Michigan Law Review

Volume 49 | Issue 3

1951

TAXATION-THE LINCOLN ELECTRIC QUESTION: MUST "ORDINARY AND NECESSARY" BUSINESS EXPENSES BE ALSO "REASONABLE" IN AMOUNT

R. Lawrence Storms S. Ed.
University of Michigan Law School

COMMENTS

TAXATION—THE LINCOLN ELECTRIC QUESTION: MUST "ORDINARY AND NECESSARY" BUSINESS EXPENSES BE ALSO "REASONABLE" IN AMOUNT?—The United States Court of Appeals for the Sixth Circuit has recently determined in *Commissioner v. Lincoln Electric Co.*[1] that the element of reasonableness is inherent in the phrase "ordinary and necessary" as used in the paragraph of the Internal Revenue Code authorizing deductions for business expenses.[2] It will be of interest to develop the history of the case throughout its ten years of litigation, to examine some of the collateral points raised, and to attempt a critique of the merits of the court's position.

I

Facts, Background, and History of the Litigation

The undisputed facts showed that the Lincoln Electric Company of Cleveland, Ohio, manufactured and sold welding supplies, electrodes, and electric arc welding machines. Eighty-five per cent of the employees operated on a piece-work rate without restriction upon the amount anyone produced. The base pay of other employees whose duties could not be made the basis of a scientifically ascertained piece-work treatment was the same or higher than the wage rate paid by community competitors. An annual bonus plan was initiated in 1934 which in 1940 amounted to approximately 100% of base pay, about a year's wages to the employees.

In 1936 the Employees' Advisory Board suggested as an addition to the incentive plan an employees' retirement annuity policy. Lincoln purchased such a plan from the Sun Life Insurance Company of Canada and paid premiums annually after 1936, paying $400,000 in 1940, and $575,000 in 1941.[3]

Also in 1941, and again at the suggestion of the Employees' Advisory Board, the company adopted an employees' trust, and paid into it $1,000,000 which otherwise would have been paid to the employees as part of their bonus. This fund and the earnings were to be distributed to the employees at the end of ten years, or prior thereto, at the direction of the Employees' Trust Advisory Committee, but in no case could any part of the trust estate revert to the company or be used for its benefit.

The results of these incentive provisions were immediate and gratifying. By 1941, work stoppages and other labor difficulties were elimi-

[1] (6th Cir. 1949) 176 F. (2d) 815.

[2] I.R.C., 26 U.S.C.A. (1948) §23(a)(1)(A) states that in computing net income there "*shall* be allowed as deductions. . . . 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. . . ." Emphasis added.

[3] Premium payments for the years prior to 1940 were not contested.

nated; the hours of direct labor required to manufacture a given unit were cut in half, as was the selling price; and the productivity of an individual employee, and dividends, earned surplus, and undivided profits were greatly increased. The uncontradicted evidence showed the incentive plan to be responsible for those happy results.[4]

In its return for the year 1940, the taxpayer deducted from gross income the annuity premiums, and in its return for 1941 deducted the annuity premiums and the trust payment. The commissioner disallowed the deductions and determined a deficiency for both years.

In the first appearance in the Tax Court,[5] the company protested the assessment of additional taxes and contended that the amounts paid were properly deductible either (1) as compensation paid for personal services actually rendered, or (2) as ordinary and necessary expenses of carrying on its business,[6] or (3) as part of the cost of goods sold,[7] but lost on all three grounds. The reasoning of the Tax Court on each ground may be briefly stated as follows. (1) The payments were not compensation for services rendered because:[8] neither the employee nor his estate would be entitled to receive anything of value in the future unless he remained an employee and rendered services in that employment;[9] the statute pre-supposes that to be deductible as compensation the expenditure must have been paid to the employee, i.e., an immediate correspondence is required between the deduction of one taxpayer and the taxability of another; the payments were voluntary and not pursuant to either a prior agreement or enforceable obligation. (2) The payments were not ordinary and necessary business expenses because: even if ordinary, "necessary" means more than commendable; if ever necessary to build up and retain a loyal and efficient working force, such a force had already been developed; if anything, the amounts

[4] Judge Simons, speaking for the court in the first appeal of the case, (6th Cir. 1947) 162 F. (2d) 379, said, "This appraisal of the results of the taxpayer's labor policy sufficiently illuminates the picture, even if a model of understatement. . . ."

[5] Lincoln Electric Co. v. Commissioner, 6 T.C. 37 (1946).

[6] The first two grounds urged were based on I.R.C. §23(a)(1)(A), supra note 2. Deductions "shall" be allowed for "all the ordinary and necessary expenses" of a business, "including a reasonable allowance for salaries or other compensation. . . ."

[7] Gross income includes "gains, profits, and income derived from . . . the transaction of any business carried on for gain or profit. . . ." I.R.C. §22(a). In the case of a manufacturing business, "'gross income' means the total sales, the cost of goods sold. . . ." Treas. Reg. 111, §29.22(a)-5.

[8] Since the payments did not qualify as "compensation," the court thought it unnecessary to pass on the question of reasonableness. That question became "moot."

[9] Under the annuity the employee would have to survive to retirement age and have worked all that while unless the paid-up annuity equaled his salary or $3500. As for the trust, the court thought any benefit to the employee was too illusory and too much subject to the control of the committee.

were capital expenditures to insure good future relations, thus not current expenses;[10] the payments were for services, although not allowable compensation deductions, and therefore cannot be deducted as ordinary and necessary expenses per other provisions.[11] (3) The payments did not constitute an element of cost of goods sold because: they were voluntary payments made after all costs were paid and the manufacture completed; the taxpayer treated them as deductions; a contrary conclusion would mean that section 23(a) does not apply to manufacturing corporations.

On the first appeal to the circuit court,[12] an immediate hurdle confronting the company was the government's contention that the findings of the Tax Court were factual, that they involved accounting practices, and thus were not reviewable under the *Dobson* rule.[13] The taxpayer argued that the *Dobson* case did not prevent review, and that it at any rate was not applicable in view of the more recent Federal Administrative Procedure Act.[14] The holding was that the act does govern review of Tax Court decisions, but the court declined to specify in what respects its review power had been enlarged, instead relying on the *Bingham* case to justify review.[15]

The circuit court held the payments were expenses, for the company had paid out its money and under no circumstances could it get it back. Further, it considered that the "rationalization and philosophic content"

[10] Here the court cites Welch v. Helvering, 290 U.S. 111, 54 S.Ct. 8 (1933).

[11] In Roberts Filter Mfg. Co., 10 T.C. 26 (1948), the Tax Court continued to maintain the position that if the payments are of the nature of compensation, but not deductible, they may not be deducted on the basis of other statutory provisions despite the previous ruling of the circuit court in the first appeal of the Lincoln case.

[12] (6th Cir. 1947) 162 F. (2d) 379. Through the remainder of the text the writer uses "circuit court" in referring to the United States Court of Appeals for the Sixth Circuit.

[13] Dobson v. Commissioner, 320 U.S. 489, 64 S.Ct. 239 (1943), followed in Commissioner v. Scottish American Investment Co., Ltd., 323 U.S. 119, 65 S.Ct. 169 (1944); John Kelly Co. v. Commissioner, 326 U.S. 521, 66 S.Ct. 299 (1946), and McDonald v. Commissioner, 323 U.S. 57, 65 S.Ct. 96 (1944).

[14] 60 Stat. L. 237 (1946), 5 U.S.C. (1946) §1101. The fighting point involved for this particular question was as to whether the Tax Court is indeed a "court" and thus not affected by the act, or whether it is a "mere independent agency."

[15] Trust under the Will of Bingham v. Commissioner, 325 U.S. 365, 65 S.Ct. 1232 (1945) held that the matter of law subject to review included the application of the law to the facts, and that construction of statutory terms can raise clear-cut questions of law. The entire question of the state of the law with respect to review of Tax Court decisions is exceedingly confused, and has not been particularly clarified in practice by the 1948 amendment to §1141(a) of the I.R.C. by which federal appellate courts are given the same right to review Tax Court decisions as they have to review district court nonjury decisions. For a treatment of the question as raised in the Lincoln case, see 18 OKLA. B.A.J. 1175 (1947) and 42 ILL. L. REV. 794 (1948).

of Justice Cardozo's opinion in *Welch v. Helvering*[16] compels a conclusion that the expenses were ordinary in view of the company's history of high incentive wages in order to avoid labor disputes and promote employee loyalty; and that the uncontradicted evidence of the company's growth and the part the plan played in it shows that they were necessary. Having so decided, the court saw no necessity for considering the other two suggested grounds for relief, and stated further that "in any event we will not be obliged to determine their reasonableness, for that is concededly within the exclusive province of the Tax Court, and it has given no consideration to it in view of its decision that the payments were neither ordinary and necessary expenses nor compensation."[17] The case was accordingly remanded for disposition in conformity with the decision.[18]

With the parties again in the Tax Court, the commissioner now argued that since the circuit court had decided that the payments were ordinary and necessary expenses but had refused to consider whether they represented compensation, and if so, reasonable compensation, the Tax Court should therefore decide the crucial issue, i.e., the reasonableness of the payments as compensation. However, the Tax Court thought itself precluded from considering reasonableness since the opinion and mandate were pointed towards deductibility without reference to compensation, and the issue of reasonableness arises only in connection with compensation.[19] This time the diligent commissioner appealed.

On the second appeal,[20] the circuit court was required to interpret its first opinion. The court rejected the commissioner's contention that

[16] 290 U.S. 111, 54 S.Ct. 8 (1933), where the taxpayer's payments were for the purpose of creating good will for a new venture, instead of retaining existing good will, and thus were of the nature of capital outlays. At 113-114 Cardozo said, "Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. . . . The expense is an ordinary one because we know from experience that payments for such a purpose . . . are the common and accepted means of defense against attack. . . . The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part."

[17] (6th Cir. 1947) 162 F. (2d) 379 at 382.

[18] It is perhaps significant that when confronted with a similar problem only a few months later, the Tax Court in Roberts Filter Mfg. Co., 10 T.C. 26 (1948), respectfully but specifically refused to follow the circuit court. At p. 36 the Tax Court said, "With all due deference to the Circuit Court, we adhere to the views we expressed in our decision in the cited [Lincoln] case and prefer to follow that decision here."

[19] Lincoln Electric Co., P-H Tax Ct. Memo. Dec. ¶47,320 (1947). The commissioner now allowed the 1940 payments.

[20] (6th Cir. 1949) 176 F. (2d) 815.

although the payments were ordinary and necessary expenses they were also compensatory in nature and so limited to a reasonable amount. It stated that the deduction it had authorized was based on the broader ground of ordinary and necessary expenses, which would include items not of a compensatory nature, such as rent, advertising, transportation, repairs and other operating charges. As to them, there is no express statutory provision limiting them to a reasonable amount as there is for payments of compensation for personal services.[21] However, the court added, ". . . 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 incurred or paid by the taxpayer in an unlimited amount."[22]

Its former opinion was not an order to allow the deductions in full, but rather that the Tax Court was wrong in holding as a matter of law that the payments were not of the nature and character to qualify them as ordinary and necessary business expenses. Therefore, since business expenses must be reasonable in amount, the fact question of reasonableness is for the Tax Court to decide.[23]

After ten years of bitter litigation, the case is now again in the Tax Court, this time for hearing and determination solely on the question of reasonableness of the expenses.[24]

II

Some Collateral Points of Interest Raised by the Case

The taxpayer's argument, rejected by the Tax Court at the original trial and never again considered, that his payments to the annuity and trust must be allowed as part of the cost of goods sold,[25] as a matter of statutory construction and as a constitutional right, deserves some attention. As a matter of statutory construction, while the starting point

[21] I.R.C., 26 U.S.C.A. (1948) §23(a)(1)(A), quoted supra note 2.

[22] (6th Cir. 1949) 176 F. (2d) 815 at 817.

[23] Judge Allen dissented on two grounds: one, that the conclusion reads into the statute a limitation which does not exist there, and two, that the judgment in effect grants a rehearing of a case in which final judgment had been rendered and from which no review proceedings were prosecuted.

[24] Memorandum and Order of the Tax Court dated August 8, 1950, Docket No. 1296. Previously, the United States Supreme Court had denied taxpayer's application for certiorari to review the circuit court's decision in the second appeal. Lincoln Electric Co. v. Commissioner, 338 U.S. 949, 70 S.Ct. 488 (1950).

[25] The application of this principle of course would not account for the payments in their entirety, but only to the extent that they were made on account of those directly or indirectly engaged in the production of goods, a presumably ascertainable figure.

of all income taxation is gross income,[26] total receipts do not constitute gross income, if the command of the regulation concerning manufacturing businesses is to be followed.[27] That is, before there can be any income at all, the taxpayer must recoup its cost or investment in the goods it sells and out of which arises its income.[28] It is from this profit or income that various deductions are allowed by section 23.

In *Woodside Acres Inc. v. Commissioner*,[29] the issue was whether the cost of goods sold, the produce of a dairy herd, was to be taken into account in computing gross income, or whether it was to be treated as a deduction from gross income. The point was important, for if more than twenty per cent of the taxpayer's "gross income" came from the dairy farm, it would not be subject to a deficiency as a personal holding company. The Board of Tax Appeals held the disputed costs to be a part of the costs of goods sold, and that they were to be taken into account in arriving at gross income.[30] The Court of Appeals for the Second Circuit affirmed,[31] but there is very little other authority.[32]

26 I.R.C., 26 U.S.C.A. (1948) §22(a). In connection with this whole problem, three categories of income can be distinguished: (1) gross receipts; (2) gross income (gross receipts less cost of production); (3) net income (gross income less deductions). Congress does not purport to tax gross receipts. If it did, or could, we would see the curious result of Corporation A, with $1,000,000 gross receipts and $900,000 expenses, paying a much larger tax than Corporation B with $150,000 gross receipts and $50,000 expenses although the net income of both corporations is exactly the same. Congress could levy an ungraduated excise tax on gross receipts, but that is not to be confused with an income tax.

27 In the case of a manufacturing business, "'gross income' means the total sales, less the cost of goods sold. . . ." Treas. Reg. 111, §29.22(a)-5. Section 23(a) of the I.R.C. deals only with "deductions from gross income." Ordinarily it makes no difference whether a given payment is taken into account in computing gross income under §22(a) or is taken as a deduction from gross income under §23(a). In either case the net taxable income will be the same. But Lincoln argued that there may be times when it is important to keep the distinction in mind, for whether or not a thing is correctly called gross income may be decisive as to the nature of a taxpayer's liability.

28 MONTGOMERY, AUDITING THEORY AND PRACTICE, 5th ed., 203 (1940); KESTER, PRINCIPLES OF ACCOUNTING 492-4 (1936).

29 (2d Cir. 1943) 134 F. (2d) 793.

30 "Congress, as a matter of grace, has allowed some specific deductions under section 23. If it has allowed a deduction for some item which is in fact a part of the cost of production, the allowance of the deduction would not change the character of the item and the amount should, nevertheless, be subtracted from gross receipts in determining gross income from the business operation." Woodside Acres, Inc., 46 B.T.A. 1124 at 1127 (1942).

31 Woodside Acres, Inc. v. Commissioner, (2d Cir. 1943) 134 F. (2d) 793. The cost probably would have been deductible under section 23(a), but evidently the court felt the items had to be taken into account in arriving at gross income under section 22(a). At least a tacit acceptance of this reasoning is indicated by the form adopted by the Department of Internal Revenue for taxpayers' returns, for Schedule C of Form 1040 distinguishes between cost of goods sold and other business deductions. The net profit of the business is then carried forward as income.

32 See 1 MERTENS, LAW OF FEDERAL INCOME TAXATION §5.10 (Supp. 1949).

As for the matter of constitutional right, the question whether Congress can constitutionally tax gross income or only net income is not necessarily involved. Congress has never attempted to tax gross receipts; but even assuming that it can, and that it need allow no deductions whatever,[33] still there can be no income, however called, from the production and sale of goods until the taxpayer's cost of producing those goods is first recovered.[34] It is at least arguable that to permit the commissioner to disallow a part of the cost of producing the goods from the sale of which the income arises would be to that extent not to tax income but to lay a capital levy,[35] no matter how broadly section 22(a) is construed.[36]

Another collateral question of interest is that of the tax consequences under present tax law[37] when an employer contributes money to provide retirement annuities at a later date, or for some similar pur-

[33] As Lincoln's brief points out, it is only on this basis that the relatively recent doctrine that deductions are a matter of legislative grace has any meaning. New Colonial Ice Co., Inc. v. Helvering, 292 U.S. 435, 54 S.Ct. 788 (1934). If Congress can tax gross income, then Congress can deny all deductions, or as a matter of legislative grace allow so much or so little as it chooses. Another question however is whether Congress intended deductions to be narrowly construed. The intent found in the statutes is clearly to tax only net income, and it would seem that deductions are just as important, and no more narrowly to be construed than the inclusions. See Griswold, "An Argument Against the Doctrine That Deductions Should be Narrowly Construed as a Matter of Legislative Grace," 56 HARV. L. REV. 1142 (1943). The company accepted the doctrine, however, but asserted that costs incurred in the production of goods for sale stand on a different footing. The taxpayer's argument with respect to the particular expenditures in question would gain weight if he could show they were part of "direct costs," as opposed to "indirect."

[34] Only income can be taxed, which was defined in Eisner v. Macomber, 252 U.S. 189, 40 S.Ct. 189 (1920) as "gain derived from capital, from labor, or from both combined . . . [including] profit gained through a sale or conversion of capital assets. . . ." The controversy over Macomber has raged only over the question whether what was held not to be income could in fact be treated as income, and not at all over the proposition that what is not income cannot be taxed as income.

[35] It would at least raise the question of Art. I, §2, cl. 3, of the Constitution, requiring apportionment for a direct tax on property. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 15 S.Ct. 673 (1895). Due process arguments under the Fifth Amendment are also logical.

[36] Professor Magill has said: "This line of decisions, from Doyle v. Mitchell Bros. Co. [247 U.S. 179, 38 S.Ct. 467 (1918)] down to date, indicates that the term 'income' does not mean total gross receipts from the sale of property. . . . It would seem clear to the ordinary person that only the gain over the original cost is income. The Court has adopted the same view. Hence, the cost of goods sold must be allowed as a deduction from gross receipts in arriving at the income which is subject to tax under the [16th] amendment and the revenue laws." MAGILL, TAXABLE INCOME, rev. ed., 359 (1945).

[37] The Lincoln decision of course related to years prior to the 1942 amendments, Revenue Act of 1942, 56 Stat. L. 798 (1942), so that the currently important sections 23(p) and 165 did not apply.

pose,[38] and the rights of the employees are not fully vested.[39] The commissioner may argue, even though the contributions are beyond recall by the employer, that they are not deductible as a business expense or as compensation if the rights therein of the employees are subject to sufficient contingencies.[40] The reception of the Tax Court to this position apparently depends upon the volume of the bundle of rights the employees possess.[41]

The original decision of the Tax Court in the *Lincoln* case cast some doubts as to deductions even under a plan qualified under the 1942 amendments, where the benefits were contingent on survival and continued employment, since section 23(p) requires a satisfaction of section 23(a), and the Lincoln payments were held not to qualify under section 23(a).[42] The regulations issued under the 1942 amendments specifically provide that a retirement plan may provide forfeitable or nonforfeitable benefits,[43] and Mimeograph 6021, hurriedly issued by the Bureau, sufficiently took care of that issue.[44]

A few observations as to a requirement of reasonableness of payments under the type of plans in question is in order. The regulations provide that a contribution to be deductible must, when added to other

38 It is clear that the annuity or trust "payments" must be actually contributed. Mere book accruals of contingent future liabilities are not deductible. Caxton Printers, 27 B.T.A. 1110 (1933), and cases cited in Wilcox Investment Co., 3 T.C. 458 (1944). For a discussion of contributions to a trust exempt under §165, see K. R. CLARK, PROFIT SHARING AND PENSION PLANS, c. 2 & 3 (1946).

39 Briefly, if all the employee needs to do (once the contribution is made) to receive it is to wait until a certain age, or a period of time, or until separation from service, his rights would seem to be fully vested and "nonforfeitable." Treas. Reg. 111, §29.165-7. However, the word is yet to be delimited.

40 See 7 INST. FED. TAX. 80 (1949) note 4, for a list of cases.

41 7 INST. FED. TAX. 80 (1949) analyzes the factors which have influenced the Tax Court.

42 In 1942, Congress expressly said that the deductions were no longer to be taken under section 23(a). In the new section, 23(p), it said that payments under such plans "shall not be deductible under sub-section (a), but shall be deductible, if deductible under sub-section (a), without regard to this sub-section, under this sub-section, but only to the following extent. . . ." Cutting through this draftsmanship, the translation seems to be: . . . "Shall no longer be taken under 23(a), but hereafter shall be allowed only under the new 23(p) provided they are payments of a kind which satisfy not only the requirements of the new 23(p) but also the requirements of 23(a)." I.R.C., 26 U.S.C.A. (1948) §23(p)(1).

43 The Treasury Department had urged Congress to provide that a contribution must be vested in the employees before an employer was entitled to deduction, but that recommendation was not approved as far as qualified plans are concerned. 7 INST. FED. TAX. 80 (1949).

44 INT. REV. BUL., 1946-2 Cum. Bul. 43. ". . . vesting . . . is not necessary to meet the applicable requirements of 165(a) . . . and, where such requirements are met, . . . the contribution may be considered as ordinary and necessary expenses and as compensation for services actually rendered. . . ." But discounting may be required for forfeitures.

compensation, be reasonable in amount.[45] On the first remand of the *Lincoln* case, the Tax Court, although reversed on the point, thought that the question of reasonableness arises only in connection with compensation, and that the circuit court wanted to allow a deduction without reference to compensation. Yet in the *Roberts* decision,[46] the Tax Court held that if the payments are intended as compensation, the tests of compensation may not be ignored and the amounts deducted under another provision.

There is nothing specific in the legislative history of the Revenue Act of 1942 to indicate whether the test of reasonableness is applicable to deferred benefits. However, the pension provisions of the act do set up restrictions interrelated to section 23(a),[47] and attempt a comprehensive coverage of situations involving deferred receipt of compensation. Section 23(p)(1)(d) allows the employer a deduction, where contributions are made to a nonexempt trust, only if the rights of the employees are nonforfeitable. This section seems to deal with deferred compensation plans, and the Tax Court apparently feels that the section cannot be avoided by arguing that the deferred and forfeitable amounts are not compensation.

III

The Merits of the Holding on the Principal Issue. Must "Ordinary and Necessary" Expenses Also be "Reasonable"?

The term "reasonable" can of course be considered in two ways, reasonable as a class or kind of expense, or reasonable in amount. It is evident that in the Sixth Circuit, at least, a business expense to be deductible must be not only "ordinary and necessary" as the statute expressly commands, but also can be deducted only to the extent that it is reasonable in amount. The merits of this position should be examined.

The original income tax acts provided for the deduction of ordinary and necessary expenses.[48] A provision for "reasonable" compensation appeared for the first time in the Revenue Act of 1918,[49] and this particular area of the act has remained constant since that time. It may be ar-

[45] Treas. Reg. 111, §29.23(p)-1.

[46] Roberts Filter Mfg. Co., 10 T.C. 26 (1948).

[47] Supra note 42. If the reference is to "compensation" as used in 23(a), then it would seem to be limited to reasonable amounts. Of course if one follows the rule of the Sixth Circuit, there is a "limit" of reasonableness even though this interrelation is to the business expenses contemplated in 23(a).

[48] 38 Stat. L. 167, 172, §§II B & G(b) (1913).

[49] 40 Stat. L. 1066, 1077, §§214(a)1, 234(a)1 (1919).

gued that Congress thought it had not provided a test of reasonableness for business expenses, and that the 1918 revision was intended to change the allowable limits for deduction for one item only, i.e., compensation, and to leave other deductions intact. Also, businessmen and their lawyers have operated for over thirty years believing they would not have to show reasonableness if they could show their business expenses to be ordinary and necessary.

To be sure, "extraordinary, unusual, and extravagant" amounts may be a badge to show that an expenditure is not what it purports to be, as pointed out in the *Botany* case.[50] Similarly, in *Limericks, Inc. v. Commissioner*,[51] relied on by the commissioner in the *Lincoln* case, the Tax Court and the Court of Appeals for the Fifth Circuit agreed that certain rent payments were not deductible because they were in fact distributions of dividends in the guise of rent. And in *Stanley Imerman*, the Tax Court reversed the commissioner's ruling that a rent payment exceeded a reasonable amount, saying, "Rent paid or incurred during the taxable year is an allowable deduction and the fact that the amount thereof may have been high or low, when considered in the light of current conditions, does not of itself change or affect the amount of the deduction to which the taxpayer is entitled."[52] However, the commissioner was not precluded from determining the true nature of the disputed payments, i.e., whether or not a gift.

It may be that some of the controversy presently raging is simply a beating of straw men. It may be, as the Government contended in its brief, that "the short answer to all this is that such a difference [between class or kind and amount] does not exist; an expenditure which exceeds a reasonable amount cannot be classified as an ordinary and necessary expense, to the extent that it exceeds reasonable limitations." It may be that if an "extraordinary, unusual, and extravagant" amount may be held not to be ordinary and necessary and thus not deductible, then an expense "unreasonable" in amount may be nondeductible, not because of a new or different test of reasonableness, but simply because unrea-

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

[51] 7 T.C. 1129 (1946), affd. (5th Cir. 1948) 165 F. (2d) 483.

[52] 7 T.C. 1030 at 1037 (1946). The Lincoln Co. offered other proof that the test of reasonableness of amount is applicable only in the case of compensation. See Reg. 111, §29.23(a) and its various sub-paragraphs. For instance, as for traveling expenses, the context of Reg. 111, §29.23(a)-2 indicates that there is a limitation on the class or kind of expense which is to be allowed, but not upon the amount which the traveler considers proper to spend. A careful reading of Commissioner v. Flowers, 326 U.S. 465, 66 S.Ct. 250 (1946) seems to bear out the above statement. The I.R.C. itself, §23(a)-1 says there "shall" be allowed, "all the ordinary and necessary expenses. . . ."

sonable is synonymous with extraordinary and extravagant. Yet all of this would seem to be the question and not the answer.[53]

That a completely new test has in fact been added in the Sixth Circuit seems to be perfectly clear.[54] The circuit court on the first appeal held the payments to be of an ordinary and necessary class, and in the second appeal imposed the restriction of reasonableness. So while in a great many cases the results will prove to be no different because of the new test, yet in truth the *Lincoln* result is quite different.

There can be reasonable differences of opinion as to reasonableness of expenditures.[55] The taxpayer's brief points out that there is at least a doubt as to whether revenue agents have any particular natural aptitude qualifying them to say for a myriad of businesses what amount it is proper to lay out for an expense conceded to be "ordinary and necessary," and that the power to disallow could be a tool for compelling surrender of otherwise lawful claims on pain of loss of those over which the agent has discretionary power, or for exacting from one what is not exacted from another.

The commissioner and his agents are apparently given the privilege of deciding reasonableness subject to a final answer in the courts, providing the taxpayer has the means of fighting for perhaps ten years as in the *Lincoln* case. It can be strongly urged that a businessman, with all the calculations and risks he assumes, should be allowed to use his own judgment, and not have to forecast what a stranger to his problems may ultimately decide about the reasonableness of that judgment.[56]

R. Lawrence Storms, S. Ed.

53 Professor Peters poses some interesting examples of how an ostensible profit can be turned into an actual loss because of a subsequent disallowance of a deduction of an expense which at the time of the expenditure was thought by the businessman to be ordinary and necessary for his business. Similarly, differences of opinion of two revenue agents could result in Company A having a loss and Company B a profit under identical facts for the two companies. Also, a company may be faced with the problem of not paying out dividends until its tax return is ultimately passed and the deductions allowed, at the same time fearing a possible penalty tax under section 102 for withholding dividends should the agent determine that all deductions were clearly proper. Peters, "Lincoln Electric Co. Case," 4 MIAMI L.Q. 12 (1949).

54 If the term "reasonable" is inherent in the "ordinary and necessary" phrase of the statute governing business expenses, then must it not be also inherent in the "ordinary and necessary" phrase of the statute governing non-business expenses? The commissioner evidently will apply that construction to §23(a)-2, as indicated in Reg. 111, §29.23(a)-15(a)(2). Peters, supra note 53, raises this question, although some of his examples appear extravagant, as does his fear that because of the Lincoln decision we are apparently at or past the crossroads leading to "totalitarianism" and "free enterprise."

55 Probably there are often such disagreements at the time the business decision is made.

56 "No case has been found where an excessive payment, made in an arm's length transaction and not involving a dividend, a distribution of profits or a gift, was held to be