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Article 9

Taxation - Requirement That an Ordinary and Necessary Business Expense Must be Reasonable

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posed until the commencement of the action and any action based on past care furnished must fail.[12]

As the above discussion precludes the possibility of state recovery for past care of indigent incompetents, it is appropriate now to consider the course of action provided by statute[13] to which the state is limited and in which the responsible family members, consisting of the father, mother, husband, wife and children of the dependent, shall have their liability fixed. The authorities having charge of the dependent person or the board in charge of the institution where the dependent person may be, must apply to the county judge of the county in which the dependent person resides for an order to compel maintenance and must serve a notice of such application upon the responsible family members at least ten (10) days before a hearing which the county judge must hold to hear the allegations and proofs in the matter. The county judge will then, by order, require maintenance from such relatives, if they be of sufficient ability, in the following order: first the husband or wife; then the father; then the children; and lastly the mother. The order will fix a weekly or monthly sum sufficient for the support of the dependent to be paid for a fixed period or until further order of the court. In the event that any responsible relative is unable wholly to maintain the dependent, but is able to contribute to such support, the judge may order two or more responsible relatives to maintain the dependent and specify the amount each shall contribute. If it be established that the responsible relatives are unable to wholly maintain the dependent but are able to contribute to such maintenance, the judge shall order a sum to be paid weekly or monthly by each relative in proportion to his ability. These orders may be enforced by proceedings as for contempt. Also, the state is safe in furnishing maintenance once the order has been made because the statute authorizes suit against any person disobeying such an order and recovery in the amount prescribed by the order.

ELWIN J. ZARWELL

Taxation — Requirement that an Ordinary and Necessary Business Expense Must Be Reasonable — Taxpayer, a manufacturing corporation, deducted premiums paid on an employees' retirement annuity policy and contributions to a trust fund for employees' benefit from its gross income for 1940 and 1941 as an ordinary and necessary business expense.[1] The Tax Court disallowed this deduction ruling that the pay-

[12] Guardianship of Heck, 225 Wis. 636, 275 N.W. 520 (1937).
[13] Supra note 5.
[1] Sec. 23 (a) (1) (A) of the Internal Revenue Code. It was conceded that the payments were not qualified for deduction under Sec. 23 (p) as then in effect which allowed deductions for payments to pension and other plans under certain conditions.

ments were neither compensation for services actually rendered, nor an ordinary and necessary business expense.[2] The Circuit Court of Appeals reversed and remanded on the sole ground that these payments constituted an ordinary and necessary business expense, passing over the compensation issue.[3] The Tax Court ruled on remand that under the Circuit Court opinion the payments were deductible as an ordinary and necessary business expense regardless of whether they were reasonable.[4] The Commissioner appealed, contending that reasonableness of amount must be considered. *Held:* Reversed and remanded. While there is no express statutory provision limiting ordinary and necessary expenses to a reasonable amount, yet ". . . the element of reasonableness is inherent in the phrase 'ordinary and necessary.' Clearly it was not the intention of Congress to automatically allow as deductions operating expenses . . . in an unlimited amount." The prior opinion dealt only with the nature and character of the payments, not with their amounts. *Commissioner v. The Lincoln Electric Company, 176 F.(2d) 815 (C.C.A. 6th, 1949); cert. den., 94 L.Ed. 372 (1950).*

The Court in its decision is apparently seeking two ends, to allow a deduction for payments which failed to qualify under Sec. 23 (p) or as compensation, and at the same time to limit the amount of the deduction. To accomplish these ends, it was necessary to bridge a statutory gap by injecting the reasonable amount test, found only in the compensation clause, into the general expense provision. The decision will have only limited effect on payments to pension and retirement plans set up since 1942 because Sec. 23 (p) has been amended[5] and

[2] Commissioner v. The Lincoln Electric Company, 6 T.C. 37 (1944). Taxpayer's primary contention that the payments constituted compensation was rejected because it was not "paid to employees" and the benefits conferred were nebulous and uncertain; the secondary contention that they were ordinary and necessary expenses was rejected on the ground that they were not necessary because the end sought existed prior to the expenditure, and not ordinary expenses but more in the nature of capital expenditures.

[3] Commissioner v. The Lincoln Electric Company, 162 F.(2d) 379, 35 AFTR 1470 (C.C.A. 6th, 1947). The Court held they were necessary because they had in fact benefited taxpayer's business and were ordinary because not unique in that business, and said that "If . . . they constitute such expenses it will not become necessary to consider whether they are allowable deductions because they constitute compensation. . . ."

[4] Commissioner v. The Lincoln Electric Company, 8 T.C.M. Dec. 16, 136 (CCH, 1947).

[5] The general rule of Sec. 23 (p), as amended by the Revenue Act of 1942, now reads as follows: "If contributions are paid by an employer to or under a . . . pension . . . or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under subsection (a) but shall be deductible, if deductible under subsection (a) without regard to this subsection, under this subsection but only to the following extent. . . ." The section does not apply to a plan that does not defer receipt of compensation, but if the section does apply, the contributions are deductible only to the extent that they are ordinary and necessary expenses and are reasonable compensation. Treas. Reg. 111, Sec. 29.23 (p)-1. Tavannes

the Tax Court has refused to allow a deduction as an ordinary and necessary expense.[6] Whether the decision in its broad construction will be applied to all ordinary and necessary expenses[7] depends on the logic of its position and more particularly on its practical consequences in tax controversies. The decision opens the expense accounts of taxpayers to scrutiny on an issue formerly reserved to compensation cases[8] and is certainly a valuable bargaining factor for the Commissioner. Both the desirability and logic of such a position is open to serious question.

The language of the Code section[9] under which the deduction was taken appears to be clear and free of ambiguity; the first clause contains the general rule and the specific expenses following are enumerated only because such expenses are further limited or defined. For example, compensation is an ordinary and necessary business expense,[10] but to be deductible, it must meet the further requirements that it be reasonable and for personal services actually rendered.[11] It should fol-

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Watch Company v. Commissioner, 176 F.(2d) 211 (C.C.A. 2d, 1949) (Payments made to employees' profit sharing plan after 1942 can be deducted under Sec. 23 (p) only, and not under Sec. 23 (a).). Accord: Times Publishing Company v. Commissioner, 13 T.C. 329 (1949).

[6] Where the deduction had been allowed under Sec. 23 (a) prior to 1942, it had usually been as compensation. See Alvin Glen Hall v. Commissioner, 7 T.C. 1220 (1946); Surface Combustion Corporation et.al., v. Commissioner, 9 T.C. 631 (1947); Roberts Filter Mfg. Co. v. Commissioner, 10 T.C. 26 (1948) (Since the payments did not constitute compensation, a deduction was not allowed under the general provision. The Court expressly refused to follow the first Circuit Court opinion in the Lincoln case, *supra,* note 3.).

[7] Treas. Reg. 111, 29.23 (a)-2 requires that traveling expenses be reasonable. In Commissioner v. Flowers, 326 U.S. 465, 66 S.Ct. 250 (1946), the Court said that this regulation interpreted prior and successive revenue acts and therefore is impliedly approved by Congress and has the force of law. The Court in the present case cites the Flowers case as precedent for its decision.

[8] Immerman v. Commissioner, 7 T.C. 1030 (1946). (The Code does not limit deductions for rental payments to a reasonable amount as in the case of compensation; the amount of the payment does not affect the deduction.).

[9] I.R.C. Sec. 23. DEDUCTIONS FROM GROSS INCOME.
In computing net income there shall be allowed as deductions:
(a) Expenses.—
(1) Trade or business expenses.—
(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession for purposes of the trade or business, or property to which the taxpayer has not taken or is not taking title or in which he has no equity.

[10] Treas. Reg. 111, Sec. 29.23 (a)-1, (a)-6.

[11] But see Griswold, Erwin N., *New Light on "Reasonable Allowance For Salaries."*—, 59 Harv. L. Rev. 286 (1945), contending that the reasonable compensation provision was not intended to be restrictive, but was intended to allow a deduction to closely held corporations and individually owned businesses for salaries where none in fact had been paid, for purposes of computation of excess profits tax under the act of October 3, 1913.

low logically that Congress intended the further limitations to apply only to the particular expense to which they relate.

The premises of the present decision are unclear. The Court may be adding the word "reasonable" to the statutory words "ordinary and necessary," but since there is no authority existing in a judicial body to revise legislation, the decision must be taken as construing the present language of the statute. Two possible approaches suggest themselves. First, reasonableness of amount is part of and "inherent in the phrase 'ordinary and necessary.'" The difficulty presented by such an interpretation is that the phrase refers to the kind of expenses that will be deductible and not to the amount of payments. The leading case of *Welch v. Helvering*[12] defined a necessary expense as one appropriate and helpful to the development of the taxpayer's business, and an ordinary expense as one not unique in the life of the group or community.[13] The origin and nature of the expense determines its deductibility under Sec. 23 (a).[14] While there is no hard and fast rule as to what expenses are ordinary and necessary, the principles and standards used in the cases seem to exclude the idea of reasonableness of amount as a part of the phrase "ordinary and necessary," or the idea that the amount of an expense is a criterion of whether it is ordinary and necessary.[15] On the other hand, the court may be saying that a disbursement, unreasonable in amount, is not an "expense in carrying on a trade or business." Such interpretation is consistent with the cases relied upon as precedent by the Court, but is certainly inconsistent with the language and tenor of its opinion. The *Botany* case[16] was a decision on the deductibility of compensation payments and construed Sec. 12 (a) of the Revenue Act of 1916 which contained the general rule of Sec. 23 (a) without the present provision for reasonable

[12] 190 U.S. 111 (1933) (While it may be helpful, and therefore necessary, to taxpayer's business with his former employer's customers that he satisfy the bankrupt employer's obligations to such customers, it is not usual, and therefore not ordinary, to pay another's debts.). The Court in the first appeal of the Lincoln case, *supra,* note 3, used the definitions in the Welch case in reaching its decision.

[13] Stanley and Kilcullen, *The Federal Income Tax* (1948), p. 54 (". . .what is ordinary and necessary depends on the type of business . . . and the business customs of the time and in the locality. . . . It is not necessary that the expenses be ordinary in that it is frequently made by the taxpayer. . . ."); Deputy v. Du Pont, 302 U.S. 488 (1939).

[14] Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1942); Kornhauser v. U.S., 276 U.S. 145 (1928) (Where a suit against a taxpayer is directly connected with, or proximately resulted from his business, attorney fees are deductible expenses because a suit ordinarily and decessarily requires the use of counsel.).

[15] For language indicating that it is a criterion, see Commissioner v. Heininger, 320 U.S. 467, 64 S.Ct. 249 (1943); L. O. 1045, C.B. Dec. 133 (1920); 47 C.J.S. 254, Sec. (c) (1946) (The case cited as authority, however, National Cottonseed Products Corp. v. Commissioner, 76 F.(2d) 839 (C.C.A. 6th, 1935) treated the payments as additional compensation.).

[16] Botany Worsted Mills v. U.S., 278 U.S. 282, 49 S.Ct. 129 (1929).

compensation. There the Court found it unnecessary to determine whether unreasonable compensation is an ordinary and necessary expense, but decided that an "extravagant" and "extraordinary" amount, having no relation to the services rendered, is not in reality payment for services. The *Limericks* case[17] decided that unreasonable rental paid by a corporation to its principal stockholder was in fact a distribution of net profits and ". . . in no sense a legitimate business expense." These cases permit a scrutiny of the nature of the expense if there is a question of whether the payment is another form of disbursement in the guise of a business expense, but are not authority for the position that legitimate business expenses can be disallowed because the amount is excessive. In view of the Court's prior decision that the payments were ordinary and necessary business expenses, it is difficult to see the applicability of these decisions.[18]

The more reasonable interpretation of the statute is that Congress did not intend that a businessman's judgment as to the amount he should pay in incurring a business expense should be open to question, nor that he should be penalized for making a bad bargain. The authority of the Commissioner to question the reasonableness of amounts paid as compensation has been seriously questioned.[19] A decision where authority to question the amounts of all business expenses is found in the Commissioner by inference and analogy is certainly open to doubt. In compensation cases, the elements of close relation between expender and recipient[20] and control by the recipient[21] can be used to disallow the deduction on the ground that the payment is not in fact compensation. Therefore, it would seem that in the field of general expenses, the Commissioner is adequately protected against excessive payments on the issue of business expense and there is no reason to extend to general expenses the additional power that he has assumed in the compensation cases.

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[17] Limericks Inc. v. Commissioner, 162 F.(2d) 483 (C.C.A. 5th, 1949).

[18] The Court in the present case explained that since the issue in the prior case was a question of law, i.e., the nature of payments to pension plans as conforming to the requirements of the statute, any question of fact is left open, and whether the amounts paid are reasonable is a question of fact. Query as to whether the only question of fact open is whether the disbursements were payments to a pension plan, and if so, is not the statute satisfied and the amount immaterial? The dissent felt the issue had been finally determined and viewed the decision as an unauthorized rehearing of the prior decision.

[19] See Griswold, Erwin N., *The Deduction of "A Reasonable Allowance For Salaries"*—The Undefined Power of the Commissioner, 56 Harv. L. Rev. 947 (1943) contending that the only instances where the amount of compensation should be open to question are: 1) payments made to stockholders where they are in effect a dividend; 2) payments which are in substance gifts. See also Griswold's subsequent article, *supra,* note 11. His theory is that the only question is whether the payments are compensation, and if they are compensation, the reasonableness of their amount is not open to scrutiny.

[20] Lydia Pinkham Medicine Co. v. Commissioner, 128 F. (2d) 986 (C.C.A. 1st, 1942).

[21] Supra, note 16.