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# Newi v. Commissioner: Home Office Deduction and Equal Treatment for Employees

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## NEWI V. COMMISSIONER: HOME OFFICE DEDUCTIONS AND EQUAL TREATMENT FOR EMPLOYEES

Over the past decade the Tax Court has repeatedly faced disputes involving the deduction of employee home expenses under § 162 of the Internal Revenue Code.<sup>1</sup> The failure of that court to deal decisively with the issue has finally been remedied by the Second Circuit in *Newi v. Commissioner*.<sup>2</sup>

George Newi, a salesman of television advertising, used his den to study each day's selling activities and to view television commercials. Although Newi was provided with adequate office and television facilities, he found it more convenient to work at home.<sup>3</sup> Newi took a deduction for this use of his den. The deduction was disallowed by the Internal Revenue Service because Newi was not required to work at home as a condition of his employment.<sup>4</sup> The Tax Court allowed the deduction,<sup>5</sup> however, and IRS appealed. The court of appeals found that since distance and delay made it impractical for Newi to return to his downtown office at night his home office expense was "appropriate and helpful"<sup>6</sup> and, therefore, deductible under § 162.

### § 162 DEDUCTIONS

In order to receive a § 162 deduction<sup>7</sup> a taxpayer must prove that the expenses claimed were "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."<sup>8</sup> That the expense was incurred<sup>9</sup> or that it was of a business

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1. INT. REV. CODE of 1954, § 162.

2. 432 F.2d 998 (2d Cir. 1970), *aff'g* 38 P-H Tax Ct. Mem. 735 (1969).

3. 432 F.2d at 999-1000. Record at 48.

4. 432 F.2d at 999-1000.

5. George H. Newi, 38 P.H Tax Ct. Mem. 735 (1969).

6. 432 F.2d at 1000.

7. The language of § 162(a) has not been altered since the Revenue Act of 1918, ch. 18 § 214(a) (1), 40 Stat. 1057, 1066. All references to this trade or business deduction will be to § 162 although the identical provisions of its pre-1954 predecessors will occasionally be involved.

8. INT. REV. CODE of 1954, § 162(a). In contrast to § 162, §§ 262 and 263 render personal and capital expenses nondeductible unless specifically allowed elsewhere in the Code. IRS treats all costs of maintaining a household as nondeductible under § 262 unless the taxpayer "uses part of the house as his place of business." Treas. Reg. § 1.262-1(b) (3) (1958).

9. This requirement insures that a deduction is not allowed for an expense that was never sustained. *Security Flour Mills v. Commissioner*, 321 U.S. 281 (1944). It further insures that the expense is properly allocable to the taxable year. *Lucas v. American Code Co.*, 280 U.S. 445 (1930).

nature<sup>10</sup> is seldom at issue. In practice, deductibility under § 162 has turned on the meaning of "ordinary and necessary."<sup>11</sup> The inherent flexibility of this phrase has provided courts with wide discretion to limit or expand the coverage of § 162 in accordance with the policy considerations deemed significant in each case.<sup>12</sup>

In 1933 the Supreme Court, in *Welch v. Helvering*,<sup>13</sup> defined "necessary" to mean "appropriate and helpful"<sup>14</sup> and "ordinary" to require that the expense be both noncapital and consistent with normal business practices. In 1966, however, the Court in *Commissioner v. Tellier*<sup>15</sup> redefined "ordinary" so as to require merely that the expense be noncapital.<sup>16</sup> Following *Tellier*, therefore, a noncapital expense need

10. The cases interpreting § 162 have used the term "business" in two distinct senses—"business in fact" and "business at law." "Business in fact" is a common sense definition requiring that the activity involved not be a hobby or some other strictly personal endeavor. *See, e.g.,* Celeste B. Smith, P-H TAX CT. REP. & MEM. DEC. ¶ 71,122 (May 27, 1971); James E. Ashe, 36 P-H Tax Ct. Mem. 862 (1967). "Business at law," however, is not a requirement for deductibility. It is, rather, a shorthand expression of a court's overall decision concerning deductibility, expressed in terms of proximate relationship to business. "Business" in this second sense is really equivalent to "ordinary and necessary." *See* notes 11-12 *infra*.

11. Given the business of the particular taxpayer . . . the real problem lies in the taxpayer's attempt to connect . . . [his permissible deductions with his actual expenses] . . . What sort of legalistic wiring will close the circuit . . . ?

Boehm, "Ordinary and Necessary Expenses": Proximate Relationship as a Rejuvenated Test for Deductibility, 30 U. CIN. L. REV. 1, 6 (1961).

12. In a manner reminiscent of the tort concept of proximate cause courts have used "ordinary and necessary" as a tool for limiting the deductibility of expenses which are actually incurred in the taxpayer's business so as to effectuate the courts' policy preferences. In interpreting the cases in this manner, Boehm argues that the courts are legitimately, although not always expressly, using "ordinary and necessary" to narrow § 162 so as to deny a deduction for extravagant expenses. In so doing, according to Boehm, the courts have referred to such expenses as not proximately caused by business, as not proximately related to business, or as too remote. *Id. See, e.g.,* Lykes v. United States, 343 U.S. 118, 128 (1952) (Jackson, J., dissenting); Bingham's Trust v. Commissioner, 325 U.S. 365, 370 (1945); Commissioner v. Heininger, 320 U.S. 467, 470-71 (1943); Deputy v. DuPont, 308 U.S. 488, 493-94 (1940); Kornhauser v. United States, 276 U.S. 145, 153 (1928); H.R. REP. No. 2333, 77th Cong., 2d Sess. 75 (1942); S. REP. No. 1631, 77th Cong., 2d Sess. 88 (1942).

13. 290 U.S. 111 (1933).

14. Despite the widely divergent interpretations of the terms "ordinary and necessary" in combination, there is general agreement as to the correct interpretation of the word "necessary" standing alone:

We may assume that the payments to creditors of the Welch Company were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. . . . He certainly thought they were, and we should be slow to override his judgment.

*Id.* at 113; *accord*, Commissioner v. Tellier, 383 U.S. 687 (1966); Commissioner v. Heininger, 320 U.S. 467 (1943).

15. 383 U.S. 687 (1966). The expenses incurred by the taxpayer in an unsuccessful defense against criminal charges of securities and mail fraud were allowed as business deductions.

16. The principle function of the term "ordinary" in § 162(a) is to clarify

only be "appropriate and helpful" to satisfy the "ordinary and necessary" language of § 162.

### TREATMENT OF EMPLOYEES UNDER § 162

Section 162 makes no distinction between employees and self-employed taxpayers. Judicial interpretation of the section has created such a distinction. The federal tax was originally intended to be a levy on net income,<sup>17</sup> but early courts balked at granting employee business deductions. Consonant with this prejudice, the courts utilized a whipsaw test based upon an employer benefit theory to defeat employee business deductions. On the one hand, the courts reasoned, if the employee's expense benefited the employer's business, the expense was the employer's. On the other hand, the expense was held to be personal and non-deductible

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the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset.

*Id.* at 689-90.

17. Although the federal tax is actually levied on an amount which is more than net income, the allowance of business deductions is essentially an attempt to achieve a tax base approximating net income. In 1913, during the Senate debate over the wording of the business expense deduction provisions of the first income tax act under the sixteenth amendment, Senator John Sharp Williams (D.-Miss.), the floor manager of the bill, explained the business expense section as an attempt to define net income:

The object of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures and losses. It is not to reform men's moral characters; that is not the object of the bill at all . . . the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year.

50 CONG. REC. 3849 (1913).

This principle has since been honored more in the breach than in the observance. With the advent of World War I and higher tax rates, violation of this net income principle became particularly severe:

The sum and substance of it all is that you can pay a 2 per cent tax out of an income which you are supposed to have but have not, but if you are to pay a 50 per cent tax you have got to have the income out of which to pay it. Although originally when we were dealing with lower rates of taxes there was something to be said for the viewpoint that the Government's expected revenue should not be reduced by outside transactions, some of which have been characterized as gambling, the practical force of this viewpoint is entirely overcome when we are seeking to collect very high taxes out of an income which does not in fact exist. We are in a situation now where the Government can get a very heavy revenue out of actual incomes and where it is not only unnecessary but unjust to seek a revenue out of a theoretical and nonexistent [*sic*] income—whatever may be the cause of its nonexistence.

*Hearings on the Revenue Act of 1918 before the House Comm. on Ways and Means*, 65th Cong., 2d Sess., pt. 1, at 243 (1918).

While the situation may be somewhat less severe today, the principle remains that to tax more than net income is to tax nonexistent income. The importance of this theory lies in its continuing attractiveness to equitable instincts. The movement towards a liberalized definition of "ordinary and necessary" is at its core a movement toward this goal.

if not of benefit to the employer's enterprise.<sup>18</sup>

In 1938, with the decision in *Schmidlapp v. Commissioner*,<sup>19</sup> the Second Circuit rejected this whipsaw approach and permitted a bank executive to deduct the costs of entertaining his employer's customers. Speaking for the court, Judge Learned Hand reasoned:

It is no answer to say that [the expenses] were for the bank's benefit; so were all the taxpayers services; if it did in fact give him to understand that he was to extend a factitious hospitality in its interest, the cost of it was a necessary expense of his office.<sup>20</sup>

Relying on *Schmidlapp*, subsequent decisions abandoned the notion that wage earners could not deduct § 162 expenses.<sup>21</sup>

Nevertheless, vestiges of the previous bias against wage earners still remained. Employees were subjected to more rigorous standards of proof than those imposed upon self-employed taxpayers. At the core of this discrimination was a revised employer-benefit rule. Cases following *Schmidlapp* theorized that employee expenses were personal and non-deductible if not of benefit to the taxpayer's employer.<sup>22</sup> However, the expenses benefiting an employer were deductible by the employee if all other § 162 requirements were satisfied. In making proof of employer-

18. This principle was adopted by a series of cases in the 1920's and early 1930's. Franklin M. Magill, 4 B.T.A. 272 (1926); Arthur B. Chivers, 4 B.T.A. 1083 (1926); E. S. Frischkorn, 7 B.T.A. 431 (1927); Hal E. Roach, 20 B.T.A. 919 (1930); Carl J. Schmidlapp, P-H B.T.A. Mem. 542, *rev'd*, 96 F.2d 680 (2d Cir. 1938). See also Lempert, *Who Can Deduct a Business Expense*, 11 TAX L. REV. 433 (1956) [hereinafter cited as Lempert]; Osmond, *The Corporate Executive and the Business Expense Deduction*, 33 TAXES 68 (1955) [hereinafter cited as Osmond]; Rothschild & Sobernheim, *Expense Accounts for Executives*, 67 YALE L.J. 1363 (1958); Note, *Deductibility of Expenses Incurred for the Benefit of Another*, 66 HARV. L. REV. 1508 (1953) [hereinafter cited as *Deductibility of Expenses*].

19. 96 F.2d 680 (2d Cir. 1938).

20. *Id.* at 682.

21. "[E]very person who works for compensation is engaged in the business of earning his pay. . . ." Noland v. Commissioner, 269 F.2d 108, 111 (4th Cir. 1959), *cert. denied*, 361 U.S. 885 (1959). See also Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961); Caruso v. United States, 236 F. Supp. 88 (D.N.J. 1964).

The pre-*Schmidlapp* whipsaw test continues to have application as a device to prevent deduction shifting. Thus stockholders may not deduct unreimbursed expenses of benefit to the business. Noland v. Commissioner, *supra*. In addition, executives who voluntarily forego reimbursement may not deduct the expenses that would have been reimbursed. Heidt v. Commissioner, 274 F.2d 25 (7th Cir. 1959).

22. The fact that the expenditure is for the employer's primary benefit does not lessen deductibility; rather it is only because the employer expects the expenditure that it is a business one. . . .

*Deductibility of Expenses*, *supra* note 18, at 1509. Accord, Lempert, *supra* note 18, at 436; Osmond, *supra* note 18.

benefit a prerequisite to deductibility, courts required a showing of that which had previously precluded a § 162 deduction.

Three standards for the application of the employer-benefit rule emerged. Section 162 expenses were deductible if: (1) the employee was required or expected to incur the expense as "a condition of his employment";<sup>23</sup> (2) the employee's compensation reflected the expense<sup>24</sup> or (3) the expense was likely to contribute to the employee's advancement.<sup>25</sup>

The courts displayed a marked preference for the restrictive "condition of employment" test in the years immediately following *Schmidlapp*. During the 1950's, however, they developed a greater willingness to grant deductions upon the satisfaction of any of the tests.<sup>26</sup> Nevertheless, in the early 1960's, concern over extravagant expense account practices returned the "condition of employment" test to prominence.<sup>27</sup> It was at this time the home office deduction became a significant issue.

#### THE HOME OFFICE DEDUCTION FOR EMPLOYEES

The 1962 decision of *Harold H. Davis*<sup>28</sup> represents the first Tax Court application of the "condition of employment" test to the home office deduction.<sup>29</sup> Davis, a college professor, used a room above his

23. *Schmidlapp v. Commissioner*, 96 F.2d 680, 681 (2d Cir. 1938) ("expected"); A.D. Crews, 21 P-H Tax Ct. Mem. 453, 455 (1952) ("required"). *Accord*, Fred F. Fischer, 16 P-H Tax Ct. Mem. 456, 461 (1947); Andrew Jergens, 17 T.C. 806, 811 (1951); Grover Tyler, 13 T.C. 186, 189 (1949). *Cf.* W.W. Bercaw, 16 P-H Tax Ct. Mem. 28, 31 (1947).

24. Harold A. Christensen, 17 T.C. 1456, 1457 (1952); Andrew Jergens, 17 T.C. 806, 811 (1951); Grover Tyler, 13 T.C. 186, 189 (1949).

25. Originally, expenses likely to lead to advancement were treated either as capital expenses or as personal expenses. *Welch v. Helvering*, 290 U.S. 111, 115-16 (1933); I.T. 1520, I-2 CUM. BULL. 145 (1922). The ruling was reversed by I.T. 2688, XII-1 CUM. BULL. 251 (1933). Both rulings involved research expenses of college professors. By 1963, IRS conceded that proof of a relationship between advancement and research expenditure would render the expenditure deductible. Rev. Rul. 63-275, 1963-2 CUM. BULL. 85. *See* note 41 *infra*.

26. Harold A. Christensen, 17 T.C. 1456 (1952), represented a breakthrough in this respect. This case, which was reviewed by the whole court, held that an employee expense was deductible although it was not incurred as a condition of his employment. *Id.* at 1457.

27. *Harold H. Davis*, 38 T.C. 175 (1962), reflects this concern. *Davis* was decided during the height of congressional debate over the Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960, 974 (codified in scattered sections of INT. REV. CODE of 1954). Section 4(a)(1) of that Act imposed special substantiation requirements upon travel, entertainment and gift expense deductions. INT. REV. CODE of 1954, § 274. This provision fulfilled a campaign promise made by Pres. Kennedy. Eager to do its part, the Tax Court resurrected the "condition of employment" test as a screening device to prevent extravagant deductions. The overzealous application of that test is reflected in *Davis*.

28. 38 T.C. 175 (1962), *vacated*, No. 18188 (9th Cir., Jan. 3, 1964).

29. In all but one of the employee home office cases before *Davis*, the deduction

garage to prepare lectures, grade exams, perform research and hold student conferences.<sup>30</sup> While admitting that he was not required by his employer to use his home, Davis argued that the inadequacy of his campus office rendered his home office expenses "ordinary and necessary" within the meaning of § 162.<sup>31</sup> The Tax Court rejected this argument and, in dicta, implied that the mere inadequacy of the employer-provided office would not satisfy the "condition of employment" test.<sup>32</sup> The court refused to find the expense "necessary" even though Davis' compensation was partially determined by scholarly writing.<sup>33</sup> In disallowing the deduction, the court indicated that satisfaction of any standard less than "condition of employment" would not suffice.<sup>34</sup>

Judge Raum's strong dissent in *Davis* previewed the subsequent liberalization of the home office deduction. Speaking for five members of the court, he accused the majority of distinguishing employees from other taxpayers.<sup>35</sup> He reasoned that Davis' expenses should be deductible as "ordinary and necessary" since they were "appropriate, in carrying on his profession as a teacher."<sup>36</sup> Raum insisted that this result should not differ even if Davis worked at home for his own convenience.<sup>37</sup>

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was allowed without regard to whether or not the employer required that a home office be maintained. In *Madge H. Evans*, 8 P-H B.T.A. Mem. 164 (1939), an employee-actress was allowed the deduction. Miss Evans used her home to memorize her lines and for other business-related purposes. In *Freda W. Sandrich*, 15 P-H Tax Ct. Mem. 236 (1946), a producer-writer-director worked at home and received the deduction because "The confusion and constant interruptions at the studio made it impossible to do effective creative work at that place." *Id.* at 238. Neither Evans' nor Sandrich's employer required a home office. The deduction was also allowed in *Morris S. Schwartz*, 30 P-H Tax Ct. Mem. 795 (1961). Schwartz used his home for research and other activities related to his job as a teacher and a lecturer.

In the only pre-*Davis* case denying the deduction, an employee improperly took the deduction in computing adjusted gross income under § 22(n) of the 1939 Code (§ 62 of 1954 Code) rather than as an itemized deduction in computing taxable income. *Chester C. Hand*, 16 T.C. 1410 (1951). Thus, the result in *Davis* was not supported by the prior cases.

30. 38 T.C. at 177-80.

31. *Id.* at 179-80; Record at 95-96; Petitioner's Brief at 3, 50.

32. 38 T.C. at 180.

33. *Id.* at 176.

34. *Id.* at 179-80.

35. [W]here the taxpayer is compelled by his employer to incur certain expenses, that fact itself may be highly pertinent in allowing the deduction. But the absence of such compulsion certainly does not, of itself, require the opposite result. . . .

[I]t is important to lay at rest any possible argument that petitioner's right to deduction must be denied because he was an employee rather than one who was self-employed. There is *nothing in the law establishing any such distinction*. If the expenses are "ordinary and necessary," proximately related to the taxpayer's work, they are deductible.

38 T.C. at 186-87 (emphasis added) (Raum, J., dissenting).

36. *Id.* at 187.

37. *Id.* at 187-88.

Six months after *Davis* the IRS issued Revenue Ruling 62-180, apparently to restate and solidify the *Davis* holding:

The burden of proof rests upon the taxpayer to establish (1) that, as a condition of his employment, he is required to provide his own space and facilities for performance of some of his duties. . . .<sup>38</sup>

The strength of *Davis* and Revenue Ruling 62-180 was seriously undercut by the Tax Court in *Clarence E. Peiss*.<sup>39</sup> On facts nearly identical to those in *Davis*, the *Peiss* court granted the home office deduction without mentioning *Davis*, Revenue Ruling 62-180 or the "condition of employment" test. *Peiss* allowed the deduction apparently because the taxpayer's campus office was inadequate for research and his compensation and advancement were determined by his research productivity.<sup>40</sup>

*Peiss* may be analyzed as (1) an exception to Revenue Ruling 62-180 limited to researching professors;<sup>41</sup> (2) an "inadequate office" exception to the "condition of employment" test<sup>42</sup> or (3) a rejection of that test.<sup>43</sup> While the vitality of the "condition of employment" test remained an open question, it was clear that *Peiss* represented a modification of *Davis*.

Unfortunately, the *Peiss* decision did little to resolve the controversy surrounding the meaning of "ordinary and necessary" in the home office

38. Rev. Rul. 62-180, 1962-2 CUM. BULL. 52, 53.

39. 40 T.C. 78 (1963), *appeal dismissed*, CCH 1964 STAND. FED. TAX REP., 1964 Case Table, ¶ 70,838 (7th Cir. 1964), *acquiesced in*, 1968-2 CUM. BULL. 2.

40. 40 T.C. at 80, 83-84.

41. In an apparent attempt to limit the impact of *Peiss*, IRS issued a ruling in 1964 which established a college researching exception to the Rev. Rul. 62-180 "condition of employment" test. According to its terms, the new ruling allowed a college professor to deduct his home office expenses if he:

has certain duties which encompass . . . the communication and advancement of knowledge through research and publication . . . [and] . . . [t]he college does not furnish adequate space and facilities necessary to carry on such independent research.

Rev. Rul. 64-272, 1964-2 CUM. BULL. 55. This ruling was consistent with Rev. Rul. 63-275, 1963-2 CUM. BULL. 85, issued a year earlier, which recognized that "likelihood of advancement" would be sufficient to satisfy the employer-benefit rule. In the home office context, however, that ruling and Rev. Rul. 64-272 represented an anomaly. Employees other than college professors were still supposedly subjected to Rev. Rul. 62-180's "condition of employment" test and could not have a deduction merely because the expense made advancement more likely.

42. In light of later cases this interpretation of *Peiss* seems to be the most accurate one. See Herman E. Bischoff, 35 P-H Tax Ct. Mem. 603 (1966); Valentine J. Anzalone, 33 P-H Tax Ct. Mem. 549 (1964).

43. The cases since have undermined this view. See Valentine J. Anzalone, 33 P-H Tax Ct. Mem. 549 (1964).



context. Subsequent Tax Court decisions further contributed to this confusion. In *Neil M. Kelly*,<sup>44</sup> the court, without citing authority, held that a pilot had failed to prove "necessary" a home office even though he had no employer-provided office. In *Valentine J. Anzalone*,<sup>45</sup> the Tax Court, relying on the "condition of employment" test, denied a home office deduction to a sales engineer who was provided with an adequate office. Relying on *Peiss*, the court in *Robert C. McGuire*<sup>46</sup> permitted a high school principal the home office deduction for performance of administrative tasks.<sup>47</sup> Likewise, in *Herman E. Bischoff*,<sup>48</sup> a commercial artist was allowed the deduction since his business office was improperly heated and air-conditioned and, therefore, "undesirable."<sup>49</sup>

*Kelly* and *McGuire* did little to clarify the vagaries of *Peiss*, for neither explained the basis for its outcome. *Anzalone*, however, demonstrated that *Peiss* was not a rejection of the "condition of employment" test. In *Anzalone*, Judge Mulrone (who had decided *Peiss*) applied the "condition of employment" test upon a finding that the office was adequate. Nevertheless, the court in *Bischoff* relied upon *Peiss* in rejecting the "condition of employment" test.<sup>50</sup> *Bischoff's* rejection of that test may have been dictum, however, since the office provided *Bischoff* by his employer was inadequate.

The confusion was in no way lessened by *Larry N. Kutchinski*.<sup>51</sup> Mrs. Kutchinski, a college typing instructor, prepared lessons and graded papers at home because she had no business office. The Tax Court disallowed the deduction since the taxpayer's wife failed to prove that she had requested and had been denied an office.<sup>52</sup> This finding is

44. 33 P-H Tax Ct. Mem. 521 (1964).

45. 33 P-H Tax Ct. Mem. 549 (1964).

46. 34 P-H Tax Ct. Mem. 1286 (1965).

47. McGuire's failure to prove that he used one room exclusively for business was not fatal to deductibility. The court applied a pro rata formula with both "area" and "time of use" factors. *Id.* at 1287.

48. 35 P-H Tax Ct. Mem. 603 (1966).

49. *Id.* at 604. The court also found that the taxpayer worked more efficiently at home. *Id.*

50. We have no doubt that the studio maintained at petitioner's home was used for business purposes. Although his employer did not specifically require him to maintain such facility, it certainly was appropriate to the conduct of his trade or business in the circumstances of this case. Cf. *Clarence Peiss* 40 T.C. 78, 83-84. To be deductible as an ordinary and necessary business expense, it is sufficient that the expenditure be "appropriate and helpful" to the conduct of the business; it need not be "required" . . . cf. *Commissioner v. Tellier*. . . .

35 P-H Tax Ct. Mem. at 604. Judge Raum, in *Bischoff*, was consistent with his *Davis* dissent. But despite its strong language, *Bischoff* accomplished no more than the establishment of an inadequate office exception.

51. 37 P-H Tax Ct. Mem. 247 (1968).

52. *Id.* at 250.

particularly questionable, for there was no employer-provided office, much less an adequate one. Furthermore, it was clear that Mrs. Kutchinski's activities at home were required by her job.<sup>53</sup>

#### NEWI V. COMMISSIONER

Again faced with a case in which the taxpayer was provided an adequate office, the Tax Court in *Newi* allowed the deduction.<sup>54</sup> In upholding this decision, the Second Circuit focused on the taxpayer's convenience, finding it "wholly impractical"<sup>55</sup> for *Newi* to return to his business office in the evenings.<sup>56</sup> Both courts explicitly rejected the Government's argument that the "condition of employment" test and the adequacy of the employer-provided office precluded deductibility.<sup>57</sup>

This result was based upon the court's application of *Tellier* to the home office context.<sup>57</sup> Since *Tellier* redefined "ordinary" to mean noncapital, thus eliminating the focus on the business practices of the taxpayer's employer, the sole criterion for deductibility after *Tellier* is the "appropriateness and helpfulness" of the expense to the taxpaying employee.<sup>58</sup>

This redefinition of "ordinary" and the subtle shift away from considerations of benefit to employer which it initiated are reflected in *Newi*'s treatment of employer-benefit as irrelevant.<sup>59</sup> Consistent with

53. *Id.* at 249.

54. 38 P-H Tax Ct. Mem. at 740.

55. 432 F.2d at 1000.

56. The deduction was allowed because *Newi*'s office was twenty blocks from his home, a taxi was difficult to obtain during the theater hour and traffic congestion would cause him to miss some television programs. *Id.* By way of contrast, the court characterized *Newi*'s den study as the most appropriate place for him to view television:

It would be hard to imagine a better method than, in the isolation of his study-den, to view, ponder over and make notes relating to television programs.

*Id.*

57. 38 P-H Tax Ct. Mem. at 740; 432 F.2d at 999-1000.

58. See note 16 *supra* & text accompanying.

59. The Government had argued in the court of appeals that the expense of providing *Newi* with an office was deductible only by *Newi*'s employer:

In addition to the fact that the expenses involved are essentially personal . . . , here the employer assumed the expense of providing adequate facilities to its employees for the performance of their duties. The facilities were open and available to the taxpayer even after working hours. There is no indication that the employer expected the employee to furnish additional facilities or that the employee's choice to use his own "office" rather than the employer's had any effect on his salary. While it may have been more convenient for the employee to work at home, there is no indication that the outside work itself could not have been performed at the employer's office. While an employee is considered as being in a trade or business, his trade or business is not that of the employer . . . . Where the employer undertakes to provide the necessary facilities for proper performance of the employee's duties and the employee is not expected to provide such facilities, the expenses of providing work facilities are those of the employer, and

this position, the court of appeals also considered irrelevant the adequacy of the employer-provided office.<sup>60</sup> Once the employer-benefit basis of the "condition of employment" test was eliminated, there remained no need for an "inadequacy" exception. The *Newi* court looked through the eyes of the employee rather than those of the employer in order to determine the legitimacy of the deduction.

#### POSSIBLE RAMIFICATIONS OF NEWI

It has traditionally been argued that expansion of employee deductions will result in increased administrative complexity, burdensome costs and loss of revenue.<sup>61</sup> Appreciating the potential impact of *Newi*, the Commissioner argued to the Second Circuit that upholding the Tax Court

would open the doors for a business deduction to any employee who would voluntarily choose to engage in an activity at home which conceivably could be helpful to his employer's business. . . .<sup>62</sup>

The Commissioner's concerns are not without basis. The "condition of employment" test has provided a convenient administrative screening

the employee cannot convert such expenses into his own business expenses by assuming the expense thereof. . . .

Appellant's Brief at 12-13 (citations omitted). Despite this argument, neither the Tax Court nor the Second Circuit made a single reference to the needs of *Newi*'s employer.

60. 432 F.2d at 999-1000.

61. R. GOODE, *THE INDIVIDUAL INCOME TAX* 76-98 (1964).

A net income tax should allow the deduction from gross receipts of all costs of obtaining income. The U.S. tax makes adequate provision for the deduction of most business costs, as reflected in accounting statements, and for most costs of obtaining investment income. Provisions are less complete for deducting costs of earning income as [an] . . . employee.

. . . .  
The difficulties arise mainly in connection with items that may combine consumption and cost elements.

*Id.* at 76. After discussion of these problem expenses, Goode concludes that the administrative difficulty of distinguishing between the cost and consumption elements justifies the stricter standards imposed on employees. *Id.* at 97, 98.

62. *Id.* at 1000, quoting Appellant's Brief at 11-12. The court answered: [T]he Tax Court's construction of "ordinary and necessary" [to mean] "appropriate and helpful" . . . opens the doors just long enough to enable this Taxpayer to pass through it into his cloistered study to pursue his business. . . .

432 F.2d at 1000.

If the court seriously believed that *Newi* would be limited to its facts, then it was a very poor prophet. In a series of five home office cases in 1971, the Tax Court applied *Newi* liberally to allow the deduction. See notes 67-69 *infra*.

63. The old "condition of employment" standard screened out most fraudulent claims, thus eliminating the need to impeach a taxpayer's testimony as to the actual use of his home.

device, allowing IRS to make determinations on the basis of objective data. The *Newi* standard, which would require a case-by-case examination of subjective claims, would result in increased costs of enforcement. Without the "condition of employment" test IRS faces the impossible task of impeaching fraudulent deductions for expenses incurred in the privacy of the home.<sup>63</sup> Consequently, if a taxpayer proves the costs of maintaining an office at home and testifies to its use for business purposes, *Newi* would force IRS to grant the deduction unless it could prove that the office did not contribute to the taxpayer's convenience or efficiency.

Although home office expense may not be as large as other deductions for the average taxpayer, its increased availability should encourage more taxpayers to itemize.<sup>64</sup> Widespread use of itemized deductions would increase both the complexity of returns and the cost of handling them.<sup>65</sup> When coupled with the increased cost of enforcement under the *Newi* rule, these expenses could prove significant. The dimensions of this potential rise in cost are accentuated by the fact that over eighty per cent of all taxpayers are employees heretofore subjected to the restrictive "condition of employment" test.<sup>66</sup>

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64. Employee business deductions represent the fifth largest class of itemized deductions. IRS, STATISTICS OF INCOME-1969, INDIVIDUAL INCOME TAX RETURNS 370 (1971). Thus, the home office deduction may have a "tipping effect," encouraging itemization. The home office cases demonstrate that the amounts involved are not insignificant: *Newi* allowed over \$700, *Bischoff* \$700 and *Peiss* over \$300.

65. As our country's population and economy grow, the Service's workload also increases. Our operations are a direct reflection of that growth. We *must* keep up.

One measure of the Service's work is the total number of tax returns filed, but this factor considered alone can be misleading. Although the Tax Reform Act of 1969 is estimated to eliminate the filing of 5.6 million low income returns in 1971 the increase in the number of complex returns and additional complexity introduced by the Tax Reform Act will increase our workload. The increasing complexity of returns produces obvious and also subtle demands that make tax administration more difficult and costly.

*Hearings on 1971 Treasury Appropriations before the Subcomm. on Departments of Treasury and Post Office and Executive Office Appropriations of the House Appropriations Comm., 91st Cong., 2d Sess., pt. 2, at 693-94 (1970)* (statement of former Commissioner Randolph W. Thrower) (emphasis in original). Since 1944, efficient administration of the federal income tax system has depended upon widespread use of the standard deduction. Thus, it is a matter of grave alarm for IRS that since 1944 the percentage of tax returns claiming the standard deduction has declined steadily from over eighty per cent in 1944 to just over fifty per cent in 1969. See IRS, STATISTICS OF INCOME, INDIVIDUAL INCOME TAX RETURNS, for the years 1944 through 1969.

66. Since 1937 returns reporting salaries and wages have composed over eighty per cent of all returns. See IRS, STATISTICS OF INCOME, INDIVIDUAL INCOME TAX RETURNS, for the years 1937 through 1969. The general trend has been towards an increase in this figure. In 1969 (the last year for which figures are available), the

These arguments represent legitimate concerns. The fears may be somewhat premature because recent cases appear to apply a general reasonableness limitation to the "appropriate and helpful" test; the deduction is allowed only if it is reasonable for the employee to perform his tasks at home.<sup>67</sup> This would indicate that *Newi* is not a carte blanche grant of the deduction to all employees and, therefore, should not inconvenience tax administration to the extent feared by IRS.

This reasonableness test has presented the Tax Court with an opportunity to recognize several important policies. In addition to a general policy in favor of employee free choice, the court has displayed a willingness to interpret § 162 to serve policies such as employee convenience, efficiency and productivity.<sup>68</sup> In addition, at least one recent case indicates that concern for the taxpayer's safety may play an important role in satisfying the "appropriate and helpful" test in the future.<sup>69</sup>

While these considerations are not alone sufficient to outweigh the need for efficient tax administration, there remains an overriding policy

figure reached 90.8 per cent. *Id.* for 1969, at 4 (1971). Approximately ninety per cent of all returns with itemized deductions in 1969 reported salaries and wages. *Id.* at 87.

None of these figures should be taken as a prediction that eighty per cent of all returns will now claim the home office deduction. A more telling figure in terms of the home office deduction is the more than two million public elementary and secondary school teachers (previously denied the deduction). HEW, DIGEST OF EDUCATION STATISTICS 37 (1970). It may well be that this group more than any other will benefit from the liberalized home office deduction. See note 68 *infra*.

67. James L. Denison, P-H TAX CT. REP. & MEM. DEC. ¶ 71,249 (Sept. 28, 1971); Christopher A. Rafferty, P-H TAX CT. REP. & MEM. DEC. ¶ 71,202 (Aug. 18, 1971); Marvin L. Dietrich, P-H TAX CT. REP. & MEM. DEC. ¶ 71,159 (July 6, 1971); Stanley E. Bailey, P-H TAX CT. REP. & MEM. DEC. ¶ 71,107 (May 17, 1971).

68. In May, 1971, the court allowed the deduction to a pilot who used his home to store flight records and hold occasional union meetings (when it was inconvenient to meet at the union hall). Stanley E. Bailey, P-H TAX CT. REP. & MEM. DEC. ¶ 71,107 (May 17, 1971). In July, 1971, *Newi* was cited as controlling in Marvin L. Dietrich, P-H TAX CT. REP. & MEM. DEC., ¶71,159 (July 6, 1971). A resident physician and his wife were allowed the deduction for a room in which to read journals, prepare lectures and grade papers. Although Dietrich had access to study facilities at the hospital library (Record at 60, 61; Respondent's Brief at 16, 55, 56, 58), he worked at home because it was "easier" and more "efficient" to do so. Record at 30, 61. In August and September, 1971, two small claims decisions relied on *Newi* to allow the deduction to employees who failed to satisfy the "condition of employment" test. Christopher A. Rafferty, P-H TAX CT. REP. & MEM. DEC. ¶ 71,202 (Aug. 18, 1971); James L. Denison, P-H TAX CT. REP. & MEM. DEC. ¶ 71,249 (Sept. 28, 1971).

In *Rafferty*, an aerospace engineer was allowed the deduction although he had been provided an office. In *Denison*, two school teachers were allowed the deduction even though other teachers were able to complete similar tasks at the school during their free hour. The court reasoned that "the method of presentation, the material to be corrected, and the sincere desire to teach the subject well, distinguishes [taxpayer] from his fellow teachers." P-H TAX CT. REP. & MEM. DEC. ¶ 71,249, at 71-1133. In November, 1971, a college professor was allowed the deduction under Rev. Rul. 64-272. Bruce B. Steinmann, P-H TAX CT. REP. & MEM. DEC. ¶ 71,295 (Nov. 22, 1971).

69. James L. Denison, P-H TAX CT. REP. & MEM. DEC. ¶ 71,249, at 71-1133 (Sept. 28, 1971)

supporting *Newi*'s liberalization of the home office deduction—the uniformly recognized income tax principle of horizontal equity. This principle has been described as follows:

Equity in taxation is that aspect of tax fairness that is concerned with similarities among taxpayers. Equity is achieved when persons and businesses in a similar economic position are taxed the same. Tax equity is one of the applications of a broader idea that taxes to be fair should be neutral—that is, they should not change the relative positions of taxpayers.<sup>70</sup>

It is not the province of courts to strike down expressly discriminatory language of the Code unless the discrimination amounts to a denial of constitutional rights.<sup>71</sup> However, where the Code does not expressly discriminate (as in § 162) courts are obligated to examine critically any interpretations which do so.<sup>72</sup> Self-employed taxpayers have been allowed the home office deduction without limitations comparable to the "condition of employment" test. This discriminatory treatment of employees as a taxpayer class is without convincing justification.<sup>73</sup> *Newi* correctly applies the principle that like cases demand like results. Thus, on balance *Newi* was justified in eradicating a long-standing discrimination against employees.

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70. R. BLOUGH, *THE FEDERAL TAXING PROCESS* 387-88 (1952).

Ethical principles are significant because they influence the character of the tax and fiscal system in terms of its objectives and functions . . . [E]thics in taxation involves the criteria of fiscal justice. . . .

The essence to tax justice lies in the principle to tax neutrality, and may be referred to as the issue of uniformity versus selectivity or discrimination. Stout, *Ethics in Federal Taxation*, 41 *TAXES* 44, 45 (1963). See also R. MAGILL, *THE IMPACT OF FEDERAL TAXES* 7 et seq. (1943).

71. None would dispute that a taxing measure may indeed be found unconstitutional, but as Judge Learned Hand observed, the "mere inequality of incidence has never been held enough." . . . Unconstitutionality derives neither from unequal imposition nor from unequal incidence, but rather from that special instance where the act is "so arbitrary as to compel the conclusion that it does not involve an exertion of the taxing power, but constitutes, in substance and effect, the direct exertion of a different and forbidden power, as, for example, the confiscation of property. . . ."

*Lionberger v. United States*, 371 F.2d 831, 837 (Ct. Cl.), cert. denied, 389 U.S. 844 (1967) (citations omitted).

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

73. The job needs of many employees seem as convincing as those of self-employed persons. The old rule was unsound because it failed to examine the substance of the taxpayer's need for the home office in each case. By rejecting the "condition of employment" test the Tax Court has recognized that not every self-employed taxpayer needs an office and that employees sometimes do need offices. In thus focusing on the nature of the taxpayer's job and not on his status as an employee, the court has given recognition to the interests of individual taxpayers.