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Ordinary and Necessary Business Expense as a Deduction

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ORDINARY AND NECESSARY BUSINESS EXPENSE AS A DEDUCTION.—In an interpretation of a provision of the Revenue Act of 1926,[1] the court said,

> "Practically any reasonable expenditure that has *benefited the business* [2] has been allowed to be deducted as an expense." [3]

Courts and commentators, in attempting to explain what is meant by expenditures that benefit business, have said,

> "In order that an expenditure may constitute an allowable deduction under the statute [4] three elements must concur: (1) The expenditure must have been incurred 'in carrying on any trade or business'; (2) it must have been an ordinary expenditure in such connection; and (3) it must have been a necessary expense in such connection." [5]

What is an "ordinary and necessary expense" has been the subject of much litigation in our courts. The determination of whether the expenditure has been an ordinary and necessary expense [6] has

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[1] REV. ACT 1926, §214, 26 U. S. C. A. §955,
"(a) In computing net income there shall be allowed as deductions:—
"(1) All ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.
"(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business; * * *."

[2] Italics mine.

[3] Poinsett Mills Case, 1 B. T. A. 6 (1924); Holt Granite Mills Company's Appeal, 1 B. T. A. 1246 (1925); Appeal of Victor J. McQuade, 4 B. T. A. 837 (1926) (purchase by petitioner of theatre tickets); Dickenson v. Comr., 8 B. T. A. 722 (1927) (yacht bought to bring customers to see the factory as a selling inducement); Aitken v. Comr., 12 B. T. A. 692 (1928); Hutchison v. Comr., 13 B. T. A. 1187 (1928); Hirsch-Weils Manufacturing Co. v. Comr., 14 B. T. A. 796 (1928); Pierce v. Comr., 18 B. T. A. 447 (1929); Lucas, Comr. v. Ox Fibre Brush Co., 281 U. S. 115, 51 Sup. Ct. 273 (1930); American Rolling Mill Co. v. Comr., 41 F. (2d) 314 (C. C. A. 6th, 1930); Harris & Co. v. Comr., 16 B. T. A. 705, 48 F. (2d) 187, 188 (C. C. A. 5th, 1931).

[4] *Supra* note 1.

[5] HOLMES, FEDERAL INCOME TAX (6th ed. 1925) §481; KLEIN, FEDERAL INCOME TAXATION (1929) 394; Seufert Bros. Co. v. United States, 60 F. (2d) 1061, 1062 (C. C. A. —, 1932).

[6] Poinsett Mills Case, *supra* note 3; Appeal of Victor J. McQuade, *supra* note 3; Dickenson v. Comr., *supra* note 3; Brodbeck v. Comr., 8 B. T. A. 969 (1927); Zimmerman v. Comr., 28 F. (2d) 769 (C. C. A. 5th, 1928); Cohn v. Comr., 31 F. (2d) 874 (C. C. A. 4th, 1929); Ox Fibre Brush Co. v. Blair, Comr., 32 F. (2d) 42 (C. C. A. 4th, 1929); United States v. Black & Kohner Mercantile Co., 33 F. (2d) 196 (C. C. A. E. D. Md. 1929); Kaufman Dept. Stores, Inc. v. Comr., 34 F. (2d) 257 (C. C. A. 3rd, 1929); Corning Glass Works v. Lucas, Comr., 37 F. (2d) 798 (C. C. A. D. C. 1929; KLEIN, *op. cit. supra* note 5, at 395, "Extraordinary and unnecessary expenditures in the maintenance or operation of a business are not to be treated as allowable deductions, since the expression 'ordinary and necessary' undoubtedly refers not only to the character of the expense, but also the amount thereof. * * * What constitutes 'ordinary and necessary' expenses varies not only with the

proved a very interesting one. In the various situations that have come up before the courts, such situations as capital investments,[7] ordinary expenses,[8] and necessary [9] expenditures have appeared. The

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nature of the business done but also with the conditions prevailing in the business generally"; Seabright Woven Felt Co. v. Ham, 38 F. (2d) 114 (C. C. A. Me. 1930); Providence Coal Mining Company v. Lucas, Comr., 39 F. (2d) 109 (C. C. A. St. Louis 1930); United States v. Rosenthal Co., 39 F. (2d) 425 (C. C. A. 5th, 1930); Cohen v. Comr., 39 F. (2d) 540 (C. C. A. 2d, 1930); American Rolling Mill Co. v. Comr., 41 F. (2d) 314 (C. C. A. 6th, 1930); Forbes Lithograph Manufacturing Co. v. White, Comr., 42 F. (2d) 287 (C. C. A. Mass. 1930); Spring Canyon Coal Co. v. Comr., 43 F. (2d) 78 (C. C. A. 10th, 1930); Frank & Seder Co. v. Comr., 44 F. (2d) 147 (C. C. A. 3rd, 1930); Seufert Bros. Co. v. Comr., 44 F. (2d) 528 (C. C. A. 9th, 1930); Buroughs Bldg. Material Co. v. Comr., 47 F. (2d) 178 (C. C. A. 2d, 1931); Parkersburgh Iron & Steel Co. v. Burnet, Comr., 48 F. (2d) 163 (C. C. A. 4th, 1931); A. Harris & Co. v. Lucas, Comr., *supra* note 3; Lucas, Comr. v. Woffard, 49 F. (2d) 1027 (C. C. A. 5th, 1931); National Piano Mfg. Co. v. Burnet, Comr., 50 F. (2d) 310 (C. C. A. D. C. 1931); Texas & P. Ry. Co. v. United States, 52 F. (2d) 1041 (C. C. A. Ct. of Claims 1931); Robinson v. Comr., 53 F. (2d) 810 (C. C. A. 8th, 1931); Hecht v. United States, 54 F. (2d) 968 (C. C. A. Ct. of Claims 1932); Lloyd v. Comr., 55 F. (2d) 842 (C. C. A. 7th, 1932); Luden Machinery Co. v. United States, 57 F. (2d) 911 (C. C. A. Ct. of Claims 1932); Bliss v. Comr., 57 F. (2d) 984 (C. C. A. 5th, 1932); R. H. Heflin, Inc. v. United States, 58 F. (2d) 482 (C. C. A. Ct. of Claims 1932); Hutchings v. Burnet, Comr., 58 F. (2d) 514 (C. C. A. D. C. 1932); Comr. v. Continental Screen Co., 58 F. (2d) 625 (C. C. A. 6th, 1932); White v. Comr., 61 F. (2d) 726 (C. C. A. 9th, 1932); Alexander Sprunt & Co., Inc. v. Comr., 64 F. (2d) 424 (C. C. A. 4th, 1933); Samuel Heath Co. v. Comm., 2 Fed. Supp. 637 (1933); MONTGOMERY, FEDERAL TAX HANDBOOK (1933-34) 318, "Deductibility of an expense hinges, in many cases, upon whether direct or definite benefit to the business of the taxpayer can be shown. If it can, the expense is deductible, whether it be a contribution to * * * a fund to bring new business in district, etc."

[7] Duffy v. Central R. R. Co. of New Jersey, 268 U. S. 55, 45 Sup. Ct. 429 (1925); Manley v. Comr., 6 B. T. A. 707 (1927); KLEIN, *op. cit. supra* note 5, at 415, "The price paid (for good will) is the cost of an asset and does not represent an expense"; George H. Bowman Co. v. Comr., 32 F. (2d) 404 (C. C. A. D. C. 1929); Black Hardware Co. v. Comr., 39 F. (2d) 460 (C. C. A. 5th, 1930); Great Northern Ry. Co. v. Comr., 40 F. (2d) 709 (C. C. A. —, 1930); King Amusement Co. v. Comr., 44 F. (2d) 709 (C. C. A. 6th, 1930); hicago, R. I. & P. Ry. Co. v. Comr., 47 F. (2d) 990 (C. C. A. 7th, 1931); Parkersburgh Iron & Steel Co. v. Burnet, Comr., 48 F. (2d) 163 (C. C. A. 4th, 1931); First National Bank of Omaha v. Comr., 49 F. (2d) 70 (C. C. A. 8th, 1931); Newspaper Printing Company v. Comr., 56 F. (2d) 125 (C. C. A. 3rd, 1932); Fire Companies Building Corporation v. Burnet, Comr., 57 F. (2d) 943 (C. C. A. D. C. 1932); Cripple Creek Coal Company v. Comr., 63 F. (2d) 829 (C. C. A. 7th, 1933).

[8] HOLMES, *op. cit. supra* note 5, at 908, "The word 'ordinary' has been defined as meaning 'common, usual, often recurring' "; Ellis v. Burnet, 50 F. (2d) 343 (C. C. A. D. C. 1931); Stacey v. United States, 60 F. (2d) 1061, 1062 (C. C. A. 1932), "The words 'ordinary expense' would seem to imply that the expense was an annual or at least a periodical or recurrent expense growing out of the conduct of a business as opposed to an expense which is extraordinary and infrequent." Welch v. Comr., 63 F. (2d) 976, 977 (C. C. A. 8th, 1933), "We can see no possible basis upon which payments of this character can be treated as 'ordinary' expenses of his business."

[9] Lambert v. Yellowley, 291 F. 640 (C. C. A. 1923); *In re* Wyley Co., 292 Fed. 900 (C. C. A. 1923); Welch v. Comr., *ibid.*, "It would be rather

courts, however, have adhered to the wording of the statute[10] and claimed that an expense, to be deductible, must be both necessary and ordinary.[11]

In *Donnelley* v. *Commissioner*,[12] the taxpayer and one Knight were partners in the brokerage business. Bankruptcy proceedings had been instituted against it, but were dismissed before a discharge was ordered, because of the settlement of the firm's debts for less than the amount due. Donnelley, now affluent, has paid a sum of money to the former creditors, representing both principal and interest on the old debts, and desires to have the amount so paid, deducted from his gross income. The court held that, though the act was a commendable one, the money so expended did not fall within the term "ordinary and necessary expenses," and so could not be allowed as a deduction.[13]

A similar situation arose in *Welch* v. *Commissioner*,[14] where the petitioner was adjudged a bankrupt, and his debts were discharged. Later, he again entered business and, desiring to re-establish his credit, decided to pay his former creditors. He paid by check, indorsed, "The payee of this check, by the endorsement hereof, accepts and agrees to apply the same on its claim against E. L. Welch Company (the bankrupt concern), according to the terms of the letter of transmittal. *It has nothing to do with the present or future business*[15] relations with the maker of the check and is not to be considered an acknowledgment of any existing claim or renewing any barred claim against him." The court said,

> "There may be room for argument and difference as to whether payments of this character, under the circumstances here, are 'necessary' or not. It would be rather clear that they would be helpful in a business way, and that helpfulness might approach or reach necessity. However, we can see no possible basis upon which payments of this character can be treated as 'ordinary' expenses of his business."[16]

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clear that they (expenses) would be helpful in a business way, and that helpfulness might approach or reach necessity." Mayor v. Chesapeake, etc. Co., 92 Md. 692, 48 Atl. 465 (1901); KLEIN, *op. cit. supra* note 5, at 394, "The word 'necessary,' depending on the connection in which used, has been given several meanings extending from a meaning importing absolute physical necessity to convenient or useful or essential."

[10] *Supra* note 1.

[11] *Ibid.*

[12] 68 F. (2d) 722 (C. C. A. 1934).

[13] *Supra* note 5.

[14] *Supra* note 8.

[15] Italics mine. Having nothing to do with the present or future business relations the expenditure was not such as to merit its being deducted from the gross income as an expense recognized by the Revenue Act.

[16] *Supra* note 8, at 977.

In *A. Harris & Company* v. *Commissioner*,[17] the petitioner, in order to maintain its business, gave out passes to its customers to see motion pictures. The commissioner permitted the deduction as a necessary and ordinary expense of the business. The procedure of giving passes did not substantially aid the petitioner's business, as it was hampered because of the lack of credit. The petitioner, herein, had at a prior time accomplished a compromise with his creditors. To again obtain credit, he found it necessary to pay them the money he had been allowed under the compromise. In permitting the deduction of the money so paid by Harris & Company, from his gross income, the court stated,

> "It is evident that the words 'ordinary and necessary' in the statute are not used conjunctively, and are not to be construed as requiring that an expense of a business is to be both ordinary and necessary in a narrow, technical sense. On the contrary, it is clear that Congress intended the statute to be broadly construed to facilitate business generally, so that any necessary expense, not actually a capital investment, incurred in good faith in a particular business, is to be considered as an ordinary expense of that business. This is in effect the construction given the statute by the Treasury Department and the Courts." [18]

It would seem as though the *Harris* case[19] is overruled by the *Welch*[20] and *Donnelley* cases;[21] however, in the latter cases the expenditures were made, not because it was necessary to maintain a normal unhampered credit, but because of the good faith of the taxpayer. In the former case,[22] Harris found that it was necessary for him to appease his former creditors with a repayment of the debt, otherwise he could not continue in business. Klein, in his *Federal Income Taxation,* said,

> "What constitutes 'ordinary and necessary expense' varies not only with the nature of the business done, but also with the conditions prevailing in the business generally, so that expenditures which might properly be classified as expenses at one time could clearly not be so classified at another time. * * * Each case depends upon its own facts and circumstances. The very item which in one instance is a deductible expense

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[17] *Supra* note 3.
[18] *Id.* at 188.
[19] *Ibid.*
[20] *Supra* note 8.
[21] *Supra* note 12.
[22] *Supra* note 17.

may in another, attended by other circumstances, be a non-deductible expenditure." [23]

When the courts are confronted with situations similar to those presented in the *Donnelley*,[24] *Welch* [25] and *Harris* [26] cases, it is not difficult to understand the position in which the court is placed. On one side it is faced with the words of the statute and, on the other, the petitioners' peculiar position.[27] The courts have decided each case upon its own particular facts; and though it may seem harsh that one in the position of Donnelley or Welch should not be permitted the deduction, it is not difficult to see that the court has recognized the fact that if a deduction were permitted, it would open the way for fraud.

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[23] KLEIN, *op. cit. supra* note 5, at 395.

[24] *Supra* note 8.

[25] *Supra* note 17.

[26] *Supra* note 3.

[27] *Supra* note 1.