BRIEF FOR THE RESPONDENTS IN OPPOSITION

INDEX

CITATIONS

In the Supreme Court of the United States

October Term, 1932

No. 905

Thomas H. Welch, petitioner

v.

David Burnet, Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 23-24) is reported in 25 B.T.A. 117. The opinion of the Circuit Court of Appeals (R. 38-40) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 24, 1933 (R. 40-41). The petition for writ of certiorari was filed April 24, 1933. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether petitioner, having voluntarily paid claims against a bankrupt corporation with which he had been associated for which claims he was not legally liable, may deduct the amounts so paid as ordinary and necessary business expenses because these payments tended to strengthen his business standing and credit in the business in which he was then engaged.

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the statutes and regulations involved are set forth in the Appendix (*infra*, pp. 9, 10).

STATEMENT

The following is a summary of the facts found by the Board of Tax Appeals (R. 22–23):

During 1922 the petitioner was secretary of the E. L. Welch Company, a Minnesota corporation, engaged in the grain business. Except for ten shares of stock owned by him, all the stock of the E. L. Welch Company was owned by petitioner's father. For several years prior to 1922 taxpayer had been in close touch with the customers of E. L. Welch Company, having traveled through the territory in which it did business during three or four months each summer making and dealing with present and prospective customers. He took charge of all grain as it came in to Minneapolis and attended to its grading and sale. His father looked after the financial end of the business only.

On March 23, 1922, the E. L. Welch Company was adjudged an involuntary bankrupt, and the

petitioner was adjudged a voluntary bankrupt on August 5, 1922. Both the company and he were discharged from liability for debts. Shortly thereafter the petitioner entered into a contract with the Kellogg Company to purchase grain for it on a commission basis. In order to reestablish his standing and credit and to revive new business contacts with former customers of the E. L. Welch Company, the petitioner decided to reimburse certain creditors of the E. L. Welch Company as far as he was able. Beginning in 1924, he made small payments to all of the numerous creditors, except two, by a special check which bore the following indorsement:

> The payee of this check, by the endorsement hereof, accepts and agrees to apply the same on its claim against E. L. Welch Company, according to the terms of the letter of transmittal. It has nothing to do with present or future business relations with the maker of the check and is not to be considered as acknowledging any existing claim or renewing any barred claim against him.

From 1924 to 1928 petitioner earned commissions and made payments to reimburse creditors of the E. L. Welch Company as follows:

Year	Commissions	Credits of E. L. Welch Co.
1924	$18,028.20	$3,975.97
1925	31,377.07	11,968.20
1926	20,926.25	12,815.72
1927	22,119.61	7,379.73
1928	28,177.56	11,068.25

On his income-tax returns for 1924, 1925, and 1926 petitioner reported only the amount remaining from commissions earned after payments of the above amounts to creditors of the E. L. Welch Company. On his income-tax returns for 1927 and 1928 he reported the total commissions received and deducted the payments to creditors of the E. L. Welch Company.

The Commissioner added the payments for 1924, 1925, and 1926 to petitioner's income and disallowed the deductions taken in 1927 and 1928. The Board of Tax Appeals sustained this action (R. 24–25), and upon appeal the Circuit Court of Appeals affirmed (R. 40–41).

ARGUMENT

The petitioner contends that the amounts paid to the creditors of the bankrupt corporation were deductible, in computing his income taxes for the years in question, as ordinary and necessary expenses incurred in carrying on his individual business. It is submitted that these items do not come within the terms of Section 214 (a) (1) of the Revenue Act of 1924 and the similar provisions of the 1926 and 1928 Acts (*infra*, p. 9) which allow the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *."

The claims upon which the payments were made were not legal obligations of petitioner, and they did not directly arise out of the conduct of his own business. They were made because it was believed that, by enhancing petitioner's financial and business standing among former customers of the bankrupt corporation with which he had been associated, his

individual business would be benefited. Such an indirect relation between the payments and the business is not sufficient to justify the deduction. See *Lloyd* v. *Commissioner*, 55 F. (2d) 842 (C.C.A. 7th); *Ellis* v. *Burnet*, 50 F. (2d) 343 (App. D.C.). The words of the statute taken in their ordinary meaning preclude the allowance of the payments as *ordinary* and *necessary* business expenses. Webster's dictionary defines "ordinary" as "common, usual, often recurring," and it defines "necessary" as "impossible to be otherwise, indispensable, requisite or essential." The expenditures here do not come within either of these definitions. The deductions claimed must be denied because the payments had no necessary connection with the petitioner's individual business. They arose independently of, and were not current operating expenses incident to, the normal conduct of his business. Cf. *Simmons Co.* v. *Commissioner*, 33 F. (2d) 75 (C.C.A. 1st), certiorari denied, 280 U.S. 588. As we are dealing with the right to a deduction, petitioner must bring himself clearly within the statute.

Since such cases as the instant one necessarily depend upon their particular facts, there is no rule of universal application which is controlling. However, the result below seems to be sustained by decisions in closely analogous cases. In *White* v. *Commissioner*, 61 F. (2d) 726 (C.C.A. 9th), a partnership sought to deduct payments made in settlement of a separate individual debt of one of its members. It was claimed that the amount paid was deductible as an ordinary and necessary expense on the ground that it was necessary to avoid a lawsuit by the creditor bank, thus protecting the credit of the partnership. The court held that, while it might be expedient to pay the obligation of a partner incurred in a former business venture, it did not follow that the amount paid was deductible as an ordinary and necessary expense of the partnership. The court said (p. 729):

> It certainly cannot be said that the payments involved were ordinary expenses, nor have the petitioners sustained the burden of showing them to be necessary. It is conceded by the parties that White had a valid legal defense to an action instituted against him by the bank and that there was no liability of the new partnership to the bank for this indebtedness.

The voluntary assumption of another's obligation is not an ordinary and necessary business expense within the meaning of the Revenue Acts. *Robinson* v. *Commissioner*, 53 F. (2d) 810 (C.C.A. 8th); *National Piano Mfg. Co.* v. *Burnet*, 50 F. (2d) 310 (App.D.C.). See *Mastin* v. *Commissioner*, 28 F. (2d) 748 (C.C.A. 8th); *Stephenson* v. *Commissioner*, 43 F. (2d) 348 (C.C.A. 8th). The court said in the *National Piano case* that the payment by one corporation of another's Federal income tax, if voluntary, would not be a necessary expense.

The regulations of the Treasury Department under the Revenue Acts of 1924, 1926, and 1928 (*infra*, pp. 9–10) limit deductions, under the provision for "ordinary and necessary expenses" in carrying on a "trade or business", to the current operating expenses incurred in producing the income. This long-continued administrative construction, accompanied by repeated reenactment of the statutory provisions under which it was adopted, constitutes an approval and adoption of the construction. See *Burnet* v. *Guggenheim*, No. 283, October Term, 1932, decided February 6, 1933; *Massachusetts Mutual Life Insurance Co.* v. *United States*, No. 322, October Term, 1932, decided February 6, 1933.

The petitioner asserts that the present case cannot be reconciled with *A. Harris & Co.* v. *Lucas*, 48 F. (2d) 187 (C.C.A. 5th). In that case a department store, which had been discharged from its debts in a compromise settlement, found that its borrowing power had been seriously impaired, and, in order to reestablish its credit, paid its former creditors the balance of the debts due them. The court pointed out that the question in such cases depends upon the peculiar facts and decided that such payments in the case of the taxpayer involved were necessary to preserve and continue its business and hence were allowable as deductions. The two cases are distinguishable. In the *A. Harris & Co. case* the payments were made by the party which had incurred the claims paid. In the instant case the payments were made by one who never had been liable for the debt and there was no such intimate relationship between petitioner's business and the payments made here as there was in the *Harris case*, where the payment was necessary to obtain credit for the same enterprise which had previously proved to be an unsafe credit risk.

The statement in the *A. Harris & Co. case*, to the effect that the statute is not to be construed as requiring a deductible expense to be both ordinary and necessary, is contrary to the weight of authority. *Hubinger* v. *Commissioner*, 36 F. (2d) 724 (C.C.A. 2d), certiorari denied *sub nom. New Haven Bank* v. *Lucas*, 281 U.S. 741; *Lloyd* v. *Commissioner*, *supra*; *Parkersburg Iron & Steel Co.* v. *Burnet*, 48 F. (2d) 163 (C.C.A. 4th); *White* v. *Commissioner*, *supra*. That statement was not necessary to the conclusion reached in view of the fact that the court classified the payments as advertising expenses, and as such they were clearly both ordinary and necessary.

The other cases cited by the petitioner appear to be so clearly distinguishable as not to require separate analysis.

CONCLUSION

The decision below was correct and does not seem to conflict with the decisions of other Federal courts. The case turns upon its particular facts. The petition should be denied.

Respectfully submitted.

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May, 1933

APPENDIX

Revenue Act of 1924, c. 234, 43 Stat. 253, 269:

SEC. 214. (a) In computing net income there shall be allowed as deductions:

(1) 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. (U.S.C., Title 26, Sec. 955.)

Section 214 (a) (1) (U.S.C.App., Title 26, Sec. 955) and Section 215 (a) (2) and (3) (U.S.C.App., Title 26, Sec. 956) of the Revenue Act of 1926, c. 27, 44 Stat. 9, 26, 28, and Section 23 (a) of the Revenue Act of 1928, c. 852, 45 Stat. 791, 799, are identical.

Treasury Regulations 65, promulgated under the Revenue Act of 1924:

ART 24. *Methods of accounting.*— * * *

(2) Expenditures made during the year should be properly classified as between capital and income; that is to say, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; * * *.

ART. 101. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under the provisions of articles 121–251. * * * Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see article 102), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. But see article 293. * * *

ART. 112. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. See articles 21–24 and 50. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. But see section 206 and articles 1621–1626. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. * * *

The pertinent regulations under the 1926 and 1928 Acts are to the same effect.

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