WORKING EXPENSES AND WORKING LOSSES

A STUDY OF TAXATION LAW

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THE DELIMITATION OF working expenses and working losses is, for many and obvious reasons, outstandingly important in the taxation of income. For the taxpayer the two concepts are the key to reduction of the tax computation basis. The legislator faces, not only corresponding questions of practical policy, but also problems of legislative technique. In this respect, the formulation of the rules proves to be intimately connected with that of the provisions for computation of income. We have one coin with two faces. This is easily understood when one compares the structure of the present German and Danish income-tax systems.

German law distinguishes between different income groups. For one group, which comprises the most important kinds of independent business activities,[1] income is established as the profit on operations and is computed as the difference between the net capital at the beginning and at the end of the computation period.[2] Thus, the assessment of working capital and its individual components is the decisive factor in arriving at the net income. It is easily understood that any loss, depreciation or expenditure then involves an income reduction, while the extraction of values from the business for purposes unconnected with the operation of the business, such as all private consumption, has no influence on the computation of income. For the other group income is considered to be the sum of benefits which have accrued to the taxpayer in the computation period, less expenses incurred in obtaining and securing his income.[3] In German law this method of measuring the income is applied exclusively to income derived from non-independent activities, from capital or from casual earnings.

[1] German Income Tax Code, sec. 2 subsec. 4: "Einkünfte ... sind 1. bei Land- und Forstwirtschaft, Gewerbebetrieb und selbständiger Arbeit der Gewinn ..." The German Corporation Tax Code also applies the "Gewinn" concept of the Income Tax Code.

[2] German Income Tax Code, sec. 4: "Gewinn ist der Unterschiedsbetrag zwischen dem Betriebsvermögen am Schluss des Wirtschaftsjahres und dem Betriebsvermögen am Schluss des vorangegangenen Wirtschaftsjahrs, vermehrt um den Wert der Entnahmen und vermindert um den Wert der Einlagen ..."

[3] German Income Tax Code sec. 2, subsec. 4: "Einkünfte ... sind 2. bei den anderen Einkunftarten der Überschuss der Einnahmen über die Werbungskosten."

The Danish law, on the other hand, applies to all income a technique for measuring the net income which is similar to that which German law applies only to the latter of the two groups mentioned above. The Danish system is in many respects less logical than the German one. It is built on a basis which has long since been abandoned by German law, except in the case of certain special income groups. In Denmark practical experience has made it increasingly obvious that income measurement differs according to types of income and that many practical problems would become easier through the application, to some extent, of a method of income computation based on a valuation of the changes in the business capital. It should also be mentioned that the application of modern accounting principles frequently comes very close to an adoption of such a method, even if it has not been recognized in the tax legislation. However, the Danish legislature has hesitated to revise the basic features of the taxation system and has not paid much regard to the need for a more adequate description of the concept of income.

Whichever of these two income techniques is applied, it seems to be obvious that working expenses as well as working losses must relate to dispositions closely connected with earning of the income, as is in fact reflected in the income tax laws of several countries. The Danish State Tax Act of 1922, sec. 6, deals with expenses incurred during the year in order "to acquire, secure and maintain the income". The Swedish Local Income Tax Act of 1928 differs from the Danish Income Tax Act by treating the different income groups individually, particularly by separating business earnings from, e.g., income derived from non-independent activities. In respect to business income sec. 29 of this Act simply rules that if an expenditure is to be deductible it must be a "working expense"; but for income from non-independent work, sec. 33, it makes the deductibility dependent on whether the expense can legitimately be characterized as a working expense in connection with accomplishing the work undertaken for earning the income. Norwegian tax legislation is terminologically almost identical with Danish law. Although Scandinavian tax legislation thus emphasizes the necessity of there being a genuine connection between expenditures and the income-earning process, one often finds an interpretative tendency to replace the provisions governing deduction of expenditures by the criterion that the expenditure shall be necessary or normal, thus reminding one of the American Internal Revenue Code, sec. 162 (a), which speaks

of "the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business". In Scandinavian tax legislation, however, there seems to be no cogent reason to try to narrow the concept of costs, apart from the insistence upon a certain direct and real connection between the expenses and the income earning activity. Even if the words of the legislation do not compel us to introduce such limitations, it is, however, an important question whether they must be interpreted to the effect that they implicitly demand that expenses or losses in order to be deductible must be necessary, appropriate or normal.

If it is possible to imagine a society in which taxable income is measured on a computation of what the taxpayers *ought* to have earned by reason of a certain accomplishment or through possession of a certain capital, limitations of the kind just mentioned would certainly be a natural consequence. We have, however, to bear in mind that such a system is Utopian. It is the actual result that counts. On the other hand one must admit that this fact does not exclude the possibility of restricting the right to deduct expenses and losses. A Danish writer tried to do this recently.[4] He undertook to define working expenses as normal and necessary expenses. He had, however, to make the additional qualification that in deciding on normality and necessity the taxpayer should be allowed a certain freedom of choice regarding dispositions involving expenditures. An approach like this does not solve the main problem. We still have to investigate the correctness of the initial statement.

Probably the reason why so many writers have found it difficult to formulate a realistic definition of the cost concept is that they are confusing economic and legal aspects. From an economic viewpoint it is natural to consider costs as part of the acquisition of maximum profit. When considering the cost rules of taxation law from this angle it cannot be denied that there appear to be many deviations, both positive and negative, from the rules which ought to be in force according to the main viewpoint. However, the difficulties disappear when one realizes that the legal delimitation has nothing to do with the question of what may be considered expedient in order to obtain the maximum earnings. At the most one might say that the tax legislation—probably for good reasons—assumes that in the great majority of cases the

[4] Eggert Möller: "Afgrænsningen driftomkostninger — privatforbrug." *Revision og Regnskabsvæsen* 1958, pp. 505 ff.

human desire for profit will be decisive for the economic dispositions, but precisely in taxation law this leads to the leaving out of account whether in each individual case the dispositions could be endorsed by a professor of economics. Taxation law is not an economic subject and its concepts such as costs and losses can only be established from a legal viewpoint. The lawyer often has to use coarse tools when the economist can use finer instruments—and vice versa.

However, the confusion of legal and economic views is not the only thing we have to fight. The subject also offers an interesting example of confusion of the legal viewpoints that assert themselves in borderline cases with the viewpoints which are decisive in the great majority of cases. This can be illustrated in the following way: a number of dice are divided into three groups—one consisting of white dice, another of black dice, and the third consisting of dice which have black as well as white sides. In each of the three groups some—but not all—of the dice have a red dot. One might find it desirable, for some special purpose, to divide the group of black-and-white dice according to whether they have a red dot or not, but it will be erroneous to conclude that for this reason the red dot should alone be decisive for the placing of all the dice. In the same way, the necessity or normality of an expense may be a suitable test for the treatment of some borderline cases, but this should not lead us to the conclusion that these traits should be decisive for the treatment of all expenses whatsoever. We must therefore start by asking whether, in a given case, there is sufficient reason for applying the tests peculiar to the borderline cases.

In forestry the costs incurred in connection with different kinds of cultivations have recently been discussed. It appears that to some extent Danish forestry has costs which are out of proportion to the total increment of volume. The high costs may be explained by the fact that in a country like Denmark, with its dense population, forests often take the form of parks adjoining the houses of wealthy people who are more interested in the look of the trees than in the profit-making aspect. From an economic viewpoint the high forestry costs incurred in such cases ought not to be deductible. From a legal viewpoint it is quite obvious that the costs are working expenses, and it is not even a borderline case which would justify a closer re-examination of the appropriateness of the expenses. However, by mixing up the legal and the economic aspects one is forced to establish a particular

defence for forest owners' deduction rights. Also it is evident that wages to workers which strictly speaking are redundant have to be accepted as costs unless, for special reasons, the wage costs are classifiable as private consumption or distribution of profit. It should be added that even in the case of wage costs for domestic workers there may be such a particular connection between expenses and income that one is forced to consider the possibilities of a working expense. In such borderline cases accessory considerations, such as, for instance, the necessity of the expense, may enter the picture.

Therefore, the main question which every tax system must answer is this: When does a disposition cease to be part of the current process of income earning as such? One has to find criteria for a delimitation of the mere use of the income, the consumption *vis-à-vis* the dispositions considered to be in the interest of the operations. When tax legislation attempts to define working expenses and working losses the results rarely amount to more than indications, and consequently the choice of words is of rather small importance. This is a phenomenon one often meets in statutory texts. Normally, it occurs whenever the legislature feels forced to establish a connection between a set of rules and a sector of community life by a description which it is almost impossible to make exact. The drafter of tax laws is in a particularly difficult position inasmuch as time and again he will face the extremely complicated and multifarious functions connected with the actual economic behaviour of the taxpayer. A possible solution is to give a simple, practicable rule which more or less applies to the same cases as the intended complicated principle. It is much easier to impose a tax on automobiles with a net weight of more than 1,000 kilograms than to describe to what extent or under what criteria the automobile and its driving is a fundamental part of a quite obscure trade function. Furthermore, a fiscal desire to be able to intervene against exaggerated deductions may account for the legislator's difficulties.

The formulae the drafter will find are therefore, as a rule, entirely irrelevant as a basis for a proper interpretation. It is a hopeless task to circumscribe the concept of working expenses by a proper interpretation of the formula in sec. 6 of the Danish State Tax Act—that which serves "to acquire, secure and maintain the income"—because a number of equally logical but divergent results of an exegesis of this formula can easily be established. American tax legislation applies the term "ordinary and necessary

expenses in obtaining income",[5] which on the face of it is another definition. However, even a superficial study of American cases in this field will teach us that this American definition says no more than the Danish expression. Every attempt to find the meaning of the statute text concerned with the aid of its tenor alone will be equivalent to the exegesis of a theologian. What is essential is that everywhere the legislator shall use one expression or another in order to set up rules to decide when a disposition can be considered a part of the activity from which the income during the earning period is derived. In the various legislations you find a rich variety of detailed provisions concerning precisely specified categories of expenses and losses, as well as attempts to cut through the general principle in limited cases by means of special rules of deduction. But these elaborations are not sufficient. However composite or differentiated one tries to make the concept of deductible expense, there is no escape from the difficulties inherent in the very approach to the problem.

The doubtful cases in the field of expenses are generally those concerning the separation either of the expenses which are regarded as part of the consumption or of the dispositions which pertain to the capital. In respect to losses it is primarily the latter dispositions that prevail. As mentioned below (pp. 167 ff.) this apparent difference is probably only due to the fact that whenever a business asset of a non-capital nature is lost, the loss is regarded as being connected with the income-earning activity. An expenditure which does not result in a capital asset is not deductible as such. Its connection with the earning of income has to be investigated before the deduction is allowed. The complicated limitation of capital expenditure has been left out of the present investigation.

A. WORKING EXPENSES OR CONSUMPTION

Sec. 6 of the Danish State Tax Act reflects the need to establish the dividing line between economic dispositions involved in the procurement of the income and those which represent the use

[5] In 1954 the American Law Institute recommended that the words "be eliminated and that instead a corporation be permitted to deduct all expenses incurred and losses sustained, subject to certain specified limitations relating

of income after it is earned. This is an old problem, which in English law has been discussed in the decision of the House of Lords in *Mersey Docks and Harbour Board* v. *Lucas* (1883),[6] and many later cases. In the case cited, the statutes of a corporation required that an annual amount should be credited to a sinking fund to retire at maturity the borrowed capital liabilities of the corporation. This was of course regarded as equivalent to any other application of the profit of the corporation. As stated by Lord President Dunedin in a later case, it may be a perfectly prudent thing to consolidate your business—but if a sum is carried to a reserve fund out of profits it is still profit. Cases from many countries, however, provide ample evidence that it may be extremely difficult to decide whether a payment has been made out of profits "after they have been earned" and that this so-called test may lead to contradictory results. All the taxpayer's expenses are functionally related, and therefore the task must be to decide how close the taxpayer's expenses shall be to the earning. As mentioned above, it is necessary to establish positively what is and what is not part of the earning process. Legally, however, this method cannot be used even for a rough classification. With a view to eliminating a large number of cases in which the disposition may be of importance for the earning, but, particularly as regards individuals, cannot be accepted as sufficiently closely connected with the acquisition of the income, it has everywhere been necessary to use another point of departure, namely: *What can normally be characterized as consumption—considering the general conditions prevailing in community life?* A Danish author, Glistrup,[7] rightly refers to the central point that deduction for everybody means deduction for nobody. Legally there are good reasons for considering as consumption all expenses that—in respect of size and character—are normal for practically all taxpayers. If travelling expenses from home to job are often looked upon as consumption this is not due to any disregard of them as important factors in the earning process, but because this item must be regarded as normal for all taxpayers; a uniform deduction, therefore, would be meaningless and individual deduc-

to capital expenditures, disbursements of profits, gifts and public policy". The ambiguous character of the "ordinary" and "necessary" test is clearly reflected in the cases dealing with advertising and business promotion; see Bowen, *The Tax Magazine* 1957, pp. 11 ff.

[6] App. Cas. 891, see LaBrie, *The Meaning of Income in the Law of Income Tax*, Toronto 1953, pp. 279 ff.

[7] See Glistrup, *Skatteret*, Copenhagen 1957, p. 182.

tion determined by the actual travelling expenses of each taxpayer would involve arbitrariness and discrimination with no relation to the individual ability to pay tax. The point which is advocated here is not approved in German tax law. Under the German Income Tax Code, sec. 9, the taxpayers' travelling expenses from home to job are deductible. Until 1954 the German legislation required that the expenses should be necessary but this provision was abandoned in the tax reform of 1955. As a consequence the German taxpayer now has a free choice as regards the means of conveyance and can claim deductibility for the expenses actually incurred. Danish law implements a policy which in many respects recalls American law, cf. Internal Revenue Code, sec. 162 (a), allowing deduction of travelling expenses incurred while a person is away from home in the pursuit of a trade or business. In November 1959 the Danish Minister of Finance, however, proposed to allow deduction of expenses due to travelling between the home of the taxpayer and his place of business if the annual expenses exceed a certain amount.

The dominating principle in most tax systems is, however, that expressed in the Internal Revenue Code, sec. 262—that no deduction shall be allowed for personal, living, or family expenses. Therefore, not only private spending for recreation and amusements but also expenses for housekeeping, travelling, clothing, education, nursing, rents, etc., are considered as consumption.

The concept of private consumption may differ from time to time and from country to country. Whether it should comprehend more or less is mainly a question of fiscal policy. Comparisons of legal systems will, however, frequently reflect a parallelism in the various tax systems on this point. If the legislator has not solved the problem of classifying the different types of expenditures, the classification reflects a judicial distinction which is a direct consequence of a system that aims at the taxation of net income. The explanation is quite simple: nearly all the expenditures of an individual are of some—though possibly of indirect—importance to his ability to produce income. In finding net income we are forced to regard the economic behaviour of the taxpayer as representing either an activity displayed in pursuit of profit or consumption. It may be a distinction of an artificial and controversial nature—like many important legal distinctions —but is probably unavoidable. "An individual is thus regarded for tax purposes as having two personalities: one is a seeker after profit, who can deduct the expenses incurred in that search; the

other is a creature satisfying his needs as a human being and those of his family but who cannot deduct such consumption and related expenditures. But since the individual remains one individual, where is that dividing line? Moreover, is it an absolute line in the sense that an expenditure belongs entirely to one or the other of the personalities, or may an expenditure be allocated between them?"[8]

Although it might appear difficult to define what consumption is in respect to taxation, the general principles of delimitation appear fairly stable, and the problem therefore is more theoretical than practical. Nearly all conflict cases are characterized by a need for individually determined expansions of the generally applied consumption concept. Cases of doubt do not arise *until an expense which according to general principles is classifiable as consumption is particularly connected with a concrete acquisition of income or, vice versa, where working expenses cover needs having the same characteristics as those normally satisfied by consumption.* As practical difficulties are generated by these two groups of cases, they deserve special mention.

1. The concept of working expenses has been expanded to cover cases which by their general character fall within the area of consumption. The circumstances which entail an expansion of the concept of working expenses are always of such a content that they reflect, in a particular manner, a connection between expenditure and income; generally they arise from expenses which in the case of the individual taxpayer exceed what is usual, but this characteristic is, of course, far from being sufficient. The somewhat negative consequence of this is that the share of the expenses which by its extent equals the habitual satisfaction of needs cannot be taken into consideration. Therefore, one will often hear in these cases about the "extraordinary expense" incurred for one reason or other, for instance, travel, maintaining two homes, etc. What is required in addition to the criterion mentioned appears rather to be the evidence of a relationship between part of the income and the pertinent "extraordinary expense". It is not sufficient to substantiate that such extraordinary costs have been incurred in order to strengthen business connections. A contractor who had invited 220 people to celebrate his silver wedding maintained in a case recently settled that half of the guests had been invited wholly or partly for business

[8] Surrey and Warren, *Federal Income Taxation*, 1955, p. 247.

reasons.[9] It is to be hoped that the guests' subsequent awareness of the tax case did not spoil their pleasure at having attended, but it is, apart from this, easy to understand that the contractor's mixed motives were irrelevant in a tax case. The connection between income and expenses need not always be contingent upon a separation of a particular part of the income to be a connecting link. Thus, a glass-blower's additional expenses for beverages are considered in Danish practice as a case in which the connection between the expenses and income is sufficient as a defence of deductibility.[1]

Some tax systems allow in general terms the deduction of medical expenses. The American Internal Revenue Code, sec. 213, provides an example. If such provisions are lacking, as for instance in Danish law, health expenses must be regarded as a typical example of application of the income—even if they have a close connection with the earning of the income. Thus, the extra dental expenses of a solo horn player or the expenses of a woman pediatrist for psychoanalytical treatment were not accepted as business expenses,[2] whereas the extra expenses of invalids for transportation are respected in Danish practice. Practice in these latter cases undoubtedly reflects a deliberate modification of the principles ordinarily applied, generated by humanitarian reasoning, but on the other hand it must be stressed that it is only the excess of transportation expenses over the normal that the invalids are allowed to deduct. The connection theory is also clearly reflected in the rules on "double housekeeping". It is in no way the necessity which determines, but whether the need for double housekeeping is attributable to particular trade conditions.

When we turn to educational expenses, we find a growing tendency to take account of special considerations. Many of these expenses were originally, and to a great extent still are, regarded as examples of capital expenditure. The profit-seeking character of educational expenses is therefore of minor importance. By and by this principle is being broken down—a striking example being the new Danish provision concerning expenses connected with doctoral theses, which are now deductible.[3]

[9] Danish Tax Court 1958, No. 138. The decision may be compared with the American case of *Stern* v. *Commissioner*, 15 T.C. 517 (1950).

[1] Danish Tax Court 1957, No. 49.

[2] Danish Tax Court 1956, No. 121, and 1958, No. 147.

[3] According to the Danish *Ligningslov*, which forms a supplement to the State Tax Act, printing expenses as well as other expenses connected with

The proposals made by different pressure groups in Sweden—and later in Denmark—to give academically trained persons a right to make annual depreciation deductions on their total educational "investment" also provide illustrative examples of a new trend in taxation policy and possibly in the tax law.[4] The capital expenditure barrier is overcome simply by claiming the right to depreciate education (as if it were a parallel to some kind of machinery).

An American case of 1953[5] emphasizes the necessity of distinguishing some educational expenditures from those made to acquire a capital asset. "Even if in its cultural aspect knowledge should for tax purposes be considered in the nature of a capital asset... the rather evanescent character of that for which the petitioner spent his money—(a lawyer's expenses spent to attend a course at a tax institute)—deprives it of the sort of permanency such a concept embraces..." If this is true one would imagine that such expenditures would find difficulty in passing the test regarding their connection with the profit-seeking activity. However, numerous Danish tax court decisions show great efforts to solve this problem, too. As we are dealing with borderline cases a requirement of necessity might be expected. The Danish decisions seem to be content with a distinction between educational expenses and those that are incurred only in order to bring the scholar's knowledge of his subject up to date.[6] This somewhat hairsplitting distinction appears rather obscure, when closely analysed. However, it serves the purpose of finding some parallel between business expenses and the normal expenses of university teachers and above all it goes some way to meet the need to give some tax relief to scholars.

In other areas also, it seems easy to obtain direct confirmation of the theory that neither necessity nor reasonableness is a decisive factor and that what really determines the matter is the functional role played by the expense in the earning of income. This is clearly shown by cases where the income of the taxpayer flows from different sources. A university professor in Århus who, because of housing difficulties in Århus, still maintains his home in Copenhagen, is not allowed to deduct travelling expenses al-

the scientific work are deductible if the thesis has been accepted by the university.

[4] A Swedish tax committee of 1944 made two reports on this subject, *S.O.U.* 1950: 21 and 1951: 13; see Mutén, *Svensk Skattetidning* 1954, pp. 361 ff.

[5] *Coughlin* v. *Comm.*, 203 F. 2d. 307 (2d. Cir. 1953).

[6] Danish Tax Court, 1958, No. 139.

though they must certainly be regarded as necessary; whereas his colleague who lives at Århus and travels to and from Copenhagen in order to earn extra income, may deduct the expenses connected with the job.

In many cases it is quite evident that the fact that the expenditure has been or will be covered by somebody else—for instance the employer—is regarded as decisive, and frequently the deduction is limited to the amount which the taxpayer is entitled to claim as compensation. An architect who had been travelling in the service of a public institution received compensation corresponding to the cost of undertaking the journeys by rail. The extra expense incurred owing to his use of his private car was not approved.[7] The correctness of this decision is dubious. The decision was not based on the fact that travelling by car was regarded as unnecessary. If the institution in question had defrayed the car expenses, the tax court would no doubt have accepted the whole amount, and normally business expenses are not divided so that only part of the expenses may be deducted. The case of the architect can easily be distinguished from cases in which extraordinary expenses, that is expenses considerably larger than the normal, are qualified as deductible. In the latter category the above-normal expense indicates the connection with the earning of income, while in the former category this connection is obvious in respect of the total amount. The tax inspector will not try to decide in which cases a business executive might have gone by train instead of by air.

Frequently the question of deductibility is influenced by the concept of income. In Denmark, for instance, a man who lives in a house of which he is the owner must add the rental value of the property to his income. The consequence is that he has to be allowed to deduct expenses for repairs, interest on mortgages, etc. It might be a better solution to remove this kind of income as well as the expenses from the computation of income. The result of the present system is in fact a tax premium to taxpayers who are living in their own houses.

Many private recreational expenses have given rise to doubtful cases, because the activity in question has some resemblance to business activity and because there can be no question that even income derived from hobbies is taxable income. In some cases the activity must be respected as having a real business character.

[7] Danish Tax Court, 1958, No. 136.

A taxpayer who was selling valuable sporting guns was allowed to deduct the expenses spent for hunting grounds which he hired in order to give the customers a chance to try the guns. In other cases the fact that the activity in question is a pure hobby cannot be disguised. In two recent cases a Danish court of appeal has affirmed tax court decisions which refused to approve deductibility of net losses arising, respectively, from the shooting and breeding of pheasants and the breeding and racing of horses.[8] In the first case most of the expenses were of the type normally arising from indulging in shooting as a mere hobby; apart from these expenses there was no proof that the breeding of pheasants had resulted in a net loss, and in these circumstances the court was not compelled to decide whether the latter activity was of a "business character". In the second case, concerning horse breeding, the court stated that this activity lacked a business character. One wonders whether this is a satisfactory solution of the problem. In both cases the taxpayer had certainly obtained income from his hobbies, and it seems to have been tacitly accepted that these items of gross income were not added to his normal income. This means that expenses are apparently deductible from the income from the same source, but are limited to the amount of the income. As the Danish tax law does not have separate income classes—unlike for instance the British system with its different "schedules"—and as all deductible expenses—with one exception, which is irrelevant in this context—are deductible from gross income as a whole, it seems that the difficulty of limiting certain groups of expenses leads to the introduction of special and separate income groups. It may also be that there is a general tendency to strengthen the conditions under which deductibility is acknowledged; this takes the form of stipulating that expenses which normally belong to the private consumption area must, in order to be admitted, not only be closely connected with the acquisition of income, but also be covered by the income from the activity which caused the expense. If this is true, a host of contradictions may be expected—for instance when not only businessmen but also other taxpayers are allowed to carry the net loss of a year forward to a future period.

2. Expenditures which appear to have or have in fact the character of real working expenses may be disqualified, because they serve at the same time to cover private consumption. Most

[8] 1959 U.f.R. 561 and a decision of May 8, 1959, not yet reported.

cases falling within the description above arise from travelling expenses, "business dinners" and similar "entertainment expenses". Even if it is uncontested that they are closely connected with the earning of income, they may be qualified as private consumption. We are not thinking of the many situations where a taxpayer tries to give an entirely private living and household expense the appearance of an operating expense of business. While such cases are certainly of practical importance, they are of minor interest from the legal point of view. The cases which need to be investigated are those in which the expenditure as such is obviously incurred in pursuit of business, but where a 100 per cent deductibility would mean a privilege in comparison with the lot of other taxpayers. This problem has not yet been properly solved in Denmark. Part of the population gets a meal at a restaurant at at lower "net cost" than the less favoured, who cannot charge the additional cost to the magic expense account. The tax policy in our country has aimed at adding "saved living expenses" to the income of the taxpayer. In certain groups of cases standard rates are introduced to show the maximum of deductible expenses, but the system is far from being perfect.

3. In all income tax systems the question arises when a disbursement is really a non-deductible gift. The true nature of a compensation or salary may be disguised by the taxpayer, but in most cases it is not too difficult to show that no real connection between the expenditure and the carrying on of trade exists. In other groups of cases the connection may be present, if the purposes of trade and business are defined as including a social function. In this way many welfare and pension plans may be classified as involving operating expenses, and the tendency to favour the welfare of employees has, in Denmark as well as in many other countries, resulted in special provisions in order to allow "social" expenses.

Recently a special statute covering all these types of expenses was introduced in Denmark.[9] On the other hand, the Danish tax system has not yet made other exceptions; it has, for instance,

[9] "Lov om beskatningen af renteforsikringer m. v.", 1958. This statute deals primarily with the question of the deductibility of private insurance expenses and also with the extent to which insurance expenses paid by the employer are deductible in relation to him, without being included in the gross income of the employee. In the last chapter of the statute the Minister of Finance is authorized to allow deductibility in respect of all expenses which are incurred for the benefit of former or present employees.

hitherto refused to accept the deductibility of charitable contributions. A limited exception (gifts to a maximum amount of 1,000 Danish kroner in any one year) has been proposed and may be adopted by Parliament. Larger donations will therefore only be deductible in the rare cases where they are directly connected with the earning of income. The latest Danish decisions show that the mere fact that the taxpayer intended to obtain publicity and good will by making the donation or charitable contribution will not help him.[1] The court demands that there should exist an actual business connection between the donor and the recipient, and furthermore that the donation should have an actual business function. These cases therefore also illustrate the general importance of the function of a given disbursement rather than its necessity or its reasonableness.

B. LOSSES

1. In the previous section of this article I have tried to show the weight attached to the function of the expense in the income-seeking activity. This test seems far more important than the nature of the expense itself, its reasonableness or the necessity of incurring it. Turning to the question of deductibility of losses we find that there is reason to believe that the same principles govern the legal treatment of this matter.[2] Danish tax law has no special provision regarding losses. However, in course of time a theory was developed as a result of a multitude of cases. Without going into an analysis of these cases it seems sufficient to stress a striking peculiarity: that the court tried to define the character of the factors causing the loss. It asked what kind of risk or peril had been the background of the loss. This way of looking at the problem led to great difficulties. What kind of dangers or risks are connected with the carrying on of the trade? Is an accidental fire to be classified as a result of a business risk, if it happens in a timber business or a textile mill?

[1] See Thøger Nielsen, *U.f.R.* 1959 B, pp. 178 ff.

[2] When one turns to losses, the present author claims that the deductibility cannot depend on the normality or reasonableness of the loss. The deductibility may, however, be influenced by the way in which the loss is regarded as a functional factor within the economic activity of the taxpayer, and in this respect the parallel may be defended.

Is it of any importance to know whether the fire was caused by an employee during or after working hours? One does not need too much imagination to extend this series of questions with a lot more just as awkward. The Tax Court decisions frequently displayed a picture of that kind of wisdom which derives its strength from the fact that nobody apart from the court is competent to hold a different opinion—a situation which far too often decides the fate of tax law.

The reason why the Tax Court has ventured into such a blind alley is obvious. Every taxpayer may have financial losses, and you have to find those which he is suffering in pursuit of income. It seems logical to look for an answer by investigating the events leading to the loss. In many cases there is a parallel between this kind of investigation and that which is found in a normal civil lawsuit in tort. As a proof of this theory it may be mentioned that several decisions also began to pay attention to the question whether the taxpayer himself had caused the loss by his own negligence. If this road were to be followed, the tax inspector would soon be able to deny the deductibility of 90 per cent of all losses, as human negligence will always be one of the principal causes of financial losses. Tax law will have to accept man as he is and not as he ought to be.

In a growing number of cases it was obvious that the character of the assets or economic interest lost by the taxpayer was just as important as, if not more important than, the human or technical factors causing the loss. If stock-in-trade had been destroyed accidentally there could be no doubt that the loss must be taken into consideration regardless of the background of the destruction. This fact and other similar ones were not even discussed, although the latest development has shown that such cases represent the key to a better understanding of the principles governing this part of tax law. While it is correct that the deductibility of losses must be decided by the functional role played by the loss, in the same way as we have seen above in respect of expenses, the great misunderstanding was simply the false theory that the factors causing the loss could be of some help for this decision. On the contrary, it is obvious that one must look at the true nature of the loss itself, and a deductible loss must be acknowledged whenever an asset which plays an active and actual role in the current process of income earning is lost, whether the loss has the character of a casualty or is a loss from the disposition of property. This puts before us the difficult

task of deciding when an asset is part of what may be called the business property of the taxpayer. In this respect the new Danish Depreciation Act of 1957[3] has meant a great improvement and has at least shown the main principles on which we must build in the future.

2. The Danish statute of 1957 introduced the declining balance method and allowed a fixed annual rate of 30 per cent to be computed on the depreciated cost of all kinds of machinery and business equipment. Ships are also covered by the new system. Depreciation is computed on the total value (cost) of the taxpayer's assets as a whole. If a single piece of the machinery or business equipment is sold, the proceeds of the sale are deducted from the total balance. The reduction of the balance will reduce the future amount of depreciation and a profit will therefore indirectly and gradually be taxed as income. In the same way a loss will gradually influence the computation of income. In addition to these provisions there is, however, a supplementary one giving the taxpayer the right to deduct single losses at once by deducting the difference between the depreciated cost and the (lower) sale value.[4]

These provisions are made applicable also in the case of accidental destruction of machinery or equipment. This means that all kinds of physical business assets, apart from real property, are acknowledged as a functional part of the actual process of earning income. If a loss of such assets is the consequence of the taxpayer's dispositions or it is caused by other circumstances regardless of their nature, it must always be taken into consideration when computing income.

These principles are the result of a long and complicated evolution in Danish tax law. To understand this it must be remembered that it is a fundamental principle of Danish tax law not to tax capital gains and not to allow any deduction of capital losses, and originally all assets which had not been acquired for the purpose of selling them were part of the capital—even if the assets served pure business purposes. Twenty years ago, exceptions were made in respect of machinery and

[3] "Lovbekendtgørelse om skattefri afskrivninger m. v.", 1958, and Regulations of October 31, 1957 and December 16, 1957.

[4] The Danish Depreciation Act, sec. 4. It may be mentioned that business assets with a useful life of less than three years and costing less than 800 Danish kroner may be deducted in full in the year of the purchase. The loss of such assets will therefore not affect the income.

business equipment. Losses were made deductible, but profit was taxed only if it amounted to more than 30 per cent of the original cost. Now it is obvious that even assets which the business man acquires without any intention of making a profit by selling them must influence the computation of income, if they are sold or lost.[5]

Having got so far as this, it seems necessary to give up the idea of defining operating losses as those which are caused by "business risks". All losses must be regarded as connected with the earning of income and must reduce the net profit provided, however, that the loss is regarded as affecting only the capital assets of the taxpayer.

3. It may be of some interest to compare the structure of the new Danish system with the American Internal Revenue Code. If we start with the fundamental sec. 165 we find that the differentiation between corporations and individuals, to the effect that a corporation's losses are deductible as such, while the losses of an individual must fulfil certain conditions in order to be deductible, does not exist in Danish law. Our system still treats the computation of income in the same way, whether it is a corporation or an individual that earns the income. It is possible that some day the American system, which has parallels in other highly developed tax systems, will be introduced in Denmark too.[6]

A comparison may, however, be made when looking at the treatment of individuals. Under sec. 165 (c) of the American Code, losses incurred in a trade or business or in any transaction entered into for profit shall be deductible. This limitation is quite similar to the allowance, under sec. 212, of expenses incurred for the production of income, and both are similar to the principles governing Danish tax law. The profit-seeking activity is

[5] If business property is sold at a profit, the total consideration received must be credited to the depreciation account. In this way it may happen that the account will show a negative balance, which in fact will represent a profit on the sales that has not been taxed. In this case the taxpayer has the right to keep the balance during the accounting period in question and the following year. If the negative amount has not been remitted at the end of the last year by the purchase of new items, the amount must be added to the income. In special circumstances the Minister of Finance may prolong the respite. This prolongation may, however, be given on condition that the taxpayer shall give a bond to secure that he will be able to pay the income tax which he may be charged in the future.

[6] It seems, however, to be more realistic to adopt the principle of German tax law, according to which an independent activity is treated in the same way whether it is carried on by a corporation or not.

the decisive test. In addition to the losses incurred in a profit-seeking activity, sec. 165 allows deductibility of casualty losses. This allowance certainly goes further than Danish law before 1957.[7] Losses arising from casualties were, prior to that date, only deductible if the casualty could be regarded as the consequence of a risk connected with the activity of the taxpayer. Since the adoption of the Depreciation Act it does not matter at all how the loss has happened. As already mentioned, a loss is deductible if, and only if, the property lost is business property.

To complete this comparative survey the American treatment of capital gains and losses must be taken into consideration. In this connection we may for a moment forget the fact that the Internal Revenue Code imposes a special capital gains tax, while the Danish system, apart from a few recently introduced exceptions, has made the differentiation between income and capital transactions a question of tax or no tax. It will easily be understood that this peculiarity does not diminish the importance of the subject.[8]

A loss deductible under the Internal Revenue Code, sec. 165, may still be treated as a non-deductible capital loss under sec. 1211, cf. sec. 1221.[9] The Code defines capital loss as a loss of capital assets, but the latter term does not include:

(1) stock-in-trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

[7] The difference between the American casualty test and the Danish treatment of such losses is clearly illustrated in a long series of Danish cases dealing with losses from theft. The Tax Court demands a close connection between the stolen property and the business activity. Especially when money has been stolen, it may be very difficult to ascertain whether the money must be regarded as part of the business property—for instance, when a farmer loses his wallet by theft while he is out one evening. The American provision seems reasonable as a manifestation of the wish to tax according to the individual ability to pay taxes.

[8] As a matter of fact the Danish State Tax Act, sec. 5, is the background of by far the greater number of tax cases. According to this section the fluctuation of the value of assets belonging to the taxpayer does not affect the income. Nor does the profit from a sale which does not belong to the trade of a taxpayer or which has not been made on speculation. It is the last mentioned provision that the Danish Supreme Court has interpreted as meaning that the term speculation demands that the property shall have been *acquired for the purpose of selling it.*

[9] A loss which is not deduntible under sec. 165 cannot be deducted under sec. 1211.

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in sec. 167, or real property used in his trade or business.[1]

Non-depreciable personal property is a capital asset unless it is covered by subsection (1) above. These limitations are in principle similar to the limitations now in force in Denmark. There is, however, one important difference. According to the Danish statute, loss of real property is not deductible and this rule is not affected by the fact that real property may be depreciable and may be used in the trade or business. On the other hand, U. S. Tax Court—in *Hazard* v. *Commissioner* (1946)—held that a loss sustained by the taxpayer on the sale of his former residence was deductible. When he moved to another city the house had been rented until it was sold three years later. The court found that the property had been used in the trade or business of the taxpayer. A Danish tax court must necessarily regard a loss like this as being of a capital nature.[2]

As already mentioned, the loss on non-depreciable personal property may be deductible if it is stock-in-trade or has been held for sale to customers in the ordinary course of a trade or business. The latter test is of a different nature compared with the Danish State Tax Act, sec. 5 (a). Here the purpose of the taxpayer when acquiring the asset is the deciding factor. Therefore the subsequent decision of a taxpayer to hold property for sale is of no importance if the asset has not originally been acquired for the purpose of selling it later.

4. The result of the analysis above is that the Danish tax system has recognized all losses as deductible, if the asset affected by the loss is not of a capital nature.[3] Correspondingly, it may be

[1] Furthermore, such assets as for instance copyrights, accounts or notes receivable are excluded from capital asset treatment. It should be remembered that sec. 1221 is the decisive factor when speaking of losses; in the case of capital gain sec. 1231 must be taken into consideration, and this may lead to the result that a loss may be ordinary while gain on the same asset may be capital.

[2] This leaves a question which has not yet been answered by the Danish Tax Court. Does the treatment of all real property losses as capital losses also apply if it is a typical business risk which causes the loss, and where is the borderline between ordinary repair and non-deductible expenses which serve to re-establish the lost property?

[3] When speaking of a loss of an asset, it must be remembered that losses frequently take the form of a creation of a new obligation. Generally this manifestation of a loss may be treated according to the same principles as those mentioned above.

said that only the loss of business assets is recognized, such assets being defined in the following way:

(a) Stock-in-trade and other property includible in inventory.
(b) Depreciable personal property used in the trade or business. If it is only partly used in this way it will only partly be accepted as a business asset.
(c) Property—personal or real, depreciable or non-depreciable—which has been acquired by the taxpayer for the purpose of selling it at a profit.

A loss of business assets is deductible, regardless of the way in which the loss has occurred—whether it is due to a disposition of the taxpayer or not, and whether the disposition constitutes a sale or an exchange. If the property is not of a business nature no deduction of loss is allowed, regardless of the way the loss has arisen.

Some recent court decisions, however, make it obvious that the whole question of limiting deductible losses has not yet been answered. While such assets as, for instance, accounts receivable, patent rights etc., easily find their place on the analogy of the principles already described, other types of property may present difficulties.[4]

This may be illustrated by some examples. A taxpayer may be holding some securities for investment. He decides to sell the securities and invest the capital in some temporary business activity and is promised a 50 per cent share of the profit. Shortly afterwards the partnership is dissolved with a total loss of the invested capital. In some of these cases the tax court has acknowledged that the partnership interest must be classified as an asset acquired for the purpose of getting the investment back with a profit, and the loss has therefore been recognized as deductible.[5] The tax court treated this disposition as analogous to the acquisition of new securities for the purpose of selling them at a profit. In most cases this analogy is not present, and, whenever

[4] It may be mentioned that some assets, as for instance good-will, patent rights and similar property may be subject to a special capital gains legislation which has recently been introduced in Denmark. If for instance a patent right has not been acquired by the taxpayer for the purpose of selling it at a profit the gain on the sale is of a capital nature. Instead of being free of any tax such gain is now subject to a 30 per cent capital gains tax. Even in this case a loss of the same asset will be deductible from income. It may therefore be said that the introduction of the special capital gains tax has resulted in a right to deduct losses even in cases where the principles described above would not lead to deductibility.

[5] Danish Tax Court 1950, Nos. 22, 133 and 160, 1951, No. 56.

the investment has been made as a loan or has been planned as a more permanent investment, losses are non-deductible. These distinctions are difficult enough, but even more difficult is the question to what extent losses in partnership cases and similar cases shall be classified as a capital loss of the partnership interest or as a loss of ordinary business character, which is the result of the activity of the partnership. In some cases, where the partnership has been liquidated immediately after the formation, this has been the reason for treating the loss as a capital loss of the partnership interest.[6]

In the cases just mentioned and in similar cases, we are dealing with taxpayers who are investing their own capital to promote their own business activity or, what comes close to that, an activity of a partnership of which the taxpayer is a partner. Danish tax law does not tax a partnership as an entity and there is no special partnership return.

Many cases, however, deal with the various ways in which the taxpayer promotes his business interests by investing a part of his capital in a corporation. Such investments are typically made with the aim of keeping the acquired stock permanently.[7] All kinds of motives may be behind the investment. The corporation may be a customer or an important supplier, and the purchase of the stock of the corporation may be a question of gaining control or good-will. In such cases it may be very difficult to decide whether the asset is a business asset, and the above-mentioned principles are not broad enough to cover these cases. To the three categories must be added a fourth, covering "investments held for the production of income".

In Denmark the Tax Court now and then seems to be willing to admit that investments may have such a character, especially if the investment is a customary accessory to the trade. An example is the way in which wine merchants often have to offer financial help to restaurants and hotels in order to secure the sale of wines and spirits.[8] Another group of Tax Court decisions deals with losses due to financial aid given by lawyers and accountants to their clients.[9] In cases where the aid has been dictated only by the wish to bolster up the finances of the client, in order to maintain the income, the loss has frequently been

[6] Danish Tax Court 1949, No. 138.

[7] The principle laid down in sec. 5 of the Danish Tax Act would therefore lead to the result that the loss of the stock must be capital.

[8] Danish Tax Court 1954, No. 126.

[9] Danish Tax Court 1950, No. 132, 1956, No. 95, 1957, No. 128.

regarded as deductible. It is very difficult to find the guiding principles of the Tax Court decisions, because in so many cases there is also an attempt to defend another line of thinking: that investments which are aimed at obtaining or merely securing a permanent source of income cannot be regarded as business assets.

As early as 1930 a Danish Supreme Court decision approved a Tax Court decision of the latter kind.[1] A wholesaler bought for 50,000 kroner shares in a company in order to obtain a contract of considerable size. He kept the shares for four years. The stock was then found to be worthless. Under these circumstances the Supreme Court affirmed the decision of the Tax Court to disallow deduction for the loss, because the taxpayer had failed to prove that the acquisition of the stock had been necessary in order to obtain the contract.

Two Supreme Court decisions of 1956 and 1958[2] make it a very difficult task to ascertain whether a more liberal tendency in allowing deductibility is on its way.

During the war a textile wholesaler had great difficulty in securing the necessary supplies to keep his business going. In 1941 business contact was established with a flax-processing plant. In addition he subscribed for preference shares in the corporation owning the plant, as fresh capital was needed. This was made a condition of his obtaining supplies. The wholesaler contended that the acquisition of the preference shares was not an investment in order to create a permanent source of income. His interest in the shares was limited, as they represented the only way in which he was able to obtain deliveries during the war. He kept the shares until 1949, when he sold them at a loss, as the flax plant was now having difficulties owing to the change in market conditions. The Revenue Department submitted that the property should be regarded as a capital asset and referred the court to the case of 1930. This view was accepted by the Tax Court. The Court of Appeal, however, reversed this decision. The Supreme Court, which upheld the decision of the Court of Appeal, emphasized in its opinion that the taxpayer had been able to prove that his only purpose had been to acquire the shares in order to get supplies, and that the only reason why he had held the shares for some time after the war had ended was the difficulty of getting supplies from other sources.

[1] 1930 U.f.R. 68.
[2] 1956 U.f.R. 792 and 1958 U.f.R. 570.

In both the case of 1930 and the case just mentioned the purpose for which the taxpayer had made the investment was regarded as a main question, but in the former case the fact that the taxpayer had kept the shares for a long period was considered to make the investment a capital investment, while the taxpayer in the latter case was able to persuade the Court that the investment still had the character of an asset needed for business purposes.

In 1946 a group of farmers formed a corporation for the production of insulating material made of straw. Their purpose was primarily to sell the surplus straw from their farms. After a period of seven years the corporation had to go into voluntary liquidation as the capital had been consumed. The Court of Appeal accepted that the sole purpose had been to create marketing facilities for the sale of the surplus production of straw. Nevertheless it found that this investment had served to create a new permanent source of income and therefore affirmed the Tax Court decision to the effect that the loss in question could not be deducted from income. The decision of the Court of Appeal was in 1958 affirmed by the Danish Supreme Court, "as this kind of business activity had no natural or customary connection with farming". It remains to be seen how far the courts will go to keep this line, which makes it a condition that the taxpayer shall have kept the investment within his ordinary and customary sphere of the trade.

As mentioned in the introduction to this paper, the fundamental background of the difficulties is a system which does not recognize that income cannot be computed in the same way in all income groups. In the world of business, dynamic principles are gradually pushing forward, and some day Danish tax law will have to acknowledge that the total capital involved in a profit-seeking activity must share the fate of this activity, even when one is measuring taxable income. The old division between capital movement, on the one hand, and gains and losses which form an integral part of the income-producing activity, on the other, will always be an important matter in all income tax systems. We must, however, expect that it will lose its power in all those cases where income has to be computed as a result of a dynamic activity. The Danish tax system is an illustration of all the difficulties caused by legislation which tries to treat phenomena which are dissimilar in their nature as if no differences existed.