

## Comparision of General Expense Provisions of U.S. and Korean Tax Law to Suggest Guildelines for Interpretation of Korean Tax Law

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### Abstract

*This essay reviewed and analyzed the general provisions for a business deduction of the U.S. and Korea, and compared them to see if the interpretation of I.R.C. § 162(a) as confirmed and established by the U.S. courts can be useful as a tool to interpret the general provision of Korea. This essay has come to observe that: Generally, for a deductible expense, the Korean system adopts a negative method, allowing all expenses to be deductible unless otherwise provided. The U.S. system, however, adopts a positive system, which means an expense is deductible only if a separate provision to allow doing so is provided; just as "ordinary and necessary" are paralleled in I.R.C. § 162(a), so "ordinary and directly related to revenue" are paralleled in the Korean Corporation Tax Law(CTL). But the meaning of "necessary" and "directly related to revenue" are different; the interpretation to the meaning of "ordinary" by the U.S. Supreme Court may be applicable to the interpretation of article 19(2) of the CTL; the standards developed in the U.S. with respect to deciding what a "trade or business" may not be applicable to the CTL; and interpretation rules or precedents established as related to "in connection with" and "carrying on" in the interpretation of the meaning of ordinary in I.R.C. § 162(a) can be useful guidelines to interpret the meaning of "in connection with" in the CTL.*

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## I. Introduction

The main objective of this essay is to suggest guidelines for the interpretation of Korean tax law, especially article 19(2) of Beopinse beob [Corporation Tax Law(CTL)]. Taxable income is calculated as gross income minus deductible expenses. The CTL uses an all-inclusive system to calculate taxable income, which means that all income must be included in gross income from whatever source derived, even though only expenditures that are permissible under tax law are deductible. In terms of permissible tax expenses, one general section of the CTL defines the conditions for deducting business expenses, and many other individual sections extend or limit those provisions in the general section. Thus, even though some expenditures are theoretically deductible, for policy or other reasons they may not be fully deductible.

This essay will begin by analyzing a general provision of a business expense under the U.S. tax law. Both the U.S. and Korea have a general provision for the deduction of a business expense. Even though they have adopted a different legal system, these general provisions have many aspects in common since article 19(2) of the CTL was modeled after I.R.C. § 162(a). In this essay, we will review the general provisions of both countries and then compare them, especially to see if the interpretation of I.R.C. § 162(a) as confirmed and established by the U.S. courts can be useful as a tool to interpret the general provision of Korea.

## II. The Review and Analysis of the Section 162(a) of the Internal Revenue Code in the United States

For taxpayers engaged in business activities, tax is imposed on net income, not gross receipts or gross income.<sup>1)</sup> Net income from the taxpayer's business activities is calculated by subtracting business expenses

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1) See *e.g.* Tank Truck Rentals, Inc. v. Comm'r, 356 U.S. 30, 33 (1958); see also I.R.C. § 63 (taxation on net income).

from gross income.<sup>2)</sup> The determination of what qualifies as a deductible business expense is pivotal to calculating taxable income. I.R.C. § 162(a)<sup>3)</sup> provides a general rule for the deduction of business expenses: “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 ...”

Thus, to be qualified as a deductible expense under this section, the expense must be (a) ordinary and necessary, (b) (paid or incurred) in carrying on a trade or business, and (c) paid or incurred within the taxable year.

### 1. *Ordinary and Necessary*

To meet qualification for a deduction under § 162, the expense must be both “ordinary” and “necessary.”<sup>4)</sup>

#### 1) *Ordinary*

Ordinary does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. Instead, ordinary expense means a customary or usual expense incurred within the experience of a particular trade, industry, or business community even if uncommon for a particular taxpayer.<sup>5)</sup> In *Welch v. Helvering*, Mr. Welch had been an executive with a bankrupt company. When he became a commission agent in the same line of business as his former company, he voluntarily paid some of the former company’s unpaid debts so that he might establish good relationships with customers. Under this circumstance, the Commissioner of the Internal Revenue Service denied the debt paid by Mr. Welch as a deductible expense, insisting that the debt is a capital expense.

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2) Gross income is “all income from whatever source derived.” I.R.C. § 61(a); In a manufacturing, merchandising, or mining business, “gross income” means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Treas. Reg. § 1.61-3.

3) In addition to business deduction under this section, I.R.C. § 212 allows a deduction for an expense to profit-seeking activities satisfying conditions thereto.

4) *Welch v. Helvering*, 290 U.S. 111, 113 (1933); *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940); *Comm’r v. Lincoln Sav. & Loan Ass’n*, 403 U.S. 345, 353 (1971).

5) *Welch*, 290 U.S. at 113.

The Supreme Court affirmed the decision of the Commissioner, stating the payment by Mr. Welch, instead of being ordinary, is in a high degree extraordinary.<sup>6)</sup>

(1) Payment of expenses or debt not obligated

Thus, under *Welch v. Helvering*, generally, payment of the obligation of another taxpayer by one taxpayer is not ordinary. This rule was reiterated by the Supreme Court in *Deputy v. Du Pont*.<sup>7)</sup> However, obligations of the other person paid by a taxpayer to protect or promote his own business may be deductible if some conditions are met.<sup>8)</sup> The Court in *Lohrke v. Commissioner* applied the following two prong test to find whether obligations of another person paid by a taxpayer can be deductible: i) ascertaining the purpose or motive which cause the taxpayer to pay the obligations of the other person; ii) determining whether it an appropriate expenditure for the furtherance or promotion of that trade or business, which means determining whether there is a sufficient connection between the expenditures and the taxpayer's trade or business.<sup>9)</sup> Following *Lohrke*, the Tax Court has analyzed this two prong tests to decide whether the payment by a taxpayer without legal obligation can be deductible as

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6) But the Supreme Court admitted that kind of payment is necessary expense since it is appropriate and helpful.

7) In *Deputy v. Du Pont*, a substantial shareholder of Du Pont borrowed Du Pont stock from other shareholders, which he sold to some key employees of Du Pont to enable them to acquire stock in Du Pont. He sought a deduction for the expenses of acquiring the stock, but the Court held that such expenses were not deductible since they were not ordinary expenses. The Court reasoned that although they may have enhanced the value of his interest as a shareholder in Du Pont, the expenses were the ordinary and necessary expenses of the trade or business of Du Pont, not one of its shareholders.

8) See *Lohrke v. Comm'r*, 48 T.C. 679, 688 (1967).

9) In *Lohrke v. Comm'r*, the taxpayer was receiving a substantial amount of royalty income from the licensing of a patent on a process used in the synthetic fiber industry. The taxpayer also had a substantial interest in a corporation that used this process in the conversion of synthetic fibers into fabrics. The corporation made a shipment of defective fiber to a British corporation. The taxpayer agreed to assume personally any loss to the British corporation resulting from this shipment and sent his personal check to cover the loss. Under this circumstance, the Tax Court held the taxpayer's payment to the British corporation was an ordinary expense of carrying on his licensing business while applying two prong tests after analyzing several cases dealing with payment of expenses or debts not obligated to pay by a taxpayer.

business expenses.<sup>10)</sup>

(2) Connection with business activity

To be deductible as ordinary expenses, expenditures must be connected with the business activity of the taxpayer<sup>11)</sup>; that is, the taxpayer must show that there is a direct or proximate – rather than merely a remote or incidental – relationship between the claimed expenses and the operation of the taxpayer’s trade or business.<sup>12)</sup> Treasury Regulation also demands a relationship between expenditures and the taxpayer’s trade or business to be deductible expenses.<sup>13)</sup>

In *Henry v. Commissioner*, the tax payer, who was a lawyer and accountant, purchased a yacht on which he flew a red, white, and blue pennant with the numerals ‘1040’ on it, purportedly to provoke inquiries and thus promote the petitioner’s business by giving him contracts with people in yachting circles who might become clients in the future. The Tax Court held that the cost of insurance and maintenance of the yacht and depreciation were not deductible as ordinary and necessary expenses since there is not a proximate – rather than merely a remote or incidental – relationship between the claimed expenses and petitioner’s practice as a lawyer and an accountant.

In *Gilliam v. Commissioner*,<sup>14)</sup> the taxpayer, a noted artist and a teacher of art with history of mental disturbance, was travelling by airplane on a business trip when suddenly he became agitated and attacked another passenger. After the airplane landed, he was arrested. Two weeks later, he was indicted. At trial, the court rendered an acquittal verdict by reason of temporary insanity. He paid legal fees in the criminal case and paid

10) See e.g. *Canterbury Holdings, LLC v. Comm’r*, T.C. Memo 2009-175; *Schrott v. Comm’r*, T.C. Memo 1989-346.

11) Expenditures not connected with trade or business are usually personal expenses and I.R.C. § 262 prescribes disallowance of personal expenditures, providing that (a) “[n]o deduction shall be allowed for personal, living, or family expenses.”

12) See e.g. *Roy v. Comm’r*, T.C. Memo. 1997-562; *Henry v. Comm’r*, 36 T.C. 879, 884 (1961); *In Reed v. Comm’r*, 35 T.C. 199 (1960).

13) Treas. Reg. § 1.162-1(a) provides that “[B]usiness expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer’s trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162.”

14) T.C. Memo 1986-81.

settlement amounts to the assaulted passenger. The taxpayer claimed deductions for the amounts paid on his individual income tax return. However, the Commissioner of the Internal Revenue Service disallowed the amounts claimed by him. The Tax Court held that the payments of attorney fees and settlement amounts by the taxpayer were not ordinary and not deductible as business expenses. The Tax Court reasoned that the amounts paid by the taxpayer did not arise from the business but from his personal medical condition although he was travelling on business during which ordinary expenses might be incurred.

Unlike in *Gilliam v. Commissioner*, in *Dancer v. Commissioner*,<sup>15)</sup> the Tax Court held that the taxpayer's payment of damages arising from an automobile accident, which occurred while taxpayer was travelling on business, was deductible as an ordinary business expense. In *Dancer*, the taxpayer, a trainer and driver of trotting horses, was involved in an automobile accident while traveling between the farm where he trained horses and his principal office, located in his home, where he intended to conduct business. A suit was brought against the taxpayer. The case was settled with the majority of damage being paid by the taxpayer's automobile insurance while the remaining part paid by the taxpayer himself. The taxpayer claimed the payment by him as a deduction on his federal income tax return. But the Commissioner of the Internal Revenue Code disallowed the amounts claimed by him. The Tax Court noted that traveling between two business locations was an integral part of the taxpayer's business, rather than a personal commuting expense. The Tax Court reasoned that "lapses by drivers seem to be an inseparable incident of driving a car . . . Costs incurred as a result of such an incident are just as much a part of overall business expenses as the cost of fuel."<sup>16)</sup> The Court in *Gilliam* distinguished the present case (*Gilliam*) from the *Dancer* by noting that driving in *Dancer* was an integral part of the taxpayer's business and automobile accidents were an inevitable part of driving. By contrast, the taxpayer's unusual outburst in *Gilliam* would have been criminal but for his temporary insanity defense and thus was not an ordinary or inevitable part of air travel.

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15) 73 T.C. 1103 (1980).

16) *Id.* at 1109.

## 2) Necessary

Generally necessary means “appropriate and helpful” in developing and maintaining a taxpayer’s business.<sup>17)</sup> Since a taxpayer usually does not incur expenditure unless required or justified by the needs of the business, courts are slow to override the taxpayer’s judgment as to the necessity for incurring expenditures.<sup>18)</sup> Further, necessity is a minimum requirement for a deduction.<sup>19)</sup> The necessity involved need not be unavoidable or indispensable, instead intended to result in some benefit to the taxpayer’s business.<sup>20)</sup> Thus, for example, if a taxpayer needed to keep a plane on 24-hour standby because the timing of business trips was unpredictable and uncontrollable, the expense of doing so was necessary even if the actual use of the plane was limited.<sup>21)</sup>

### (1) Reasonable Amount

Although to be necessary, an expense need not be absolutely essential or be the only means to the end, the means chosen must nonetheless be reasonable in amount in relation to its purpose. If an expense is unreasonable in amount, it will not meet the ordinary and necessary requirement.<sup>22)</sup>

I.R.C. § 162(a)(1) provides only reasonable salary or compensation shall be allowed.<sup>23)24)</sup> In evaluating deductible reasonable salary or compensation, there is no bright line test for determining the reasonableness of

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17) Welch, 290 U.S. at 113 (1933); *Comm’r v. Heininger*, 320 U.S. 467, 471 (1943); *Comm’r v. Tellier*, 383 U.S. 687, 689 (1965).

18) J. MARTIN BURKE & MICHAEL K. FRIEL, *TAXATION OF INDIVIDUAL INCOME* 251 (8th ed. 2007); MERTENS, *LAW OF FEDERAL INCOME TAXATION* § 25:18 (2010).

19) *Tellier*, 383 U.S. at 689 (stating that the term “necessary” as imposing only the minimal requirement that the expense be “appropriate and helpful”).

20) MERTENS, *supra* note 18, at § 25:18; BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 20.3.2 (3rd ed. 2009).

21) *Palo Alto Town & Country Vill., Inc. v. Comm’r*, 565 F.2d 1388 (9th Cir. 1977).

22) BORIS I. BITTKER ET. AL., *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 11-3 (3rd ed. 2003); MERTENS, *supra* note 18, at § 25:14.

23) See MICHAEL Q. EAGAN, *Reasonable Compensation*, 26 STAN. L. REV. 441, 447 & n. 35 (1974).

24) Section 162(m) disallows the deduction of certain employee compensation in excess of \$1,000,000.

compensation — all facts and circumstances must be considered.<sup>25)</sup> But roughly speaking there are two methods; the multi-factor test and independent investor test. In the multi-factor test, the court generally takes a number of factors into account, including the type and extent of services rendered by the shareholder-employee, the contribution she makes to the corporation's business, and the corporation's profitability.<sup>26)</sup> On the other hand, some of the circuit courts of appeal have applied a much simpler test, which is whether an independent investor would be satisfied with the return received on her investment in the corporation given the amount of compensation being paid.<sup>27)</sup> But since the element of reasonableness is inherent in the phrase "ordinary and necessary,"<sup>28)</sup> regardless of whether the expenditure is salary or compensation, all expenditure must be reasonable in amount to be deductible.<sup>29)</sup>

## (2) Public Policy Consideration

An expense that otherwise meets the requirements of I.R.C. § 162(a), but whose payment frustrates public policy, may not be deductible. The I.R.C. reflected these policy considerations in 1969, which are embodied in I.R.C. §§ 162(c) (illegal bribes, kickbacks, and other payments), 162(f) (fines and penalties),<sup>30)</sup> and 162(g) (treble damages under the antitrust).<sup>31)</sup>

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25) Treas. Reg. § 1.162-7(b)(3).

26) For "multi-factor test" see e.g. *Pepsi-Cola Bottling Co. v. Comm'r*, 528 F.2d 176, 179 (10th Cir. 1976) (stating that when determining the reasonableness of a salary ... the situation must be considered as a whole, with no one factor being decisive); *Owensby & Kritikos, Inc. v. Comm'r*, 819 F.2d 1315, 1323 (5th Cir. 1987) (applying a test consisting of eight factors); *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241, 1245 (9th Cir. 1983) (listing five factors).

27) For "independent investor test" see e.g. *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 838 (7th Cir. 1999); *Eberl's Claim Serv., Inc. v. Comm'r*, 249 F.3d 994, 1003 (10th Cir. 2001).

28) J. MARTIN BURKE & MICHAEL K. FRIEL, *supra* note 18, at 253.

29) See *Comm'r v. Lincoln Elec. Co.*, 176 F.2d 815 (6th Cir. 1949), *cert. denied*, 338 U.S. 949 (1950).

30) I.R.C. § 162(f) codified the ruling of the Supreme Court in *Tank Truck Rentals*, 356 U.S. 30 (1958) (denying deduction for fines incurred for intentional as well as innocent violations of state motor vehicle maximum weight statute to truck operator and holding the test of non-deductibility is always the severity and immediacy of the frustration resulting from allowance of the deduction).

31) In addition, I.R.C. § 280E disallows a deduction or credit for expenses incurred in illegal drug trafficking.

### (3) Not Capital Expenditure

The “ordinary” requirement is also related to the determination between current and capital expenditures.<sup>32)33)</sup> The courts generally have ruled that an expense constitutes a capital expenditure when it creates a separate and distinct asset or produces a significant future benefit.<sup>34)</sup> Also, I.R.C. § 263(a) prescribes capital expenditures, which must be denied current deductions, which are (i) any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate; or (ii) amounts expended in restoring property or in making good the exhaustion thereof for which an allowance has been made.

## 2. Carrying on a Trade or Business

### 1) Trade or Business

Under I.R.C. § 162(a), a taxpayer is allowed to deduct ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. The primary role of the trade or business requirement is to distinguish the taxpayer’s personal or investment activities from his business ones.<sup>35)</sup> However, since neither the I.R.C. nor its regulations provide any definition of “trade or business,” the courts have developed elements to be in trade or business, mainly based on the test of facts and circumstances.<sup>36)</sup> As for the most basic elements, to be engaged in a trade or business, a taxpayer must be involved in an activity with

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32) Kevin J. Coenen, *Capital or Ordinary Expense? The Proper Tax Treatment of a Target Corporation’s Expenditures in an Acquisitive Reorganization*, 58 OHIO ST. L. J. 583, 587 (1997); MERTENS, *supra* note 18, at § 25:16; BORIS I. BITTKER ET. AL., *supra* note 22, at ¶ 11.03[1].

33) Tellier, 383 U.S. at 689–690 (“The principal function of the term ‘ordinary’ in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset”).

34) See *Indopco, Inc. v. Comm’r*, 503 U.S. 79 (1992) (a significant future benefit); *Comm’r v. Lincoln Sav. & Loan Ass’n*, 403 U.S. 345 (1971) (a separate and distinct asset).

35) See Carol Duane Olson, *Toward a Neutral Definition of ‘Trade or Business’ in the Internal Revenue Code*, 54 U. CIN. L. REV. 1199 (1986); *Green v. Comm’r*, T.C. Memo. 2005-250, *aff’d*, 507 F.3d 857 (5th Cir. 2007).

36) See *e.g. Higgins v. Comm’r*, 312 U.S. 212, 217 (1941).

continuity and regularity and must have the primary purpose of creating income or profit rather than merely engaging in a hobby or amusement diversion.<sup>37)</sup> In *Commissioner v. Groetzinger*, the taxpayer devoted 60 to 80 hours per week to pari-mutuel wagering on dog races with a view to earning a living from such activity, had no other employment, and gambled solely for his own account. His efforts generated gross winnings of \$70,000 on bets of \$72,032, with a net gambling loss for the year of \$2,032. Upon audit, the Commissioner of Internal Revenue determined that the taxpayer was subject to a minimum tax. Under the I.R.C., such items could be lessened by certain deductions that were “attributable to a trade or business carried on by the taxpayer.” the Tax Court held that he was in the “trade or business” of gambling, and that no part of his gambling losses was subject to a minimum tax. The Court of Appeals affirmed the ruling of the Tax Court.

In investment activities such as trading securities, courts have distinguished between a trader and an investor; an investor is not considered to be in trade or business,<sup>38)</sup> but a trader may be engaged in trade or business.<sup>39)</sup> In *Higgins v. Commissioner*, a taxpayer with extensive investments in real estate, bonds and stocks, and who devoted a considerable portion of his time to the oversight of his interests and hired others to assist him in offices rented for that purpose, claimed the salaries and expenses incident to looking after his properties were deductible under Section 23(a) of the Revenue Act of 1932 (the predecessor of present § 162(a)). But the Commissioner refused the deductions. The Supreme Court held that the salaries and expenses incident to looking after a taxpayer’s own

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37) *Comm’r v. Groetzinger*, 480 U.S. 23, 35 (1987).

38) See *Higgins*, 312 U.S. at 218; *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983) (holding that to be a trader, a taxpayer’s activities must be directed to short-term trading, not the long-term holding of investments, and income must be principally derived from the sale of securities rather than from dividends and interest paid on those securities); see also *Cameron v. Comm’r*, T.C. Memo. 2007-260.

39) For numbers and frequency of trading to be a trader, see Robert J. Wille, *The Amount of Trading That Makes a “Trade or Business in Cameron v. Commissioner”*, 62 TAX LAW. 297 (2008); Glenn P. Schwartz, *How Many Trades Must a Trader Make To Be in the Trading Business?*, 22 VA. TAX REV. 395 (2003). For problems of taxation on trader, see Shu-Yi Oei, *A Structural Critique of Trader Taxation*, 8 FLA. TAX REV. 1013 (2008).

investments were not deductible under section 23(a).<sup>40)</sup>

(1) Activity with Continuity and Regularity (Extensive Activity)

A factor used by courts to determine whether a taxpayer is engaged in a trade or business is the presence of extensive activity over a substantial period of time.<sup>41)</sup> The courts have characterized this test as requiring continuous and regular activity.<sup>42)</sup> But since the level of activity or time spent is not an effective test, the degree of personal effort and skill may be a more desirable standard to test whether the taxpayer would be engaged in a trade or business with continuous and regular base.<sup>43)</sup>

(2) Profit Motive

A trade or business requires a profit motive.<sup>44)</sup> Since a business is a course of activities engaged in for profit, activities for a purpose other than profit do not evidence business engagement.<sup>45)</sup> A corporation is normally deemed to be engaged in a trade or business unless it is operated solely for the pleasure or recreation of its members.<sup>46)</sup> Whether the taxpayer's expectation of making a profit was in good faith is crucial.<sup>47)</sup> Regarding

40) The Congress enacted the predecessor of current I.R.C. § 212 in 1942 (*See* H. Rept. 2333, 77th Cong., 2d Sess. (1942), 1942-2 C.B. 372) in response to the Higgins and to give relief to "Higgins-type" taxpayers. I.R.C. § 212 allows a deduction for the ordinary and necessary expenses of producing or collecting income, maintaining property held for the production of income or determining, collecting or refunding any tax. Thus, under the present tax law, the expenses incurred by an investor would be deductible even though the investor would not be considered to carry on a trade or business.

I.R.C. § 212 is applicable only to individuals, however, presumably on the theory that the I.R.C. § 162(a) covers the same ground for corporations that the §§ 162(a) and 212 in combination cover for other taxpayers. At any rate, it has been generally assumed since 1942 that a corporation can deduct under the § 162(a) any expenses that could be deducted under the § 212 by an individual proprietor. *See* BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 5.03 (7th Ed. 2005).

41) *McDowell v. Ribicoff*, 292 F.2d 174, 178 (3d Cir. 1961); *Stanton v. Comm's*, 399 F.2d 326, 329 (5th Cir. 1968); *Wiles v. United States*, 312 F.2d 574, 576 (10th Cir. 1962).

42) *See* Groetzinger, 480 U.S. at 35; F. Ladson Boyle, *What Is a Trade or Business?*, 39 *TAX LAW* 737 (1986); Sergio Pareja, *It Taxes a Village: The Problem With Routinely Taxing Barter Transactions*, 59 *CATH. U. L. REV.* 785, 819 (2010).

43) F. Ladson Boyle, *supra* note 42, at 759-762.

44) *See* Groetzinger, 480 U.S. at 35.

45) MERTENS, *supra* note 18, at § 25:7.

46) *Id*; *Int'l Trading Co. v. Comm'r*, 275 F.2d 578, 584 (7th Cir. 1960).

47) *See e.g.* *Malmstedt v. Comm'r*, 578 F.2d 520, 527 (4th Cir. 1978) (holding that the test of

whether the taxpayer's expectation of profit should be reasonable, the Circuit courts were split. Some require only a good faith; others do both a good faith and its reasonableness.<sup>48)</sup> However, the legislative history of Treasury Regulation § 1.183 shows that the Treas. Reg. § 1.183 resolved the issue by rejecting the requirement that the taxpayer's profit expectation be reasonable.<sup>49)</sup> Thus, a taxpayer's profit intent needs to only be in good faith and does not have to be reasonable.<sup>50)</sup> Treas. Reg. § 1.183-2(b)<sup>51)</sup> sets forth nine factors to consider determining whether a taxpayer had the requisite profit motive: (i) the extent to which the taxpayer carries on the activity in a businesslike manner; (ii) the taxpayer's expertise; (iii) the time and effort expended by the taxpayer; (iv) the expectation that assets used in the activity may appreciate in value; (v) the success of the taxpayer in similar activities; (vi) the taxpayer's history of income or loss in the activity; (vii) the amount of occasional profits; (viii) the financial status of the taxpayer; and (ix) the elements of personal pleasure or recreation in the activity. The application of these factors depends on the facts and circumstances presented by each individual case. All facts and circumstances with respect to the activity are to be taken into account; no one is determinative.<sup>52)</sup>

### (3) Additional Requirement- Goods and Services

Is any additional condition required in addition to profit motive for a deduction? It may be in issue whether a taxpayer must do more than carrying on a regular course of conduct with the intent to earn a profit to be deemed engaged in a trade or business, in other words, whether the

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deductibility as a business expense is whether the business was undertaken "in good faith for the purpose of making a profit," not whether its efforts were unsuccessful).

48) See e.g. compare *Mercer v. Comm'r*, 376 F.2d 708, 711 (9th Cir. 1967) (holding only a good faith expectation of profit, irrespective of whether or not others might view that expectation as reasonable) with *Godfrey v. Comm'r*, 335 F.2d 82, 84 (6th Cir. 1964) (holding that the taxpayer's expectation of profit should be both reasonable and in good faith).

49) Bureau of National Affairs (BNA), *Tax Management Portfolios-U.S. Income Series*, 548 § II (2010); F. Ladson Boyle, *supra* note 42, at 743.

50) BNA, *supra* note 49 and accompanying text.

51) It is said that this regulation originally enacted to interpret I.R.C. § 183 is also applicable to determine profit motive for a taxpayer to be engaged in a trade or business under the § 162. See e.g. *Faulconer v. Comm'r*, 748 F.2d 890, 893 (4th Cir. 1984).

52) Treas. Reg. § 1.183-2(b); *Ranciato v. Comm'r*, 52 F.3d 23, 25 (2d Cir. 1995); *Faulconer*, 748 F.2d, at 894-895.

taxpayer must also hold himself out to others as offering “goods or services” for a price. The goods or services requirement to constitute a trade or business originated with Justice Frankfurter’s concurring opinion in *Deputy v. Du Pont*,<sup>53)</sup> where he stated that “carrying on any trade or business” involves holding one’s self out to others as engaged in the selling of goods or services.

Before the ruling of *Commissioner v. Groetzinger*, lower courts were divided<sup>54)</sup> on whether there was any further condition or holding out goods and services rendering to others<sup>55)</sup> to satisfy the trade or business requirement. However, in *Commissioner v. Groetzinger*,<sup>56)</sup> the Court rejected the concurring opinion of Justice Frankfurter. Now, other than the profit motive, no additional requirement is needed to be engaged in a trade or business.

## 2) Carrying On

To be deductible, an expense must also have been paid or incurred after the taxpayer’s trade or business actually commenced. Expenses incurred such as preopening or starting up prior to operating are nondeductible. So, the “carrying on requirement” results in a distinction between preopening or startup costs and operating costs of a business.<sup>57)</sup> Business development usually begins with two stages pre-business. First, in the “investigatory stage,” a person may review several kinds of business before making a

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53) 308 U.S. at 499.

54) For examples of cases demanding goods and services requirements, *see e.g.* *Gentile v. Comm’r*, 65 T.C. 1, 2 (1975); *Estate of Cull v. Comm’r*, 746 F.2d 1148 (6th Cir. 1984), *cert. denied*, 472 U.S. 1007; *Gajewski v. Comm’r*, 723 F.2d 1062 (2d Cir.1983), *cert. denied*, 469 U.S. 818; *Noto v. United States*, 598 F.Supp. 440 (D.N.J. 1984), *affirmed without opinion* 770 F.2d 1073 (3d Cir. 1985).

For cases not requiring goods and services *see e.g.* *Ditunno v. Comm’r*, 80 T.C. 362, 371 (1983); *Meredith v. Comm’r*, 49 T.C. Memo 318 (1984); *Nipper v. Comm’r*, 47 T.C. Memo 136 (1983), *aff’d*, 746 F.2d 813 (11th Cir. 1984) (*per curiam*).

55) For further discussion on this subject, *see* F. Ladson Boyle, *supra* note 42.

56) 480 U.S. at 34.

57) In addition, the carrying on requirement assists preventing a taxpayer from deducting personal expenses not associated with the operation of a trade or business. *See* J. MARTIN BURKE & MICHAEL K. FRIEL, *supra* note 18, at 260.

decision to acquire or to enter into a specific business.<sup>58)</sup> Generally, the expenses incurred during this phase are not deductible.<sup>59)</sup>

The second stage in the development of a business occurs after the taxpayer has made a decision to acquire or enter into a specific business and starts preparation for its operation.<sup>60)</sup> Expenses in this stage such as training and pre-operating costs are properly characterized as capital expenditures.<sup>61)</sup>

### 3. *Paid or Incurred Within the Taxable Year.*

I.R.C. § 162(a) requires that expenditures for a business deduction must have been paid or incurred during the taxable year. This requirement is related to the timing rule. Since no deduction is allowed to a taxpayer on the cash receipt basis unless a payment was made during the taxable year, a taxpayer adopting the cash method is only permitted to deduct expenses in the year they are paid. On the other hand, an accrual method taxpayer is permitted to deduct expenses in the year they are incurred. Under the accrual method, a deduction is allowed in a taxable year when the requirements of the all-events test and the economic performance requirement are met.<sup>62)</sup>

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58) *Id.* at 259.

59) Business investigatory expenses, which are so-called “start-up” expenses, that would be deductible but for “carrying on” requirement are deductible on a pro rata basis over 60 months, if the taxpayer properly elects to take advantage of the provision of I.R.C. § 195.

60) J. MARTIN BURKE & MICHAEL K. FRIEL, *supra* note 18, at 260.

61) Pre-operating expenses that would be deductible but for the “carrying on” requirement are also deductible on a pro rata basis over 60 months if the taxpayer properly elects to take advantage of this provision under § 195.

62) I.R.C. § 446 provides that a taxpayer may compute taxable income under any of the following accounting methods: (i) the cash receipts and disbursements method; (ii) an accrual method; or (iii) any other method permitted by the Code or any combination of the foregoing methods.

Under the cash method, all items that constitute gross income are included in the taxable year for which they have been actually or constructively received. Reg. § 1.446-1(c)(1)(i). Expenses are deductible in the taxable year they are paid. Reg. § 1.446-1(c)(1)(i). Under the accrual method, income and deductions are not included for a taxable year unless the requirements of the all-events test and the economic performance requirement are met. Reg. § 1.446-1(c)(1)(ii).

### III. The Review and Analysis of the Article 19 of the Corporation Tax Law in Korea<sup>63)</sup>

Under the Korean tax law, taxation is imposed on net income or taxable income. Taxable income is calculated as gross income minus deductible expenses.<sup>64)</sup> The Corporation Tax Law (CTL) of Korea uses an all-inclusive system to calculate income, which means that all income must be included in gross income from whatever source derived.<sup>65)</sup> However, all expenses are not deductible. In terms of deductible expenses, a general provision of article 19 of the CTL provides provisions for deductible business expenses, following many other individual sections to extend or limit deduction otherwise allowable in the general provision article 19.

Article 19 provides:

(1) Deductible expenses shall mean expenses or losses arisen from transactions resulting in any decrease in the net assets of a corporation, excluding the repayment of capital or equities, appropriation of surplus, and other transactions as prescribed in this CTL; (2) Except as otherwise prescribed by this CTL and any other Acts, expenses or losses under paragraph (1) shall be those expenses or losses which are paid or incurred in connection with any trade or business and which are generally accepted as ordinary or directly related to revenue.

#### *1. Analysis and Interpretation of Article 19 Paragraph 1*

Paragraph (1) of article 19 proclaims a general principle for deductible expenses, allowing all expense matching “all-inclusive” income; that is,

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63) Unlike in the United States, Korea has a separate income tax statute each for a corporation and an individual. In this article, we will deal with mainly corporate aspects. In general, a corporation and a sole proprietorship have many provisions in common to calculate a business income.

64) CTL art. 14, para. 1.

65) CTL art. 15, para. 1.

article 19 (1) generally allows all expenses incurred for all earned income as deductible expenses. Expenses are conceptually accrued as a result of transaction decreasing net asset.<sup>66)</sup> However, the repayment of capital or equities and appropriation of surplus funds are not expenses since these are capital transactions. In addition, some transactions are excluded as prescribed in the CTL for tax policy reasons.

1) *Expenses or Losses Arisen from Transactions Resulting in Any Decrease in the Net Assets*

(1) Decrease in Net Assets

Deductible expenses are amounts accrued from transactions resulting in a decrease in net assets of a business entity. It does not matter what is a transaction if the transaction decreases the net asset of a business entity. But, as described earlier, some transactions, such as capital transactions, are not allowable to be deductible expenses. Deductible expenses mean expenses or losses that arise from transactions resulting in any decrease in the net assets of a corporation. The concept of net assets borrows from accounting.<sup>67)</sup> A net asset, which is also called equity, is a residual interest of an entity that remains after deducting its liabilities.<sup>68)</sup> The reason for a decrease in net assets is divided into two categories: one caused by a decrease in assets and the other caused by an increase in liabilities. For deductible expense purposes, the reason for the decrease in net assets does not matter.<sup>69)</sup>

(2) Expenses or Losses

The concepts of expenses or losses have same meanings as in accounting.<sup>70)71)</sup> Expenses are outflows, the using up of assets, or incurrence

66) See *infra* III. 1. (1), (2).

67) Wan-Souk Kim, *The Interpretation of Expenses in Corporate Income Tax Law*, 19 KOREAN J. TAX'N RES. No. 2, 70 (2002).

68) Financial Accounting Standards Board (FASB), *Statement of Financial Accounting Concepts No. 6*, (1985), para. 49 (1985); Korea Accounting Standard Board (KASB), *Statement of Financial Accounting Concepts*, para. 104 (2003).

69) Wan-Souk Kim, *supra* note 67.

70) TAERO LEE & MANSOO HAN, *LECTURE ON TAXATION 405* (6th ed. 2010); but Professor Lee disagrees with this opinion, see CHANGHEE LEE, *LECTURE ON TAXATION 707* (8th ed. 2009).

71) It seems that the tax authorities also consider the concepts of expenses or losses as the

of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.<sup>72)</sup> Some examples of expenses include advertising expenses, commission expenses, rent expenses, cost of goods sold, salaries expenses, and so on. Expenses also include costs used up during the accounting period such as interest expenses, insurance expenses, and depreciation expenses. On the other hand, losses are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions, events, and circumstances affecting the entity except those that result from expenses or distributions to owners.<sup>73)</sup> Examples of losses include the loss on the sale of an asset used in the business, loss from a lawsuit settlement, and loss from retirement of bonds. However, there are some losses that are closer to operations, such as the loss on write-down of inventory from cost to market. Theoretically, expenses and losses are different in meaning, but very often the meaning of expenses in accounting comprises losses either.<sup>74)</sup>

## 2) *Repayment of Capital or Equities and Appropriation of Surplus*

### (1) Repayment of capital or equities

Repayment of capital or equities, though they are transactions resulting in decrease in net assets, is excluded from deductible expenses. Under Sangbeob [Commercial Act]the Korean Commercial Code (KCC)], repayment of capital occurs on retirement of shares<sup>75)</sup>or redemption of redeemable shares.<sup>76)</sup> In concept, a decrease of assets from capital transactions such as the retirement of shares or redemption of redeemable shares is not an expense.<sup>77)</sup> Thus, this provision is not so meaningful.

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same in accounting. See General Rule 13-0-1 of the CTL (defining the meanings of expenses and losses the same as in accounting).

72) FASB, *Statement of Financial Accounting Concepts No. 6* (1985), para. 80; KASB, *Statement of Financial Accounting Concepts* (2003), para. 120.

73) FASB, *Statement of Financial Accounting Concepts No. 6* (1985), para. 83; KASB, *Statement of Financial Accounting Concepts* (2003), para. 122.

74) KASB, *Statement of Financial Accounting Concepts* (2003), para. 122.

75) KCC art. 343.

76) KCC art. 345

77) FASB, *Statement of Financial Accounting Concepts No. 6* (1985), paras. 80, 83; KASB,

### (2) Appropriation of surplus

Surplus is the amount of net assets exceeding paid-in capital. Surplus is composed of two parts. One is capital surplus that arises from capital transactions; the other is earned surplus that is originated from operating activities. Surplus under article 19(1) means only the latter since capital surplus is apportioned for formal capitalization and set-off losses, which are not called “appropriation of surplus.”<sup>78)</sup> The reason why appropriation of surplus is excluded from deductible expenses is that appropriation of surplus must be disposed according to the stipulations prescribed in, for instance, the KCC or articles of incorporation, and that disposable earned surplus is the residual amount after paying tax.<sup>79)80)</sup>

### 3) Other Transactions as Prescribed in the CTL

Among the transactions resulting in a decrease in net assets, some items are not deductible for tax policy reasons. The CTL describes these items in article 19(2) through article 28. On the other hand, some items, whose transactions do not result in decrease in net assets, are allowable as deductible expenses for tax benefits or incentives to a taxpayer even though they are not within the ambit of meanings to a deductible expense. This kind of items is prescribed in articles 29 through 38.

## 2. Analysis and Interpretation of Article 19 Paragraph 2

Article 19 provides:

(1) Deductible expenses shall mean expenses or losses arisen from transactions that cause any decrease in the net assets of a corporation, excluding the repayment of capital or equities, surplus funds, and other transactions as prescribed in this Act. (2) Except as

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*Statement of Financial Accounting Concepts* (2003), paras. 120, 122.

78) Wan-Souk Kim, *supra* note 67, at 72.

79) *Id.*

80) However, a certain merit-based remuneration may be deductible even though it is paid from appropriation of surplus if conditions prescribed in the Presidential Decree (Sihaengryeong) are met. See CTL art. 20, no. 1; art. 20, para. 1 of Presidential Decree of the CTL.

otherwise prescribed by this CTL and any other Acts, expenses or losses under paragraph (1) shall be those losses or expenses which are paid or incurred in connection with any trade or business and which are generally accepted as ordinary or directly related to revenue.

While paragraph (1) proclaims a general principle to allow all expenses matching “all-inclusive” income, paragraph (2) confines the scope of application to paragraph (1) with detailed standards. So, to qualify as deductible expenses, when combining paragraphs (1) and (2) together, expenses must be (i) paid or incurred in connection with a trade or business and (ii) generally accepted ordinary or (iii) directly related to revenue as well as they arose from transactions resulting in decreasing in net assets.

#### *1) History and Background of Introducing Article 19 Paragraph 2*

Article 19(2) was newly introduced by the wholly amended CTL on December 28, 1998 (Act No. 5581). According to the proposal of the new legislature, the paragraph was enacted to adopt an international general standard for a deductible expense in order to prevent a corporation from deducting expenditures as deductible expenses without justifiable reasons and to avoid disputes in dealing with deductible expenses between the government concerned and a taxpayer.<sup>81)</sup> Actually, article 19(2) is modeled after I.R.C. § 162(a).<sup>82)</sup> Even though the Korean government said that it adopted an international standard for deductible expenses, it seems that only the United States among major developed countries provides article 19(2) type- provision.<sup>83)</sup>

#### *2) Generally Accepted Ordinary Expense*

An ordinary expense is contrary to an extra-ordinary expense. The CTL

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81) Ministry of Finance and Economy, 98 REVISED TAX LAW GUIDE 180 (1999); The National Assembly of Republic of Korea, Finance and Economy Committee, *Review Opinion on 1998 Tax Bill* (1998).

82) Wan-Souk Kim, *supra* note 67, at 62; TAERO LEE & MANSOO HAN, *supra* note 70, at 405-406.

83) *See e.g.* Income Tax Act in Germany art. 4 IV; Corporate Income Tax Act in Japan art. 22(4).

has not provided any definition for the term. Unlike in the U.S. tax code, that of Korea has the adjective “generally accepted” before ordinary. The meaning of ordinary in the CTL of Korea is thought to have the same meaning as in I.R.C. §162(a).<sup>84)</sup> In Supreme Court [S. Ct.], 2007Du12422, Nov. 12, 2009 (S. Kor.) the Court ruled that “generally accepted ordinary expense” means expenses that other taxpayers involved in the common type of business would like to make payment under the same circumstances, and when deciding whether a certain expense belongs to the “generally accepted ordinary expense”, the court must objectively consider purpose of expenditure, type, amount, and effect all together, but expenditures against public order must be excluded. This is a unique highest case dealing with the interpretation of the meaning “ordinary expense,” and still there is no administrative ruling or regulation. The construction of the Supreme Court in 2007Du12422 for ordinary expenses as “expenses that other taxpayers involved in the common type of business would make payments under the same circumstances” is in line with the interpretation of the meaning of ordinary in the I.R.C. § 162(a) by the U.S. Supreme Court, for instance, in *Welch v. Helvering* or *Deputy v. Du Pont*.

### 3) *Directly Related to Revenue*

The CTL or its regulation does not define the meaning of “directly related to revenue.” Nor the court’s precedent does still exist. Some argue that this has no independent meaning because all expenses directly related to revenue are business expenses.<sup>85)</sup> Others maintain that this has the same meaning as the term “necessary” under I.R.C. § 162(a).<sup>86)</sup> Still others argue an expense “directly related to revenue” may be deductible even though the expense does not meet conditions of “ordinary” or “in connection with a trade or business” or both.<sup>87)</sup> Regarding what is revenue, it is said that revenue in this section should comprise of broader concept than that of

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84) See e.g. Wan-Souk Kim, *supra* note 67, at 63-65; TAERO LEE & MANSOO HAN, *supra* note 70, at 405-406.

85) See e.g. Changhee Lee, *Ordinary Expenses for Deductible Expenses*, STUDY ON COMMERCIAL CASE V, 446 (1998).

86) See e.g. TAERO LEE & MANSOO HAN, *supra* note 70, at 405-406.

87) Wan-Souk Kim, *supra* note 67, at 74, 78.

accounting, including revenue earned from non-operating activities and capital transaction.<sup>88)</sup> But, if complying with this opinion, a deductible expense is acceptable so broadly that it might be against the objective to introduce paragraph 2 in addition to paragraph 1. As described earlier, paragraph 2 is introduced to limit the scope of paragraph 1.

#### 4) *In Connection with a Trade or Business*

Professor Changhee Lee says that “in connection with a trade or business” means during in pursuit of profit. He maintains that it is not necessarily expenses occurred while engaged in activities related to business objective recorded in laws or articles of incorporation. According to his opinion, expenditures paid contrary to or against a taxpayer’s will, such as loss from damage or theft, can be deductible expenses, too.<sup>89)</sup> Now, there is no other opinion or precedent of courts dealing with this matter. Regarding what is a trade or business, either it is considered as activities that are continuous and regular with purpose of creating profit or asset.<sup>90)</sup> Or it is said that trade or business means a corporation’s affairs as described in article 26(2) of Beopinse beob sihaeng gyuchik [Enforcement Rules on the Corporation Tax Law(CTL)].<sup>91)</sup> According to the Enforcement Ordinance, corporate affairs are such prescribed in laws as corporate affairs or those recorded in articles of incorporation or register books as its business objectives.<sup>92)</sup>

## IV. Comparisons of the Two Countries for the Interpretation Guide of Korean Tax Law

It is thought that article 19(2) was modeled after I.R.C. § 162(a).<sup>93)</sup> In Korea, there is not much debate among scholars, no precedent of courts, or

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88) Wan-Souk Kim, *supra* note 67, at 78.

89) Changhee Lee, *supra* note 85.

90) TAERO LEE & MANSOO HAN, *supra* note 70, at 405.

91) Wan-Souk Kim, *supra* note 67, at 75.

92) *Id.*

93) *See supra* note 84.

administrative regulations. As such, this section analyzes and compares the general provisions of the two countries, or § 162(a) of the U.S. and article 19(2) of Korea to give guidelines to interpret the Korean provision of article 19(2).

As a general provision for deductibility of a business expense, § 162(a) of Internal Revenue Code<sup>94)</sup> 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." Thus, under I.R.C. § 162(a), to be qualified as deductible expenses, expenses must be (a) ordinary and necessary, (b) (paid or incurred) in carrying on a trade or business, and (c) paid or incurred within the taxable year.

Article 19 of the CTL of Korea, which is a general provision for the deductibility of a business expense, provides:

(1) Deductible expenses shall mean expenses or losses arisen from transactions resulting in any decrease in the net assets of a corporation, excluding the repayment of capital or equities, appropriation of surplus, and other transactions as prescribed in this CTL; (2) Except as otherwise prescribed by this CTL and any other Acts, expenses or losses under paragraph (1) shall be those losses or expenses which are paid or incurred in connection with any trade or business and which are generally accepted as ordinary or directly related to revenue.

Based on the foregoing, under the CTL, in order for an expense to be deductible, expenses must be (i) paid or incurred in connection with a trade or business and (ii) generally accepted ordinary or (iii) directly related to revenue as well as they arose from transactions resulting in decreasing in net assets.

### *1. Expenses Arising from Transactions Decreasing Net Assets*

Under the CTL, as a basic requirement for a deductible expense, an

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94) In addition to a business deduction, the Internal Revenue Code allows deduction for expenses to profit seeking. See I.R.C. § 212.

expense should arise from transactions that decrease assets. Since, by concept, any expense results in decreasing net assets as described earlier, in the Korean tax system, generally all expenditures may be allowable as deductible expenses unless otherwise provided. On the other hand, under the U.S. tax system, a deduction is considered as a legislative grace, and, to be deductible expenses, there must be a provision to allow such deductions.<sup>95)</sup> I.R.C. § 161 also provides that “In computing taxable income ..., there shall be allowed as deductions the items specified in this part...”

So, for a deductible expense, the Korean system adopts a negative method, which means in general all expenses are deductible unless otherwise provided. In contrast, the U.S. system adopts a positive system, which means an expense is deductible only if a separate provision to allow doing so is provided. In Korea, the tax authorities have a burden of proof to deny the claimed expenses by a taxpayer.<sup>96)</sup> On the other hand, in the United States, the burden of showing the right to the claimed deduction is on the taxpayer.<sup>97)</sup>

## 2. *Paid or Incurred Within the Taxable Year*

This is related to the timing rule. I.R.C. § 162(a) requires that a deduction for a business expense must have been paid or incurred during the taxable year. The U.S. income tax system adopts an annual accounting system in which a taxpayer selects a taxable year and reports all income and deductions that occur in that year. I.R.C. §§ 441(a) and 461(a) provide this rule in detail. Thus, regardless of the provision of “paid or incurred within the taxable year” in §162(a), an expense cannot be deductible unless it is paid or incurred within the taxable year. So the provision of “paid or incurred within the taxable year” in I.R.C. § 162(a) as a general provision for deductibility is not so meaningful. Korean tax system also adopts an

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95) See *e.g.* *White v. United States*, 305 U.S. 281, 292 (1938); *Interstate Transit Lines v. Comm’r*, 319 U.S. 590, 593 (1943).

96) For more detailed discussion, see Joonmyeong Lee, *Burden of Proof in Tax Litigation*, 115 STUDY ON TAX PRACTICE (Materials of Tax Community) (2008).

97) *White*, 305 U.S. at 292; *Interstate Transit Lines*, 319 U.S. at 593; *United States v. Olympic Radio and Television*, 349 U.S. 232, 236 (1955).

annual accounting system. Article 40 of the CTL generally provides the timing rule. Unlike in I.R.C. § 162(a), however, article 19 in the CTL of Korea, the general provision for a deductible expense, does not provide the time rule.

### 3. *The “Generally Accepted as Ordinary or Directly Related to Revenue” in Korea and the “Ordinary and Necessary” in the United States*

#### 1) *Necessary and Directly Related to Revenue*

In the CTL, an equivalent element to necessary in the I.R.C. may be “directly related to revenue” because just as “ordinary and necessary” are paralleled in I.R.C. § 162(a), so “ordinary and directly related to revenue” are paralleled in the CTL. As we discussed earlier, the CTL or its regulation does not define the meaning of “directly related to revenue.” Moreover, there is no court precedent. Scholars are divided on this interpretation, either denying any independent meaning<sup>98)</sup> or maintaining the same meaning as the “necessary” in the I.R.C. § 162(a),<sup>99)</sup> or admitting a deduction regardless of whether meeting conditions of “ordinary” or “directly connected with a trade or business” or both.<sup>100)</sup>

The reasoning for the opinion that “directly related to revenue” and “necessary” are of the same meaning is that article 19(2) of the CTL is modeled after I.R.C. § 162(a), and, in §162(a), ordinary and necessary are prescribed paralleled and so are “ordinary” and “directly related to revenue” in article 19(2).

However, this opinion is not persuasive. In article 19(2), “ordinary” and “directly related to revenue” are selective, which means that if either one of two (“ordinary” and “directly related to revenue”) is satisfied, that expense is deductible, assuming other conditions are met. On the other hand, under I.R.C. §162(a), to be deductible, expenses must be both ordinary and necessary.<sup>101)</sup> Generally, necessary means “appropriate and helpful” in

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98) See CHANGHEE LEE, *supra* note 85 and accompanying text.

99) See TAERO LEE & MANSOO HAN, *supra* note 70, at 404-406

100) See *supra* note 87 and accompanying text.

101) See *supra* note 4.

developing and maintaining a taxpayer's business<sup>102)</sup> and necessary requirement demands only minimum requirement.<sup>103)</sup> The courts are reluctant to deny a deduction by reason of not satisfying the necessary requirement while honoring the taxpayer's judgment.<sup>104)</sup> If the meaning of "directly related to revenue" is deemed as that of necessary in the I.R.C. §162(a), the scope of deductible expenses is expanded since, in article 19(2), "directly related revenue" is selective (either ordinary or "directly related revenue") unlike in the I.R.C. §162(a), where both ordinary and necessary are required and the latter demands only minimum requirement. Thus this kind of interpretation is contrary to the intent of Korean Congress to restrict the scope of a deductible expense in article 19(2) from the broader admission of a deductible expense in section 19(1). Moreover, it is too broad interpretation beyond implication of the meaning of "directly related to revenue" if the meaning of "directly related to revenue" is construed to have the same meaning as "necessary" in § 162(a). Thus, it is unreasonable to think that "directly related to revenue" in article 19(2) in the CTL and "necessary" in the I.R.C. § 162(a) are of the same meaning. Therefore, the meaning of necessary in the Internal Revenue Code is not applicable to Korean Corporate Tax Law.

## 2) Ordinary Expense

Broadly speaking, an ordinary expense means contrary to an extraordinary expense. The CTL does not contain an explicit definition. Only a few precedents exist to interpret its meaning. Since the provision of article 19(2) in the CTL is modeled after the I.R.C. § 162(a), the interpretation of the ordinary in the § 162(a) will provide a guideline to interpret the Korean counterpart provision 19(2). Therefore, the meaning of ordinary in the CTL can be considered to have the same meaning as interpreted in *Welch v. Helvering* and *Deputy v. Du Pont*, where the U.S. Supreme Court interpreted that an ordinary expense meant a customary or usual expense incurred within the experience of a particular trade, industry, or business

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102) See *supra* note 19.

103) See *supra* note 21.

104) See Henry, 36 T.C. at 884; see also J. MARTIN BURKE & MICHAEL K. FRIEL, *supra* note 18 and accompanying text; MERTENS, *supra* note 18 and accompanying text.

community even if uncommon for a particular taxpayer. The Supreme Court in Korea recently adopted the interpretation of ordinary in *Welch*.<sup>105</sup> More detailed interpretation and application of the courts in the United States concerning what is the meaning of the ordinary requirement is applicable to construe the meaning of “ordinary” in CTL in Korea as well.

(1) Payment of expenses or debt not obligated

Under the interpretation of §162(a), the payment of the obligation of another taxpayer by one taxpayer is not ordinary.<sup>106</sup> In the same way, in article 19(2) of CTL, generally the payment of the obligation of others by a taxpayer is not ordinary in accordance with the same reasoning in *Welch v. Helvoering* or *Deputy v. Du Pont*. However, in a certain circumstance, obligations of the other person paid by a taxpayer may deductible, for instance, a payment to protect or promote his own business like in *Lohrke v. Commissioner*. The Court in *Lohrke* applied the two prong test to decide the deductibility of the obligations of the other person paid by a taxpayer.<sup>107</sup> Just as the Supreme Court of Korea recently accepted the concept of ordinary as established in *Welch*, the two-prong test in *Lohrke* would provide Korean tax authorities and the courts with a useful resource to interpret ordinary requirement in unusual circumstances.

(2) Reasonable Amount

If an expense is unreasonable in amount, it would not have met the ordinary and necessary requirement.<sup>108</sup> I.R.C. § 162(a)(1) provides only a reasonable salary or compensation shall be allowed. Though all facts and circumstances must be considered to test reasonableness, courts have applied a multi-factor test or independent investor test. In the Korean counterpart provision article 19(2), before ordinary, an adjective phrase of “generally accepted” exists (like [g]enerally accepted ordinary...). So, in article 19(2), the provision itself has a phrase restricting the meaning of ordinary unlike ordinary in § 162(a), where only salary or compensation as illustrations is prescribed to be reasonable for a deduction.

It is not clear what the meaning of “generally accepted” is. But, at least

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105) Supreme Court [S. Ct.], 2007Du12422, Nov. 12, 2009 (S. Kor.).

106) *See supra* II. 1. (1).

107) *See supra* note 9 and accompanying text.

108) *See supra* note 22.

an unreasonable amount is not considered as a generally accepted ordinary expense. In connotation of “generally accepted ordinary”, the concept of that the expenses should be reasonable is comprised of. So, the meaning of “reasonable” in the ordinary context as established by the U.S. courts in the interpretation of “ordinary” in §162(a) may be a useful tool to interpret the meaning of “generally accepted” followed by “ordinary” in article 19(2).

In deciding whether a certain amount is reasonable, the multi-factor test is not useful as a tool since it is too broad and does not provide a practical guideline. On the other hand, the independent investor test seems to be very helpful to interpret the phrase “generally accepted” in article 19(2).

### (3) Public Policy Consideration

Expenses that otherwise meet the requirement of I.R.C. §162(a), but the payment of which frustrate public policy, may not be deductible. For instance, fines paid by a trucking company for violations of state maximum-weight laws were nondeductible, even if the offenses were inadvertent.<sup>109)</sup> The I.R.C. reflected these policy considerations, which are embodied in §§ 162(c) (illegal bribes, kickbacks, and other payments), 162(f) (fines and penalties),<sup>110)</sup> 162(g) (treble damages under the antitrust), and 280E (illegal drug trafficking).

Korea does not have any general provision to deny the expenses that otherwise meet the requirement of deductible expenses for public policy reason. Some individual provisions provide for the denial of a deduction for certain expenditures such as article 21, paragraph 4 (fines and penalties) of the CTL and article 50, paragraph 1, no.4 (bribes) of Presidential Decree of the CTL. But the Supreme Court of Korea also held that illegal expenses would not be deductible if to allow deduction would be against public order.<sup>111)</sup> But still Korea has no provision like section 280E. So whether expenditure used to earn illegal income such as in drug trafficking can be

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109) I.R.C. §162(f); In *Tank Truck Rentals, Inc.*, *infra* note 110.

110) I.R.C. § 162(f) codified the ruling of the Supreme Court in *Tank Truck Rentals, Inc. v. C.I.R.*, 356 U.S. 30 (1958) (denying deduction for fines incurred for intentional as well as innocent violations of state motor vehicle maximum weight statute to truck operator, and holding the test of non-deductibility is always the severity and immediacy of the frustration resulting from allowance of the deduction)

111) Supreme Court [S. Ct.], 2007Du12422, Nov. 12, 2007 (S. Kor.); Basically public order in Korea has the same meaning as public policy in the United States.

deductible is in issue. To clarify this issue, the Korean Government needs to enact a provision like section 280E.<sup>112)</sup>

As described above in article 19(2), the phrase of “generally accepted” restricts the meaning of ordinary and has a connotation that expenditures should not be against public policy. In addition to this connotation, “generally accepted” implies that the expenditures should be reasonable in amount. In §162(a), ordinary itself means that an expenditure should be reasonable and not against public policy. But, article 19(2) of Korea, unlike in § 162(a), has an adjective phrase before ordinary, “generally accepted,” to clarify the meaning of ordinary. The Supreme Court of Korea also held that an expense against public policy is not a generally accepted ordinary expense.<sup>113)</sup>

#### (4) Not Capital Expenditure

Under I.R.C. § 162(a), the term “ordinary” means a capital expenditure is not an ordinary expense. The principal function of the term “ordinary” in § 162(a) is to clarify the distinction between those expenses that are currently deductible and those that are in the nature of capital expenditures.<sup>114)</sup> But since without § 162(a) capital expenditures cannot be deductible currently based on § 263, the function to discern currently deductible expenses and capital expenditures is not very meaningful.<sup>115)</sup>

An interpretation of the Korean counterpart, article 19(2) of the CTL, shows that capital expenditures cannot be ordinary expenses as well.<sup>116)</sup> Without the basis of article 19(2), capital expenditures are not deductible expenses under article 19(1) because a capital expenditure by concept is not the expense that decreases a net asset. So, in Korea also, deriving from “ordinary” a basis of denying a deduction of a capital expenditure is not so

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112) For further study, see CHANGROK WOO, *Deductibility of Illegal Expenses*, 5 STUDY ON SPECIAL L. 412 (1997); Byungcheol Choi, *Deductibility of an Expense Paid for Illegal Income or an Expense Illegal Itself*, Commentary of the Supreme Court Rulings 533-534 (30Ho, 1998); SANGSHIN LEE, *Illegal Expenses and Tax Law*, 10-2 SEOUL TAX L. REV. 225 (2004); see also Supreme Court [S. Ct.], 96Nu6158, May. 8, 1998 (S. Kor).

113) Supreme Court [S. Ct.], 2007Du12422, Nov. 12, 2007 (S. Kor).

114) Tellier, 383 U.S., at 689-690.

115) See BORIS I. BITTKER ET. AL., *supra* note 22, at ¶ 11.03[1].

116) See WAN-SOUK KIM, *supra* note 67, at 77; TAERO LEE & MANSOO HAN, *supra* note 70, at 406-407.

much meaningful. In addition, article 31(2) of the Presidential Decree provides the scope of a capital expenditure. In a borderline case, whether expenditure is a current expense or a capital expenditure, the analysis and reasoning in *Indopco, Inc. v. Commissioner* and *Commissioner v. Lincoln Sav. & Loan Ass'n* can be applicable to solve similar issues in Korea.

#### 4. *Carrying on a Trade or Business v. in Connection with a Trade or Business*

In article 19(2) of the CTL, to be deductible, an expense must be paid or incurred in connection with a trade or business as well as be ordinary. Under the § 162(a), to be deductible, expenses must be paid or incurred in carrying on any trade or business as well as be ordinary and necessary.

##### 1) *Trade or Business*

Under the U.S. tax code, since no definition of trade or business exists, the courts have tested it using a test of facts and circumstances.<sup>117)</sup> As basic elements to be engaged in trade or business, a taxpayer must be involved in an activity with continuity and regularity and must have the primary purpose of creating income or profit rather than merely engaging in a hobby or amusement diversion.<sup>118)</sup> From this perspective, an investor is not considered to be engaged in trade or business, but a trader is considered as being engaged in trade or business.<sup>119)</sup>

The primary role of the trade or business requirement in § 162(a) is to distinguish the taxpayer's personal or investment activities from his business ones.<sup>120)</sup> A corporate entity itself by concept is engaged in profit-seeking activities on a regular and continuous basis. So a trade or business requirement to a corporate entity is not meaningful. As a result, the standards developed in the United States with respect to deciding what is a trade or business may not be applicable to the CTL in Korea. In Korea, the issue on trade or business is not what is a trade or business but its scope.

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117) See *supra* note 36.

118) *Groetzinger*, 480 U.S. at 35.

119) See *supra* notes 38-40 and accompanying texts.

120) See *supra* note 35 and accompanying text.

## 2) *Carrying On*

To be deductible, an expense must also have been paid or incurred after the taxpayer's trade or business actually commenced. Expenses incurred prior to commencement such as preopening or starting up are nondeductible. So business investigatory expenses, which is so-called "start-up" expenses before making a decision to acquire or to enter into a specific business, is not deductible.<sup>121)</sup> Likewise, pre-operating expenses paid after the taxpayer has made a decision to acquire or enter into a specific business and starts preparation for its operation are not deductible.<sup>122)</sup> Start-up or pre-operating expenses that would be deductible but for the "carrying on" requirement are deductible on a pro rata basis over 60 months if a taxpayer properly elects to meet requirements prescribed in § 195.

Article 19(2) does not prescribe the words of "carrying on," but instead provides "in connection with." As discussed *infra*, "carrying on" and "in connection with" are preconditions for the ordinary requirement of I.R.C. § 162(a). In Korea start-up or pre-operating expenses may not be allowable as currently deductible expenses since they are not connected with trade or business even though the section 19(2) does not provide the word of "carrying on." So it is reasonable interpretation that the context of "in connection with" in section 19(2) comprises of the meaning of "carrying on" in § 162(a). Since the CTL has no provision like I.R.C. § 195 to allow intangible assets, amortization for start-up or pre-operating expenses is not allowable. In practice, the Korean tax authorities allow its deduction anyway.

## 3) *In Connection with a Trade or Business*

In accordance with the I.R.C., in order to be deductible, an ordinary expense must be connected with the business activity of a taxpayer.<sup>123)</sup>

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121) J. MARTIN BURKE & MICHAEL K. FRIEL, *supra* note 18, at 259; *see also supra* note 58.

122) J. MARTIN BURKE & MICHAEL K. FRIEL, *supra* note 18, at 260; *see also supra* note 60.

123) Expenditures not connected with trade or business are usually personal expenses and the I.R.C. § 262 prescribes disallowance of personal expenditures, providing that (a) "[n]o deduction shall be allowed for personal, living, or family expenses."

Thus, the taxpayer must show that there is a direct or proximate — rather than merely a remote or incidental — relationship between the claimed expenses and the operation of the taxpayer’s trade or business.<sup>124)</sup> The Treasury Regulation § 1.162-1(a) provides that “[B]usiness expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer’s trade or business...” Based on the foregoing, taking the definition of ordinary in § 162(a) and its interpretation by courts and its regulation combined together, “in connection with trade or business” is a precondition for an ordinary expense even though it is not explicitly included in the wording of § 162(a).

In Korea, “in connection with trade or business” is prescribed as an independent condition for a deduction. Thus, as to the meaning of “in connection with a trade or business,” there is an opinion that it means during the pursuit of profit.<sup>125)</sup> However, it is more reasonable interpretation that “in connection with trade or business” in article 19(2) has the same meaning as a precondition for an ordinary expense in § 162(a). Therefore, even in Korea, the taxpayer must show that there is a direct or proximate relationship between the claimed expenses and the operation of the taxpayer’s trade or business.

Accordingly, it arrives at the conclusion that “in connection with trade or business” in article 19(2) of the CTL implies both “carrying on” and “in connection with” as a precondition for the ordinary requirement of I.R.C. § 162(a). Therefore, interpretation rules or precedents established as related to “in connection with” and “carrying on” while interpreting the meaning of ordinary in I.R.C. § 162(a) can be useful guidelines to interpret the meaning of “in connection with” in article 19(2).

## V. Conclusion

As a general provision for deductibility of a business expense, § 162(a) of the Internal Revenue Code provides: “There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during

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124) See *supra* note 12.

125) CHANGHEE LEE, *supra* note 85, at 446.

the taxable year in carrying on any trade or business.” Thus, under I.R.C. § 162(a), to be qualified as deductible expenses, expenses must be (i) ordinary and necessary, (ii) (paid or incurred) in carrying on a trade or business, and (iii) paid or incurred within the taxable year. Similarly, a general provision for deductibility of business expenses, article 19 of the CTL of Korea, which is a general provision for the deductibility of a business expense, provides:

(1) Deductible expenses shall mean expenses or losses arisen from transactions resulting in any decrease in the net assets of a corporation, excluding the repayment of capital or equities, appropriation of surplus, and other transactions as prescribed in this CTL; (2) Except as otherwise prescribed by this CTL and any other Acts, expenses or losses under paragraph (1) shall be those losses or expenses which are paid or incurred in connection with any trade or business and which are generally accepted as ordinary or directly related to revenue.

This article reviewed and analyzed the foregoing general provisions for business deduction of two countries, the U.S. and Korea, and compared them to see if the interpretation of I.R.C. § 162(a) as confirmed and established by the U.S. courts can be useful as a tool to interpret the general provision of Korea. This article has come to the conclusion that:

Generally, for a deductible expense, the Korean system adopts a negative method, allowing all expenses to be deductible unless otherwise provided. For this reason in Korea the tax authorities have a burden of proof to deny the tax payer’s claimed expenses. The U.S. system, however, adopts a positive system, which means an expense is deductible only if a specific provision to allow doing so is provided. So under the U.S. system a deduction is considered a matter of legislative grace, imposing a taxpayer to burden to show the right to the claimed deduction.

Both countries have adopted annual tax accounting and have separate provisions to prescribe the timing rule. Thus, it does not matter whether the general provisions for a deduction prescribe the timing rule even though I.R.C. § 162(a) provides it while article 19(2) of the CTL does not.

The interpretation of “ordinary” in the § 162(a) provides a guideline to interpret the meaning of “ordinary” in the CTL, since the CTL does not

contain an explicit definition of “ordinary” and only a few precedents exist to interpret its meaning. The U.S. Supreme Court has interpreted an ordinary expense as meaning a customary or usual expense incurred within the experience of a particular trade, industry, or business community. This meaning of “ordinary” by the U.S. Supreme Court will be applicable to the interpretation of article 19(2) of the CTL.

The meaning of “reasonable” as established by the U.S. courts in the interpretation of “ordinary” in § 162(a) also may be a useful tool to interpret the meaning of “generally accepted” in article 19(2), since the “generally accepted” in article 19(2) comprises of the meaning that expenses should be reasonable. The U.S. courts have applied a multi-factor test or independent investor test to test reasonableness. The independent investor test may be applicable to the interpretation of the CTL.

Expenses that otherwise meet the requirement of I.R.C. § 162(a), but the payment of which frustrates public policy, may not be deductible. The I.R.C. reflects these policy considerations, which are embodied in §§ 162(c) (illegal bribes, kickbacks, and other payments), 162(f) (fines and penalties), 162(g) (treble damages under the antitrust), and 280E (illegal drug trafficking). Korea does not have any general provision to deny for public policy reasons the expenses that otherwise meet the requirement of deductible expenses even though some individual provisions provide for the denial of a deduction for certain expenditures. The phrase of “generally accepted” in article 19(2) has also a connotation that expenditures should not be against public policy. But whether expenditure paid to earn illegal income such as in drug trafficking can be deductible is in issue. Thus to clarify this issue the Korean Government needs to enact a provision like section 280E.

The standards developed in the U.S. with respect to deciding what a “trade or business” is may not be applicable to the CTL, since a corporate entity itself by concept is engaged in profit-seeking activities on a regular and continuous basis and unlike the U.S. tax code, Korea has a separate tax statute each for a corporation and an individual.

Interpretation rules or precedents established as related to “in connection with” and “carrying on” in the interpretation of the meaning of ordinary in I.R.C. § 162(a) can be useful guidelines to interpret the meaning of “in connection with trade or business” in the CTL, since “in connection

with trade or business” in article 19(2) of the CTL implies both “carrying on” and “in connection with” as a precondition for the ordinary requirement of I.R.C. § 162(a).

Finally the meaning of “necessary” in I.R.C. § 162(a) and “directly related to revenue” in the CTL are different, so the meaning of necessary in the I.R.C. is not applicable to the interpretation of the CTL.

KEY WORDS: Ordinary, Necessary, Trade or Business, Business Expense

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