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NON-TRADE AND NON-BUSINESS EXPENSE DEDUCTIONS:
SECTION 23(A)(2) OF THE INTERNAL REVENUE CODE

R. W. Nahstoll

Among the innovations introduced into the Internal Revenue Code by the Revenue Act of 1942 was the provision allowing deduction from gross income, in the computation of net income, of non-trade and non-business expenses. Every revenue act including the Act of 1894, has provided in one form or another for the deduction of trade and business expenses. Prior to the 1942 amendment, the relevant provisions of section 23 of the code read as follows:

"Deductions from gross income. In computing net income there shall be allowed as deductions:
(a) Expenses.

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Mr. Magill suggests that business deductions were allowed by the commissioner under the Act of 1862, though the provision therein covered only taxes. Magill, Taxable Income 336 (1936).
(1) 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, of property to which the taxpayer has not taken or is not taking title or in which he has no equity:

(2) Corporate Charitable Contributions.

This provision lent itself to judicial moulding in construction of the phrase, "carrying on a trade or business," and it was the Supreme Court's rigid interpretation thereof that led to adoption of the present section 23(a)(2), which allows deduction of non-trade and non-business expenses.

The 1941 case of *Higgins v. Commissioner*\(^2\) was the immediate force motivating Congressional action, but at least three other cases must be inspected for their contribution.\(^3\) In *Van Wart v. Commissioner*, the taxpayer was a minor and beneficiary of a trust created by the will of her grandfather. As guardian of the taxpayer, her father brought suit to enforce his demands that the trustees pay over to the taxpayer accumulated income and future income as it annually accrued. Attorneys' fees for services in the litigation were paid in 1924. The Supreme Court affirmed the reversal of a holding by the Board of Tax Appeals that such fee was deductible as an ordinary and necessary expense in carrying on business, under the Act of 1924. After finding that the ward, not the guardian, was the taxpayer, and that "the attorney's fee arose out of litigation conducted in the name of the ward" and that it "was paid for her benefit out of her income," the Court said, simply, "The ward was not engaged in any business. So far as appears the same thing is true of the guardian."\(^4\)

There followed the *Higgins* case, brought under the Act of 1932. Taxpayer had been for over thirty years engaged in the large scale business of realty investments and investments in stocks and bonds. From his home in Paris, he kept in personal touch with his New York

\(^2\) 312 U.S. 212, 61 S.Ct. 475 (1941), rehearing den., 312 U.S. 714, 61 S.Ct. 728 (1941).


office by cable, telephone and mail. His personal activity in the management of each of the two sides of his business was substantial. The work was carried on by large staffs which followed regular business practices. It was conceded that the real estate activities constituted a "business" but the Supreme Court, affirming the circuit court of appeals and the Board of Tax Appeals, ruled that the management of the taxpayer's own investments, "no matter how large the estate or how continuous or extended the work required may be,"\(^6\) did not as a matter of law constitute the carrying on of a business.\(^6\) In support of this denial, the Court rested its conclusion "upon a conception of carrying on business similar to that expressed by this Court for an antecedent section [214(a) of the Act of 1924]\(^5\) and cited in support thereof only the *Van Wart* case. The latter, we have seen, merely stated the bald conclusion that "the ward was not engaged in any business." Moreover, it would seem doubtful, at best, that the continuous, active management of the taxpayer's own investments for the purpose of producing income (*Higgins* case) should have been found analogous to the sporadic litigation brought merely to force delivery of income (*Van Wart* case).

The *Pyne* and *City Bank Farmers Trust Co.* decisions followed within three months. In the latter case\(^7\) the Court denied deduction from the gross income of a trust, the corpus of which was stocks and bonds, of commissions paid to a trustee charged with the duties of applying a sufficient portion of the trust income to the education and support of the beneficiary and accumulating the surplus income until majority of the beneficiary at which time it was to be paid over, the corpus to be continued in trust for the beneficiary and his descendants. The trustee's activities were limited to reviewing the stocks and bonds in trust, several times a year; selling securities and re-investing the proceeds in other stocks and bonds; collecting interest and dividends on

\(^5\) Previous cases had employed the test of the scale and continuous nature of the taxpayer's activity in his own investments and had found them sufficiently extensive to constitute a "business." Kales v. Commissioner, (C.C.A. 6th, 1939) 101 F. (2d) 35; Harvey H. Ostenberg, 17 B.T.A. 738 (1929) [Question of deductions for losses, under § 204(b) of the Act of 1921]; C. W. Stimson, 22 B.T.A. 26 (1931) (same); Austin B. Barney, 36 B.T.A. 446 (1937) [under § 23(a) of the Act of 1928]; Cornelia W. Roebling, 37 B.T.A. 82 (1938) [under § 23(a), Act of 1928]. Other cases, applying the test and holding against the taxpayer were: Bedell v. Commissioner, (C.C.A. 2d, 1929) 30 F. (2d) 622, [question of offsets of losses under § 204(b), under Act of 1918]; Kane v. Commissioner, (C.C.A. 2d, 1928) 100 F. (2d) 382, [under § 23(a) of Act of 1928].

\(^6\) 312 U.S. 212 at 218, 61 S.Ct. 475 (1941).

\(^7\) The *City Bank Farmers Trust Co.* case arose under the Act of 1928.
securities; keeping account books for the trusts and rendering state-
ments to the interested parties; preparing and filing income tax re-
turns; and distributing income to the beneficiaries.

The Supreme Court held justifiable the summary of the Board of
Tax Appeals that

"'The above facts demonstrate conclusively to us that this is
a case of passive investment and not of carrying on a business,
for not only is the trustee limited in its investments, but is cau-
tioned in effect to be a safe investor rather than a participant in
trade or business, and, plainly carrying out the testator's injunc-
tions, it conducts no business, because it has, as above seen, no
expenses of conducting business other than the collection of cou-
pons and mailing bonds, amounting to a few dollars, and an even
more negligible amount for transfer stamps or notary fees.'"

In stating this flagrant non sequitur, the board apparently disre-
garded the cost of highly trained business acumen. The Supreme
Court, sustaining the board's conclusion, held that "the instant trusts
were not 'business trusts' but existed merely to hold and conserve
property and distribute the income received.'"

Thus, management of securities held on trust for another, like
management of one's own securities, was denied the status of a "busi-
ness."

The Pyne case resulted in the Supreme Court's vacating a judg-
ment of the Court of Claims based on recognition by the latter that
the executor of a large estate was engaged in a "business." The Su-
preme Court held such a finding unjustified, though the estate was
being continued much as it had been handled during the life of de-
cedent who, prior to his death, "'was engaged in business as a financier
and investor, maintaining an office where he employed an office man-
ger and an average of six clerks....'" The executor's operations
were held to be a continuance of financial and investment activities
similar to those denied deduction in the Higgins case. While the
Court conceded that it is not impossible for an executor to be actively
engaged in carrying on a "business," it held that, "'it cannot be said as
a matter of law that an executor comes into this category merely be-
cause he conserves the estate by marshalling and gathering the assets
as a mere conduit for ultimate distribution.'"

8 313 U.S. 121 at 125, note 3, 61 S.Ct. 896 (1941). (Italics supplied.)
9 Id. at 125, note 4.
10 The Pyne case arose under the Act of 1934.
11 313 U.S. 127 at 129, 61 S.Ct. 893 (1941).
12 Id. at 132.
These decisions impelled Congress, on the recommendation of the Treasury Department, to amend section 23(a)(2), by the following provision for deduction of non-trade and non-business expenses in the 1942 Act:

"Non-trade or non-business expenses.—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."\(^\text{14}\)

Important in the construction of section 23(a)(2) is the issue of its relation to section 23(a)(1). A suggestion of Congressional intent that the newer section be accorded a construction parallelizing section 23(a)(1) has been found in the following statement:

"Expenses, to be deductible under section 23(a)(2), must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income, or to the management, conservation, or maintenance of property held for that purpose.

"A deduction under this section is subject, except for the requirement of being incurred in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23(a)(1)(A) of an expense paid or incurred in carrying on any trade or business."\(^\text{15}\)

\(^{13}\) See testimony of Mr. Randolph Paul before the House Committee on Ways and Means, I Hearings Before Committee on Ways and Means on Revenue Revision of 1942, 77th Cong., 2d sess., p. 88 (1942).

\(^{14}\) 56 Stat. L. 798 at 819, § 121. In the form adopted, the section was § 118 of the original H.R. Bill 7378, 77th Cong., 2d sess., introduced July 14, 1942.

\(^{15}\) H.R. Rep. 2333, 77th Cong., 2d sess., p. 75 (1942). S. Rep. 1631, 77th Cong., 2d sess., p. 88 (1942). This language has been incorporated into TREAS. REG. II, § 29.23(a)-15. This parallel construction finds support in Lumpkin v. Bowers, (D.C. S.C. 1943) 50 F. Supp. 874 at 876, wherein the court quotes from Welch v. Helvering, 290 U.S. 111 at 114, 54 S.Ct. 8 (1933), defining the phrase as used in § 23(a)(1): "'Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. Nonetheless, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.'" The case was reversed on other grounds in Bowers v. Lumpkin, (C.C.A. 4th, 1944) 140 F. (2d) 927, cert. den., 322 U.S. 755, 64 S.Ct. 1266 (1944); 151 A.L.R. 1340 (1944). The circuit court said, "Hence it may not be doubted that Congress, in amending § 23 of the Internal Revenue Code by the Revenue Act of 1942, used the phrase, 'all the ordinary and necessary expenses' under the caption 'Non-Trade or Non-Business Expenses' in the same sense and with the same
But what appears to be the better interpretation is not the parallel one.

*McDonald v. Commissioner* involved the deductibility of campaign expenses, including a substantial contribution to the party "war chest," incurred by the petitioner who had been appointed to a Pennsylvania court to complete an unexpired term on the understanding that he would contest the next primary and general elections. The majority of the Court denied the deductions under section 23(a)(2) on the stated theory that in enacting section 121 of the 1942 Act, Congress purported

"... to afford relief for a specifically defined inequitable situation which has become manifest by the decision of the Court in *Higgins v. Commissioner*..." In that case, this Court held that by previous enactments Congress had made no provision for allowable deductions from profitable transactions not covered by the statutory concept of ‘business’ income.

Moreover, said the Court, under section 48(d) of the code the performance of the functions of a public office was treated as a "business" so the expenses connected therewith could not be deducted under section 23(a)(2). Further, "legislative history" pointed to disallowance of the deduction as a business expense under section 23(a)(1).

"The amendment of 1942 merely enlarged the category of incomes with reference to which expenses were deductible. It did limitations that it had previously used in connection with trade and business expenses." Id. at 929. In regard to what business expenses are "ordinary and necessary" within meaning of income tax laws permitting deductions, see Annotation 84 L. Ed. 426.

Since what is "ordinary and necessary" constitutes a pure question of fact to be determined in the commonly accepted meaning of the words, according to Commissioner v. Heininger, 320 U.S. 467, 64 S.Ct. 249 (1943), decided the same day as Dobson v. Commissioner, 320 U.S. 489, 64 S.Ct. 239 (1943), it is unlikely that the Tax Court's determinations of this question will be disturbed on appeal. Cf. Bingham's Trust v. Commissioner, 325 U.S. 365, 66 S.Ct. 1232 (1945), especially the concurring opinion of Justice Frankfurter. See note 27, infra. Compare also Commissioner v. Wiesler, (C.C.A. 6th, 1947) 161 F. (2d) 997, affg. 6 T.C. 1148 (1946), dealing with status under the Dobson rule of Tax Court's finding that a business expense is "ordinary and necessary" within § 23(a)(1).

37 Opinion by Justice Frankfurter. Chief Justice Stone and Justices Roberts and Jackson concurred in the opinion; Justice Rutledge concurred only in the result.
38 312 U.S. 212, 61 S.Ct. 475 (1941). For disposition of a case similar to the Higgins case since the 1942 Act, see Milner v. Commissioner, T.C. Dkt. 107151, 108673, 1 T.C. 1215, 1943 P-H MEMO. DEc., ¶ 43,055.
39 323 U.S. 57 at 61, 63, 65 S.Ct. 96 (1944).
40 An annotation collecting cases considering deductibility of campaign expenses prior to the 1942 Act is found in 155 A.L.R. 128 (1945).
not enlarge the range of allowable deductions of 'business' expenses."\textsuperscript{21}

A more liberal, and more convincing view of section 121 is found in the dissent of Mr. Justice Black.\textsuperscript{22} It asserts:

"The language it [Congress] utilized was certainly far broader than was required to meet the narrow problem presented by the \textit{Higgins} case. Congress specifically disposed of the \textit{Higgins} problem by allowing a deduction for the expenses incurred in '... the management, conservation or maintenance of property held for the production of income.' Had Congress simply enacted those words, and nothing more, it might properly have been inferred that it intended to grant the type of deduction denied in the \textit{Higgins} case, and no other. But it provided an additional deduction, in the very same section, for expenses incurred 'in the production ... of income.'"\textsuperscript{28}

The argument in favor of parallel construction is recognized, but its limitations respected, in the following words taken from the dissent:

"Before the 1942 Act, an expense to be deductible had to be 'ordinary and necessary' in its relation to the taxpayer's business; under the new section it need only be 'ordinary and necessary' in its relationship to the taxpayer's efforts to produce income. Hence, while the words 'ordinary and necessary expenses,' defining permissible deductions, remained unchanged in the new section, they were given added content in their new relationship. Since the enactment of the new section, the two questions essential to determination of deductibility are: Were the expenses incurred in an effort to produce income? Were these expenses, or part of them, 'ordinary and necessary' in connection with that effort?"\textsuperscript{24}

\textsuperscript{21} 323 U.S. 57 at 62, 65 S.Ct. 96 (1944).

\textsuperscript{22} With whom Justices Reed, Murphy and Douglas concurred.

\textsuperscript{23} 323 U.S. 57 at 67, 65 S.Ct. 96 (1944).

\textsuperscript{24} Id. at 66. The McDonald case is criticized in Diamond, "The Shadow of McDonald v. Commissioner," 16 PA. B.A.O. 293 (1945) [reprinted in 23 TAXES 511 (1945)]; 13 GEO. WASH. L. REV. 489 (1945); 19 TENN. L. REV. 92 (1945). But, in Low v. Nunan, (C.C.A. 2d, 1946) 154 F. (2d) 261 at 264, affg. C.C. Dkt. 2190, 1944 P-H MEMO. DEC., 44,277, deduction of telephone toll charges, railroad fares, entertainment expenses was disallowed under § 23(a)(2). The court said, "We think that none of the expenditures was 'ordinary.' We believe that § 23 (a)(2) must be read in the light of Deputy v. DuPont [308 U.S. 488, 493-494, 60 S.Ct. 363 (1940)], although it was decided before the 1942 amendment which added § 23 (a)(2)."
The subsequent case of *Bingham's Trust v. Commissioner* sug-
gests a liberalism more in harmony with the dissent in the *McDonald*

Involved were questions of the deductibility by trustees of a testamentary trust of three items of expense: (1) payment made by trustees for legal services in litigation in which they sought to establish that the appreciation in value of securities turned over to the legatee did not represent a gain taxable to the estate; (2) fees for legal serv-
ices in connection with the annual payment by the trustees during the continuance of the trust; (3) fees and expenses for attorneys’ services in respect to tax and other problems arising upon the expiration of the trust and relating to the final distribution of the trust fund among the residuary legatees.

Under a rigid interpretation of section 23(a)(2), the circuit court of appeals reversed the Tax Court and disallowed the deductions. The Supreme Court, reversing the circuit court, recognized the double-
barreled character of the section and denied “merit in the [circuit] court’s conclusion that the expenses were not deductible because they were not for the production of income.” The Court ruled that the property while held for distribution was nevertheless so held pursuant

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26 (C.C.A. 2d, 1944) 145 F. (2d) 568 at 570, holding that such items are not deductible when, (1) “incurred merely to prevent the incidence of taxes which neither affected the yield of investment capital nor its appreciation”; (2) “only related to legal advice in respect to distribution to a legatee, and not to the management of any property held for the production of income.”

27 While the Court was unanimous in the result it reached, it was divided in its reasoning. The division arose in the question of applicability of the Dobson rule. The majority thought the problem of statutory interpretation (to determine the meaning of “property held for the production of income”) presented a “‘clear cut’ question of law,” review of which was not foreclosed by the Dobson decision. A concurring minority (Justices Frankfurter, Roberts and Jackson) opined that such holding defeated the doctrine of the Dobson case which, they said “eschewed sterile attempts at differenti-
tation between ‘fact’ and ‘law’ in the abstract” and had sought to establish as non-
reviewable decisions of the Tax Court on “all matters peculiarly within [its] com-
petence.” The minority felt that “the interpretation of tax statutes and their applica-
tion to the particular circumstances” qualify as such matters and that the decision of the Tax Court should have been reinstated without independent review.

The effect of the case on the Dobson doctrine has not been authoritatively assessed. It is, however, difficult to deny the contention asserted by the minority.

28 325 U.S. 365 at 373, 65 S.Ct. 1237 (1945). It will be observed, however, that though this decision is felt to be within the spirit of Justice Black’s dissent in the *McDonald* case, its holding is consistent with the majority opinion, relying as it does on the “management, conservation, or maintenance of property held for the production of income” clause, rather than on the “for the production or collection of income” clause.
to a proper function of the trustee included in his duties of "management" of the trust properties.\textsuperscript{29} The expense of contesting a tax deficiency was held to constitute an expense of "management" of trust property held for the production of income.\textsuperscript{30}

The factor requisite to satisfy the conservative construction of the majority of the Court in the \textit{McDonald} case, but not required by the liberal construction, is that the non-business expenses must be of such nature that if they were business expenses they would be deductible. It is difficult to see how this requisite can be properly sustained. Notwithstanding the ambiguity present in the Senate and House reports, respecting the parallel constructions of sections 23(a)(1) and 23(a)(2), the discussion of the 1942 Revenue Bill in the House\textsuperscript{82} suggests a broader intent—an intent consistent with Justice Black's contention that it was purposed to adjust the deduction provisions to a policy of "taxation on net, not on gross, income [which] has always been the broad basic policy of our income tax laws."\textsuperscript{82}

Two fundamental considerations control deductibility under section 23(a)(2):

\textsuperscript{29} It may be that the precise tenor of the Bingham case is limited by the emphasis placed by the Court upon the fact that at the time the expenses in question were incurred, the property was being held for the purpose of winding up the trust. However, Congressional intent was to include not only property which may produce income in the future, but also property which, although no longer productive to the taxpayer, has produced income in the past. Similarly, it is to include property held merely for disposition or to minimize a loss with respect thereto. S. Rep. No. 1631, 77th Cong., 2d sess., p. 87 (1942). Stella Elkins Tyler, 6 T.C. 135 (1946), expresses Tax Court approval of the Regulations statement that "income" includes income which has been realized in a prior taxable year or may be realized in subsequent taxable years.

\textsuperscript{30} Taxpayer's argument that litigation, an unsuccessful prosecution of which would have subjected income-producing property to a judgment lien, constituted "conservation" of that property had been previously rejected by the Tax Court in John W. Willmott, 2 T.C. 321 (1943).

\textsuperscript{82} Rep. Disney, discussing the bill said, "The bill contains a provision which will allow taxpayers to deduct expenses incurred for the production or collection of income whether or not such expenses are connected with the taxpayer's trade or business. Furthermore, the amendment permits the deduction of expenses incurred for the management, conservation, or maintenance, of property held by the taxpayer for the production of income." 88 Cong. Rec. 6376 (1942). (Italics supplied.)

\textsuperscript{82} 323 U.S. 57 at 66-67, 65 S.Ct. 96 (1944). Professor E. N. Griswold, in a note at 56 Harv. L. Rev. 1142 (1943) dealing with the construction of deduction provisions generally, says, at p. 1144-1145, "... there is no need ... to deny that Congress has very great power over the deductions which are allowed. The fact remains that Congress has never sought to tax gross income. We are not dealing with a question of power, but of intention. And the whole structure and the history of the income tax makes it plain that the intention of Congress to allow deductions has been just as clear as its intention to tax income."
First, is the item an expense, as distinguished from a capital expenditure?

Second, is the expense incurred in the production or collection of income or in the management, conservation, or maintenance of property held for the production of income as distinguished from a personal expense?

The cleavage between the conservative and liberal constructions is not in regard to whether capital expenditures are deductible, for even the most ardent exponents of the liberal view would not contend that the purchase price, for instance, of securities should be deductible as an expense item. Instead, the dispute has to do with the definition of capital expenditures and more particularly with the question whether the definition of expenses adopted for section 23(a)(1) is to be applied for section 23(a)(2). The leading case arising on this point under section 23(a)(2) is Bowers v. Lumpkin involving the deductibility of expenses incurred by the taxpayer in connection with litigation to defend against suit brought by the Attorney General of South Carolina in which the latter sought unsuccessfully to invalidate taxpayer's title to stock purchased by her from trustees of a fund set up by her former husband. The circuit court disallowed the deductions on the ground that Congressional intent in enacting section 121 of the 1942 Act was confined to mitigation of the harshness of the Higgins case and thus items classed as capital expenditures under section 23(a)(1) must be similarly treated under section 23(a)(2). Accordingly such items were to be treated as part of the cost of the stock for determination of gain or loss when subsequently sold.

The question of the distinction between capital expenditures and business expense items is discussed in 4 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 25.17 (1942).


The Court based its holding on portions of Treas. Reg. 111, §29.23(a)-15(b), supra, note 15 (as part of the former Treas. Reg. 103, as amended). The question remains whether the Regulations are consistent with Congressional intent.

In Cynthia Kuser Herbst, T.C. Dkt. 109224, 1943 P-H MEMO. DEC., # 43,309, the Tax Court distinguished several types of legal fees as deductible expenses and capital expenditures.

The Lumpkin case was followed in Coughlin v. Commissioner, 3 T.C. 420 (1944), involving expenses of litigation challenging petitioner's title to stocks and other properties claimed by the adversary to be rightfully part of the estate of the mother of the parties, of which estate the petitioner was administrator. See also, note 40, infra.
Six days after the Lumpkin decision, the Tax Court rendered its decision in the case of Margery K. Megargel, and allowed deductions of fees and expenses incurred by a taxpayer whose suit to recover stock previously transferred had been settled by payment to the taxpayer of a sum considered by the court to be of the nature of capital gain from the sale of stock. The decision was based on a portion of section 29.23(a)-15 of Regulations 111, and was acquiesced in by the commissioner. The writer's search has disclosed no judicial attempt to reconcile these two decisions, and the Megargel case may be regarded as the talisman of the liberal application.

Bearing in mind that the Lumpkin case is based on the restricted purpose of section 121 of the act of 1942, as enunciated in the majority opinion of the McDonald case, it may be found to have been weakened by the relative liberality of the Bingham case. For the present, the Lumpkin doctrine appears to have commanded a respectable following and the issue is regarded by Mr. Mertens as more or less


38 "The term 'income' for the purpose of Section 23(a)(2) comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter incurred in connection therewith are deductible. . . ."

39 Holding contra, at least as to expense of attorney's fees incurred in proceedings to challenge a will, where in settlement of the proceeding the taxpayer received from the estate certain notes and cash, B. M. Spears, T.C. Dkt. 11731, 1947 P-H MEMO. DEc., ¶ 47,071.

40 Helvering v. Stormfeltz, (C.C.A. 8th, 1944) 142 F. (2d) 982. (Ward who recovered judgment against his guardian for money embezzled was allowed to deduct that portion of the legal expenses allocable to recovery of interest, but not allowed to deduct the portion allocable to recovery of capital. The unliquidated claim was denied recognition as "property held for the production of income." This is consistent with Treas. REG. 111, § 29.23(a)-15. Accord, Edmunds v. United States, (D.C. Mo. 1947) 71 F. Supp. 29. Don A. Davis v. Commissioner, 4 T.C. 329 (1944) (selling commissions paid in connection with the disposition of securities by one not a dealer in securities held not deductible as expenses but must be treated as offsets against selling price in determining the gain or loss incidental to the disposition of the property). Affirmed, (C.C.A. 8th, 1945) 151 F. (2d) 441 at 443: "The selling expenses which the petitioner sought to deduct, had they been paid or incurred in carrying on a business, would not have been deductible from gross income under § 23(a)(1)(A), as 'ordinary and necessary expenses,' but would have constituted deductions from the proceeds of sale. . . . We agree with the Tax Court that Congress did not intend to permit an individual to deduct from gross income, as ordinary and
settled.\textsuperscript{41} Yet, the Tax Court's decision in the \textit{Megargel} case is not without support. In \textit{Walter S. Heller},\textsuperscript{42} attorneys' fees paid by a taxpayer in his litigation as dissenting stockholder to recover under a California statute the cash value of his stock in a corporation merged with another corporation were held deductible. The Tax Court found it "obvious that Congress intended that some expenditures pertaining to assets of a purely capital nature were to be allowed as deductions from gross income" because of the Congressional definition of income to include gain from the disposition of property as well as recurring income.\textsuperscript{43} It must not be overlooked, however, that both the \textit{Megargel} and \textit{Heller} cases were resolved on grounds other than that the suit was brought to recover or perfect title.\textsuperscript{44}

necessary expenses, under § 23(a)(2), selling costs of a kind which would not be deductible as business expenses under § 23(a)(1)(A)." Cert. den., 327 U.S. 783, 66 S.Ct. 682 (1946). Coughlin v. Commissioner, 3 T.C. 420 (1944), see note 36, supra; Ernest Smith, T.C. Dkt. 7097, 1946 P-H MEMO. DEC., ¶ 46,009; B. M. Spears, T.C. Dkt. 11731, 1947 P-H MEMO. DEC., ¶ 47,071. For an early prognosis that the Lumpkin doctrine would prevail, see Schwanbeck, "Non-Trade and Non-Business Deductions," 22 TAXES 466 (1944).

\textsuperscript{41} MERTENS, LAW OF FEDERAL INCOME TAXATION, § 25,120, p. 290 (1947 Supp.): "... Was it the intention, in connection with the 1942 change, notably by reference to expenses in the 'conservation' of property held for the production of income, to permit deductions for expenditures of the type which would formerly have been considered 'capital expenditures' rather than deductible expenses? There was some controversy concerning this for a time; though it appeared to be quite clear from the committee reports on the measure and the general purpose of the amendment that Congress had no such intention. That it did not, and that such expenditures remain non-deductible as current expenses, has since been established by decision of one of the Circuit Courts of Appeals [citing Bowers v. Lumpkin]."


\textsuperscript{43} Also, James H. Knox Trust, 4 T.C. 258 (1944). The entire amount of commission paid to trustees of a testamentary trust for receiving and paying out trust assets was held deductible from gross income of the trust under § 23(a)(2) though they had been paid from the corpus of the trust. It was so held against the contention that the commissions were paid "for the mere act of receiving the trust corpus" and that they were therefore capital expenditures and not ordinary and necessary expenses. The Court found that they were paid "for the services performed or to be performed by the trustees in the maintenance and conservation of the trust assets." Id. at 265.

\textsuperscript{44} Add to these cases the subsequent case of Bartholomew v. Commissioner, 4 T.C. 349 (1944), appeal dismissed, (C.C.A. 9th, 1945) 151 F. (2d) 534, where the court allowed deduction of expenses of litigation brought to defend from his parents the estate of a child actor. Though admitting that "the litigation sought to strip him of his property," the court distinguished this from "recovery of capital" or "defense of property."

T.D. 5513, 1946 INT. REV. BUL. 61, approved May 14, 1946, amending TREAS. REG. 111, § 29,23(a)-15, includes what appears to be an incorporation of the Bartholomew ruling: "Reasonable amounts paid or incurred for the services of a guardian or
The history of a still more recent case has suggested a tendency toward liberality without an overruling of the *Lumpkin* case. The petitioner was an officer of a corporation whose stockholders had brought suit against him for alleged breach of fiduciary duties in connection with the organization of an associated syndicate. The stockholders sought to have the stock held by petitioner in the syndicate impressed with a trust for the benefit of the corporation. In disallowing the deduction of expenses of the suit, the Tax Court held that defense of litigation attacking the taxpayer’s title to property was an “expenditure capital in its nature [which] becomes part of the basis.” Citing *Bowers v. Lumpkin*, and *James C. Coughlin*, as authority, the Court said:

“And we can not agree that the effect of the *Bingham* case was to discredit or overrule these authorities.... The test accordingly seems to us to be whether prior to the amendment such a deduction as that now in controversy would have been permitted to a taxpayer admittedly engaged in carrying on a trade or business.”

On appeal, the circuit court reversed the Tax Court and allowed the deduction on the theory that the expenses were actually incurred in a defense of the charge that the petitioner had breached his fiduciary duties, and that the fees were not “any the less deductible because his liability, if proved, might have destroyed his equitable title to the stock he held.” It must, however, be conceded that the effect of this appellate decision may be negligible insofar as section 23(a)(2) is concerned, because the circuit court apparently regarded the expenses as “business” expense, allowable under section 23(a)(1)(A).

To date, it appears that the protagonists of a liberal interpretation, as expressed by Justice Black’s *McDonald* dissent, are supported by the wording of section 23(a)(2), by logic, yea, by all authority except the courts.

committee for a ward or minor, and other expenses of guardians and committees which are ordinary and necessary, in connection with the production or collection of income inuring to the ward or minor, or in connection with the management, conservation, or maintenance of property, held for the production of income, belonging to the ward or minor, are deductible.” Applying the amended regulation, see note 46, infra.  

45 Harold K. Hochschild, 7 T.C. 81 (1946).
46 Id. at 87. Kohnstamm v. Pedrick, (D.C. N.Y. 1946) 66 F. Supp. 410, which allows as deductible within the Bingham definition of “management,” expenses of litigation brought by an incompetent’s committee to obtain instructions as to whether the committee should elect, on behalf of the ward, to take his share, as in intestacy, of his deceased wife’s estate.
The second fundamental consideration is that of distinguishing expenses which are merely personal and hence non-deductible.47 This distinction survives from earlier acts. Clearly, expenses incurred in maintaining property as a “sport, hobby or recreation” are not deductible.48 Likewise, certain specific expenses are listed by Regulations 111 as being non-deductible:

“Commuter’s expenses; 49 expenses of taking special courses or training; expenses for improving personal appearance; the cost of rental of a safe-deposit box for storing jewelry and other personal effects; 50 and expenses such as expenses in seeking employment or in placing oneself in a position to begin rendering personal services for compensation, 51 campaign expenses of a candidate for

47 “Sec. 24(a) General Rule.—In computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses, except extraordinary medical expenses deductible under section 23(x): . . . .”

This section was amended so to read by § 127(b), Revenue Act of 1942, 56 Stat. L. 826, which added the clause excepting “extraordinary medical expenses.”

Mildred A. O’Connor, 6 T.C. 323 (1946) (cost of hiring a nursemaid to care for infant children of petitioner and husband, both of whom were employed, and to assist petitioner in discharge of household duties, held, personal expenses.)

48 H.R. Rep. 2333, 77th Cong., 2d sess., p. 75 (1942). S. Rep. 1631, 77th Cong., 2d sess., p. 88 (1942), TREAS. REG. 111, § 29.23(a)-15(b): “The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case, including the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer and the uses to which the property or what it produces is put by the taxpayer.” Disallowing the deduction: R.C. Coffey, 1 T.C. 579, affd., (C.C.A. 5th, 1944) 141 F. (2d) 204. Allowing the deduction: Norton L. Smith, 9 T.C. 1150 (1947).

49 Commuter’s expenses may qualify as business deductions; however, this possibility has been considerably impaired by the highly-controversial case of Commissioner v. Flowers, 326 U.S. 465, 66 S.Ct. 250 (1946), rehearing den., 326 U.S. 812, 66 S.Ct. 482 (1946). Taxpayer’s expenses for running his automobile are deductible under § 23(a)(1) in the proportion he uses it as required by his business. The balance is non-deductible, it being a personal expense. Hubbart v. Commissioner, 4 T.C. 121 (1944); Albert Nelson, 6 T.C. 764 (1946); Lewis F. Jacobson, 6 T.C. 1048 (1946).

50 Rental of safe-deposit box for keeping of income producing securities is, however, deductible. W. N. Fry, 5 T.C. 1058 (1945); Albina Bodell, T.C. Dkt. 109651, 1943 P-H MEMO. DEC., ¶ 43,015.

51 It is difficult to understand how this denial would withstand analysis. “Expenses incurred in seeking or taking up a new job,” says Mr. Mertens, “are non-deductible [as trade or business deductions under § 23(a)(1) ] since they are not incurred away from home and possibly for the further reason that they are not in the pursuit of an established trade or business . . . .” 4 MERTENS, LAW OF FEDERAL INCOME TAX-
public office, bar examination fees and other expenses incurred in securing admission to the bar, and corresponding fees and expenses incurred by physicians, dentists, accountants, and other taxpayers for securing the right to practice their respective professions."

A surprising number of cases have already been decided on the issue of the nature of the expense as personal or for the production of income. They show no well-defined line of distinction. In connection with the allowance of deduction of legal and accounting fees arising from tax controversies, the trend suggests liberality. The Regulations purported to disallow such expenses, and early cases were in accord. In *John W. Willmott*, the taxpayer’s expenses for litigation arising from the commissioner’s disallowance of deductions of income from securities and realty claimed by taxpayer to have been conveyed to his wife and son were held non-deductible under section 23(a)(2), despite

*Treasury Regulations*, § 29.23(a)-15(b). "Expenditures incurred for the purpose of preparing tax returns (except to the extent such returns relate to taxes on property held for the production of income), for the purpose of recovering taxes (other than recoveries required to be included in income), or for the purpose of resisting a proposed additional assessment of taxes (other than taxes held for the production of income) are not deductible expenses under this section, except that part of which the taxpayer clearly shows to be properly allocable to the recovery of interest required to be included in income." By T.D. 5513, Approved May 14, 1946, this portion of the regulation was changed to read: "Expenses paid or incurred by an individual in the determination of liability for taxes upon his income are deductible. If property is held by an individual for the production of income, amounts expended in determining a property tax imposed with respect to such property during the period when so held are deductible. Expenses paid or incurred by an individual in determining or contesting any liability asserted against him do not become deductible, however, by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability. Thus, expenses, paid or incurred by an individual in the determination of gift tax liability except to the extent that such expenses are allocable to interest on a refund of gift taxes, are not deductible, even though property held by him for the production of income must be sold to satisfy an assessment for such tax liability or even though, in the event of a claim for refund, the amount received will be held by him for the production of income."

2 T.C. 321 (1943). Accord, Edward Peterson, T.C. Dkt. 110005, 1945 P-H Memo. Dec., ¶ 45,130, in which expenses of attorneys’ fees incurred by taxpayer in protesting assessment of his profits from a partnership were held non-deductible.
the contention that, had the matter not been litigated, half the property would have been subject to a judgment lien. This was held not to be "conservation" within the meaning of the act. Development since the Willmott case is illustrated in the history of the Stoddard case. In March, 1944, the Circuit Court of Appeals for the Second Circuit affirmed a disallowance of deduction of fees paid in 1936 to accountants for services in helping the taxpayer successfully to contest the payment of taxes assessed against him by the commissioner in previous years. After quoting section 23(a)(2), the Court said,

"To extend this language to make it possible for taxpayers to deduct not only expenses which resulted, or were intended to result, in the acquisition of taxable income but also the expense of litigation over the amount of their income taxes would be too great a stretch in the absence of anything to indicate that Congress intended so to encourage litigation."

The following year brought the Bingham case, on the basis of which the circuit court reversed its previous holding in the Stoddard case. Subsequent cases in accord lead to the suggestion that legal expenses

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55 It has been held that expenses incurred in the recovery of taxes were deductible in the proportion that represented recovery of interest, but not recovery of overpayments. P. E. Foerderer, T.C. Dkt. 109076, 1943 P-H Memo. Dec., ¶ 43,102, aff'd, (C.C.A. 3d, 1944) 141 F. (2d) 53. James McFaddin, 2 T.C. 395 (1943). That the bureau persists in refusing to recognize an impending lien as an element ascribing to litigation the character of conservation, see text to note 57, infra.

56 (C.C.A. 2d, 1944) 141 F. (2d) 76.

57 Id. at 80. Cf. Hord v. Commissioner, (C.C.A. 6th, 1944) 143 F. (2d) 73, wherein similar fees were disallowed, but the opinion implies an alternative ground of insufficient evidence.


59 Howard E. Cammack, 5 T.C. 467 (1945) (litigation to recover a claimed tax deduction for loss on stock which became worthless in 1932. The Tax Court found this to be connected with “management”). Herbert Marshall, 5 T.C. 1032 (1945) (litigation contesting commissioner’s disallowance of taxpayer’s right to report his income divided as community property). Williams v. McGowan, (C.C.A. 2d, 1945) 152 F. (2d) 570 (litigation in 1940 to secure refund of taxes paid for the years 1936 and 1937). Philip D. Armour, 6 T.C. 359 (1946) (litigation over personal holding company surtax deficiencies for which taxpayer was liable as transferee). William P. Toms, T.C. Dkt. 7417, 1946 P-H Memo. Dec., ¶ 45,062. (Petitioner, whose principal source of income arose from ownership of corporation stock, incurred expenses in litigation in which he was sued for alleged breach of contract for the sale thereof. The expenses were held deductible under the Bingham doctrine.) James A. Connelly, 6 T.C. 744 (1946). (Litigation on a contested deficiency due to disallowance of a stock loss held deductible on authority of Cammack case. The fact that taxpayer was unsuccessful in his litigation is immaterial.) Dunitz v. Commissioner, 7 T.C. 672 (1946) (expenses of successful defense of proposed assessment for alleged realization of taxable income by reason of purchase of bonds at discount held de-
in all tax controversies are deductible, whether or not the disputed taxes relate to property held for the production of income.

For a period, it was not so clear that either expenses of tax advice, as distinguished from expenses of litigation, or accounting and bookkeeping fees, are regularly deductible. But, there appears no reason in logic or principle to discriminate against such expenses in favor of litigation fees. Though they are not incurred so directly for “conservation” or “management,” they appear to be no less a proper expense in the determination of taxes. Admitting the theory of taxing only net income, these expenses would seem to be within the purpose of section 121. More recent decisions have recognized these deductions. Also, Regulations III, section 29.23(a)-15(b) has been amended to provide that

“Expenses paid or incurred by an individual in the determination of liability for taxes upon his income are deductible.”

The recent case of David L. Loew, concerned fees paid to accountants for preparation of income tax returns, also fees paid for keeping books on petitioner’s securities and depositing in his bank account dividends received. All such expenses were held deductible under the Bingham doctrine since they were directly connected with deductible). Pelham G. Wodehouse, 8 T.C. 637 (1947). See note 53, supra, for change in the pertinent Regulation.

Myrhl Frost, T.C. Dkt. 112333, 1943 P-H Memo. Dec., ¶ 43,155, allowed the deductions of amounts paid to a public accountant for services rendered in connection with the keeping of books respecting income collected from real estate and for preparation of income tax returns. There followed Aldus C. Higgins, 2 T.C. 948 (1943), affd., (C.C.A. 1st, 1944) 143 F. (2d) 654; J.S. Floyd, T.C. Dkt. 112513, 1943 P-H Memo. Dec., ¶ 45,421; Frank G. Hogan, 3 T.C. 691 (1944); Hord v. Commissioner, (C.C.A. 6th, 1944) 143 F. (2d) 73; Davis v. Commissioner, 4 T.C. 329 (1944), affd., (C.C.A. 8th, 1945) 151 F. (2d) 441, where such expenses were disallowed. But, see David L. Loew, 7 T.C. 363 (1946), infra.

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William Heyman, 6 T.C. 799 (1946). Fees for accountants’ services in conferences and consultations with representatives of the Bureau of Internal Revenue, as a result of which petitionor paid additional taxes, held, deductible. The court was divided on the point of whether such fees, to be deductible, need be connected with taxes on property held for income.


7 T.C. 363 (1946). The Court treats R.C. Coffey, James McFaddin, 2 T.C. 395 (1943); Aldus C. Higgins, 2 T.C. 948 (1943); Stoddard v. Commissioner, (C.C.A. 2d, 1945) 152 F. (2d) 445 (first case); and Hord v. Commissioner, (C.C.A. 6th, 1944) 143 F. (2d) 73, as overruled by the Bingham case.
or proximately resulted from the enterprise—"the management of property" held for the production of income.

The question of whether the standards distinguishing personal expenses and business expenses under section 23(a)(1) are to be adopted for application of section 23(a)(2) was in issue in the case of Warren Leslie, Sr. In disallowing expenses of a caretaker on property which had formerly been a residence, a majority of the Tax Court held the problem comparable to that involved when a loss is sustained on the sale of former residential property. This imposed on the taxpayer the burden of proving "some unmistakable act of conversion or appropriation" to income-producing purposes. The minority, on the other hand, respected the liberal purpose of section 121. The minority contended that in order to satisfy section 23(a)(2), it is necessary only to show that the property is not carried as "a sport, hobby or recreation." This satisfied, the expenses for residential property became important only as prohibited by section 24(a)(1) as "personal expenses." Denying the propriety of closely following the construction of section 23(a)(1), the dissent says,

64 6 T.C. 488 (1946). Petitioners, husband and decedent wife, on a joint return, claimed deduction for loss and caretaker's expenses on property which had been so badly damaged by a hurricane in 1938 that it could not be occupied thereafter without extensive repairs. They decided not to occupy it again. Repairs were never made and petitioners made no attempt to rent; though they did grant to a realtor the right to try to sell the property, no sale ever resulted. The property was conveyed to a mortgagee in 1940, at an alleged loss of thirty-three thousand dollars. A caretaker had been employed on the property during the interval. Loss resulting from disposition of the property in 1940 was disallowed as resulting from disposition of residential property [§ 23(e)(2)].

65 The majority distinguished Mary L. Robinson, 2 T.C. 305 (1943), (in which there was shown a sufficient act of conversion of the former residence). Cf. Guggenheimer, T.C. Dkt. 111821, 1943 P-H Memo. Dec., ¶ 43,432 (no clear evidence of conversion); S. Wise, T.C. Dkt. 5721, 1945 P-H Memo. Dec., ¶ 45,298 (expenses of advertising for sale a residence taxpayer had occupied during the year, before he moved to a newly built residence, held, non-deductible); Thora Scott Ronalds, T.C. Dkt. 2384, 1946 P-H Memo. Dec., ¶ 46,224; George W. Ritter, T.C. Dkt. 9096, 1946 P-H Memo. Dec., ¶ 46,237.


67 6 T.C. 488 at 497: "The whole history of this question convinces me that nothing need be shown except a change from a residence status to a non-residence status, for the passage of the Act of 1942 is proof enough that conversion to a business property is not requisite, and if so (and the property is not mere hobby, which is nowhere suggested in this case, but negatived by the former residence feature), then all that
"I think section 121 of the Revenue Act of 1942 was definitely intended to do away with any comparison with losses, and that we should view the matter only to inquire whether property is 'held for the production of income,' and not set up requirements based on losses, or the former statute, or analogy thereto. Conversion or appropriation, though necessary to change a residence to business property, is logically unnecessary to divest it of a personal character. If such test is still requisite, the statute seems to have accomplished little, if anything."

That the liberal philosophy of the minority is not likely to be adopted is indicated by cases involving a different, but very interesting, question. In *Julius A. Heide,* petitioner was one of four co-trustees who commenced proceedings for an intermediate accounting. The proceedings eventually culminated in a final accounting. Remaindermen and special guardians for infants and incompetents objected to the accounts, charging mismanagement (no bad faith was charged) of the subject trusts. Protracted litigation threatened. To settle the matter, the parties stipulated, inter alia, that the trustees should each be charged $3,000, payable in equal portions to the trusts. The Tax Court allowed under section 23(a)(2) petitioner's deduction of the $3,000 he paid. A three-judge minority dissented on the ground that, notwithstanding petitioner agreed as part of the settlement to waive compensation for his services, the surcharge was not related to the question of petitioner's compensation as trustee. Hence, reasoned the minority, the sum paid was not an expense incurred in the production or collection of income. On appeal, the circuit court reversed, disallowing the deduction on the ground that the expense was not "ordinary and necessary." To be the residence idea adds is the provision of § 24(a)(1)." A. D. Amerise, 1 T.C. 1108 (1943), held that the petitioner who had leased his residence and temporarily rented other quarters for himself and family was not entitled to deduct that rental cost. It continued as a family living expense.

68 6 T.C. 488 at 497-498. That the matter is not yet settled to the satisfaction of the entire court is suggested by the dissent's last words (p. 499), "I regret the length of this dissent, but I feel that this is the crucial stage in an important subject." It is interesting to note that Disney, J., who wrote the dissent, wrote the majority opinion in *Harman v. Commissioner,* 4 T.C. 335 (1944), wherein fees paid to one for services in negotiating a loan were held to be capital expenditures and not deductible, on the authority of two earlier cases distinguishing business expenses from capital expenditures.

69 8 T.C. 314 (1947). To the effect that the Tax Court may be impressed by whether and when the taxpayer waives right to administrator's compensation in a case of this kind. Cf. Hyman Y. Josephs, 8 T.C. 583 (1947), appeals pending, C.C.A. 8th.

deductible, the surcharge paid must be one to reimburse for a depletion which was itself necessary to administration of the trust, else Congress would be found to have provided a means to "subsidize delinquent trustees."

Miscellaneous expenses incurred in connection with the production of income or the management, conservation or maintenance of property held for that purpose are deductible. These include expenditures for rent, telephone, maintenance of an office (including an allowance for depreciation of office furniture), secretarial service, safe-deposit box rental, travel to look after property held for income, and attorneys' fees paid by a writer to look after the taxpayer's literary interests. But, always the burden is on the taxpayer to show that his claimed deduction falls clearly within the deductions provided for by statute. If expenses are incurred for purposes which would qualify only a part thereof as deductible, the taxpayer bears the burden of proving which portion is deductible at the risk of losing all.

One general rule, elementary in statement, warrants comment by reason of the interesting questions anticipated in future cases within its purview. In order to qualify under section 23(a)(2) the expense must be incurred in relation to the income of the taxpayer seeking the deduction. Where the taxpayer was a minority owner of two corporations and provided the corporations with the services of experienced employees, the salaries paid by the taxpayer to the employees were held non-deductible. It was assumed by the court that the presence of the employees enhanced the corporations' chances of success. The

72 Rentschler v. Commissioner, 1 T.C. 814 (1943).
73 Albina Bodell, T.C. Dkt. 109651, 1943 P-H MEMO. Dec., ¶ 43,015; W. N. Fry, 5 T.C. 1058 (1945).
74 R. C. Coffey, 1 T.C. 579 (1943), affd., (C.C.A. 5th, 1944) 141 F. (2d) 204; E. M. Godson, T.C. Dkt. 4913, 4914, 1946 P-H MEMO. Dec., ¶ 46,182. Harry Kanelas, T.C. Dkt. 112053, 1943 P-H MEMO. Dec., ¶ 43,429, allowed deduction of travel expenses of taxpayer and his attorney for trip to Ireland to collect sweepstake winnings. Section 23(a)(1) expressly includes "traveling expenses" as a business expense; no express mention is made in § 23(a)(2).
75 Pelham G. Wodehouse, 8 T.C. 637 (1947).
77 Claire S. Strauss, T.C. Dkt. 111094, 1943 P-H MEMO. Dec., ¶ 43,216 (1943).
deductions were disallowed, however, because the income immediately benefitted was that of the corporations, and only indirectly was the income of the taxpayer related. The expenses were not necessary and ordinary for the taxpayer, at least in the absence of a showing that the corporations could not provide the services they needed.\(^\text{78}\)

In no event is a deduction under section 23(a)(2) allowed for expenses incurred in the production of income which by reason of some provision of the code is tax exempt.\(^\text{79}\)

In effect, section 23(a)(2) is applicable to all prior years with the result that expenses of the required non-trade or non-business character may be claimed as refunds in all cases not barred by the statute of limitations.\(^\text{80}\)

**Conclusion**

Notwithstanding the probable constitutional power of Congress to tax gross income, the policy behind the federal program has been one of taxing net income. For those who anticipated the relatively recent provision for deduction of non-trade and non-business expenses as a step toward achieving that end for the individual taxpayer, and equalizing his position with that of business organization, the cases to

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\(^{79}\) "Sec. 24. Items Not Deductible. (a) General Rule.—in computing net income no deduction shall in any case be allowed in respect of—... (5) Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this chapter, or any amount otherwise allowable under § 23(a)(2) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this chapter;..." See Edward Mallinckrodt, Jr., 2 T.C. 1128 (1943), aff'd., (C.C.A. 8th, 1945) 146 F. (2d) 1, 33 A.F.T.R. 325, cert. den., 324 U.S. 871, 65 S.Ct. 1084 (1945); Mary K. Ellis, T.C. Dkt. 7176, 1947 P-H Memo. Dec., \(\|\) 47,160.

\(^{80}\) Revenue Act of 1942. Section 121(d), 56 Stat. L. 819, provides that the amendments of that section shall be applicable to taxable years beginning after December 31, 1938, § 121(e) further provides that, "For the purposes of the Revenue Act of 1938 or any prior revenue Act the amendments made to the Internal Revenue Code by this section shall be effective as if they were a part of such revenue Act on the date of its enactment." But, these must be read in the light of I.R.C. § 322(b). There appears to be no basis for the ruling in J. Dale Dilworth, T.C. Dkt. 4130, 1945 P-H Memo. Dec., \(\|\) 45,271, to the effect that the amendment is inapplicable to the year 1938.
date hold considerable disappointment. The source of the difficulty appears to lie in

(1) The unfortunate Congressional statement that “a deduction under this section is subject, except for the requirement of being incurred in a trade or business, to all the restrictions and limitations that apply in the case of the deduction under Section 23(a)(1)(a) . . .”;

and

(2) Congressional mention that the amendment was motivated by the holding in the Higgins case.

These have served to ground a restricted interpretation which blossomed in the McDonald and Lumpkin cases.

Vestiges of these decisions are to be found in recent opinions, despite the vigorous and persuasive dissent in the McDonald case and the relatively liberal doctrine of Bingham’s Trust v. Commissioner. It is believed, however, that the latter case will ultimately provide precedence for judicial recognition that the Congressional remarks simulating the two sections intended nothing more than that “ordinary and necessary” expenses of producing income by means other than through trade or business are deductible even as “ordinary and necessary” expenses of producing income through trade or business are deductible—that Congress was merely indicating that it was correcting rather than creating a discrimination. It seems even now a not unreasonable hope that the liberal construction will prevail.