Florida Law Review

Volume 26 | Issue 3 Article 11

March 1974

Income Tax: Death of the Employer Mandate for Home Office Deductions

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INCOME TAX: DEATH OF THE EMPLOYER MANDATE TEST FOR HOME OFFICE DEDUCTIONS

Stephen A. Bodzin, 60 T.C. 820 (1973)

Taxpayer, an Internal Revenue Service attorney, maintained an office in his residence for purposes of familiarizing himself with current tax law developments and completing job assignments during evenings and weekends. He accordingly deducted that portion of his rent and other residential expenses reasonably allocable to his home office as a section 162[1] business expense. The Internal Revenue Service disallowed the deduction on the grounds that maintenance of the home office was not mandated by taxpayer's employer as a condition of employment. The United States Tax Court, sitting en banc, refused to follow this "employer mandate" test and HELD, taxpayer's home office expenses were appropriate and helpful in his occupation and were therefore deductible section 162 business expenses.[2]

Section 162 provides: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[3] "Ordinary" expenses have been defined as those costs that are normal or usual for the group of which the taxpayer is a part.[4] "Necessary" expenses are expenses that are "appropriate and helpful" to his business;[5] they need not be "absolutely essential."[6] Although

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1. INT. REV. CODE OF 1954, §162.

2. 60 T.C. 820 (1973) (Drenne, Featherston, Quealy & Scott, JJ., dissenting). Interestingly, since Bodzin was working for the Interpretative Division of the Internal Revenue Service, the instant case assumes the characteristics of an in-house fight. In order for home office expenses to be deductible, the Service requires that the employer condition employment on the employee's having an office in his home. Earlier cases permitting deductions for home office expenses could arguably have been decided on the rationale that the employer mandate test was satisfied by implication. *See, e.g.*, Christopher A. Rafferty, 30 CCH Tax Ct. Mem. 848 (1971); Herman E. Bischoff, 26 CCH Tax Ct. Mem. 538 (1966). In the instant case, however, Bodzin's employer had not actually or impliedly required a home office. Although Bodzin had deadlines to meet, they were self-imposed. The office supplied by the IRS was of adequate size, was available for use 24 hours a day and 7 days a week, and was always appropriately heated or cooled. The distance from Bodzin's home to the IRS office (about 30 minutes) and his membership in a car pool made overtime work at the main office difficult; it did not make it impossible. Although the employer mandate test was not met, Bodzin's office in his residence *was* appropriate and helpful to his overtime work. 60 T.C. at .

3. INT. REV. CODE OF 1954, §162(a).

4. *E.g.*, Lilly v. Commissioner, 343 U.S. 90 (1952); Welch v. Helvering, 290 U.S. 111 (1933). Thus, an expenditure for coating a company's basement, which was used for curing hams and bacons, to prevent contamination from oil seeping from a nearby refinery, was found to be an ordinary expense and not a capital expenditure even though the particular taxpayer would probably never again make a similar expenditure. Midland Empire Packing Co., 14 T.C. 635 (1950).

5. Commissioner v. Heininger, 320 U.S. 467 (1943); Welch v. Helvering, 290 U.S. 111 (1933); Blackmer v. Commissioner, 70 F.2d 255 (2d Cir. 1934).

6. Commissioner v. Pacific Mills, 207 F.2d 177, 180-81 (1st Cir. 1953).

these definitions seem clear, much of the controversy surrounding the deductibility of employee home office expenses has centered around their necessity.[7]

Deductions for home office expenses were generally allowed in early cases without any showing that the employer had required the expenditures.[8] The employer mandate test was first used to deny deductions for the costs of an office in a residence in *Harold H. Davis*.[9] The value of that decision as precedent is somewhat questionable, however, since the case was remanded on appeal[10] and, since the Tax Division of the Department of Justice admitted an error in denying the deduction.[11] In his dissenting opinion, Judge Raum noted that although an employer's requirement that an employee must make

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7. It is clear that the expense must be incurred primarily in carrying on a trade or business. INT. REV. CODE OF 1954, §162(a). Thus, if an expenditure is predominately personal as opposed to business related, it is non-deductible personal expense and the "necessary" test need not be considered. Recognizing this, the instant court declared: "A finding that the home office was simply for the taxpayer's personal convenience would bar the deduction if the Court concluded that personal convenience was the primary reason for maintaining the office. *Such a finding would displace any conclusion as to* 'appropriateness' and 'helpfulness.'" (Emphasis added.) 60 T.C. at .

8. *See, e.g.*, Morris S. Schwartz, 20 CCH Tax Ct. Mem. 725 (1961); Freda W. Sandrich, 5 CCH Tax Ct. Mem. 234 (1946). Historically, deductions by employees have been looked at with greater suspicion than deductions by employers. Early cases disallowed employees' deductions that were for the benefit of the employer, unless there was a relation between the expenditure and the amount of compensation received from the employer. Hal E. Roach, 20 B.T.A. 919 (1930); Franklin M. Magill, 4 B.T.A. 272 (1926). The rationale was that one tax entity should not be permitted to take a deduction for paying the expenses of another tax entity. When the employer mandate test was first established by Judge Learned Hand in Schmidlapp v. Commissioner, 96 F.2d 680 (2d Cir. 1938), it was actually used to *allow* a deduction. Moreover, *Schmidlapp* can be interpreted to mean that *if* an expenditure is required by an employer, it is deductible; not that an expenditure *must* be required by an employer to be deductible. The court said: "It is no answer to say that [the expenditures] were for the bank's benefit; so were all the taxpayer's services; if it [the bank] did in fact give him to understand that he was to extend a factitious hospitality in its interest, the cost of it was a necessary expense of his office." *Id.* at 682. Nevertheless, some courts have treated the employer mandate test as the exclusive standard to be applied. *See, e.g.*, Manoel Cardoza, 17 T.C. 3 (1951) (professor denied a deduction for overseas travel not required by his employer). *Cf.* Hill v. Commissioner, 181 F.2d 906 (4th Cir. 1950) (teacher allowed a deduction for additional education when that was an acceptable manner of renewing her teaching certificate). *Cardoza* and *Hill* were important precedents to the development of the traditional view of non-deductibility because the primary emphasis in the first enunciation of the employer mandate test, Harold H. Davis, 38 T.C. 175 (1962), was on education rather than on home office expenses.

9. 38 T.C. 175 (1962). Although deductions for education expenses and a portion of the home office expenses in *Davis* were claimed under §162, most of the home office expenses were claimed as §167 depreciation expenses. The distinction is insignificant, however, since both the majority and the dissent used their respective tests of deductibility under §162 to decide whether the home office was business property depreciable under §167. 38 T.C. 175, 180, 187 (1962).

10. The Ninth Circuit Court of Appeals vacated and remanded the *Davis* case by stipulation in an unpublished decision on Jan. 30, 1964.

11. Lewis, *Taxes and the Professor's Home Office — Rulings, Cases, and Commentary*, 47 CHI. B. RECORD 161 (1965).

certain expenditures as a condition of employment tends to show "necessity," such a requirement is *not* a prerequisite to section 162 deductions;[12] "necessary" expenses need only be "appropriate and helpful."[13]

The Commissioner has consistently taken a contrary view. In the year *Davis* was decided, Revenue Ruling 62-180[14] formalized the Commissioner's "employer mandate" test for home office deductions. The ruling denied deductions to employees unless maintenance of a home office was mandated by an employer, even though use of the office was closely related to the nature of the employment.[15]

Judicial reluctance to overrule administrative interpretations[16] was manifested by the Tax Court's initial circumvention of the issue dealt with in Revenue Ruling 62-180. For example, in *Clarence Peiss*[17] a professor was allowed a deduction for research facilities in his home. The case can be interpreted, however, as holding that the employer mandate test had been satisfied by implication, since the taxpayer's rank and salary were partially determined by his productivity as a researcher.[18] Inasmuch as the employer did not provide adequate research or office facilities,[19] the professor was effectively forced to use his home.[20]

The *unqualified* employer mandate requirement of Revenue Ruling 62-180[21] was upheld in *Valentine J. Anzalone.*[22] In that case the taxpayer was provided with an always available office, which was located twenty-five minutes from his home.[23] The court sustained the Commissioner's finding that the home office expense was not a condition of taxpayer's employment and was therefore a personal expense expressly nondeductible[24] under section 262.[25]

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12. 38 T.C. 175, 186 (1962).
13. *Id. See* notes 5, 6 *supra.*
14. Rev. Rul. 62-180, 1962-2 CUM. BULL. 52.
15. *Id.* "An employee who, as a condition of his employment, is required to provide his own space and facilities for performance of his duties and regularly uses a portion of his personal residence for that purpose may deduct a pro rata proportion of the expenses of maintenance and depreciation on his residence. However, the *voluntary,* occasional or incidental *use by an employee* of a part of his residence *in connection with his employment* does not entitle him to a business expense deduction." (Emphasis added.)
16. Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948); Fawcus Mach. Co. v. United States, 282 U.S. 375, 378 (1931).
17. 40 T.C. 78 (1963), *acquiesced* in 1968-2 CUM. BULL. 2.
18. *Id.* at 80.
19. *Id.*
20. Rev. Rul. 63-275, 1963-2 CUM. BULL. 85, and Rev. Rul. 64-272, 1964-2 CUM. BULL. 55 acknowledge that in most cases an implied job requirement to do independent research would be sufficient to allow a deduction for facilities in the home, even if he had tenure and could not lose his job. *See* J. CHOMMIE, FEDERAL INCOME TAXATION 77, 81 (1968).
21. Rev. Rul. 62-180, 1962-2 CUM. BULL. 52.
22. 23 CCH Tax Ct. Mem. 497 (1964).
23. The facts in *Anzalone* are very similar to those in the instant case.
24. 23 CCH Tax Ct. Mem. at 498.
25. INT. REV. CODE OF 1954, §262.

Nevertheless, most decisions have allowed the home office deduction under proper circumstances, despite taxpayers' failure to meet the "employer mandate" test. For example, the "appropriate and helpful" test advocated by Judge Raum in *Davis* was applied by him in *Herman E. Bischoff*[26] to determine whether an expenditure was deductible as an ordinary and necessary business expense. Although Judge Raum stated that such an expense need not be required by the employer to be deductible,[27] his comment may be regarded as dictum. The lack of appropriate heating or air conditioning after hours, coupled with the employer's requirement that Bischoff work overtime to meet deadlines implied an employer mandate for a home office.

More recently, the landmark case of *Newi v. Commissioner*[28] further signaled the decline of the employer mandate test. The Second Circuit Court of Appeals affirmed a Tax Court memorandum decision[29] holding that otherwise deductible home office expenses were not to be disallowed for the lack of an employer mandate. Although the Second Circuit did not expressly overrule Revenue Ruling 62-180,[30] *Newi* has subsequently been cited as abolishing the ruling's employer mandate test.[31] Nevertheless, *Newi* has also been limited to its facts and thus held inapplicable under essentially identical factual situations. In *Paul J. O'Connell*[32] primary emphasis was placed upon the lack of an employer mandate and thus the lack of necessity.[33] As a result of these conflicting interpretations of *Newi* and its effect on the employer mandate tests, a definitive ruling was needed.

The instant case developed as an Internal Revenue Service in-house fight.[34] Since the Service, as taxpayer's employer, did not request, require, nor expect taxpayer to have a home office there was no express employer mandate. Furthermore, there could be no *implied* employer mandate because Bodzin was never required to work overtime and because his employer provided an office that was always accessible and comfortable. The primary issue, therefore, was whether the "appropriate and helpful" test or the "employer

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26. 25 CCH Tax Ct. Mem. 538 (1966).

27. *Id.* at 539.

28. 432 F. 2d 998 (2d Cir. 1970).

29. George H. Newi, 28 CCH Tax Ct. Mem. 686 (1969).

30. Newi v. Commissioner, 432 F.2d 998, 1000 (2d Cir. 1970).

31. LeRoy W. Gillis, 32 CCH Tax Ct. Mem. 429 (1973) (sales manager for an insurance company used an extra room in his home for business purposes); Richard K. Johnson, 31 CCH Tax Ct. Mem. 941 (1972) (taxpayer used part of his apartment for office space and storage of tools used in his work); James L. Denison, 30 CCH Tax Ct. Mem. 1074 (1971) (taxpayer used his den to correct papers and to prepare lesson plans and visual aids); Christopher A. Rafferty, 30 CCH Tax Ct. Mem. 848 (1971) (taxpayer was a field engineer who was not provided an office by his employer and who did technical work and kept technical literature in his home office); Marvin L. Dietrich, 30 CCH Tax Ct. Mem. 685 (1971) (unfairness of treating an employee differently from an employer was emphasized).

32. 31 CCH Tax Ct. Mem. 837 (1972).

33. *Id.* at 842-43. The court also implied that the taxpayer had failed to meet his burden of proof, saying it had not been shown "petitioner could not have done his work at the . . . office as well or better than at his apartment." *Id.* at 843.

34. See note 2 *supra*. The amount of the deduction was not at issue in the instant case.

mandate" test was to be applied in determing deductibility of home office expenses. Finding no reason to deviate from the test normally used to determine whether an expenditure is "necessary," the *Bodzin* majority applied the "appropriate and helpful" test.[35] The instant holding therefore affirmed the majority of earlier cases,[36] which had held that the Revenue Ruling 62-180 employer mandate test need not be met in order to deduct home office expenses.

There were, however, three dissenting opinions in the instant case expressing belief that the expenditure was a non-deductible personal expense.[37] Additionally, the contentions of two of the dissenting opinions were supported by analogies to the recent United States Supreme Court case of *Fausner v. Commissioner*,[38] in which a taxpayer attempted to deduct a portion of his commuting expenses because he was forced to transport his tools to and from work. The Court held that the cost of transporting tools could be deducted only when such expenses were in addition to normal commuting expenses.[39]

The attempt to analogize *Fausner* to the instant case ignores the fact that a specific portion of Bodzin's home had been set aside to be used primarily for business purposes, thus falling outside the scope of section 262 nondeductible personal expenses.[40] The argument can therefore be made that the home office "uses up" part of the taxpayer's home, while the transportation of a commuter's tools neither "uses up" any of the commuter's assets nor causes him additional expense.

Furthermore, since *Fausner* allows deductions only for expenditures that are in addition to normal expenditures,[41] application of the *Fausner* test to home office expenses would go beyond the employer mandate test. Using the *Fausner* test, no home office deduction would be allowed an employee who is required by his employer to have a home office if its creation did not require additional space in the taxpayer's home. Only if a larger apartment were rented or a larger house built to accommodate the office would the *Fausner* test allow the taxpayer a deduction.

Since the majority in the instant case did not feel that *Fausner* was applicable, the requirement that a home office be necessary[42] is satisfied if it is appropriate and helpful to the business of the taxpayer.[43] Nevertheless, the

35. 60 T.C. at (1973).
36. *See* note 31 *supra.*
37. 60 T.C. at (1973) (Drennen, Featherston, Quealy & Scott, JJ., dissenting).
38. 413 U.S. 838 (1973) (per curiam).
39. *Id.* at .
40. *See* Treas. Reg. §1.262-1(b)-3 (1958).
41. Fausner v. Commissioner, 413 U.S. 838 (1973).
42. See text accompanying note 3 *supra.*
43. 60 T.C. at (1973). The Government has appealed *Bodzin* to the Fourth Circuit Court of Appeals. CCH 1974 Stand. Fed. Tax Rep. 70,652.

taxpayer always bears the burden of proof.[44] He must not only show that the home office expenditure is ordinary and necessary, but also that a particular part of his home is used for the office,[45] that it is used regularly,[46] that it is not primarily for his own convenience,[47] and that the amount of the deduction is reasonable. The percentage of floor space used as an office and the percentage of time that space is used for business must both be considered in determining what is a reasonable deduction.[48]

The present decision is a logical and welcome clarification of the law for the taxpayer with a home office. The "employer mandate" test was an unreasonable standard, not imposed on other section 162 deductions. In contrast, the "appropriate and helpful" test is a fair basis for determining the deductibility of any expense incurred in a "trade or business." A legitimate deduction is now available for many white-collar taxpayers who previously have been wrongly excluded by the Commissioner's "employer mandate" test.

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44. *E.g.*, Larry N. Kutchinski, 27 CCH Tax Ct. Mem. 216 (1968) (deduction was denied when taxpayer failed to show the amount of time he had used the home office); Neil M. Kelly, 23 CCH Tax Ct. Mem. 472 (1964) (deduction denied when taxpayer failed to show that it was necessary for him to have a home office and that a specific portion of his home was used as an office).

45. Neil M. Kelly, 23 CCH Tax Ct. Mem. 472 (1964).

46. Larry N. Kutchinski, 27 CCH Tax Ct. Mem. 216 (1968).

47. 60 T.C. at (1973).

48. Rev. Rul. 62-180 set up the "percentage floor space-percentage time" formula. As originally devised, the deduction was determined by multiplying the expenditure (rent, for example) by the percentage of the apartment used as an office and then by the percentage of time the office is used for business purposes. The percentage of time was determined on a 24-hour-per day basis: if the office were used 2 hours per day as an office, then it was considered to have been used 2/24ths of the time. Martha E. Henderson, 27 CCH Tax Ct. Mem. 109 (1968). A taxpayer has successfully contended, however, that the percentage of time should be computed on the basis of the total time the room is *actually used*: if a room is used 8 hours per day, 2 hours of which it is used as an office, the office has been used 2/8ths of the time as an office. G. W. Gino, 60 T.C. 304 (1973). *Gino*, however, is on appeal by the Government to the Ninth Circuit. 9 CCH 1974 STAND. FED. TAX REP. 70,655.