BRIEF FOR RESPONDENT

INDEX

CITATIONS

Cases:

In the Supreme Court of the United States

OCTOBER TERM, 1933

No. 33

THOMAS H. WELCH, PETITIONER
v.
GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

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

BRIEF FOR THE RESPONDENT

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 reported in 63 F. (2d) 976.

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, and was granted May 22, 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 may deduct as an ordinary and necessary expense in carrying on his individual business amounts voluntarily paid to the creditors of a bankrupt corporation with which he had been associated.

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the statutes and regulations are set forth in the Appendix, pp. 14–16, *infra*.

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 into 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	20,925.25	12,815.72
1927	22,119.61	7,379.72
1928	26,177.56	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).

SUMMARY OF ARGUMENT

The words of the statute taken in their ordinary meaning preclude the allowance of the payments here involved as ordinary and necessary business expenses. The assumption of corporate debts by a stockholder is not ordinarily an expense of the stockholder's business, and clearly the expense was not necessary but voluntary and gratuitous. The deductions claimed must be denied because the payments had no necessary connection with the petitioner's individual business and were not current operating expenses incident to the normal conduct of his business. Admittedly the payments had some effect upon his business, but they were too indirect to justify the deduction under the statute.

One purpose of the payments was to build up the business. The resulting benefit extended substantially beyond the year of payment. Payments made for such a purpose must be regarded as closely analogous to capital expenditures, which are not allowable as deductions.

The use of the coordinate conjunction requires, in the absence of a different legislative intent, that an expense be both ordinary and necessary to be deductible.

ARGUMENT

During the years in controversy the petitioner was engaged in the business of purchasing grain on a commission basis for the Kellogg Company. From the gross income of his business he seeks to deduct as an ordinary and necessary business expense amounts paid to the creditors of the E. L. Welch Company, a bankrupt corporation, with which he was formerly connected as an officer and a stockholder. It is submitted that these payments 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. 14), 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 payments were unusual and gratuitous rather than ordinary and necessary. The words in the statute must be presumed to be used in their ordinary meaning. *Old Colony R.R. Co.* v. *Com-*

missioner, 284 U.S. 552; *Woolford Realty Co.* v. *Rose,* 286 U.S. 319, 327. *Ordinary* is defined as common, usual, often recurring. The word *necessary* is susceptible of conveying various shades of meaning and is used at times as a synonym for essential, indispensable, requisite, inevitable, and at other times for expedient, appropriate, needful, incidental, convenient. In individual cases the courts have adopted the meaning which most clearly reflects the intention of the legislature.

It is submitted that it is not common, usual, often recurring, for a minority stockholder owning only a small fraction of the capital stock to pay the discharged debts of a bankrupt corporation. The assumption of corporate losses by a stockholder is not ordinarily an expense in the stockholder's individual business in view of the separate taxable identities of a corporation and an individual. Nor was the expense *necessary* in the sense that it was essential, needful, requisite, or indispensable. The claims upon which the payments were made were not the obligations of the petitioner. The debts were not the debts of the taxpayer's business, and their payment was voluntary and gratuitous and therefore not deductible. *Louden Machinery Co.* v. *United States,* 57 F. (2d) 911 (C.Cls.). In *Blackwell Oil & Gas Co.* v. *United States,* 60 F. (2d) 257 (C.C.A. 10th), the corporation assumed all costs and expenses of a suit brought against ten of its principal stockholders. The suit was compromised, and the corporation claimed the amount

paid as a deduction. The court said that the amount paid was not the debt of the corporation, was voluntarily paid, and under no circumstances was it allowable under the statute. Likewise a gratuitous payment by a corporation to settle a dispute between its stockholders was not allowed. *One Hundred Five West Fifty-fifth St.* v. *Commissioner,* 42 F. (2d) 849 (C.C.A. 2d). To the same effect *Robinson* v. *Commissioner,* 53 F. (2d) 810 (C.C.A. 8th), involving taxes paid on another's property, also *White* v. *Commissioner,* 61 F. (2d) 726 (C.C.A. 9th), involving payments made by a partnership in settlement of a separate individual debt of one of its members. See also *National Piano Mfg. Co.* v. *Burnet,* 50 F. (2d) 310 (App.D.C.); *Mastin* v. *Commissioner,* 28 F. (2d) 748 (C.C.A. 8th); *Stephenson* v. *Commissioner,* 43 F. (2d) 348 (C.C.A. 8th).

It has been held that an expenditure made because it was considered expedient or convenient does not satisfy the statute. *White* v. *Commissioner, supra.* An amount paid by a corporation under an agreement whereby former stockholders discontinued litigation and the remaining stockholders obtained control was held not deductible as a business expense, although the corporation benefited through the termination of litigation which was harming it. *Newark Milk & Cream Co.* v. *Commissioner,* 34 F. (2d) 854 (C.C.A. 3d). A bank taking over the assets and liabilities of another bank was not entitled to deduct from income

a bonus paid for the purpose of securing a favorable contact with the depositors of the liquidating bank. *First Nat. Bank of Omaha* v. *Commissioner,* 49 F. (2d) 70 (C.C.A. 8th).

The regulations of the Treasury Department under the Revenue Acts of 1924, 1926, and 1928 (*infra*, p. 14), have consistently construed the provision allowing the deductions for business expense as including the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. Among these items are management expenses, commissions, labor, advertising, insurance, and rents. Expenses of this character are current operating expenses. *Williams* v. *Burnet,* 59 F. (2d) 357 (App.D.C.); *Simmons Co.* v. *Commissioner,* 33 F. (2d) 75 (C.C.A. 1st), certiorari denied, 280 U.S. 588. Further support is found in the fact that this long-continued administrative construction, accompanied by repeated reenactment of the statutory provision under which it was adopted, constitutes an approval and adoption of the construction. *Burnet* v. *Guggenheim,* 288 U.S. 280; *Massachusetts Mutual Life Ins. Co.* v. *United States,* 288 U.S. 269.

Only such deductions as are authorized by the statute are permitted. *Spring Canyon Coal Co.* v. *Commissioner,* 43 F. (2d) 78 (C.C.A. 10th), certiorari denied, 284 U.S. 654; *Lloyd* v. *Commissioner,* 55 F. (2d) 842 (C C.A. 7th); *Kenan v. Bowers,* 50 F. (2d) 112 (C.C.A. 2d). Deductions are a matter of legislative grace and petitioner must

bring himself clearly within the statute. It is submitted that since the claims upon which the payments were made were not the obligations of the petitioner and did not directly arise out of the normal conduct of his business, the deductions do not come clearly within the statute and must be disallowed.

If the payments made by petitioner do not meet the requirement of being "ordinary and necessary" expenses of the taxable year in carrying on a business, it is unnecessary to inquire further in an attempt to classify them. See *Great Northern Ry. Co.* v. *Commissioner,* 40 F. (2) 372 (C.C.A. 8th), certiorari denied, 282 U.S. 855; *Isabelle Hammond-Knowlton, Administratrix,* v. *Commissioner,* 19 B.T.A. 947. But if they are capital expenditures they are necessarily not within the class of current business expenses. If these payments may be regarded as being connected with petitioner's business, we believe they are essentially capital expenditures.

The Board found that the payments in question were made "to reestablish his standing and credit and to revive new business contacts with former customers of the E. L. Welch Company." (R. 22.) The taxpayer testified that his purpose was to "reestablish my business" (R. 34), and that he built up a large business because he acted square with the creditors (R. 33). Even though expenditures for the purpose of reestablishing his credit may be deductible (*A. Harris & Co.* v. *Lucas,* 48 F. (2d) 187

(C.C.A. 5th)), there would seem to be no doubt that expenditures for the purpose of building up a business are in the nature of a capital expenditure, since a continuing benefit inures to the taxpayer throughout future years. The taxpayer testified that as a result of these payments he was then, at the time of the Board hearing, doing business with a number of former customers of the corporation. (R. 33.) Thus because of payments made as early as 1924 he was enabled to secure business in 1931. Public favor and the possibility of future patronage constitute goodwill which is a capital asset. *Colony Coal & Coke Corp.* v. *Commissioner,* 52 F. (2d) 923 (C.C.A. 4th). Expenditures made to acquire an asset are not deductible. Regulations 65, Art. 292, *infra.*

The petitioner contends that the expenditures were ordinary and necessary because they were made in order to reestablish his standing and credit and to build up his business. Payments made for such a purpose cannot be said to arise directly out of the conduct of one's business; and while they may have some incidental effect upon his business, the relationship between them and the business is too indirect to justify the deduction. *White* v. *Commissioner, supra.* Plainly they fall short of being current operating expenses incident to the normal conduct of the business. *Lloyd* v. *Commissioner, supra; Ellis* v. *Barnet,* 50 F. (2d) 343 (App. D.C.).

The case of *Kornhauser* v. *United States,* 276 U.S. 145, involved the deductibility of attorneys' fees paid to retain earnings of the taxpayer's business. The case turned upon the question whether the fees represented a business or a personal expense, and it was held that the expense of retaining business income was directly connected with the operation of the taxpayer's business. The expenditures of the instant case can be allowed only on the theory that they were directly connected with the earnings of his business. It is submitted that payments made to enhance one's financial standing or to secure lasting benefits are too indirectly connected with the current operations of a business to fall within the statute.

The case of *Commissioner* v. *Peoples Pittsburg Trust Co.,* 60 F. (2d) 187 (C.C.A. 3d), is not in point. The taxpayer as part of his regular duties as an officer of the corporation executed the tax returns for the corporation. He and another were indicted for conspiracy to defraud the United States by means of false and fraudulent returns but were subsequently acquitted. The court stressed the consideration that the taxpayer's business was that of being a corporate officer performing duties devolving upon him as an executive head of the corporation and that the expense of defending the charge was deemed necessary to remove a criminal quality attributed to acts performed by him in carrying out his trade or business. The direct relationship between the expense and the business is reasonably apparent.

For the same reason the case of *American Rolling Mill Co.* v. *Commissioner,* 41 F. (2d) 314 (C.C.A. 6th), is also distinguishable. Contributions to a civic improvement fund were found to be reasonably incidental to the business of the company, which employed a large part of the city's population. The case of *Corning Glass Works* v. *Lucas,* 37 F. (2d) 798 (App.D.C.), certiorari denied, 281 U.S. 742, is distinguishable for the same reason as are the Board cases cited by the petitioner.

The statement in the *A. Harris & Co. case, supra,* 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; White* v. *Commissioner, supra; Parkersburg Iron & Steel Co.* v. *Burnet,* 48 F. (2d) 163 (C.C.A. 4th). The word *and* is a coordinate conjunction expressing the relation of addition. The word *or* is a disjunctive particle in its accurate use and marks an alternative. *Central Trust Co.* v. *Howard,* 275 Mass. 153. While the courts are often compelled to construe *and* as meaning *or* and again *or* as meaning *and* to give effect to the clear intention of the legislature (*United States* v. *Fisk,* 70 U.S. 445; *Union Insurance Co.* v. *United States,* 73 U.S. 759), neither *and* or *or* may be interchanged when the meaning of the language used in the statute is plain and there is nothing in it to call for such substitution. Endlich's *Interpretations of Statutes,* Section 305. The reason given by the court in the *Harris case* does not warrant the substitution there made, for it does not appear correct to say that an expenditure is allowable if it is not a capital expenditure. *Commissioner* v. *Field,* 42 F. (2d) 820 (C.C.A. 2d); *Tunnel R.R. of St. Louis* v. *Commissioner,* 61 F. (2d) 166 (C.C.A. 8th), certiorari denied, 288 U.S. 601; *Burroughs Bldg. Material Co.* v. *Commissioner,* 47 F. (2d) 178 (C.C.A. 2d). Furthermore, the regulations have construed *and* in its cumulative sense, and repeated reenactments of the statute have not disturbed this construction.

CONCLUSION

We submit that the decision below is correct and should be affirmed.

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SEWALL KEY,
JOHN G. REMEY,
Special Assistants to the Attorney General.

SEPTEMBER, 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. 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. 292. *Capital expenditures.*—Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. See section 214 (a) (8) of the statute and article 161. Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architect's services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities are an offset against the selling price. Expenses of the administration of an estate, such as court costs, attorney's fees, and executor's commissions, are chargeable against the corpus of the estate and are not allowable deductions.

Amounts to be assessed and paid under an agreement between bondholders or stockholders of a corporation, to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. See article 543. An assessment paid by a stockholder of a national bank on account of his statutory liability is ordinarily not deductible but, subject to the provisions of the statute, may in certain cases represent a loss. As to items not deductible by corporations, see section 235 and articles 581 and 582.

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

U. S. GOVERNMENT PRINTING OFFICE: 1933

OPINION