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# COMMENTS

## PUTTING THE HOUSE IN ORDER: AN ANALYSIS OF AND PLANNING CONSIDERATIONS FOR HOME OFFICE DEDUCTION

*Section 280A of the Internal Revenue Code allows a taxpayer to deduct expenses incurred with respect to his home office only if the home office qualifies as a principal place of business, is a place of business where he meets or deals with patients, clients, or customers, or is in a separate structure detached from his residence. These exceptions, designed to permit a home office deduction only to deserving taxpayers, have been a point of contention between the Internal Revenue Service and taxpayers. In this comment, the author examines the statutory components of section 280A, reviews the decisional law, suggests possible methods for resolution of inconsistencies in judicial interpretation and application of the section, and posits tax planning considerations.*

### I. INTRODUCTION

The home office deduction has been the source of an ongoing struggle between the taxpayer and the Internal Revenue Service (IRS or Service). For years, taxpayers prevailed in this confrontation because of the liberal standards used by the courts in allowing the deductions. Unfortunately, these victories led to taxpayer abuse and eventually drew the attention of Congress. Determined to curtail taxpayer abuse, Congress, in 1976, enacted section 280A of the Internal Revenue Code (Code), a general exclusionary statute providing only limited exceptions. Subsequently, the Service, armed with the new highly restrictive statute, became the overwhelming winner in the battle over home office deductions as both deserving and nondeserving taxpayers were denied deductions. Recently, however, the pendulum has swung back in favor of the taxpayers as the courts have begun to apply an increasingly liberal reading to section 280A.

This comment begins with an overview of section 280A. Following this overview, the discussion focuses on three of the more litigated areas regarding the home office deduction: the exclusive use requirement, the principal place of business exception, and the use by patients, clients, or customers in meeting or dealing exception. An amendment to the statutory language of this latter requirement is suggested. Finally, this comment presents a technical roadmap through section 280A, and suggests possible tax planning considerations, problems, and opportunities.

## II. OVERVIEW OF SECTION 280A

### A. Pre-Section 280A

Before the enactment of section 280A in 1976,<sup>1</sup> home office deductions were governed by sections 162,<sup>2</sup> 167,<sup>3</sup> and 212.<sup>4</sup> With respect to the home office, these sections provided deductions for "ordinary and necessary" expenses incurred in carrying on a "trade or business" or "for the production of income."<sup>5</sup> The major limitation on the home office deduction was set forth in section 262,<sup>6</sup> which disallowed deductions for personal expenses not specifically allowed by the Code.<sup>7</sup>

In 1962, the IRS issued Revenue Ruling 62-180 to govern home office deductions.<sup>8</sup> The Ruling required that the taxpayer establish the following: (1) the portion of his residence used as a home office; (2) its regular use; (3) the extent of use; (4) that the use was a condition of employment; and (5) the pro rata portion of maintenance expenses attributable to such use.<sup>9</sup> The courts' interpretation of the applicable sections, however, differed from the position espoused by the IRS,<sup>10</sup> and as might be expected,

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1. Tax Reform Act of 1976, Pub. L. No. 94-455, § 601.90, Stat. 1520, 1569-72 (1976) (codified at I.R.C. § 280A (1982)).
  2. I.R.C. § 162(a) (1976) (current version at I.R.C. § 162(a) (1982)). Section 162(a) in essence allows a deduction for expenses paid or incurred in carrying on a trade or business, *see* I.R.C. § 162(a) (1982), but is now preempted with respect to the home office deduction by section 280A. *Id.* § 280A(a).
  3. I.R.C. § 167(a) (1976) (current version at I.R.C. § 167(a) (1982)). Section 167(a) allows a deduction for depreciation of property used in a trade or business, or held for the production of income, *see* I.R.C. § 167(a)(1)-(2) (1982), but is now preempted with respect to the home office deduction by section 280A. *Id.* § 280A(a).
  4. I.R.C. § 212(1) (1976) (current version at I.R.C. § 212(1) (1982)). Section 212(1) in pertinent part allows a deduction for expenses paid or incurred in the production or collection of income, *see* I.R.C. § 212(1) (1982), but is now preempted with respect to the home office deduction by section 280A. *Id.* § 280A(a).
  5. *See, e.g.,* *Newi v. Commissioner*, 432 F.2d 998 (2d Cir. 1970) ("ordinary and necessary" expenses of maintaining a home office deductible under section 162); *Hall v. United States*, 387 F. Supp. 612 (1975) (same); *Peiss v. Commissioner*, 40 T.C. 78 (1963) (same); *Wisconsin Psychiatric Servs., Ltd. v. Commissioner*, 76 T.C. 839 (1981) (depreciation deduction allowed under section 167 for portion of home used by taxpayer in his trade or business); *Aslam v. Commissioner*, 41 T.C.M. (CCH) 1217 (1981) (same); *Furmanski v. Commissioner*, 33 T.C.M. (CCH) 225 (1974) (same); *Imhoff v. Commissioner*, 39 T.C.M. (CCH) 978 (1980) (expenses incurred for the production of income deductible under section 212); *Scott v. Commissioner*, 31 T.C.M. (CCH) 439 (1972) (same); *Semel v. Commissioner*, 24 T.C.M. (CCH) 1176 (1965) (same).
  6. I.R.C. § 262 (1976) (current version at I.R.C. § 262 (1982)). Section 262 in pertinent part disallows any deduction for personal, living, or family expenses that are not otherwise expressly excepted, *see* I.R.C. § 262 (1982), but is now preempted with respect to the home office deduction by section 280A. *Id.* § 280A(a).
  7. *See, e.g.,* *Sharon v. Commissioner*, 591 F.2d 1273 (9th Cir. 1978) (personal expenses incurred in maintaining a home office not deductible under section 262); *Bodzin v. Commissioner*, 509 F.2d 679 (4th Cir. 1970), *cert. denied*, 423 U.S. 825 (1975) (same); *Meehan v. Commissioner*, 66 T.C. 794 (1976) (same).
  8. Rev. Rul. 62-180, 1962-2 C.B. 52.
  9. *Id.* at 52-53.
  10. *Compare* Rev. Rul. 62-180, 1962-2 C.B. 52 (providing a strict five-part test), *with*

a flood of litigation followed.

The most significant interpretation of the statutory "ordinary and necessary" requirement came in *Newi v. Commissioner*,<sup>11</sup> a 1970 decision in which the Second Circuit interpreted "ordinary and necessary" as requiring that the expense merely be "appropriate and helpful."<sup>12</sup> The Service argued that an employee was not eligible for a home office deduction unless maintenance of the home office was a "condition of his employment."<sup>13</sup> The Second Circuit rejected the Service's position, and merely focused on the "appropriate and helpful" nature of the taxpayer's home office in the performance of his employment.<sup>14</sup>

In *Bodzin v. Commissioner*,<sup>15</sup> the tax court further liberalized the requirements for home office expense deductions. In *Bodzin*, the taxpayer worked as an attorney-adviser for the IRS. Although the IRS did not require its employees to work evenings or weekends, the taxpayer nonetheless worked two or three evenings a week, and three to five hours on weekends in his home office.<sup>16</sup> The tax court, with four judges dissenting, found the home office expenses "necessary" because they were "appropriate and helpful" in conducting the taxpayer's business.<sup>17</sup>

On appeal, the Fourth Circuit reversed the tax court's decision<sup>18</sup> and held that the rental of an apartment was a nondeductible personal

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*Newi v. Commissioner*, 432 F.2d 998 (2d Cir. 1970) (providing a liberal "appropriate and helpful" standard), *aff'g*, 28 T.C.M. (CCH) 686 (1969) and *Gino v. Commissioner*, 60 T.C. 304 (1973) (not requiring a strict adherence to the Revenue Ruling).

11. 432 F.2d 998 (2d Cir. 1970). The taxpayer, a salesman of television time for the American Broadcasting Company, spent three hours each evening in his home study reviewing his day's notes, studying various research materials, and viewing the television advertisements of his employer and their competitors. *Id.* at 999. Although the study was used exclusively for his occupational activities, the taxpayer was not required by his employer to maintain the home office and was provided with adequate office space that could be used during evening hours. *Id.* at 999-1000. The taxpayer, however, would have missed several programs if he were forced to travel back to his work office at the end of the day because of the traffic and congestion of New York City. *Id.*
12. *Id.*
13. *Id.*
14. *Id.* at 1000. The Commissioner expressed concern that the court's decision might open the door for a business deduction to any employee engaged in an activity at home that could be construed as helpful to his employer. The Second Circuit stated: "The Commissioner need have no such concern. This case opens the doors just long enough to enable this Taxpayer to pass through it into his cloistered study to pursue his business." *Id.*
15. 60 T.C. 820 (1973), *rev'd*, 509 F.2d 679 (4th Cir.), *cert. denied*, 423 U.S. 825 (1975).
16. *Id.* at 821-23.
17. *Id.* at 824-26. The court stated: "We have found . . . that the expenses at issue were directly related and pertained to his business — that of a Government attorney. It makes no difference that the petitioner was not required to maintain a home office, that he wanted merely to do a good job, and that he liked his work." *Id.* at 826.
18. *Bodzin v. Commissioner*, 509 F.2d 679 (4th Cir.), *rev'g* 60 T.C. 820 (1973), *cert. denied*, 423 U.S. 825 (1975).

expense under section 262. The appeals court found it unnecessary to consider the "appropriate and helpful" standard, but did suggest that if the taxpayer could show that his work office was "unavailable or unsuitable" for the activities carried on in his home office, he might then qualify for a deduction.<sup>19</sup> In *Sharon v. Commissioner*,<sup>20</sup> the tax court, faced with facts similar to *Bodzin*,<sup>21</sup> abandoned the "appropriate and helpful" test and adopted a liberal version of the Fourth Circuit's "unavailable or unsuitable" test.<sup>22</sup>

### B. The Enactment of Section 280A

In response to the uncertainties created by the conflicts between the various courts and the Service, Congress enacted section 280A.<sup>23</sup> The reports from both the House and Senate expressed displeasure with the results that courts had reached under the "appropriate and helpful" test, and emphasized that personal and family expenses would no longer be treated as "ordinary and necessary" business expenses, especially when those expenses did not result in an additional or incremental cost incurred through the business use of a home.<sup>24</sup> In enacting section 280A, Congress intended to provide definitive rules to replace the subjective "appropriate and helpful" test.<sup>25</sup>

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19. *Id.* at 681.

20. 66 T.C. 515 (1976), *aff'd per curiam*, 591 F.2d 1273 (9th Cir. 1978), *cert. denied*, 442 U.S. 941 (1979).

21. In both *Bodzin* and *Sharon*, the taxpayers were employed as attorneys by the Internal Revenue Service. Neither taxpayer was required to maintain a home office nor to work beyond regular hours. Similarly, both taxpayers were provided with work offices available at anytime. *Sharon v. Commissioner*, 66 T.C. 515, 517-18 (1976), *aff'd per curiam*, 591 F.2d 1273 (9th Cir. 1978), *cert. denied*, 442 U.S. 941 (1979); *Bodzin v. Commissioner*, 60 T.C. 821, 823 (1973), *rev'd*, 509 F.2d 679 (4th Cir.), *cert. denied*, 423 U.S. 825 (1978).

22. *Sharon*, 66 T.C. at 524. The tax court applied a balancing test for deductions, noting the precedence of section 262 over section 162. *Id.* For a detailed discussion of the history of the home office deduction before the enactment of section 280A, see Note, *The Deductibility of Home Office Expenses Under Section 280A: Personal Convenience vs. Business Necessity*, 36 TAX LAW. 1199, 1201-05 (1983).

23. See H.R. REP. NO. 658, 94th Cong., 1st Sess. 160 (1975), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 2897, 3053; S. REP. NO. 938, 94th Cong., 2d Sess. 147 (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439, 3579.

24. The reports expressed concern over the ability of taxpayers to convert nondeductible personal and family expenses into deductible business expenses simply because, under the facts of the particular case, it was "appropriate and helpful" to his trade or business to do a portion of his work at home. H.R. REP. NO. 658, 94th Cong., 1st Sess. 160 (1975), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 2897, 3054; S. REP. NO. 938, 94th Cong., 2d Sess. 147 (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439, 3579-80.

25. The House and Senate committees found that the "appropriate and helpful" test increased the inherent administrative problems because of the subjective nature of the test. H.R. REP. NO. 658, 94th Cong., 1st Sess. 160 (1975), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 2897, 3053; S. REP. NO. 938, 94th Cong., 2d Sess. 147 (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439, 3579.

The general rule of section 280A<sup>26</sup> provides that "no deduction . . . shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence."<sup>27</sup> The general rule, however, is inapplicable to the extent that the expense item is allocable to a portion of the dwelling unit<sup>28</sup> that is exclusively used on a regular basis:<sup>29</sup>

26. The text of section 280A provides in pertinent part:

§ 280A. Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.

(a) General Rule. — Except as otherwise provided in this section, in the case of a taxpayer who is an individual or an S corporation, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.

(b) Exception for interest, taxes, casualty losses, etc. — Subsection (a) shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity).

(c) Exceptions for certain business or rental use: limitation on deductions for such use. —

(1) Certain business use. — Subsection (a) shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis. —

(A) [as] the principal place of business for any trade or business of the taxpayer,

(B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or

(C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.

In the case of an employee, the preceding sentence shall apply only if the exclusive use referred to in the preceding sentence is for the convenience of his employer.

I.R.C. § 280A(a)-(c)(1) (1982).

27. *Id.* § 280A(a).

28. The proposed regulations for section 280A state that: "For purposes of . . . this section, the phrase 'a portion of the dwelling unit' refers to a room or other separately identifiable space; it is not necessary that the portion be marked off by a permanent partition." Proposed Treas. Reg. § 1.280A-2(g)(1) (proposed July 21, 1983).

The tax court found that a permanent partition was unnecessary, but that the absence of a partition was a factor for the court to weigh in determining whether there was in fact a separate area used exclusively and regularly for a business purpose. *Weightman v. Commissioner*, 42 T.C.M. (CCH) 104 (1981).

In *Gomez v. Commissioner*, 41 T.C.M. (CCH) 585 (1980), the taxpayer used furniture and furnishings in her living room for business purposes. The court, however, could find no specific portion of the room that was used exclusively for business and, therefore, denied the deduction. *Id.* *But see Weightman v. Commissioner*, 42 T.C.M. (CCH) 104 (1981) (court found taxpayer's testimony credible as to the existence of a specific portion of the room used exclusively for business purposes).

29. I.R.C. § 280A(c)(1) (1982); *see infra* notes 39-58 and accompanying text. The term "regular basis" is not defined in section 280A. The Congressional reports state that, "[e]xpenses attributable to incidental or occasional trade or business use . . . [are] not [to] be deductible." The reports, however, provide no further guidance. H.R. REP. NO. 658, 94th Cong., 1st Sess. 161 (1975), *reprinted in* 1976 U.S. CODE CONG.

(1) as the taxpayer's principal place of business,<sup>30</sup> or

(2) as a place which is used by patients, clients, or customers in meeting or dealing with the taxpayer.<sup>31</sup>

Moreover, if a separate structure, unattached to the taxpayer's home, is used exclusively and regularly by the taxpayer in connection with his trade or business, then a deduction will be allowed.<sup>32</sup> When an employee maintains a home office, a deduction is available only if the home office is for the "convenience of his employer."<sup>33</sup> Finally, section

& AD. NEWS 2897, 3055; S. REP. NO. 938, 94th Cong., 2d Sess. 148-49 (1976), reprinted in 1976 U.S. CODE CONG. & AD. NEWS 3439, 3581. Additionally, the IRS's proposed regulations posit a "facts and circumstances" test to determine "regular use." Proposed Treas. Reg. § 1.280A-2(h) (proposed Aug. 7, 1980). In 1981 the tax court ruled that occasional and irregular business use of a home office was insufficient. See *Jackson v. Commissioner*, 76 T.C. 696 (1981); see also *Borom v. Commissioner*, 41 T.C.M. (CCH) 179, 185 (1980) (intermittent use of home office does not satisfy "regular basis" requirement).

30. I.R.C. § 280A(c)(1)(A) (1982); see *infra* notes 59-113 and accompanying text. Section 280A permits deductions only to taxpayers carrying on a "trade or business." Thus, the Court of Appeals for the Federal Circuit in *Moller v. United States*, 721 F.2d 810 (Fed. Cir. 1983), held that home office expenses incurred by taxpayers for the "production of income" are not deductible. In *Moller*, the taxpayers spent 40 or more hours each week managing their large investment portfolio from their home office. The court found that the taxpayers were more interested in earning income through long-term appreciation and dividends, rather than from short-term profit on sales of securities. Therefore, they were not engaged in a "trade or business" and not eligible for home office deductions. *Id.* at 811-15; accord *Shaller v. Commissioner*, 49 T.C.M. (CCH) 10 (1984).

The tax court, in *Meiers v. Commissioner*, 49 T.C.M. (CCH) 136 (1984), stated in dictum that ownership and management activities are important attributes of a "trade or business." In *Meiers*, the taxpayers performed only limited accounting duties and did not engage in any managerial functions. Consequently, the court held that the taxpayers were not in a "trade or business," and thus not eligible for a home office deduction. *Id.*; see also *Gestrich v. Commissioner*, 74 T.C. 525 (1980), *aff'd*, 681 F.2d 805 (3d Cir. 1982); *Curphey v. Commissioner*, 73 T.C. 766 (1980).

31. I.R.C. § 280A(c)(1)(B) (1982); see *infra* notes 114-59 and accompanying text.
32. I.R.C. § 280A(c)(1)(C) (1982). A deduction will be allowed when a separate structure is used "exclusively" and "regularly" in connection with a taxpayer's trade or business. The subsection does not require that the separate structure be the taxpayer's "principal place of business" or that it be used as a place of business for "meeting or dealing." The exception may be less stringent because the cost of maintaining a separate structure that is used exclusively for business is usually substantial. The tax court has ruled that a garage attached to a house does not meet the requirements of section 280A(c)(1)(C). *Garvey v. Commissioner*, 43 T.C.M. (CCH) 1003 (1982); see also *Borom v. Commissioner*, 41 T.C.M. (CCH) 179 (1980) (holding that a carport attached to a house does not qualify as a "separate structure"). For a further discussion of the separate structure exception, see *Kulsrud, Recent Statutory and Judicial Developments Have Liberalized Home Office Deductions*, 56 J. TAX'N 344, 349 (1982).
33. I.R.C. § 280A(c)(1) (1982). Neither the statute nor the legislative history defines "convenience of [the] employer." The Congressional reports, however, do make it clear that the old "appropriate and helpful" test is no longer valid. H.R. REP. NO. 658, 94th Cong., 1st Sess. 160-61 (1975), reprinted in 1976 U.S. CODE CONG. & AD. NEWS 2897, 3053-55; S. REP. NO. 938, 94th Cong., 2d Sess. 147-48 (1976), reprinted in 1976 U.S. CODE CONG. & AD. NEWS 3439, 3579-80. For a discussion of the "convenience of [the] employer" test, see *Ward, Home Office Deductions: The*

280A sets a limit on the amount of expenses deductible in any taxable year.<sup>34</sup>

In *Curphey v. Commissioner*,<sup>35</sup> the IRS maintained that section 280A permitted only one "principal place of business" for each taxpayer. The tax court, however, ruled that a taxpayer could have more than one "principal place of business" if he had more than one trade or business.<sup>36</sup> The Service refused to acquiesce in the *Curphey* holding and steadfastly maintained that a taxpayer could have only one "principal place of business."<sup>37</sup>

Congress settled the dispute in 1981 by amending section 280A to allow a deduction if the taxpayer's residence is used "as the principal place of business of any trade or business of the taxpayer."<sup>38</sup> Congress has not, unfortunately, reacted to other problems regarding the interpretation of section 280A with the same speed and guidance.

For instance, the courts have not squarely considered whether incidental personal use of a home office will disqualify the taxpayer for a deduction under the "exclusive use" test. Furthermore, two tests have emerged for determining a taxpayer's "principal place of business." In addition, the tax court recently gave an expanded reading to "patients, clients, or customers" and has rejected its prior view of that clause. Lastly, the tax court has reversed its interpretation of "meeting or dealing" from a liberal stance to a more conservative one. Section 280A is in a state of flux and is in need of both judicial and legislative action.

### III. AREAS OF LITIGATION

#### A. "Exclusive Use"

Meeting the "exclusive use" test is a prerequisite for any home office deduction for it applies to all three of the exceptions enumerated in section 280A(c).<sup>39</sup> The term "exclusive use" implies a standard precluding even incidental personal use of the home office, and that implication is supported by the legislative history. Common sense, however, suggests that a minimal amount of personal use should not disqualify the taxpayer.

The Congressional reports posit a strict test, requiring that a taxpayer use a separate part of his residence "solely" for business to satisfy

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*Development and Current Status of Section 280A(c)(1)*, 13 CUM. L. REV. 195, 213-14 (1982).

34. I.R.C. § 280A(c)(5) (1982); see *infra* notes 186-210 and accompanying text.

35. 73 T.C. 766 (1980).

36. *Id.* at 775-76. The taxpayer worked full time as a dermatologist at a hospital and also owned six rental properties that he managed from his home. *Id.* at 767.

37. See Proposed Treas. Reg. § 1.280A-2(b)(2) (proposed Aug. 7, 1980); see also Private Letter Ruling 8030024, 179 I.R.S. LTR. RUL. (CCH) 8030024 (Apr. 28, 1980).

38. Black Lung Benefits Revenue Act of 1981, Pub. L. No. 97-119, § 113, 95 Stat. 1635, 1641-43 (1981) (emphasis added). The amendment was made retroactive to tax years after 1975. *Id.*

39. I.R.C. § 280A(c)(1) (1982).



the "exclusive use" test.<sup>40</sup> The reports set forth the following example: "[A] taxpayer who uses a den in his dwelling unit to write legal briefs, prepare tax returns, or engage in similar activities as well for personal purposes, will be denied a deduction . . . ."<sup>41</sup> Applying this example, the tax court, in *Weiner v. Commissioner*,<sup>42</sup> denied a deduction to a taxpayer when her home office was used for both business and pleasure.<sup>43</sup> Similarly, in *Chauls v. Commissioner*,<sup>44</sup> a high school music teacher who used half of his L-shaped living room primarily for rehearsals of the school's chorus and opera<sup>45</sup> failed to meet the "exclusive use" test because he held occasional parties in the entire living room area.<sup>46</sup> Not surprisingly, the Service has adopted the strict standard in its proposed regulations, seizing upon Congress's use of "solely" in the committee reports.<sup>47</sup>

To inject the term "solely" into the "exclusive use" test would defeat virtually all home office deductions because nearly all home offices are used for personal purposes from time to time. Just as business offices located outside of the home are often used for incidental personal purposes, such as making non-business telephone calls and writing personal letters, home offices are also unavoidably used for these same minimal personal purposes. It would be impractical and imprudent to disqualify deductions to taxpayers for such *de minimis* use<sup>48</sup> and would frustrate

40. H.R. REP. NO. 658, 94th Cong., 1st Sess. 161 (1975), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 2897, 3054; S. REP. NO. 938, 94th Cong., 2d Sess. 148 (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439, 3581.

41. H.R. REP. NO. 658, 94th Cong., 1st Sess. 161 (1975), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 2897, 3054-55, S. REP. NO. 938, 94th Cong., 2d Sess. 148 (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439, 3581.

42. 40 T.C.M. (CCH) 977 (1980).

43. *Id.* at 978. The taxpayer used a room in her apartment for both personal purposes and to search for employment as an actress, hostess, demonstrator, or model. *Id.* at 977-78. The petitioner initially testified that her use of the room was exclusively for business but later admitted that the room was also used for personal purposes. *Id.* at 978.

44. 41 T.C.M. (CCH) 234 (1980).

45. *Id.* at 235. The business portion of the room contained a grand piano, bench, chair, and stereo receiver. *Id.*

46. *Id.* at 235-36. The tax court determined that the taxpayer's home office was neither his "principal place of business," nor a place to meet or deal with patients, clients, or customers. In dictum, the *Chauls* court concluded that the taxpayer did not meet the "exclusive use" test. *Id.*

Under similar circumstances, the tax court denied a deduction when the taxpayer used a room as his office and as his bedroom because the taxpayer failed to show that the room was used "exclusively" for business purposes. *Odom v. Commissioner*, 44 T.C.M. (CCH) 1132 (1982).

47. Proposed Treas. Reg. § 1.280A-2(g)(1) (proposed July 21, 1983). The proposed regulations require that there be "no use" of the home office "at any time" for nonbusiness purposes. *Id.*

48. See Lang, *When a House is Not Entirely a Home: Deductions Under Internal Revenue Code § 280A for Home Offices, Vacation Homes, etc.*, 25 UTAH L. REV. 275, 290-91 (1981); Note, *The Home Office Deduction*, 25 ST. LOUIS U.L.J. 607, 613 (1981).

the Congressional goal of providing home office deductions to deserving taxpayers.<sup>49</sup>

Notwithstanding Congress's use of "solely," and the burden of proof placed on the taxpayer, the "exclusive use" test has proven to be a difficult issue for the Service to prevail on when the home office is in a separate room. In *Green v. Commissioner*,<sup>50</sup> the IRS contested the taxpayer's home office deduction claiming that the taxpayer failed to satisfy the "exclusive use" test.<sup>51</sup> The taxpayer testified that he had converted a bedroom into an office and used the telephone in that room strictly for business. The Service was unable to produce evidence of personal use by the taxpayer and on cross-examination did not undermine his credibility. On these facts, the tax court concluded that the taxpayer had met his burden of proof.<sup>52</sup> It therefore seems difficult for the IRS to rebut a taxpayer's testimony by merely contending that the room was not exclusively used.<sup>53</sup>

Although section 280A requires that the home office be used exclusively for business purposes, a deduction will be allowed even if the home office is used in part for a non-qualified business purpose. In *Frankel v. Commissioner*,<sup>54</sup> the tax court was presented with a situation where both the husband and wife used the same room for business purposes. Even though the husband used the room exclusively and regularly in connection with his occupation, he met neither the "principal place of business" nor the "meeting or dealing" exception of section 280A. Thus, the husband's use did not qualify for a home office deduction.<sup>55</sup> The wife's use, however, did meet all the requirements of section 280A.<sup>56</sup> The *Frankel*

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49. See *supra* note 24 and accompanying text.

50. 78 T.C. 428, *rev'd on other grounds*, 707 F.2d 404 (9th Cir. 1983).

51. *Id.* at 432. The IRS also claimed that the taxpayer's converted bedroom was neither his "principal place of business" nor regularly used as a place of business to meet or deal with patients, clients, or customers. *Id.*

52. *Id.* Regarding the burden of proof in tax cases, the law is well settled that deductions are a matter of legislative grace and that a taxpayer seeking a deduction must prove that he satisfies the terms of the applicable statute allowing such deduction. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934). The Service's determinations in the notice of deficiency are presumed to be correct and the taxpayer bears the burden of proving any error in such determination. *Welch v. Helvering*, 290 U.S. 111, 115 (1933); TAX CT. R. PRAC. & PROC. 142(a). For a discussion on meeting this burden of proof, see *infra* notes 173-85 and accompanying text.

53. See *Thalacker v. Commissioner*, 48 T.C.M. (CCH) 1104 (1984) (court found there was "exclusive use" based solely on taxpayer's credible testimony); *Weightman v. Commissioner*, 42 T.C.M. (CCH) 104 (1981) (same). *But see Andrews v. Commissioner*, 41 T.C.M. (CCH) 1533 (1981) (exclusive use not shown). See generally Note, *The Home Office Deduction*, 25 ST. LOUIS U.L.J. 607, 613-15 (1981) (Commissioner often concedes "exclusive use" and attacks the home office deduction on other grounds).

54. 82 T.C. 318 (1984).

55. *Id.* at 329.

56. *Id.* at 319-22. Mrs. Frankel was involved in preparing a report for the U.S. Comptroller of the Currency that required both researching and interviewing. *Id.* at 322. She used the home office to store her notes and to write the report. Mrs. Frankel's fee was based on the Comptroller's estimate that the study would take only 35 days.

court held it unnecessary to allocate the home office expenses between Mr. and Mrs. Frankel, and granted the taxpayers the full home office deduction.<sup>57</sup>

The holding in *Frankel* comports with the language in section 1.280A-2(g)(1) of the proposed Treasury Regulations, which states that to qualify for a deduction there must be no use of the portion of the dwelling unit at any time during the year other than for business purposes.<sup>58</sup> The Regulation does not require that there be only one business use, it requires only that there be no personal use. The Frankels satisfied this requirement because Mr. Frankel's use, though not qualifying under section 280A, was nevertheless for business purposes.

In sum, a room used as a home office may be put to many different business purposes and still qualify for a deduction under section 280A. When the room, however, is also used by the taxpayer as extra space for a party, a place to watch television, or for other personal matters, the taxpayer risks the loss of the entire deduction.

### B. "Principal Place of Business"

Perhaps no other area involving section 280A creates more litigation than the "principal place of business" exception. The controversy narrows to a factual determination of where the taxpayer's "principal place of business" is located. The taxpayer attempts to prove that his "principal place of business" is in his home, while the Service attempts to prove that it is elsewhere. The tax court has applied a stringent "focal point" test, which turns on where the taxpayer's goods or services are exchanged.<sup>59</sup> This test follows the legislative intent of section 280A and, as such, has frustrated most taxpayer claims.<sup>60</sup> Recently, however, the Second Circuit has developed a "time and importance" test, which analyzes the amount of time consumed by the activity and the activity's importance to the taxpayer's occupation.<sup>61</sup> This test has provided unwarranted deductions to taxpayers and is essentially a step backward toward the "appropriate and helpful" test. The Second Circuit has overruled the tax court twice in reaching its results<sup>62</sup> and the possibility of reconciliation

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Mrs. Frankel, however, worked full time on the project from the end of January to the beginning of March and part time thereafter until late November making revisions and incorporating new material. *Id.*

57. *Id.* at 323-30.

58. Proposed Treas. Reg. § 1.280A-2(g)(1) (proposed July 21, 1983).

59. See *Baie v. Commissioner*, 74 T.C. 105, 109 (1980); *Aab v. Commissioner*, 42 T.C.M. (CCH) 1519, 1521 (1981); see also *Drucker v. Commissioner*, 79 T.C. 605, 616, 623 (1982) (Wilbur, J., dissenting), *rev'd*, 715 F.2d 67 (2d Cir. 1983).

60. See, e.g., *Jackson v. Commissioner*, 76 T.C. 696 (1981); *Baie v. Commissioner*, 74 T.C. 105 (1980).

61. See *Weissman v. Commissioner*, 751 F.2d 512, 514 (2d Cir. 1984); *Drucker v. Commissioner*, 715 F.2d 67, 69 (2d Cir. 1983).

62. See *Weissman v. Commissioner*, 751 F.2d 512 (2d Cir. 1984), *rev'g* 47 T.C.M. (CCH) 520 (1983); *Drucker v. Commissioner*, 715 F.2d 67 (2d Cir. 1983), *rev'g* 79 T.C. 605 (1982).

between the two courts is unlikely. A clarification by the Supreme Court of the appropriate test would be helpful.

The "focal point" test originated in *Baie v. Commissioner*,<sup>63</sup> a 1980 case before the tax court. In *Baie*, the taxpayer operated a hot dog stand about one mile from her home. As a result of limited space, the taxpayer prepared the food for the stand in her home kitchen. In addition, the taxpayer used a second bedroom in her home to maintain the stand's records and other paperwork.<sup>64</sup> The tax court stated that "[n]othing in the legislative history of section 280A or the Commissioner's regulations furnishes any guidance as to the scope of the 'principal place of business' concept in the context of section 280A."<sup>65</sup> The court, therefore, found it necessary to provide guidance and concluded that the "focal point" of the business activities determines the taxpayer's "principal place of business."<sup>66</sup> Applying its new test, the *Baie* court found that the taxpayer did not meet the "principal place of business" exception.<sup>67</sup> Although the tax court recognized that Mrs. Baie's preliminary preparation at home was beneficial to the operation of the business, because the final packaging and sales occurred at the stand, the *Baie* court held that the taxpayer's "principal place of business" was the stand and not her home.<sup>68</sup>

After *Baie*, the tax court applied the "focal point" test to numerous factual situations.<sup>69</sup> In each case the "principal place of business" determination turned on where the goods or services were exchanged.<sup>70</sup> Under this maxim, because a teacher is paid to teach at school, the school is the teacher's "principal place of business."<sup>71</sup> Similarly, a nurse's "principal place of business" is the hospital,<sup>72</sup> and a judge's is the court room.<sup>73</sup> Because the tax court considers the amount of time spent at each location

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63. 74 T.C. 105 (1980).

64. *Id.* at 106.

65. *Id.* at 109.

66. *Id.*

67. *Id.* at 109-10.

68. *Id.*

69. *See, e.g.*, *Jackson v. Commissioner*, 76 T.C. 696 (1981) (real estate agent with home office and office at broker's place of business denied a deduction); *Trussell v. Commissioner*, 45 T.C.M. (CCH) 190 (1982) (judge with home office and chambers at court denied a deduction); *Weightman v. Commissioner*, 42 T.C.M. (CCH) 104 (1981) (college professor with office at home and at school denied a deduction).

70. *See Baie v. Commissioner*, 74 T.C. 105, 109 (1980); *Aab v. Commissioner*, 42 T.C.M. (CCH) 1519, 1521 (1981); *see also Drucker v. Commissioner*, 79 T.C. 605, 616, 623 (1982) (Wilbur, J., dissenting), *rev'd*, 715 F.2d 67 (2d Cir. 1983).

71. *See, e.g.*, *Moskovit v. Commissioner*, 44 T.C.M. (CCH) 859 (1982), *aff'd by unpublished order*, (10th Cir. Oct. 19, 1983); *Besch v. Commissioner*, 43 T.C.M. (CCH) 286 (1982), *aff'd by unpublished order*, (7th Cir. Sept. 20, 1983); *Warganz v. Commissioner*, 42 T.C.M. (CCH) 568 (1981), *aff'd by unpublished order*, (3d Cir. Oct. 15, 1982); *Cousino v. Commissioner*, 41 T.C.M. (CCH) 722 (1981), *aff'd*, 679 F.2d 604 (6th Cir.), *cert. denied*, 459 U.S. 1038 (1982). *But cf.* *Weissman v. Commissioner*, 751 F.2d 512 (2d Cir. 1984) (under Second Circuit's "time and importance" test, a professor's home office may be his "principal place of business").

72. *Lopkoff v. Commissioner*, 45 T.C.M. (CCH) 256, 258 (1982).

73. *Trussell v. Commissioner*, 45 T.C.M. (CCH) 190, 191-92 (1982).

to be only one factor,<sup>74</sup> these conclusions hold true even when the taxpayer works a substantially greater percentage of time in a home office. Although the results reached by the tax court under the "focal point" test perhaps have denied deductions to some deserving taxpayers,<sup>75</sup> the results are predictable and further the Congressional intent of limiting home office deductions.

In 1983, however, the Second Circuit reversed the tax court's application of the "focal point" test in *Drucker v. Commissioner*<sup>76</sup> and created a new standard. Ernest Drucker was a concert violinist for the Metropolitan Opera Association (Met).<sup>77</sup> The tax court noted that Drucker was compensated by the Met for attending rehearsals and performing in concerts,<sup>78</sup> and that "[a]s a professional musician, petitioner was required to practice numerous hours in order to maintain, refine and perfect his skill."<sup>79</sup> Although as a practical matter, private practice was necessary for Drucker to carry on his duties, such off-premise practice was not required by his employer. The Met, however, did not provide private studios for the necessary solo practice and, consequently, Drucker used one room in his apartment exclusively as a private studio thirty hours a week.<sup>80</sup>

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74. See *Drucker v. Commissioner*, 79 T.C. 605, 612 (1982), *rev'd*, 715 F.2d 67 (2d Cir. 1983); *Green v. Commissioner*, 78 T.C. 428, 433 (1982); *Jackson v. Commissioner*, 76 T.C. 696, 700 (1981).

75. See, e.g., *Frankel v. Commissioner*, 82 T.C. 318 (1984); *Drucker v. Commissioner*, 79 T.C. 605 (1982), *rev'd*, 715 F.2d 67 (2d Cir. 1983); *Baie v. Commissioner*, 74 T.C. 105 (1980).

76. 715 F.2d 67 (2d Cir. 1983), *rev'g* 79 T.C. 605 (1982). The Second Circuit *Drucker* decision consolidated the claims of three professional musicians. *Id.* at 68. The tax court denied Drucker's claim and on that authority disposed of the other two claims by memorandum. See *Cherry v. Commissioner*, 44 T.C.M. (CCH) 1316 (1982); *Rogers v. Commissioner*, 44 T.C.M. (CCH) 1312 (1982). Because the Second Circuit opinion focuses on the Drucker appeal, this comment will only discuss the facts regarding Ernest Drucker [hereinafter referred to as "taxpayer" or "Drucker"].

77. *Drucker*, 79 T.C. at 606.

78. *Id.* Drucker was compensated by the Met for the following activities:

- (1) 3 pre-season rehearsal weeks of 27 1/2 hours per week;
- (2) 27 regular-season weeks of 26 hours per week;
- (3) 7 tour weeks of 15 hours per week;
- (4) 2 weeks of park performances;
- (5) 5 vacation weeks; and
- (6) 5 supplemental unemployment weeks.

*Id.*

All rehearsals and regular-season performances were conducted at the Lincoln Center in New York City. During his vacation, Drucker performed with the Chautauqua Institution for 49 days and was compensated for those performances by the Chautauqua Institution. *Id.* at 606-07.

79. *Id.* at 607. The tax court stated that, "[p]etitioners' parts have to be perfected prior to a rehearsal or performance, since every error can be detected by his colleagues and his conductor. An error can distract other members of the orchestra, and has the potential to disrupt the entire orchestra." *Id.* at 608.

80. *Id.* at 608-09. Drucker's individual practice consisted of reviewing and rehearsing the current and upcoming productions, particularly difficult technical passages. *Id.* at 607-08.

The nature of the taxpayer's business, the activities it involved, and the locations where the Met performed were considered by the tax court in determining the "principal place of business." The tax court, in a seven to six decision, concluded that the taxpayer was in the "business of being an employee."<sup>81</sup> Thus, the activities of the petitioner were viewed from both the employee's and the employer's viewpoint. The tax court stressed that the taxpayer's employer required him to attend group rehearsals and performances, but did not require him to practice alone. Although Drucker may have spent more time at his home studio than at any performance site, the tax court concluded that performing was by far the most important business activity, for without performances the Met could not exist.<sup>82</sup>

The tax court's majority recognized that there are exceptions to the rule that an employee's "principal place of business" is at his employer's office. Specifically, the majority noted that the "focal point" for an artist may be his studio where he spends hours creating his work and not the gallery where his finished work is shown.<sup>83</sup> The majority distinguished a musician from an artist in two ways. First, an artist need not be present at the gallery during an exhibit, whereas a musician must be at the theater to present his final product. Second, admirers of art rarely watch an artist paint, while music lovers attend a performance specifically to watch and to hear a musician play.<sup>84</sup>

The dissenting opinion criticized the majority holding and stated that the distinction made between artists and musicians was without merit.<sup>85</sup> Judge Wilbur, writing for the dissent, explained that an author or lecturer is not paid simply for the end product, but is instead paid for all the work leading up to that product. Similarly, a musician is "not simply compensated for the final moments of the long hours he worked everyday; he [is] compensated for the time he [works] in maintaining, refining, and perfecting his professional skills on a year-round basis, as well as for exhibiting those skills."<sup>86</sup>

The Second Circuit reversed the tax court,<sup>87</sup> noting that employment as a professional musician was "a strange way to make a living" and that the tax court failed to grasp that reality.<sup>88</sup> The appellate court found that home practice was a "condition of employment," and that the tax court was clearly erroneous when it found that private practice was a necessity but not a "condition of employment."<sup>89</sup> The Second Circuit

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81. *Id.* at 612. The court found that the taxpayer was not in a separate trade or business of being a professional musician. *Id.* at 612-13.

82. *Id.* at 613-14.

83. *Id.* at 613.

84. *Id.*

85. *Id.* at 623 & n.8 (Wilbur, J., dissenting).

86. *Id.* at 623 (Wilbur, J., dissenting).

87. *Drucker v. Commissioner*, 715 F.2d 67 (2d Cir. 1983), *rev'g* 79 T.C. 605 (1982).

88. *Id.* at 69.

89. *Id.*

stated that it did not have to upset the tax court finding that Drucker was in the business of being an employee, but added that this was the "rare situation in which an employee's principal place of business is not that of his employer."<sup>90</sup> Both in time and importance, the court held that the home studio was Drucker's "principal place of business." According to the Second Circuit, the place of performance was irrelevant as long as the musicians were prepared, and preparation resulted from solo practice in the home.<sup>91</sup>

The Second Circuit reviewed the legislative history of section 280A, focusing on the prior abuses of taxpayers in claiming personal living expenses as "ordinary and necessary" business expenses, and concluded that the law was not enacted to deny deductions to taxpayers like Drucker. Although Drucker had no work office, he was still required to practice privately, and was thus forced to allocate and maintain extra residential space that resulted in additional expenses distinct from his nondeductible personal living expenses.<sup>92</sup>

The Service announced its non-acquiescence in the Second Circuit ruling<sup>93</sup> and maintained that in determining a taxpayer's "principal place of business," the controlling criterion is not the number of hours spent at each location, but is instead how much "business" or other activity with income generating potential is performed at each location. The essence of the Service's position with respect to *Drucker* is that because the taxpayer was paid for performing, and not for practicing, his income-producing activity took place at the Met concerts and not at his home studio. Hence, the "focal point" of his activities was wherever the Met performed. The Service went on to criticize the Second Circuit for adopting a standard similar to the old "appropriate and helpful" standard rejected by Congress in enacting section 280A. Because of the unique factual situation involved, however, the Service has decided not to petition for a writ of certiorari to the Supreme Court.<sup>94</sup>

Following the *Drucker* decision, the tax court continued to apply its strict "focal point" test.<sup>95</sup> Relying on the *Drucker* rationale, instructors who spent more time working in their home office than in their school sought to claim deductions.<sup>96</sup> But in each case, the tax court found for

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90. *Id.*

91. *Id.* The *Drucker* court found that the taxpayer spent less than half of his time performing at the Lincoln Center for the Met and that those performances were made possible only through home practice. *Id.*

92. *Id.* at 69-70. The taxpayer's use of his home office was found to be a business necessity rather than a personal convenience. As such, the home office was maintained for the "convenience of his employer." *Id.* at 70.

93. See Action on Decision, *Drucker v. Commissioner* (Dec. 8, 1983) (available April 25, 1985, on Westlaw, Genfed library, Tax file).

94. *Id.*

95. *Meiers v. Commissioner*, 49 T.C.M. (CCH) 136 (1984); *Bradfield v. Commissioner*, 48 T.C.M. (CCH) 1071 (1984).

96. *Weissman v. Commissioner*, 47 T.C.M. (CCH) 520 (1983), *rev'd*, 751 F.2d 512 (1984); *Sternberg v. Commissioner*, 48 T.C.M. (CCH) 965 (1984).

the Commissioner and stated that the *Drucker* decision applied to very limited circumstances and not to teachers.<sup>97</sup> The Second Circuit, however, disagreed.<sup>98</sup>

In *Weissman v. Commissioner*,<sup>99</sup> the taxpayer was an associate professor of philosophy at City College of the City University of New York. Aside from teaching, meeting with students, and grading exams, Weissman "was required to do an unspecified amount of research and writing in his field in order to retain his teaching position."<sup>100</sup> The college provided Weissman with an office on campus but he was required to share it with several other professors and the office did not contain a typewriter. Moreover, the office was not a safe place to leave his materials or equipment. Weissman was allowed to use the school library, but it did not provide him with any reserved space for his research materials or for the use of his typewriter; hence, the petitioner set up a home office in his apartment. He spent eighty percent of his working hours researching and writing in his home office and twenty percent performing teaching functions at his campus office.<sup>101</sup>

The Second Circuit found that the tax court's "focal point" test may be helpful in many cases, but was inadequate when dealing with a taxpayer whose occupation involves two very different activities; for example, practice and performance as in *Drucker*, or writing and teaching as in *Weissman*.<sup>102</sup> The appeals court observed that the "focal point" of a professor's activities is normally the college where he teaches but that each case should be examined on its own facts.<sup>103</sup>

The *Weissman* court, following *Drucker*, reiterated its "time and importance" test for determining a taxpayer's "principal place of business." Interpreting its *Drucker* decision, the court analyzed the "importance" prong by using three factors: (1) the nature of the business activity; (2) the characteristics of the space in which such activity can be conducted; and (3) the practical need to use a home office.<sup>104</sup> Against this backdrop, the court then looks at the key issue: where is the dominant portion of the taxpayer's work performed?<sup>105</sup>

Applying this test, the *Weissman* court found that the taxpayer's business activities consisted of both teaching at school and researching and writing at home. The court noted that researching and writing re-

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97. *Weissman*, 47 T.C.M. (CCH) at 522-23; *Sternberg*, 48 T.C.M. (CCH) at 967.

98. *Weissman v. Commissioner*, 751 F.2d 512 (2d Cir. 1984), *rev'g* 47 T.C.M. (CCH) 520 (1983).

99. 751 F.2d 512 (2d Cir. 1984).

100. *Id.* at 513 (quoting *Weissman v. Commissioner*, 47 T.C.M. (CCH) 520, 521 (1983)).

101. *Weissman*, 751 F.2d at 513.

102. *Id.* at 514.

103. *Id.* at 516.

104. *Id.* at 514-15. The court noted that the test was very similar to the test set forth in proposed regulation § 1.280A-2(b)(3) (proposed July 21, 1983). *Id.* at 515 n.5.

105. *Id.* at 515-16.



quires "a place to read, think, and write without interruption . . . ."106 The space provided by the college did not satisfy these needs because of the lack of privacy and unsafe conditions. Thus, the use of a home office was essential. The court then found that Weissman's home office was the site of the great majority of his work and, therefore, concluded that it was his "principal place of business."<sup>107</sup>

Judge Kelleher, dissenting in *Weissman*,<sup>108</sup> predicted that the court would face a barrage of home office deduction cases and that the majority opinion "opens the doors to an endless array of Section 280A cases; to all sorts of 'creative' deductions of home office expenses."<sup>109</sup> Researching and writing, according to the dissent, were only incidental to the petitioner's primary employment function of teaching.<sup>110</sup>

Congress's two objectives when enacting section 280A were to deny business deductions of personal expenses and to provide an objective, easily applied standard.<sup>111</sup> The Second Circuit held in both *Drucker* and *Weissman* that the home office expenses were deductible under section 280A. In both cases, the Second Circuit reasoned that the expenses would not have been incurred but for the taxpayers' occupations, and as such, the expenses were for business purposes.<sup>112</sup>

A factual comparison of *Drucker* and *Weissman* demonstrates that the Second Circuit's reasoning in *Drucker* is persuasive, while the court's analysis in *Weissman* is suspect. As noted by the court, *Drucker*'s use of his home office for solo practice was essential to his occupation as a professional musician. Concededly, as part of Weissman's duties as a university professor, he was required to publish articles. Nonetheless, this function was secondary to his primary responsibility of teaching. More-

106. *Id.* at 515.

107. *Id.* at 515-16.

108. The dissenting opinion, in the two to one decision, was written by Judge Kelleher of the United States District Court for the Central District of California who was sitting by designation. *Id.* at 517-21 (Kelleher, J., dissenting).

109. *Id.* at 519 (Kelleher, J., dissenting). It is interesting that this same "floodgates" warning was given to the Second Circuit 15 years ago when it allowed a home office deduction in *Newi v. Commissioner*, 432 F.2d 998, 1000 (2d Cir. 1970). See *supra* note 14. The *Newi* case eventually prompted the enactment of section 280A. See H.R. REP. NO. 658, 94th Cong., 1st Sess. 157-58, 160 (1975), reprinted in 1976 U.S. CODE CONG. & AD. NEWS 2897, 3051, 3053-54; S. REP. NO. 938, 94th Cong., 2d Sess. 145, 147 (1976), reprinted in 1976 U.S. CODE CONG. & AD. NEWS 3439, 3577, 3579-80.

110. *Weissman*, 751 F.2d at 517 (Kelleher, J., dissenting). Following Judge Kelleher's lead, it is likely that the Commissioner will express his non-acquiescence in the *Weissman* decision and will again chastise the Second Circuit for returning to the "appropriate and helpful" standard.

111. H.R. REP. NO. 658, 94th Cong., 1st Sess. 160 (1975), reprinted in 1976 U.S. CODE CONG. & AD. NEWS 2897, 3053-54; S. REP. NO. 938, 94th Cong., 2d Sess. 147 (1976), reprinted in 1976 U.S. CODE CONG. & AD. NEWS 3439, 3579-80; see *supra* notes 24-25 and accompanying text; see also *Drucker v. Commissioner*, 79 T.C. 606, 611-12 (1982), *rev'd*, 715 F.2d 67 (2d Cir. 1983).

112. *Weissman v. Commissioner*, 751 F.2d 512, 516 (2d Cir. 1984); *Drucker v. Commissioner*, 715 F.2d 67, 70 (2d Cir. 1983).

over, Drucker, as a musician, could only practice in a private, quiet room, and his employer failed to provide such a room. In contrast, Weissman's researching and writing could be accomplished in a room that was not private and not quiet. Moreover, Weissman's employer provided him with a semi-private office and the use of the school library. Thus, *Weissman* is factually distinguished from *Drucker*, and therefore application of the *Drucker* rule to the *Weissman* case is inappropriate.

The *Drucker* test, refined in *Weissman*, does very little to promote Congress's second goal of objectivity and ease of administration. Although this test appears fair and simple, in that it looks to the number of working hours spent at each location, problems are inherent in its application. For instance, the determination of a taxpayer's "principal place of business" imposes difficult evidentiary burdens on the IRS and, consequently, the Service is hard pressed to rebut a taxpayer's assertion.<sup>113</sup> Furthermore, determining which activities are "work-related" is subjective and open to various interpretations, which in turn, lead to increased litigation. In sum, the Second Circuit's test cultivates neither of Congress's aims.

The "focal point" test set forth by the tax court, though not perfect, is nonetheless a better measure of the legislative intent of section 280A. First, the test furthers Congress's intent of preventing personal expenses from being transformed into deductible business expenses. Because the test invariably holds that an employee's "principal place of business" is his employer's office, only taxpayers who operate a business from their home will qualify under the "principal place of business" exception. Accordingly, the opportunity for a taxpayer to deduct his personal expenses under section 280A is necessarily diminished. Second, because determining where a taxpayer's goods or services are exchanged is straightforward, the "focal point" test promotes Congress's goal of providing an objective and easily administered standard. In sum, although the "focal point" test denied Drucker a deduction when apparently he deserved one, that result is the cost of a "bright line," workable standard.

### C. "Used by Patients, Clients, or Customers in Meeting or Dealing"

The second exception to the general disallowance of home office deductions is for the use of a residence as a place to meet or deal with patients, clients, or customers. There is no legislative history dealing with the language and recent court decisions have been inconsistent in the interpretation of the section. Consequently, taxpayers are left with little guidance.

The phrase "patients, clients, or customers" apparently was aimed at professionals such as doctors, accountants, insurance salesmen, and

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113. See *supra* notes 50-53 and accompanying text.

the like.<sup>114</sup> Accordingly, if this type of professional uses a room in his home exclusively and regularly to meet with his "patients, clients, or customers," then presumably a deduction will be allowed.

A problem arises, however, for other professionals and for non-professionals. In *Chauls v. Commissioner*,<sup>115</sup> the taxpayer was a college music instructor who used a portion of his home to meet with members of the college opera and choir for rehearsal. The teacher argued that the students should be considered his "customers," or at least "customers" of the college because they paid tuition to the college. The tax court found that under the ordinary definition of "patients, clients, or customers" the students of the college could not be considered "customers" of either the petitioner or the college.<sup>116</sup> In like fashion, the Service stated in a letter ruling that a politician's constituents were not included within the statutory phrase.<sup>117</sup> The Service relied on the exclusionary nature of section 280A and concluded that exceptions should be narrowly construed.<sup>118</sup>

In 1982, the tax court expanded the application of "patients, clients, or customers" in *Green v. Commissioner*.<sup>119</sup> The taxpayer in *Green* was an employee who was required to be available at night to receive phone calls from his employer's clients.<sup>120</sup> The tax court found that the "patients, clients, or customers" exception was not limited to professional persons, and cited the "convenience of [the] employer" requirement as indicia of Congress's intent that an employee may qualify.<sup>121</sup> The tax court determined that the petitioner qualified under the exception by receiving phone calls from his employer's clients,<sup>122</sup> thus intimating that an employer's "clients" are his employee's "clients" for purposes of section 280A.

Two years later the tax court made its position clear in *Frankel v. Commissioner*.<sup>123</sup> The petitioner, an editor of the New York Times, used his home office to speak with elected officials, public figures, and employees of the New York Times.<sup>124</sup> The Commissioner argued that as an

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114. See *Green v. Commissioner*, 78 T.C. 428, 434 (1982), *rev'd on other grounds*, 707 F.2d 404 (9th Cir. 1983).

115. 41 T.C.M. (CCH) 234 (1980).

116. *Id.* at 236.

117. See Private Letter Ruling 8048014, 197 IRS LTR. RUL. (CCH) 8048014 (Aug. 26, 1980).

118. *Id.*

119. 78 T.C. 428 (1982), *rev'd on other grounds*, 707 F.2d 404 (9th Cir. 1983); see *infra* notes 131-34 and accompanying text.

120. *Green*, 78 T.C. at 430. The taxpayer was an account executive responsible for administrative and physical management of seven condominiums. *Id.*; see also *infra* notes 131-34 and accompanying text.

121. *Green*, 78 T.C. at 434.

122. *Id.* at 436.

123. 82 T.C. 318 (1984).

124. *Id.* at 321. Almost every night Mr. Frankel spoke by telephone from his home office with other employees of the Times on work related matters. He also spoke by telephone with "prominent politicians at the national, State, and local levels, labor lead-

employee of the newspaper, the employee's clients or customers were only the readers and subscribers of the newspaper. The tax court found this view "unnecessarily restrictive" and cited *Green* as authority.<sup>125</sup> Further, the *Frankel* court decided that the "patients, clients, or customers" exception should not be narrowly limited to self-employed professionals, but rather should "be construed to include the types of people (exclusive, perhaps, of other employees) with whom employees customarily deal in the ordinary course of their employers' trades or businesses."<sup>126</sup> Therefore, the tax court's holding in *Frankel* allows an employee to qualify for a home office deduction when the employee uses a home office to deal with his employer's "patients, clients, or customers."

Further ambiguity in the "used by patients, clients, or customers in meeting or dealing" exception involves the interpretation of "meeting or dealing." Originally, the tax court, in *Green v. Commissioner*,<sup>127</sup> declared that client-initiated telephone calls to the taxpayer's home office constituted a "meeting or dealing."<sup>128</sup> The Ninth Circuit, however, reversed the tax court's decision in *Green*, and held that the exception applied "only to home offices visited by the taxpayer's clients."<sup>129</sup> At the tax court's next opportunity, it adopted the Ninth Circuit's view.<sup>130</sup>

In *Green*, the taxpayer was an account executive responsible for managing seven condominiums for a real estate development company.<sup>131</sup> His duties included supervising the resident managers and working with each building's board of directors. *Green* could not be reached during much of the workday and as a result he was required to be available after work hours to receive phone calls from managers and board members.<sup>132</sup> The tax court, with seven judges dissenting, held that there was no legislative mandate requiring in-person contact.<sup>133</sup> Moreover, in its analysis of the statutory language the tax court opined that if the term "meeting" means "in person" contact, then "dealing" must mean something different, lest the term be mere surplusage.<sup>134</sup>

The Ninth Circuit, however, looked to the "plain language" of sec-

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ers, and other leaders of the community." Such individuals called to discuss their views and insure that the Times was aware of their positions. *Id.* Mr. Frankel averaged one such phone call per night. *Id.* at 325.

125. *Id.* at 324. The court also stated that "elected officials and public figures would eminently qualify as 'readers and subscribers' of the Times." *Id.*

126. *Id.* at 324-25. The tax court noted that the Commissioner had issued no regulations and that nothing in the legislative history of section 280A suggested a contrary result. *Id.* at 325.

127. 78 T.C. 428 (1982), *rev'd*, 707 F.2d 404 (9th Cir. 1983).

128. *Id.* at 434-36.

129. *Green v. Commissioner*, 707 F.2d 404, 407 (9th Cir. 1983), *rev'g* 78 T.C. 428 (1982).

130. *Frankel v. Commissioner*, 82 T.C. 318 (1984).

131. *Green*, 78 T.C. at 429.

132. *Id.* at 434-35.

133. *Id.* The tax court stated, however, that in most cases telephone contact would not satisfy the requirements of section 280A(c)(2). *Id.* at 436.

134. *Id.* at 435. The tax court majority concluded that, "[e]ven if the term 'meeting'

tion 280A to interpret the statute.<sup>135</sup> The court stated: "Green's use of the room is not enough. The plain language of the statute requires that the office be *used by clients* as a place of business for meeting or dealing with the taxpayer."<sup>136</sup> The appeals court criticized the tax court for its "metaphysical" reasoning that "dealing" means something less than physical use.<sup>137</sup> Instead, the Ninth Circuit agreed with the Service's postulation that dealing could connote either "personal contact through which a deal is arranged" or "clients' meeting with the taxpayer's employee or agent."<sup>138</sup> Accordingly, under the Ninth Circuit's analysis a taxpayer will be denied a home office deduction unless "patients, clients, or customers" physically visit his home office.<sup>139</sup>

Because the tax court had not found the "plain meaning" of the statute to be so plain, the appeals court examined the legislative history of section 280A.<sup>140</sup> The Ninth Circuit determined that Congress's intent was to tie the home office deduction to expenses, and concluded that actual use of the home office by the client was necessary to insure that the taxpayer sustained home office expenses.<sup>141</sup>

In *Frankel v. Commissioner*,<sup>142</sup> the tax court reconsidered its holding in *Green*. After reviewing the Ninth Circuit's analysis of the "plain meaning" of section 280A and its legislative history, the tax court agreed with the Ninth Circuit and declared it would no longer read the exception as: "'(B) as a place of business which is used by the taxpayer in meeting or dealing with patients, clients, or customers,' when in fact the words of the statute say just the opposite."<sup>143</sup> The tax court acknowledged that the policy underlying section 280A is to allow a deduction if

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were restricted to physical encounters, the addition of the word 'dealing,' used disjunctively, connotes a less immediate contact such as by a telephone call." *Id.*

135. *Green v. Commissioner*, 707 F.2d 404, 405-07 (9th Cir. 1983), *rev'g* 78 T.C. 428 (1982).

136. *Id.* at 406 (emphasis in original).

137. *Id.*

138. *Id.*

139. The Ninth Circuit also stated that the only other circuit to consider the issue was the Sixth Circuit in *Cousino v. Commissioner*, 679 F.2d 604 (6th Cir.), *cert. denied*, 459 U.S. 1038 (1982), where the deduction was denied.

In *Frankel v. Commissioner*, 82 T.C. 318 (1984), Chief Judge Dawson argued in his dissenting opinion that reliance on *Cousino* was misplaced. *Id.* at 334 (Dawson, C.J., dissenting). In Chief Judge Dawson's view, *Cousino* was weak authority on this issue because it was summarily affirmed without oral argument and its remarks concerning the "meeting or dealing" requirement were mere dictum. *Id.* (Dawson, C.J., dissenting).

140. *Green*, 707 F.2d at 407.

141. *Id.* The Ninth Circuit found that the other two exceptions provided in section 280A involved situations where taxpayers incurred substantial expenses in converting part of their home into a place of business. The court pointed out that a taxpayer who constructs a separate structure for business use is likely to incur a substantial expense. Similarly, a taxpayer who converts a room in his home into his "principal place of business" is also likely to incur substantial expense. *Id.*

142. 82 T.C. 318 (1984).

143. *Id.* at 328.

the taxpayer incurs a substantial expense in converting a part of his home into a place of business.<sup>144</sup> Although the *Frankel* court found that the taxpayer used the claimed office exclusively for business and that the office had caused the taxpayer to incur substantial expenses, it denied the deduction because no clients visited the office.<sup>145</sup>

Chief Judge Dawson, writing for the six dissenters, blasted the majority for its quick willingness to overrule its holding in *Green*.<sup>146</sup> The Chief Judge questioned the majority's adherence to the rules of stare decisis and puzzled over whether taxpayers in later years would take a position consistent with *Green* in hopes that the tax court might reverse its course again.<sup>147</sup>

The Chief Judge found that Congress enacted section 280A for two reasons: (1) to deny business deductions for personal expenses where there are little or no incremental costs associated with the business use of the residence; and (2) to provide a set of objective standards for determining the allowability of home office deductions.<sup>148</sup> According to the dissent, the first objective is met by the "exclusive use" and "regular basis" tests.<sup>149</sup> It is, however, the requirements of subsections 280A(c)(1)(A), (B), and (C) that provide the objective standards of Congress's second objective.<sup>150</sup> Thus, allowing deductions when substantial home office expenses have been incurred comports with Congress's first objective, but does not, by itself, satisfy Congress's second objective. The dissent responds to the majority's "plain meaning" argument by asserting that the majority focused on the words "used by clients" instead of the entire phrase "used by patients, clients, or customers in meeting or dealing."<sup>151</sup> Under either focus, however, the dissent concluded that use by clients is satisfied by client-initiated telephone calls.<sup>152</sup>

The dissent's position is well reasoned from a technical as well as a policy vantage point. Congress enacted section 280A to curtail taxpayer abuse in claiming home office deductions when the expenses of maintaining the home office were nominal. The section is aimed at denying deductions to taxpayers who use their home office for business and for pleasure, and as such entail no additional expenses for the business use. Without doubt, Congress has succeeded in prohibiting deductions to

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144. *Id.* at 328-29.

145. *Id.* at 327-28.

146. *Id.* at 331-32 (Dawson, C.J., dissenting). The dissent did not suggest that the tax court was unable to overrule its prior decision in *Green*. Instead, Chief Judge Dawson noted that the tax court in *Green* had fully considered the statutory language of section 280A and the pertinent legislative history, and therefore it should not reverse its position merely because the Ninth Circuit's interpretation differed. *Id.* (Dawson, C.J., dissenting).

147. *Id.* (Dawson, C.J., dissenting).

148. *Id.* at 333 (Dawson, C.J., dissenting).

149. *Id.* (Dawson, C.J., dissenting).

150. *Id.* (Dawson, C.J., dissenting).

151. *Id.* at 333-34 (Dawson, C.J., dissenting).

152. *Id.* at 332-33 (Dawson, C.J., dissenting).

nondeserving taxpayers, but at the same time it has prohibited deductions to deserving taxpayers who have incurred substantial expenses in maintaining a home office. The Ninth Circuit's opinion in *Green* and the tax court's decision in *Frankel* are classic illustrations of deserving taxpayers being denied home office deductions based on a shallow interpretation of section 280A. But, as Chief Judge Dawson points out, the tax court is not so well settled that it may not again change course in the near future.<sup>153</sup>

#### D. Proposed Alternative

Numerous courts deciding home office deduction cases have sympathized with the taxpayers, but nonetheless denied the deduction.<sup>154</sup> As Judge Nims stated in *Baie v. Commissioner*:<sup>155</sup>

Section 280A provides a broad general rule requiring disallowance of deductions attributable to the business use of a personal residence, irrespective of the type or form of business use. . . . Unfortunately for the petitioners here, the words of the law which Congress passed are straightforward and much broader in their applicability — sufficiently broad as to catch petitioners in their net. We are not, therefore, at liberty to 'bend' the law, much as we may sympathize with petitioner's position.<sup>156</sup>

Congress has excluded deductions for far more taxpayers than it intended when it enacted section 280A. Congress's purpose was to disallow deductions for dubious claims that had little connection to the taxpayer's trade or business; those expenses that in reality were personal expenses.<sup>157</sup> Because the courts have chosen not to remedy the problem by judicial fiat, Congress should respond by amending section 280A. It is suggested that section 280A(c)(1)(B) be amended to read as follows:

(B) as a place of business used by the taxpayer in meeting or dealing with patients, clients, or customers in the normal course of his trade or business.

The amended section would then parallel the interpretation the tax court originally gave the subsection in *Green*.<sup>158</sup> The amendment would allow deductions to taxpayers who deserve them yet disallow deductions to nondeserving taxpayers. The suggested amendment would provide a closer tie between expenses and deductions but leave intact hurdles for a taxpayer to meet. That is, a taxpayer would still have four requirements

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153. *Id.* at 331 (Dawson, C.J., dissenting).

154. *See, e.g., Baie v. Commissioner*, 74 T.C. 105, 110 (1980); *Garvey v. Commissioner*, 43 T.C.M. (CCH) 1003, 1006 (1982).

155. 74 T.C. 105 (1980).

156. *Id.* at 110.

157. *See supra* note 24 and accompanying text.

158. *See Green v. Commissioner*, 78 T.C. 428, 435 (1982), *rev'd*, 707 F.2d 404 (9th Cir. 1983); *see also Frankel v. Commissioner*, 82 T.C. 318, 328 (1984).

to satisfy: (1) exclusive use; (2) regular use; (3) meeting or dealing with patients, clients, or customers in the normal course of his trade or business; and (4) in the case of an employee, use for the convenience of his employer.<sup>159</sup>

Under this amendment, the taxpayers in *Green* and *Frankel* would have qualified for deductions. In both instances the four-prong test was met and in both instances the taxpayers incurred expenses in their trade or business. For example, Frankel purchased his house because it had an extra room that could be converted into a home office.<sup>160</sup> A house without an extra room would presumably cost less, and therefore the additional cost incurred by Frankel in purchasing the larger home should be attributable as an expense of his trade.<sup>161</sup>

In addition, whether the "meeting or dealing" is by telephone or in person should make no difference as long as it is in the normal course of business and the other three prongs of the test are satisfied. The courts' current distinction allows a taxpayer who is required by his employer to set up and maintain a home office for personal meetings with clients to deduct those expenses, but disallows a deduction to a taxpayer, such as *Green*, who is required by his employer to maintain a home office to "meet or deal" with clients by telephone. This distinction is without merit because both taxpayers incur the same expenses for employment reasons and, as such, should receive the same deductions. In contrast, the proposed amendment retains the goal of an objective standard, ties allowable deductions to business related expenses, and is no more difficult for the Service to administer than the current section. For these reasons, Congress should enact the proposed amendment to bring fair treatment to this area of section 280A.

#### IV. PRACTICAL CONSIDERATIONS

##### A. Avoidance of Section 280A

With the numerous obstacles imposed by section 280A, many taxpayers fail to qualify for a deduction for one reason or another. Consequently, it is often beneficial for taxpayers to avoid the exclusionary effect

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159. The four enumerated requirements are the basic criteria under section 280A. See *supra* notes 26-33 and accompanying text.

160. *Frankel*, 82 T.C. at 328.

161. *Green* would also have qualified for a home office deduction under the proposed amendment. *Green* met the four-prong test by using his home office "exclusively" and "regularly" to "deal" with "clients" and maintained the home office for the "convenience of his employer." *Green*, 707 F.2d at 406. Moreover, *Green* incurred expenses in his trade or business by maintaining his home office. The Second Circuit found that *Green* "never asserted that he sustained a major expense in setting aside a room for phone calls." *Id.* at 407. *Green*, however, did claim an \$840 home office deduction, presumably based on depreciation and the cost of maintenance, utilities, and insurance. The IRS did not challenge the accuracy of the allocation of expenses. *Id.* at 405. Thus, it appears that *Green* did incur substantial expenses in his trade or business.



of the section by structuring their affairs to fall outside its purview. One method of sidestepping the home office deduction rules has recently withstood scrutiny by the tax court in *Feldman v. Commissioner*.<sup>162</sup>

In *Feldman*, an *en banc* decision, the taxpayer was an employee, director and shareholder of a public accounting firm, and was responsible for substantial administrative duties. Because Feldman's work office was open to the rest of the staff, it lacked the privacy necessary for confidential discussions and uninterrupted work periods.<sup>163</sup> To fulfill his obligations, Feldman was expected to do a great deal of his work outside of the office, and he maintained an office in his home exclusively for that purpose. Feldman and the firm negotiated a written lease agreement that provided for the firm to pay Feldman \$5,400 each year for the use of his home office.<sup>164</sup> Feldman reported this amount as rental income and deducted from it the costs of maintaining the leased office.<sup>165</sup> The IRS disallowed the deduction, claiming that the arrangement was a sham. The Service argued that the payment was labeled as "rental income" instead of "compensation" solely to circumvent the rules of section 280A.<sup>166</sup> The tax court held that the taxpayer was entitled to a deduction under section 280A(c)(3), which allows the deduction of expenses associated with the rental of a dwelling unit.<sup>167</sup>

Although the court found that the rental provided in the agreement was excessive and that the lease was not negotiated at arm's length, it nonetheless held the agreement to be "bona fide."<sup>168</sup> The *Feldman* court added that a business necessity was required to support such a lease agreement. The court held that the problems of confidentiality and frequent interruptions in Feldman's work office gave rise to a business necessity for the lease agreement.<sup>169</sup> The *Feldman* court stated that the "degree of business necessity [here] goes far beyond the 'appropriate and helpful' standard for deduction of home office [expenses]. . . ." <sup>170</sup>

The *Feldman* decision provides tax advisors with a valuable planning tool. In most cases, when an employee claims a home office deduction he must meet the "principal place of business" or "meeting or

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162. 84 T.C. 1 (1985).

163. *Id.* at 2.

164. *Id.* at 2-3.

165. *Id.* at 3.

166. *Id.* at 5.

167. *Id.* at 5-7.

168. *Id.* The tax court stated that the "excessive rent [did] not necessarily taint the character of the entire payment," but was only one factor considered in determining the validity of the lease agreement. *Id.* at 6. Similarly, the *Feldman* court found that a close relationship between the lessor and the lessee did not void the agreement, but merely subjected it to closer scrutiny to ensure that the payments made were for the rental of the property. *Id.*

169. *Id.*

170. *Id.* Judge Nims concurring opinion, joined by five other judges, noted that "close scrutiny will be given similar fact patterns in the future where the possibility of compensation disguised as rent may be present." *Id.* at 9 (Nims, J., concurring).

dealing" exception.<sup>171</sup> This is often difficult because an employee's "principal place of business" is generally held to be at the employer's office, and because few employees meet personally with clients in their home office. Therefore, as a general rule, the cost of maintaining the home office is not deductible. Under a rental agreement, however, the strict home office deduction rules do not apply, and the employee can deduct his home office expenses against his rental income.

The benefits of a rental agreement can best be illustrated by the following example:

Assume that Bob and Sue Johnson are the sole shareholders of ABC Corporation (the Corporation), which operates a retail sporting goods store. Because of limited office space in the store, it is necessary for Bob to do most of the Corporation's paperwork at home. The cost of maintaining the home office is \$2,000 and its fair rental value is \$4,000. The Corporation has earnings and profits of \$4,000 and the Johnsons have personal income of \$25,000.

Bob would not qualify for a home office deduction under section 280A(c)(1) because his "principal place of business" is at the store, and he does not "meet or deal" with "clients" in his home office. The Johnsons, therefore, have four options: (1) not to distribute the corporate earnings; (2) distribute \$4,000 as a dividend; (3) draw a \$4,000 salary bonus; or (4) enter into a rental agreement with the Corporation. The first two options have a substantial drawback: these methods subject the Johnsons to double taxation (that is, once at the corporate level and then again upon distribution at the shareholder level). Although the third option reduces income and tax at the corporate level, the Johnsons would report \$4,000 as income and the Corporation would be liable for \$422 of payroll taxes.<sup>172</sup>

The fourth option, using a *Feldman* lease agreement, provides three advantages. First, the Corporation would deduct \$4,000 as rental expense and reduce income and tax at the corporate level. Second, the Johnsons would report \$4,000 of gross rental income and \$2,000 of home office expenses, resulting in net rental income of only \$2,000. Third, the Corporation would not be forced to pay additional payroll taxes.

The chart below sets forth the results under each of the four options.

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171. The taxpayer may also qualify for a deduction by using a "separate structure," I.R.C. § 280A(c)(1)(C) (1982), or "inventory storage" space, *id.* § 280A(c)(2).

172. Based on average 1984 rates, the corporation would pay 7.05% Social Security Tax, 0.8% Federal Unemployment Tax, and 2.7% Maryland State Unemployment Tax, thus, resulting in total payroll taxes of \$422 ( $10.55\% \times \$4000 = \$422$ ). See Treas. Pub. 539, Employment Taxes and Information Return Requirements, 31,225, 31,233, 31,237 (Rev. Nov. 1984); MD. ANN. CODE art. 95A, § 8 (1979 & Supp. 1984).

	Option 1	Option 2	Option 3	Option 4
Corporate Income	\$ 4,000	\$ 4,000	< \$422 >	\$ 0
Corporate Tax	600	600	0	0
Personal Income	25,000	29,000	29,000	27,000
Personal Tax	3,565	4,665	4,665	4,065
Total Tax	4,165	5,265	4,665	4,065

The Johnsons must take steps to document the "bona fide" nature of the transaction and to ensure that a "business necessity" underscores the rental agreement. To evidence the "bona fide" nature of the transaction, the Johnsons and the Corporation should execute a simple written lease at the beginning of the Corporation's tax year. The lease should provide for rent at the home office's fair rental value of \$4,000. Furthermore, special attention should be taken to ensure that the Corporation makes timely lease payments. With respect to the "business necessity," it would be advisable for the corporate minutes to show that the rental agreement was executed to provide adequate space and privacy for the completion of corporate paperwork. In sum, the rental agreement approach provides a viable and attractive alternative to section 280A for taxpayers to deduct home office expenses.

### B. Record Keeping

It is well settled that the taxpayer has the burden of proving that any deficiency assessed by the Service is incorrect.<sup>173</sup> Accordingly, it is important for each taxpayer to keep adequate records to support his deduction. In the IRS publication, *Business Use of Your Home*,<sup>174</sup> the Service states that no particular method of record keeping is required, only that the records necessary to figure the deduction be kept.<sup>175</sup> The Service, however, suggests that cancelled checks, receipts, and other evidence of expenses paid be retained.<sup>176</sup>

In *Diller v. Commissioner*,<sup>177</sup> the tax court reiterated the maxim that taxpayers "have the burden of proof to establish both the *amount* and *character* of the expense."<sup>178</sup> Diller produced only vague and general testimony as to expenses incurred and, consequently, the court refused to speculate as to those expenses and denied the entire deduction.<sup>179</sup> Similarly, the tax court has found unpersuasive a taxpayer's argument that the deduction "represented the minimum expenses that could have been incurred in . . . using a portion of [his] home for business purposes."<sup>180</sup>

173. *Welch v. Helvering*, 290 U.S. 111, 115 (1933); see *supra* note 49.

174. Treas. Pub. 587, *Business Use of Your Home*, 35,401 (Rev. Nov. 1984).

175. *Id.* at 35,402.

176. *Id.*; see also Treas. Reg. § 1.162-17(d) (1958).

177. 37 T.C.M. (CCH) 1332 (1978).

178. *Id.* at 1335 (citing *Welch v. Helvering*, 290 U.S. 111, 115 (1933) and Tax R. Prac. & Proc. 142(a)) (emphasis supplied).

179. *Diller*, 37 T.C.M. (CCH) at 1335.

180. *Carlson v. Commissioner*, 41 T.C.M. (CCH) 1090, 1091-92 (1981).

Moreover, many taxpayers have failed to meet their burden of proof when their only evidence was their own self-serving testimony.<sup>181</sup>

Section 274(d) sets forth the record keeping necessary to claim a deduction for travel, entertainment, and gifts.<sup>182</sup> The section requires contemporaneous record keeping and documentary evidence. Although section 274(d), of course, is not controlling on home office deductions, it does provide basic guidelines for substantiating any deduction. To substantiate the regular use of a home office, it is advisable to keep a diary that includes the date of use, the amount of time used, the business purpose, and the patients, clients, or customers present. Similarly, to substantiate gross income attributable to the home office, a time sheet and the related billings should be kept for all work done in the home office. Testimony by the taxpayer and others may be used to verify the exclusive use test, but it must be remembered that the taxpayer has the burden of persuasion.

In some cases where taxpayers have kept inadequate records, not only have their deductions been denied, but they have also been assessed a penalty for filing an inaccurate return.<sup>183</sup> Section 6653 states that when an underpayment of tax is "due to negligence or intentional disregard of [the] rules or regulations" a penalty may be imposed.<sup>184</sup> A taxpayer may be penalized five percent of the underpayment when the tax return is filed without an intent to defraud, but is subject to a penalty of fifty percent of the underpayment when the underpayment is attributable to fraud.<sup>185</sup>

### C. *Limitation on Deduction*

A deduction for expenses related to the use of part of a residence for business purposes is limited in two ways: (1) the type of expense allowed; and (2) the amount of expense allowed.

There are three types of expenses related to the maintenance of a home office: direct, indirect, and unrelated.<sup>186</sup> Direct expenses are those costs incurred specifically for the home office. Painting, repairing, and

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181. *See, e.g.*, Jackson v. Commissioner, 76 T.C. 696 (1981) (regular use not shown); Roth v. Commissioner, 43 T.C.M. (CCH) 45 (1981) (gross income attributable to home office not proven); Andrews v. Commissioner, 41 T.C.M. (CCH) 1533 (1981) (exclusive use not shown), *aff'd by unpublished order* (4th Cir. July 6, 1982); Klutz v. Commissioner, 38 T.C.M. (CCH) 724 (1979) (percentage of home used for business not shown). *But see* Green v. Commissioner, 78 T.C. 428 (1982) (exclusive use shown), *rev'd on other grounds*, 707 F.2d 404 (9th Cir. 1983); *see also supra* notes 50-53 and accompanying text.

182. I.R.C. § 274(d) (West Supp. 1984).

183. *See, e.g.*, McCabe v. Commissioner, 46 T.C.M. (CCH) 390 (1983); Taylor v. Commissioner, 42 T.C.M. (CCH) 1077 (1981).

184. I.R.C. § 6653 (1982).

185. *Id.* § 6653(a)-(b). In McCabe v. Commissioner, 46 T.C.M. (CCH) 390 (1983), the tax court sustained the imposition of a negligence penalty by the Service. The taxpayer made several omissions and unjustified deductions. His excuse of "general confusion" did not refute the determination of negligence. *Id.* at 394.

186. Treas. Pub. 587, Business Use of Your Home, 35,401, 35,401-02 (Rev. Nov. 1984).

cleaning the office are examples of expenses directly related to the use of the home office for business purposes. As such, the full cost of the direct expenses are deductible within the statutory limitation.

By contrast, indirect expenses are those costs that benefit the entire house. These expenses are for the general maintenance and upkeep of the entire home. For example, real estate taxes are an expense that benefit not only the office portion of a home, but the entire home. Likewise, the cost of mortgage interest, home insurance, rent, utilities, repairs, and depreciation are indirect expenses. Because the cost of an indirect expense is not exclusively for the benefit of the business portion of the home, an allocation must be made.<sup>187</sup> The allocation can be made on any reasonable basis; however, the Service suggests allocation on a per room basis where rooms are of about equal size, or otherwise on a square foot basis.<sup>188</sup>

Unrelated expenses are those costs incurred in maintaining a home that do not benefit the business portion. For instance, repairs to the stove in the kitchen will be of no business benefit to an accountant's home office.<sup>189</sup> The proposed regulations state that lawn care expenses are unrelated expenses and not allocable as a deduction.<sup>190</sup> In *Graves v. Commissioner*,<sup>191</sup> however, a pre-section 280A case, the tax court held in a memorandum opinion that lawn care expenses were deductible for a professional who used his home office as a place to meet clients.<sup>192</sup> The tax court reasoned that expenses related to the care and maintenance of the entrance were "ordinary and necessary" business expenses.<sup>193</sup> Presumably, the holding in *Graves* is premised on the rationale that if clients are to visit the taxpayer's home office, the entrance to the home office must be accessible and maintained. Although *Graves* was only a memorandum decision and predated the enactment of section 280A, its rationale is sound and should support a deduction under section 280A. But, if a taxpayer uses his home office as his "principal place of business" and no clients visit the office, the *Graves* rationale will be of no assistance to the taxpayer in arguing against the Service's proposed regulation.

Once a taxpayer has determined he is eligible for a home office deduction and has calculated the appropriate home office expenses, he must then apply the overall limit imposed by Code section 280A(c)(5). The

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187. *Id.*

188. Proposed Treas. Reg. § 1.280A-2(i)(3) (proposed Aug. 7, 1980); see also *Feldman v. Commissioner*, 84 T.C. 1 (1985) (where rooms in the home are not of equal size, an allocation must be made on a square foot basis).

189. See Proposed Treas. Reg. § 1.280A-2(i)(3) (proposed Aug. 7, 1980). Unrelated expenses also include "repairs to personal areas of [the] home . . . and landscaping." Treas. Pub. 587, Business Use of Your Home, at 35,402.

190. Proposed Treas. Reg. § 1.280A-2(i)(3) (proposed Aug. 7, 1980).

191. 20 T.C.M. (CCH) 148 (1961).

192. The taxpayer ran a "country style" law practice from his rural home. *Id.* at 149.

193. *Id.* The court allowed deductions for the cost of snow shoveling, lawn mowing, and other services necessary for the maintenance of the entrance. *Id.*

statute provides that expenses related to the home office that would not be deductible but for the business use cannot exceed:

- (1) The gross income for the taxable year derived from the home office, less
- (2) The deductions allocable to such use that are allowable without reference to section 280A.<sup>194</sup>

The Congressional committee reports explain the limitation and the amount of deduction, and provide an analysis of its application.<sup>195</sup> This legislative history further provides that where gross income is derived from both the business use of part of the home and from other facilities, a reasonable allocation based on the particular facts and circumstances is to be made. The deduction is limited to gross income attributable to the home office in excess of deductions allowed without regard to the taxpayer's business (e.g., interest and taxes).<sup>196</sup>

Because "gross income" for purposes of section 280A is neither defined in the statute nor in the legislative history, the general definition of "gross income" under section 61 should govern. Section 61 broadly defines gross income as "all income from whatever source derived . . . ."<sup>197</sup> Not surprisingly, the tax court has decided in interpreting section 280A(c)(5) that when a taxpayer produces no income from the use of a portion of his home, no home office deduction is allowed.<sup>198</sup>

Curiously, proposed regulation section 1.280A-2(i) sets forth a definition of gross income different from section 61 and posits an order for deductions different from that provided for in section 280A(c)(5).<sup>199</sup> The regulation defines gross income as "gross income from the business activity in the unit reduced by expenditures required for the activity but not allocable to use of the unit itself, such as expenditures for supplies and compensation paid to other persons."<sup>200</sup> This definition realigns the order of deductions by first reducing gross income by ordinary expenses not related to the maintenance of the home office, and in effect limits the home office deduction to net income. Section 280A(c)(5), however, pro-

194. I.R.C. § 280A(c)(5) (1982).

195. H.R. REP. NO. 658, 94th Cong., 1st Sess. 161-62 (1975), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 2897, 3055; S. REP. NO. 938, 94th Cong., 2d Sess. 149 (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439, 3581-82.

196. H.R. REP. NO. 658, 94th Cong., 1st Sess. 161-62 (1975), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 2897, 3055; S. REP. NO. 938, 94th Cong., 2d Sess. 149 (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439, 3581-82.

197. I.R.C. § 61(a) (1982). This definition includes "gross income derived from business." *Id.* § 61(a)(2).

198. *See, e.g., Gestrich v. Commissioner*, 74 T.C. 525 (1980), *aff'd by unpublished opinion*, 681 F.2d 805 (3d Cir. 1982); *Parker v. Commissioner*, 47 T.C.M. (CCH) 1760 (1984); *Warganz v. Commissioner*, 42 T.C.M. (CCH) 568 (1981), *aff'd by unpublished opinion*, 696 F.2d 987 (3d Cir. 1982); *Hughes v. Commissioner*, 41 T.C.M. (CCH) 1153 (1981).

199. Compare Proposed Treas. Reg. § 1.280A-2(i)(2)(iii) (proposed July 21, 1983), with I.R.C. § 61(a) (1982) and *id.* § 280A(c)(5).

200. Proposed Treas. Reg. § 1.280A-2(i)(2)(iii) (proposed July 21, 1983).

vides for gross income, not net income.<sup>201</sup> Furthermore, the legislative history provides no authority for a different interpretation.<sup>202</sup>

In a private letter ruling, the Service informed the taxpayer, an accountant operating his business out of his home, that gross income did not mean gross receipts.<sup>203</sup> The Service relied on the proposed regulations and asserted without further reasoning that gross income meant "gross income from the business activity . . . reduced by expenditures required for the activity . . ." <sup>204</sup> Considering section 280A's express use of the term *gross income*, the Service's position is suspect.

Subsection (c)(5) of the proposed regulations states that business deductions associated with the use of a home office are allowable in the following order:

(1) the allocable portion of home office deductions allowable without regard to any use of the home for trade or business (e.g., mortgage interest and real estate taxes);

(2) home operating expenses allocable for the business portion of the residence that do not result in a reduction of the basis of the property (i.e., utilities, insurance, repairs);

(3) home operating expenses allocable to the business portion of the residence that do reduce basis (i.e., depreciation).<sup>205</sup>

Again, there is no statutory authority or legislative history to support the Service's rearrangement of the order of expenses. Seemingly, the proposed regulations do not comport with the Code and, therefore, should fail.

Moreover, the proposed regulations contravene Congress's intent in enacting section 280A. Normally, when a taxpayer incurs a loss in the operation of his trade or business, his loss is fully deductible.<sup>206</sup> The effect of the proposed regulations, however, is that no taxpayer reaches or increases a net loss by use of the home office deduction. The legislative intent of section 280A was aimed at eliminating taxpayer abuses in the home office area that resulted in personal and family expenses being deducted as business expenses.<sup>207</sup> Congress also sought to limit home office deductions associated with a bona fide business use of a home. Congress did not set out to punish, by limiting their deductions, entrepreneurs working out of their home. Notwithstanding this apparent Congressional intent, many commentators,<sup>208</sup> and at least one profes-

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201. I.R.C. § 280A(c)(5)(A) (1982).

202. See H.R. REP. NO. 658, 94th Cong., 1st Sess. 161-62 (1975), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 2897, 3055; S. REP. NO. 938, 94th Cong., 2d Sess. 149 (1976), *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3439, 3581-82.

203. Private Letter Ruling 8347012, 352 IRS LTR. RUL. (CCH) 8347012 (Aug. 15, 1983).

204. *Id.*

205. Proposed Treas. Reg. § 1.280A-2(i)(5) (proposed Aug. 7, 1980).

206. I.R.C. § 165(c)(1) (1982).

207. See *supra* note 24 and accompanying text.

208. See, e.g., Kulsrud, *Recent Statutory and Judicial Development Have Liberalized*

sional tax service,<sup>209</sup> teach the method prescribed by the regulations. The area seems ripe for litigation.<sup>210</sup> \*

The mechanical differences between the Code and the proposed regulation can best be illustrated by the following example:

Assume that Diane Smith is a lawyer employed full time as a professor. On a part time basis, Diane operates a private law practice from her home. Diane uses one-fifth of her residence exclusively and regularly as her "principal place of business" and as a place to meet clients. Diane earns \$3,300 of gross income from her private practice. She pays the following expenses in connection with her law practice:

Secretarial services	\$500
Supplies	\$460
Postage	\$200

In addition, she incurs the following home ownership expenses:

Roof repair	\$600
Lawn care cost	\$250
House insurance	\$550
Utility services	\$1,000
Mortgage interest	\$9,000
Real estate taxes	\$1,700
Depreciation	\$8,200

As shown below, under the Code's limitation on liabilities, Diane would deduct \$2,640 for home office expenses and would show a net loss of \$500. On the other hand, using the limitations imposed by the proposed regulations, Diane would only deduct \$2,140 for home office expenses and would show neither gain nor loss from her legal practice.

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*Home-Office Deductions*, 56 J. TAX'N 340, 350-51 (1982); Ward, *Home Office Deductions: The Development and Current Status of Section 280A(c)(1)*, 13 CUM. L. REV. 195, 214-16 (1982-83); Comment, *The Home Office Deduction*, 25 ST. LOUIS U.L.J. 607, 623-26 (1981).

209. BENDER'S TAX RETURN MANUAL ¶ 341.3(1) (1985).

210. In 1981, a taxpayer successfully challenged the proposed regulations governing deductions allowable on vacation homes as being inconsistent with section 280A(c)(5)(B). *Bolton v. Commissioner*, 77 T.C. 104 (1981), *aff'd*, 694 F.2d 556 (9th Cir. 1982).

\* After this issue went to press, the tax court reviewed the proposed regulations' limitation on home office deductions in *Scott v. Commissioner*, TAX CT. REP. (CCH) Dec. 42,024, 2936 (1985). The tax court found the Commissioner's interpretation of the term "gross income" to be inconsistent with section 280A's legislative history and its purpose. The *Scott* court rejected the proposed regulations' definition of "gross income" and adopted the Section 61 definition of "gross income." *Id.* at 2940.



Code Section 280A (c)(5) Method

Gross income from private law practice \$3,300

	<u>Total</u>	<u>Allocable to office</u>
Less: Interest	\$ 900	\$ 180
Real estate taxes	1,700	<u>340</u>
<b>TOTAL</b>		<u>\$ 520</u>

Limitation on home office deductions \$2,780

	<u>Total</u>	<u>Allocable to office</u>
Less: Roof repair	\$ 600	\$ 120
Lawn care	250	50
Insurance	550	110
Utilities	1,000	200
Depreciation	8,200	1,640
<b>TOTAL</b>		<u>\$2,120</u>

Gross income after home-related expenses \$ 660

Less: Secretarial services	\$ 500
Supplies	460
Postage	200
<b>TOTAL</b>	<u>\$1,160</u>

Net loss from private law practice < \$ 500 >

Proposed Regulation § 1.280A-2(i)(5) Method

Gross income from private law practice \$3,300

Less: Secretarial services	\$ 500
Supplies	460
Postage	200
Total expenses not related to home use	<u>\$1,160</u>
Gross income as defined by regulation § 1.280A-2(i)(5)	<u>\$2,140</u>

	<u>Total</u>	<u>Allocable to office</u>
Less: Interest	\$ 900	\$ 180
Real estate taxes	1,700	<u>340</u>
Total expenses allocable to office deductible regardless of business use		<u>\$ 520</u>
Limitation on home office deductions		\$1,620

	<u>Total</u>	<u>Allocable to office</u>
Less: Roof repair	\$ 600	\$ 120
Lawn care	250	0
Home insurance	550	110
Utilities	1,000	<u>200</u>
Total non-basis reducing home office expenses		<u>\$ 430</u>
Limitation on further deductions		\$1,190
	<u>Total</u>	<u>Allowable to office</u>
Less: Depreciation	\$8,200	\$1,640
Portion of depreciation expense allowed up to limitation		<u>\$1,190</u>
Net income or loss		<u><u>-0-</u></u>

#### D. Sale of Residence and Section 1034

For a taxpayer who contemplates claiming a home office deduction under section 280A, it is important that he consider the effect of the deduction in relation to the section 1034 rollover provisions. Section 1034 provides for the non-recognition of gain in certain cases where a taxpayer sells his home and purchases a replacement home.<sup>211</sup> When the home is used by the taxpayer as both his principal residence and as a place of business, an allocation must be made between the two uses.<sup>212</sup> Only the gain on the residential portion is given non-recognition treatment; the gain on the business portion must be recognized.<sup>213</sup>

The Service originally declared in a private letter ruling that the business use requirements for a home office deduction under section 280A were not determinative of whether the residence was being used for a non-residential purpose under section 1034.<sup>214</sup> Three years later, however, Revenue Ruling 82-26 held that an allocation is only necessary under section 1034 when a home office deduction is taken under section 280A.<sup>215</sup> Therefore, if the taxpayer fails to qualify for a home office deduction in the year of sale, no allocation is required, and the entire gain is unrecognized.

Hence, it appears advantageous to take a deduction for home office expenses in any year except the year of sale.<sup>216</sup> Nonetheless, two nega-

211. I.R.C. § 1034(a) (1982).

212. Treas. Reg. § 1.1034-1(c)(3)(ii) (1960).

213. *Id.*

214. Private Letter Ruling 7935003, 131 IRS LTR. RUL. (CCH) 7935003 (May 14, 1979).

215. Rev. Rul. 82-26, 1982-1 C.B. 114-15.

216. For a detailed analysis and computation of when taking a home office deduction in the year of sale is advantageous, see Everett, *Home Office Expense Deductions: More Trouble Than They Are Worth?*, 58 TAXES 589, 591-92 (1980).

tive consequences result from taking the deduction: (1) the basis of the house is reduced by the depreciation taken, which will cause a higher gain upon sale;<sup>217</sup> and (2) because the IRS is wary of home office deductions and specifically asks on a separate line of the Federal income tax return if any expense related to a home office is being deducted,<sup>218</sup> seemingly, the chance of an audit is enhanced. These disadvantages should be weighed by each taxpayer, but on the whole the advantages of claiming a deduction will probably outweigh the disadvantages.

## V. CONCLUSION

No statutory rule is without problems and nearly all require a limited amount of judicial gloss. Congress enacted section 280A to achieve two goals: (1) to eliminate taxpayer abuse of home office deductions; and (2) to provide objective rules to stem the flow of litigation. The judicial interpretation of the various clauses of section 280A has in many instances served to frustrate, rather than to promote Congress's goals.

For example, the adoption by the Court of Appeals for the Second Circuit of the "time and importance" test for determining whether a home office is a "principal place of business" fails to meet the Congressional goals of an objective and easily applied standard. The tax court's "focal point" test, however, furthers the Congressional goals, and is therefore a better standard. In addition, the judicial construction of the "meeting or dealing" exception has created inequity by denying deductions to taxpayers who incur substantial expenses in maintaining home offices used only for telephone contact with clients. Legislative reform, whether by the proposed amendment or by some other means, is necessary to remedy the situation.

Qualifying for a home office deduction requires careful planning. First, the use of a *Feldman* - rental agreement should be considered when a taxpayer cannot otherwise qualify for a home office deduction, so as to allow the taxpayer a home office deduction "through the backdoor." Second, as with all deductions, good record keeping and substantiation are vital to securing a full deduction. Third, the deduction limitation imposed by the proposed regulations is inconsistent with section 280A and, as such, should not withstand a challenge before a court. Fourth, gain on the sale of a home is deferrable to the extent it is used as a residence in the year of sale, and therefore, a calculation is necessary to determine whether a home office deduction should be taken.

Section 280A is fraught with problems and in need of both legislative reform and pragmatic judicial interpretation. Nonetheless, section

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217. I.R.C. § 1016(a)(2) (1982).

218. TREAS. PUBL., PACKAGE X, 75, line G (1984).

280A, as it stands, remains a valuable tax planning tool worthy of taxpayer consideration.

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