

William & Mary Law Review

Volume 30 (1988-1989)
Issue 2 *The American Constitutional Tradition
of Shared and Separated Powers*

Article 17

February 1989

Campbell v. Commissioner: The Availability of Business Expense or Loss Deductions for Insured Contingencies

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Robert B. Lachenauer, *Campbell v. Commissioner: The Availability of Business Expense or Loss Deductions for Insured Contingencies*, 30 Wm. & Mary L. Rev. 433 (1989),
<https://scholarship.law.wm.edu/wmlr/vol30/iss2/17>

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NOTES

CAMPBELL v. COMMISSIONER: THE AVAILABILITY OF BUSINESS EXPENSE OR LOSS DEDUCTIONS FOR INSURED CONTINGENCIES

INTRODUCTION

John Doe is a taxpayer who runs a warehousing and storage business as a sole proprietorship. One day, one of John's employees, due to a case of mistaken identity, releases the contents of one of the storage compartments to a person who does not own the goods. John maintains business liability insurance to protect his operations from such mistakes. The contents of the compartment cannot be recovered from the person to whom they were released, and John's insurer admits liability on the rightful owner's claim against John for the value of the goods misdelivered. However, for reasons to be explored later,¹ John decides not to pursue the available insurance reimbursement and pays the rightful owner's claim for the value of the goods out of business funds.

This Note explores whether, at the end of the taxable year, John may deduct the payment to the true owner of the property as either a business expense under section 162(a)² or a loss relating to his trade or business under sections 165(a) and (c)(1).³

1. See *infra* text accompanying notes 36-37, 86-87.

2. I.R.C. § 162(a) states, in pertinent part: "(a) In general.—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. . . ." I.R.C. § 162(a) (1986).

3. I.R.C. § 165 states, in pertinent part:

(a) General rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * *

(c) Limitation on losses of individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

On September 22, 1987, the Tax Court decided *Campbell v. Commissioner*.⁴ Presented with an individual taxpayer like John

(3) except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

I.R.C. § 165(a), (c) (1982 & Supp. 1986).

In 1964, subsection (c)(3) was amended to provide, in pertinent part, that "[a] loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds \$100." Revenue Act of 1964, Pub. L. No. 88-272, § 208(a), 78 Stat. 43 (currently codified at I.R.C. § 165(c)(3)(h) (Supp. 1986)).

In 1982, Congress struck the above amendment from § 165(c)(3) and in its place inserted the following: "except as provided in subsection (h)." Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 203(b), 96 Stat. 422 (codified at I.R.C. § 165(c)(3) (1982 & Supp. 1986)). The \$100 floor was moved to subsection (h)(1), and a new provision was added to part 2 to subsection (h), which provided that, to be deductible, the aggregate of all personal casualty losses (after application of the \$100 floor) had to exceed 10% of the adjusted gross income of that individual. *Id.* § 203(a), 96 Stat. 422 (codified as amended at I.R.C. § 165(h)(2)(A)). These changes are effective for tax years beginning after December 31, 1982.

In 1984, subsection (h) was amended to read as follows:

(2) Net casualty loss allowed only to the extent it exceeds 10 percent of adjusted gross income.—

(a) In general.—If the personal casualty losses for any taxable year exceed the personal casualty gains for such taxable year, such losses shall be allowed for the taxable year only to the extent of the sum of—

(i) the amount of the personal casualty gains for the taxable year, plus

(ii) so much of such excess as exceeds 10 percent of the adjusted gross income of the individual.

Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 711(c)(2)(A)(ii), 98 Stat. 943 (codified at I.R.C. § 165(h) (2)(A) (1982 & Supp. 1986)). These changes are effective for tax years beginning after December 31, 1983.

Finally, in 1986, Congress added paragraph (E) to subsection (h)(4), which provides: "(E) Claim required to be filed in certain cases.—Any loss of an individual described in subsection (c)(3) to the extent covered by insurance shall be taken into account under this section only if the individual files a timely insurance claim with respect to such loss." Tax Reform Act of 1986, Pub. L. No. 99-514, § 1004(a), 100 Stat. 2388 (codified at I.R.C. § 165(h)(4)(E) (Supp. 1986)). These changes are effective for losses sustained in tax years beginning after December 31, 1986.

4. 56 T.C.M. (P-H) 2578 (1987). The Tax Court publishes "regular" decisions, which represent important legal issues. "Memorandum" decisions, on the other hand, involve well-established legal issues and are not officially published. G. RICHMOND, *FEDERAL TAX RESEARCH: GUIDE TO MATERIALS AND TECHNIQUES* 69 (3d ed. 1987).

Although *Campbell* involved a factual determination utilizing the well-established standard of "ordinary and necessary" under § 162, the court's decision propounded a novel construction of the standard. A question arises, then, as to why the court relegated *Campbell* to memorandum status. At least two possibilities exist. The Tax Court might have desired further case law development in this area before attempting to rule conclusively—perhaps

Doe, who attempted to deduct a payment made by his insured sole proprietorship, the Tax Court denied the deduction as a business expense under section 162(a).⁵ Because the court applied the standards for evaluating deductibility under the applicable Internal Revenue Code statutes incorrectly, the effect of the case on the law in this area is uncertain.

This Note examines the situation presented in *Campbell*. The Note uses the case as a starting point to analyze the case law and relevant Internal Revenue Code statutes, to define and develop the issues, and to examine the inherent problems that occur when a taxpayer attempts to take a tax deduction after voluntarily declining to pursue insurance reimbursement. The Note suggests a comprehensive treatment of deductibility in these types of cases as an alternative to the "all-or-nothing" approach to deductibility that the courts and Commissioner employ currently.⁶

"ORDINARY AND NECESSARY" IN SECTION 162(A): THE STANDARD

Section 162(a) authorizes the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."⁷ The seminal case interpreting this language is the Supreme Court's decision in *Welch v. Helvering*.⁸

In *Welch*, a taxpayer, in an effort to "solidify his credit and standing" in the grain trade, attempted to pay the debts of the company that previously had employed him as an officer.⁹ The company had gone bankrupt and owed money to customers. In an attempt to reestablish business relations with these prior clients,¹⁰ the taxpayer made substantial payments to satisfy the deficiencies

marking *Campbell* as a temporary aberration. Alternatively, the decision to assign the case memorandum status may reflect an attempt to draw as little attention to the dispute as possible.

5. *Id.* at 2579-81.

6. The Commissioner of the Internal Revenue Service [hereinafter "the Commissioner"].

7. I.R.C. § 162(a) (1982 & Supp. 1986). This language dates back to the Revenue Act of 1924, 43 Stat. 253, 269, and has remained largely unchanged to the present day.

8. 290 U.S. 111 (1933).

9. *Id.* at 112.

10. *Id.*

and deducted these amounts as ordinary and necessary expenses of his grain brokerage business.¹¹

Applying the "necessary" criteria of section 162(a), the Court stated that "payments to creditors of the [predecessor company] were necessary for the development of the [taxpayer'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."¹²

In *Commissioner v. Heininger*,¹³ the Court reiterated the *Welch* standard, stating "the expenses incurred . . . can also be assumed appropriate and helpful, and therefore 'necessary.'"¹⁴ Later, in *Commissioner v. Tellier*,¹⁵ the Court elaborated: "Our decisions have consistently construed the term 'necessary' as imposing only the minimal requirement that the expense be 'appropriate and helpful' for 'the development of the [taxpayer's] business.'"¹⁶ More recently, the Court reiterated that it would not question the necessity of reasonable business judgments.¹⁷ The admittedly "minimal requirement"¹⁸ of the statutory language thus implies only that the taxpayer believe that the payments made or expenses incurred were "appropriate and helpful" to the success of his business.¹⁹

In addition to the "necessary" requirement, section 162(a) also dictates that business costs must be "ordinary" to be deductible. The Court in *Welch* noted that:

Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary . . . does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often.²⁰

11. *Id.* at 113.

12. *Id.* (emphasis added) (citation omitted).

13. 320 U.S. 467 (1943).

14. *Id.* at 471.

15. 383 U.S. 687 (1966).

16. *Id.* at 689; see also *Lilly v. Commissioner*, 343 U.S. 90, 93-94 (1952); cf. *Kornhauser v. United States*, 276 U.S. 145, 153 (1928).

17. *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 385 n.18 (1983).

18. 383 U.S. at 689.

19. *Id.* See also *Welch v. Helvering*, 290 U.S. 111, 113 (1933).

20. 290 U.S. at 113-14.

Struggling to reify an undefinable intuition, the Court admittedly articulated a test that was more “a way of life” than “a rule of law.”²¹

Subsequent cases interpreted the *Welch* “ordinary and necessary” test as requiring that the expense be “directly related to the trade or business of the taxpayer.”²² Courts often employ this articulation of the test to distinguish business costs from nondeductible personal expenses.²³ In yet another variation, the Court has provided a more concrete articulation of the “ordinary” criteria: “The principal function of the term ‘ordinary’ . . . is to clarify 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.”²⁴ Under this version of the standard, “ordinary” expenses are those that do not add to the value or result in an extension of the useful life of a particular asset.²⁵ In other words, expenses that do not benefit the business beyond the normal time frame of annual business operations qualify as “ordinary.”²⁶

21. *Id.* at 115. In fact, the Court said: “One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.” *Id.* Such open-ended analysis renders consistent application of the deductibility criteria more crucial. Although judges may have interpreted *Welch* differently, prior to *Campbell*, courts routinely cited and ostensibly applied the *Welch* language to evaluate ordinariness. In *Campbell*, the court failed even to mention this language or to apply 50 years of analysis based on it, rendering its conclusions highly suspect.

22. *See, e.g.*, *Knight-Campbell Music Co. v. Commissioner*, 155 F.2d 837, 839 (10th Cir. 1946).

23. *See, e.g.*, *Wollesen v. Commissioner*, 56 T.C.M. (P-H) 3293, 3297-98 (1987); *Cooper v. Commissioner*, 67 T.C. 870, 872-73 (1977); *Blaess v. Commissioner*, 28 T.C. 710, 713-17 (1957); *see also* *Boulder Bldg. Corp. v. United States*, 125 F. Supp. 512, 514-15 (W.D. Okla. 1954) (using *Welch* language and criteria to distinguish business expenses in the nature of capital expenditures from personal expenses).

24. *Commissioner v. Tellier*, 383 U.S. 687, 689-90 (1966).

25. *See* Treas. Reg. § 1.263(a)-1(b) (as amended in 1987).

26. *See, e.g.*, *Fall River Gas Appliance Co. v. Commissioner*, 349 F.2d 515, 516 (1st Cir. 1965) (a capital expenditure is an expenditure that has a life of more than one year); *United States v. Akin*, 248 F.2d 742, 744 (10th Cir. 1957) (an expenditure is in the nature of a capital outlay if it produces an asset having a useful life in excess of one year). Classic examples of expenditures that do not benefit the business beyond the normal operational time frame of one year, resulting in “ordinary” characterization, are: employees’ yearly salaries and insurance premium payments for coverage of a year or less. Regarding the ordinari-

Given the amorphous nature of the "ordinary and necessary" standard, a court presumably could reach a marginally defensible conclusion any given way on any set of facts. The inquiries "[w]hether an expenditure is directly related to a business and whether it is ordinary and necessary are doubtless pure questions of fact in most instances."²⁷ Despite the uncertainty of result, however, the two terms operate (up until *Campbell*) in perfect tandem, with courts assigning no analytical weight to the "necessary" prong of the "ordinary and necessary" standard.²⁸ Many subsequent cases assigned no weight to the "necessary" language because the Court in *Welch* assumed the payments were necessary, thus reducing the relevant inquiry solely to the ordinariness of the payment.²⁹ The emergence of the necessity prong as a basis for denying deductibility in *Campbell* was, then, a significant development that has introduced considerable uncertainty into the interpretation of section 162.

Campbell v. Commissioner: APPLICATION OF THE ORDINARY AND
NECESSARY STANDARD

The taxpayer in *Campbell* was the sole proprietor of an actuarial consulting business.³⁰ One of the business's clients was an employee benefit and annuity fund. The taxpayer's business calculated refunds for the participants in the fund who withdrew from

ness of salary expenditures, see I.R.C. § 162(a)(1) ("There shall be allowed as a deduction all the ordinary and necessary expenses [of] . . . any trade or business, including—a reasonable allowance for salaries or other compensation for personal services. . ."); regarding the ordinariness of the current portion of insurance premiums, see, e.g., *Peters v. Commissioner*, 4 T.C. 1236, 1242 (1945); *Jephson v. Commissioner*, 37 B.T.A. 1117, 1120 (1938) (both holding that payment of an insurance premium for coverage in excess of one year *could not* be fully expensed in the year paid; rather, only the amount representing the current period's pro rata portion of the coverage may be deducted currently); see generally Note, *Income Tax Accounting: Business Expense or Capital Outlay*, 47 HARV. L. REV. 669 (1934).

27. *United States v. Heininger*, 320 U.S. 467, 475 (1943).

28. In no reported case has a court determined business expenses to be ordinary under § 162(a), but denied deductibility of those expenses on the grounds that they were not necessary. 3 Fed. Taxes (P-H) ¶¶ 11,033, 11,102 (1988). Cf. *Podems v. Commissioner*, 24 T.C. 21, 22-23 (1955) (court discussed necessity almost exclusively, but specifically held the expense in question to be neither ordinary nor necessary).

29. See, e.g., *Sam P. Wallingford Grain Corp. v. Commissioner*, 74 F.2d 453, 454 (10th Cir. 1934).

30. 56 T.C.M. (P-H) 2578, 2578 (1978).

the investment plan prior to their retirement.³¹ Two of the fund's participants had exactly the same name; when one of them withdrew, the taxpayer's firm calculated the paid-in benefits for the wrong (non-terminating) employee.³² As a result, the fund paid \$13,035.45 to the incorrect employee and was unable to recover the money.³³

The taxpayer's business maintained a \$1,000,000 errors and omissions-type liability insurance policy.³⁴ The policy had a \$5,000 deductible, and the coverage would have reimbursed the taxpayer's business for the amount of the accidental payment, less the deductible.³⁵ However, fearing loss of the client fund's business, and the possibility of increased premiums or policy cancellation,³⁶ the firm reimbursed the fund from its own resources instead of claiming the available compensation.³⁷ On his tax return for that year, the taxpayer claimed the payment to the fund as a business expense.³⁸

The Commissioner allowed the amount of the deductible on the errors and omissions policy as a deduction.³⁹ He contended, however, that the amount of the payment over the deductible amount did not qualify as a necessary business expense because the taxpayer elected not to file an insurance claim.⁴⁰

The Tax Court noted that the issue presented was "a novel one, for which we find no case directly on point."⁴¹ Persuaded by the Commissioner's assertion that failure to claim reimbursement from an available fund designed for that purpose precluded the deduc-

31. *Id.*

32. *Id.*

33. *Id.* The parties agreed by stipulation that the money was not recoverable from the person to whom it had been paid. *Id.*

34. *Id.* at 2579.

35. *Id.*

36. *Id.* at 2580.

37. *Id.* at 2578-79.

38. *Id.* at 2579. Under the federal taxation scheme, income and expenses of businesses organized as sole proprietorships are reflected on the tax returns of the sole proprietors through incorporation of Schedule C. *Profit or (Loss) From Business or Profession*, I.R.S. Publication No. 334, pt. VI, no. 27, at 94 (1987).

39. 56 T.C.M. (P-H) at 2579.

40. *Id.*

41. *Id.*

tion of business expenses under section 162(a), the Tax Court denied the deduction.⁴²

Precedent in Campbell

In *Campbell*, the Commissioner allowed the taxpayer a deduction for the amount of the insurance policy deductible (\$5,000) because the taxpayer had to pay this amount regardless of whether a claim was filed, regardless, in fact, of whether insurance coverage existed at all. In so doing, he conceded that this part of the payment was ordinary.⁴³ On appeal, the Tax Court accepted the Commissioner's finding that the expenditure was ordinary.⁴⁴ Relying principally on *Heidt v. Commissioner*⁴⁵ and *Whitney v. Commissioner*,⁴⁶ however, the court denied deductibility of the remainder of the payment (\$8,035) on the grounds that this portion was not "necessary."⁴⁷

In *Heidt*, the court denied a corporate executive a deduction for automotive expenses he incurred in connection with his job because he failed to claim the reimbursement for these expenses available from his employer.⁴⁸ This case, however, was clearly distinguishable from *Campbell* on its facts, as well as its rationale. In *Heidt*, the party willing to reimburse the taxpayer (the employer) required that the employee incur the expenses for the employer's benefit.⁴⁹ In *Campbell*, on the other hand, the insurer willing to reimburse was a third party, completely unrelated to the transaction giving rise to the expense. Also, the expense in *Campbell* was not incurred to benefit the insurer in any way.⁵⁰

42. *Id.* at 2579-81.

43. *Id.* at 2579.

44. *Id.*

45. 274 F.2d 25 (7th Cir. 1959).

46. 13 T.C. 897 (1949).

47. 56 T.C.M. (P-H) at 2579-80.

48. 274 F.2d at 26-27. The taxpayer claimed the business expense deductions under § 23(a) of the Internal Revenue Code of 1939, which was the predecessor provision to I.R.C. § 162(a) in the 1986 Code and is identical in its ordinary and necessary language. *Id.* at 27 n.3.

49. *Id.* at 26.

50. Moreover, the deduction of expenses has been allowed when the taxpayer has foregone insurance reimbursement and such expenses were deemed unreimbursable "as a practical matter of fact." I.R.S. Position Rep. (CCH) ¶ 44,011 (Jan. 8, 1986) (acquiescing in the decision reached in *Kessler v. Commissioner*, 54 T.C.M. (P-H) 1095 (1985)). This rare situation is applicable to *Campbell*, a case in which the taxpayer could not practicably obtain

Moreover, the rationale underlying *Heidt*—that the principal-agent relationship of the parties involved in the transaction created the potential for widespread assignment of income⁵¹ manipulations between the employer and the employee⁵²— is inapposite to the dispute in *Campbell*. The closeness of the employer-employee relationship, especially when the employee is also a controlling or sole stockholder in the corporation, as well as the widespread and recurring nature of reimbursement transactions between these types of parties, give rise to significant motive and opportunity to engage in assignment of income improprieties. The court in *Heidt* was thus justifiably concerned with identifying the appropriate taxpayer authorized to take the deduction for the expenses incurred. This logic was inapplicable in *Campbell*, however. The taxpayer and the insurer were unrelated, except for the connection of the insurance contract, a tie neither party was anxious to see put to use.⁵³ No incentive to engage in assignment of income abuses existed. The parties did not stand to gain anything collectively from an attempt to flout the tax laws, and reduce their over-

insurance reimbursement because of the possibility of business loss, premium increase, or policy cancellation. 56 T.C.M. (P-H) at 2580. In the Action on Decision, the I.R.S. stated that it considered Kessler's position to be analogous to that of the taxpayer in *Hills v. Commissioner*, 76 T.C. 484 (1981), a case in which the Commissioner allowed a loss deduction although insurance reimbursement was available. Because the taxpayers in both *Kessler* and *Campbell* were unable practically to claim reimbursement, the court should have applied the reasoning of *Kessler* (and, by extension, *Hills*), not *Heidt*, and allowed the deduction. See *IRS Says Deduction OK, Even if Reimbursement Available*, 36 TAX'N FOR ACCT. 158 (1986) ("[A] taxpayer who can establish that reimbursement, although nominally available, is unavailable as a practical matter should be able to deduct out-of-pocket . . . business expenses."). Further, the reasoning of *Heidt* has not been applied strictly, lessening its precedential value. See, e.g., *Neal v. Commissioner*, 50 T.C.M. (P-H) 556, 557 (1981).

51. Assignment of income (or deductions in *Campbell*) refers to the process by which related taxpayers attempt to employ various devices (transaction structure, special code sections) to attribute income to a party who did not earn it (or to enable a party to take a deduction for which he incurred no economic detriment) to exploit the tax rate and treatment differentials between the two taxpayers and effect a lower overall tax liability for the two-taxpayer unit. B. BITTKER, 3 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 75 (1981).

52. 274 F.2d at 28.

53. Although most taxpayers carry insurance, they would prefer not to use it; higher premiums or policy cancellations often result from insurance claims. Insurance becomes a last line of defense and is used sparingly unless the calamity is of such proportion that insolvency or bankruptcy may result. Of course, insurance companies are content to write policies and collect premiums without having policyholders make claims for reimbursement.

all tax liability. Additionally, the concept of assignment of income does not fit well in the context of an insurer-insured relationship. The liability for the expense or loss suffered due to the accident or casualty belongs to the insured, not the insurer. No assignment of income or deductions can result when the taxpayer simply elects to keep that which is already his, pay the expense himself, and claim his deduction.⁵⁴

Similarly, *Whitney v. Commissioner*⁵⁵ provided little theoretical support for the court's conclusions. In *Whitney*, the taxpayer, sole trustee of a trust established to liquidate a corporation in which he was a major stockholder, paid a personal injury claim brought against a trust employee.⁵⁶ Under Massachusetts law, a trustee was personally liable to third parties for torts committed by any trust employee, but also had a right of indemnification against the trust for any such payments he was required to make.⁵⁷ Rather than seek reimbursement, the taxpayer chose to deduct the payment on his tax return.⁵⁸ However, the statute he relied on for the deduction authorization was section 23(e)(1) or (2), the predecessor statute in the Internal Revenue Code of 1939 to section 165(c)(1) and (2)⁵⁹ relating to *losses*, not business expenses. The court denied the loss deduction, stating that the payment was reimbursable from another source. The court, then, engaging in a loss analysis, denied the deduction by construing the loss statute.⁶⁰ The words "ordinary and necessary" do not appear anywhere in the opinion. *Whitney* stands for the proposition that, on the facts presented, under the predecessor statute of the modern loss statute embodied

54. When the taxpayer does not claim insurance reimbursement and pays the claim himself, he is clearly entitled to a deduction based on all assignment-of-income criteria. The taxpayer has disbursed money to the client fund to rectify the payment error; he is the party deserving relief through a tax deduction. To allow *any other* taxpayer to deduct the expense Campbell incurred in this situation would violate assignment-of-income principles. Of course, if the taxpayer chooses to make a claim on his policy, and thus "assign" his deduction to the insurer through the vehicle of the policy, no impropriety results. Accordingly, an insured taxpayer who decides to keep his deduction has the right to do so, and no assignment-of-income impropriety results by virtue of his insurance coverage.

55. 13 T.C. 897 (1949).

56. *Id.* at 897, 899-900.

57. *Id.* at 900.

58. *Id.* at 899.

59. I.R.C. § 23(e)(1), (2) (1939).

60. 13 T.C. at 897, 901.

in section 165(c)(1) and (2), the taxpayer sustained no loss. One of the most important aspects in *Whitney*, moreover, is the latent potential for assignment of income or deductions abuse discussed above.⁶¹ *Whitney*, therefore, addressed a question closely related to the issue decided in *Heidt*; further, both decisions were colored by the assignment of income abuse potential present. This question, however, was totally distinct from the one presented in *Campbell*.⁶²

The Tax Court in *Campbell* added a new wrinkle to the “ordinary and necessary” inquiry by accepting the characterization of the expenditure in issue as “ordinary” but not “necessary.”⁶³ Up until *Campbell*, necessity followed from ordinariness;⁶⁴ the “necessary” language added nothing specific to the test of deductibility under section 162(a). The Tax Court departed from more than fifty years of settled statutory interpretation.

Additionally, the court’s analysis of the necessity of the payment in question did not even mention the traditional articulation of “necessary” set forth in *Welch*⁶⁵ and applied in later cases,⁶⁶ that

61. See *supra* note 51 for the definition of assignment of income. The taxpayer in *Whitney* essentially had the ability to choose which of his tax paying “personalities”—the trust liquidating a company in which he was a major stockholder, or him individually—would claim the deduction. He attempted to “assign” the deduction to the personality that would prove the greatest tax savings. However, as was shown above, such assignment of income abuse potential was not present in *Campbell* because the insured and insurer were not so related that the tax savings of one would accrue to the benefit of the other. See *supra* notes 52-53 and accompanying text.

62. The Tax Court asserted that the cites to § 23(e)(1) and (2) in *Whitney* had been inadvertent and claimed that the court had meant to cite § 23(a)(1) and (3), the “ordinary and necessary” language relating to business deductions in the predecessor statute to § 162(a) of the 1939 Code. However, the court’s analysis had dealt exclusively with the loss provisions of (e)(1) and (2). Furthermore, the taxpayer’s assertions demonstrate that the basis of deductibility asserted had been the loss provisions, not the expense provisions. The *Campbell* court’s assertion, then, is highly suspect. See *Campbell v. Commissioner*, 56 T.C.M. (P-H) 2578, 2579 n.4 (1987).

63. See *supra* text accompanying notes 43-47.

64. Cf. *Welch v. Helvering*, 290 U.S. 111, 113 (1933) (court will assume “necessity,” whenever expenses are arguably appropriate and helpful to the business).

65. *Id.*

66. See *Commissioner v. Tellier*, 383 U.S. 687, 689 (1966); cf. *Lilly v. Commissioner*, 343 U.S. 90, 93-94 (1952) (“Necessity” to be determined in light of the “ways of conduct . . . prevailing in the business world,” (quoting *Commissioner v. Heininger*, 320 U.S. 467, 472 (1943)); *Kornhauser v. United States*, 276 U.S. 145, 152 (1928) (Pre-*Welch* case treating the

the payments be "appropriate and helpful"⁶⁷ in the taxpayer's estimation.⁶⁸ The taxpayer in *Campbell* asserted no claim for reimbursement under the policy because he feared a loss of client fund business to competitors, and cancellation of coverage or increased policy premiums.⁶⁹ The Tax Court called these allegations "vague" and purported not to rule on the availability of the deduction if the taxpayer had made sufficient allegations.⁷⁰ Yet support for any section 162 expense deduction probably could not have been made with greater concreteness. Clearly, the taxpayer met the *Welch*⁷¹ necessity standard by demonstrating that he thought the business's absorption of the expense would be appropriate and helpful. In rejecting the taxpayer's assertions, the Tax Court essentially ruled negatively on the question it ostensibly reserved. Because the court failed to apply the correct standard for evaluating deductibility under section 162(a), the result it reached is of questionable credibility.⁷²

POLICY RATIONALES FOR DENYING DEDUCTIBILITY OF *Campbell* PAYMENTS: A CRITIQUE

Although the business expenditure in *Campbell* was directly related to the business's operation and thus clearly deductible under the accepted statutory interpretation, the court denied the deduc-

"ordinary and necessary" language as a unified standard, emphasizing the "ordinary" language).

67. *Welch*, 290 U.S. at 113.

68. *Id.*

69. *Campbell v. Commissioner*, 56 T.C.M. (P-H) 2578, 2580 (1987).

70. *Id.*

71. 290 U.S. at 113. Had the taxpayer been threatened previously with premium increase or policy cancellation by its insurer the danger would have appeared more imminent. See *Miller v. Commissioner*, 733 F.2d 399, 400 n.3 (6th Cir. 1984). However, threats prior to the assertion of deductibility are not required by the *Welch* necessity concept.

72. One of the more striking aspects of *Campbell* is the court's application of *Heidt* and *Whitney* to the fact pattern. The more logical precedent to apply would have been *Kentucky Utils. Co. v. Glenn*, 394 F.2d 631 (6th Cir. 1968), which denied a § 162 deduction claimed by a business when compensation was available. *Kentucky Utilities* had been overruled, but its position had been reinstated legislatively (at least for individual taxpayers) by changes in the Tax Reform Act of 1986, enacted shortly before the *Campbell* decision. The court's failure to apply or even to mention the position taken in *Kentucky Utilities* may stem from its recognition that the analysis in that case (or lack thereof) was flawed. Rather than reaching for a precedent that was inapposite, however, the court should have ruled in the taxpayer's favor due to the lack of compelling grounds for denying the deduction.

tion.⁷³ In effect, the court selected one type of business expense for special treatment without articulating a principle for drawing a new line between deductible and nondeductible business expenses. Absent a principle in tax policy to identify which expenditures receive this special treatment, *all* section 162 deductions could conceivably be denied according to the whim of a court.

The Double Dip Justification

The most prevalent tax policy reason asserted to deny deductibility when a taxpayer pays an insurance claim himself although insurance compensation is available is the “double-dip” or “wind-fall” argument.⁷⁴ Although not relied on in *Campbell*,⁷⁵ this objection to deductibility has been asserted in cases when insured taxpayers who paid for property losses themselves sought casualty loss deductions under section 165.⁷⁶ The “double-dip” logic operates in exactly the same manner for section 162 deductions as it does in the section 165 loss context,⁷⁷ and may have been an unarticulated rationale in *Campbell*.⁷⁸

The “double-dip” argument asserts that business taxpayers receive an impermissible and unwarranted double benefit if they can deduct both the insurance premiums on policies in force and the amounts of any expenditures they make to satisfy covered claims.⁷⁹ Adherents to this view argue that a tax deduction is, in essence, a subsidy, resulting in a transfer of a percentage of the cost of the deducted item (equal to the taxpayer’s marginal tax rate) to the

73. See *supra* notes 30-42 and accompanying text.

74. *Miller v. Commissioner*, 733 F.2d 399, 409 (6th Cir. 1984) (Contie, J., dissenting); *Hills v. Commissioner*, 691 F.2d 997, 1008-09 (11th Cir. 1982) (Hatchett, J., dissenting).

75. Nevertheless, the “double-dip” logic may have been an unarticulated rationale in *Campbell*. An alternative to the § 162 expense analysis in *Campbell* is a § 165 loss analysis. See *infra* text accompanying notes 110-18. The “double-dip” reasoning applies with equal force under both § 162 and § 165 due to the similarity of the situations in which a taxpayer might seek the deduction under one or the other section.

76. 733 F.2d at 409 (Contie, J., dissenting); 691 F.2d at 1008-09 (Hatchett, J., dissenting).

77. See *infra* notes 133-45 and accompanying text.

78. The applicability of the double-dip reasoning to § 162 cases inheres in the near perfect similarity of the situations in which the deduction is sought under either Code section. In both situations, (1) the taxpayer makes an expenditure of funds (2) for which he could claim insurance compensation, but does not (3) and then attempts to deduct both the uncompensated expenditure and the premium on the applicable insurance policy.

79. 733 F.2d at 409 (Contie, J., dissenting).

Treasury.⁸⁰ If both the cost of the insurance premiums⁸¹ and the cost of reimbursing others on covered claims are deductible, the taxpayer theoretically could deduct the same cost twice. Proponents of this view would assert that *Campbell* was correctly decided.

The "double-dip" argument, however, fundamentally misapprehends both the nature of the *Campbell*-type payments and the operation of insurance coverage in general. Insurance premium payments are simply a way of securing a third party's willingness to assume some of the liability for potential claims against the business entity. The payments, therefore, are a risk-spreading mechanism designed to encourage the continued financial and operational stability of the business.⁸² Clearly, then, premium payments serve a valuable function for the business, even if it makes no claims against the underlying policy. The logic of the double-dip, however, coupled with *Campbell's* "necessity" concept,⁸³ would dictate that if a business makes no claim against the policy, the expenditure was technically not "necessary" for that year, and is not deductible. The Tax Code, however, recognizes that insurance coverage is an ordinary and necessary expense and allows a deduction for insurance premiums in years when the underlying coverage remains unused. Although intangible, the benefits to the business from "unused" insurance coverage are many: the encouragement of banks to lend money, the incentive for businessmen to place orders and provide supplies, and the encouragement of individuals to accept employment based on the stability and security provided by

80. 691 F.2d at 1009 (Hatchett, J., dissenting).

81. *Carnation Co. v. Commissioner*, 640 F.2d 1010 (9th Cir. 1981). "Insurance premiums are deductible as 'ordinary and necessary business expenses.'" *Id.* at 1012.

82. See G. COUCH, *CYCLOPEDIA OF INSURANCE LAW* ¶ 1:3 (2d rev. ed. 1984); G. RICHARDS, *RICHARDS ON THE LAW OF INSURANCE* § 2 (5th ed. 1952); see also *Group Life and Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 211 (1979) ("The primary elements of an insurance contract are the spreading and underwriting of a policyholder's risk."); *SEC. v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 73 (1959) ("There is no true underwriting of risks, the one earmark of insurance as it has commonly been conceived . . ."); *Trustees of the Univ. of Pa. v. Lexington Ins. Co.*, 815 F.2d 890, 901 (3rd Cir. 1987) ("Insurance policies are risk-spreading devices. They exist primarily because the stakes of liability to an insured are greater than they are to the insurer, which can spread the loss across all of its customers.").

83. *Campbell v. Commissioner*, 56 T.C.M. (P-H) 2578, 2579-81 (1987).

business insurance. The payment of insurance premiums is thus "appropriate and helpful"⁸⁴ even if the coverage is not used.

Furthermore, the "double-dip" argument is unrealistic. For compelling reasons, businesses often forego insurance reimbursement.⁸⁵ Continued claims on an insurance policy cause premiums to increase. The taxpayer, by paying a claim himself, tries to avoid higher premiums in the future,⁸⁶ thus characterizing these payments as prepaid insurance premiums.⁸⁷ The taxpayer elects to pay now instead of later. Although this approach is admittedly more costly in the short run, it reflects an effort to control long-term increases in insurance rates.⁸⁸ Courts should recognize that a deduction permitted for the payment of a claim represents future premium *increases*; the current premium payment represents only the existing cost of insurance coverage. The fallacy of the double-dip logic is thus identified: the same dollars of expense are not deducted more than once. A deduction for the self-paid claim would permit the taxpayer to recover the increase in insurance cost he would have been able to deduct as an ordinary and necessary business expense in later years.

PRACTICAL CONCERNS: DEDUCTIBILITY OF *Campbell*-TYPE PAYMENTS

Despite the compelling policy reasons for making *Campbell*-type payments deductible under section 162(a), practical problems still remain. Three interrelated practical problems, which must be resolved before the policy considerations supporting deductibility

84. *Welch v. Helvering*, 290 U.S. 111, 113 (1933).

85. *See infra* note 88.

86. *Axelrod v. Commissioner*, 56 T.C. 248 (1971) (Fay, J., concurring). Three of the judges in *Axelrod* asserted that "[t]he insured individual is frequently compelled to forego the desirable benefits of his insurance coverage in order to avert the otherwise inevitable cancellation of his policy or prohibitive increase of his insurance rates." *Id.* at 260.

87. *Hills v. Commissioner*, 691 F.2d 997, 1004-05 (11th Cir. 1982).

88. Theoretically, payment can be spread over future years, leading to a premium increase that is lower than the increases that the insurance company would have imposed had the taxpayer claimed on the policy. At the very least, under this option, the rate of premium increase is determined primarily by the taxpayer, not the insurance company. Admittedly, the taxpayer gambles that the higher insurance rates he incurred by making the payment instead of claiming the insurance compensation will be lower than the increase the insurance company would have exacted had he filed a claim. Even if the taxpayer loses the gamble, he will have succeeded in keeping his insurance policy unmarred by claims, lessening the ever-present possibility of policy cancellation.

may be given effect, are the useful life of the payment, the future benefits derived from such payments, and the revenue effects of permitting deductibility.

Useful Life

When a business makes an expenditure for business property to be used in the production of income for more than one year, the Code generally requires capitalization of the payment.⁸⁹ Any capital expenditures⁹⁰ for the acquisition of capital assets are not deductible;⁹¹ however, the taxpayer may be able to take a depreciation or amortization deduction.⁹² Amortization deductions reflect an effort to avoid distortion of the taxpayer's income for the taxable period, and to better match a business entity's income with the costs incurred to generate that income.⁹³ The problem, then, with the *Campbell*-type payment is that despite the validity of the business reasons asserted for foregoing insurance reimbursement, the expenditure benefits future tax periods by keeping insurance pre-

89. I.R.C. § 263(a)(1) (Supp. 1986), entitled "Capital Expenditures," states: "(a) General Rule.—No deduction shall be allowed for—(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property . . ." The term "capitalized" means simply that no deduction against current income is permitted for such expenditures.

90. Treas. Reg. § 1.263(a)-2 (as amended in 1987) states: "The following paragraphs of this section include examples of capital expenditures: (a) The cost of acquisition, construction, or erection of buildings, machinery and equipment furniture and fixtures, and similar property having a useful life substantially beyond the taxable year." *Id.* (emphasis added).

91. See *supra* notes 89, 90.

92. No practical difference exists between amortization and depreciation deductions. For reasons of conventional usage, the former term is applied to deductions involving the wasting of intangible assets (contract rights, patents, franchises, etc.), and the latter term is applied to parallel deductions regarding the wasting of tangible assets. See B. BITTKER, *FUNDAMENTALS OF FEDERAL INCOME TAXATION* ¶ 10.1 (1983); Schenk, *Depreciation of Intangible Assets: The Uncertainty of Death and Taxes*, 13 WAYNE L. REV. 501, 527 (1967).

93. B. BITTKER, *supra* note 92, ¶ 10.1; see also *Massey Motors, Inc. v. United States*, 364 U.S. 92, 96 (1960) ("It was the purpose of [the depreciation provisions of the Code] . . . and the regulations to make a meaningful allocation of . . . [asset] cost to the tax periods benefited by the use of the asset."). See generally Lee, *Start-Up Costs, Section 195, and Clear Reflection of Income: A Tale of Talismans, Tacked-On Tax Reform, and a Touch of Basics*, 6 VA. TAX REV. 1 (1986) (asserting that the essence of the allowance of depreciation and amortization deductions is the avoidance of distortion of income). Professor Lee argues, quite correctly, that the disallowance of any depreciation or amortization deduction for payments benefitting future periods creates as much, if not more, distortion of income as would the allowance of a deduction for the payment in full in the year of expenditure. *Id.* at 40.

miums lower. The payment has created an intangible asset, not unlike prepaid insurance. To amortize (deduct) part of this prepaid asset each year in the future, a reasonable estimate of its useful life must be established. Making such an estimate is often quite difficult and arbitrary.⁹⁴

Future Benefits Generated by the Payments

A second obstacle to the deductibility of *Campbell*-type payments, closely related to the first, is their very nature. Such payments represent future rather than current insurance costs. Businesses often fail to claim reimbursement because they fear policy cancellation or premium increases.⁹⁵ In essence, by absorbing the expense now, policy premiums will be lower in future years due to the absence of claims. From this viewpoint, the economic characterization of the payment is clear: although paid to an unrelated third party, the expenditure is essentially a lump-sum prepaid insurance premium.⁹⁶

Characterization of the payment as an insurance premium removes most objections to current, full deductibility.⁹⁷ The Treasury regulations under section 162 specifically identify insurance

94. The Treasury regulations relating to depreciation mandate, as a condition precedent to an amortization deduction, that the useful life of an intangible asset "be estimated with reasonable accuracy." Treas. Reg. § 1.167(a)-3 (as amended in 1960); see also Lee, *supra* note 93, at 38. On the other hand, some courts allow an amortization deduction even when the taxpayer cannot establish useful life of an asset, if the taxpayer can establish that the asset does waste. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1920). The *Cohan* doctrine states that, if the taxpayer can establish that expenditures were made that are deductible in some amount, the court is required to "make as close an approximation as it can" of what the useful life should be and to allow the deduction. *Id.* at 544. See Lee, *supra* note 93, at 39; see also *Wisconsin Psychiatric Servs. v. Commissioner*, 76 T.C. 839, 852-53 (1981) (*Cohan* approximation of condominium useful life); *Joyce v. Commissioner*, 25 T.C. 13, 15-16 (1955) (*Cohan* approximation of depreciation allowance). In part, these two parallel and contradictory lines of authority suggest the need for a legislative solution to the useful life problem involved in *Campbell*-type payments.

95. *Campbell v. Commissioner*, 56 T.C.M. (P-H) 2578, 2580 (1987).

96. See *Hills v. Commissioner*, 691 F.2d 997, 1004-05 (11th Cir. 1982), which first asserted this theory of the economic reality of *Campbell*-type payments. Ironically, in this case, the Commissioner made this assertion.

97. See *supra* text accompanying notes 79-81.

premiums as ordinary and necessary business expenses.⁹⁸ Denying deductibility in this instance allows the Tax Court to assert its own arbitrary view of necessity and opens a Pandora's box of frightening proportions. Deference to business judgment⁹⁹ is one of the policies underlying section 162 and the Treasury regulations in this area. Additionally, the Commissioner does not question the necessity of any other types of payments made as "bona fide" business expenses within the *Welch* standard. To permit the Tax Court to arbitrarily remove the kind of business expenses incurred in *Campbell* from the purview of that test and subject them to more rigorous scrutiny is unjustified.¹⁰⁰ Businesses seek to maximize profits. This goal not only "legitimizes" as necessary all payments in pursuance of that goal, but also guards against frivolous or wasteful payments.

Further, important business policy considerations support deductibility in cases like *Campbell*. Businesses should be encouraged to insure. Insurance provides the company, as well as those with whom it deals, an available fund of reimbursement in the event of a calamity. Such a fund often means the difference between solvency and bankruptcy when substantial losses occur. *Forcing* businesses to use their insurance coverage for every reimbursable loss, however, increases the cost of insurance for everyone, provides a disincentive for businesses to maintain insurance, and supplies a reason for insurers to contemplate termination of many taxpayers' coverage.¹⁰¹

98. Treas. Reg. § 1.162-1(a) (as amended in 1975). The regulation states: "Among the items included in business expenses are . . . insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business." *Id.*

99. See *Welch v. Helvering*, 290 U.S. 111 (1933), in which Justice Cardozo stated that the payments were necessary because the taxpayer viewed them as "appropriate and helpful" to his business. He emphasized that the Court "should be slow to override" this judgment. *Id.* at 113.

100. Compare I.R.C. § 280G (1982 & Supp. 1986), which provides a mechanism for the disallowance of certain excessive "golden parachute" payments. Note, however, that specific statutory authority effects this disallowance.

101. One author has asserted that these effects are of little consequence. The author argues that businesses are able to self-insure if their coverage is cancelled and will simply pass the increased cost of higher insurance premiums along to the consumer. Taxpayers also will be able to claim a higher deduction as a section 162(a) business expense for these expenditures, if premiums increase. Comment, *Bartlett v. United States: Deduction of Nonbusiness Losses not Compensated by Insurance—The Need for a Separate Standard for Individu-*

However, although current statutory language supports full, current deductibility for *Campbell*-type payments, such payments *do* secure future benefits to the business. Substantial future benefits usually indicate a payment is a capital expenditure, for which no current deduction in excess of the current period's pro rata portion is allowed.¹⁰² The current statutory provisions, then, are inappropriate tools to analyze the deductibility of *Campbell*-type payments, which possess the hybrid characteristics of current *and* limited future benefits.

Revenue Effects and Rationale of Deductibility

The final concern with the deductibility of *Campbell*-type payments is the effect on the amount of tax revenue collected. The revenue effects of allowing the deduction of the "self-insurance" payment in cases such as *Campbell* are largely neutral. Viewing the insured and the insurer, by virtue of the insurance contract running between them, as an *economic unit* for purposes of the expense incurred, the unit's net worth has decreased by an amount equal to the expense.¹⁰³ The tax system should allow the unit a deduction for the expense at some point.¹⁰⁴ If the deduction is allowed to the insured taxpayer, the insurer's taxable income is increased. The insurer is unable to take a deduction because it pays no reimbursement to the taxpayer on his policy. Although the taxpayer takes the deduction and thereby reduces his tax liability, the insurer is not allowed a deduction, and the Treasury collects the proper amount of tax.¹⁰⁵ If, on the other hand, the insured tax-

als, 18 WM. & MARY L. REV. 200, 211 (1976). As a matter of policy, this rationalization is very unsatisfactory. Self-insurance requires businesses to put needed capital out of reach, putting a severe financial strain on many enterprises. Additionally, for businesses that do not have the adequate resources to self-insure, policy cancellation forcing this option makes the overall business operation much riskier and raises the possibility that should a calamity occur, parties deserving of reimbursement from the business will go uncompensated. Denial of the deduction sought in cases like *Campbell* produces no greater revenue than a policy of allowing the deduction. The government should have no interest in a policy that produces no benefits and at the same time is saddled with the evils of reducing business decision-making flexibility and increasing consumer price levels and insurance costs.

102. See *supra* notes 89-91 and accompanying text.

103. *Hills v. Commissioner*, 691 F.2d 997, 1006 (11th Cir. 1982).

104. *Id.*

105. See *id.*

payer claims reimbursement, he will offset this amount against the expense, and his taxable income will not change. The reimbursement has no tax effect *per se*, but the taxpayer's income is increased by the amount of the expense because the expense no longer "shields" any other income; the expense is fully cancelled out against the amount of reimbursement received. The insurer will get a deduction for the claim paid to the taxpayer. Again, the proper amount of tax is collected. The correct amount of tax is extracted from the economic unit, then, regardless of which party takes the deduction.¹⁰⁶

106. A simple example will illustrate the foregoing assertions. Assume the following. Insurance Co. ("I") has net taxable income of \$1,000,000. Taxpayer ("T") has net taxable income of \$50,000. The deduction at issue is a \$10,000 payment, all of which is covered by T's insurance policy with I. A flat tax of 30% applies to both taxpayers.

The tax that should be collected from the two-taxpayer unit of I and T is:

$$\begin{array}{r}
 \$ 1,000,000 \text{ (I's income)} \\
 \quad 50,000 \text{ (T's income)} \\
 \underline{- 10,000 \text{ (deductible expense)}} \\
 \$ 1,040,000 \times 30\% = \underline{\$312,000} \text{ (total tax)}
 \end{array}$$

If T seeks and obtains reimbursement from I, he must take this money into income, and he receives an offsetting deduction for his payment of the \$10,000 to the claimant:

$$\begin{array}{r}
 \$ 60,000 \text{ (income, including reimbursement)} \\
 \underline{- 10,000 \text{ (deduction for reimbursing the claimant)}} \\
 \$ 50,000 \text{ (taxable income)} \times 30\% = \underline{\$15,000} \text{ (tax collected)}
 \end{array}$$

I is allowed a deduction for the payment to T on T's policy as a cost of its insurance operations:

$$\begin{array}{r}
 \$ 1,000,000 \text{ (income)} \\
 \underline{- 10,000 \text{ (reimbursement expense deduction)}} \\
 \$ 990,000 \text{ (taxable income)} \times 30\% = \underline{\$297,000}
 \end{array}$$

The total tax collected is \$312,000, the proper amount.

Assume now that T does not seek reimbursement from I and deducts the \$10,000 payment as a § 162 expense:

$$\begin{array}{r}
 \$ 50,000 \text{ (taxable income)} \\
 \underline{- 10,000 \text{ (deduction for expense of payment)}} \\
 \$ 40,000 \text{ (taxable income)} \times 30\% = \underline{\$12,000}
 \end{array}$$

Because T does not seek reimbursement on his policy and I makes no payment to T, I is not entitled to a deduction:

$$\$ 1,000,000 \text{ (taxable income)} \times 30\% = \underline{\$300,000}$$

Additionally, denying *Campbell*-type deductions may actually have a negative impact on the revenues. Again, due to compelling business reasons, many taxpayers would continue to pay claims themselves even if such payments were not deductible. Other taxpayers, however, would not pay claims themselves if such payments were not deductible. Insurance companies could claim deductions for reimbursements to these taxpayers.¹⁰⁷ As a result, deductions would shift from the individual taxpayer policyholders to the insurance companies. For tax years beginning after July 1, 1987, however, the top corporate tax rate of 34% (that would be applicable to insurance companies) exceeds the top individual tax rate of 28% (that would be applicable to individuals, and sole proprietorship income, as in *Campbell*).¹⁰⁸ The higher top corporate tax rate will enable insurance companies claiming deductions to shield more income than individuals claiming the same deductions due to the lower top individual tax rate. Denying deductibility to individual taxpayers would encourage increased deductions at the corporate level and would thus *decrease* revenues to the Treasury.¹⁰⁹

The total tax collected is again \$312,000, the proper amount. Thus, no loss of revenue occurs if T forgoes reimbursement and claims a deduction.

This example assumes that T and I were subject to an identical tax rate. For tax years after 1986, however, I's marginal tax rate would exceed T's, causing the Treasury to experience a loss of revenue if T claims reimbursement and I takes a deduction. *See infra* note 108 and accompanying text.

107. *See supra* text accompanying note 106.

108. See I.R.C. § 11(b) (1982 & Supp. 1986) for the corporate tax structure and I.R.C. § 1(a)-(h) (1982 & Supp. 1986) for individual tax rates (the top marginal tax rate of 28% (33% with § 1(g)'s 5% surcharge, which phases out) is effective for tax years beginning after December 31, 1987).

109. Historically, top individual rates have exceeded corporate rates, a fact that helps to explain the Service's longstanding position. See I.R.C. § 1(a) (1954) for the higher individual tax rates previously applicable and I.R.C. § 11(b) (1954) for the higher corporate rates previously applicable. The applicable tax law in *Campbell* was the law in force for 1982. 56 T.C.M. (P-H) 2578 (1987). Whether the Service will be as aggressive in asserting the approach articulated in *Campbell* in later cases arising under post-1986 tax law will be interesting to observe. Regardless of the Service's policies, however, a particular view of the *Campbell* dispute is not justifiable under the tax statutes simply because it is productive of the most revenue.

AN ALTERNATIVE BASIS FOR DEDUCTIBILITY IN *Campbell*: SECTION 165*Section 165 and Campbell*

An alternative to denying a deduction for *Campbell*-type payments as a business expense under section 162 is to allow the deduction as a business loss under section 165. The distinction between losses, governed by section 165, and expenses, governed by section 162, is found in the "nature and occasion of the expenditure,"¹¹⁰ and was once cryptically described as "self-evident."¹¹¹ The distinction is a difficult and confusing one to draw because an event often displays the characteristics of both categories.¹¹² The case law provides little clarification in the way of definite standards or tests.¹¹³ However, expenses, unlike losses, entail a certain element of exchange: they are expenditures made in anticipation of producing business income. Losses, on the other hand, exhibit a forfeiture flavor, a unilateral relinquishment of something of value, often involuntarily.¹¹⁴

Campbell-type payments reflect both expense and loss qualities.¹¹⁵ One could view the payment the taxpayer made to reim-

110. *Holt v. Commissioner*, 69 T.C. 75, 78 (1977).

111. *Id.*

112. B. BITTKER, *supra* note 92, ¶ 12.7.

113. *See, e.g., Seufert Bros. v. Lucas*, 44 F.2d 528, 530-31 (9th Cir. 1930) (criticizing Board of Tax Appeals for denying relief when taxpayer claimed an expense rather than a loss deduction; loss deduction allowed); *L. Heller and Son, Inc. v. Commissioner*, 12 T.C. 1109, 1112, (1949) (taxpayer asserted that a payment was deductible as a business expense or loss; court declined to label the payment and concluded that, on one or the other ground, the deduction was permissible); *see also* 6 J. MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* § 25.29 (1988) (asserting that, when trying to distinguish expenses from losses, "[t]he best approach is to determine the character of the item involved and then to review the cases, considering the deductions allowable for items of that character.")

114. *Compare United States v. Winters*, 261 F.2d 675 (10th Cir. 1958) (cost of liquor used by lawyer to entertain clients treated as an expense), *cert. denied*, 359 U.S. 943 (1959) with *Fuller v. Commissioner*, 213 F.2d 102 (10th Cir. 1954) (cost of liquor confiscated in dry state treated as a loss). *See also Holt*, 69 T.C. at 78, in which the court stated that "confiscation and forfeitures result[] in losses, not expenses"; 7 J. MERTENS, *supra* note 113, § 28.37 (arguing that "[m]any items deductible under the heading of expense may be called losses to the extent that they do not bring in an equivalent consideration in services or property to the payor.")

115. *See, e.g., Kentucky Utils. Co. v. Glenn*, 394 F.2d 631, 632 (6th Cir. 1968) (taxpayer asserted that his payment was a loss or an expense).

burse the client fund and to maintain current insurance rates as a business expense. However, one could also view the misdirected payment made by the fund at the taxpayer's direction as a business loss because no income was expected from the taxpayer's reimbursement of the fund. Section 165 is a viable alternative statutory basis for deduction because the erroneous payment exhibits loss properties.

Section 165(a) provides a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise."¹¹⁶ Section 165(c) limits deductions by individuals under subsection (a) to, among other things, "losses incurred in a trade or business."¹¹⁷ Much of the litigation involving this Code section has turned on the meaning of the phrase "not compensated for by insurance or otherwise."¹¹⁸

The Historical Interpretation of "Not Compensated for by Insurance or Otherwise"

Kentucky Utilities

One of the first cases to interpret the "not compensated for by insurance or otherwise" language, in a factual situation strikingly similar to *Campbell*, was *Kentucky Utilities Co. v. Glenn*.¹¹⁹ In that case, the utility sustained damage to a generator as the result of an accident.¹²⁰ The equipment was under warranty and insured at the time of the accident, but the utility feared an adverse impact on its business relations with the manufacturer or the insurer if it forced either party to bear the full cost of repairs under the warranty or insurance policy respectively.¹²¹ The three parties agreed in a settlement to share the cost.¹²² On its tax return, the utility claimed a deduction for its share of the loss under section

116. I.R.C. § 165(a) (1986). For the text of the statute see *supra* note 3.

117. I.R.C. § 165(c)(1) (1986). For the text of the statute see *supra* note 2.

118. See, e.g., *Kentucky Utilities*, 394 F.2d at 633.

119. *Id.* at 631. For the court's analysis of the § 23(a) (forerunner to § 162(a)) claim the taxpayer asserted, see *id.* at 633.

120. *Kentucky Utils. Co. v. Glenn*, 250 F. Supp. 265, 269 (W.D. Ky. 1965), *aff'd*, 394 F.2d 631 (6th Cir. 1968).

121. *Id.* at 270.

122. *Id.* The manufacturer bore 44% of the repair cost, the utility paid 30%, and the insurer contributed 26%.

23(f), the predecessor statute in the 1939 Code to section 165(a).¹²³ Stating that "when a claim is *disputed* and a settlement is made, the amount not recovered is allowable as a loss,"¹²⁴ the court denied the deduction because the utility's claim against the insurer was not in dispute.¹²⁵ On appeal, the Sixth Circuit affirmed.¹²⁶ Some commentators¹²⁷ regard *Kentucky Utilities* as "the genesis of the theory that a taxpayer may not elect to forego an insurance claim and deduct this loss under Section 165."¹²⁸

123. The Code section read: "(f) Losses by Corporations. In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise." *Kentucky Utils. Co. v. Glenn*, 394 F.2d 631, 632 n.1 (6th Cir. 1968) (quoting I.R.C. § 23(f) (1952)).

124. 250 F. Supp. at 269 (emphasis added).

125. *Id.* at 271. In denying the deduction, the court relied on *Protzmann v. Commissioner*, 276 F.2d 684, 686 (1st Cir. 1960), a bad debt case that did not involve insurance or construe the loss provisions of the Code.

126. 394 F.2d at 633. The Sixth Circuit relied, however, not on *Protzmann*, as the district court had, but on *Sam P. Wallingford Grain Corp. v. Commissioner*, 74 F.2d 453 (10th Cir. 1934), a case involving the payment of debts of predecessor corporations. The court in *Wallingford* asserted the long-established principle "that voluntary payments do not give rise to losses within the meaning of [§ 23(f)]." *Id.* at 454. The Sixth Circuit cited *Wallingford*, however, for the proposition that the loss sustained in *Kentucky Utilities* "was not an 'uninsured loss.'" 394 F.2d at 633. That quote, however, does not appear in *Wallingford*. See *Hills v. Commissioner*, 76 T.C. 484, 490 n.7 (1981). Furthermore, *Wallingford* did not involve insurance. *Miller v. Commissioner*, 733 F.2d 399, 403 (6th Cir. 1984).

127. See *Summers, Loss Deductions: The Effect of Failure to File an Insurance Claim After Hills*, 61 TAXES 275, 276 (1983). Another author has described the *Kentucky Utilities* holding as follows:

[A]n insured loss is equivalent to one "covered" by insurance The implication of the *Kentucky Utilities* holding is quite clear. . . . Because the loss was not an "uninsured loss," [*Kentucky Utilities Co. v. Glenn*, 397 F.2d at 633] by affirming the district court's view that it was not a loss "not compensated for by insurance or otherwise" [*Kentucky Utilities*, 250 F. Supp. at 270] the Sixth Circuit equated "insured" with "compensated." Therefore, if "insured" is equivalent to "covered," then *Kentucky Utilities* stands for the proposition that "covered" is equivalent to "compensated."

Case Comment, *Hills v. Commissioner: The Meaning of Compensated for by Insurance in Internal Revenue Code Section 165(a)*, 43 OHIO ST. L.J. 513, 519 (1982).

128. See, e.g., *Summers, supra* note 127, at 276.

Hills v. Commissioner: Kentucky Utilities *Abandoned*

In *Hills v. Commissioner*,¹²⁹ the taxpayers' summer home had been burglarized.¹³⁰ The stolen property was insured against theft, but the taxpayers, fearing policy cancellation, did not claim reimbursement from their insurer. They elected instead to deduct the loss under section 165(c)(3).¹³¹ Noting that the policy entitled the taxpayers to reimbursement for vandalism and theft, the Commissioner denied the deduction.¹³²

In its review of prior cases, the Tax Court acknowledged that this case was the first to "squarely present" the question of whether "compensated" was equivalent to "covered" under section 165(a).¹³³ Relying predominantly on the legislative history of the section, the accompanying regulations, and the "everyday" use of the words compensated and covered, the Tax Court determined that the two words were not synonymous, and allowed the deduc-

129. 76 T.C. 484 (1981).

130. The statute applicable in *Hills* was the Internal Revenue Code of 1954, as amended and in effect for 1976. *Id.* at 485 n.1.

131. *Id.* at 485. The taxpayers feared policy cancellation because they had claimed reimbursement for losses on three previous occasions during a six-year period. All of the prior thefts had occurred at the summer home. *Id.*

132. *Id.* at 486.

133. *Id.* Prior to *Hills*, the tax court had flirted with the "compensated means covered" assertion. In 1971, the Tax Court decided *Axelrod v. Commissioner*, 56 T.C. 248 (1971). Although one of the questions presented for consideration was whether "compensated" meant "covered," the majority disposed of the case on other grounds. In a concurring opinion, Judge Quealy, relying heavily on *Kentucky Utilities*, all but said "compensated" and "covered" were synonymous. *Id.* at 260-63 (Quealy, J., concurring). A later Tax Court memorandum opinion, *Morgan v. Commissioner*, 47 T.C.M. (P-H) 523 (1978), stated explicitly "'compensated for by insurance' means covered by insurance." In the district courts, the precedents received similar treatment. In *Bartlett v. United States*, 397 F. Supp. 216 (D. Md. 1975), the court accepted the government's argument that "compensated" was equivalent to "covered," relying heavily on *Kentucky Utilities* and on Judge Quealy's concurrence in *Axelrod*. Finally, in *Waxler Towing Co. v. United States*, 510 F. Supp. 297 (W.D. Tenn. 1980) the court denied the section 165(a) loss deduction claimed, stating: "Although the Code and its interpretive regulations do not specifically state that 'not compensated for' means 'not covered by' insurance, the case law makes a convincing basis for such a meaning." As this chronology shows, although no cases had faced the issue squarely, by the time *Morgan* and *Waxler Towing* were decided, the proposition that "compensated" and "covered" were synonyms for the purposes of section 165(a) had gained considerable support in dictum. Then, the Tax Court decided *Hills v. Commissioner*.

tion.¹³⁴ The court rejected the Commissioner's assertion that the taxpayers only sustained a loss because of their voluntary decision not to claim insurance reimbursement. In the court's view, the Commissioner's logic would unjustifiably advantage taxpayers who decided not to insure.¹³⁵ Finally, in commenting on prior prece-

134. 76 T.C. at 491-92. The original language of the Revenue Act of 1894 permitted deductions for "losses actually sustained during the year . . . and not covered by insurance or otherwise, and compensated for." *Id.* at 487. The court asserted that this language had been altered to eliminate redundancy: all losses compensated by insurance were also necessarily covered by insurance. The phrase "not compensated for by" conveyed the concepts of absence of coverage, or nonreceipt of compensation from coverage (the two conditions under which the deduction was available), and was more efficient. *Id.*

Further, the court argued that the Treasury Regulations accompanying § 165(a) did not support the Commissioner's expanded interpretation of the "not compensated for by" language. Treasury Regulation § 1.165-1(a) stated that a deduction was available for losses "sustained during the taxable year *and not made good* by insurance or some other form of compensation." *Id.* Similarly, Treasury Regulation § 1.165-(c)(4), in defining the allowable loss deduction, provided that "proper adjustment shall be made for any . . . insurance or other compensation *received*." *Id.* at 487-88. These regulations helped to establish that the actual receipt of reimbursement is the circumstance inconsistent with the allowance of a loss deduction under section 165. *Id.* at 488.

Lastly, the court asserted, the "normal, everyday meaning" of compensated was "to pay" or "to make up for." *Id.* at 486-87. Thus, to equate "compensated" with "covered" runs counter to the prevailing meaning of the word "compensated." *Id.* at 487.

135. *Id.* The dispute between the Commissioner and the Tax Court warrants further discussion. In *Miller v. Commissioner*, 733 F.2d 399 (6th Cir. 1984), the Sixth Circuit, following the Tax Court's lead in the decision below, allowed an insured taxpayer a § 165 casualty loss deduction on facts similar to *Hills*. Judge Contie in *Miller*, however, disagreed with the Tax Court's assertion in *Hills* that an uninsured taxpayer's loss also results from a voluntary decision—the decision not to insure. The judge stated: "One problem with this argument [that the loss of a taxpayer who decides not to insure is voluntary] is that § 165 refers only to the situation as it exists at the time of, and after, the casualty. Events and decisions preceding the casualty are simply irrelevant." *Miller*, 733 F.2d at 406 (Contie, J., dissenting). However, this assertion proves too much. If decisions preceding the casualty are irrelevant, then the taxpayers' decisions in *Miller* and *Hills* to insure, which preceded the casualty, are irrelevant and cannot operate to bar the deduction. A counterargument is that the procurement of insurance prior to the loss may be considered because its effects continue at the time of the casualty (i.e., insurance compensation is available). However, this argument again proves too much. The effects of the decision not to insure also continue at the time of the casualty—because insurance compensation is unavailable. The insured taxpayer's decision not to claim reimbursement is, then, no more culpable than the uninsured taxpayer's decision not to purchase coverage.

As the Eleventh Circuit stated when it considered *Hills* on appeal: Congress did, indeed, intend § 165 "to serve as optional insurance coverage for those who suffer property damage but who choose to collect from Uncle Sam rather than their insurance company." *Hills v. Commissioner*, 691 F.2d 997, 1005 (11th Cir. 1982) (quoting *Bartlett v. United States*, 397 F. Supp. 216 (D. Md. 1975) in reaching an opposite conclusion). This observation creates no

dent, the Tax Court openly rejected *Kentucky Utilities*.¹³⁶

On appeal, the Eleventh Circuit affirmed the Tax Court's allowance of the deduction.¹³⁷ At this stage, the Commissioner opposed the deduction on two grounds.¹³⁸ First, he asserted that the taxpayers had not sustained a "loss" within section 165.¹³⁹ Second, he contended that the economic reality of the failure to pursue insurance compensation had the same effect as if the taxpayers had received reimbursement and had immediately given it back to the insurance company as a premium payment on their coverage. Characterized as a premium payment, it would be a nondeductible personal expense.¹⁴⁰

In rejecting the Commissioner's first contention, the court adopted a two-part view of section 165 loss situations.¹⁴¹ The statute, said the court, asked two distinct questions: "(1) Was there a loss?; and (2) Was [the loss] compensated for by insurance or otherwise?"¹⁴² The Commissioner's position, which implied that the taxpayer sustained no loss until all avenues of compensation were exhausted, impermissibly lumped the two inquiries together. The court insisted that a loss had clearly occurred once the thief had taken the property.¹⁴³ The analysis of the availability of the deduction then shifts, as the statutory language demands, to whether compensation was received.¹⁴⁴ To impose a duty to pursue compen-

theoretical inconsistency in the Code because § 165 *already* serves as alternative insurance coverage for those taxpayers who do not maintain insurance policies.

136. 76 T.C. at 489-90.

137. *Hills v. Commissioner*, 691 F.2d 997 (11th Cir. 1982).

138. *Id.* at 999. The Commissioner also revived his argument that the taxpayer's loss was due to a voluntary election to forego insurance reimbursement, not from the theft. *Id.* The court saw this argument as another way to assert that "compensated" meant "covered" in the context of § 165(a), a contention that it joined the Tax Court in condemning. *Id.* at 1004. See *infra* notes 149-60 and accompanying text, and *supra* note 135.

139. *Hills*, 691 F.2d at 1000-04.

140. *Id.* at 1004-06. See *infra* note 146.

141. *Id.* at 1002-04.

142. *Id.* at 1000.

143. *Id.* at 1001.

144. *Id.* The court referred to the inquiry regarding the second, or compensation question, as the "compensation phase" of the loss transaction. *Id.* The wording of § 165(a) and the accompanying regulations made clear that the importance of the "compensation phase" was whether reimbursement was *received*; the fact that compensation could have been received had no impact on the deductibility inquiry. *Id.* at 1000-01 & n.11. See O'Neil & Thompson, *The Compensated versus Covered Casualty Loss Issue—Has it Finally been*

sation, the court held, "would be to run afoul of the clear statutory language" of section 165.¹⁴⁵

The court conceded the economic validity of the Commissioner's second argument: the money paid by the taxpayer to replace the stolen items was really a nondeductible insurance premium.¹⁴⁶ However, the court noted that an equally correct assertion would be made if the Commissioner's argument was turned inside out: all insurance premiums are really prepaid casualty losses.¹⁴⁷ Yet the Tax Code, because it contains specific statutory provisions to the contrary,¹⁴⁸ permits *neither* argument on policy grounds. The Commissioner's assertion, argued the court, was of no force when juxtaposed against an explicit, conflicting congressional policy to allow the deduction of payments in the form of out-of-pocket expenses due to casualty losses, but not in the form of insurance premiums to guard against those losses. Subsequent to *Hills*, therefore, both the Tax Court and the Eleventh Circuit were willing to allow casualty loss deductions to individual insured taxpayers even if they made no claim for insurance reimbursement.

Miller v. Commissioner: *The Death Knell for Kentucky Utilities*

Although *Hills* weakened the reasoning advanced in *Kentucky Utilities*, *Miller v. Commissioner*¹⁴⁹ finally laid it to rest. In *Miller*, the taxpayer's insured boat was damaged in an accident.¹⁵⁰ The taxpayer, who had made four claims in a little over four years on his three insurance policies covering the boat, his car, and apartment, elected not to file a claim and deducted the damage amount

Resolved?, 16 TAX ADVISER 164, 166 (1985) ("A casualty, however, is a loss; whether it remains a loss is a question of compensation. If a taxpayer has a casualty . . . at the moment [the casualty occurs] there is a loss.").

145. *Id.* at 1001.

146. *Id.* at 1004. For individual taxpayers, insurance premiums are nondeductible personal expenditures. I.R.C. § 262 (1986).

147. *Hills*, 691 F.2d at 1005.

148. Regarding the nondeductibility of insurance premium payments made by an individual taxpayer not in connection with his business, see *supra* note 146. Regarding the deductibility of insurance premium payments made in connection with a taxpayer's business operations, see *supra* note 98.

149. *Miller v. Commissioner*, 50 T.C.M. (P-H) 1565 (1981), *aff'd*, 733 F.2d 399 (6th Cir. 1984). In *Miller*, the applicable law was the Internal Revenue Code of 1954, as amended and in effect for 1976. *Id.* at 1566 n.2.

150. *Id.* at 1566.

on his tax return.¹⁵¹ The Commissioner denied the deduction because the taxpayer failed to claim available reimbursement from his insurance company.¹⁵²

The Commissioner again argued that the “compensated for” language in section 165(a) meant “covered by.”¹⁵³ Relying on *Hills*, the Tax Court found for the taxpayer.¹⁵⁴ The Commissioner appealed, and the Sixth Circuit affirmed the Tax Court’s decision.¹⁵⁵ In so doing, the court explicitly overruled its decision in *Kentucky Utilities Co. v. Glenn*.¹⁵⁶

The court recognized that *Kentucky Utilities* could be interpreted as asserting either 1) that the taxpayer must exhaust all possibilities of insurance reimbursement before claiming a section 165(a) “sustained loss,” or 2) that the words “not compensated for by” insurance were meant to be read as “not covered by” insurance.¹⁵⁷ The court rejected the first interpretation because such a reading would render the “not compensated for by” phrase of the section unnecessary.¹⁵⁸ The court also rejected the second contention that “compensated for by means covered by”¹⁵⁹ because the plain language of the section, its legislative history, and public policy all indicated that compensated and covered are not synonyms.¹⁶⁰

151. *Id.*

152. *Id.*

153. *Id.*

154. *Id.* at 1567.

155. *Miller v. Commissioner*, 733 F.2d 399 (6th Cir. 1984).

156. *Id.* at 404 (“Our decision in *Kentucky Utilities* is overruled to the extent it is interpreted as denying any taxpayer [such as *Miller*, a § 165(a), (c)(3)] deduction.”)

157. *Id.* at 402.

158. *Id.* See *supra* note 134 and accompanying text.

159. 733 F.2d at 402. The court stated:

Section 165(a) reflects the intent of Congress that the question of whether a loss is sustained should be resolved independently of any insurance consequences involved. This conclusion is bolstered by the rule of statutory construction that requires courts to construe the language of a statute so as to avoid making any word meaningless or superfluous.

Id.

160. *Id.* at 404. The court cited the same legislative history on which *Hills* had relied and asserted that the overriding policy behind § 165’s “compensated” language was to deny double compensation to those taxpayers who had recovered from their insurers. *Id.* at 403-04. The dissent launched a three-fold attack on the allowance of the deduction: 1) the taxpayer’s voluntary election to forego insurance compensation severed the causal connection

The Tax Reform Act of 1986 and Section 165

Statutory changes to section 165 of the Code in the Tax Reform Act of 1986¹⁶¹ ostensibly foreclosed the judicial interpretation given the section by *Miller* and *Hills*. Subsection 165(h)(4)(E) was added, which provides that “[a]ny loss of an individual described in subsection (c)(3) [losses of property not connected with a trade or business] to the extent covered by insurance shall be taken into account under this section only if the individual files a timely insurance claim with respect to such loss.”¹⁶² Thus, for taxpayers in situations to which this new provision applies, “compensated for by” insurance *does* mean “covered by” insurance for purposes of section 165(a).

In discussing the amendment, the House Committee Report noted that *Miller* and *Hills* allowed individual taxpayers to deduct losses even when insurance compensation was available if the taxpayer elected not to claim the reimbursement.¹⁶³ The Committee,

between the loss and the casualty; 2) no loss was sustained because the transaction was not “closed” (because possibilities of recovery from the insurer still existed); and 3) the majority’s holding resulted in preferred tax treatment for businesses. *Id.* at 405-09. The dissent’s admission that “compensated” does not mean “covered” contradicts the first two contentions; they are simply variants of that assertion. The final argument is undermined by other sections of the Code that explicitly provide preferential tax treatment for businesses (i.e., § 162, which allows businesses to deduct insurance premiums, although under § 262, individual taxpayers cannot). *See also* *United States v. Geneser*, 405 U.S. 93, 103 (1972) (bad debt characterization case). In *Geneser*, the Court stated:

The Code itself carefully distinguishes between business and nonbusiness items. It does so, for example, in § 165 with respect to losses. . . . It gives particular tax benefits to business losses . . . and business expenses, and gives lesser benefits, or none at all, to nonbusiness losses . . . and nonbusiness expenses. It does this despite the fact that the latter are just as adverse in financial consequence to the taxpayer as are the former. But this distinction has been a policy of the income tax structure ever since the Revenue Act of 1916 . . . provided differently for trade or business losses than it did for losses sustained [in nonbusiness transactions].

Further, to support the assertion that businesses are unduly preferred under the majority’s decision, the dissent relied upon the “double-dip” objection suggested in the *Hills* dissent. 733 F.2d at 409. This objection however, is without merit; businesses are not doubly benefitted by the majority’s interpretation of § 165. *See supra* notes 74-88 and accompanying text.

161. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1004(a), 100 Stat. 2085 (codified at I.R.C. § 165(h)(4)(E) (Supp. 1986)).

162. I.R.C. § 165(h)(4)(E).

163. H.R. COMM. REP. NO. 426, 99th Cong., 1st Sess. 658 (1986).

however, focused exclusively on “personal casualty losses” that were “not connected with a trade or business or a transaction entered into for profit.”¹⁶⁴ Similarly, when explaining the reasons for the proposed change in the statute, the Committee recommended that “[t]he deduction for *personal casualty losses* should be allowed only when . . . [the taxpayer first] mak[es] a claim against the insurance company.”¹⁶⁵ Finally, the Committee’s explanation of the operation of the new provision stated: “Under the [new subsection] a taxpayer is not permitted to deduct a casualty loss *for damages to property not used in a trade or business*” unless an insurance claim is first filed.¹⁶⁶ Because of the impact and focus of these changes, deductibility under section 165 and, at least partially, the *Hills/Miller* rationale, is still a viable alternative for the taxpayer in *Campbell*-type situations.

The statutory changes made by the 1986 Act obviously were directed exclusively at personal casualty losses, or losses claimed under section 165(c)(3).¹⁶⁷ However, because the loss sustained related directly to his or her business, the taxpayer in a *Campbell*-type situation would assert deductibility for his or her payment under section 165(c)(1), which was left completely untouched by the statutory changes to section 165(c)(3) that resulted from the addition of 165(h)(4)(E). Moreover, the court in *Miller* implied that its holding allowing the deduction was applicable to business taxpayers.¹⁶⁸ Congress purported to overrule *Miller* with the 1986 statutory changes. Yet, these changes affected only the availability of nonbusiness related casualty loss deductions under section 165(c)(3). The logic of *Miller* as it relates to taxpayers such as *Campbell*, then, is still sound. Further, *Miller* focused its analysis on section 165(a) and its “compensated for by” language, not sec-

164. *Id.*

165. *Id.* (emphasis added).

166. *Id.* (emphasis added).

167. The court in *Miller* recognized that the changes made to § 165 by the 1982 amendments of the 1954 code (i.e., addition of 10% floor in § 165(h)) were “designed to limit § 165 deductions for *non* business taxpayers.” *Miller*, 733 F.2d 399, 409 n.6 (6th Cir. 1984) (emphasis added). Because the changes made by the 1986 Act (addition of subparagraph (4)(e) to subsection (h)) were placed in a subsection dealing exclusively with nonbusiness casualty losses, then, they, too, operate only to limit deductions for personal casualty losses. See I.R.C. § 165(h)(1), (2), (3).

168. *Miller*, 733 F.2d at 401 n.6.

tion 165(c)(3). Because no statutory changes were made to section 165(a), the *Miller* interpretation of that subsection is still highly relevant to the deductibility inquiry.¹⁶⁹ Finally, Congress' failure to change section 165(a) implicitly ratifies the *Hills/Miller* analysis as it applies to business taxpayers. Section 165, then, remains a legitimate statutory alternative under which business taxpayers may claim deductions for losses covered by insurance.¹⁷⁰

AN ALTERNATIVE TO THE DENIAL OF DEDUCTIBILITY FOR *Campbell* PAYMENTS

Structure of the Alternative

Regardless of whether they are treated as business expenses or business losses, a basic dilemma emerges when insured taxpayers make *Campbell*-type payments. Although the *nature* of the payment and its direct connection to the business of the taxpayer suggest current deductibility, the *timing* of the payment precludes this treatment. A compromise should be fashioned.¹⁷¹ Fortunately,

169. See Burke & Friel, *Recent Developments in the Taxation of Individuals - Miller v. Commissioner: The Sixth Circuit Heads for the Hills*, 9 THE REV. OF TAX'N OF INDIVIDUALS 185-86 (1985). The authors assert:

Miller and *Hills* may have considerable relevance, for the section they primarily interpreted was Section 165(a), not Section 165(c)(3). These decisions are thus of interest to taxpayers engaged in trade or business or in a profit-seeking transaction, who incur losses covered by insurance and who elect for whatever reason not to seek insurance reimbursement. . . . [T]hese business or profit-seeking taxpayers have an assured deduction without having to trust to the vagaries of [, *inter alia*, § 162].

Id. at 186.

170. Why the taxpayer in *Campbell* did not assert deductibility for his payment under § 165 remains a question. The taxpayer apparently argued that because no statutory change parallel to § 165(h)(4)(E) was imposed on deductions claimed under § 162, he was entitled to the § 162 deduction. *Campbell v. Commissioner*, 56 T.C.M. (P-H) 2578, 2580-81 & n.7 (1987). *Campbell*, however, did not explicitly assert a deduction under § 165(a) and (c)(1).

171. Compromises other than those §§ 174 and 195 employ are possible. One simple solution would be to allow the taxpayer in *Campbell*-type situations to capitalize the payment in an asset account entitled "prepaid insurance premiums," or the like, but not to allow the deduction of this amount. Under this approach, the taxpayer's benefit would be deferred until disposition or liquidation of the business. At that point, the asset account would increase the taxpayer's basis in the entity, thus reducing the gain from the transaction.

However, a significant drawback to this and similar approaches is the distortion of income created by the failure to allocate any of the costs of the payment to the years in which they are used. See Lee, *supra* note 93, at 14 (capitalization of the expenditure and its addition to

the Code itself has provided two model alternatives in section 174,¹⁷² dealing with research and experimental expenditures, and section 195,¹⁷³ treating start-up business organizational expenses.

The solution sections 174 and 195 suggest is to use the sixty-month convention those sections employ and modify it on a yearly basis to provide slightly accelerated deductions in the earlier years of the five-year amortization period. The amount of the deductible on the policy would remain deductible in the year payment was made, as in *Campbell*.¹⁷⁴ This amount, plus twenty-five percent of the remainder of the amount of the payment, would be allowed as a deduction in the first twelve months. Over the next four successive twelve-month periods, twenty-five percent, twenty percent, twenty percent, and ten percent of the amount of the original loss, less the policy deductible recovered in year one, would be deductible. Application of the proposed scheme would be mandatory.¹⁷⁵ The deductions would be unavailable if the taxpayer did not elect the special amortization treatment outlined above. The proposed deduction regime would also include a provision analogous to section 195(b)(2), which allows deduction of the balance of the deferred expense created by the amortization rules if the business is

the basis of a long-lived asset, such as the business itself, produces distortion of income if no amortization is allowed). The compromise solution modeled on §§ 174 and 195 was chosen because it provides a treatment of the payments in issue more consistent with the overarching tax policy of preventing distortion of income.

172. Section 174 is an optional provision that allows the taxpayer to treat nonexpensed research and experimental costs as deferred expenses. "In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer. . . ." I.R.C. § 174(b)(1)(C) (1986).

173. Section 195 and § 174 treat start-up expenses alike, with one exception. As a general rule, start-up expenses are not deductible. However, the taxpayer may elect to amortize these costs (including costs associated with such activities as investigating the creation or acquisition of an active trade or business) as deferred expenses:

(b) Election to Amortize

(1) In general.—Start-up expenses may, at the election of the taxpayer, be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction prorated equally over such period of not less than 60 months as may be selected by the taxpayer. . . .

I.R.C. § 195(b)(1) (1986). Thus, although § 195 is an optional provision, because the expenses at issue are otherwise nondeductible, a taxpayer must elect this section to secure a deduction.

174. 56 T.C.M. (P-H) 2578, 2579 (1987).

175. See *supra* note 173.

disposed of completely by the taxpayer during the sixty-month period.¹⁷⁶

Effects of the Alternative

This proposal strikes a balance between the positions the taxpayer and the Commissioner asserted in *Campbell*. The plan appropriately effects an approximately equal division of the tax burden between the Treasury and the taxpayer, although the taxpayer is favored slightly. Additionally, the revenue effects of the proposal are neutral. The plan also has the advantage of producing roughly the same deduction flow that would occur if the taxpayer claimed the available insurance compensation and the company subsequently raised his rates. Further, the policy underlying sections 174 and 195 is consistent with the proposal. One author has observed that the *raison d'être* for the approach developed in these Code sections was to remove the primary bar to deductibility caused by the inability to determine a reasonable useful life for the assets created by certain expenditures.¹⁷⁷ The alternative suggested solves the useful life problem with a reasonable assumption.¹⁷⁸ Finally, the broad theory of the alternative approach has received overall support in the tax literature.¹⁷⁹

176. Section 195(b)(2) (1986) provides:

(2) Dispositions before close of amortization period. In any case in which a trade or business is completely disposed of by the taxpayer before the end of the [60 month] period . . . any deferred expenses attributable to such trade or business which were not allowed as a deduction by reason of [§ 195(a)] may be deducted. . . .

Id.

177. B. BITTKER, *supra* note 92, ¶ 12.13.

178. See generally Mundstock, *Taxation of Business Intangible Capital*, 135 U. PA. L. REV. 1179, 1187-89 (1987) (citing several studies indicating that intangibles such as advertising, and research and development expenditures "depreciate" at the rate of approximately 20% per year).

179. See Schenk, *supra* note 92, at 529 ("to properly match income and the expenses incurred to produce the income, depreciation should be allowed on intangible assets"). See also Lee, *supra* note 93, at 32-38. Lee asserts that the proper treatment of costs with useful lives that, though indeterminable, are known to be substantially in excess of one year is to treat the expenditure itself as the asset created, and amortize it over some approximation of its useful life. The treatment of *Campbell*-type payments proposed by this Note does just that, and solves the useful life conundrum statutorily by employing a 60-month assumption.

CONCLUSION

The payment the taxpayer made in *Campbell* was clearly connected with his actuary business. Consequently, the denial of the deduction as a business expense under section 162 was erroneous. The payment is indistinguishable from other ordinary and necessary expenses a business enterprise incurs. The taxpayer made a business judgment that the long-term interests of the enterprise would be served best by not claiming insurance reimbursement for the mistake. The payment was thus necessary within that term's meaning in section 162. The existence of insurance coverage cannot change this result. The denial of the deduction in *Campbell* represents a far-reaching and fundamentally inconsistent interpretation and application of section 162.

Alternatively, the money Campbell paid to reimburse the fund also qualifies for deductibility as a loss under section 165. Again, the existence of insurance coverage for the contingency cannot change this result. Based on the detriment suffered if insurance compensation is not actually received, the deduction should be available. This interpretation of section 165 allows the taxpayer himself to determine whether he can claim a casualty loss under this section whenever a loss has occurred. However, the preservation of this flexibility is inherent in the statutory structure of section 165. Despite statutory changes, section 165 supports the deduction asserted by the taxpayer in *Campbell*.

Yet, although consistent with sections 162 and 165, the allowance of full, current deductibility in *Campbell* runs afoul of the Code's core concept of preventing distortion of income by matching income, and the expenses incurred to generate that income, for a given time period. *Campbell*-type payments benefit future periods and the duration of those benefits is uncertain, making the "useful life" of the intangible asset created by the payment difficult to determine.

To resolve the tension between these competing tax policies, and to maintain consistency in the application of section 162, a legislatively-fashioned compromise that would permit the deduction to be taken over a five-year period is appropriate. The proposed compromise not only provides relief for the taxpayer from the economic detriment suffered because of the expenditure but also comports with the economic realities of the situation. Although more

complex than the all-or-nothing approach to deductibility that the majority of courts have followed, this integrated alternative is preferable to the judiciary's irreconcilable decisions and inconsistent interpretations of individual Code provisions.

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