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Deductibility of Treble Damages Paid for Breach of National Health Service Corps Scholarship Contracts: The Misuse of I.R.C. 265(a)(1) in *Stroud v. United States* and of the Claim Test in *Keane v. Commissioner*

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DEDUCTIBILITY OF TREBLE DAMAGES PAID FOR BREACH OF NATIONAL HEALTH SERVICE CORPS SCHOLARSHIP CONTRACTS: THE MISUSE OF I.R.C. § 265(a)(1) IN *STROUD* v. *UNITED STATES* AND OF THE ORIGIN OF THE CLAIM TEST IN *KEANE* v. *COMMISSIONER*

*Richard C.E. Beck**

I. INTRODUCTION.....	1
II. <i>STROUD</i> AND I.R.C. § 265(a)(1).....	6
A. <i>Stroud</i> aka GCM 39,336	8
B. History of I.R.C. § 265(a)(1)	13
1. Revenue Ruling 83-3 and Its Erroneous Reimbursement Theory	15
2. The Tax Benefit Rule and Revenue Ruling 83-3	21
C. The Error: I.R.C. § 265(a)(1) Does Not Apply at All.....	22
D. Origin of the Claim Test: What if There are Two Origins?.....	24
E. Capitalization Under the Indopco Regulations	28
III. <i>KEANE</i> AND THE EMPLOYEE INTEREST DEDUCTION	29
A. Nature of the Settlement	31
B. Employee Business Interest	33
IV. CONCLUSION	35

I. INTRODUCTION

It must be a rare occurrence that a tax deduction for one and the same expense is disallowed by two different courts in the same year on two entirely different and unrelated theories, and rarer still that both theories are wrong. But just that happened

* Professor of Law, New York Law School. My thanks to Professor James Maule for his helpful comments and to my research assistant, Karen Cross. Thanks also to New York Law School for its generous support.

in the two 1995 decisions *Stroud v. United States*¹ in the district court for the District of South Carolina and *Hawronsky v. Commissioner*² in the tax court. Three years later, yet a third unrelated and erroneous theory was invoked to deny the same deduction in *Keane v. Commissioner*,³ a 1998 Tax Court Memorandum Decision, which fails to mention either *Stroud* or *Hawronsky*. None of these decisions has been commented upon in the tax literature, but both *Stroud* and *Hawronsky* are routinely cited in reference works, with no hint of any suspicion that they are wrongly decided.⁴

The deduction in question was for statutorily prescribed treble damages—and trebled deemed interest—paid by physicians whose medical education had been paid for by the National Health Service Corps (NHSC) in exchange for a contractual obligation to practice primary-care medicine at a site in an underserved area designated by the NHSC. The service obligation is for the greater of two years or one year for each school year for which a scholarship was granted.⁵ Physicians who default on their service obligation are required by the statutorily prescribed terms of the contract to pay damages in the amount of triple the amount paid by the government plus triple an amount of deemed interest calculated as if the scholarship had been a loan at the highest prevailing rate.⁶

Congress established the NHSC in 1970 and its Scholarship Program in 1976 for the purpose of alleviating the geographic and specialty maldistribution of physicians and other health practitioners in the United States.⁷ In order to assure the provision of primary health services, scholarships are granted to

1. 906 F. Supp. 990 (D.S.C. 1995).

2. 105 T.C. 94 (1995).

3. 75 T.C.M. (CCH) 2046 (1998).

4. See, e.g., BORIS I. BITTKER, MARTIN J. MCMAHON, AND LAWRENCE A. ZELENAK, *FEDERAL INCOME TAXATION OF INDIVIDUALS* (3d ed. 2002).

5. 42 U.S.C. § 254l (2000 & Supp. 2003).

6. 42 U.S.C. § 254o(b)(1)(a) (2000 & Supp. 2003).

7. See generally Lora C. Siegler, Annotation, *Validity and Construction of Provisions of National Health Service Corps Scholarship Program (42 USCS §§ 254l et seq.) with Respect to Proceedings Under 42 U.S.C.S. § 254o(b)(1)(A) for Recovery of Treble Damages from Scholarship Recipients Failing to Fulfill Obligations*, 108 A.L.R. FED. 313, 319-23 (1992).

physicians, dentists, nurses, physician assistants, and other health professionals.⁸ The scholarships provide both tuition and fees for health care training, and also a monthly stipend for living expenses.⁹ During the years in question, the full amount of such payments was exempt from tax. The NHSC program is administered by the Public Health Service (PHS), an agency in the Department of Health and Human Services (HHS).

A scholarship recipient must sign a written contract obliging himself to serve a post-training period of obligated service in an area in which there is a shortage of health professionals.¹⁰ This service is always remunerated, and in the case of physicians, it may be satisfied by working directly for a governmental agency, or more often by working in a private clinic, or even by independent private practice, provided the location is approved by the NHSC.¹¹ The terms and conditions of the contract between the participant individual and the NHSC are statutorily prescribed and always include a fixed formula for the treble damages plus trebled interest for a participant's breach.¹²

An earlier version of the statute in effect from 1972 until 1977 required only single damages, that is, a return of the government's money plus deemed interest, as many similar State programs still do.¹³ The federal single-damages version was repealed in 1976 and the current triple-damage provision went into effect in 1977. The purpose of the new provision was evidently to give the NHSC a stiff penalty to help enforce the

8. See 42 U.S.C. § 254l(a).

9. See generally Siegler, *supra* note 7, at 320.

10. 42 U.S.C. § 254l(b).

11. Siegler, *supra* note 7, at 320 ("The requirement is for service in the full-time practice of the recipient's profession, as either a member of the NHSC or a private practitioner, in an [Health Manpower Shortage Area] designated by the Secretary of the Department of HHS.").

12. 42 U.S.C. § 254o(b). The applicable formula in the cases at issue was a sum equal to three times the amounts actually paid by the government, plus three times "the interest on such amounts which would be payable if at the time the amounts were paid they were loans bearing interest at the maximum legal prevailing rate, as determined by the Treasurer of the United States[.]" multiplied by a fraction whose numerator is the months of unserved obligation and whose denominator is total months of service obligation. *Id.*

13. Siegler, *supra* note 7, at 317-18.

scholarship participants' service obligation, and the NHSC has often used the threat of this penalty to coerce adherence to its detailed regulations and procedures.

According to 42 U.S.C. § 254o(b)(1)(A), the treble damages are due if the participant fails to begin or to complete his service obligation "for any reason." The obligation of service or treble damages may be waived pursuant to regulations delegated to the HHS only if "compliance by the individual is impossible or would involve extreme hardship to the individual and if enforcement of such obligation with respect to any individual would be unconscionable."¹⁴

The federal courts have decided more than three dozen reported cases over the question whether the treble-damages provision of the statutory contract is enforceable in a multitude of factual circumstances and under a variety of legal theories, but nearly all of the physicians who have resisted payment have lost.¹⁵ The reported cases nearly always arise from the system by which the NHSC assigns participants to locations for their tours of service.¹⁶ The assignment process is left to the discretion of the NHSC¹⁷ which determines, after consultation with state and local authorities, which locations qualify for status as Health Professional Shortage Areas (HPSA).¹⁸ Then, the NHSC annually prepares a list of available locations for which a participant may apply, the HPSA Opportunity List (HPOL). Only sites on the HPOL qualify for fulfillment of the service obligation. The earlier a participant applies, the better the choices. A participant who has not found a location by a certain time will be assigned by the NHSC to any location it chooses. If

14. 42 U.S.C. § 254o(d)(2).

15. See generally Siegler, *supra* note 7, at 321-22.

16. There is considerable friction between participants and the NHSC. A 1990 study reported that 13% of participants had failed to complete their service obligations and paid damages instead. Another 1992 study reported considerable unhappiness among participants, many of whom felt they were treated like "indentured servants." See generally Kristine Marietti Byrnes, Note, *Is there a Primary Care Doctor in the House? The Legislation Needed to Address a National Shortage*, 25 RUTGERS L.J. 799, 813 nn.68-69 (1994).

17. 42 U.S.C. § 254l(f)(1)(B)(iv).

18. Formerly "HMSA" for "Health Manpower Shortage Area."

the NHSC declares a participant to be in default (because, for example, he failed to obtain permission for deferral from the NHSC in order to complete a residency, or because he was unable to find a qualifying site),¹⁹ the NHSC will always forbear to enforce the damages obligation if the participant will acknowledge his default and liability for treble damages and agree again to perform his service obligation by signing a “forbearance agreement.”²⁰ But those in default go to the bottom of the applicant list and have no choice as to where they will be assigned. So they often default again, and eventually are forced to pay.

The tax question is whether the treble damages payment is deductible. In *Stroud*, the district court held against the taxpayer on the theory that, since the tuition and living stipend had been tax-exempt, I.R.C. § 265(a)(1)²¹ barred any deduction because the damages were expenses “allocable to” tax-exempt income.²² A deduction for current interest on the taxpayer’s obligation to pay the treble damages was also denied.²³

In *Keane*, the taxpayer’s deduction of interest payments on a promissory note for a reduced portion of the treble damages was denied on the theory that the origin of the government’s compromised claim was a scholarship, and the interest was therefore student loan interest, which is personal and nondeductible under I.R.C. § 262 and I.R.C. § 163(h).²⁴

19. Disputes ending in default often arise because the participant’s professional or personal situation may change during the five to eight years of his medical education, making the service obligation unexpectedly burdensome. For example, the participant may decide to specialize in a field which is unacceptable to the NHSC, or his family situation may make it inconvenient or impossible for him to serve at the site to which the NHSC assigns him. Very often the participant in default does in fact serve the poor, but disagrees with the HHSC as to whether the site of his practice does—or should—qualify as an approved site.

20. See generally Siegler, *supra* note 7, at 350-359; *United States v. Redovan*, 656 F. Supp. 121 (E.D. Pa. 1986); *United States v. Beane*, 1990 U.S. Dist. LEXIS 5776 (E.D. Pa. May 7, 1990).

21. I.R.C. § 265(a)(1) (2000).

22. 906 F. Supp. at 993-94.

23. *Id.* at 996.

24. 75 T.C.M. (CCH) 2046.

In *Hawronsky*, the deduction was denied under the purported authority of I.R.C. § 162(f), on the theory that the damages were in effect a “fine . . . or similar penal[t]y paid to a Government for the violation of any law.”²⁵ The errors in *Hawronsky* will be treated in a companion article.

The thesis of this article is that both *Stroud* and *Keane* were wrongly decided. The treble damages constituted a deductible business expense of buying out the NHSC service obligation. They were not incurred in order to obtain a tax-free scholarship which had been received many years earlier, but rather for the purpose of earning taxable income currently through medical practice elsewhere. I.R.C. § 265(a)(1) simply does not apply to these business damages. Current interest on the taxpayer’s obligation to pay the treble damages in the future are a business expense for the same reason, and should be deductible unless barred as unreimbursed employee business interest, an argument which was not raised or discussed in either decision.

II. *STROUD* AND I.R.C. § 265(a)(1)

Dr. Nancy Stroud attended Tufts Medical School in Massachusetts from 1978 to 1982 and her medical education was paid for by an NHSC scholarship. Although Dr. Stroud was born, raised, and schooled in Massachusetts and would have preferred to remain there, she decided to perform her residency at the Medical University of South Carolina because she was advised that no positions for obstetricians were likely to become available in Massachusetts for her to perform her service obligation under the NHSC contract, but that such positions would be available in South Carolina. During the final year of her 1982-1986 residency, Dr. Stroud was in constant contact with the PHS to discuss where she would perform her obligated service. It was at this time that she discovered that there were no openings for her specialty on the HPOL list for the entire state of South Carolina—despite the lack of obstetricians in five counties and a very high infant mortality rate.²⁶

25. *Hawronsky*, 105 T.C. at 97.

26. Appellant’s Brief at 5-9, *Stroud v. United States*, No. 95-3139, 1996 WL

Dr. Stroud's husband had been a licensed real estate broker in South Carolina since 1980. By the time Dr. Stroud learned that the NHSC would not allow her to fulfill her service obligation in South Carolina, her husband could not abandon the real estate practice he had been building for six years, and she was forced to give notice to the NHSC that she would "financially fulfill" her service obligation. The NHSC placed her in default as of July 1, 1986.²⁷ Dr. Stroud did not have the funds to pay the treble damages. After lengthy negotiations, she was allowed to pay the liquidated damages, plus interest, in installments, pursuant to a "Repayment Agreement" executed November 25, 1987.²⁸ The Strouds made payments under that Agreement in the years 1989, 1990, and 1991, and deducted both the principal of the treble damages (except for the original scholarship amount) and current interest on the note. The IRS invoked I.R.C. § 265(a)(1) to deny the deductions and claimed that the treble damages and interest were allocable to tax-exempt income—the exempt scholarship. The Strouds paid the deficiencies and then sued for a refund.

The government argued that the district court in *Stroud* should disallow the deduction under the I.R.C. § 162(f) theory of *Hawronsky*, arguing that the damages were, in effect, a fine or penalty.²⁹ Although he was aware of the *Hawronsky* decision and cited it,³⁰ Judge Norton chose to consider only the I.R.C. § 265(a)(1) theory and did not take the easier route of simply following *Hawronsky*. If the reason was that he saw the weakness of the *Hawronsky* decision, he did not say so.

It should be noted that the two theories are not quite equivalent in their effects because they may have contradictory implications for other tax issues. One such issue was present in *Stroud*—the deductibility of current interest paid on a promissory note to pay the NHSC damages over time. If the damages are a business expense, interest on them would be

477240 (4th Cir. Aug. 23, 1996).

27. *Stroud*, 906 F. Supp. at 991.

28. *Id.* at 991-92.

29. *Id.* at 993.

30. *Id.* at 994 n.8.

deductible because the interest is not itself a penalty even if the principal is. But if the damages are a cost of earning tax-free income, presumably the interest is an additional cost of earning tax-free income, and so not deductible.

A. *Stroud* aka GCM 39,336

In *Stroud*, the district court incautiously relied on the government's General Counsel Memorandum (GCM) 39,336,³¹ which it found to be "clearly on point."³² The court first

31. I.R.S. Gen. Couns. Mem. 39,336 (October 12, 1984).

32. 906 F. Supp. at 993. That it is "on point" is unsurprising, because this GCM is the IRS's internal memorandum of law underlying the advice it gave in a private letter ruling to another NHSC physician who was in precisely the same circumstances.

GCM 39,336 begins by rejecting the correct proposal of the IRS Individual Tax Division to analyze the damages in three parts: a repayment of the scholarship itself, which would be nondeductible, and two deductible portions consisting of a "penalty" portion and the "interest," which was how the taxpayers in both *Hawronsky* and *Stroud* reported the damages.

Despite the inauspicious beginning, GCM 39,336 then quite logically asserts that the taxpayer had an unrestricted right to his scholarship, and that the damages became due solely as a result of the taxpayer's subsequent breach of the service agreement. The GCM then correctly states that the taxpayer incurred no indebtedness to the government upon receipt of the scholarship, and therefore no part of the damages constituted interest.

At this point GCM 39,336 maintains that although the amount of the damages is calculated by reference to the amount of the scholarship received, the "nexus" between the scholarship and the damages "is not substantial enough" to apply the doctrine of *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969) (limiting taxpayer oil company's deduction for repayment of overcharges to customers for natural gas to 72½% because taxpayer had already enjoyed 27½% depletion deduction when overcharges were received; denying double benefit of exclusion and deduction for the same item). This assertion seems erroneous because the taxpayer's compelled reimbursement of the original untaxed scholarship (a component of the treble damages) appears perfectly analogous to the *Skelly Oil* compelled reimbursement of (partially) untaxed oil revenues.

Then GCM 39,336 acknowledges the general rule that a payment of damages for breach of an employment contract is deductible, citing Rev. Rul. 67-48, 1967-1 C.B. 50 (holding deductible employee's payment of liquidated damages pursuant to employment contract for failure to complete agreed period of service after training because attributable to salary received).

Just when one expects the inevitable conclusion that the damages are deductible in full because they are payable solely on account of the breach of

considered and rejected the taxpayer's argument that Revenue Ruling 67-48³³ permitted the deduction. That ruling held that an employee (coincidentally, a resident physician) could deduct an amount paid to a former employer as liquidated damages for breach of an employment contract by leaving before the end of the agreed term of employment as a loss under I.R.C. § 165(c)(1).³⁴ The court distinguished this ruling with two observations: first, that the taxpayer in the instant litigation had never been an employee of the government;³⁵ and second, that

contract, GCM 39,336 abruptly reverses course and invokes I.R.C. § 265(a)(1) to deny a deduction not just for the amount of the scholarship originally received, but for the entire treble damages payment, on the ground that all the damages are "directly allocable" to the tax-exempt scholarship. This breathtaking conclusion is buttressed solely by *Manocchio v. Commissioner*, 78 T.C. 989, 994 (1982), *aff'd on other grounds*, 710 F.2d 1400 (9th Cir. 1983), which is itself erroneous and is criticized in detail below.

The author of the 1984 GCM 39,336 must have been aware of the above-cited appeal of *Manocchio*, which had been decided a year earlier, but he does not cite it. As explained below in Part II.2., however, the Ninth Circuit rejected the tax court's reliance on I.R.C. § 265(a)(1) in *Manocchio*, and if the Ninth Circuit was correct, all authority for basing the conclusion in GCM 39,336 on I.R.C. § 265(a)(1) vanishes.

33. Rev. Rul. 67-48, 1967-1 C.B. 50.

34. The conclusion is correct, except that the deduction should have been allowed under I.R.C. § 162 rather than I.R.C. § 165. A "loss" (when the term refers to a particular item rather than to an overall loss) refers to a transaction in property, not to a payment in cash, except in special circumstances not relevant here, such as a "gambling loss" for which the tax term has been imported from ordinary non-tax usage. See RICHARD A. WESTIN, *SHEPARD'S TAX DICTIONARY* (1993).

35. GCM 39,336 distinguishes Rev. Rul. 67-48 for a different reason—on the ground that there the taxpayer's salary was taxable rather than tax-exempt. However, a closer look leads to a different conclusion. The underlying Rev. Rul. 67-48 is I.R.S. Gen. Couns. Mem. 33,328 (Sept. 7, 1966), from which we learn that the first proposed version of the ruling would have divided the liquidated damages into two parts: a reimbursement of excess salary which is deductible, and a reimbursement of the cost of untaxed training, which is not. The training program was for resident physicians who were offered a higher initial salary if they agreed to remain as hospital staff for periods after their training was completed. (Why the cost of training, if repaid as damages, should not be deductible is not explained, and is anything but apparent. The repaid expenses would seem to fit squarely within the deductible expenses for business education allowed under Treas. Reg. § 1.162-5.) According to GCM 33,328, all the damages in fact represented a return of salary and should therefore be deductible. Nowhere, however, is there any suggestion that if some of the damages had been a nondeductible return of the value of untaxed training, that

the NHSC contract is governed by statutory standards rather than contractual principles.³⁶ The court failed to explain the relevance of these observations, and their relevance is far from obvious. In any event, the court then stated that because it agreed with GCM 39,336 that the payments at issue are nondeductible as allocable to tax-exempt income, it would decline to decide whether the payments are otherwise deductible under I.R.C. §§ 162 or 165.³⁷

Having cleared away this obstacle, the court found the question easy and the answer obvious. Were Dr. Stroud's treble damages payments (the deductions) allocable to tax-exempt income (the scholarship)? Clearly, yes. The nature of the tax-exempt income is Dr. Stroud's scholarship; the relationship it bears to the deductions is one of direct causation. "The payments could hardly be more 'allocable' to the scholarship funds—they would not be owed without a breach of the scholarship agreement."³⁸

The taxpayer argued that the damages payments were not *directly*, but *indirectly* allocable to the scholarship, and that therefore only a reasonable proportion should be deemed nondeductible, citing subsection (c) of Treasury Regulations § 1.265-1:

Expenses and amounts otherwise allowable which are directly allocable to any class or classes of exempt income shall be allocated thereto; and expenses and amounts directly allocable to any class or classes of nonexempt income shall be allocated thereto. If an expense or amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in

this should result in denial of a deduction for the reimbursement of salary as well. Just the reverse was suggested—it was assumed that a proper allocation would be made, namely that the refund of salary would be deductible, and the refund of untaxed training costs would not.

36. *Stroud*, 990 F. Supp. at 993 (citing *United States v. Vanhorn*, 20 F.3d 104 (4th Cir. 1994)).

37. *Id.* at 994.

38. *Id.*

each case shall be allocated to each.³⁹

The taxpayer contended that the payments at issue were indirectly allocable to both nonexempt income (her taxable income from private practice), and exempt income (the scholarship funds), and sought to analogize her case to *Induni v. Commissioner*.⁴⁰

The taxpayer in *Induni* was employed by the United States Immigration and Naturalization Service (INS) in Canada and was entitled to receive a tax-exempt Living Quarters Allowance (LQA) intended to pay his rent and utilities. Instead of renting, the taxpayer bought a home and received a tax-free LQA equal to 10% of the purchase price of the home. The taxpayer sought to deduct his mortgage interest and real property tax expenses relating to his residence, but the tax court denied the deductions to the extent that they were reimbursed by the tax-exempt LQA: "In our view, petitioner's mortgage interest and real property taxes are the housing expenses intended to be covered by the rent component of the LQA. As such, the deductions are indirectly allocable to a class of tax-exempt income within the meaning of section 1.265-1(c)[.]"⁴¹

Judge Norton then stated that although the expenses for which the taxpayer in *Induni* claimed a deduction were not exactly the same expenses which the LQA was intended to cover, they were nevertheless "indirectly" allocable to the exempt LQA because they fit within the broader purpose of the LQA. Judge Norton then concluded:

Here, this court need not make an analogy to find that the Plaintiffs' payments are allocable to Dr. Stroud's scholarship . . . [T]he deductions are not indirectly allocable to the scholarship, but directly allocable to it. Furthermore, because the full amount of Plaintiffs' liability is directly allocable to the tax-exempt scholarship, "the entire deduction is disallowed without regard to the amount of exempt income actually

39. Treas. Reg. 1.265-1(c).

40. 98 T.C. 618 (1992), *aff'd*, 990 F.2d 53 (2d Cir. 1993) (disallowing home mortgage interest and property tax deductions to the extent the taxpayer received a tax-exempt government housing subsidy for living abroad).

41. 906 F. Supp. at 995 (quoting *Induni*, 98 T.C. at 623).

received.”⁴²

Judge Norton’s conclusions are based upon two related errors, both borrowed from GCM 39,336. First, after admitting that the damages are only due upon breach of the scholarship agreement, he conflates the breach with the scholarship itself. The breach is an independent business decision to buy out one taxable employment obligation in favor of another which occurred many years after the scholarship agreement was made.⁴³ Second, Judge Norton misunderstood the meaning of “direct” and “indirect” allocations under the Regulations, which refer to *classes* of income, not to *items* of income. This misreading was necessary in order to make it appear that I.R.C. § 265(a)(1) applied in the first place. It did not. I.R.C. § 265(a)(1) applies to the costs of earning tax-exempt income, and the treble damages are clearly not a cost of earning the scholarship; they are a cost of the breach of the service agreement.

Going a little deeper, the *Induni* decision was irrelevant because it was itself erroneously based upon I.R.C. § 265(a)(1). Housing expenses abroad are not a cost of earning the exempt LQA; they are a cost of living and working abroad. Although the result in *Induni* was correct, it should have been decided under the principle of I.R.C. § 111.⁴⁴ What *Stroud* and *Induni* have in common is that they represent opposite sides of a single problem: double tax benefits for a single tax item. In *Stroud* the taxpayer first received a tax-free item which she later repaid as an otherwise deductible expense, just as in *United States v. Skelly Oil Co.*,⁴⁵ which should have governed the situation. In *Induni*, the taxpayer first paid an otherwise deductible expense for which he later received a tax-free reimbursement. In both cases a

42. *Id.* (citing GCM 39,336).

43. The issue of separating the scholarship from the breach will be discussed in the last section of this Article concerning Keane and the origin of the claim test.

44. I.R.C. § 111 (2000).

45. 394 U.S. 678 (1969) (limiting taxpayer oil company’s deduction for repayment of overcharges to customers for natural gas to 72½% because taxpayer had already enjoyed 27½% depletion deduction when overcharges were received; denying double benefit of exclusion and deduction for the same item).

double tax benefit should be avoided, but not by means of I.R.C. § 265(a)(1), which does not apply to problems of transactional accounting such as these. In *Induni* the error was harmless because the right result was reached despite the misapplication of I.R.C. § 265(a)(1). In *Stroud*, however, the result was an absurdly incorrect disallowance of the entire treble damages and current interest, rather than the correct amount of the original scholarship alone.

The illegitimate expansion of I.R.C. § 265(a)(1) into areas of transactional accounting for which it was not designed has a long and confusing history, but it aroused little or no opposition because it apparently, but only apparently, led to correct results. The courts did not parse the statute or Treasury Regulations under I.R.C. § 265(a)(1) very carefully as long as the IRS's result seemed correct, and by the time *Stroud* was decided, the misapplication of I.R.C. § 265(a)(1) in this area was already settled law. Without this prior body of erroneous doctrine, the fatal mistake made in *Stroud* would have been impossible. In order to appreciate how these errors came about, it is necessary to review some history.

B. History of I.R.C. § 265(a)(1)

The original predecessor of current I.R.C. § 265(a)(1) was enacted as section 24(a)(5) in the Revenue Act of 1934⁴⁶ in order to disallow deductions for the production of tax-exempt income. Such deductions would, in effect, shelter unrelated taxable income and provide an unwarranted double tax benefit. The specific situations Congress had before it when it enacted (former) section 24(a)(5) were: (1) expenses incurred for the purpose of producing exempt interest on state securities; (2) exempt salaries received by state employees; and (3) exempt income from leases of state school lands.⁴⁷ The House version would have disallowed all such expenses.

It is clear from the italicized words in the legislative history below that the statutory language "allocable to," later to cause

46. Revenue Act of 1934, Pub. L. No. 73-216, 48 Stat. 683, 691.

47. See generally *id.* at 683-84.

great confusion, should be read as interchangeable with "paid or incurred for the production of" tax-exempt income. The House Report states:

Section 24(a)(5). Disallowance of deductions *attributable* to tax-exempt income: This paragraph has been added to the bill to eliminate as deductions from gross income expenses *allocable* to the production of income wholly exempt from the income tax. Under the present law interest on State securities, salaries received by State employees, and income from leases of State school lands are exempt from Federal income tax, but expenses *incurred* in the production of such income are allowable as deductions from gross income.⁴⁸

The Senate version adds the express proviso that such deductions are disallowed even if the tax exempt income fails to materialize, and also limits the provision to tax-exempt income other than interest, which was then dealt with in a separate provision. The Senate Report states:

The House bill disallows amounts otherwise allowable as deductions which are *allocable* to one or more classes of tax-exempt income even though the income fails to materialize or is received in an amount less than the expenditures made or incurred. For instance, under the present law, salaries received by State employees, income from leases of State school lands, and the interest on State and some classes of Federal securities are exempt from the income tax. It is contended that under the existing law all expenses *incurred* in the production of such income are allowable as deductions. The House bill specifically disallows expenses of this character. While your committee is in general accord with the House provision, it is not believed that this disallowance should be made to apply to expenditures incurred in earning tax-exempt interest. To do so might seriously interfere with the sale of Federal and State securities⁴⁹

I.R.C. § 265(a)(1) prohibits otherwise allowable deductions

48. ROBERT L. DOUGHTON, REVENUE ACT OF 1934, H.R. REP. NO. 73-704 (1934), *as reprinted in* 1939-1 C.B. (Part 2) 554, 571 (emphasis added).

49. PAT HARRISON, REVENUE BILL OF 1934, S. REP. NO. 73-558 (1934), *as reprinted in* 1939-1 C.B. (Part 2) 586, 606 (emphasis added).

for expenses which are allocable to classes of income (other than interest) which are wholly exempt from tax. Until *Stroud*, the provision had been applied—albeit in a haphazard manner—in essentially two different types of situations. The first is that which was originally contemplated by Congress when the provision was enacted: disallowance of direct costs of earning tax-exempt income. Here would belong, for example, disallowance of deductions for legal fees in suits to acquire tax-exempt inheritances, damages for personal injuries, or for state and foreign income taxes imposed on items exempt from federal income tax. If the expenses are incurred to earn a mixture of taxable and tax-exempt income, they will be denied a deduction in the same proportion that the tax-exempt income bears to total income.⁵⁰

The second situation, and one of more recent provenance, is the result of the IRS's efforts to extend the prohibition to disallow expenses for deductible items for which the taxpayer has arguably been paid reimbursement with tax-free grants in one form or another. GCM 34,506⁵¹ ably recounts the history and purpose of I.R.C. § 265(a)(1), and concludes that Congress's intent requires that the provision be applied in *only* two situations: first, in the original situation in which the expense is incurred for the purpose of earning tax-exempt income; and second, where the taxpayer receives tax-exempt income which is earmarked for a particular purpose, and the taxpayer incurs expenses in carrying out that purpose.⁵² The GCM was only half right: the second application is erroneous, and is the root of the problem in *Stroud*.

1. Revenue Ruling 83-3 and Its Erroneous Reimbursement Theory

The IRS first published its new "reimbursement" theory in Revenue Ruling 83-3.⁵³ It disallowed otherwise deductible

50. Treas. Reg. § 1.265-1(c).

51. I.R.S. Gen. Couns. Mem. 34,506 (May 26, 1971).

52. *Id.* at 14-15.

53. Rev. Rul. 83-3, 1983-1 C.B. 72.

educational expenses when the taxpayer received a tax-free scholarship or tax-free veterans' educational benefit intended to subsidize the same studies,⁵⁴ and disallowed home mortgage interest and property deductions to the extent the taxpayer received a parsonage housing allowance, which is tax exempt under I.R.C. § 107.⁵⁵ Congress soon partially overruled the IRS on the "reimbursement" theory in the Tax Reform Act of 1986 by enacting I.R.C. § 265(a)(6)(B)⁵⁶ for the purpose of rescuing the home mortgage and property tax deductions for parsons and military personnel. A fascinating question involving fringe benefits generally lurks in these disputes but is beyond the scope of this article.⁵⁷

54. The tax court decided in favor of the IRS on this issue as early as 1952 in *Banks v. Commissioner*, 17 T.C. 1386 (1952). After waffling back and forth, the IRS's current position was not announced in a published ruling until Rev. Rul. 83-3.

55. I.R.C. § 107 (2000 & Supp. 2003).

56. I.R.C. § 265(a)(6) provides that "[n]o deduction shall be denied under this section for interest on a mortgage on, or real property taxes on, the home of the taxpayer by reason of the receipt of an amount as—(A) a military housing allowance, or (B) a parsonage allowance excludible from gross income under section 107."

57. The IRS has also disallowed—under the "original" use of I.R.C. § 265(a)(1)—the reverends' trade or business deductions in proportion to the amount their tax-free parsonage allowance bears to their total trade or business income from the ministry, and this disallowance was approved by the tax court in *Deason v. Commissioner*, 41 T.C. 465 (1964), and more recently in *Dalan v. Commissioner*, 55 T.C.M. (CCH) 370 (1988).

Very curiously, parsons seem to be the sole group which has been targeted for both the "original" and the "reimbursement" kinds of disallowance under I.R.C. § 265(a)(1).

However, the "original" application of I.R.C. § 265(a)(1) seems impeccable as applied to employee business expenses of all taxpayers who receive any tax-free fringe benefits. Employees do after all earn both taxable and tax-exempt income from their business expenses. There is no apparent reason why the *Deason* doctrine should not disallow all taxpayers' trade or business deductions in proportion to their receipt of all tax-exempt fringe benefits, not just the parsonage allowance, including, for example, the quite similar exclusion for employee housing provided for the benefit of the employer under I.R.C. § 119 (2000). If such benefits as medical and life insurance and educational subsidies are included, the disallowance for many taxpayers might be very significant. For example, if tax-free fringe benefits represented one quarter of the value of an employee's total compensation, it should follow that one quarter of the employee's otherwise deductible employee business expenses should be denied under I.R.C. § 265(a)(1). Congress almost certainly did not intend this result. It

Although the reimbursement cases have generally led to reasonable results, the use of I.R.C. § 265(a)(1) in such situations stretches the meaning of “allocable to” beyond recognition and can easily create confusion⁵⁸ and error. The risk of error derives from the fact that once an expense is found to be “allocable to” tax-exempt income, a deduction must be denied in its entirety even if it exceeds the amount of exempt income earned.⁵⁹

This rule makes perfect sense if it is limited to the direct costs of earning exempt income, and it has an exact parallel in the rules which deny deductions for personal living expenses altogether, whether or not the exempt consumption is actually received. Similarly, business deductions are generally allowed in full, whether or not the hoped-for business income is actually realized. If the taxpayer does not have sufficient business income for the year, the deductions are still allowable to offset other income or as a carryforward. All three rules apply to *classes* of income and expense, not to *items*.

The case of reimbursements is entirely different. If a reimbursement is less than the otherwise deductible expense it pays for, denial of the entire deduction is inappropriate. In fact, the courts and the IRS seem to have understood this point, because they have never applied an entire disallowance rule in reimbursement cases. They arrive at the correct result, but without seeing that it is impossible to base this result on I.R.C. § 265(a)(1).

Both the problem and its solution can be seen in two decisions, *Manocchio v. Commissioner*,⁶⁰ and *Induni v.*

is a glitch, and the Code should probably be amended to remove it.

58. Rev. Rul. 83-3 itself already displays confusion. The ruling lists four reported authorities in which the new meaning of “allocable to” has purportedly been applied to situations “where tax-exempt income is earmarked for a specific purpose and deductions are incurred in carrying out that purpose.” Rev. Rul. 83-3, 1983-1 C.B. 72, 73. Two of these, *Heffelfinger v. Commissioner*, 5 T.C. 985 (1945), and Rev. Rul. 74-140, 1974-1 C.B. 50, disallowed deductions for income taxes, respectively foreign and state, which had been imposed on income which was exempt from federal tax. This is an impeccable application of the core original meaning of I.R.C. § 265(a)(1), not of the new reimbursement application.

59. Treas. Reg. § 1.265-1(b).

60. 78 T.C. 989 (1982), *aff’d on other grounds*, 710 F.2d 1400 (9th Cir.

Commissioner.⁶¹ In *Manocchio*, the issue was whether a pilot who paid for a flight training course could deduct the full cost as a business expense, even though the Veterans Administration (VA) reimbursed the pilot for 90% of the cost and the reimbursement was tax exempt. The tax court denied the deduction to the extent it was reimbursed by the VA, under the purported authority of I.R.C. § 265(1).⁶² In doing so, the court acknowledged that the legislative history of I.R.C. § 265(1) indicated that Congress seemed principally concerned with denying a deduction for the direct costs of earning exempt income, rather than reimbursement situations like that in *Manocchio*. The court further acknowledged that an alternative analysis existed which would lead to the same conclusion: the deduction should be denied simply because it was reimbursed; the taxpayer did not pay the expense; the VA did.⁶³ On appeal, the United States Court of Appeals for the Ninth Circuit affirmed on precisely this alternative rationale, and did not review the tax court's construction of I.R.C. § 265(1).⁶⁴

The Ninth Circuit's analysis was correct for at least two reasons. First, even if the reimbursement were *taxable*, the same outcome was required, albeit by a slightly different path. The deduction would be allowed but the taxable reimbursement would restore 90% to income and result in a net deduction of 10% of the flight training expense.⁶⁵ Thus, it is the mere fact of reimbursement which is decisive, not the fact that the reimbursement is tax-exempt.⁶⁶

1983).

61. 98 T.C. 618 (1992), *aff'd* 900 F.2d 53 (2d Cir. 1993).

62. Predecessor of I.R.C. § 265(a)(1), since renumbered.

63. 78 T.C. at 998.

64. 710 F.2d at 1402.

65. The tax court acknowledged that the taxpayer would be left in the same tax situation if the reimbursement was taxable, but pointed out that this need not always be the case. For example, a tax-exempt reimbursement is more valuable than a taxable one if the taxpayer does not itemize and takes the standard deduction instead. *Manocchio*, 78 T.C. at 996.

66. The Ninth Circuit's approach provides a principled explanation why gift reimbursements do not trigger disallowance of otherwise allowable deductions under I.R.C. § 265(a)(1). See I.R.S. Gen. Couns. Mem. 34,506 (May 26, 1971). "There is ample evidence in the legislative history that the section

Second, the direct route taken by the Ninth Circuit is clear and simple. More importantly, it avoids the specter of denying *all* the allocable expenses even if they exceed the amount of the reimbursement. In *Manocchio*, the tax court decided the taxpayer's expense was "allocable to" the tax-exempt reimbursement as if it were a cost of earning the reimbursement, apparently because the taxpayer had to submit a receipt for his expense. The tax court correctly permitted a deduction for the remaining 10% of the costs actually paid but not reimbursed. It is far from clear how the court arrived at this result, because it decided the training expenses could be allocated to only one class of income—the exempt reimbursement.⁶⁷ If it had followed the I.R.C. § 265(a)(1) analysis to its logical conclusion, it would have been forced to deny the deduction in its entirety as "directly allocable to" tax-exempt income.⁶⁸ After all, the taxpayer was required to pay 100% of the cost of flight training in order to obtain the 90% reimbursement.

If the tax court had applied Treasury Reg. § 1.265-1(c) as written, it would have been led to a very different, and wrong, conclusion. That regulation prescribes that when an expense is "indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof . . . shall be allocable to each."⁶⁹ There is a class of nonexempt income to which the expense is "indirectly" allocable—the pilot's taxable salary. If the expense had not been so allocable, it would not

[265(a)] does not apply to disallow a deductible expense attributable to the expenditure of a completely unrestricted gift." If one concentrates on whether the taxpayer has paid the expense, it is clear the taxpayer has done so even where the expense is paid by a family member because the economic effect is the same as if the family member made an unrestricted gift to the taxpayer, who then uses the gift to pay a deductible expense. This is no different from paying deductible expenses out of the taxpayer's own tax-exempt interest from municipal bonds. This economic-equivalence analysis cannot apply to third-party arms-length reimbursements such as scholarships, veterans' benefits, housing allowances and the like, because such benefits are provided to subsidize the targeted activity. There are no unrestricted scholarships payable regardless of whether one enrolls in school, or a foreign housing allowance payable whether or not one lives abroad.

67. *Manocchio*, 78 T.C. at 995.

68. Treas. Reg. § 1.265-1(b)-(c).

69. Treas. Reg. § 1.265-1(c).

have been deductible as a business expense in the first place. It follows from the Regulations that the flight training deduction should have been denied in the same proportion that the taxpayer's exempt reimbursement bears to the sum of his total income—the pilot's taxable salary plus the reimbursement. The reported facts in the *Manocchio* opinion provide only that petitioner's training expenses were \$4,162 in 1977, the reimbursement was \$3,743, and the deficiency was \$924. The exact proportions cannot be calculated from these facts. However, assuming the taxpayer's taxable salary was about \$30,000, it would follow that approximately 90% of the training expense should be deductible as allocable to producing the taxable income, and 10% denied as allocable to producing the reimbursement, which is the exact reverse of what the tax court correctly decided.

The Regulations under I.R.C. § 265(a)(1) simply do not work in the *Manocchio* situation. One reason is that the terminology "directly and indirectly allocable" is very confusing and poorly chosen. Expenses which are allocated solely to one class of income are termed "directly allocated" in Treas. Reg. § 1.265-1(c), and those which are allocable partly to one class and partly to another are called "indirectly allocable" to each class in some proportion. For example, if a taxpayer recovers a personal injury award of \$1,000, of which \$600 is taxable punitive damages and \$400 is tax-exempt, and incurs legal expenses of \$100, \$40 of the expenses would be disallowed as "indirectly allocable" to a class of tax-exempt income. But that \$40 expense is allocable just as "directly" (in normal English) to the \$400 exempt income as it would have been if the entire recovery had been exempt. "Wholly" and "partly" allocable would have been much clearer terms than "directly" and "indirectly."

The terminology problem becomes even worse in *Induni*.⁷⁰ There, the taxpayer's home mortgage interest and property tax payments, which were slightly in excess of his tax-exempt housing subsidy, also had to be "allocated" for I.R.C. § 265(a)(1) and *Manocchio* to apply. The tax court ostensibly made its

70. 98 T.C. 618.

allocation under the same allocation Regulation § 1.265-1(c), criticized above, but did not identify any class of taxable income to which the mortgage interest and taxes might be allocable so as to justify allowing a deduction for the 14.1% of the expenses in excess of the exempt LQA. The reason is, obviously, there is none. Home mortgage interest and taxes are not expenses incurred in order to produce income of any kind or class.⁷¹ Despite its garbled reading of § 265(a)(1), however, the tax court did manage to get the right answer.

In the final analysis, the tax court was not really applying I.R.C. § 265(a)(1) at all. It was applying the Ninth Circuit's approach to *Manocchio* instead, and denying the deductions only to the extent necessary to avoid an unjustified double tax benefit.

2. The Tax Benefit Rule and Revenue Ruling 83-3

It is not entirely clear why the IRS ever thought it needed to invoke I.R.C. § 265(a)(1) in the first place in Revenue Ruling 83-3, *Manocchio*, and *Induni*. The Ninth Circuit's approach to *Manocchio* is fully capable of dealing with the "reimbursement" line of cases. It is possible that the IRS did not believe it had a clear statutory basis for denying the deductions offset by tax-exempt reimbursements, or for denying the exempt status of reimbursements which are statutorily excludible. I.R.C. § 111 does not apply by its literal terms to the facts in *Manocchio* and *Induni* because the expenses and reimbursements in those cases both occurred in the same year. If the reimbursements had been made in a later year, I.R.C. § 111 would have been applicable,⁷² and the taxpayer would have taken the reimbursement into

71. See Treas. Reg. § 1.861-8(e)(9)(ii), 1.861-8T(d)(2)(iii)(D) (as amended in 2005). Home mortgage interest and real property taxes are not definitely related to any class or classes of gross income for the purpose of allocating and apportioning expenses.

72. Section 111(a) provides: "Gross income does not include gross income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter." I.R.C. § 111(a) (2000). This statement of the "exclusionary" side of the tax benefit rule implies that the recovery of an item which was deducted in a prior year is taxable in the year of recovery of the prior deduction.

income to the extent of the prior deduction, assuming that the reimbursement is a recovery or an event “fundamentally inconsistent” with the deduction.⁷³ When both recovery and deduction occur in the same year, the only correct result can be to net them, as the tax court in effect did.

Also, a “recovery” for purposes of I.R.C. § 111 is usually a two-party affair in which the same party who originally received the deductible item returns it, such as a refund of state taxes or repayment of a debt which appeared worthless. It may be that the IRS did not feel confident of success in three-party transactions like *Manocchio* and *Induni* where the reimbursement comes from the government rather than from the payee of the deductible expense.

C. The Error: I.R.C. § 265(a)(1) Does Not Apply at All

By now it should be clear that I.R.C. § 265(a)(1) is both literally and conceptually inapplicable to these “reimbursement” situations, and is *a fortiori* inapplicable to *Stroud*. Like I.R.C. § 111, it is intended to forestall double tax benefits, but there the resemblance ends. I.R.C. § 265(a)(1) is designed to triage expenses of producing income in the sense of gains or profits, but the reimbursement situations do not involve profits. Pilots do not take training courses in order to earn reimbursements, nor do people live and work abroad to earn housing subsidies. Such reimbursements may provide an incentive in the form of a discount or rebate, but they are not profit. By definition one cannot earn a profit from a reimbursement. Literally and etymologically, a reimbursement is a return or replacement of funds which one had in the first place.

The language of the regulations under I.R.C. § 265(a)(1) simply cannot be made to fit the reimbursement situations, and if the government had read its own regulations more carefully, the error in Revenue Ruling 83-3 would never have arisen. The

73. *Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370 (1983) (holding distribution of cattle feed in tax-free corporate liquidation in year after feed was deducted is fundamentally inconsistent with prior deduction where shareholders acquire basis in feed, and is a “recovery” within the meaning of I.R.C. § 111).

regulations speak consistently of allocating a *proportion*, not an *amount*, of expenses to classes of exempt and non-exempt income. A *proportion* necessarily refers to a percentage, or ratio, between quantities. It does not and cannot refer to a simple comparison of arithmetic amounts in absolute terms. But the “reimbursement” situations, like I.R.C. § 111 cases generally, always turn on absolute amounts of addition and subtraction and never involve proportions and percentages.

The erroneous “reimbursement” application of I.R.C. § 265(a)(1) did no harm in *Manocchio* and *Induni*—largely because I.R.C. § 265(a)(1) was not really applied at all. But the further extension of this mistaken theory in *Stroud* unfortunately did produce the wrong result. In *Stroud*, the IRS inappropriately used a proportional approach to a supposed reimbursement for the first time, and the result was disastrous. Ultimately, the error is due to the fact that I.R.C. § 265(a)(1) is not applicable to the situation in *Stroud* at all, either in its original or its “reimbursement” form. Doctors obviously do not pay treble damages in the current year in order to earn a tax-free scholarship to medical school which was paid for half a dozen years earlier. They pay current damages to be released from a current onerous work obligation in order to buy freedom for other career endeavors.

Nor does the fact pattern in *Stroud* resemble even slightly the second, and illegitimate, “reimbursement” application of I.R.C. § 265(a)(1). The taxpayers’ expenses in *Manocchio* and *Induni* were properly denied as deductions because the government, not the taxpayers, paid the expenses. But neither the government nor anyone else reimbursed the taxpayer’s triple damages in *Stroud*. The taxpayer paid the full cost of the triple damages herself. The only portion of the treble damages that should be denied a deduction is the single-damages portion representing the actual scholarship amount, under *Skelly Oil*,⁷⁴ just as the taxpayer reported on her tax return. All the remaining amounts are deductible as business expenses under the IRS’s own Revenue Ruling 68-47.

74. 394 U.S. 678.

The ultimate source of the error in *Stroud* was that the court failed to see that the origin of the government's claim for damages was not the original receipt of the scholarship, which was long old and cold, but rather the taxpayer's breach of contract. A similar misperception of the origin of the government's claim for damages caused the error in *Keane*, discussed below in section III. In *Keane*, however, unlike in *Stroud*, the origin of the claim test was invoked explicitly.⁷⁵

D. Origin of the Claim Test: What if There are Two Origins?

The leading case for the origin of the claim test is *United States v. Gilmore*.⁷⁶ The court in *Gilmore* held that the taxpayer could not deduct attorney's fees in a divorce action as a business or investment expense, even if his purpose was to protect his income-producing properties, because although the effects of the divorce would be felt in his profit-seeking activities, the claims arose in the personal context of divorce.⁷⁷ The *Gilmore* doctrine holds that a claim's personal or business character is to be determined by its origin rather than its effects.

In *Stroud*, however, the issue had nothing to do with the future effects of the interest or damages settlement. The issue in *Stroud* was, rather, as between two possible origins in the past, how far back does one go? Was the origin of the claim in the original scholarship, or in the later breach?

For this question there is some authority, and it is firmly on the side of going back only as far as the breach. Only three months after *Gilmore* was decided, the tax court considered whether attorney's fees for the collection of defaulted alimony payments were deductible under I.R.C. § 212(1) in *Elliott v. Commissioner*.⁷⁸ The Tax Court had no difficulty allowing the deduction, and the IRS acquiesced.⁷⁹ Although the issue was not discussed in *Elliott*, nor did the *Elliot* court even mention

75. 75 T.C.M. (CCH) at 2048-49.

76. 372 U.S. 39 (1963).

77. *Id.*

78. 40 T.C. 304 (1963), *acq. in result*, 1964-2 C.B. 3.

79. *Id.* (March 16, 1964).

Gilmore, it seems fair to read the decision as holding that a separate action for enforcement of collection of alimony long after the divorce is old and cold is independent of the divorce, and has its own origin *in the breach of the obligation*. The chain of origins is cut off at that point, and *Gilmore* does not require reaching further back to the more remote origin in the divorce.⁸⁰

In another example, a business deduction for training expenses was at issue in *Hundley v. Commissioner*.⁸¹ Although the issue in *Hundley* was not explicitly framed as involving the origin of the claim test, it could have just as easily been decided under that theory. The taxpayer in *Hundley* was a high school athlete whose father agreed to train him and act as his manager and agent. The father periodically sacrificed other employment to work with his son. They formally agreed that the son would owe his father nothing for his services if he failed to obtain a major-league contract. But if he succeeded, he would evenly split any major-league signing bonus with his father. Two years later, a major-league team signed the son and awarded a large bonus payable over five years. The taxpayer divided the bonus with his father as agreed and deducted the payment as a business expense.⁸²

The IRS allowed only 10% of petitioner's deduction in *Hundley* because the taxpayer was still in high school when services were rendered, except for a two-week period when he negotiated his professional contract.⁸³ The general rule for educational expenses, as for job-seeking expenses, is that the taxpayer must already be engaged in a trade or business in order to be eligible to claim a deduction. Expenses to train for or seek a first job are not deductible.⁸⁴

The tax court held for the taxpayer, however, on the ground

80. *But see Wild v. Comm'r*, 42 T.C. 706 (1964). One year after *Elliott*, the tax court extended the deductibility of attorney's fees to include negotiating a right to alimony even as part of an ongoing divorce. This does not negate the conclusion in the text, however. And in any case, the decision appears to be wrongly decided for the reasons Judges Raum and Pierce give in their dissents.

81. 48 T.C. 339 (1967).

82. *Id.* at 340-44.

83. *Id.* at 344.

84. *Id.* (citing I.R.C. § 162 (1954)).

that the father's fee was not due or payable at all unless and until the son actually entered the trade or business of professional baseball—the son's obligation was contingent on obtaining a major-league contract. Thus, the origin of the obligation was in his trade or business, and his payment was a cost of that business.⁸⁵

In the NHSC situation, as in *Hundley*, the taxpayer received educational and vocational services *gratis*, and tax exempt, subject only to a contingent duty to pay if a future business contingency arose. In both cases the contingency did materialize. And in both cases the character of the expense, business *vel non*, should be determined as of the time the contingent expense became actual. If at that time the taxpayer is engaged in a trade or business, and the payment is an expense of the business, the expense should be allowed as a deduction.

If *Hundley* is correctly decided, *Stroud* represents an even stronger case for allowing the deduction. Both situations involved tax-free professional training which would be paid for only if a business-related contingency arose. In *Hundley*, the contingency was both expected and desired by both parties. In *Stroud*, the contingency of breach was neither desired nor expected by either party at the time of contract.⁸⁶ Thus, the case for characterizing the damages in *Stroud* as relating to a current substitution of one medical practice for another seems *a fortiori* compelling. To relate it back to the remoter non-business origin of the contingent obligation appears strained and unrealistic.

As Justice Jackson stated in his dissent in *Lykes v. United States*,⁸⁷ joined by Justice Frankfurter, it is the proximate cause of an expense which matters:

A majority of my brethren seem to think they can escape this conclusion by going further back in the chain of causation.

85. *Id.*

86. The treble damages are so high that no one would ever sign on the NHSC program with the intention of dropping out and paying them. In Dr. Stroud's case, the damages amounted to nearly six times the sum the government actually advanced to her.

87. 343 U.S. 118 (1952) (holding that legal fees paid by donor in litigation over amount of gift tax owed were not deductible, before 1954 enactment of I.R.C. § 212(3)).

They say the cause of this legal expense was the gift. Of course one can reason, as my brethren do, that if there had been no gifts there would have been no tax, if there had been no tax there would have been no deficiency, if there were no deficiency there would have been no contest, if there were no contest there would have been no expense. And so the gifts caused the expense. The fallacy of such logic is that it would be just as possible to employ it to prove that the lawyer's fees were caused by having children. If there had been no children there would have been no gift, and if no gift no tax, and if no tax no deficiency, and if no deficiency no contest, and if no contest no expense. Hence, the lawyer's fee was not due to the contest at all but was a part of the cost of having babies. If this reasoning were presented by a taxpayer to avoid a tax, what would we say of it? So treacherous is this kind of reasoning that in most fields the law rests its conclusion only on proximate cause and declines to follow the winding trail of remote and multiple causations.⁸⁸

A very close analogy to *Stroud* lies in Private Letter Ruling (PLR) 2001-27-022,⁸⁹ in which the taxpayer was a physician who sold his practice. As part of the sales agreement, the selling physician agreed to continue practicing with the buyer for a period of time under a fee-splitting arrangement, during which he would refer cases to the buyer, not compete with the buyer, and not solicit former patients.⁹⁰ However, the taxpayer breached the agreements by going back into practice on his own, and was forced in arbitration to pay the buyer damages. The tax question was whether the taxpayer was required to capitalize the damages paid as part of the sales agreement, or whether the damages could be deducted currently as expenses separate and independent of the sales contract. The PLR correctly concluded that the damages were deductible:

[E]ven though the first event in the fact pattern was the sale of

88. *Id.* at 128.

89. I.R.S. Priv. Ltr. Rul. 2001-27-022 (April 4, 2001). Although the PLR was decided long after *Stroud* and *Keane*, it does not purport to introduce any change in the law and is fully consistent with what precedent did exist on the question of alternative origins of a claim.

90. *Id.*

Dr. A's medical practice, a capital transaction. . . . Dr. B did not, for example, seek specific performance or rescission of the asset purchase agreement. The claims submitted to arbitration arose from Dr. A's practice of medicine over two years later and . . . the ancillary agreements[.]⁹¹

This is a close parallel to *Stroud*. One need only substitute the bar against deducting expenses of earning tax-exempt income for the bar against deducting capital outlays. For example, suppose a taxpayer accepts employment abroad, the income from which is tax-exempt under I.R.C. § 911. As a condition of employment, the taxpayer agrees to a restrictive covenant not to divulge any confidential information or solicit any of his former employer's clients and customers in the event he leaves to work for a competitor. If the taxpayer does return to the United States and does work for a competitor, in breach of the restrictive covenant, and is forced to pay damages to the first employer, it seems beyond doubt that the damages would be deductible. Under the same reasoning as PLR 2001-27-022, the damages would be current expenses of the United States business, rather than allocable to the earlier contract to earn tax-exempt income abroad.

E. Capitalization Under the Indopco Regulations

The taxpayer in *Stroud*, as in nearly all the treble-damages cases, effectively bought four years of freedom from her service obligation. It would make perfect sense for the taxpayer to capitalize the treble damages payment and amortize it over its life term of four years, except that at the time Revenue Ruling 68-47⁹² was in effect—and this ruling permitted an immediate deduction. In the meantime, however, the “Indopco Regulations,”⁹³ which govern whether certain intangibles must be capitalized, became final as of December 1, 2003.⁹⁴ These

91. *Id.*

92. 1967-1 C.B. 50 (holding employee's payment of liquidated damages, pursuant to employment contract for failure to complete agreed period of service after training, to be deductible).

93. Treas. Reg. § 1.263(a)-4 to -5.

94. See Ethan Yale, *The Final INDOPCO Regulations*, 5 TAX NOTES 435

regulations require capitalization of a payment made by a taxpayer in order to terminate a contract providing the payee with the exclusive right to acquire or use the taxpayer's property or services.⁹⁵ This regulation appears to apply to the *Stroud* situation and to render Revenue Ruling 68-43 obsolete. The Ruling, however, has not been revoked.

The Indopco Regulations generally do not purport to change the cost recovery rules applicable to the intangibles which must be capitalized. Thus, presumably a payment such as that in *Stroud* would be amortized under I.R.C. § 167(a) ratably over its useful life of four years. This amortization, in turn, might remove the deductions from the reach of I.R.C. §§ 162(f) and 265(a)(1) for yet another reason: these provisions by their terms apply to current deductions and have no explicit effect upon amortization deductions allowable under I.R.C. § 167(a).

The Indopco Regulations were not on the horizon in 1995 when *Hawronsky* and *Stroud* were decided. On the other hand, *Indopco v. Commissioner* was decided in 1992 and had already laid down the dubious doctrines that capitalization is the general rule for expenses which have future value, and that no identifiable asset was necessary in order for capitalization to be the proper treatment.⁹⁶ Though the argument would have been very creative at the time, the taxpayers in *Hawronsky* and *Stroud* might well have argued, perhaps even successfully, that the NHSC damages should be capitalized and amortized in light of *Indopco*, and that the amortization deductions were arguably outside the ambit of both I.R.C. §§ 162(f) and 265(a)(1).

III. KEANE AND THE EMPLOYEE INTEREST DEDUCTION

In *Keane v. Commissioner*,⁹⁷ the taxpayer was again a

(2004).

95. Treas. Reg. § 1.263(a)-4(d)(7)(i)(B). Similarly, a taxpayer who buys his way out of a noncompete agreement must capitalize the payment under Treas. Reg. § 1.263(a)-4(d)(7)(iii), Example 3.

96. 503 U.S. 79 (1992) (holding that professional fees for friendly takeover not currently deductible, and must be capitalized, because had future value and no requirement of separate identifiable asset for capitalization rule to apply).

97. 75 T.C.M. (CCH) 2046 (1998).

physician who allegedly breached his NHSC service obligation. The facts are not developed copiously, but it appears that the NHSC permitted Dr. Keane a deferment of his service obligation for one year in order to begin his internship and residency in physical medicine and rehabilitation at Stanford University Medical Center. After his first year at Stanford, the NHSC refused to grant any further deferments based on “policy changes in the program” which are not explained in the reported decision.⁹⁸ Dr. Keane remained to complete his residency at Stanford despite the NHSC’s refusal to grant a further deferment. The NHSC declared Dr. Keane in default, and Dr. Keane sued for a declaratory judgment of his rights in the District Court for the District of Columbia.⁹⁹ The NHSC appears to have applied these policy changes retroactively, and the suit was settled by compromise (essentially for single damages) suggesting that the NHSC was less than certain of the strength of its case for the full treble damages. Dr. Keane executed a promissory note to pay \$125,000 to the government, representing \$45,805 in original principal plus \$79,195 in previously accrued interest. Subsequent interest on the unpaid balance of these sums was to accrue at the rate of 7.22%. The facts are not spelled out in any detail, but it appears that the parties intended these amounts to represent the original principal and deemed interest without trebling.

The issue in *Keane* apparently concerned only the deductibility of the post-settlement interest on the unpaid balance of the promissory note. Indirectly, however, this raised some of the very same issues as in *Hawronsky* and *Stroud*. If the underlying principal of the promissory note, the compromised damages, was deductible, or was even a nondeductible business expense, the post-settlement interest on the note would be deductible as well. Therefore, it became necessary once again to determine whether the principal amount owed was a business expense.

98. *Id.* at 2048.

99. Brief for Respondent at 6-7, *Keane v. Comm’r*, 75 T.C.M. (CCH) 2046 (1998) (No. 23705-95).

A. Nature of the Settlement

Special Trial Judge Dean correctly reasoned that to determine the tax effect of a settlement one must look to the underlying nature of the claim which was compromised.¹⁰⁰ If the underlying claim had a business origin, the interest on the settlement would also have a business nature and would support a deduction under I.R.C. § 162. Then, however, Judge Dean held that the underlying dispute related to the NHSC scholarship and the settlement represented repayment of that scholarship. Because the scholarship was for medical training which had qualified the taxpayer for a new and different profession, the court said repayment of the scholarship was a nondeductible personal expense under Treas. Reg. § 1.162-5(a). It follows, the court said, that the taxpayer's interest payments on the promissory note are also nondeductible personal expenses—in fact, interest on a student loan—rather than business expenses under either I.R.C. § 162 or I.R.C. § 163. Without explanation, the court declined the IRS's invitation to apply I.R.C. § 265(a)(1) to deny the interest deduction, and the opinion mentions neither *Hawronsky* nor *Stroud*. Judge Dean's decision is curt and conclusory and virtually devoid of explanation.

Judge Dean's analysis is utterly mistaken. It is true that when the characterization of a settlement is specified by the parties, that characterization will ordinarily be respected for tax purposes. But that rule applies only to allocations between real and actual claims. The government had no claim for recovery of a student loan. The government's only real claim against the taxpayer was for treble damages under 42 U.S.C. § 254o(b)(1). The settlement agreement itself explicitly acknowledges this legal basis, even if it misstates that interest had previously accrued.

The *Keane* settlement recites that:

Dr. Keane shall pay . . . (\$45,805.00) in original principal (*i.e.*, the monies *expended on Dr. Keane's behalf for his medical school tuition and expenses*), plus previously accrued interest

100. *Keane*, 75 T.C.M. (CCH) 2046.

totaling . . . (\$79,195.00) claimed by the Secretary under 42 U.S.C. Section 254o(b)(1)), plus additional interest on the unpaid balance compounded at . . . (7.22%) per annum¹⁰¹

The taxpayer incurred no indebtedness at the time of entering into the scholarship contract. And the imputed interest called for in the treble damages clause is not interest for tax purposes, but is an element of damages to compensate the government for its loss of the use of the money. It is well-established that, in the absence of actual indebtedness which is presently enforceable, there can be no interest for tax purposes. The rule applies to all types of contingent debt which may become actual only after some intervening event. This rule applies, for example, to "pre-judgment interest" which is an element of damages but is not interest for tax purposes because no valid and enforceable debt is created until judgment.¹⁰² The IRS itself in its own GCM 39,336, which the tax court so heavily relied upon in *Stroud*, explicitly acknowledges that the imputed interest of the NHSC damages clause is not interest for tax purposes because no indebtedness was created at the time of making the contract, correctly citing *Joseph W. Bettendorf*.¹⁰³

The *Keane* settlement thus cannot be in lieu of repayment of a scholarship loan plus student loan interest because the government was not entitled to, and did not make, any such claim. The settlement is, of course, in lieu of the treble damages. And the tax treatment of the treble damages has been established above in the treatment of *Stroud*; the original scholarship amount is nondeductible under *Skelly Oil*, and the imputed "interest" is an element of damages which is deductible as a business expense.¹⁰⁴

101. *Id.* at n.3.

102. See, e.g., *Rozpad v. Comm'r*, 154 F.3d 1 (1st Cir. 1998); see generally Alice G. Abreu, *Distinguishing Interest from Damages: A Proposal for a New Perspective*, 40 BUFF. L. REV. 373 (1992).

103. 3 B.T.A. 378 (1926) (finding that damages for wrongful detention of funds is not interest on indebtedness for tax purposes).

104. There is one possible loose end. The amount paid might have been allocated for tax purposes in exact proportion to the amounts of the underlying claims. In other words, the \$46,000 of "principal" might have been treated as one-third original principal and two-thirds trebled, or roughly \$15,333 return of

B. Employee Business Interest

The only issue in *Keane* was the deductibility of the current interest paid on the settlement. Unfortunately, the proper question to determine the issue was never even raised, much less decided: whether the interest was employee business interest or self-employed business interest. We have already determined that the interest cannot be student interest on an educational loan and that it must be business interest. However, that is not the end of the question regarding the deductibility of the interest. The identical question arose in *Stroud* because she did not pay all of her damages at once, but entered into a repayment agreement over time and paid interest on the promissory note. The deductibility of this current interest was decided against the taxpayer in *Stroud*, as in *Keane*. If the *Stroud* court was right in denying a deduction for the damages under I.R.C. § 265(a)(1), then denying the current interest deduction would also have been correct because the current interest would have been nondeductible as an additional cost “allocable to” the tax-exempt scholarship, or because it would have fallen within the residual category of non-deductible “personal” interest under I.R.C. § 163(h)(1)(A).¹⁰⁵ Note, however, that if the court had denied the deduction of the damages under the *Hawronsky* theory that I.R.C. § 162(f) applied, the deduction for current interest would

scholarship and \$30,667 trebled damages, and the \$79,000 or “previously accrued interest” might have been regarded as one-third imputed interest of about \$26,333, and the other two-thirds or the remaining \$53,667 as the trebling of the imputed interest. This would have had no other tax effect than to reduce the non-deductible amount from \$46,000 down to \$15,333, with all the balance remaining deductible. It would have had no tax effect upon the deductibility of the current interest paid on these settlement amounts because both types of principal are business payments (even though some portion was not deductible). Given the language of the settlement agreement and the apparent intention of the parties, it seems preferable to respect the settlement allocation as written because the allocation is reasonable and both claims are genuine. Also, it seems more in the spirit of *Skelly Oil* to forbid deduction of the full scholarship amount received tax-free in order to avoid any amount of double tax benefit.

105. Judge Norton’s opinion on this point is so cryptic and confusing that it is not entirely clear why he denied the deduction for current interest. See 906 F. Supp. at 995.

have been allowable. Interest on a penalty is not itself a penalty, and because I.R.C. § 162(f) applies only to otherwise deductible business expenses, interest on the disallowed damages would have been deductible trade or business interest, at least on the assumption that *Hawronsky* was self-employed.

Employment status is the wrinkle. After the 1986 Act, business interest incurred by an employee is not deductible at all. This interest is now termed "personal" and is therefore nondeductible under the rather clumsy language of I.R.C. § 163(h)(1) and (2)(a).¹⁰⁶ Legislative history is apparently nonexistent for this absurdly harsh rule. Most other unreimbursed employee business expenses are cut down by the 2% floor of I.R.C. § 67, which is itself largely unjustified; but at least the deductions are allowed in some part if they are substantial. By contrast, and inexplicably, employee business interest is not deductible at all. It may be that the drafters of this rule thought that an occasional business interest expense of an employee was likely to be limited to *de minimis* amounts on a credit card, or that if the interest expense were legitimately for business, the employer would have reimbursed the expense. If the rule rests upon either of these assumptions, the drafters were sorely mistaken, as can be seen in *McKay v. Commissioner*.¹⁰⁷

In *McKay*, the taxpayer's interest expense of some \$44,000 on a loan to pay his legal fees was denied, even though some amounts were paid while the taxpayer was self-employed, on the ground that the taxpayer's litigation grew out of his earlier employment.¹⁰⁸ The taxpayer's suit was against his former employer for wrongful discharge and related causes of action. Thus, the rule of *McKay* seems to be that it is the purpose of the borrowing which determines whether business expense is disallowed as employee interest,¹⁰⁹ and not the employment status of the taxpayer at the time of payment or even at the time

106. "[T]he term 'personal interest' means any interest . . . other than – (A) interest . . . allocable to a trade or business (other than the trade or business of providing services as an employee)" I.R.C. § 163(h)(2)(A) (2000).

107. 102 T.C. 465 (1994).

108. *Id.*

109. The facts indicate that the taxpayer was discharged in 1983, but did not begin his lawsuit or his borrowings until a year later. 48 T.C. at 14, 36.

of borrowing.¹¹⁰

Thus, whether the current interest was deductible on the taxpayers' obligations in both *Stroud* and *Keane* would appear to depend exclusively on the taxpayers' purpose for incurring the obligation. If the taxpayer signed the note to buy her freedom to practice, or to continue practicing, medicine as an employee, the interest, whenever paid (apparently even if paid after later switching to self-employment) would be entirely non-deductible as employee business interest. If the taxpayer signed the note to practice, or continue practicing, medicine while self-employed, the interest would be deductible in full when paid. This slightly absurd question was—or should have been—the only relevant question regarding deductibility of the interest. But the question was never raised, much less briefed, in either *Stroud* or *Keane*.¹¹¹ On appeal, the Fourth Circuit blindly affirmed the district court's misapplication of I.R.C. § 265(a)(1) in *Stroud*, and approved the district court's conclusion that the current interest on the note was personal as well.¹¹² But the Fourth Circuit did reverse the complete denial of the interest deduction and allowed a partial deduction for the years 1989 and 1990—years when the personal interest deduction was still being phased out.

IV. CONCLUSION

The lessons to be learned from these erroneous decisions are not limited to uncovering and understanding the mistakes lawyers and the courts committed in *Stroud* and *Keane*, nor to recognizing the threat that the IRS will continue to unreasonably extend its arsenal of disallowance provisions under I.R.C. §§

110. This is in accordance with Treas. Reg. § 1.163-8T(c), which asserts that debt is to be allocated (as business, personal or otherwise) in accordance with the use of the loan proceeds, and that if there are no loan proceeds (as in the NHSC obligations), then allocated as if there were proceeds; i.e. as if used for whatever purpose the obligation were incurred. Treas. Reg. § 1.163-8T(c)(3)(ii). Interest paid is to be allocated in the same manner as the principal, regardless of when the interest is paid. Treas. Reg. § 1.163-8T(c)(2)(ii).

111. Not enough facts were recited in either reported decision to make it clear what the outcome should have been.

112. *Stroud v. United States*, No. 95-3139, 1996 WL 477240 (4th Cir. Aug. 23, 1996).

162(f), 265(a)(1), and 163(h) into new and unpredictable reaches. The most significant danger is that the IRS seems increasingly aggressive and unreasonable in its interpretations of law, and the courts seem uncritically deferential to the government. If the IRS is outgunned by big business, as is often asserted, it seems equally true that the IRS in turn outguns relatively defenseless taxpayers with whom the mainstream business tax bar is largely unconcerned.