Michigan Law Review

Volume 58 | Issue 1

1959

Taxation - Ordinary and Necessary Expenses - Deduction of Advertising Expenses Incurred to Defeat State Initiative Measures

Robert J. Paley S.Ed.
University of Michigan Law School

TAXATION—ORDINARY AND NECESSARY EXPENSES—DEDUCTION OF ADVERTISING EXPENSES INCURRED TO DEFEAT STATE INITIATIVE MEASURES—Petitioners were members of a partnership engaged in the wholesale distribution of beer in Washington. In 1948 the partnership made contributions to a publicity campaign instituted to defeat an initiative to be presented to the voting public, the passage of which would have placed retail beer and wine sales exclusively in state hands. In their 1948 tax returns petitioners deducted the amount contributed as ordinary and necessary business expense. After the Commissioner disallowed the deduction the petitioners paid the deficiency under protest and sued for a refund in the district court. That court denied the refund, ruling that the payments were expended for the defeat of legislation within the meaning of an existing treasury regulation[1] which prohibited deduction of such expenditures

[1] Treas. Reg. 111, §29.23 (0)—1.

as ordinary and necessary business expense under section 23 (a) (1) (A) of the 1939 Internal Revenue Code. The court of appeals affirmed.[2] On certiorari to the United States Supreme Court, *held,* affirmed. The pertinent regulation is designed to implement the sound public policy of keeping the Treasury out of political controversies and has acquired the force of law due to (1) reenactment without change of the code provision which the regulation interprets and (2) consistent rulings by the courts disallowing such deductions in accordance with the regulation. *Cammarano v. United States,* 358 U.S. 498 (1959).[3]

In determination of taxable income, all ordinary and necessary business expenses are deductible from gross income.[4] The expense involved in the instant case would seem to qualify as both ordinary[5] and necessary,[6] since any businessman would reasonably be expected to oppose legislation which threatens to put him out of business. Nevertheless, the deduction was denied on the basis of the interpretation of allowable ordinary and necessary business expenses found in the treasury regulations. The court in the principal case based its decision primarily on the so-called "reenactment" doctrine.[7] Courts have often stated that reenactment without change of a

[2] (9th Cir. 1951) 246 F. (2d) 751.

[3] The court also decided the companion case of Strauss v. Commissioner of Internal Revenue, 358 U.S. 498 (1959), involving an almost identical fact situation, the only differences being that in Strauss prohibition was being directly voted in at the state-wide election and the petitioner was a corporation, thereby making Treas. Reg. 103, §19.23 (q)-1, Treas. Reg. 111, §29.23 (q)-1 and Treas. Reg. 118, §39.23 (q)-1 the appropriate regulations under the 1939 code. These regulations disallowed deductions by corporations for expenses incurred in the promotion or defeat of legislation.

[4] I.R.C., §162 (a). The principal was case decided under I.R.C. (1939), §23 (a) (1) (A) which provided for the same deduction.

[5] "Ordinary" has been interpreted to mean an expense that normally would be incurred by a taxpayer in a similar business if faced with the situation. See Welch v. Helvering, 290 U.S. 111 (1933). See also Kornhauser v. United States, 276 U.S. 145 (1928), holding that attorney's fees incurred in defending claim of one partner against the other arising out of partnership of money owed was an ordinary expense of doing business. Certainly such an expense is generally not thought of as recurring, nor was there evidence that such an expense had previously been incurred. An ordinary expense may arise only once in the taxpayer's lifetime. See Deputy v. DuPont, 308 U.S. 488 (1940).

[6] The word "necessary" has been interpreted to mean appropriate or helpful. See Alverson v. Commissioner, 35 B.T.A. 482 (1937). See also Miller v. Commissioner, 37 B.T.A. 830 (1938) which held that an insurance agent expending his own money to obtain policies with a new company for his clients after his company failed was necessary to protect his business though he was under no legal or moral obligation to incur such expenses.

[7] The Court also relied upon Textile Mills Securities Corp. v. Commissioner, 314 U.S. 326 (1941), which upheld the validity of the identical regulation. However, Textile Mills is distinguishable from the principal case on three distinct grounds: in Textile there was (1) a direct appeal to Congress; (2) no danger of substantial or complete impairment of the taxpayer's business; (3) a contingent expense, the amount of which depended solely upon how much property was successfully recovered, which was deemed opprobrious by the court. Since the expenses involved in the principal case were incurred to influence the voting public rather than a group of legislators and there is no indication that such activity was undesirable in terms of any apparent policy considerations, the upholding of the regulation in Textile Mills should not necessarily control. See Holzman, "Tax Classics," 30 TAXES 149 (1952) for a discussion of the Textile Mills case and the effects of the decision.

code provision where regulations exist under which cases have been previously decided is tantamount to congressional approval of such regulations.[8] This rule has been subjected to criticism. Some courts have stated that reenactment is an unreliable indicium of congressional intent,[9] and that the regulation will not be followed if it is unreasonable[10] or inconsistent with the law under which the regulation was promulgated.[11] At most the regulations should be used as an indication to the taxpayer of the stand the Commissioner intends to take. Under such a view a court would indulge in no presumptions of congressional approval of the regulations without actual manifestations of such approval, but rather would determine the controversy before it by reference to its own view of the law. If this were done courts would have to deal with the issues presented by reference to their own views of the law, without resorting to the unrealistic reenactment doctrine to substantiate their decisions. Yet the almost overwhelming weight of authority involving similar fact situations has followed the decision in the principal case, stating that the regulation is controlling because of the reenactment doctrine.[12]

It is questionable whether the decision in the instant case is sound in terms of the policy considerations which are often inherent in disallowing

8 See Textile Mills Securities Corp. v. Commissioner, note 7 supra; Helvering v. Winmill, 305 U.S. 79 (1938); Poe v. Seaborn, 282 U.S. 101 (1930).

9 See Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955). See also 1 MERTENS, LAW OF FEDERAL INCOME TAXATION §3.24 (1954; 1959 Supp.) stating that it is absurd to indulge in the fiction that the full import of Treasury regulations is known to the members of Congress. It is similarly improbable that the legislators have actual knowledge of relevant cases applying the regulation.

10 See Commissioner v. Clark, (7th Cir. 1953) 202 F. (2d) 94.

11 Lynch v. Tilden Produce Co., 265 U.S. 315 (1924).

12 Herbert Davis, 26 T.C. 49 (1956); Revere Racing Assn. v. Scanlon, (1st Cir. 1956) 232 F. (2d) 816; McClintock-Trunkey Co., 19 T.C. 297 (1952), revd. on other grounds (9th Cir. 1954) 217 F. (2d) 329; Old Mission Portland Cement Co. v. Commissioner, (9th Cir. 1934) 69 F. (2d) 676. All of the above cases involved expenditures to influence the general voting public to vote a certain way on referendums, initiatives, etc. For cases involving influence of legislatures rather than the voting public, see Mary E. Bellingrath, 46 B.T.A. 89 (1942); American Hardware & Equipment Co. v. Commissioner, (4th Cir. 1943) 202 F. (2d) 126; Roberts Dairy Co. v. Commissioner, (8th Cir. 1952) 195 F. (2d) 948, cert. den. 344 U.S. 865 (1952); The Mosby Hotel Co., P-H T.C. Mem. Dec. ¶54,288 (1954). It has been held that expenses incurred to influence legislation are not ordinary. H. R. Cullen, 41 B.T.A. 1054 (1940), revd. on other grounds (5th Cir. 1941) 118 F. (2d) 651; The Adler Co., 10 B.T.A. 849 (1928). However, the view that such expenses are not ordinary is not generally followed. See G. T. Wofford, 15 B.T.A. 1225 (1929); Appeal of Independent Brewing Co. of Pittsburgh, 4 B.T.A. 870 (1926), which held expenses incurred in influencing legislation were deductible as ordinary and necessary business expense. See also Luther Ely Smith, 3 T.C. 696 (1944), which allowed as an ordinary and necessary business expense deduction a contribution to an organization which contemplated an amendment to the state constitution through an initiative voted upon by the people. The Commissioner acquiesced in this decision until 1958 when he withdrew his acquiescence and stated that expenditures to promote or defeat a constitutional amendment are not deductible under I.R.C., §162(a). 1958 Cum. Bul. No. 255, p. 91, Jan.-June. See generally Spiegel, "Deductibility of Lobbying Initiative and Referendum Expenses: A Problem for Congressional Consideration," 45 CALIF. L. REV. 1 (1957), for an exhaustive discussion of the problem.

deduction of certain expenses. Deductions are often said to be a matter of legislative grace,[13] and expenses which are ordinary and necessary have been disallowed when they are contrary to a clearly defined public policy.[14] Although the general question of what expenses violate public policy has engendered much confusion, the policy violations usually concern expenses incurred in carrying on some illegal activity.[15] However, disallowance of the deduction in the principal case cannot be based on an illegal activity. While perhaps at one time pressure on Congress was looked upon with sufficient disfavor by the courts to warrant such disallowance because of the undesirability of the activity,[16] the fact that Congress has chosen to regulate rather than prohibit lobbying in its own quarters[17] indicates only certain aspects of it can now be regarded as undesirable.[18] Nevertheless, the regulations disallow deductions for lobbying expense.[19] But even if it should be conceded that influencing the legislature is so undesirable that the expenses incurred thereby should be disallowed as a deduction, it does not necessarily follow that the expense incurred in the principal case should be disallowed.

13 See Deputy v. DuPont, note 5 supra; White v. United States, 305 U.S. 281 (1938); City Ice Delivery Co. v. United States, (4th Cir. 1949) 176 F. (2d) 347. Despite such statements by the courts, it is questionable whether deductions are a matter of legislative grace with regard to the income tax. Failure to allow such deductions might be a tax on property rather than on income which is beyond the scope of the Sixteenth Amendment, thereby requiring apportionment to be constitutional.

14 Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958); Black v. United States, (Ct. Cl. 1955) 129 F. Supp. 956; Commissioner v. Longhorn Portland Cement Co., (5th Cir. 1945) 148 F. (2d) 276.

15 For example, the illegal expenses of a legal business have been held to be nondeductible. An example of such expense is a fine for violation of a state statute which has been said would violate state policy if a deduction were allowed. Tank Truck Rentals, Inc. v. Commissioner, note 14 supra; Hoover Express Co. v. United States, 356 U.S. 38 (1958); Helvering v. Superior Wines & Liquors, (8th Cir. 1943) 134 F. (2d) 373. See also 59 YALE L.J. 561 (1950). *Yet* the illegal expenses of an illegal business have been allowed as deductions. Examples of such expenses are wages and rent expenditures incurred in gambling which is illegal under state law. Commissioner v. Sullivan, 356 U.S. 27 (1958); Cohen v. Commissioner, (10th Cir. 1949) 176 F. (2d) 394. However, in the Cohen case, amounts paid for protection without which a gambling establishment could not be run were held not to be a legitimate business expense and thus not deductible. See generally Schwartz, "Business Expense Contrary to Public Policy: An Evaluation of The Lilly Case," 8 TAX L. REV. 241 (1953), and note, 51 COL. L. REV. 752 (1951).

16 See Hazelton v. Scheckells, 202 U.S. 71 (1906); Trist v. Child, 21 Wall. (88 U.S.) 441 (1874).

17 This regulation is contained in the Federal Regulation of Lobbying Act, 60 Stat. 839-842 (1946), 2 U.S.C. (1952) §§261-270. The act was held valid, insofar as applicable to representations made directly to members of Congress, in United States v. Harris, 347 U.S. 612 (1954). See comment, 56 YALE L.J. 304 (1947).

18 See 98 CONG. REC. 2881 (1952), where Senator Humphrey said, ". . . There is nothing wrong in being a legitimate lobbyist—in fact it may be very desirable. . . ." Not only is some lobbying desirable, it may also be an exercise of the First Amendment rights of speech and petition. See National Association of Manufacturers v. McGrath, (D.C. D.C. 1952) 103 F. Supp. 510, vacated as moot 344 U.S. 804; United States v. Rumely, (D.C. Cir. 1952) 197 F. (2d) 166, affd. 345 U.S. 41 (1953); United States v. Harriss, note 17 supra. See also the opinion of Justice Douglas, concurring in the principal case, at 513.

19 Proposed Treas. Reg. 162-15 (c) (1956).

Arguably, the only type of undesirable influence on legislation consists of highly concentrated pressure exerted on a small group of legislators, which might unduly influence their judgment.[20] But in the instant case the pressure was no more than a broad publicity campaign, less direct in its application, aimed at persuading the voting public to vote against the measure. Despite this difference, the Court in the instant case indicates that allowance of the deduction for such expense would violate public policy because of a tax advantage which would inure to petitioners. The Court states that as purchased publicity can influence the outcome of legislation affecting the entire community, campaigners on both sides should stand on equal footing as far as tax deductions are concerned.[21] In so holding, the Court appears to be extending the use of public policy as a basis for disallowance of certain expense deductions. In the past disallowance on policy grounds generally has been predicated on either the illegality or the undesirability of the activity giving rise to the expense. By this decision, the doctrine has been extended to embrace disallowances where tax advantages might inure to a party which could be contrary to the public interest, despite the fact that the activity resulting in the expense was above reproach. The Court's opinion ignores the petitioner's policy argument that all ordinary and necessary expenses incurred in legitimate business activity should be deductible if the aggrieved taxpayer is to be treated equally with other taxpayers. The better approach would seem to be to wait until Congress expressly manifests its intent to disallow a seemingly deductible expense rather than speculating on their probable intent. In this way, decisions could be based on reasonable interpretations of relatively precise law without regard to vague notions of public policy.[22]

Robert J. Paley, S.Ed.

[20] See United States v. Harriss, note 17 supra, at 625, for a discussion of the undesirable aspects of direct lobbying. See also United States v. Rumely, note 18 supra, where at 197 F. (2d) 174 and 177, the court sharply distinguishes direct lobbying at the "buttonhole" and lobbying through the medium of public opinion with regard to the undesirable elements involved.

[21] See principal case at 513.

[22] See Paul, "The Use of Public Policy by the Commissioner in Disallowing Deductions," UNIV. OF SO. CAL. TAX INSTITUTE 715 (1954), criticizing the concept of public policy as a basis for disallowing certain expenses. See also Spiegel, "Deductibility of Lobbying, Initiative and Referendum Expenses: A Problem for Congressional Consideration," 45 CALIF. L. REV. 1 (1957), proposing congressional clarification of the problem of whether expenses incurred to influence legislation can be deducted as ordinary and necessary business expense.