adjusted basis provides that adjusted basis is reduced by the amount of allowable depreciation even if the allowed depreciation is less, a condition that acknowledges not only a difference between the two terms but also that a taxpayer may deduct less depreciation than is allowable. Similarly, the definition of depreciation that is subject to depreciation recapture also acknowledges the difference between “allowed” and “allowable” but also the existence of situations in which taxpayers have deducted less depreciation than was allowable. Sparing a taxpayer from depreciation recapture treatment for allowable but unallowed depreciation deductions is inconsistent with the notion that “shall be allowed” means “must be deducted.” The term “allowed” means something other than a required deduction for all that is allowable.

So in using both terms, Congress clearly implies that they have different meanings. Yet Congress did not provide definitions for the two terms. Implications are valuable, but more is required. When a statute uses words that it does not define, it becomes helpful to ascertain how the IRS and the courts have interpreted those words.

B. IRS Perspectives: A Road Sign of Some Clarity

Decades ago, the Bureau of Internal Revenue, the IRS’ predecessor, weighed in with its distinction between the terms “allowable” and “allowed”:

> The word “allowable” designates the amount permitted or granted by the statutes, as distinguished from the word “allowed” which refers to the deduction actually permitted or granted by the Bureau.[68]

In reaching this conclusion, the Bureau reasoned consistently with statutory interpretation principles set forth by the Supreme Court for terms used in, but not defined by, a statute. According to the Court, the meaning of an undefined term must be determined from its “known and ordinary signification.”[69] Put another way, “the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover.”[70] It makes no difference that the term in question is in a tax statute.[71]

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[68] I.T. 2944, XIV-2 C.B. 126 (1935).

[69] Old Colony R. Co. v. Comr., 284 U.S. 552, 560 (1932), quoting Levy's Lessee v. McCartee, 6 U.S. 102, 110 (1904).

[70] Lynch v. Alworth-Stephens Co., 267 U.S. 364, 370 (1925).

[71] DeGanay v. Lederer, 250 U.S. 376, 381 (1919).

Looking to everyday use, something is allowable if it is permissible.[72] Something that is permissible is something that is an opportunity, and cannot be something that is a requirement.[73] Thus, an allowable deduction is one that the taxpayer is permitted to claim, just as the Bureau concluded. All deductions for which a taxpayer qualifies, therefore, are allowable deductions, and any attempt to deduct an item that is not allowable, if detected, will be rejected because the item is not allowable as a deduction. Logically, therefore, no item can be claimed as a deduction unless it is allowable.

What does it mean, then, for a deduction to be allowed? It must mean that something has happened to the item in question to move it beyond the character of merely being allowable. According to the Bureau, a deduction that is allowed is a deduction that is permitted or granted. Barring a mistake or failure to audit a return, the IRS would not permit a taxpayer to deduct an item that is not allowable.[74]

What matters most from the Bureau's interpretation, which the IRS has not rescinded, is that allowable and allowed are two different concepts. There must be, therefore, allowable deductions that are not allowed. Barring an error, the IRS would not, and should not, refuse to a taxpayer a deduction that is allowable to the taxpayer. Accordingly, allowable but unallowed deductions will exist if the taxpayer fails to claim an allowable deduction. As this article explains, it is not unusual for taxpayers to forego allowable deductions.

What necessarily follows is the concept that a deduction does not become allowed until the taxpayer does something to trigger allowance of an allowable deduction, by doing whatever is required to claim the deduction on the return. In turn, this permits the IRS to accept the claimed deduction, thus causing it to become an "allowed" deduction or to reject the deduction, thus causing it to be "disallowed" provided no court holds in favor of a taxpayer who objects to the disallowance.

If the taxpayer claims a deduction for an item that is not an allowable deduction, and the IRS fails to detect that claim, the item ends up being an allowed deduction even though it was not allowable. This conclusion is evident from the provision in section 1016 requiring reduction of adjusted basis by the amount of depreciation allowed with respect to the property, though not to be less than allowable depreciation.[75] If there were no such thing as an allowed but unallowable

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[72] Merriam-Webster Online Dictionary, http://www.m-w.com/dictionary/allowable (visited 25 May 2006).

[73] Merriam-Webster Online Dictionary, http://www.m-w.com/dictionary/permitted (visited 25 May 2006).

[74] See Virginian Hotel Corp. v. Helvering, 319 U.S. 523, 527 (1943) ("If the deductions are not challenged, they certainly are "allowed," since tax liability is then determined on the basis of the returns. Apart from contested cases, that is indeed the only way in which deductions are "allowed.").

[75] §1016(a)(2).

deduction, the reduction would equal allowable depreciation, for in no instance could the allowed deduction be higher.

C. Judicial Examination of "Allowed" and "Allowable"

The question of how the words "allowed" and "allowable" relate to each other was expressly presented to and decided by the Tax Court in Lenz v. Comr.[76] The taxpayers took the position that allowable deductions and allowed deductions are different concepts, whereas the IRS argued that these terms have the same meaning for purposes of section 163(d) even though they "may have different meanings in other contexts." The Court soundly rejected the IRS position:

> Throughout the Code, a distinction is made between the terms "allowable deduction" and "allowed deduction", which distinction is not insignificant. Day v. Heckler, 735 F.2d 779, 784 (4th Cir. 1984). Unfortunately, as with many terms of art in the area of tax law, these terms are often interchanged with one another, causing confusion. We must rely on the words of the statute as generally understood, and to do otherwise would be to redraft the statute. United States v. Locke, 471 U.S. 84, 95-96 (1985). "Allowed" and "allowable" have fixed meanings in the tax arena, and we interpret statutes using these terms in light of their understood meanings except where to do so would create absurd results. See United States v. American Trucking Associations, Inc., 310 U.S. 534, 542-543 (1940).
>
> "Allowable deduction" generally refers to a deduction which qualifies under a specific Code provision whereas "allowed deduction", on the other hand, refers to a deduction granted by the Internal Revenue Service which is actually taken on a return and will result in a reduction of the taxpayer's income tax. See Reinhardt v. Commissioner, 85 T.C. 511, 515-516 n.6 (1985); see also sec. 1.1016-3(a)(1)(i)(a), Income Tax Regs. Respondent in fact defined the terms "allowable" and "allowed" in I.T. 2944, XIV-2 C.B. 126 (1935), as follows:
>
> > The word "allowable" designates the amount permitted or granted by the statutes, as distinguished from the word "allowed" which refers to the deduction actually permitted or granted by the Bureau.
>
> Thus, one might have an item of expense which is allowable as a deduction; however, the deduction is not allowed. In Day v. Heckler, supra at 784, for example, it was noted that certain land clearing expenses were an "allowable deduction" under the Code; however, such deduction would not be "allowed" unless the taxpayer made an election to take such deduction.[77]

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[76] 101 T.C. 260 (1993).

[77] Id. at 265.

The analysis in Lenz has been followed by other courts. In Sharp v. United States,[78] the Court of Appeals for the Federal Circuit relied on a dictionary definition of "allowable" as "permissible: not forbidden or improper,"[79] noted that an item can be an allowable deduction even if it does not provide a tax benefit, and pointed to the reduction of adjusted basis by allowable depreciation regardless of whether the deduction was "actually taken."[80] In Flood v. United States,[81] the Court of Appeals for the Ninth Circuit quoted with approval the definition of "allowed deduction" set forth by the Tax Court in Lenz.[82]

What is important about Lenz is not simply the affirmation of the difference between "allowed" and "allowable" but the surprising attempt on the part of the IRS to argue that the two words had the same meaning within the context of section 163. It is this sort of advocacy that contributes to the confusion overshadowing the question of whether all deductions are mandatory.

In Reinhardt v. Comr.,[83] a case cited by Lenz, the taxpayers' tax liability under the since-repealed maximum tax on personal service income[84] was in issue. One of the elements in computing that limitation is personal service taxable income, defined as personal service income "reduced by any deductions allowable under section 62 which are properly allocable to or chargeable against such personal service income."[85] The taxpayers had received reimbursement for automobile expenses which was properly included in gross income and treated as personal service income. The taxpayers, though entitled to claim an offsetting deduction for automobile expenses, did not do so, and the IRS did not compel the taxpayers to claim that deduction. However, when computing the personal service income maximum tax, the IRS subtracted the automobile expense deduction. The taxpayers objected, arguing that "otherwise properly deductible expenses under sec. 1348 should be deducted only to the extent such expenses are allowed as deductions for the regular tax computation."[86] Though the taxpayers' argument made no sense to the extent that its acceptance by the court would increase, not decrease, their income tax liability, the court explained the taxpayers' analytical error as follows:

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[78] 14 F.3d 583 (Fed. Cir. 1993).

[79] Webster's Third New International Dictionary (1986).

[80] 14 F.3d at 587-88.

[81] 33 F.3d 1174 (9th Cir. 1994).

[82] Id. at 1178 n.5.

[83] 85 T.C. 511 (1985).

[84] §1348, as in effect before repeal by Pub. L. 97-34, §101(c)(1).

[85] §1348(b)(2) (flush language), as in effect before repeal by Pub. L. 97-34, §101(c)(1).

[86] 85 T.C. at 515, n. 6.

> While we do not see how it helps petitioners, they may be drawing a distinction between a deduction "allowed" and one "allowable." Sec. 1348(b)(2) provides in part that the term personal service net income means personal service income reduced by any deductions allowable under sec. 62 which are properly allocable to or chargeable against such personal service income. Whether the automobile expenses were allowed as a deduction on petitioners' return is not determinative of whether such expenses are allowable as a deduction under sec. 1348. See, for example, sec. 1016(a)(2) and sec. 1.1016-3(a)(1)(i), Income Tax Regs., regarding the definitional difference between allowed and allowable.

Unquestionably, the use by Congress of the term “allowable” rather than the term “allowed” in now-repealed section 1348(b)(2) demonstrates that the latter word does not mean the former, and that for there to be a difference there must exist allowable deductions that are not allowed because they are not claimed and thus not allowed. In fact, this is what occurred in Reinhardt. The taxpayers failed to claim a deduction allowable to them, and the IRS did not compel them to claim that deduction for purposes of computing their income tax liability, even though the IRS correctly subtracted the deduction in computing personal service net income for purposes of determining the limitation on the taxation of personal service income.

What is important about Reinhardt, and perhaps even more important about Lenz is the notion that allowed deductions do not include allowable deductions that do not reduce the taxpayer's income tax. In its simplest manifestation, this notion makes sense, for surely it is pointless to allow a deduction that leaves the taxpayer's tax liability unchanged or causes it to increase. Yet this notion, as so expressed, does not answer the question of whether a taxpayer may forego a deduction that would decrease tax liability in order to obtain some other benefit, for the taxpayer or some other person, because the requirement that it be “actually taken on a return” begs the question of whether the taxpayer is required to claim the deduction on the return.

IV. Lessons from How Unclaimed Depreciation Is Treated

Statutory distinctions between “allowable” depreciation deductions and “allowed” depreciation deductions support both an affirmative and a negative response to the question of whether deductions are mandatory. The support provided for the negative response is much stronger, though, than what can be gathered for the affirmative answer.

Section 167 provides that there “shall be allowed” a depreciation deduction, the computation of which is addressed by both that section and section 168. Section 1016 then provides that the adjusted basis of the depreciable property must be reduced by the allowed depreciation, but by no less than the allowable depreciation, a requirement designed to generate gain if the property is sold for an amount inconsistent with the property having decreased in value by as much as the depreciation would indicate.

The reduction in section 1016 is equivalent to the greater of allowed or allowable depreciation, which suggests not only that there can be allowed depreciation that exceeds allowable depreciation but also that there can be allowable depreciation that exceeds allowed depreciation.

If the phrase “shall be allowed” in section 167 means “must be claimed” then the distinction in the section 1016 reduction would not need to, and could not, exist.

It has been argued that in reducing adjusted basis by the amount of allowable depreciation, even if a lesser amount has been claimed and allowed, Congress created a disincentive for taxpayers to try preserving adjusted basis by omitting the depreciation deduction when claiming it would not provide a tax benefit.[87] Though this argument makes sense, it is nowhere as strong as it would be had Congress drafted section 1016 to require reduction of adjusted basis by the amount of allowable depreciation, plus any excess of improperly claimed and allowed depreciation in excess of allowable depreciation. That the section 1016 basis reduction rule reinforces the distinction between “allowed” and “allowable” cannot be denied, but whether it establishes a rule of mandatory deductions applicable not only to depreciation but all other deductions is highly questionable.

The reason this argument is questionable is found in the depreciation recapture provisions. By limiting depreciation recapture to allowed rather than allowable depreciation, Congress neutralizes the deterrent effect that the argument attributes to it. By permitting allowable but unallowed depreciation to escape ordinary income characterization under the depreciation recapture rules, Congress has acknowledged and implicitly approved the instances in which taxpayers fail to claim otherwise allowable depreciation deductions. That is not to discount the adverse impact on a taxpayer of reducing adjusted basis by the amount of allowable depreciation, even if it was not claimed,[88] but is intended to illustrate that the adverse impact is far less than what it could be if Congress wanted the strongest possible disincentive for failure to claim depreciation.

The attempt to rely on the distinction in the section 1016 basis reduction between allowed and allowable depreciation deductions to refute the argument deductions are mandatory also has been criticized because Congress allegedly was more concerned with “an allowable deduction that was not claimed” rather than “an allowable deduction that was not allowed.”[89] The statute, however, does not refer to allowable deductions that are not claimed but to allowable deductions that are not allowed. There is nothing in section 1016 to suggest that there can be unclaimed but allowed depreciation deductions.

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[87] Post by Jeffrey Killen to ABA-TAX listserv (Apr. 20, 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R55957&I=-3 (visited 31 July 2006).

[88] See Post by Jeffrey Killen to ABA-TAX listserv (Apr. 21, 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R62303&I=-3 (visited 31 July 2006).

[89] Post by Jeffrey Killen to ABA-TAX listserv (Apr. 20, 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R55957&I=-3 (visited 31 July 2006).

V. Seeking Guidance from Legislative History

It has been suggested that the legislative history accompanying the introduction of adjusted gross income into the federal income tax law admits of no conclusion other than that deductions are mandatory.[90] The Senate Finance Committee stated:

> Eleventh, the bill introduces a new concept, adjusted gross income. It is defined to mean gross income less business deductions, deductions attributable to rents and royalties, and losses treated as losses from the exchange or sale of property. In the case of an employee, adjusted gross income consists of gross wages or salary less expenses of travel or lodging in connection with his employment. It will be seen, therefor, that in general adjusted gross income means gross income less business deductions.[91]

This language, however, does nothing to answer the basic question because no adjective is used to modify the phrase "business deductions," the word "deductions" in the phrase "deductions attributable to rents and royalties," the word "losses," or the word "expenses." There is no more or less support for arguing that adjusted gross income means "gross income less allowable business deductions" than there is for arguing that adjusted gross income means "gross income less allowed business deductions." As has been explained, both "allowed" and "allowable" are used in section 62 to describe the deductions that are subtracted from gross income in order to compute adjusted gross income.

The Senate Finance Committee Report also explained:

> Fundamentally, the deductions...permitted to be made from gross income in arriving at adjusted gross income are those which are necessary to make as nearly equivalent as practicable the concept of adjusted gross income, when that concept is applied to different types of taxpayers deriving their income from varying sources...For example, in the case of an individual merchant...gross income under the law is gross receipts less cost of goods sold. Similarly, the gross income derived from rents and royalties is reduced by the deductions attributable thereto...in order that the resulting gross income will be on a parity with the income from interest and dividends in respect of which latter items no deductions are permitted in computing adjusted gross income...[92]

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[90] Post by Rod Goodwin to ABA-TAX listserv (Apr. 19, 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R45427&I=-3 (visited 31 July 2006).

[91] S. Rep. 885, 78th Cong., 2d Sess. , 1944 C.B. 858, at 859 (1944).

[92] Id. at 877-878.

Yet again the language does little, if anything, to resolve the question of whether deductions are mandatory. On the one hand, a phrase such as "the deductions ... permitted to be made" suggests that deductions are permissible but not mandatory. On the other hand, a phrases such as "gross income from rents and royalties is reduced by the deductions" suggests that the reduction takes place, though the absence of an adjective such as "allowed" or "allowable" to modify the word deductions leaves that phrase no more useful than its counterpart in the first quotation from the Senate Finance Committee report. To the extent "gross income under the law is gross receipts less cost of goods sold" is advanced as determinative, the weakness of this language is that it does not address deductions. Cost of goods sold is a reduction in the process of computing gross income, and thus whatever gloss one wishes to put on the words "is ... less" loses its shine when it is transferred to the world of deductions. If anything, Congress used the words "less" and "reduced" and not the verb "deduct" when referring to these reductions, thus highlighting the difference between a reduction and a deduction.

VI. The Significance of Deductions Requiring an Election

Determining whether deductions are mandatory is further complicated by the existence of Internal Revenue Code provisions that require a taxpayer election as a prerequisite to taking the deduction. Even if the taxpayer satisfies all of the other requirements for the deduction, a taxpayer can choose to ignore the election and thus forego the deduction.

For example, section 179 permits the taxpayer to elect to deduct some or all of the cost of eligible property in the year of its acquisition, in an amount higher than would be deducted using the standard depreciation deduction.[93] Similar elections exist for the cost of pollution control facilities,[94] the cost of certain refinery property,[95] the cost of qualified film and television productions,[96] expenditures for the removal of architectural and transportation barriers,[97] reforestation expenditures,[98] start-up expenditures,[99] environmental remediation costs,[100] corporate organizational expenditures,[101] partnership organization and syndication fees,[102] and a

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[93] §179(a), (c).

[94] §169(a), (b).

[95] §179C(a), (b).

[96] §181(a), (c).

[97] §190(a).

[98] §194(a).

[99] §195(b).

[100] §198(a).

[101] §248(a).

variety of other items a full listing of which is not necessary to demonstrate the point. Individual taxpayers deduct itemized deductions if they elect to do so.[103]

The existence of these “by election” deduction provisions suggests that because Congress has provided that for certain deductions taxpayers may choose to elect the deduction or ignore it, the necessary inference is that for any other deduction the taxpayer has no such choice. The degree to which this logical interpretation should dictate the answer to the question depends in part on the purpose of Congress in requiring an election by the taxpayer for these selected deductions.

The election that Congress requires for these selected deductions is more than an expression of choice. In every instance, there are specific instructions, provided either in the statute or in IRS guidance issued pursuant to statutory authorization, that demand a litany of information from the taxpayer. For example, the section179 expensing election requires the taxpayer to identify the items of property to which the election applies. This sort of requirement permits the IRS to determine if the taxpayer's other deductions affected by the expenditure subject to the election have been properly computed. In other words, these deductions are of such a nature that it is insufficient for a taxpayer merely to claim them without providing additional information with respect to the specific expenditures that are within the deduction. For deductions not tagged with an election provision, omitting the deduction from the tax return does not implicate other deductions or create a need for additional information.

Thus, the logical inference that the existence of deductions tagged with election provisions means that all other deductions are mandatory is completely counter-balanced by the logical inference that election provisions are tagged to those deductions claiming of which would leave IRS verification of the taxpayer's computation of other deductions difficult or even impossible. This inference is buttressed by the other conditions that attach to the election provisions. Each election provision contains language that directs the IRS to specify the time, manner, and place for making the election. These requirements are consistent with the notion that the purpose of the election is to give a platform for IRS collection of relevant information rather than to imply that all other deductions are mandatory.

Tipping the balance in favor of treating elections as informational platforms rather than as indirect imposition of a mandatory character on other deductions is unavoidable when the significance of the terms “allowed” and “allowable” are re-visited. If deductions without election provisions are mandatory, then the distinction between allowed and allowable would need to be restricted to those deductions. Thus, for example, one would refer to allowable section 179 deductions, the maximum available to the taxpayer, and allowed section 179 deductions, the amount actually claimed, but use of allowed or allowable with respect to section 168 deductions would make no sense because under the mandatory deduction approach those deductions would be required. Yet the distinction in section 1016 between allowed and allowable when computing the reduction in adjusted basis on account of depreciation, and the distinctions in the depreciation

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[102] §709(b).

[103] §63(e)(1).

recapture provisions between allowable and allowed depreciation, do not differentiate between section 179 and section 168 deductions. When given the opportunity to treat allegedly mandatory and voluntary deductions differently, Congress passed it up.

A closer look at the election to itemize deductions strengthens the argument that existence of the election does not resolve the question, and can be viewed as support for the conclusion that deductions are not mandatory. The analysis begins with section 63(a) which provides, "Except as provided in subsection (b), ... the term 'taxable income' means gross income minus the deductions allowed by this chapter (other than the standard deduction)."[104] The exception in (b) applies to any "individual who does not elect to itemize his deductions for the taxable year" and provides that in this situation, "the term 'taxable income' means adjusted gross income, minus (1) the standard deduction, and (2) the deduction for personal exemptions..."[105] Accordingly, there are two definitions of taxable income, one for taxpayers who do not elect to itemize their deductions and one for taxpayers who do so elect.

The statutory language for the election of itemized deductions is in the inverse: "Unless an individual makes an election under this subsection for the taxable year, no itemized deduction shall be allowed for the taxable year."[106] The language does not specify that if the election is made, all itemized deductions must be claimed. It simply makes the election a prerequisite for claiming itemized deductions. Itemized deductions, in turn, are defined as "the deductions allowable under this chapter other than (1) the deductions allowable in arriving at adjusted gross income, and (2) the deduction for personal exemptions..."[107] Itemized deductions, therefore, are certain allowable deductions, but not necessarily allowed deductions.

Translated, these statutory provisions inform taxpayers that a portion of allowable deductions is separated into a group called itemized deductions. No deduction may be claimed for an allowable itemized deduction unless the taxpayer makes the itemized deduction election. If the taxpayer does so, the taxpayer is free to deduct an itemized deduction, but the taxpayer is not required by this language to deduct all allowable itemized deductions. If the taxpayer were required to deduct all allowable itemized deductions once the election were made, the language would provide that "An individual who makes an election under this subsection for the taxable year must deduct all otherwise allowable itemized deductions." Although the language of section 63(d) does not specifically state that deductions are not mandatory, neither does the election it describes specifically make deductions mandatory.

VII. The Depth of Legislative Grace

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[104] §63(a).

[105] §63(b).

[106] §63(e)(1).

[107] §63(d).

The maxim delivered by the Supreme Court decades ago, that deductions are a matter of "legislative grace"[108] has been repeated by that Court and others close to two thousand times.[109] Using the word "grace" to describe the legislative attitude underlying deductions is inconsistent with the notion that deductions are mandatory. Grace in this context means favor, privilege, or reprieve,[110] all of which are acts that can be offered and rejected. Even from a theological perspective, many religious denominations do not consider grace as a mandatory blessing but as a gift that can be rejected.[111]

Undeniably, many deductions are enacted by Congress as tax incentives, designed to encourage taxpayers to engage in particular activities or in some instances to refrain from specified activities.[112] Although some taxpayers engage in activities that would not otherwise get their attention but for the tax deduction carrot dangled before them, other taxpayers would engage in those activities even if no deduction was available, because they have other reasons to pursue those activities.[113] It defies the logic of tax incentives to insist that a taxpayer claim a deduction for engaging in an activity because the tax deduction is not necessarily the aim of the taxpayer. In other words, offering a reward might trigger a desired result, but it is nonsensical to interpret deduction provisions as demanding the acceptance of the reward.

The legislative grace analysis does not persuade everyone. One commentator concluded that "While deductions are a matter of legislative grace, the language of the code does not seem to

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[108] New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934).

[109] E.g., INDOPCO, Inc. v. Comr., 503 U.S. 79, 84 (1992); Interstate Transit Lines v. Comr., 319 U.S. 590, 593 (1943); Deputy v. DuPont, 308 U.S. 488, 493 (1940).

[110] Merriam-Webster Online Dictionary, http://www.m-w.com/dictionary/grace (visited 25 May 2006).

[111] E.g., Catechism of the Catholic Church, Article 2, II, 2003, http://www.vatican.va/archive/catechism/p3s1c3a2.htm#II (visited 1 June 2006) ("Grace is first and foremost the gift of the Spirit..."); The Catechism on the End Times, part 2, paragraph 679, http://www.ewtn.com/devotionals/mercy/catechism.htm (visited 1 June 2006) ("By rejecting grace in this life, one already judges oneself..."). Lutheran Book of Concord, Free Will, or Human Powers, item 83, http://www.bookofconcord.org/fc-sd/freewill.htm (visited 1 June 2006) (grace can be accepted); The Larger Catechism, Presbyterian Church (USA), 7.178, Q&A 68, http://www.pcusa.org/oga/publications/boc.pdf (visited 1 June 2006) ("willful neglect and contempt of the grace offered to them...").

[112] See Martin A. Sullivan, "Economic Analysis: Tax Incentives and Economists," 111 Tax Notes 20 (2006).

[113] See Christopher Bergin, "What's the Incentive for Scrapping Incentives," 111 Tax Notes 85 (2006) ("Why pay someone to do something they should be doing anyway?")

make claiming a deduction optional."[114] He reached this conclusion by treating the word "shall" in section 63 as "not may." However, as previously explained, the meaning of "shall" does nothing to prove that the word "allowed" means "claimed" rather than "accepted if claimed." In other words, the language of the code does not make deductions a matter of legislative command.

VIII. Lessons from Specific Instances Involving Foregone Deductions

A. Dependency Exemption Deductions

Although the Congress, both in its legislative drafting and its committee reports, offers little in the way of unassailable authority on the question of whether deductions are mandatory, the IRS speaks volumes when it interprets the dependency exemption deduction. Recall that section 151(a) provides that "[i]n the case of an individual, the exemptions provided by this section shall be allowed as deductions in computing taxable income." If the "deductions are mandatory" interpretation of the phrase "shall be allowed" is accepted as conclusive, the personal and dependency exemption deductions are mandatory. Yet that is not how the IRS has treated these deductions. Though the IRS could be wrong, its position in this respect is predictive of its position on the question generally.

One instance in which the question is significant is the section 25A Hope Scholarship[115] and Lifetime Learning credits,[116] which cannot be claimed by a taxpayer with respect to whom a section 151 dependency exemption deduction is allowed to another taxpayer.[117] If the value of the credit to the dependent outweighs the value of the dependency exemption deduction to the other taxpayer, the other taxpayer has incentive to forego the dependency exemption deduction. An obvious instance in which this incentive would exist is the other taxpayer having adjusted gross income so high that his or her exemption deductions would be phased down to zero under section 151(d)(3).

If all deductions that "shall be allowed" are mandatory, the taxpayer entitled to the dependency exemption deduction would be required to claim it, and the dependent would be foreclosed from claiming the section 25A credits. That result, however, is inconsistent with the drafting of section 25A(g)(3). If Congress intended to preclude all dependents from claiming the section 25A credit, it would have used the word "allowable" in section 25A(g)(3), namely, "If a deduction under section 151 with respect to an individual is allowable to another taxpayer .... no credit shall be allowed under subsection (a) to such individual...." Evidence that Congress can use the word "allowable" when it so chooses is found in section 151(d)(2), which states: "In the case of an

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[114] Kris Hill, "In AMT? Even the Capital Gains Rate May Be Higher For You," 103 Tax Notes 119, 121 (2004).

[115] §25A(a)(1), (b).

[116] §25A(a)(2), (c).

[117] §25A(g)(3)(A).

individual with respect to whom a deduction under this section is allowable to another taxpayer ... the exemption amount applicable to such individual ... shall be zero." In other words, a parent who chooses not to claim a dependency exemption deduction for a dependent child cannot, by doing so, change the child's zero personal exemption amount to anything other than zero. If Congress wanted that choice to be available it would have used the word "allowed" rather than "allowable" in section 151(d)(2).

Both section 25A(g)(2) and section 151(d)(2) reflect the existence of situations in which taxpayers choose to ignore a dependency exemption deduction. Neither provision insists that the taxpayer take the deduction that section 151(a) says "shall be allowed." Instead, section 25A(g)(3) describes what happens if the section 151 deduction is foregone.

The IRS addressed this precise situation in PLR 200236001. The parents chose to forego the dependency exemption deduction allowable to them with respect to one of their children. Even though the amount of that child's personal exemption remained zero, that child was permitted to take the section 25A credit because no section 151 dependency exemption deduction had been allowed to the parents with respect to that child. The IRS concluded that the deduction was not an allowed deduction because the parents did not claim it, putting the IRS, in this instance, on the side of those who argue that a deduction must be claimed in order to be allowed, and that failure to claim a deduction pulls it out of the category of "allowed" deductions. The IRS explained:

> Congress deliberately chose the "allowed" standard for the education tax credit because that standard permits more flexibility to a family than does the "allowable" standard found in §151. See H. Rep. 105-148, 105 Cong., 1st Sess., 1997-4 C.B. (Vol. 1) 319, 639-640. That flexibility is illustrated by the facts of this case. Although neither the taxpayer nor his parents could derive any tax benefit from the operation of the §151 rules, his modified AGI was low enough that he — although not his parents — could derive some tax benefit from the education tax credit. The intra-family allocation of the credit to the taxpayer — which the parents achieved by not claiming him as a dependent — conferred a tax advantage upon the family as a whole, in a manner consistent with Congressional intent.

The flexibility to which the IRS refers is the ability of a taxpayer to forego claiming an allowable deduction in instances in which the word "allowed" is used to describe the deduction. At no point in its analysis did the IRS take the position that the words "shall be allowed" in section 151(a) precluded the parents from foregoing the deduction.

B. Section 183 Not-for-Profit Activities

The IRS also contributes important guidance to the effect of foregoing deductions in its regulations interpreting section 183(d). Under section 183(d), an activity is presumed to be an activity engaged in for profit, and thus unaffected by the prohibition in section 183(a) on the deduction of expenses attributable to activities not engaged in for profit, if the gross income derived from the activity exceeds "the deductions attributable to such activity" for three or more of the five taxable years ending with the taxable year for which the determination is made.[118] There is a more generous provision of two years out of seven, rather than three out of five, that applies to certain horse-related activities,[119] but that difference does not affect the analysis related to the question of whether deductions are mandatory.

As explained in II, E, above, section 183(d) provides an incentive for a taxpayer to forego deductions in order to fit within the for-profit presumption. Thus, a taxpayer whose activity has shown a profit in two of the preceding four years and losses in the other two needs to show a profit in the current, fifth year in order to avoid retroactive denial of the losses deducted in the two previous loss-generating years. Foregoing some deductions in order to show a profit would make sense if the tax savings from those losses exceeds the tax benefits of the foregone deductions.

Section 183(d) does not address the question of whether deductions can be ignored for this purposes. The statute simply states, parenthetically, that in determining whether gross income from the activity exceeds deductions, the deductions are to be “determined without regard to whether or not such activity is engaged in for profit.” That parenthetical language is necessary to prevent a loop of reasoning, but it does not define “deductions” in any other way.

In regulations, the IRS clarifies the statute by setting forth the presumption in the following terms: “If for ... [a]ny two of five consecutive taxable years ... the gross income derived from an activity exceeds the deductions attributable to such activity which would be allowed or allowable if the activity were engaged in for profit, such activity is presumed ... to be engaged in for profit.”[120] By using the phrase “allowed or allowable” the IRS, in effect, has accepted the existence of allowable deductions that are not claimed, and thus not allowed. If the word “allowed” means what the “deductions are mandatory” proponents contend, the regulation could have been written as follows: “If for ... [a]ny two of five consecutive taxable years ... the gross income derived from an activity exceeds the deductions attributable to such activity which would be allowed if the activity were engaged in for profit, such activity is presumed ... to be engaged in for profit.” The fact that the word “allowable” is joined with “allowed” reinforces not only the point that the two words have different meanings but also the view that there can exist deductions that are allowable but not allowed, namely, that there can be foregone deductions. Of course, in this instance the IRS takes the position that foregone deductions nonetheless are taken into account in determining whether there is an excess of gross income over deductions that would trigger the for-profit presumption. In other words, the taxpayer is free to ignore the deductions, but that won’t give the taxpayer any section 183(d) advantage.

This specific issue reached the Tax Court in Dyer v. Comr.,[121] involving taxpayers who failed to

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[118] §183(d).

[119] Id. (last sentence).

[120] Regs. §1.183-1(c)((1).

[121] 47 T.C.M. 17 (1983).

deduct real property taxes and insurance with respect to an activity in order to make the activity show a profit so that challenges to the alleged for-profit status of the activity could be forestalled. The court noted that "[c]reation of such an artificial profit tends to adversely influence the question of profit motive."[122] Significantly, the taxpayer was not required to deduct the otherwise deductible expenses but simply denied for-profit status, thus precluding the portion of the deductions that exceeded gross income from the activity. The court cited one case,[123] but that case involved deductions which the taxpayers tried to shift to a different taxable year without giving up their claim to the deduction. That case, therefore, adds nothing to the analysis.

C. The Bad Debt Deduction

Section 166 states that "there shall be allowed as a deduction any debt which becomes worthless during the taxable year."[124] In James A. Messer Co. v. Comr.,[125] the Tax Court explained that "a taxpayer who fails to deduct a bad debt in the year in which it becomes wholly worthless loses the deduction."[126] The court relied on the principle that a taxpayer may not shift a deduction that the taxpayer wishes to claim from the year for which it is allowable to a later year,[127] but concluded that by ordering its affairs with respect to the debt so that the worthlessness occurred in a year of the taxpayer's choosing the taxpayer was gaining a tax advantage "not to be equated with tax evasion"[128] where other factors also favored the timing of the taxpayer's actions in seeking foreclosure on the property securing the debt.
The court's description of a failure to claim a deduction is not that the taxpayer is compelled to file an amended return or otherwise to make the claim, but simply that the deduction is lost. Such an outcome is inconsistent with the concept of mandatory deduction, and not only was the argument that "shall be allowed," which appears in section 166, means "must be claimed" not presented to, or discussed by, the court, that language did not preclude the court's description of an unclaimed deduction as one that the taxpayer loses.

D. Prior Law Income Averaging

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122 Id. at ___, n.6.

123 Brown v. Comr., 36 T.C.M. 77 (1977).

124 §166(a).

125 57 T.C. 848

126 Id. at 860.

127 See Denver & Rio Grande Western R.R. Co. v. Comr., 32 T.C. 43 (1959), aff'd, 279 F.2d 368 (10th Cir. 1960).

128 57 T.C. at 862,

Under the income averaging method of tax computation that was repealed in 1986,[129] the taxpayer's taxable income for each of the three taxable years preceding the taxable year for which income averaging was applied was part of the income averaging computation.[130] In Lynch v. Comr.,[131] the taxpayers argued that they were entitled to use income averaging even though they could not produce a copy of their federal income tax return for one of the three taxable years preceding the year in issue. The court accepted the taxpayers' testimony that they searched unsuccessfully for the return, and that the accountant who prepared it was dead. The taxpayers produced evidence of their income, which was corroborated by evidence produced by the employer. The taxpayers, on brief, "stated that they were willing to forego the personal exemptions and any other deductions for 1968 to which they may be entitled for the purpose of income averaging."[132] The court accepted the taxpayers' testimony and evidence, and ignored all deductions in determining the taxpayers' taxable income for purpose of the income averaging computation.

It is significant that the taxpayers were not required to claim any deductions, and that their taxable income was computed without regard to any deductions. There were no provisions in the former income averaging rules specifically defining taxable income for income averaging purposes in a manner different from how it is defined generally. If deductions are mandatory, the waiver by the taxpayers in Lynch of their deductions should have been rejected. It wasn't. That the taxpayers in Lynch were permitted to forego the personal exemption deduction, despite the "shall be allowed" language in section 151, was consistent with the conclusion reached in VIII, A, above, that "shall be allowed" does not preclude taxpayer failure to claim that, or any other, deduction barring a specific provision to the contrary.

E. Prior Law Exception to Charitable Contribution Deduction Limitation

Under a long-since repealed provision in section 170, certain taxpayers were permitted to ignore the then-in-effect 20-percent-of-adjusted-gross-income and 10-percent-of-adjusted-gross-income limitations[133] applicable to the charitable contribution deduction.[134] A taxpayer qualified for this unlimited charitable contribution deduction if, for the taxable year in question and for eight of the ten preceding taxable years, the sum of the taxpayer's charitable contributions plus the income taxes paid by the taxpayer exceeded 90 percent of the taxpayer's taxable income for the year.[135]

[129] See §1301 as in effect before repeal by Pub. L. 99-514, §141(a).

[130] See §§1301, 1302 as in effect before repeal by Pub. L. 99-514, §141(a).

[131] 45 T.C.M. 1125 (1983).

[132] Id. at ____.

[133] §170(b)(1)(A), (B) (as in effect before amendment by Pub. L. 91-172, §201(a)(1)).

[134] §170(b)(1)(C) (as in effect before repeal by Pub. L. 94-455, §1901(a)(28)).

[135] Id.

In Rev. Rul. 67-460,[136] the IRS considered a situation in which a taxpayer, by disregarding a portion of the charitable contributions, would cause income tax liability to increase, thus making the sum of income taxes plus charitable contributions greater than 90 percent of taxable income. The IRS concluded that for purposes of determining if the 90 percent test was met, all of the taxpayer's charitable contributions must be taken into account in computing income taxes paid. In GCM 33522, the IRS explained that nothing in section 170 authorized the taxpayer to deduct only a portion of charitable contributions when determining total income taxes paid for purposes of the 90 percent test, and that doing so would create, in effect, an intermediate deduction limitation that does not exist in section 170.

From the General Counsel Memorandum's careful explanation of the facts and the language used in the ruling as it progressed through the IRS, some insight is available. If the taxpayer's income tax was computed after limiting charitable contributions to 30 percent of adjusted gross income, the sum of the income tax and the total contributions exceeded 90 percent of taxable income. However, this qualified the taxpayer for the unlimited charitable contribution, which reduced the taxpayer's income tax liability to the point where it, when added to total charitable contributions, no longer exceeded 90 percent of taxable income. Put simply, there was an algebraic flaw in the statute.

In December of 1965, the IRS issued a ruling letter, concluding that if the taxpayer computed tax liability by deducting all otherwise qualified charitable contributions, and failed to meet the 90 percent test, the charitable contribution deduction would be subject to the combined 30-percent-of-adjusted-gross-income limitation. The flaw was demonstrated by the impact of imposing the combined 30-percent-of-adjusted-gross-income limitation, namely, income tax liability could increase to the point where, when added to total charitable contributions, it exceeded 90 percent of taxable income. The ruling letter stated that there is no statutory authority in section 170 to deduct only the portion of total charitable contributions that would generate a tax that, when added to total charitable contributions, would exceed 90 percent of taxable income.

The Office of IRS Chief Counsel concurred in the ruling letter, and the Interpretative Division informally concurred on October 21, 1966, in the language of a proposed publication on the issue covered by the private ruling letter, even though a proposed General Counsel Memorandum on the issue had not been issued because of the deadline for the ruling letter. The proposed publication was not approved at the Assistant Commissioner's Briefing Session held on October 27, 1966, and the proposed publication was redrafted. When the revision was submitted to the Interpretative Division in January of 1967, it identified a possible conflict between the second paragraph of the proposed publication and the private ruling letter issued in December of 1965 to the taxpayer. The proposed second paragraph stated:

> The 90 percent requirement, in the year for which the unlimited charitable contribution deduction may be allowable, must be met after applying the unlimited charitable contribution deduction in computing the income tax liability

[136] 1967-2 C.B. 123.

> for such taxable year. Furthermore, the amount of the charitable contributions used in determining whether the 90 percent requirement is met must be the same amount used as the unlimited charitable contribution deduction in computing the income tax liability.

The Interpretative Division thought that this language would "convey the impression" that the amount of charitable contributions used to determine income tax liability and to determine if the 90 percent test was met need not be the actual total charitable contributions but merely the same number. It was the disagreement between the ruling branch and the Interpretative Division that brought the matter to Chief Counsel.

Chief Counsel explained that its concurrence in the December 1965 letter ruling was based on its conclusion that there was no statutory authority in section 170 to compute the 90 percent test using only a selected portion of the charitable contributions. The General Counsel Memorandum then set forth a second reason for rejecting the use of only a portion of the charitable contributions in determining if the 90 percent test was met:

> Even if it were assumed that taxpayer could qualify for the unlimited deduction (which we could not do, in the face of the express statutory provisions referred to) we still could not condone the practice of understating the allowable charitable contributions deduction, or any other deduction item, in order to increase taxpayer's tax liability, so as to enable him to claim the unlimited charitable contributions deduction. We know of no precedents, and taxpayer cited none, establishing that a taxpayer may intentionally understate a deduction item in reporting his tax liability for the purpose of gaining a tax advantage. In fact, the only authority found supports the opposite conclusion. See Rev. Rul. 56-407, C.B. 1956-2, 564 to the effect that an individual may not understate his allowable deductions in order to increase his net earnings from self employment (which would in turn entitle him to larger social security benefits upon his retirement than he would otherwise receive had he reported his correct liability).

G.C.M. 33522 then recommended the inclusion of the following language in the proposed revenue ruling:

> In a taxable year for which the unlimited charitable contribution deduction is claimed, the full amount of the taxpayer's charitable contributions must be taken into account in computing his income tax liability as well as in determining whether the 90 percent requirement has been met.

However, when issued, Rev. Rul. 67-460 used different language:

> [I]n a taxable year for which the taxpayer seeks to qualify for the unlimited charitable contribution deduction, in determining whether the 90 percent requirement has been met, the full amount of the taxpayer's charitable contributions must be taken into account in computing his income tax liability. It

> is not permissible in such computations to take into account only a portion of the actual charitable contributions (whether or not such portion is more or less than 30 percent of adjusted gross income) for the purpose of increasing the income tax liability thus computed, and thereby qualifying for the unlimited charitable contribution deduction.

The impact of G.C.M. 33522 and Rev. Rul. 67-460 on the broader issue of whether all deductions are mandatory or whether only certain deductions, for specific purposes, are mandatory, is at best, confusing. Though obsolete, because they deal with computation of a limitation no longer in the Code, the Memorandum and the ruling present their own peculiar interpretative challenges.

It is essential to note that despite language in G.C.M. 33522 suggesting that no deduction, not just charitable contributions, could be understated, the language proposed by the Memorandum and the language used in the Rev. Rul. 57-460 does not address the amount of any deduction other than the charitable contribution deduction. Something, not disclosed in G.C.M. 33522, modified the analysis between the broad statement about deductions generally and the much more narrow proposed language. It is not unreasonable to surmise that a statement opining that no deduction may be ignored was recognized as inconsistent with the existence of deductions, such as the dependency exemption deduction discussed in VIII, A, above, which Congress and the IRS contemplate taxpayers may choose to forego.

It is also essential to consider carefully the limited scope of Rev. Rul. 67-460. Its requirement that the full amount of the charitable contributions deduction be taken into account applies "in determining whether the 90 percent requirement has been met." This is very different from the language proposed in G.C.M. 33522, which specifically would have required use of the full amount of the taxpayer's charitable contributions "in computing his income tax liability as well as in determining whether the 90 percent requirement has been met." So not only did undisclosed analysis water down G.C.M. 33522 from its wide-open assertion that all deductions must be claimed to a focus only on charitable contribution deductions, the same, or other, undisclosed analysis further watered down the Memorandum from requiring use of all charitable contribution deductions in computing both taxable income and the 90 percent test, to a revenue ruling that required full use of charitable contribution deductions only in computing taxable income for purposes of the 90 percent test. Theoretically, therefore, a taxpayer could then proceed to accept denial of the unlimited charitable contribution deduction and claim no charitable contribution deduction on the return.

It is likely that what happened is awareness by those involved of the dangers posed when using a revenue ruling focused on a narrow issue to proclaim a universal rule of tax law. Perhaps someone did point out that taxpayers ignore deductions, and that all the IRS need assert was the requirement that all charitable contribution deductions be used in determining if the 90 percent test was met. That the likelihood that this is how the scenario played out is reinforced by an understanding of what the IRS confronted. A taxpayer had demonstrated the existence of an algebraic circle in the application of the 90 percent test, and the IRS chose a reasonable, and perhaps the most plausible way, of breaking the impasse. Though the private ruling and the proposed, but rejected, public ruling seemed only to require consistency, G.C.M. 33522 and Rev. Rul. 67-460 ultimately required consistent use of the full charitable contribution deduction in resolving the computational deadlock inherent in the badly-drafted, and fortunately repealed, unlimited charitable contribution 90 percent test.

The legacy of G.C.M. 33522 is this sentence: “We know of no precedents, and taxpayer cited none, establishing that a taxpayer may intentionally understate a deduction item in reporting his tax liability for the purpose of gaining a tax advantage.” That the taxpayer did not cite any is not surprising, for surely the taxpayer approached the issue as a narrow one analyzing a specific sub-paragraph of section 170. That the IRS Chief Counsel’s Office did not identify any precedents suggests that a quick scan of regulations and rulings did not turn up any useful information. How the Bureau of Internal Revenue pronouncement on the difference between allowed and allowable, discussed in III, B, above, and venerable even in 1967, escaped notice and discussion is a puzzle. Almost all of the other authority that bears on the question of whether deductions are mandatory had not yet appeared when Rev. Rul. 67-460 was winding its way through bureaucratic review.

Nonetheless, the significance to be accorded the problematic sentence in G.C.M. 33522 must be diminished because it antedates subsequent contrary authority, because the IRS itself has subsequently accepted the concept of allowable deductions unclaimed in order to obtain tax benefits such as the education credit, because it constitutes dictum, because it did not make its way into Rev. Rul. 67-460 nor into the Memorandum’s ultimate recommendation, and because a General Counsel Memorandum is not binding authority but simply the opinion of an attorney. Worse, G.C.M. 33522 never addressed the “allowed” versus “allowable” issue that had been the subject of analysis by its predecessor Bureau and by several courts, an omission consistent with the bizarre argument raised by the IRS in Lenz, as discussed in III, C, above, that the two words have the same meaning. Perhaps IRS thinking several decades ago had not yet evolved to where it is now, open to the idea, as described in VIII, A, above, that there is no object to taxpayers failing to claim an allowable deduction in order to obtain a tax benefit.

In the final analysis, Rev. Rul. 67-460 and G.C.M. 33522 do not resolve the question. Nor are they inconsistent with the position that only certain deductions, for specific purposes, are mandatory. Were the unlimited charitable contribution deduction still in the tax law, Rev. Rul, 67-460 and G.C.M. 33522 simply would be illustrators of one more item on what is a very short list.

IX. Lessons from the Self-Employment Tax

A. Computing Self-Employment Income

Other than the attempt to construe “shall be allowed” as meaning “must be claimed,” proponents of the “deductions are mandatory” view find their strongest support in the treatment of deductions for purposes of computing the self-employment tax.[137] The analysis involves two decades-old revenue rulings, a Chief Counsel Advice Memoranda, and a case.

[137] §1402(a).

In Rev. Rul. 56-407,[138] the IRS stated, simply:

> The question has been presented whether taxpayers may disregard depreciation and other allowable deductions in computing net earnings from self-employment for self-employment tax purposes. Held, under section 1402(a) of the Self-Employment Contributions Act of 1954 (chapter 2, subtitle A, Internal Revenue Code of 1954), as amended, every taxpayer, with the exception of certain farm operators, must claim all of his allowable deductions, including depreciation, in computing his net earnings from self-employment for self-employment tax purposes.

After describing how certain farm operators must deal with deductions in light of the optional method of computation available to them, and noting that certain partnerships may qualify for the optional farm operator computation, the IRS stated, in what appears to be its reasoning: "Section 208 of the Social Security Act, as amended, provides penalties for a person who makes any false statement or representation in connection with any matter arising under the Self-Employment Contributions Act of 1954, for the purpose of obtaining or increasing benefits under the Social Security Act."

What the IRS did not state is that failure to claim allowable deductions increases self-employment income, which in turn increases social security benefits because, within limits, a person's social security benefits are higher if his or her covered income, including self-employment income, is higher.[139] The IRS relied on a specific statute that precludes a taxpayer from foregoing deductions for the specific purpose of increasing social security benefits. This is, however, only one of the many reasons for foregoing deductions that are described in II, above, and does not address the foregoing of deductions for any other purpose.

B. Shifting Deductions for Purposes of Self-Employment Income Computation

The IRS followed up Rev. Rul. 56-407 with another revenue ruling, in which it concluded that a taxpayer could not increase self-employment income by having his wife pay his business expenses.[140] This revenue ruling, however, does not address deductions that the taxpayer was giving up, but deductions that the taxpayer was trying to shift to another taxpayer. It is one thing to debate whether a taxpayer must claim all allowable deductions, but it is a very different question to ask if a taxpayer may shift deductions to another taxpayer. The answer to the latter question is sufficiently settled in the negative to make extensive discussion redundant. That answer also does nothing to inform the answer to the first question.

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[138] 1956-2 C.B. 564.

[139] See Social Security Administration, Retirement Planner, http://www.ssa.gov/r&m6.htm (visited 31 July 2006) ("Higher lifetime earnings result in higher benefits").

[140] Rev. Rul. 57-538, 1957-2 C.B. 55.

C. Computation of Social Security Benefits

Almost thirty years later, the question surfaced in litigation over denial of social security benefits by the Secretary of Health and Human Resources (HHS), which removed quarters of coverage from the taxpayer's earnings record, thus reducing the amount of her benefits.[141] The applicable HHS regulation, paralleling section 1402, defined net earnings from self-employment, used in the calculation of benefits, as "Your gross income, as figured under subtitle A of the Code, from any trade or business you carried on, less deductions attributed to your trade or business that are allowed by that subtitle." HHS argued that for purposes of computing social security benefits, "all deductions allowed by the tax code must be included when calculating net income -- regardless of whether, for tax purposes, such deductions were in fact taken by a claimant."

Because when HHS acts on its own to remove quarters of coverage from a claimant's earnings record it has the burden of proving it acted correctly, the court noted that the interpretation placed by HHS on the applicable HHS regulation, put "an extraordinary and onerous responsibility on the Social Security Administration" because it requires HHS to be "a tax expert" in identifying "deductions which are not taken by a claimant [but] nevertheless ... included when computing net income if they are 'allowed' by the Code" and "improper tax deductions" taken by the claimant but not permitted under the tax law. Though the court expressed reluctance to agree with an HHS regulation that it considered to be "based on the dubious premise that there is one objectively correct and identifiable set of deductions that apply to a claimant in any given year," it accepted the HHS interpretation of the regulation and turned to the question of whether HHS had properly applied its interpretation to the facts.

The Court concluded that HHS erroneously treated as deductions land clearing expenses that the taxpayer could have deducted had she elected to deduct them under section 182 but which she had not elected to deduct and that absent the election the deductions were not "allowed" to the taxpayer. To the HHS assertion that the deduction was "allowable" and thus should be taken into account in computing self-employment income, the court responded with the observation on which the court in Lenz relied, as described in III, C, above, namely, "The distinction between an 'allowable' deduction and an 'allowed' deduction is not insignificant." Ultimately, though, the court, by dealing with deductions that are allowed only if there is a taxpayer election, did not address the more difficult question of whether a taxpayer can ignore deductions not the subject of an election. In other words, the court did not approve or disapprove Rev. Rul. 56-407, which, surprisingly, was not cited or mentioned. That, however, simply could be a consequence of the fact IRS lawyers did not argue the case for HHS.

D. The Earned Income Tax Credit Cross-Reference

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[141] Day v. Heckler, 735 F.2d 779 (4th Cir. 1984).

Decades after Rev. Rul. 56-407 was issued by the IRS, the Chief Counsel to the IRS, in CCA 200022051, applied the conclusion in Rev. Rul. 56-407 to the determination of a taxpayer's earned income for purposes of the earned income tax credit.[142] Because section 32(c)(2), which defines earned income for purposes of the earned income tax credit, specifically incorporates by reference section 1402(a), the interpretation advanced by the IRS in Rev. Rul. 56-407 for purposes of section 1402(a) applies with equal force to section 32(c)(2). The same approach would apply to the two other income tax provisions that specifically incorporate by reference section 1402(a), the one that defines earned income for the purposes of determining if a self-employed individual is an employee for purposes of determining if a trust is a qualified retirement plan trust,[143] and the one that defines earned income for purposes of determining a self-employed individual's compensation for purposes of determining eligibility for simple retirement accounts.[144] No other income tax provision allowing deductions makes a cross-reference to section 1402(a).

It is critical to the analysis of the mandatory deduction question to read carefully the first conclusion reached in CCA 200022051: "In cases where the taxpayer reports net earnings from self-employment without claiming the applicable business expenses, the net earnings from self-employment must be adjusted by those business expenses. The taxpayer's EIC and self-employment tax liability are both computed on the adjusted net earnings from self-employment." The conclusion was not stated as an overarching general rule but as a specifically tailored analysis focused on two, and only two, situations, namely, computation of self-employment income for purposes of social security benefit calculations and for purposes of the earned income tax credit.

E. Health Insurance Costs of Self-Employed Individuals

Several years after CCA 200022051 was issued, Chief Counsel considered the section 162(l) deduction for medical insurance costs paid by self-employed individuals.[145] In CCA 200623001,[146] the Chief Counsel noted that it had previously concluded "that a self-employed individual who is a sole proprietor *may* deduct, pursuant to §162(l) of the Code and subject to the limitations in §162(l), insurance costs for the medical care of the sole proprietor and his or her spouse and dependents when the health insurance policy purchased by the sole proprietor is issued in his or her individual name rather than in the name of the sole proprietor's trade or business."[147] After receiving that advice, the IRS officials seeking it returned to ask "whether sole

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[142] CCA 200022051 (Apr. 6, 2000).

[143] §401(c)(2)(A).

[144] §408(p)(6)(A)(ii).

[145] See §162(l)(1)(A).

[146] CCA 200623001 (Mar. 3, 2006).

[147] Id. (emphasis added).

proprietors *may* deduct health insurance costs on Schedule C, Profit or Loss From Business."[148] Chief Counsel provided the answer in these words:

> Under §162(I)(4), the deduction shall not be taken into account in determining an individual's net earnings from self-employment (within the meaning of §1402(a)) for purposes of Chapter 2. Accordingly, the deduction under §162(l) must be claimed as an adjustment to gross income on the face of Form 1040. The current 2005 Form 1040 provides for the deduction on Line 29. Therefore, a self-employed individual may not deduct the costs of health insurance on Schedule C.

Advocates of the "all deductions are mandatory" approach point to the word "must" in the second sentence of the quoted conclusion as proof that the taxpayer has no choice in the matter, doing so by capitalizing the word.[149] However, the word "may" in the second paragraph of the CCA, "a self-employed individual ... *may* deduct ... insurance costs" was disregarded and not highlighted. If the use of the word "must" in connection with the issue of where a claimed deduction must be set forth meant that the deduction itself must be taken, the second paragraph would have been written "a self-employed individual ... *must* deduct ... insurance costs." Instead, the CCA states the obvious, namely, that section 162(l)(4) prohibits the taxpayer from setting forth any claimed deduction on Schedule C because it is not permitted in the computation of self-employment income, thus leaving it to be claimed on the face of Form 1040. As one commentator so aptly put it: "[A]ll this says to me is that the deduction cannot be taken on schedule C, and that it 'must' be taken, if it is to be taken at all, as an above the line adjustment on the 1040."[150]

Certainly the drafting of the CCA could be better. It would not be precedent, but it would raise fewer false hopes on one side or the other of the argument had it said, in effect, either "The deduction must be claimed and it must be claimed on the face of Form 1040" or "If the taxpayer chooses to claim the allowable deduction, it must be claimed on the face of Form 1040." Considering the precedent "may deduct" language in the CCA, the most reasonable interpretation is that the CCA stands for the following proposition: "The taxpayer may claim the deduction. The deduction, if claimed, must be set forth on the face of Form 1040." Otherwise the word "may" in the second paragraph has no meaning.

F. Significance of Self-Employment Income Computation

The attempt to cast Rev. Rul. 56-407 and CCA 200022051 as standing for the proposition that all

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[148] Id. (emphasis added).

[149] Post by Rod Goodwin to ABA-TAX listserv (June 19, 2006), http://mail.abanet.org/scripts/wa.exe?A2=ind0606&L=aba-tax&P=R60858&I=-3 (visited 31 July 2006) (upper case emphasis on word "MUST" added by poster).

[150] Post by Russell A. Willis III to ABA-TAX listserv (June 20, 2006), http://mail.abanet.org/scripts/wa.exe?A2=ind0606&L=aba-tax&P=R61754&I=-3 (visited 31 July 2006).

allowable deductions must be claimed fails on two grounds. First, the language in the ruling and the Advice Memoranda is carefully drafted to limit its applicability to the computation of self-employment income for purposes of section 1402 and for purposes of the earned income tax credit. It does not state the suggested general rule. Second, if either issuance did state, or could be interpreted as stating, such a general rule, it would conflict with the analysis in the Lynch decision, discussed in VIII, C, above. The fact that the ruling was not cited in Lynch buttresses the argument that its efficacy is limited and its analysis inapplicable to the question generally. Similarly, if the ruling or the Advice Memoranda stated, or is interpreted as stating, a general rule requiring all allowable deductions to be claimed, it would conflict with sections 1016, 1245, and 1250, which, as described in III, A, 3, and IV, above, indisputably contemplate and permit taxpayers failing to claim allowable deductions. It also would conflict with the IRS' own treatment of foregone dependency exemption deductions as described in VIII, A, above.

Thus, Rev. Rul. 56-407 and CCA 200022051 do not provide an answer to the question of whether all allowable deductions must be claimed for income tax purposes. They provide an answer to a very limited set of circumstances, the computation of self-employment income for purposes of section 1402 and the earned income tax credit. That they are drafted in narrowly focused terms and not as a general rule suggests that they are exceptions to a general rule. If they are in fact exceptions to a general rule, then the position that they take would be the opposite of the position taken in a general rule, namely, that a taxpayer is not required to claim allowable deductions, a conclusion consistent with statutory analysis, IRS conclusions with respect to other areas of the tax law, and several judicial opinions. The self-employment income definition issue teaches a lesson, but it is not the one that those who contend all allowable deductions must be claimed think it teaches.

X. Intentional Failure to Comply with Deduction Requirements

A. In General

To a certain extent, the question of whether taxpayers must claim all allowable deductions is a theoretical one. Although in some instances, the IRS, if it so chose, could detect the existence of an unclaimed but allowable deduction, in most situations the information available to the IRS would not reveal the existence of allowable deductions that the taxpayer chose to forego. This raises five significant practical concerns, discussed in B through F, below.

B. Record-Keeping Requirements

It is deceptive to consider the record-keeping requirement under section 6001[151] as the answer to the question. The regulations issued under section 6001 require "any person required to file a return of tax under subtitle A ... to keep such permanent books of account or records ... as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax ..."[152] The quoted provision begs the

[151] See Regs. §1.6001-1(a).

[152] Id.

question, because it applies to “deductions ... required to be shown” but does not identify the deductions that are required to be shown. The IRS takes the position that this regulation provision permits it to require substantiation of self-employment income for earned income tax credit purposes and to permit it to disregard any self-employment income not substantiated by the taxpayer.[153] The taxpayer must keep records, therefore, only if the deduction is claimed, but the proposition that all allowable deductions are mandatory is not compelled by the section 6001 regulations.

C. IRS Awareness of Allowable but Unclaimed Deductions

Aside from the few types of allowable deductions the existence of which can be detected by the IRS, the existence of most allowable deductions comes to the attention of the IRS only because the taxpayer has claimed the deduction. Thus, unless on audit the IRS makes inquiries one might not expect, such as “Do you have any unclaimed but allowable deductions?” rather than “Do you have any unreported gross income?” the question of whether allowable deductions must be claimed is highly unlikely to surface. This probably explains why there is so little authority and so few cases addressing the issue.

The IRS, theoretically at least, is aware of some allowable state and local tax deductions because those are reported on Forms W-2 issued to the taxpayer and also delivered to the IRS. The IRS also receives copies of partnership, trust, and S corporation returns, including Schedules K-1, and thus, theoretically at least, has access to allowable deductions passed through by those entities to their partners, beneficiaries, or shareholders. In some instances, issuance of a Form 1099 alerts the IRS to the existence of a potential deduction allowable to the payor. These situations, though, pale in comparison with the number of transactions that might generate allowable deductions but that leave no paper trail for the IRS to investigate unless the taxpayer chooses to make it known by claiming a deduction or unless the IRS “cares” about unclaimed allowable deductions and makes inquiries. The latter appears to occur only with respect to self-employment earnings for purposes of section 1402 and the earned income tax credit.

It is possible for the IRS to detect unclaimed allowable deductions by conducting a full-fledged net worth audit.[154] As a practical matter, it would be very difficult for the IRS to prove that net worth would have been higher but for an allowable, but unclaimed, deduction.[155] One practitioner reports that most audit requests focus on proof that the taxpayer paid a claimed deduction, and that outside of estate tax and project audits, the IRS has not requested all of the checks written by the taxpayer.[156]

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[153] CCA 200022051 (Apr. 6, 2000).

[154] Post by John Rodgers to ABA-TAX listserv (Apr. 19, 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R42991&I=-3 (visited 31 July 2006).

[155] Id.

[156] Id.

IRS reaction to the existence of allowable but unclaimed deductions outside of the section 1402 and earned income tax credit context was demonstrated in LaForge v. Comr.,[157] and Gaines v. Comr.[158] In LaForge, the court noted that the taxpayer had failed in prior years to deduct the club tabs at issue in the case because "he was unaware that they may have been deductible."[159] Yet in analyzing the deductibility of the expenses at issue, the court did not put into the equation the amounts that could have been but were not claimed as deductions, and the IRS did not request it to do so. In Gaines, one of the factors taken into account in deciding if the taxpayer's understatement of tax was due to fraud was the taxpayer's "willingness to give up what would otherwise be allowable deductions."[160] Neither the IRS or the Court compelled the taxpayer to claim those deductions, but the taxpayer's decision to forego the deductions was considered a factor in proving the taxpayer was trying to hide cash income by doing so.[161]

D. Substantiation Failure

Almost all deductions are subject to some sort of substantiation requirement.[162] Therefore, the easiest way for a taxpayer to push an allowable deduction out of the picture is to ignore compliance with the substantiation requirements. For example, a taxpayer could decline receipts for traveling expenses. Although the tax law requires substantiation if the taxpayer wants to claim a deduction, there is nothing in the tax law that requires a taxpayer to accept receipts for traveling expenses. Similarly, a taxpayer who receives an acknowledgment letter from a charity is not prohibited from tossing it in the recycling or trash bin. Doing so, of course, negates a prerequisite for the deduction that the taxpayer is trying to avoid. Thus, as a practical matter, the notion that a taxpayer must claim all allowable deductions loses its force with respect to most deductions because the taxpayer's own actions can make the expense not allowable as a deduction. At least two groups of commentators think that some taxpayers, in the words of one group, "may choose not to claim a ... deduction ... because the paper work isn't worth the amount of the deduction."[163]

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[157] 53 T.C. 41 (1969).

[158] T.C. Summary Op. 2003-127.

[159] 53 T.C. at 47 n.9.

[160] Id. at 30.

[161] Id.

[162] See, e.g., §170(f)(8), (11), (12) (certain charitable contributions); §274(d) (traveling expenses, entertainment expenses, gifts, listed property). See generally §7491(a)(2)(A).

[163] See Joseph D. Beams & W. Eugene Seago, "Why Some Taxpayers Benefit from Not Claiming Deductions," 84 Taxes 43, 46 (May 2006). See also Nicole E. Ballard, Cherie J. O'Neil & Donald P. Samelson, "Avoiding Taxes by Avoiding Deductions," 82 Taxes 45 (May 2004).

That taxpayers are not required to maintain substantiation records but simply are denied deductions if they fail to do so is illustrated by Henson v. Comr.[164] In that case, the taxpayers asserted that they had made cash contributions to their church, offering into evidence a calendar with numbers penciled in on certain Sundays. They did not make contributions by check, and did not keep any other record, because they described such record-keeping as against their religious beliefs. Although the Tax Court estimated the taxpayers' contributions under the Cohan doctrine,[165] the court stated, "By choosing, in accordance with their religious beliefs, not to keep records of their contributions to the church, petitioners merely chose not to qualify for the charitable contribution deduction." It is important to note that the court, though allowing the taxpayers to deduct an estimated amount, did not compel the taxpayers to keep records nor to deduct what otherwise would have been allowable. The Tax Court reacted in the same manner when the same taxpayers appeared before it with respect to a subsequent taxable year.[166]

The Tax Court's analysis in Beatty v. Comr.[167] corroborates the Henson result, although it involved a different deduction and a different taxpayer justification for refusing to produce the required substantiation. The taxpayer had claimed a political contributions deduction under section 218 as it existed before its repeal by the Revenue Act of 1978.[168] The taxpayer testified that he had made the contribution, but refused to provide documentary substantiation because he considered that requirement to infringe his rights of privacy. The taxpayer stated "that if verification was required of him then he was willing to forego the deduction as the price for preventing the government from interfering in his private affairs." Rather than compelling production of the evidence, or making an estimate under the Cohan principle, the court simply concluded that "it appears that petitioner has conceded this issue, especially since he neither requested findings of fact with respect to it nor addressed it in his brief." The taxpayer was permitted, therefore, to forego the deduction by refusing to substantiate it.

E. The Risk of Fraud and Penalties

Is it possible that deliberate destruction of documents supporting an undesired deduction, or failure to request a receipt for an undesired deduction, would trigger a tax fraud prosecution?[169]

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[164] 38 T.C.M. 510 (1979).

[165] See Cohan v. Comr., 39 F.2d 540 (2d Cir. 1930), aff'g in part & modifying in part 11 B.T.A. 743 (1928).

[166] See Henson v. Comr., 40 T.C.M. 256 (1980).

[167] 40 T.C.M. 438 (1980).

[168] Pub. L. 95-600, §113(a)(1), 93 Stat. 2763.

[169] Post by Michael E. Kitces to ABA-TAX listserv (Apr. 17, 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R39282&I=-3 (visited 31 July 2006).

Are there penalties for failure to claim a deduction?[170] No instance of such a prosecution or penalty has turned up.

The absence of fraud prosecutions for failure to claim allowable deductions is not puzzling. There are taxpayers who seek to reduce the risk of an audit, despite the low risk of audit faced by taxpayers generally, by taking very cautious positions on their returns.[171] Even some preparers advise against claiming deductions that generate losses because they think "the IRS is more likely to audit providers who show business losses."[172] For example, taxpayers may undervalue property donated to charity, or might omit office-in-home deductions,[173] knowing that these are items that increase the chance of an audit.[174] If fraud charges, or even civil penalties, were asserted against these taxpayers, the negative public reaction would be rapid and intense. It is doubtful anyone would consider these taxpayers guilty of tax fraud.[175]

It is not unknown, in the world of tax compliance and audits, for taxpayers to reach into a bag of "allowable but unclaimed" deductions to replace claimed deductions that are disallowed by the IRS during an audit.[176] Though one can argue with the strategic value of such an approach, it

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[170] Post by Syd Traum to ABA-TAX listserv (May 19, 2006), http://mail.abanet.org/scripts/wa.exe?A2=ind0605&L=aba-tax&P=R35983&I=-3 (visited 31 July 2006).

[171] See "Help Solve Your IRS Problem, Part II: Return Filing Problems, Problem 2: Fear of an Audit, http://www.taxhelponline.com/solp2.htm (visited 31 July 2006) ("Because I am afraid of being audited, I do not claim legitimate tax deductions.").

[172] See Tom Copeland, "The Art of Filing a Family Child Care Tax Return: Avoiding Common Mistakes, Claiming Proper Deductions, and Protecting Against an Audit," (NATP Annual Nat'l Conference & Expo July 2005), http://www.redleafinstitute.org/pdfs/artfcctaxrtn.pdf (visited 31 July 2006).

[173] See, e.g, Watson, "An Analysis of 'Meeting or Dealing' for Home Office Deductions," 1984 U. Ill. L. Rev. 1075, n. 59 ("There are some negative tax ramifications that ... may persuade eligible taxpayers to forego home office deductions. ... For a general discussion, see Kennedy & Anderson, Recent Changes Make It Easier to Deduct Costs Related to an Office-at-Home 12 Tax'n for Law. 18, 21 (1983). See also Everett, Home Office Expense Deductions: More Trouble Than They are Worth?, 58 TAXES 589 (1980).").

[174] See, e,g,, "How to avoid an IRS audit?", http://www.wwwebtax.com/audits/audit_avoiding.htm (visited 31 July 2006).

[175] Cf. Post by Lew Wiener to ABA-TAX listserv (Apr. 19, 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R47686&I=-3 (visited 31 July 2006).

[176] See Post by Jim Maule to ABA-TAX listserv (Apr. 19, 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R48897&I=-3 (visited 31 July

appears as though the IRS has never proposed penalties on these taxpayers for having failed to claim the deductions in the first place.

F. IRS-Prepared Returns

When a taxpayer fails to file a return, the IRS will prepare the return, known as a substitute for return, or SFR.[177] When preparing an SFR, the IRS uses income information available to it from third party reporting, but does not estimate deductions.[178] The IRS position is that "deductions are a matter of legislative grace that a taxpayer must establish he or she is entitled to" and that "in a deduction case, the burden of proof never shifts to the Service."[179]

Though the IRS gives the taxpayer an opportunity to present evidence of deductions to include on the return,[180] the IRS does not require the taxpayer to do so. As a practical matter, the taxpayer is not compelled to claim allowable deductions, and if the taxpayer fails to generate evidence proving a right to the deduction, the deduction is not allowed.[181] One practitioner reports that SFRs "never have any deductions," an observation consistent with the published IRS position.[182]

Even when dealing with section 1402, one must wonder if the IRS would insist on manufacturing deductions to be reported on an SFR for a non-filing sole proprietor in order to push the taxpayer's self-employment income below $400 so that four quarters of social security coverage could be denied to the taxpayer. The long-term benefit to the fisc of reducing the taxpayer's benefits, something that might not happen if the taxpayer generates coverage quarters in other years, surely is outweighed by the decreases in immediate income tax revenues that would be caused by the manufactured deductions.

XI. Policy Considerations

2006).

[177] See §6020; Internal Revenue Manual §4.4.9 (Feb. 1, 2006), http://www.irs.gov/irm/part4/ch04s08.html (visited 12 June 2006).

[178] Chief Counsel Memo 200142024 (Oct. 19, 2001), http://www.irs.gov/pub/irs-wd/0142024.pdf (visited 12 June 2006).

[179] Id. at 5.

[180] Id. at 7.

[181] Id. at 6.

[182] Post by Greg Stewart to ABA-TAX listserv (Apr. 19, 2004), http://mail.abanet.org/scripts/wa.exe?A2=ind0404&L=aba-tax&P=R47316&I=-3 (visited 31 July 2006).

Any tax question for which the answer is not unassailably incontrovertible is more sensibly analyzed when tax policy considerations are taken into account. With respect to the mandatory nature of deductions and credits, the chief consideration should be whether a taxpayer's omission of a deduction would damage the tax system.

If, as a matter of policy, some sort of grave harm would be caused to the income tax system by taxpayers foregoing deductions, the existing statutory framework gives no hint of such a concern. It would not be unreasonable to add to the Code a provision requiring taxpayers to claim all allowable deductions. Such a provision might even simplify the tax law. But whether that ought to be done is a totally different question from whether existing law requires such a result. It does not.

For example, the tax system is not harmed if a taxpayer, unwilling to disclose the identity of his or her favorite charities, chooses to claim no charitable contribution deductions. In such an instance, as in many others, the impact on the fisc is an increase in tax revenue. Though the IRS will refund to a taxpayer taxes that are overpaid on account of computational errors, there is no evidence that the IRS has acted, or would act, to generate a refund based on unclaimed deductions, chiefly because the IRS rarely has knowledge that the deduction exists.

There are policy concerns, however, if by ignoring a deduction or credit, the taxpayer's tax liability is decreased, a quirky result possible in what is quickly becoming a less than uncommon situation. Three important situations are those involving the alternative minimum tax, the earned income tax credit, and the education credit, discussed in II, B, F, and G, above. Ironically, the answers for the two for which there are answers diametrically oppose each other. There is no question that taxpayers may forego a dependency exemption deduction to make the education credit available to the dependent, something that would be done when the deduction's value to the taxpayer is less than the credit's value to the dependent. There is no question that overstating income for purposes of the earned income tax credit is prohibited, and the cross-reference in the credit provision to the computation of self-employment income, enacted after the IRS concluded that self-employment deductions must not be omitted, suggests that in that narrow instance deductions cannot be ignored. In this environment, finding a stable policy benchmark is much like trying to walk on jello.

There also are policy concerns when taxpayers forego deductions in order to obtain benefits other than tax benefits. Those concerns, however, are not matters of tax policy but questions for those designing the benefit program in question. The IRS and the Social Security Administration have been unambiguous in rejecting the idea that one's social security benefits can be inflated by omitting self-employment deductions. Yet taxpayers have been known to forego dependency exemption deductions not only to qualify the dependent for the education credit, but to establish the dependent's independence for borrowing purposes, or for state welfare and similar benefit programs. Any bank, government agency, or state legislature that ties qualification to federal income tax reporting needs to determine if it wants the relevant item to be the reported item or the item as it would have been reported had the taxpayer, or some other taxpayer, claimed all allowable deductions. To this extent, those issues are beyond the scope of the present Article, though they certainly deserve study and analysis.

Another policy consideration involves fairness. A taxpayer who keeps meticulous records but determines to forego a deduction makes it easier for the IRS to discover the deduction and, when and if it so chose, to demand that the taxpayer claim it. In contrast, the taxpayer whose record keeping is sloppy and incomplete is much less likely to meet such a demand. Requiring taxpayers, as a matter of policy, to claim all deductions would punish, in some sense, careful taxpayers and reward the careless ones. Worse, it would give careful taxpayers an incentive to be inattentive and forgetful, to say nothing of "accidentally" throwing out documents. Thus, a rule requiring all allowable deductions to be claimed is one that should be adopted, if at all, only through a legislative process that involves hearings and debate, and not through some poorly written Chief Counsel opinion or poorly argued tax case.

Yet another policy consideration involves legislative competence. In several instances, the inducement to forego deductions arises from ill-conceived or badly drafted statutory provisions that cause tax liability to decrease if deductions are omitted. Such was the case with the algebraic circle masquerading as an unlimited charitable contribution deduction now relegated to what is hopefully eternal rest in the tax law's scrap heap. Making the earned income credit more valuable as income increases is yet another example of short-sighted planning. Most importantly, the fiasco with the alternative minimum tax, an imposition reaching more taxpayers each year, demonstrates the pitfalls of trying to be "too cute" when the drafting of tax legislation becomes part of, and enables, the tax game.

Ultimately, the tax policy analysis causes the question to end up close to where it began. What difference does it make if a taxpayer chooses to ignore one tax advantage in order to obtain another? Put another way, does it come down to a requirement that a taxpayer choose the path that leads to the highest tax liability?

The answer may lie in the proposition set forth decades ago by Judge Learned Hand, namely: "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible."[183] Surely a taxpayer can choose to reduce or eliminate deductions by failing to qualify for the deduction or by refraining from making a payment. Why, then, should a taxpayer be prohibited from ignoring the payment and its qualification as an allowable deduction if doing so is not specifically prohibited by a statutory provision mandating the deduction?

Consider for example, the alternative minimum tax, the area of tax law in which the mandatory deduction question is almost certainly going to surface as a serious, practical problem. Congress, in enacting the alternative minimum tax has said, in effect, "Those taxpayers who take advantage of certain tax breaks, such as deductions and credits, often end up with tax liability less than we want it to be when we see the outcome of the computations. So, because you took advantage of these tax breaks, we will have you compute a different taxable income that omits certain of these

[183] Comr. v. Newman, 159 F.2d 848, 850 (2d Cir. 1947) (Hand, J., dissenting), rev'g 5 T.C. 603 (1945), nonacq., 1945 C.B. 9, cert. denied, 331 U.S. 859 (1947).

deductions and credits." If a taxpayer chooses not to take advantage of one or more of these tax breaks, should that taxpayer be saddled with the "corrective measures" of the alternative minimum tax? Why is it so wrong, or bad, for a taxpayer to forego a taxpayer-favored provision and simultaneously forego the "corrective measure" meted out to those taxpayers who do take advantage of those tax breaks? The question is, of course, rhetorical, because the answer is simply that it is not wrong or bad to do so, especially when there is nothing in the statute saying that it is prohibited.

XII. CONCLUSION

There is ample evidence in the statute itself that allowable deductions will go unclaimed. For example, the provision permitting a dependent to claim the education credit if the personal exemption deduction allowable with respect to the dependent is foregone by the other person hammers home the futility of arguing that the statute, or any other authority, compels the other person to claim that dependency exemption deduction. Similarly, requiring taxpayers to reduce adjusted basis by the amount of allowable depreciation, even though it has not been claimed, and exempting allowable but unclaimed depreciation from the depreciation recapture rules undercuts the argument that all deductions are mandatory and thus must be claimed.

The few courts facing the question have not compelled taxpayers to claim all allowable deductions and have not provided a path to a resolution of the issue. The IRS has not acted as though all deductions are mandatory. Aside from a poorly drafted, and ultimately extraneous remark in a Chief Counsel Advice, the IRS has not purported to compel taxpayers to claim all allowable deductions. Only in two limited situations, for limited purposes, has the IRS taken the position that certain deductions must be claimed. One involves the computation of self-employment income for social security purposes. The other involves the earned income tax credit issue, itself tied by cross-reference to the self-employment question.

Under these circumstances, it is reasonable to conclude that a taxpayer is not required to claim an allowable deduction unless a statutory provision so requires, or a binding judicial precedent so specifies. It would be unwise, of course, to forego a deduction that the IRS considers mandatory, such as those claimed by self-employed individuals with respect to their self-employment, whether for purposes of the self-employment tax or the earned income tax credit. Until the statute is changed or some other binding authority is issued, there is no reason taxpayers who wish to forego deductions, such as the dependency exemption deduction, should hesitate in doing so.