Christensen v. Commissioner, 71 T. C. 328 (1978)

Expenses indirectly related to income exempt under section 933(1) are not deductible.

Summary

The Christensens, who resided in Puerto Rico from 1966 to 1969, incurred legal and accounting fees during a Puerto Rican tax audit of those years. They sought to deduct these expenses on their 1972 and 1973 U. S. federal tax returns. The U. S. Tax Court held that these expenses were not deductible under section 212(3) because they were "properly allocable to or chargeable against" income exempted under section 933(1), which excludes Puerto Rican income from U. S. federal taxation. The court reasoned that allowing such deductions would provide a double tax benefit, contrary to the intent of section 933(1).

Facts

The Christensens, U. S. citizens, lived in Puerto Rico from 1966 to 1969 and filed Puerto Rican tax returns for those years. Upon returning to the U. S. in 1970, they were informed of an audit of their Puerto Rican returns. They incurred legal and accounting fees in 1972 and 1973 during this audit, which they then deducted on their U. S. federal tax returns for those years. The Commissioner disallowed these deductions, arguing they were related to income exempt under section 933(1).

Procedural History

The Christensens filed a petition with the U. S. Tax Court contesting the Commissioner's disallowance of their deductions. The Tax Court found for the Commissioner, holding that the expenses were not deductible because they were allocable to exempt income.

Issue(s)

1. Whether legal and accounting expenses incurred in connection with a Puerto Rican income tax audit are deductible under section 212(3) despite being related to income exempt under section 933(1).

Holding

1. No, because the expenses were "properly allocable to or chargeable against" income exempted by section 933(1), and allowing the deduction would provide a double tax benefit.

Court's Reasoning

The court applied section 933(1), which exempts Puerto Rican income from U. S.

federal taxation but disallows deductions allocable to that income. The court interpreted this provision broadly to prevent a double tax benefit, citing previous cases like *Roque v. Commissioner* to support its "sufficient nexus" test. The Christensens' expenses were indirectly related to their Puerto Rican income, as they would not have been incurred without it. The court emphasized that Congress intended to burden exempt income with all associated costs, including indirect ones, to prevent deductions that would effectively reduce the tax on other income. The court quoted from *Roque*, stating that section 933(1) ensures "tax-exempt income remains burdened with all costs associated with its production. "

Practical Implications

This decision clarifies that expenses indirectly related to exempt income cannot be deducted, even if they are otherwise deductible under other sections of the tax code. Legal practitioners must carefully assess whether expenses are traceable to exempt income when advising clients on deductions. This ruling impacts taxpayers who have income exempt under section 933(1) or similar provisions, as it broadens the scope of non-deductible expenses. Subsequent cases like *Hernandez v. Commissioner* have applied this principle, reinforcing the Christensen precedent. Businesses operating in territories with income tax exemptions must consider these indirect costs as part of their tax planning strategy.

