Volume 67 | Issue 1 Article 3

5-6-2022

The Strange and Curious Tax Treatment of Investment Expenses

Jay A. Soled

Mallory A. Morris

THE STRANGE AND CURIOUS TAX TREATMENT OF INVESTMENT EXPENSES

Jay A. Soled and Mallory A. Morris*

Abstract

To secure income, taxpayers often incur a wide range of expenses. At least theoretically, one might think that the Internal Revenue Code ("Code") would accord all such expenses similar tax treatment, but (i) trade or business expenses and (ii) investment expenses endure the exact opposite tax treatment: the former are generally allowed, whereas the latter are commonly disallowed. The obvious question is why there is a difference in treatment between the two.

This Article explores possible answers to that important question. It first traces the evolution of the Code's dichotomous tax treatment of trade or business versus investment expenses. It then investigates possible justifications and their associated merits for the different handling of these two expense categories. With this background information in mind, to make the tax system more administrable, equitable, and efficient, this Article advocates for the deductibility of investment expenses and describes several beneficial implications associated with the institution of this proposed reform.

* Jay A. Soled is a professor at Rutgers Business School and directs its Masters of Taxation Program, and Mallory A. Morris, Esq., is a lawyer at the law firm Dechert LLP. The authors wish to thank the participants at the 24th Annual Critical Tax Conference for their valuable insights and suggestions, including Leslie Book, Keith Fogg, Nina E. Olson, Michelle Layser, Nancy Shurtz, Mirit Eyal-Cohen, Joshua Blank, David Elkins, Patrik Emblad, Christine Kim, Cristina Trenta, Omri Marian, Eric Allen, Yvette Lind, Reuven Avi-Yonah, Ari Glogower, Diane Ring, Leandra Lederman, Charlotte Crane, Yariv Brauner, Shu-Yi Oei, Henry Ordower, Victor Fleischer, Victor Thuronyi, Orli Oren-Kolbinger, Ryan Gurule, Victoria Haneman, Ajay Mehrotra, Tessa Davis, Neil Buchanan, and Jim Repetti.

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INTRODUCTION

WHEN it comes to the issue of taxation, the Internal Revenue Code ("Code") permits deductions for expenditures incurred to produce income.[1] Hence, the Code generally taxes net, rather than gross, income.[2] Code section 162 embodies this principle, permitting the deduction of all "ordinary and necessary expenses paid or incurred during the taxable year" while carrying on a trade or business.[3] On paper, this same netting principle extends to the investment world: Code section 212(1) declares that all "ordinary and necessary expenses paid or incurred during the taxable year" related to investments are likewise deductible.[4] Hence, based strictly upon the foregoing statutory language, both sorts of expenses—(i) trade or business and (ii) investment—are on equal footing.

This similarity in deductibility makes immense sense. Neither trade or business expenses nor investment expenses appear to share the traditional characteristic associated with non-deductibility: namely, personal consumption. Unlike trade or business and investment expenses, personal consumption commonly engenders purchases of necessities (such as food, water, and shelter) and items of affluence (such as luxury goods,

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1. *See, e.g.*, Hantzis v. Comm'r, 638 F.2d 248, 249 (1st Cir. 1981) (pointing out "a fundamental principle of taxation: that a person's taxable income should not include the cost of producing that income"). The Joint Committee on Taxation affirms this principle, grouping investment and trade and business expenses within one clause:

> [T]he normal structure of the individual income tax includes the following major components: one personal exemption for each taxpayer and one for each dependent, the standard deduction, the existing tax rate schedule, *and deductions for investment and employee business expenses.* Most other tax benefits to individual taxpayers are classified as exceptions to normal income tax law.

STAFF OF THE JOINT COMM. ON TAXATION, 113TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2012–2017, at 3 (Comm. Print 2013) (emphasis added).

2. *See* JOSEPH M. DODGE, J. CLIFTON FLEMING JR. & DEBORAH A. GEIER, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY 37–38, 48 (2d ed. 1999) ("Implicit in the concept of income itself is the notion that the expenses incurred to produce gross income must reduce that gross income so that only net profit is taxed."); Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 346 (1989) ("Under the Haig-Simons definition, income includes all expenditures other than the costs of producing income."); Stuart Lazar, Schooling Congress: The Current Landscape of the Tax Treatment of Higher Education Expenses and a Framework for Reform, 2010 MICH. ST. L. REV. 1047, 1068 ("Business expenses—the costs incurred by the taxpayer in earning gross income—are nondiscretionary in the sense that the income is conditioned on the outlay." (quoting MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAX 103 (11th ed. 2009))).

3. I.R.C. § 162(a) (2021). Section 162(a) reads, in part, as follows: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." *Id.*

4. *Id.* § 212(1). Section 212(1) reads, in part, as follows: "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year–for the production or collection of income." *Id.*

entertainment, and travel).[5] Furthermore, because trade or business and investment expenses are aimed at producing more robust business profits and investment returns, Congress is a passive benefactor as additional tax revenue yields are the by-product.

But the similarity of tax treatment between these two expense categories ends with their respective statutory language. While trade or business expense deductions generally endure no limitations and are allowed in their entirety,[6] other Code sections significantly curtail the availability of investment expense deductions.[7] Indeed, under current law (written to sunset at the end of 2025), investment expense deductions are completely disallowed.[8] As a practical matter, this means that taxpayers must pay tax on their gross rather than net investment receipts, a true anathema to taxpayers.[9]

The dichotomous treatment of these two types of expenses is readily captured in the nation's principal income tax return. For the last half century, on every individual taxpayer's Form 1040 (U.S. Income Tax Return), taxpayers have taken business expense deductions "above the line" (i.e., they are utilized in computing adjusted gross income), reflecting a carte blanche approach regarding their allowance.[10] In contrast, investment expenses fall into the category of "itemized deductions" and, if taken

5. *See id.* § 262(a) ("Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."). Professor William D. Andrews, in a seminal piece on deductions, described such personal consumption in terms of "bread, wine, or travel." William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 376 (1972).

6. Admittedly, sprinkled throughout the Code, Congress has imposed some limitations associated with the deductibility of trade or business expenses. *See, e.g.*, I.R.C. § 274 (entitled "Disallowance of certain entertainment, etc., expenses").

7. *See, e.g.*, I.R.C. §§ 56 (for purposes of computing the alternative minimum tax, disallowing investment expenses), 67(a) (for purposes of computing the income tax, limiting the amount of deductible investment expenses), 68(a) (capping the amount of permissible investment expenses), 274(h)(7) (eliminating the deductibility of certain expenses related to making investments).

These limitations notwithstanding, the scope of investment advisory services involving banks, brokerage firms, and insurance companies is huge in the United States, with an estimated $1.3 trillion spent annually by investors in the financial sector industry. Alicia Phaneuf, *Financial Services Industry Overview in 2022: Trends, Statistics & Analysis*, BUS. INSIDER (Jan. 6, 2022), https://www.businessinsider.com/financial-services-industry [https://perma.cc/7Q9B-FN34].

8. *See* I.R.C. § 67(g).

9. For an overview of the theories and philosophy of tax deductions, see *supra* note 2 and accompanying text.

10. I.R.C. § 62(a)(1).

in lieu of the standard deduction,[11] must be taken "below the line" (i.e., after adjusted gross income is computed).[12]

This Article explores the reasons for the dichotomous treatment of these two sorts of expenses and the possible consequences stemming from Congress's current legislative stance. Although trade or business and investment expenses are two of the Code's most important and salient deductions, they have yet to be juxtaposed in scholarly commentary, as will be done in this Article. This is an important and instructive exercise: it reveals political priorities, possible unintended economic consequences associated with this dichotomous tax treatment, and potential pathways to meaningful tax reform.

This Article is organized in the following fashion: Part I traces the historical evolution of these expenses to illustrate how the Code's statutory language became what it is today. Part II offers several possible rationales for why the Code evidences such generosity toward one set of expenses and yet exhibits such miserliness with respect to another. Part III then posits the need for reform and proposes the direction that it should take. Finally, a conclusion summarizes the issue.

I. BACKGROUND

In the twentieth century, as a basic building block to the nation's fiscal system, in lieu of utilizing tariffs and excise taxes to raise revenue,[13] Congress sought to tax income. As a model upon which to formulate this system, the nation's legislative body relied upon a rich volume of academic works of German legal scholar Georg von Schanz and two leading U.S. economists, Robert M. Haig and Henry C. Simons.[14] At the risk of oversimplification, these theorists defined a taxpayer's income as equal to consumption plus change in net worth.[15] Many have observed that this

11. Historically, few taxpayers opted to itemize their deductions, instead preferring to take the standard deduction. *See SOI Tax Stats: Historical Table 7*, IRS, https://www.irs.gov/statistics/soi-tax-stats-historical-table-7 [https://perma.cc/4AEQ-5NCC] (last visited Jan. 26, 2022) (depicting that from 1950–2016 most taxpayers chose to take the standard deduction rather than elect to itemize their deductions).

12. I.R.C. § 63(d).

13. *See* Sheldon D. Pollack, *Origins of the Modern Income Tax, 1894–1913*, 66 TAX LAW. 295, 329 (2013) ("Within the context of the 19th century system of protective tariffs that imposed a disproportionate share of the cost of government on laborers and farmers, a vote in Congress for an income tax was invariably coupled with a vote for tariff reduction.").

14. *See* DODGE ET AL., *supra* note 2, at 37–38 (describing contributions of Schanz, Haig, and Simons); Stanley A. Koppelman, Personal Deductions Under an Ideal Income Tax, 43 TAX L. REV. 679, 684 n.18 (1988) (briefly discussing Schanz's early definition of income.).

15. *See* HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938) (defining income as "the algebraic sum of [1] the market value of rights exercised in consumption and [2] the change in the value of the store of property rights between the beginning and end

definition gets to the essential crux of the income tax, "which is to reduce private consumption and accumulation in order to free resources for public use."[16] The corollary is that "a deduction should be allowed whenever money is expended for anything other than personal consumption or accumulation."[17] Said in the vernacular of the average taxpayer: Congress should only impose taxes on what ends up in one's back pocket at the end of the day.

While there is a fair amount of controversy over what the ideal income tax base should be,[18] there is universal agreement—a true rarity when it comes to tax issues—that any expense associated with the production of income should be deductible. Why? Because such expenses to produce such income fall outside the purview of personal consumption and constitute the antithesis of accumulation.[19] Put differently, items of consumption—such as the purchase of household and consumer goods—can be thought of as an end in itself for the taxpayer. That contrasts with those expenses—such as the purchase of inventory to resell to consumers—that are incurred as means to an end, namely, to secure additional wealth. Personal consumption expenses do not generate additional taxable wealth, whereas the expenses that produce income do.[20]

Many renowned theorists affirm the nature of those expenses that should be axiomatically deductible:

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of the period in question"); *see also* Robert M. Haig, *The Concept of Income-Economics and Legal Aspects*, in THE FEDERAL INCOME TAX 7 (Robert M. Haig ed., 1921), *reprinted in* IX READINGS IN THE ECONOMICS OF TAXATION 54 (Richard A. Musgrave & Carl S. Shoup eds., 1959).

16. Andrews, *supra* note 5, at 313.

17. *Id.* at 325.

18. *See, e.g.*, Lawrence Zelenak, *Taxing Endowment*, 55 DUKE L.J. 1145 (2006) ("Writing in 1888, Francis A. Walker, the first president of the American Economic Association, claimed that the ideal tax base was neither wealth, nor income, nor consumption, but rather '*faculty*, or native or acquired power of production.' According to Walker, only this tax base–what people *could* earn, rather than the often lesser amounts they actually earn–could achieve an equitable distribution of the tax burden[.]"(footnote omitted)); William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 HARV. L. REV. 1113, 1122 (1974) (advocating that individuals be taxed on the basis of their consumption, rather than the sum of consumption and accumulation).

19. Professor Andrews himself acknowledged, however, that "[p]ersonal consumption is a complex and ambiguous concept." Andrews, *supra* note 5, at 375. The following statement made by Adam Smith centuries ago captures the genesis of this position: "The gross revenue of all the inhabitants of a great country, comprehends the whole annual produce of their land and labour; the neat [Old English for the word "net"] revenue, what remains free to them after deducting the expence [sic] of maintaining . . . ." ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 288–87 (R.H. Campbell & A.S. Skinner eds., 1979).

20. *See* Joseph M. Dodge, *Taxing Gratuitous Transfers Under a Consumption Tax*, 51 TAX L. REV. 529, 556 (1996) ("The core reason for disallowing deductions for consumption is that consumption is an end in itself of the taxpayer, whereas business and investment expenses, depreciation and losses are means to the end of generating future revenue that may or may not be consumed.").

- William D. Andrews (former Harvard professor and leading tax scholar): "Taxable income is computed by first ascertaining the *net result* of business and investment activity."[21]
- Stanley A. Koppelman (former Boston University professor and leading tax scholar): "All agree that expenditures for personal items such as food, clothing, rent, and entertainment should not be deductible *if unrelated to a profit-seeking activity*."[22]
- Stanley S. Surrey (former Harvard professor and former Assistant Secretary of the Treasury for Tax Policy): "[Consumption is] all funds spent *except where spent in the earning or production of income*—since the tax is on net income."[23]
- Boris I. Bittker (former Yale University professor and leading tax scholar) and Lawrence Lokken (former University of Florida professor and leading tax scholar): "Whatever the nature of the taxpayer's economic activities, virtually all expenses incurred in business or profit-oriented transactions may be deducted. This stands in sharp contrast to the legislative treatment of taxpayers' personal activities, which gives rise to only a few circumscribed deductions."[24]

Notice that as part of the formulation of what constitutes income—consumption plus a change in net worth—none of the foregoing theorists equates trade or business and investment expenses with either "consumption" or "a change in net worth." The incurrence of such expenditures would thus naturally result in a corresponding reduction of taxable income.

Consistent with the aforementioned theoretical framework, even at the Code's inception, Congress made clear that all business expenses were deductible;[25] left unanswered, however, was whether the Code should afford the same deductibility treatment to investment expenses. This issue remained unresolved for over three decades, until the U.S. Supreme

21. Andrews, *supra* note 5, at 380 (emphasis added).

22. Koppelman, *supra* note 14, at 680–81 (emphasis added). In the same article, he elaborated: "Gross receipts must be reduced by these expenditures to determine the income available for consumption." *Id.* at 695. Put a final way: "All voluntary expenditures unrelated to a profit-seeking activity should be considered taxable consumption under an income tax based upon power to consume." *Id.* at 706.

23. STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 21 (1973) (emphasis added).

24. See 3 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 20.1.1 (2002).

25. *See* Revenue Act of 1913, Pub. L. No. 63-16, § II, 38 Stat. 114, 167 (1913) (accounting the original legislation where Congress permitted as a deductible "the necessary expenses actually paid in carrying on any business," but excluded "personal, living, or family expenses").

Court decided *Higgins v. Commissioner*.[26] In *Higgins*, the taxpayer incurred both trade or business expenses and investment expenses.[27] Based on the Code's statutory language, the Court held that the trade or business expenses were deductible while the investment expenses were not.[28] The Court's rationale was simple: in the absence of any special provision regarding the deductibility of investment expenses, they were, by default, nondeductible items of personal consumption.[29] Stunned by this outcome, Congress immediately responded to the *Higgins* decision by legislatively overruling it; by enacting the predecessor to Code section 212, Congress made investment expenses deductible in their entirety.[30]

Although both trade or business expenditures and investment expenditures should thus reduce taxable income, in practice this fails to happen. When it comes to the former, Congress has wholeheartedly endorsed their deductibility. When it comes to the latter, however, their second-class status is readily evident. To prove this point, consider, below, three legislative curtailments that Congress has imposed on the deductibility of investment expenses.

1. *Classification as a Miscellaneous Itemized Deduction*

The Code classifies investment expenses as "miscellaneous itemized deductions[,]"[31] a classification that bears significant limitations. This originated when, in an attempt to broaden the tax base, simplify the Code, and limit questionable deductions,[32] Congress enacted the Tax Reform Act of 1986.[33] As part of this comprehensive legislation, Congress added Code section 67.[34] This Code section allows deductions for miscellaneous expenses but only if both of the following two conditions are met: (i) the taxpayer elects to itemize her deductions rather than utilize the standard deduction, and (ii) the amount of miscellaneous deductions exceeds two percent of the taxpayer's adjusted gross income.[35] Even when both of these conditions are met, only the dollar amount in excess of two percent of the taxpayer's adjusted gross income is deductible.

26. 312 U.S. 212 (1941).

27. *Id.* at 214.

28. *Id.* at 218.

29. *Id.* at 217–18 (affirming that the scope of (i) trade or business and (ii) investment activities were not coterminous, and hence expenses associated with the latter were not deductible).

30. *See* Revenue Act of 1942, Pub. L. No. 77-753, § 121, 55 Stat. 798, 819 (enacting the predecessor to Code section 212, which permitted the deductibility of investment expenses).

31. I.R.C. § 67(b) (2021).

32. *See* S. REP. NO. 99-313, at 78 (1986).

33. Pub. L. No. 99-514, 100 Stat. 2085 (1986).

34. *Id.* § 132(a), 100 Stat. 2113–16.

35. I.R.C. § 67(a).

As a practical matter, because the majority of taxpayers choose to take the standard deduction rather than itemize their deductions,[36] they essentially forgo the deductibility of their investment expenses. Furthermore, due to the two percent floor limiting the amount eligible for deduction, in those instances when taxpayers do elect to itemize, they often forfeit a large proportion of what might otherwise be deductible.[37]

2. *Placement of a Cap on Itemized Deductions*

Embodied in Code section 68, the so-called Pease limitation—eponymously named after Congressman Donald Pease, who introduced this legislation[38]—further limits the overall amount of allowable itemized deductions, including those that are miscellaneous.[39] Although this provision is only applicable to taxpayers with adjusted gross incomes above certain thresholds,[40] it can significantly diminish the dollar amount that such taxpayers may deduct.[41]

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36. *See* Michael Parisi, *Individual Income Tax Returns, Preliminary Data, Tax Year 2017*, STAT. OF INCOME BULL., Winter 2019, at 1 ("Most tax returns (68.1 percent) claimed a standard deduction . . . ."). For an excellent overview of the standard deduction, see generally John R. Brooks, *Don't Forget the Standard Deduction,* 150 TAX NOTES 1589 (2016).

37. For example, assume Taxpayer A has an adjusted gross income ("AGI") of $100,000 and has $10,000 of investment expenses that qualify as miscellaneous expenses. Two percent of their AGI is $2,000. Instead of deducting the entire $10,000, they would only be permitted to deduct $8,000, the amount exceeding the two percent floor ($10,000 of expenses minus $2,000, the two percent floor amount).

38. *See* Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11103, 104 Stat. 1388, 1388–06. It was extended by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13201(b)(3)(e), 13204, 107 Stat. 312, 462, and then gradually phased out, beginning in 2006 and ending by the end of calendar year 2009, by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 103(a), 115 Stat. 38, 44–45. It was then reinstated by the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101(b)(2)(A), 126 Stat. 2313, 2317.

39. This limitation applies after the restrictions under Code section 67 are imposed. *See* I.R.C. §68(d).

40. *Id.* § 68(b).

41. Although technical in nature, the limitation is set forth as follows: "the amount of the itemized deductions otherwise allowable for the taxable year shall be reduced by the lesser of (i) 3 percent of the excess of the adjusted gross income over the applicable amount, or (ii) 80 percent of the amount of the itemized deductions otherwise allowable for the taxable year." *Id.* § 68(a).

For an illustrative example of how this limitation applies, see Frank Armstrong III, *Pease Limitation Puts a Lid on Itemized Deductions for Wealthy Folks*, FORBES (Jan. 9, 2013), https://www.forbes.com/sites/greatspeculations/2013/01/09/pease-limitation-puts-a-lid-on-itemized-deductions-for-wealthy-folks/ [https://perma.cc/Y4FK-T9FQ]. Armstrong illustrates:

> Example: Assume a married couple has an AGI of $670,000 and the 2013 applicable amount is $300,000. The couple's itemized deductions come to a total of $45,000 and they are broken down as follows:
>
> Mortgage interest deduction - $5,000
> Property tax deduction - $5,000

Over its thirty-year existence, the Pease limitation has placed severe restrictions on the utility of investment-related expenses.[42] In those instances when such expenses (combined with other miscellaneous deductions) exceed two percent of the taxpayer's adjusted gross income and hence are theoretically deductible, the Pease limitation often subverts the availability of such deductions.

3. *Expansion of the Alternative Minimum Tax ("AMT") Base*

Several decades ago, as a mechanism to ensure that high-income taxpayers were bearing their fair share of taxes,[43] Congress enacted the AMT.[44] As part of this legislative initiative and to ascertain the AMT base, no expenses are allowed for investment expenses.[45]

As a practical matter, if a taxpayer's income is subject to AMT, there is nothing to be gained by seeking to deduct investment-related expenses. Such deductions thus lie unused on the taxpayer's tax return, unavailable for any purpose.

In light of the foregoing limitations, there appears to be a wide gulf between the theoretical Haig-Simons ("H-S") definition of "income" and

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State income tax deduction - $20,000
Charitable deduction - $15,000

Based on the fact pattern and the calculation methods listed above for limiting the itemized deductions, option (a) would result in an $11,100 reduction of the couple's itemized deductions, while option (b) would reduce the couple's itemized deductions by $36,000:

(a) 3% x $370,000 ($670,000 less $300,000) would reduce the couple's itemized deductions by $11,100.

(b) 80% x $45,000 would reduce the couple's itemized deductions by $36,000.

Since option (a)'s 11,100 reduction is the lesser of the two limitations[,] the couple's itemized deductions would only be reduced by 25 percent, taking their total itemized deductions of $45,000 down to $33,900 ($45,000 less $11,100).

Id. Currently, this provision is suspended but is scheduled to be in full force and effect beginning in 2026. Section 68(f), as enacted by Pub. L. No. 115-97, § 11046, 131 Stat. 2195 (2017), provides that section 68 "shall not apply to any taxable year beginning after" 2017 and before 2026. I.R.C. § 68(f).

42. *See generally* Reed Shuldiner & David Shakow, *Lessons from the Limitation on Itemized Deductions*, 93 TAX NOTES 673 (2001) (presenting evidence of how this limitation operates to increase many taxpayers' marginal income tax rates).

43. The legislative history of the alternative minimum tax ("AMT") reflects this sentiment. *See* H.R. REP. NO. 99-426, at 237 (1985) (establishing that the AMT will "ensure that no taxpayer with substantial economic income [can] avoid significant tax liability"). Commentators, too, echoed the sentiments of politicians. *See, e.g.*, Daniel Shaviro, *What Are Minimum Taxes, and Why Might One Favor or Disfavor Them?*, 40 VA. TAX REV. 395, 411 (2021) ("This concern reflected the importance that policymakers attached in 1986 to 'mak[ing] certain [that newspaper] stories about millionaires and corporations escaping all taxes never surfaced again.'" (alterations in original)).

44. Tax Reform Act of 1986, Pub. L. No. 99-514, § 701, 100 Stat. 2085, 2320–22 (1986).

45. *See* I.R.C. § 56(b)(1)(A)(i).

the congressional application of a definition of "income." Under the traditional H-S formulation of what constitutes income, investment expenses should categorically be deductible.[46] And this has been spelled out in explicit terms in Code section 212 since its original drafting in 1942.[47] Over the ensuing years, however, Congress passed the foregoing three legislative measures designed to treat investment expenses as if they were items of personal consumption, equivalent to the purchase of fine bottles of wine, ready to be uncorked and imbibed. To add insult to injury, as part of the final legislative assault on investment expenses, Congress has suspended their deductibility until 2026.[48]

II. POSSIBLE RATIONALES FOR THE CODE'S DICHOTOMOUS TAX TREATMENT

Though the historical evolution of the statutory language proves easy to trace, the motivation behind that evolution is less obvious. As is evident from Part I, Congress now views trade or business expenses through a different lens than the one through which it views investment expenses. The question is why. Consider the following possible rationales regarding the current congressional mode of thought: (A) a personal consumption element associated with investment expenses, (B) preferential tax treatment afforded investment returns, and (C) a naked quest for additional revenue.

A. *Personal Consumption Element Associated with Investment Expenses*

As explored in Part I, personal consumption is a determinative quality when categorizing an expense as deductible or not deductible. The subsections below accordingly explore various personal consumption elements associated with investment expenses that may have influenced the fact that tax policy treats investment expenses as dissimilar to trade or business expenses.

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46. For a discussion of the philosophies and theories of income, see *supra* notes 14–17.

47. *See* I.R.C. § 212(1) ("In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year–for the production or collection of income[.]"); *see also* Revenue Act of 1942, ch. 619, § 121, 56 Stat. at 819 (codified at 26 U.S.C. § 212 (2012) (previously section 23(a)(2) of the 1939 Income Tax Code, added by ch. 619, § 121, 56 Stat. 798 (1942))).

48. *See* I.R.C. § 67(g) (2017) (stating all miscellaneous itemized deductions are suspended); *see also* Pub. L. No. 115-97, § 11045, 131 Stat. 2195 (2017). In rare instances, however, in which an investment expense does not constitute a "miscellaneous itemized deduction" (e.g., the additional investment advisory fees that a trustee or executor incurs beyond the traditional norm to safeguard an estate's or trust's assets), it may remain deductible. *See* I.R.C. § 67(e).

1. *Investment Expenses Are More Micro- Rather than Macro-Economic in Nature*

Congress often incentivizes trades or businesses to incur expenses to augment their profits and thereby generate a whole series of macroeconomic rippling effects. These effects include, but are not limited to, increases in the nation's gross national product, declines in the unemployment rate, and growth in wages.[49] Each of the foregoing macroeconomic phenomena can constitute a metric of the nation's economic prosperity.[50]

Given the causal connection between trade or business expenses and robust economic activity, the Code accordingly promotes the former to achieve the latter. A multitude of Code sections, namely, 162, 167, 168, 195, 248, 709, and 197, epitomizes this point:

- Code section 162 sends a resounding message to taxpayers that all "trade or business expenses" are deductible in the year incurred.[51] Taxpayers know that Congress endorses their incurrence.[52] The courts grant taxpayers broad leeway in the kind of expenses that qualify for this deduction.[53] And even the Internal Revenue Service ("IRS"), in almost all instances,

49. *See* THOMAS L. HUNGERFORD & JANE G. GRAVELLE, CONG. RSCH. SERV., R41034, BUSINESS INVESTMENT AND EMPLOYMENT TAX INCENTIVES TO STIMULATE THE ECONOMY 7–14 (2010), https://www.everycrsreport.com/files/20100122_R41034_c814e51c451a5527cb84ec1093304e94cd395eb0.pdf [https://perma.cc/MA4G-YP2A] (explaining the various roles that tax incentives may play in helping bolster economic growth).

50. *See* Justin Fox, *The Economics of Well-Being*, HARV. BUS. REV. (2012), https://hbr.org/2012/01/the-economics-of-well-being [https://perma.cc/ZBF3-9S94] ("The specific metric [of a country's prosperity] that has prevailed since World War II is the dollar value of a country's economic output, expressed first as gross national product, later as gross domestic product."); Brenda Reddix-Smalls, *Credit Scoring and Trade Secrecy: An Algorithmic Quagmire or How the Lack of Transparency in Complex Financial Models Scuttled the Finance Market*, 12 U.C. DAVIS BUS. L.J. 87, 121 (2011) ("Unemployment is linked to Gross Domestic Production (GDP) by a term called Okun's Law. According to Okun's Law, for every two percent that real GDP falls below its potential full employment level over a year's time, the unemployment rate will increase by one percent." (footnote omitted)); Bruce W. Bennett, *Cashing in or Cashing Out? The Fair Tax Act of 1999*, 27 J. LEGIS. 69, 75 (2001) ("Prosperity is often defined in terms of growth of real wages. Real wages increase when labor productivity increases, and labor productivity increases when national output increases.")

51. I.R.C. § 162(a).

52. This endorsement dates back to the enactment of the modern income tax in 1913, which, despite its brevity, sanctioned the deductibility of trade and business expenses. *See supra* note 25.

53. *See, e.g.*, Sullivan v. Comm'r, 43 T.C.M. (CCH) 880 (1982) (permitting taxpayer to deduct the cost of beer that he offered to his customers free of charge as they waited for their cars to be serviced).

defers to taxpayers regarding the nature of the trade or business expenses that they incur.[54]

- Congress wrote Code sections 167 and 168 in a tax-favorable manner, implicitly inviting taxpayers to secure whatever plant and equipment they believe necessary to make their trades or businesses flourish.[55] This is evident under current law as taxpayers may immediately expense the vast majority of plant and equipment that they purchase.[56] And even in those instances when immediate expensing is disallowed, the Code still affords accelerated depreciation allowances for tangible personal property acquisitions.[57]
- Code sections 195, 248, and 709 provide generous allowances regarding trade or business start-up expenses.[58] Depending upon the dollar amount of expenses, taxpayers may immediately deduct these costs or be required to amortize them. Absent this allowance, they might otherwise have to be permanently capitalized.[59] The congressional message here could not be clearer: the government commends taxpayers who wish to start new business enterprises, and, accordingly, the expenses associated with such endeavors will be treated tax favorably.[60]
- Code section 197 permits purchased goodwill to be amortized over a 15-year time period.[61] Enacted two decades ago,[62] Code section 197 relaxed the prior rule, which required that these expenditures be capitalized.[63]

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54. INTERNAL REVENUE SERV., PUBLICATION 535, BUSINESS EXPENSES (2021), https://www.irs.gov/pub/irs-pdf/p535.pdf [https://perma.cc/V32K-8TPZ] (delineating the broad array of permissible business expense deductions).

55. *See* I.R.C. §§ 167(a), 168(a).

56. *Id.* §§ 168(k), 179(a).

57. *See, e.g.*, Douglas A. Kahn, *Accelerated Depreciation*–Tax Expenditure or Proper Allowance for Measuring Net Income?, 78 MICH. L. REV. 1 (1979) (arguing accelerated depreciation is consistent with normative tax principles).

58. I.R.C. §§ 195(a), 248(a), 709(a).

59. *Id.* § 195(b).

60. H.R. REP. NO. 96-1278, at 10 (1980) (noting that the purpose of the legislation was to "encourage formation of new businesses and decrease controversy and litigation arising under present law with respect to the proper income tax classification of startup expenditures"); S. REP. NO. 96-1036, at 11 (1980) (making a near-identical declaration).

61. I.R.C. § 197(a).

62. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13261, 107 Stat. 312 (1993).

63. *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO/GGD-91-88, TAX POLICY: ISSUES AND POLICY PROPOSALS REGARDING TAX TREATMENT OF INTANGIBLE ASSETS 2 (1991), https://www.gao.gov/assets/160/150945.pdf [https://perma.cc/BHM7-Z2TH] (noting that under prior law, "[p]urchased goodwill and other intangible assets without determinable useful lives are not amortizable"). The rationale Congress offered for adding this Code section was to eliminate controversies concern-

Beyond the foregoing generous business deduction allowances, the Code provides few limitations regarding the availability of business deduction allowances in general. Therefore, regarding trade or business expenses, if taxpayers wish to splurge on first-class plane tickets, offer their employees lavish fringe benefits, or reward trusted directors and officers with extravagant compensation packages, they may do so without any government interference.[64]

From Congress's self-interested point of view, the wealth that such trade or business expenditures produce is shared: both producers and consumers are benefactors. By way of contrast, unlike those taxpayers who engage in trade or businesses who gauge their success based upon the fulfillment of others' needs (e.g., how much inventory they can sell, the number of surgeries they perform, or pharmaceutical drugs they may dispense), those who invest gauge their success by one simple metric: how much money they, personally, can make. Accordingly, Congress does not view such expenditures as sympathetically and, thus, treats them far less tax favorably.

2. *Chemical Rushes Indicative of Personal Consumption*

There is a long history of commentators and others who equate investing with a form of gambling.[65] This comparison resonates because both activities engender risk. When taxpayers make investments, they must consider a whole continuum of risks: safe investments, such as certificates of deposit, usually engender little risk, while more precarious investments, such as providing equity to start-up enterprises, usually incite great

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ing the determination of "(1) whether an amortizable intangible asset exists; (2) in the case of an acquisition of a trade or business, the portion of the purchase price that is allocable to an amortizable intangible asset; and (3) the proper method and period for recovering the cost of an acquired amortizable intangible." S. Rep. No. 1134, 103d Cong., 1st Sess. 216 (1993).

64. *See, e.g.*, Wendy Gerzog Shaller, *Reforming the Business Meal Deduction: Matching Statutory Limitations with General Tax Policy*, 24 DUQ. L. REV. 1129, 1133 (1986) ("Although an expense must be reasonable and not extravagant or lavish to be deductible, and although such items as champagne and caviar were intended to be nondeductible excesses, the Service rarely attacks the 'lavish' element of the cost unless the taxpayer falls within . . . [the scope of an] abuse situation." (footnotes omitted)). *See generally* Mary Louise Fellows & Lily Kahng, *Costly Mistakes: Undertaxed Business Owners and Overtaxed Workers*, 81 GEO. WASH. L. REV. 329 (2013) (explaining the wide leverage that business owners have in deducting trade and business expenses).

65. *See, e.g.*, Christine Hurt, *Regulating Public Morals and Private Markets: Online Securities Trading, Internet Gambling, and the Speculation Paradox*, 86 B.U. L. REV. 371, 377 (2006) ("Any attempt to substantively distinguish all types of gambling (from slot machines to poker to sports betting) from all types of investing (from long-term ownership to day trading to purchasing derivatives) is illusory."); Christopher T. Pickens, Comment, *Of Bookies and Brokers: Are Sports Futures Gambling or Investing, and Does It Even Matter?*, 14 GEO. MASON L. REV. 227, 247–48 (2006) (claiming that gambling and investing "cannot be distinguished based on their respective consequences, because every negative consequence of gambling is also a consequence of some investing activities").

risk. The same psychology extends to gambling, where gamblers endure a whole continuum of risks. For example, at horse races, placing a bet on the favorite to "show" (i.e., betting on a horse to place in the first, second, or third positions) usually prompts little risk, whereas placing a wager on a dark or unknown horse to win is fraught with peril.

Given the potential risk of losing in gambling and recognizing that the deck is typically stacked against gamblers, the question is why gamblers nevertheless participate in this activity. The reasons are multifaceted,[66] but often it comes down to personal enjoyment: study after study indicates that gamblers have an adrenaline rush when they wager and engage in risk.[67] In scientific terms, our brains release a chemical known as dopamine, which makes us want to seek more: "Dopamine is a chemical that's released when we do something that makes us feel good—like eating pizza or having sex or exercising. These activities stimulate the brain, and the dopamine release triggers the brain to want to do them again."[68]

Human evolution is responsible for the fact that our brains have this chemical reaction. Dopamine is a chemical messenger between nerve cells, enabling us to strive and focus.[69] In evolutionary terms, dopamine appears responsible for human beings' social intelligence and our ability to work together in communal settings.[70] This is a good sensation, giving us the feeling of empowerment. Unfortunately, it's the same sensation that drug addicts often attempt to replicate by seeking to induce a similar reaction through their use of heroin and cocaine.[71]

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66. *See, e.g.*, Mark D. Griffiths, *Why Do You Gamble?*, PSYCH. TODAY (Aug. 26, 2015), https://www.psychologytoday.com/us/blog/in-excess/201508/why-do-you-gamble [https://perma.cc/TA8C-2XNW] (explaining the complex motivations that drive individuals to gamble).

67. *See* Chris Baraniuk, *Why Gamblers Get High Even When They Lose*, BBC (July 21, 2016), https://www.bbc.com/future/article/20160721-the-buzz-that-keeps-people-gambling [https://perma.cc/3Q7Q-RXSX] (reporting on various scientific studies that verified that people achieved emotional satisfaction from gambling); Ferris Jabr, *How the Brain Gets Addicted to Gambling*, SCI. AM. (Nov. 1 2013), https://www.scientificamerican.com/article/how-the-brain-gets-addicted-to-gambling/ [permalink unavailable] ("Addictive drugs and gambling rewire neural circuits in similar ways.").

68. John Wilson, *Neuropsychology of Sports Betting: There's a Reason You Want to Keep Placing More Bets*, SPORTS HANDLE (May 2, 2018), https://sportshandle.com/neuropschology-of-sports-betting-dopamine/ [https://perma.cc/TDL3-C5PT].

69. Hope Cristol, *What Is Dopamine?*, WEBMD https://www.webmd.com/mental-health/what-is-dopamine [https://perma.cc/7QNS-842A] (last updated June 14, 2021) (medically reviewed by Dr. Smitha Bhandari).

70. *See* Ann Gibbons, *Dopamine May Have Given Humans Our Social Edge over Other Apes*, SCIENCE (Jan. 22, 2018), https://www.science.org/content/article/dopamine-may-have-given-humans-our-social-edge-over-other-apes [permalink unavailable] (describing dopamine levels in chimpanzees and other primates compared to humans).

71. Scientific researchers have drawn this conclusion, namely, the connection between drug use and dopamine. *See* Nora D. Volkow, Joanna S. Fowler, Gene-Jack Wang, James M. Swanson & Frank Telang, *Dopamine in Drug Abuse and Addiction: Results of Imaging Studies and Treatment Implications*, NEUROLOGICAL REV. (2007),

When it comes to investing, the investor's brain functions much in the same way as a gambler's brain. Indeed, Harvard medical researchers have reported that when it comes to investing, "activations seen in four regions of the brain . . . in response to monetary prospects and outcomes overlap those observed in response to cocaine infusions in research subjects addicted to cocaine."[72] The reason for the brain's similar chemical reaction in gambling and investing makes sense: these chemical dynamics open the door to supposed clarity of mind.

From an income tax perspective, the similarity between the brain's chemical reaction to gambling and the brain's chemical reaction to investing warrants further examination. Consider that, ordinarily, the purchase of Xerox paper for the office printer or new pens for the business supply cabinet triggers no intrinsic gratification or fulfillment. By way of contrast, if a taxpayer pays an investment management fee to an investment professional, it's somewhat akin to tipping a blackjack dealer to deal a good hand.[73] And, if the scientific studies are correct, the taxpayer is apt to experience a chemical rush then and an even greater one if her gamble pays off and the investment proves profitable.[74]

Such chemical rushes could signify personal consumption, a clear demarcation of non-deductibility. Perhaps because these chemical rushes likely lack the same vibrancy as chemical rushes for the purchase of other items of personal consumption (such as a new car or flat-screen TV), Con-

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https://jamanetwork.com/journals/jamaneurology/fullarticle/794743 [https://perma.cc/K2HM-DJAY].

> Imaging studies have provided new insights on the role of dopamine (DA) in drug abuse and addiction in the human brain. These studies have shown that the reinforcing effects of drugs of abuse in human beings are contingent not just on DA increases per se in the striatum (including the nucleus accumbens) but on the rate of DA increases.

Id.

72. David Floyd, *How Investing and Cocaine Look [the] Same to Brain*, INVESTOPEDIA (June 25, 2019), https://web.archive.org/web/20201109042751/https://www.investopedia.com/news/study-investing-and-cocaine-look-same-brain/ [permalink unavailable].

73. *See* Anna Almendrala, *It Turns Out We Love Tipping for All the Wrong Reasons*, HUFFPOST (July 7, 2016), https://www.huffpost.com/entry/the-psychological-reasons-you-tip-at-restaurants_n_57754149e4b042fba1cf5bd5 [https://perma.cc/Z8P8-DQWJ] (explaining why part of the reason people give tips is the emotional high they receive in rewarding others' efforts).

74. The scientific community shares this perspective:

> Behavioral economists, like Princeton's Daniel Kahneman, who won the Nobel Prize for Economics in 2002, began teaming up with neuroscientists, like Peter Shizgal at Concordia University in Montreal. In one study, the pair used gambling games and neuroimaging techniques to look at what part of the brain is triggered when people anticipate winning money. They found that monetary rewards trigger the same brain activity as good tastes, pleasant music or addictive drugs.

Jane Spencer, *Lessons from the Brain-Damaged Investor*, WALL ST. J. (July 21, 2005, 12:01 AM), https://www.wsj.com/articles/SB112190164023291519 [https://perma.cc/6J2X-6TAP].

gress has hesitated to disallow them in their entirety. However, simple human biology is at least one possible rationale behind congressional reluctance to treat trade or business expenses and investment expenses the same.[75]

3. *Lack of Social Interaction and Input of Sweat and Toil*

The incurrence of trade or business expenses and the incurrence of investment expenses have a common goal in mind, namely, making profits. But, in several important respects, the similarity between the two kinds of expenses ends there.

For starters, the incurrence of trade or business expenses generally engenders dynamic social interaction and commerce between willing buyers and sellers. Sellers must produce products, secure inventory from suppliers, or perfect a specialized service skill (e.g., lawyering). Then, those taxpayers immersed in this process must market their merchandise or skills to attract a customer base. The combination of all of these activities has a penetrating economic effect that ranges from continuous social interactions with employees, independent contractors, suppliers, and office staff to regular engagements with customers at store locations or online. Sellers who incur trade or business expenses are certainly intent on enhancing their bottom lines, but buyers are able to secure sought-after goods and services at purchase prices they believe to be reasonable.

Politicians routinely applaud economic commerce of this sort.[76] Furthermore, rarely a day goes by that the press and news media don't take note with praise when employers hire huge numbers of employees[77] or

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75. Indeed, in enacting Code section 67, which limits the deductibility of investment expenses, the Senate Finance Committee asserted that this deduction (and other miscellaneous deductions) appeared to be characteristically "voluntary personal expenditures," implying that they resembled consumption expenditures rather than business expenses. S. REP. NO. 99-313, at 78 (1986).

76. *See, e.g.*, Lisa Friedman, Coral Davenport & Christopher Flavelle, *Biden, Emphasizing Job Creation, Signs Sweeping Climate Actions*, N.Y. TIMES (Jan. 27, 2021), https://www.nytimes.com/2021/01/27/climate/biden-climate-executive-orders.html [https://perma.cc/S3QY-FFZX].

> And in a clear echo of former President Barack Obama's claims that his climate policies would create millions of 'green jobs,' Mr. Biden also said his agenda would create 'prevailing wage' employment and union jobs for workers to build 1.5 million new energy-efficient homes, to manufacture and install a half-million new electric-vehicle charging stations, and to seal off one million leaking oil and gas wells.

Id.

77. There are a myriad of examples of this phenomenon. For a recent such one, see, *e.g.*, Chip Cutter, *Amazon Wants to Train 29 Million People to Work in the Cloud*, WALL ST. J. (2020), https://www.wsj.com/articles/amazon-wants-to-train-29-million-people-to-work-in-the-cloud-11607621622 [https://perma.cc/9BLX-JST8].

> Amazon.com Inc. announced an effort . . . aimed at helping 29 million people world-wide retrain by 2025, giving them new skills for cloud-computing roles as the pandemic upends many careers. The online giant committed $700 million last year to reskilling 100,000 of its own workers

government officials seek to lure Fortune 500 companies to their environs.[78] The reason for such accolades is clear: commerce of this sort enriches large swaths of society, such as suppliers, delivery personnel, office staff, and a whole host of others.

The same financial and social characterizations cannot generally be made regarding the incurrence of investment expenses. Such expenditures are usually incurred with far less human interaction and contact. Often, taxpayers engage the services of investment advisers and others with financial acumen; but once these relationships are established, although there is ordinarily periodic updating, further social interaction is typically scant.[79] In almost all cases, any interaction to be had will significantly pale in comparison to the interaction in relationships forged in traditional trade or business settings. Relatedly, when a trade or business succeeds, many others frequently ride on its coattails (e.g., employees, equity holders, and consumers). When a particular investment proves lucrative, however, its sole benefactor is usually just the investor.

Furthermore, many investors do not sweat or toil in the form of labor to realize their profits. Instead, they figuratively profit off the sweat and toil of others' labor, all the while never lifting a finger. Because almost all investors are economically well-to-do,[80] the majority of them will either reinvest their earnings or, alternatively, purchase items that have the aura of conspicuous consumption (e.g., fancy sports cars, large yachts, and private planes).[81]

> in the U.S. The new effort will build on existing programs and include new ones in partnership with nonprofits, schools and others.

Id.

78. *See, e.g.*, Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 380 (1996) ("In recent years, the states have enacted a vast array of tax provisions that are designed to lure businesses to locate their facilities in the state, and interstate 'bidding wars' offering tax breaks for major new facilities have become commonplace.").

79. *See* Forbes Finance Council, *16 Strategies to Help Financial Advisors Improve Their Customer Service*, FORBES (2020), https://www.forbes.com/sites/forbesfinancecouncil/2020/02/24/16-strategies-to-help-financial-advisors-improve-their-customer-service/?sh=4dda8ee19ed1 [https://perma.cc/B3NZ-49FD] ("Frequently, financial advisors miss the mark on check-ins with clients. An annual review is a bare minimum . . . .").

80. *See, e.g.*, Kim Parker & Richard Fry, *More Than Half of U.S. Households Have Some Investment in the Stock Market*, PEW RES. CTR. (Mar. 25, 2020), https://www.pewresearch.org/fact-tank/2020/03/25/more-than-half-of-u-s-households-have-some-investment-in-the-stock-market/ [https://perma.cc/8ULG-BP4D] (explaining that high-income families tend to have higher investments in the stock market than those families with lower incomes).

81. *See, e.g.*, Paul Sullivan, *Yachts Are for More Than Lounging*, N.Y. TIMES (Mar. 6, 2020), https://www.nytimes.com/2020/03/06/your-money/yacht-charter-adventure-cruise.html [https://perma.cc/4LBU-48XD] ("Yacht—the mere word connotes luxury and easy living. They are a symbol of wealth second only to private jets.").

This is not to say that investors, as a class of taxpayers, are merely frivolous consumers or that the process of investing does not serve useful societal and economic purposes.[82] But, as a general axiom, the public would appear to know successful businesses (i.e., those that they regularly visit in person or on online) far more than successful investors, the vast majority of whom they undoubtedly never met.[83] And nowhere is this proposition clearer than in the way that Congress, for tax purposes, treats the expenditures that each business and investor makes.

B. *Preferential Tax Treatment Afforded Investment Returns*

When it comes to making investments that may spur economic growth, Congress has sought to make the tax landscape as attractive as possible. And so, over the course of the last century, the Code has treated gains associated with capital investments with preferential tax treatment.[84] More specifically, under current law, long-term capital gains are taxed at approximately half the tax rate as is ordinary income.[85] This same pro-investment psychology also extends to expenditures made in corporate equity, the dividends from which are likewise accorded preferential tax rates.[86] Beyond preferential tax rates, the Code permits taxpayers to defer income recognition until there is a so-called realization event—generally, a sale or exchange.[87] This enables taxpayers to secure tremendous tax

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82. *See, e.g.*, Kimberly Amadeo, *How the Stock Market Affects the US Economy*, BALANCE (Nov. 27, 2020), https://www.thebalance.com/how-do-stocks-and-stock-investing-affect-the-u-s-economy-3306179 [https://perma.cc/C4GP-LZH4] ("Growing, successful businesses need capital to fund growth and the stock market is a key source. In order to raise money this way, owners must sell part of the company, and to do so they 'take the company public' through an initial public offering (IPO) of the company's shares.").

83. Most taxpayers will likely know the names of the nation's largest companies, such as Walmart, Amazon, ExxonMobil, Apple, CVS Health, Berkshire Hathaway, and UnitedHealth Group. *See Fortune 500 List of Companies 2020*, FORTUNE (2020), https://fortune.com/fortune500/ [https://perma.cc/J6NT-XEYN] (last visited Jan. 27, 2022). By contrast, far fewer will know the names of the top seven investors in the world. *See* Bryan Rich, *Meet the 7 Richest Investors on the Planet*, FORBES (Mar. 1, 2016), https://www.forbes.com/sites/bryanrich/2016/03/01/meet-the-richest-investors-on-the-planet/ [https://perma.cc/2D9B-BF7J] (naming the top investors as Warren Buffett, George Soros, Carl Icahn, Ray Dalio, James Simons, Steve Cohen, and David Tepper).

84. *See* GREGG A. ESENWEIN, CONG. RSCH. SERV., RS20250, CAPITAL GAINS TAX RATES AND REVENUES 4 tbl.1 (2007), https://www.everycrsreport.com/files/20070404_RS20250_ 97714548762fae68311bda9abfc7c8ac75cc37a5.pdf [https://perma.cc/7HBP-ECNJ] (listing the statutory marginal tax rates on long-term capital gains income). *See generally* Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319 (1993) (explaining the various rationales for a capital gains rate preference and evaluating their legitimacy).

85. *See* I.R.C. § 1(h) (2021).

86. *See id.* § 1(h)(11)(B).

87. *Id.* § 1001(c).

savings as they can prolong realization events to years of their choosing[88] and, in some instances, eliminate income recognition altogether.[89]

By way of contrast, income derived from trades or businesses is taxed as ordinary income.[90] As such, the Code does not grant a tax rate preference. Furthermore, there is no opportunity to defer income recognition.[91] Thus, when a trade or business corporate taxpayer earns income, it is subject to a flat tax rate.[92] And when a trade or business noncorporate taxpayer earns income, it is subject to a progressive tax rate.[93] In addition, depending upon the taxpayer's accounting method, income generally must be reported in the year accrued or cash payment is received.[94]

Given that the Code treats investment and trade or business incomes so dissimilarly, it can be argued that Congress purposefully took this into account in the handling of expense deductibility. More specifically, with respect to investment expense deductions, Congress treats them with circumspection; with respect to trade and business expense deductions, Congress fosters their liberal utilization. A possible rationale for these different treatment modes is that doing so attempts to level the playing field between them.

By way of example, consider the plights of Taxpayers A and B. Suppose Taxpayer A operates a business and incurs $20 of expenses and earns $100 of profits. Suppose further that Taxpayer A may deduct the entire $20 expense from the $100 profits for a net amount of $80, which is taxed at an ordinary income tax rate of 40%. After expenses and taxes, Taxpayer A would have $48 to show for her efforts (i.e., $100 (gross) – $52 [$20 (expenses) + $32 (taxes)]). By way of contrast, suppose Taxpayer B makes an investment and incurs $20 of expenses and earns $100 of profit. Suppose further that Taxpayer B may only deduct half of her investment expenses, or $10, from the $100 profit, and the resulting net $90 gain

88. *See* Rodney P. Mock & Jeffrey Tolin, *Realization and Its Evil Twin Deemed Realization*, 31 VA. TAX REV. 573, 576 (2012) ("The doctrine of realization has been intertwined with the federal tax definition of income since the early days of the U.S. income tax system. Realization is pervasive in our tax laws, and has historically been the foundation upon which income inclusion is built."); David Elkins, *The Myth of Realization: Mark-to-Market Taxation of Publicly-Traded Securities*, 10 FLA. TAX REV. 375, 376 (2010) ("Although a serious deviation from the pure concept of income, [realization] was adopted nonetheless as a means of contending with practical difficulties inherent in taxing appreciation of assets held by the taxpayer.").

89. *See, e.g.*, I.R.C. §§ 1014(a) (making the tax basis of a decedent's asset equal to fair market value at death), 1202(a) (eliminating taxable gain on so-called qualified small business stock), 1400Z-2(a) (eliminating capital gains in some cases related to opportunity zone investments).

90. *Id.* § 1222(a).

91. *Id.* § 451(a).

92. *Id.* § 11(b).

93. *Id.* § 1(a)–(c).

94. *See* Treas. Reg. § 1.451-1(a) (1987) (establishing that "[g]ains, profits, and income" must be reported in the year these items are "actually" or "constructively" received, whichever is earlier).

would be taxed at a capital gains tax rate of 20%. After expenses and taxes, the taxpayer would have $62 to show for her efforts (i.e., $100 (gross) – $38 [$20 (expenses) + $18 (taxes)]).

Even though Taxpayer B is permitted to deduct less than Taxpayer A, Taxpayer B is left with more take-home profit at the end of the day because Taxpayer B's net gain is taxed at the much lower capital gains rate. By limiting the amount of investment expenses that Taxpayer B may deduct and thereby having her bear an additional $2 tax on the amount of the disallowed deduction (i.e., 20% x $10 (disallowed deduction)), Congress is infusing the tax system with a modicum of equity, at least between (i) tradespeople or businesspeople and the income they earn, which is taxed at an ordinary tax rate; and (ii) investors and the income they earn, which is taxed at a capital gains tax rate.[95]

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95. When resolving disputes between the IRS and taxpayers, the judiciary has also embraced this symmetrical equity principle, best epitomized by the so-called Arrowsmith Doctrine. *See generally* Joel Rabinovitz, *Effects of Prior Year's Transactions on Federal Income Tax Consequences of Current Receipts or Payments*, 28 TAX L. REV. 85 (1972) (explaining the role that the *Arrowsmith* case plays in determining the amount and character of a deduction in a later year related to a payment received in an earlier year). This doctrine, eponymously named after the *Arrowsmith v. Commissioner* decision, 344 U.S. 6 (1952), demands that taxpayers exercise consistency in their tax reporting practices. To illustrate, in *Arrowsmith*, the taxpayer treated corporate liquidation proceeds as capital gains. *Id.* at 7. Yet, when the taxpayer subsequently had to refund some of the corporate liquidation proceeds that he had received years earlier, he characterized his payment on his current tax return as an ordinary loss. *Id.* Consistent with the taxpayer's prior year's tax return, in which he had reported a capital gain, the IRS argued that the related loss also had to be capital rather than ordinary. *Id.* at 8. In analyzing the facts of this case, the U.S. Supreme Court held in the IRS's favor, ruling that the reported loss, like the reported gain, had to be treated as capital in nature. *See, e.g.*, Fed. Bulk Carriers, Inc. v. Comm'r, 66 T.C. 283 (1976) (holding that amounts paid by taxpayers were essentially purchase price adjustments, and, as such, the character of such deductions must be consistent with the character of the income reported).

Utilizing the reasoning embraced in the *Arrowsmith* decision, another Supreme Court case, namely, *United States v. Skelly Oil Co.*, mandated that taxpayers, based upon how they stated their income, be consistent in the manner that they reported their deductions. 394 U.S. 678 (1969). In *Skelly Oil*, the taxpayer, a natural gas producer, earned $505,536.54 during tax years 1952 through 1957; but because of a 27.5% depletion allowance under Code section 613, the taxpayer only reported $366,513.99. *Id.* at 679-80. In 1958, however, the taxpayer had to refund the entire $505,536.54 it had previously collected from customers and sought to deduct an equivalent dollar amount. *Id.* at 680. The IRS objected, claiming that the taxpayer's deduction should be limited to what the taxpayer reported as income, otherwise "a total of $1.27 1/2 in deductions [would flow] for every $1 refunded to [taxpayer's] customers." *Id.* at 684. In analyzing the facts in *Skelly Oil*, Justice Marshall ruled in favor of the IRS's position, holding:

> In essence, oil and gas producers are taxed on only [72.5%] of their "gross income from the property" whenever they claim percentage depletion. The remainder of their oil and gas receipts is in reality tax-exempt. We cannot believe that Congress intended to give taxpayers a deduction for refunding money that was not taxed when received. . . . Accordingly, Arrowsmith teaches that the full amount of the repayment cannot, in the circumstances of this case, be allowed as a deduction.

A fairness principle thus appears to emerge that if income is accorded a preferential tax benefit, then those expenses related to its production should be correspondingly limited. Without this guiding principle, taxpayers would receive a double benefit: a preferential tax rate coupled with a full deduction allowance. The lack of outcry regarding investment deduction limitations may reflect the public's tacit acceptance of this rationale.

C. *Quest for Additional Tax Revenue in an Economically Efficient and Equitable Manner*

With the nation's deficit raging and no easy sources of revenue to be found,[96] Congress is constantly seeking politically palatable ways to secure additional tax dollars in the most economically favorable manner possible. Taxpayers, too, are proponents of the government being fiscally responsible,[97] usually as long as additional taxes are paid by someone other than themselves.[98]

Theoretically, with the annual tax gap—or the difference between what taxpayers pay in taxes in a timely manner and what they should pay if they fully complied with the tax laws[99]—hovering in the $400 billion range,[100] greater enforcement could help fulfill the government's search

Id. at 685.

96. *See, e.g.*, Jeff Cox, *U.S. Government Budget Ends Fiscal Year with a More than $3 Trillion Deficit*, CNBC (Oct. 16, 2020, 4:14 PM), https://www.cnbc.com/2020/10/16/us-government-budget-ends-fiscal-year-with-a-more-than-3-trillion-deficit.html [https://perma.cc/V6L9-XCE8] ("The final tally for the budget deficit in fiscal 2020 came to $3.13 trillion, more than triple last year's shortfall of $984 billion and double the previous record of $1.4 trillion in 2009, courtesy of a stimulus package passed that year to battle the financial crisis.").

97. *See, e.g.*, Alan S. Blinder & Douglas Holtz-Eakin, *Public Opinion and the Balanced Budget*, 74 AM. ECON. REV. 144, 144 (1984) ("Like wage-price controls, balancing the federal government budget has long enjoyed greater popularity with the public than with the public than with economists. A poll taken after a decade of the Great Depression, for example, showed that 61 percent of the populace was willing to cut federal spending immediately by enough to balance the budget, while only 17 percent were opposed.").

98. As once poetically declared by former Senator Russell Long, "Don't tax you, Don't tax me, Tax that fellow behind the tree." Robert Eisner, *Tax Incentives for Investment*, 26(3) NAT'L TAX J. 397, 397 (1973)

99. *See* INTERNAL REVENUE SERV., FEDERAL TAX COMPLIANCE RESEARCH: TAX GAP ESTIMATES FOR TAX YEARS 2008–2010 3 (2016) ("The gross tax gap is the amount of true tax liability that is not paid voluntarily and timely.").

100. *Id.* at 1.

> The estimated gross tax gap is $458 billion. The net tax gap is the gross tax gap less tax that will be subsequently collected, either paid voluntarily or as the result of IRS administrative and enforcement activities; it is the portion of the gross tax gap that will not be paid. It is estimated that $52 billion of the gross tax gap will eventually be collected resulting in a net tax gap of $406 billion.

Id.

to replenish its coffers.[101] However, for various reasons, enforcement efforts have not been fruitful[102] and, for decades, the voluntary compliance rate has stubbornly hovered around the eighty percent threshold,[103] making the unpaid twenty percent largely an impractical revenue source.

Congress therefore confronts a series of stark choices. It can raise tax rates, enlarge the tax base, deficit spend, or employ a combination of the foregoing. From a strict political point of view, raising tax rates is rarely attractive because whereas taxpayers seldom grasp the Code's many intricacies, most taxpayers understand higher tax rate brackets and their perceived loathsome implications (i.e., a higher tax burden). Furthermore, over the long term, unchecked deficit spending appears to be unsustainable.[104] This leaves Congress with the somewhat more attractive option of expanding the tax base.

To achieve an expanded tax base, aside from adding potential income sources to the tax base (e.g., making the receipt of municipal bond interest taxable),[105] one methodology is to curtail available deductions.[106]

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101. *See, e.g.*, Chye-Ching Huang, *How Biden Funds His Next Bill: Shrink the $7.5 Trillion Tax Gap*, N.Y. TIMES (Mar. 10, 2021), https://www.nytimes.com/2021/03/10/opinion/deficits-taxes-biden-infrastructure.html [https://perma.cc/AZ36-U5JA] ("The Treasury Department, for instance, estimated that each additional dollar dedicated to I.R.S. enforcement results in directly recouping about $6 in taxes owed.").

102. Due to a lack of adequate funding, the IRS has failed to audit many high-income nonfilers. *See* TREASURY INSPECTOR GEN. FOR TAX ADMIN., HIGH-INCOME NONFILERS OWING BILLIONS OF DOLLARS ARE NOT BEING WORKED BY THE INTERNAL REVENUE SERVICE (2020), https://www.treasury.gov/tigta/auditreports/2020reports/202030015fr.pdf [https://perma.cc/CQ2L-RQBQ].

103. *See IRS Releases New Tax Gap Estimates; Compliance Rates Remain Substantially Unchanged from Prior Study*, IRS (Sept. 26, 2019), https://www.irs.gov/newsroom/irs-releases-new-tax-gap-estimates-compliance-rates-remain-substantially-unchanged-from-prior-study [https://perma.cc/DTT4-MEZM].

> The tax gap estimates translate to about 83.6%, of taxes paid voluntarily and on time, which is in line with recent levels. The new estimate is essentially unchanged from a revised Tax Year 2008–2010 estimate of 83.8%. After enforcement efforts are taken into account, the estimated share of taxes eventually paid is 85.8% for both periods. And it is [in] line with the TY 2001 estimate of 83.7% and the TY 2006 estimate of 82.3%.

Id.

104. *See* CONG. BUDGET OFFICE, THE 2017 LONG-TERM BUDGET OUTLOOK (2017), https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/52480-ltbo.pdf [https://perma.cc/QNZ7-8CMJ] (predicting a very bleak financial picture if government spending and revenue collections remain on the current trajectory).

105. This would require the elimination of Section 103(a) of the Code which currently excludes the receipt of municipal bond interest from gross income.

106. An example that epitomizes this approach was the congressional institution and expansion of the alternative minimum tax. *See* Kerry S. Bucklin, *The Alternative Minimum Tax for Individuals: Present Problems and Future Possibilities*, 63 WASH. L. REV. 103, 104 (1988).

> The alternative tax is a tax reform showpiece enacted by Congress in response to public concern that wealthy individuals were paying too little

Congress has routinely gravitated toward this latter approach and has taken its scalpel to the Code to disallow deductions that it perceives as abusive, wasteful, or unnecessary.[107] To this end, while there is a sprinkle of deduction limitations in the trade or business realm (e.g., business entertainment expenditures),[108] there are far more deduction limitations in the investment realm.[109] At least three possible reasons explain congressional proclivity toward this approach.

First, compared to trade or business expenses, investment expenses are fairly narrow in scope. Trade or business expenses are vast in nature: they include locating raw materials, producing inventory, securing transit, safeguarding merchandise, and marketing wholesale and retail. It would be hard for Congress to know which of those expenses are essential and which are abusive, wasteful, or unnecessary. Therefore, Congress largely doesn't even try. With respect to investment expenses, the opposite is true: their scope is generally much narrower, limited to payments for professional advice and, in rarer instances, may include rental space, internet service fees, and wire bank charges. Congress can readily identify these expenses and, in a quest to secure additional revenue, recognizes that it won't do grave economic damage if it eliminates or restricts their deductibility.

Second, at least to date, Congress knows that curtailing the deductibility of investment expenses has only a marginal economic impact on the way taxpayers will conduct their investment affairs. There is plenty of evidence for this proposition: notwithstanding the current limitation on the deductibility of investment expenses,[110] the financial sector of the nation's economy is flourishing.[111] Restricting the deductibility of investment expenses has therefore apparently not had a significant rippling effect on

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tax. The alternative tax is an independent measure of tax liability paid when this "alternative" amount exceeds the taxpayer's regular tax liability. Alternative taxable income differs from regular taxable income in that it includes items excluded from regular taxable income, and prescribes independent treatment of deferrals.

107. *Id.*

In 1986, for example, in an endeavor to expand the tax base, Congress precluded taxpayers from taking passive loss deductions. For an excellent overview of this limitation, see Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1 (1988).

108. *See, e.g.*, I.R.C. § 274(a) (disallowing the deductibility of business entertainment expenses).

109. *See, e.g.*, *id.* § 67(g) (disallowing the deductibility of investment expenses until 2026).

110. For the next several years, the Code precludes individual taxpayers from deducting their investment expenses. *See supra* note 8.

111. *See, e.g.*, Ulku Rowe, *6 Trends that Will Shape the Financial Services Industry in 2021*, FORBES (Feb. 5, 2021), https://www.forbes.com/sites/googlecloud/2021/02/05/6-trends-that-will-shape-the-financial-services-industry-in-2021/[https://perma.cc/QS58-JGSF] (describing those trends that will keep the financial sector of the economy robust for the foreseeable future).

how taxpayers have conducted their investment affairs—but could yield additional tax revenue.

A final reason that Congress may have chosen to curb the deductibility of investment expenses is to add an element of progressivity to the income tax system. Not surprisingly, there exists much empirical evidence indicating that the bulk of the nation's investments is owned by the nation's wealthiest taxpayers.[112] Curtailing investment expense deductions thus constitutes an indirect method of increasing the income tax's progressivity without increasing tax rates. In other words, by denying investment deductions on investment earnings, Congress has ensured that investors—who are by and large taxpayers in higher tax brackets—correspondingly pay more taxes than if deductions were permitted. To illustrate, suppose Taxpayer A has a million-dollar investment portfolio that annually generates $10,000 in dividends. Suppose further that Taxpayer A pays a $1,000 annual fee for investment advice. Under current law, Taxpayer A would pay tax on the entire $10,000 of the dividends, rather than on the net amount of $9,000.

III. REFORM

As presently designed, the income tax system is broken insofar as it fails to accord with the ideal that expenses that do not engender personal consumption or wealth accumulation should be tax deductible.[113]

Admittedly, when there are sound public policy justifications to eschew the ideal, then such exceptions should be part and parcel of the Code's fabric.[114] But when it comes to the disparate tax treatment of trade or business expenses and investment expenses, a persuasive case for instituting an exception has not been made. Instead, this approach appears to be more a matter of political expediency designed to expand the tax base and secure additional revenue, rather than grounded in sensible logic.

Therefore, Congress should accord similar tax treatment to trade or business expenses and investment expenses and make both universally deductible. This Part of the Article details proposed reform measures. Section A enumerates the possible paths that reform could follow while Section B explores the practical implications associated with instituting the proposed reform measures.

112. *See* Parker & Fry, *supra* note 78.

113. For the proposition that expenditures that do not involve personal consumption should be deductible, see *supra* notes 21–24 and accompanying text.

114. For example, Congress has deemed de minimis fringe benefits to be nontaxable notwithstanding the fact that they represent accretions to wealth under Section § 61(a) because the administrative costs associated with trying to track them are not deemed administratively feasible. *See* I.R.C. § 132(e).

A. *Possible Paths to Meaningful Tax Reform*

When Congress undertakes tax reform, it must ordinarily address many competing interests.[115] Some stakeholders want to preserve their tax preferences at all costs, others seek to promote tax equity, others place a premium on administrative ease, and still others want a tax system that is efficient and enables economic decision-making to be as tax neutral as possible. Given the range of these competing interests and vastly different agendas, Congress must often make difficult and compromised choices. In trying to address the competing interests of various stakeholders, when it comes to the deductibility of investment expenses, reform can take either: (1) a moderate, or (2) a more sweeping approach. Consider the salient features of each approach and how they would likely impact reporting practices.

1. *Moderate Approach to Reform*

The framework of the moderate reform approach follows an already existing and familiar methodology found in Subchapter J of the Code. This methodology functions on a simple allocation principle: expenses are apportioned to the income type generated. Accordingly, if an expense generates tax-exempt income (e.g., interest on a bond issued by a local municipality), it would be allocated to that income category. Next, if an expense generates income subject to preferential tax rates (e.g., long-term capital gains and qualified dividends), it would be allocated to that income category. Then, if an expense generates income subject to ordinary income tax rates (e.g., short-term capital gains and interest income), it would be allocated to that income category. Finally, if an expense cannot be connected with the generation of any particular type of income, it is allocated in a pro rata fashion based upon profit generation.[116] Thus, investment expenses could be categorized as follows:

- Category A Expenses: The expenses that generate profits receiving tax-exempt status would be allocated directly to those profits.
- Category B Expenses: The expenses that generate profits receiving preferential tax treatment would be allocated directly to those profits.
- Category C Expenses: The expenses that generate profits receiving ordinary tax treatment would be allocated directly to those profits.

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115. *See, e.g.*, Michael Doran, *Legislative Compromise and Tax Transition Policy*, 74 U. CHI. L. REV. 545, 566 (2007) (noting that "the players in the tax legislative process customarily resolve their differences and successfully produce legislation by pursuing compromise outcomes").

116. *See* Treas. Reg. §§ 1.652(b)-3(a) (2021) (allocating direct expenses), 3(b) (allocating indirect expenses).

- Category D Expenses: The expenses that do not fall within the scope of Category A, B, or C would be allocated pro rata based upon profits generated per investment category.[117]

An example illustrates how this proposed expense allowance methodology would operate in practice. Suppose a taxpayer has three different types of investments with a brokerage firm:

Type 1: $4 million portfolio of tax-exempt bonds that generates $60,000 of tax-exempt return.
Type 2: $2 million portfolio of stock that generates $20,000 of annual dividend return.
Type 3: $4 million short-term bond fund that generates $120,000 in interest return.

Suppose further that as part of the taxpayer's arrangement with the brokerage firm, in addition to paying a general management fee of $20,000, the taxpayer pays three specialized annual investment fees: (1) $1,000 to manage the tax-exempt bond fund, (2) $5,000 to manage the stock portfolio, and (3) $10,000 to manage the short-term bond fund. The chart below reflects how the associated fees would be allocated under the moderate reform proposal.

APPORTIONED EXPENSE ALLOCATION CHART

	TAX-EXEMPT BOND PORTFOLIO ($4 MILLION)	STOCK PORTFOLIO ($2 MILLION)	SHORT-TERM BOND FUND ($4 MILLION)
Return	$60,000	$20,000	$120,000
Direct Expense	($ 1,000) [Cat. A]	($ 5,000) [Cat. B]	($ 10,000) [Cat. C]
Indirect Expense	($ 6,000) [Cat. D]*	($ 2,000) [Cat. D]*	($ 12,000) [Cat. D]*
Income	$60,000[118]	$13,000	$ 98,000

*Category D expense: Because the total investment return was $200,000 (i.e., $60,000 + $20,000 + $120,000), the general $20,000 indirect expense is thus allocated pro rata as follows:

- for the tax-exempt bond portfolio, $60,000/$200,000 x $20,000 = $6,000
- for the stock portfolio, $20,000/$200,000 x $20,000 = $2,000
- for the short-term bond fund, $120,000/$200,000 x $20,000 = $12,000

As embodied in Subchapter J, this approach toward expense allocation has been part and parcel of the Code for many decades and can readily be extended to apply to investment expense allocations. Doing so is consistent with practices in the trust and estate realm and, furthermore, is

117. *Id.*
118. Expenses allocated to tax-exempt income are not deductible. *See* I.R.C. § 265(a)(1).

fairer than the status quo in which Congress, in a Procrustean fashion, essentially disallows the deductibility of all investment-related expenses.[119]

2. *Sweeping Approach to Reform*

Congress can also take a more sweeping approach to tax reform. An element of this approach would be to eliminate preferential tax treatment for investment income and thereby simplify the expense allocation to fewer categories of income. Indeed, one of the chief justifications for limiting the deductibility of investment expenses rests on the fact that the Code grants preferential tax treatment to many forms of investment income.[120] If the Code no longer granted preferential tax treatment to investment income, Congress would likely reexamine whether to maintain its current limitations on investment deductions.

Tomes of academic studies and literature written by erudite scholars assert that the tax rate preference afforded various income categories (mostly in the nature of capital gains) makes little sense.[121] Of course, a host of other learned scholars proffer the exact opposite claim, namely, that there are sound reasons that certain kinds of income (again, mostly in the nature of capital gains) should be accorded preferential tax treatment.[122]

Regarding this raging debate, this is not the occasion to choose sides. Yet, for argument's sake and on the basis of assumed merit, suppose Congress decided to eliminate the tax preferences it currently extends to certain investment income and subject the receipt of all income to a common tax rate bracket structure.[123] Except in the case of investment expenditures related to the generation of tax-exempt income,[124] instituting this

119. *See supra* Section II.B.

120. *Id.*

121. *See, e.g.*, Daniel Halperin, *Commentary, A Capital Gains Preference is not EVEN a Second Best Solution*, 48 TAX L. REV. 381, 391 (1993) ("In short, a capital gains preference creates significant transactional complexity and forecloses the possibility of substantial simplification of the income tax. It should be eliminated as soon as feasible."); Walter J. Blum, *The Capital Gains Issue: A Handy Summary of the Arguments*, 35 TAXES 247 (1957) (listing twenty-five reasons that capital gains should be taxed in their entirety and eight arguments against taxing them in their entirety).

122. *See* Cunningham & Schenk, *supra* note 84.

123. For a stinging indictment of the preferential tax rates' extended capital gains, see Stanley S. Surrey, *The Federal Income Tax Base for Individuals*, 58 COLUM. L. REV. 815, 820 (1958). Surrey notes that:

> [T]he contrasting presence of 91 per cent ordinary income rates and 25 per cent capital gain rates has led to a considerable distortion in the arranging of business and family transactions and to an endless succession of tax gimmicks and schemes designed to achieve the 25 per cent rate. The result is that the capital gain preferential rate has become the greatest single source of complexity in the technical rules of the Code.

Id.

124. *See* I.R.C. § 265(a)(1) (disallowing all expenses associated with the production of tax-exempt income).

proposed change would warrant universal investment expense deductibility.

Just as with the more moderate reform proposal set forth above, an example helps illustrate how this proposed reform measure would operate in practice. To readily juxtapose the two proposals—namely, the moderate and more sweeping proposals—suppose an identical set of facts to the one posited above unfolded in which a taxpayer has the following three different types of investments with a brokerage firm:

- Type 1: $4 million portfolio of tax-exempt bonds that generates $60,000 of tax-exempt return.
- Type 2: $2 million portfolio of stock that generates $20,000 of annual dividend return.
- Type 3: $4 million short-term bond fund that generates $120,000 in interest return.

Likewise, suppose further that as part of the taxpayer's arrangement with the brokerage firm, in addition to paying a general management fee of $20,000, the taxpayer paid three specialized annual investment fees: (1) $1,000 to manage the tax-exempt bond fund, (2) $5,000 to manage the stock portfolio, and (3) $10,000 to manage the short-term bond fund.

As the chart below reflects, under the sweeping reform proposal, except for the tax-exempt investment,[125] all other investments (namely, the stock and short-term bond fund) and the income they generate ($20,000 from Type 2 + $120,000 from Type 3) could be grouped together in one aggregate investment portfolio category. The direct expense allocated to the tax-exempt income ($1,000 for Category 1) would be allocated to it, and the direct expenses ($5,000 for Category 2 + $10,000 for Category 3) resulting in taxable income would be allocated to the aggregate category. Furthermore, the indirect expense (i.e., $20,000) would be allocated in proportion to the tax-exempt and taxable income that such expense generated (i.e., (i) $60,000/$200,000 x $20,000, or $6,000; and (ii) $140,000/$200,000 x $20,000, or $14,000).

125. *Id.*

SIMPLIFIED EXPENSE ALLOCATION CHART

	TAX-EXEMPT BOND PORTFOLIO ($4 MILLION)	AGGREGATE INVESTMENT PORTFOLIO ($6 MILLION)
Return	$60,000	$140,000
Direct Expense	($ 1,000)	($ 15,000)
Indirect Expense	($ 6,000)	($ 14,000)
Income	$60,000[126]	$111,000

As evidenced by the chart above, the more sweeping reform simplifies the computation process. Aside from separating tax-exempt from taxable income, it obviates the need to go through the nettlesome and laborious task of identifying which income is accorded preferential tax treatment and which is not, and matching expenses against the type of income they generate.[127] In terms of efficiency, tax considerations would no longer have as much influence in shaping taxpayers' investment decisions.[128]

The two expense allocation charts enumerated above delineate a clear direction that tax reform should take. As previously explained, whether it be a trade or business expense or investment expense, the act of spending to generate wealth is not an act of personal consumption or accumulation. Thus, fairness would demand that taxpayers who incur such expenses be permitted dollar-for-dollar tax deductions. But notice that under the moderate reform proposal, taxpayers must endure the somewhat challenging prospect of matching deductions against different income classes. Instead, under the more sweeping reform proposal, this matching exercise is largely averted, making the sweeping approach the more attractive option.

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126. Expenses allocated to tax-exempt income are not deductible. *See* I.R.C. § 265(a)(1).

127. *See, e.g.*, Daniel N. Shaviro, *Commentary, Uneasiness and Capital Gains*, 48 TAX L. REV. 393, 398 (1993). Shaviro explains that:

> The core concept of distinguishing between capital and ordinary assets is inherently fuzzy at best, and incoherent at worst. It turns on one or more of a host of difficult distinctions, such as between business and investment assets or between extraordinary and recurrent receipts. These distinctions inevitably create difficult line drawing issues. Even where the capital gains boundaries are clear, the preference inevitably increases transactional complexity as taxpayers weigh altering their transactions to get the best tax results.

Id.

128. *See, e.g.*, Brian Van Vleck, *A Comparison of Japanese and American Taxation of Capital Gains*, 14 HASTINGS INT'L & COMP. L. REV. 719, 734–35 (1991) ("The goal of efficiency, or tax neutrality as it is sometimes termed, is furthered when these decisions are made because of their economic merit rather than their tax consequences.").

B. *Favorable Outcomes Associated with the Institution of the Proposed Reform Measures*

Were Congress to institute either the moderate or more sweeping reform proposal and thereby open the door to investment expense allowance, three favorable outcomes would likely ensue: (1) investment firms would be more inclined to make fee disclosures, (2) the nature of the fee structure of investment firms would change, and (3) there would be enhanced reliance on investment professionals.

1. *Greater Inclination of Investment Firms to Make Fee Disclosures*

Currently, investment firms have an obvious reason to keep their fees hidden: no consumer relishes paying them. To the extent that such fees remain under the proverbial radar screen and attract little attention, the greater the likelihood that customers will not complain or challenge them. But another reason informs the fee structures of investment firms: concerns with the availability of tax deductions.[129] By subtracting the fee amount prior to allocation of investment profits, taxpayers secure de facto deductions for these fees.

To illustrate, suppose a taxpayer invests $1 million in a mutual fund that secures a five percent return, or $50,000. Suppose further that the mutual fund charges a one percent management fee on the principal invested, or $10,000, which it subtracts from the overall return before reporting the profits earned by the taxpayer. In this scenario, the taxpayer would prefer that this fee be taken before his profits are allocated so that he would be taxed on $40,000 rather than $50,000 (and then be saddled with a $10,000 disallowed investment expense deduction).

If Congress made investment fees deductible, taxpayers would likely clamor to identify fee information for two reasons. First, it would enable them to make more prudent investment decisions, knowing exactly what fees they are being charged.[130] Second, armed with this information, taxpayers would then be positioned to secure an investment expense deduction. To illustrate, consider utilizing the same facts in the prior example in which the taxpayer invested $1 million and enjoyed a 5% return. This time, the taxpayer would report the entire $50,000 of profits. Simultaneously, in order to secure an investment expense deduction, the taxpayer would demand to know from the investment firm the fee that was being charged.

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129. *See* Rob Berger & Benjamin Curry, *Small Fees Have a Big Impact on Your Investments*, FORBES (Aug. 3, 2020), https://www.forbes.com/advisor/investing/mutual-fund-investment-fees/ [https://perma.cc/3GR3-39Y2].

130. Many epistemologists would likely applaud this approach, namely, the more informed one is, the more capable one is of making better choices. *See* Duncan Pritchard, John Turri & J. Adam Carter, *The Value of Knowledge*, STAN. ENCYCLOPEDIA PHIL. (Mar. 7, 2018), https://plato.stanford.edu/entries/knowledge-value/ [https://perma.cc/Y95R-MGMC].

2. *Change in the Nature of Investment Firms' Fee Structure*

The current limitation on the deductibility of investment expenses has skewed the way that investment firms arrange their fee structures. In almost all instances, when taxpayers purchase an investment, these firms charge a sales commission (i.e., either a flat dollar amount or a percentage of the overall purchase price).[131] Unlike other investment expenses, the good news for the taxpayer is that the commission payment in question is not disallowed (resulting in its forfeiture). Instead, the commission is added to the investment's tax basis.[132] At a later date when the investment is subsequently sold or exchanged, the taxpayer's augmented tax basis reduces the amount of the taxable gain or increases the amount of allowable loss.[133] But the taxpayer's use of this tax benefit to shelter taxable income or generate additional losses is available only at a future point in time and, depending upon circumstances, may be lost in its entirety.[134]

Were Congress to institute the proposed reform, the way that investment firms charge fees to their clients would likely change. More specifically, under time-value-of-money principles,[135] clientele would likely pressure investment advisers to charge fees that would yield immediate tax benefits rather than ones that had to be capitalized to be used at a later point of time. An obvious way to accomplish this goal would be for the investment firm to charge an annual management fee rather than impose an investment-by-investment commission charge.

To illustrate, suppose Taxpayer A wished to purchase 1,000 shares of Google stock, costing $400 per share, or $400,000. Suppose further that Taxpayer A paid a 1% commission, or $4,000, for this purchase. Under current law, this transaction would increase Taxpayer A's tax basis in the Google stock to $404,000, which Taxpayer A could use to minimize his future gains or maximize his losses if he sold the purchased Google stock weeks, months, or years later. Were Congress to institute one of the proposed reform measures, however, Taxpayer A would be apt to utilize the services of an investment firm that charged a periodic management fee rather than billed on a commission basis, for one simple reason: the for-

131. *See* Berger & Curry, *supra* note 129. Berger and Curry observe that:

> Fund managers pass on to investors the cost of buying and selling securities owned by the fund . . . . Some mutual funds charge investors a front-end or back-end load fee. Load fees are sales charges assessed when you buy shares (front-end load fees) or when you sell shares (back-end load fees). A typical front-end load fee in the mutual fund industry is 5.75% of the amount invested.

Id.

132. *See* Treas. Reg. § 1.212-1(k) (1975).

133. *See* I.R.C. § 1001(c) (2021).

134. *See id.* § 1014(a).

135. *See* Noël B. Cunningham, A Theoretical Analysis of the Tax Treatment of Future Costs, 40 TAX L. REV. 577, 581 (1985) ("Generally speaking, the time value of money is the difference between (1) the value of an amount of money today and (2) . . . [the value of] the same amount of money at some future time.").

mer would be immediately deductible, whereas the latter would not. Had the investment firm in this example charged an annual 1% management fee instead of a 1% commission, Taxpayer A would have an immediate $4,000 deductible investment expense.

3. *Enhanced Reliance on Investment Professionals*

The elementary laws of supply and demand are fairly straightforward. The more something costs, the less the demand; conversely, the less something costs, the greater the demand.[136] There is no reason to assume that these basic laws of economics would not apply to securing investment advice. Therefore, the more investment fees cost, the lower the demand; conversely, the less investment fees cost, the higher the demand. Making investment fees tax deductible would reduce their cost to consumers, increasing demand. To illustrate, if an investment expense management fee is $10,000 and is tax deductible, its after-tax cost is $6,000 (assuming the taxpayer utilizing these services is in the 40% tax bracket), making the utilization of such services far more economically attractive than is currently the case.

Currently, almost all taxpayers rely upon themselves rather than professionals for financial advice.[137] Were Congress to institute the proposed reform measures and the after-tax cost associated with investment professionals were to diminish, this self-reliance mentality would likely change. It is easy to imagine that as more taxpayers turn to investment professionals for advice, several positive consequences would follow. Assuming professional investment advisers were seasoned and skilled, they would likely instruct taxpayers to put a greater emphasis on diversifying their investment portfolios. They would probably guide taxpayers away from those investments that were saddled with financially burdensome fees. Finally, they would caution taxpayers against spending beyond their means and about the need to save for retirement. In sum, were taxpayers mindful of the prudent advice of their investment professionals, their financial futures would likely be brighter and more stable.

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136. *See, e.g.*, Eli Wald, *An Unlikely Knight in Economic Armor: Law and Economics in Defense of Professional Ideals*, 31 SETON HALL L. REV. 1042, 1048 (2001) (noting the "fundamental [economic] maxim that 'supply follows demand"'); Robert C. Downs, *Law and Economics: Nexus of Science and Belief*, 27 PAC. L.J. 1, 12 (1995) ("[T]he corollary to the supply and demand theories is also true, that as the price (cost) of a thing increases, its demand (utilization) will decrease . . . .").

137. *See* Jessica Dickler, *75 Percent of Americans Are Winging It When It Comes to Their Financial Future*, CNBC (Apr. 2, 2019), https://www.cnbc.com/2019/04/01/when-it-comes-to-their-financial-future-most-americans-are-winging-it.html [https://perma.cc/WT9Y-Y5R4]. However, some commentators argue that when it comes to investment advice, self-reliance is far better than relying upon the advice professionals proffer. *See, e.g.*, Sean Williams, *Why Are Fund Managers So Awful at Their Job?*, MOTLEY FOOL (Sep. 23, 2019), https://www.fool.com/investing/2019/09/23/why-are-fund-managers-so-awful-at-their-job.aspx [https://perma.cc/3KYB-RMSM].

CONCLUSION

Taxpayers routinely make out-of-pocket expenditures. In accordance with general income tax principles, on the one hand, if the expenditure in question constitutes personal consumption, it should not be deductible. On the other hand, if the expenditure in question constitutes something other than personal consumption, it should be deductible.[138] At least this is the position of almost all income tax theorists,[139] and, as previously pointed out, there is clear and logical Code verbiage in sections 162(a) and 212(1) to this effect.

But, over time, the tax treatment of trade or business expenses and investment expenses—neither of which engender personal consumption—have diverged. When it comes to the former, Congress has been benevolent in permitting their deduction and has in fact gradually broadened their deductibility. Yet, when it comes to the latter, Congress has been stingy in approving their deduction and has gradually eroded their deductibility altogether. However, after examining the possible reasons for the different tax treatment of these two types of expenses, it is clear that none proves persuasive.

Congress should therefore anchor the Code to its theoretical moorings. More specifically, it should allow the deductibility of investment expenses, putting them on equal footing with trade or business expenses. If Congress heeds this advice, the tax treatment of income and expenses would be better synced, placing the Code in a far sturdier position insofar as issues pertaining to administrability, efficiency, and equity are concerned. Put somewhat differently, the Code would no longer relegate investment expenses to a secondary status and, instead, such expenses would have the same stature of their kindred counterpart, namely, trade and business expenses.

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138. Albeit, personal consumption is not always easy to define, anything outside of its ambit, theorists aver should be deductible for tax purposes. *See* Andrews, *supra* note 5.

139. See *supra* notes 21–24 and accompanying text.