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Federal Income Taxation-Deductions: Corporate Expenditures not Incurred in Carrying on a Trade or Business

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aside as excessive only gives the power to determine the limits within which a verdict is neither excessive or inadequate, limits which in the case of personal injury might include a wide range of possible verdicts. The power to control does not give the power to find a verdict. "Like the executive veto, it arrests, but does not by its exercise give the power to enact."[37] Thus the court in the *Powers* case is, in effect, saying that it cannot and will not set aside a verdict as excessive unless it is clearly excessive, that is, it will not set aside a verdict because it is one dollar too much, but that this power to set aside a verdict when clearly excessive gives the court the power to determine the exact amount of the verdict. It is a very different thing to say that a verdict is clearly excessive than it is to say that the verdict shall be this particular amount. It is very similar to the difference between saying that you will not pay more than $100 for a particular article and saying that you will pay $50 for it.

The court adopted the practice that it did in the *Powers* case for a pragmatic reason, namely, that such a remittitur would expedite litigation and lessen the expense thereof. That this end would be accomplished can hardly be doubted. Nor can it be doubted that such an end is a desirable one. It would seem unfortunate, however, that the court would abandon a practice which has been in effect in this state for over a half a century, on these grounds. It is to be desired that when the question of additur is presented to the court it will follow the decision of the United States Supreme Court in *Dimick v. Schiedt*[38] and refuse to extend the rule any further. This would have the merit of bringing Wisconsin into line with the Federal law on the question. However, it would seem even more desirable if the court would reconsider its position on the question of remittitur.

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Federal Income Taxation—Deductions: Corporate Expenditures Not Incurred in Carrying On a Trade or Business—Petitioner, a closely-owned corporation, was engaged in the brewery supply business, and also owned rental property. It purchased certain lakeshore residential property and added extensive improvements so that the property was usable as a summer residence and for entertainment. The officers and stockholders of the corporation, all closely related, lived on the premises for about three months each summer, paying $9,000 rent annually. The expenses deducted by petitioner for the depreciation and maintenance of this property amounted to approximately $35,000 a year. The Commissioner allowed the corporate taxpayer a deduction of only $9,000 each year, that is, to the

[37] *Supra* note 28.
[38] *Supra* note 24.

extent of the aggregate rent received and included in the corporation's income. The Tax Court held that the fair rental value of such premises for a three month summer period was not in excess of the amounts paid, and that the petitioner could not deduct the maintenance expenses and depreciation in excess of the deductions allowed by the Commissioner.

The petitioner contended on appeal that where a corporation is engaged in the business of holding realty for income, it cannot be deprived of deductions for maintenance and depreciation on the sole ground that the realty was occupied by its stockholders, where the corporation collected a fair rental from them. Held: *Inter alia,* that the claimed deductions were not incurred in the taxpayer's trade or business within the meaning of the predecessor of Code Section 162(a).[1] The property had little or no business use and was held primarily for the personal use of the taxpayer's stockholders. *International Trading Co. v. Commissioner,* 275 F. 2d 578 (7th Cir. 1960).

Petitioner argued that there is no such thing as a non-business activity of a corporation and that there is a "statutory assumption" that transactions entered into by a corporation are in connection with its business. Text writers support the general view of petitioner, and this "assumption," in effect, can be found as early as 1922[2] and as recent as 1960.[3]

From a reading of the statute in its prior form and of other statutes, it is easy to see how this belief arose. The Revenue Act of 1916 contained separate deduction sections for individuals and for corporations.[4] Section 5 provided for the deduction of expenses by individuals only when "carrying on a trade or business," thereby requiring the individual to prove that he was carrying on a trade or business. Section 12, however, provided that corporations were allowed deductions of expenses "in the maintenance and operation of its business and properties." Congress, by electing to use a different phraseology in Section 12 than was used in Section 5, suggested that

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[1] INTERNAL REVENUE CODE OF 1954 §162. Trade or Business Expenses. (a) In General.—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, ...

[2] ". . . the first general section is devoted to the establishment of the distinction between business and personal expenses and is consequently applicable to individuals only." Montgomery, *Income Tax Procedure,* 851 (1922).

[3] ". . . as respects a corporation, if it is active at all, it is presumed for the purpose of section 162(a) to be engaged in trade or business." Surrey and Warren, *Federal Income Taxation,* 268 (1960 Ed.).

[4] 39 Stat. 759 (1916) §5 (Individuals) (a) . . . The necessary expenses actually paid in carrying on any business or trade, not including personal, living, or family expenses; . . . §12 (Corporations) (a) . . . All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties. . . .

there was an underlying assumption that a corporation is engaged in a trade or business.

The Revenue Act of 1918 changed Section 12 to read the same as Section 5 with regard to the phrase "trade or business."[5] Congress, in floor discussion and in committee reports, gave no indication that by the change, it intended to require corporations to have the burden of proving the additional fact that they are engaged in a trade or business.[6]

Prior to 1941, it was assumed by individual taxpayers that substantially every activity regularly carried on for the production of income would fall within the term "trade or business."[7] In 1941, the court in *Higgins v. Commissioner*,[8] held that the management of taxpayer's security investments, no matter how extensive, did not constitute a trade or business, thereby taxing the income derived from his securities and disallowing the expenses in the management of them. In 1942, the predecessor of Section 212 of the 1954 Code was enacted.[9] This new section gave to individual taxpayers the right to deduct non-business expenses which were incurred in the production or collection of income. According to the House Ways and Means Committee report, the purpose of this section was to correct the inequities that had arisen out of the inadequacy of the predecessor of Section 162(a) and the court construction thereof in the *Higgins* case.[10]

The legislature's limitation of Section 212 to individuals was interpreted by some authorities as supporting the proposition that "corporations are presumed to be engaged in a trade or business."[11] But an equally justifiable interpretation would be that the legislature was only trying to remedy the inequities which had befallen individuals as in the *Higgins* case by providing a statute to allow for deduction of non-business expenses. Cases up to this time, involved with the question of being "engaged in a trade or business," were cases involving individuals and not corporations.[12] Corporate expenses were not questioned as to whether they were incurred in

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[5] 40 Stat. 1066 (1918) §214 (Individuals) and §234 (Corporations) both read as follows: (a) . . . All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . . Note that the additional word "ordinary" was added to §214 (Individuals).

[6] Seidman's Legislative History of Federal Income and Excess Profits Tax Law 1938-1861, 909.

[7] Carson and Weiner, *Ordinary and Necessary Expenses*, 132 (1959).

[8] 312 U.S. 212 (1941).

[9] 56 Stat. 819, 26 U.S.C. §23(a)(2) (1942).

[10] Seidman's Legislative History of Federal Income and Excess Profits Tax Law 1953-1939, 1315.

[11] *Supra* note 3, at 268.

[12] Monell v. Helvering, 70 F. 2d 631 (2d Cir. 1934); Kane v. Commissioner, 100 F. 2d 382 (2d Cir. 1938); Kales v. Commissioner, 101 F. 2d 35 (6th Cir. 1939).

a trade or business, and consequently it seems the courts assumed they were.

At the legislative hearing before the Senate Finance Committee leading to the enactment of the Revenue Act of 1942, a recommendation was made to include corporations in the predecessor of Section 212.[13] The proponent's reason for this recommendation was not because the presumption did not exist, but because of the tendency of some revenue agents to extend the principle of the *Higgins* case, which involved individuals, to certain types of corporate expenditures. Committee statements failed to state the reason for not including corporations in Section 212 even after this recommendation. Whether this was based on an assumption that all corporate expenses were incurred in a trade or business and thus governed by Section 162 is not known.

Additional support for the presumption seems easily derived from the section of the code pertaining to deductible losses.[14] In Section 165 a distinction is made between those losses allowed to an individual and those to a corporation. Corporations are allowed all their losses not compensated for by insurance, while in the case of individuals, the statute specifically requires proof that the losses were sustained in trade or business or in connection with a transaction entered into for profit. It is very plain that there is no statutory requirement in Section 165 on the part of the corporation to show either of these facts which an individual must prove. Although, the wording in Section 162 differs from that in Section 165, the petitioner in the principal case contended that the asumption is basic to both.

It is the writer's opinion that the court's decision can be supported only if: (1) The court does not look at Section 165 as analogous to Section 162, and (2) the court interprets Section 162(a) and its legislative history strictly, and applies the well-established rule that "unless the claimed deductions come clearly within the scope of the statute, they are not to be allowed."[15] However, the court's

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[13] Revenue Act of 1942, Hearing Before the Committee on Finance United States Senate, Vol. 2 at 1733.

[14] The pertinent parts of the section read as follows:

§165, Losses.

(a) General Rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(c) Limitation on Losses of Individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit,

(3) . . . though not connected with a trade or business;

[15] New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934); Deputy v. duPont, 308 U.S. 488, 493 (1939); Bradley v. Commissioner, 184 F. 2d 860 (7th Cir. (1950); Greenspon v. Commissioner, 299 F. 2d 947 (8th Cir. 1956).

rejection of the contention that a corporation is "assumed" to be engaged in a trade or business is in accord with other cases. In *American Properties v. Commissioner*[16] a corporation which owned rental property was disallowed a deduction for expenses incurred in operating racing boats. The activities of constructing, maintaining, and operating racing boats did not constitute the carrying on of a trade or business. Other cases also support the decision by holding that the expense was a personal expense of the corporation's principal stockholder.[17] By so holding, the cases necessarily require an interpretation that the expenses are non-business as well as not "ordinary" and "necessary."

The disallowance of corporate deductions does not seem to be limited only to circumstances where the expense is personal. In *Interstate Transit Lines v. Commissioner,*[18] the nature of the expense was in no way personal. The corporate taxpayer made a contract with its subsidiary whereby the parent became entitled to all the subsidiary's profits and agreed to reimburse the subsidiary for any operating deficit. The court held that the payment made by the parent company to cover the operating deficit of the subsidiary was not deductible under Section 162 because it was not "the business of the taxpayer" to pay the costs of the subsidiary. No discussion was involved as to any assumption that it is incurred in a trade or business.

Under the law as it now stands the court in the principal case appears correct in rejecting any contention of a conclusive assumption. Mertens, *Law of Federal Income Taxation,* states:

> A corporation is normally deemed to be engaged in a "trade or business;" however, to the extent that it is operated solely for the pleasure or recreation of its stockholders it is not engaged in a "trade or business."[19]

The principal case also held that because the property was held primarily for the personal benefit of the stockholders, it follows that the claimed expenses were not ordinary and necessary expenses. If the expenses are disallowed on this basis, it would seem there would be no practical need for the finding that they were not incurred in a trade or business. The corporation already had the burden of proving the expense was not personal under the requirement that it must be "ordinary and necessary." "Ordinary and necessary" expenses within the meaning of Section 162 are all the ordinary and

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[16] 28 T.C. 1100 (1957), *aff'd.* 262 F. 2d 150 (9th Cir. 1958).
[17] Lanteen Medical Laboratories, Inc. v. Commissioner, 10 T.C. 279 (1948); Bardahl Mfg. C.orp., 58, 147 P-H Memo T.C. (1958).
[18] 130 F. 2d 136, *aff'd.* 319 U.S. 590 (1943).
[19] 4 Mertens, Law of Federal Income Taxation §25.08 (Zimet & Diamond Rev. 1954).

necessary expenses directly connected with or proximately resulting from carrying on any trade or business.[20] Therefore "ordinary and necessary" requires the element of proximity to business which is lacking where the expense deduction is primarily for the personal benefit of the stockholders.

All of the cases cited above[21] with the exception of *Interstate Transit Lines v. Commissioner*[22] involved expenses characterized as personal. However, it seems conceivable that in a situation similar to the *Higgins* case[23] the requirement of incurred expenses in a trade or business would result in the disallowance of other expenses which would not be disallowed under the requirements of "ordinary and necessary." The effect then would be to give the Commissioner an added weapon for the disallowance of corporate expense deductions. If the claimed deductions are for depreciation of property held for the production of income, they would be deductible under Section 167(a)(2).[24] But, as to any other expense for the production of income not constituting a trade or business, it seems the same problem now exists as to corporations that existed as to individuals prior to the original enactment of section 212.

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[20] Lanteen Medical Laboratories, Inc. v. Commissioner, 10 T.C. 279 (1948); Mills Estate, Inc. v. Commissioner, 206 F. 2d 244 (2d Cir. 1953); Northern Trust Co. v. Campbell, 211 F. 2d 251 (7th Cir. 1954).

[21] *Supra* note 17.

[22] *Supra* note 18.

[23] *Supra* note 8. See also McCoach v. Minehill and Schuylkill Railroad Co., 228 U.S. 295 (1913).

[24] §167. Depreciation.
(a) General Rule—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear
(1) of property used in a trade or business, or
(2) of property held for the production of income.