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Pepper v. Commissioner, 36 T.C. ..., no. 88 (1961)

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administrative boards to be strictly within the enabling statute. The court emphasized this desire by holding invalid even those provisions which were enacted within the statutory mandate. Should the court again be confronted with an issue similar to the instant case, a comprehensive consideration of the legislative intent and all of the statutory lanuage should be undertaken. Whether the legislature intended the enabling statute to be self-executing, and the words "shall contain" to be mandatory or permissive, are the questions which the court clearly will must consider. In the meantime, however, administrative boards in promolgating regulations should do so with an eye toward the possibility that all their regulations will be declared invalid if they do not conform strictly to the enabling statute by doing everything which they might possibly be required to do or, perhaps, authorized to do.

LEO J. KOTTAS, JR.

VOLUNTARY PAYMENTS MADE TO PROTECT ATTORNEY'S BUSINESS REPUTATION ARE ORDINARY AND NECESSARY BUSINESS EXPENSES FOR FEDERAL TAX PURPOSES.—A firm of New York attorneys often acted as intermediaries in financing new businesses and going concerns. To secure money for a business the attorneys solicited clients and business associates who loaned their money on the recommendation of these attorneys. The business involved in this case, which appeared on reasonable inspection by the attorneys to be operating successfully, was really a fiction devised by a swindler. The persons solicited by the attorneys found themselves holding worthless claims for the money they advanced to the swindler. Although the attorneys had no legal obligation to repay the lost loan funds, they undertook to do so in order to protect their good will and reputation as attorneys. After repaying the loans, the attorneys deducted the amounts of such payments as business expenses under the "ordinary and necessary" clause of section 162 of the Internal Revenue Code in 1954. The Commissioner brought an action to recover additional taxes on the grounds that these were not properly deductible business expenses under that section. The United States Tax Court held that these payments were ordinary and necessary business expenses and that the deductions should have been allowed. *Pepper v. Commissioner*, 36 T.C. ......, no. 88 (1961).

The court in the principal case was confronted with the task of construing the broad terms of section 162 of the Internal Revenue Code of 1954 which states: "In computing net income there shall be allowed as deductions . . . all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[1]

To facilitate discussion of section 162 its requirements may be broken down into and raise three general questions: 1) Was the expenses incurred in carrying on any trade or business? 2) Was the expense necessary?

[1]Section 23(a)(1)(A), 1939 Internal Revenue Code. (Similar to 1954 Code Section 162(a)).

3) Was the expense ordinary? The three requirements will be discussed in the order of their appearance.

The Commissioner argued in the principal case that the "trade or business" of the attorneys was the practice of law and not the giving of investment advice. The taxpayers produced witnesses from the New York Stock Exchange and from other law firms in the metropolitan area who testified that the type of financial advice given here was commonly given by lawyers in connection with their practice. The court discusses the problem in the following excerpt:[2]

> We are here concerned with what petitioners' "trade or business" was in 1953. It is true that the practice of law comes the closest to describing petitioners' "trade or business," yet nowhere in the Code, regulations, or decided cases is there auhority for stereotyping the profession. There is more to the modern day practice of law than just reading cases, writing briefs and appearing in trials. There are many things that are not in the purest sense the practice of law, nevertheless, they are so integrally connected with it as to be inseparable from it. An attorney may entertain a client or prospective client. Certainly, that is not what one would ordinarily think of as the practice of law, yet there is little doubt that it may be an ordinary and necessary expense which arises out of his trade or business. Review of the many decided cases is of little aid since each case turns on its own facts.

In support of its position that the financial advice arose out of taxpayer's trade or business, the court pointed out that approximately $13,000 in fees had been collected by the attorneys as a result of the legal business derived from the promoter behind this alleged corporation. The determination of the "trade or business" clause in favor of the taxpayer in this case is consistent with the generally broad construction which has been given to this clause of section 162.[3]

The decision that an attorney engaged in giving financial advice is acting within his "trade or business" as a lawyer may appear somewhat surprising to members of the Montana Bar. In view of the relative infrequency of this type of advice in Montana law practices it could be questioned whether a similar decision would be reached should a case arise involving a Montana taxpayer-attorney involved in such a practice. The fact that New York City is the hub of financial activity may be of great significance on this issue.

The court had no problem in determining that the expense in this case was a "necessary" one. As a general proposition, an expense will be considered "necessary" if it is appropriate and helpful in developing and maintaining the taxpayer's business.[4] Because of the presumption that an expenditure would not be made unless it was required, the court is reluctant to substitute its judgement for the taxpayer's decision on this matter.[5] The court disposed of the question with this brief comment:[6]

[2]Instant case at 3041.
[3]4 MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.09 (1960).
[4]Welsh v. Helvering, 290 U.S. 111 (1933).
[5]*Ibid.*
[6]Instant case at 3041.

> We may assume that the payments to the creditors of Plymouth Creations [the alleged business] were necessary, at least in the sense that they were appropriate and helpful. The petitioners certainly thought they were and we should be slow to override their judgment.

The court found the greatest difficulty with the question of what is involved in the term "ordinary" as it is used in this section. It is to that point that this article will be directed. Although the words "ordinary and necessary" have habitually been used as a unitary concept, when the elements have been distinguished, the courts have generally found the greater amount of difficulty with the former.[7] Repetition or frequency of occurrence to the taxpayer is not a valid criteria according to the Supreme Court:[8]

> Now what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. 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.

As is often the case with words of general meaning, there is no established criteria for measuring the exact limits of what is "ordinary" to a particular business. Mr. Justice Cardozo pointed this out when he characteristically stated:[9]

> One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

The court in the principal case seemed to follow (either consciously or unconsciously) the suggestion of Cardozo that only the fullness of life can supply the answer. The court took special note of the fact that petitioners conferred with other attorneys as to what they should do in this situation, and noted that the petitioners felt so strongly about the necessity for repayment that they borrowed large sums of money to make the payments. Payments made in the protection of an established business are fully deductible as ordinary business expenses.[10]

The Commissioner next attacked the deduction on the basis of its being a voluntary payment, not in any way a legal requirement. Apparently this was once a valid criteria for determining whether an expense was ordinary. In the *Welsh* case[11] the court made the following statement with respect to volunteer payments:[12]

> Men do at times pay the debts of others without legal obligation or the lighter obligation imposed by the usages of trade or by

[7]4 MERTENS, LAW OF FEDERAL TAXATION § 25.09 n.73 (1960).
[8]Welsh v. Helvering, 290 U.S. 111, 113 (1933).
[9]*Id.* at 115.
[10]L. Heller & Sons, Inc., 12 T.C. 1109 (1949); Commissioner v. Heininger, 320 U.S. 467 (1943).
[11]Welsh v. Helvering, 290 U.S. 111 (1933).
[12]*Id.* at 114.

neighborly amenities, but they do not do so ordinarily, nor even though the result might be to heighten their reputation for generosity and opulence. Indeed, if language is to be read in its natural and common meaning, we should have to say that payment in such circumstances, instead of being ordinary is in a high degree extraordinary. There is nothing ordinary in the stimulus evoking it, and none in the response.

Despite this rather strong language, and that appearing in later cases,[13] the rule stated in the *Welsh* case is no longer recognized as controlling by the tax courts. The now accepted view is that:[14]

> [T]here is no requirement that there must be an underlying legal obligation to make an expenditure before it can qualify as an "ordinary and necessary" business expense under section 23(a)(1), Internal Revenue Code of 1939. The basic question is whether, in all the circumstances, the expenditure is ordinary and appropriate to the conduct of the taxpayer's business.

Thus stated, volition becomes only one of the factors to be determined in arriving at a conclusion as to whether a deduction is allowable under the "ordinary and necessary" clause. The true measure seems closer to the "fullness of life" idea expressed by Cardozo than it does to anything as absolute as the distinction between voluntary and non-voluntary payments.

That the expense was "ordinary and necessary" when judged by the "fullness of life" criteria is shown by the testimony of an attorney who had invested in the phantom business and who described petitioner's obligation to repay in this manner:[15]

> Q. By that, you mean a moral obligation?
>
> A. I certainly mean a moral obligation, but I think I mean more than that. I think there is a legal responsibility on Mr. Pepper. I think that he was legally obligated to pay that money.

Petitioner himself testified as to his feeling of the importance of repaying this money:[16]

> We decided that it was imperative if we were to save our practice, our law practice, that we should prevent those people who had outstanding loans to Plymouth Creations from losing their money. We decided the only way that could be done was by repaying those loans ourselves. We decided that unless we paid these loans, we would lose our practice; we would lose our clients; it would be impossible for us to continue as lawyers in New York City.

[13]W. F. Young, Inc. v. Commissioner of Internal Revenue, 120 F.2d 159, 166 (1st Cir. 1941); White v. Commissioner of Internal Revenue, Pollard v. Same, 61 F.2d 726 (9th Cir. 1932); Sam Wallingford Grain Corp. v. Commissioner of Internal Revenue, 74 F.2d 453 (10th Cir. 1934); Robinson v. Commissioner of Internal Revenue, 53 F.2d 810 (8th Cir. 1931); National Piano Manufacturing Co. v. Burnet, 50 F.2d 310 (D.C. Cir. 1931).

[14]Waring Products Corp. v. Commissioner, 27 T.C. 921, 929 (1957).

[15]Instant case at 3042.

[16]*Ibid.*

The business of an attorney involves the highest degree of personal confidence and the ultimate in fiduciary relationship. Since this relationship is so important to the lawyer, expenditures made to preserve and protect it should fall squarely within the "ordinary and necessary" clause of section 162.

The case of *Miller v. Commissioner*[17] is indistinguishable in principle from the instant case. In that case the taxpayer was an insurance broker who represented twelve different insurance companies. The broker did not purport to represent any particular company or companies, but took orders from his customers and placed them with a company which the broker would select. One of the companies which he represented became bankrupt and was unable to pay several matured claims, and the policies placed with that company by the broker were worthless. The broker paid off the claims and replaced the outstanding insurance with other companies, paying for the premiums from his own pocket. The taxpayer-broker took deductions for these two outlays as "ordinary and necessary" business expenses. The court, noting that the success of a business such as this depends largely on the personal confidence which the customers have in the insurance broker, agreed with the taxpayer's contention that the payments were properly deductible as an ordinary and necessary business expense.

A more compelling argument can be made for allowing these deductions to attorneys. Without doubt, the personal relationship in an attorney-client association is a more personal relationship than that of an insurance broker with his customer. This is shown by the fact that the law of evidence makes communications between an attorney and his client privileged from disclosure.[18] In addition, an attorney is prohibited by the canons of ethics from actively soliciting business through advertising.[19] Any loss of prestige which an attorney might suffer from recommending investments would not be combated by advertising. Probably no business is so susceptible to destruction by rumor than is a lawyer's practice.

In *Dunn & McCarthy v. Commissioner*[20] the court went one step further. In that case, salesmen of the taxpayer company made loans to the president of the company for his personal use. The president of the company became hopelessly insolvent and committed suicide, leaving his debts unpaid. The taxpayer company repaid the loans to protect against loss of some of its top salesmen and the payments were considered "ordinary and necessary" business expenses.

These two cases illustrate the liberal interpretation which the courts have given the "ordinary and necessary" clause. As one court said:[21]

> It is evident that the words "ordinary" and "necessary" in the statute are not used conjunctively, and are not to be construed as requiring that an expense of a business to be deductible must be both ordinary and necessary in a narrow, technical sense. On the contrary, it is clear that Congress intended the statute to be

[17]37 B.T.A. 830 (1938), *nonacq. withdrawn*
[18]American Bar Association, Canons of Professional Ethics, Canon 27 (1936).
[19]8 WIGMORE, EVIDENCE : 2290 *et. seq.* (McNaughton revision, 1961).
[20]139 F.2d 242 (1943).
[21]Harris v. Lucas, 48 F.2d 187, 188 (1931).

broadly construed to facilitate business generally, so that any necessary expense, not actually a capital investment, incurred in good faith in a particular business, is to be considered an ordinary expense of that business. This in effect is the construction given the statute by the Treasury Department and the courts.

But the courts have drawn a line beyond which they have refused to go. In the oft-cited *Friedman* case[22] (relied upon heavily by the Commissioner in the principal case) an attorney had deposited $5,000 of his own money in court as part of an attempted composition of creditors settlement for his client. He had used his own money because he had assured several of the creditors that the money would be so deposited, and when his client failed to make the deposit he felt morally obligated to do so. The composition failed and the court refused to return Friedman's money. Friedman attempted to obtain the return of the money, but having failed, he filed a document forfeiting the money to his client's trustee in bankruptcy. When he attempted to take the deduction for that amount as an "ordinary and necessary" business expense he court balked saying:[23]

> That the circumstances of the taxpayer's payment preclude its being considered either an "ordinary and necessary expense" of his business or a loss incurred in business is clear both from the Regulations promulgated under the Internal Revnue Code and the construction Section 23(a)(1) and Section 23(e)(1) have received by the Courts. . . .
>
> The moral obligation which the taxpayer recognized here, to his financial detriment, was an extra-professional liability which resulted in a loss which is certainly not clearly covered by Section 23(a)(1) according to the accepted construction of that section.

While the factual situation in the *Friedman* case differs in some important aspects from that of the instant case, the court in the *Friedman* case indicated that it would have allowed the deduction even in that case had it not been for the fact that Friedman had a chance to get the money out without loss *after* he had complied with his moral obligation to pay it in initially. Chief Judge Magruder, after explaining how the money came to be paid into court, stated:[24]

> If these were all the relevant facts, I should hate to have to hold that the payment of $5000 by Friedman under the circumstances stated was not an "ordinary and necessary" expense paid in carrying on his professional business. The statutory language is pretty flexible.

The definition and concept of "ordinary and necessary," relied on and applied in the *Miller* and *Dunn & McCarthy* cases lead to the inevitable conclusion that the decision in the instant case is entirely correct on the question of "ordinary and necessary" business expenses. Even applying the limitation set forth in the *Friedman* case, it appears that the decision of the principal case is unimpeachable.

[22]Friedman v. Delaney, 171 F.2d 269 (1948).
[23]*Id.* at 271.
[24]*Id.* at 273.

Best: Pepper v. Commissioner

In the *Pepper* case the taxpayer set forth an alternative plea for deduction on the basis of treating the transaction as a business or non-business bad debt. While the decision in the case was based upon the deduction as an ordinary and necessary business expense, it may be worthwhile to examine the alternative claim also.

To allow a deduction for a bad debt there must first exist a valid bona fide debt owing to the taxpayer.[25] That is to say, the money must have been advanced with a reasonable belief that it would be repaid. A taxpayer who purchases an obligation under circumstances which indicate that there is no reasonable hope of recovering a substantial part of the consideration paid may not claim the cost as a bad debt.[26]

Applying these rules of law to the facts of the present case, it is easy to see why the court did not consider the possibility that such a deduction was allowable. At the time Pepper and Siegel took an assignment of the creditors' rights against the swindler they knew that there was no possibility of a "substantial recovery." The corporation (which was actually the debtor) represented nothing more than the alter ego of one man—the swindler—who had been sentenced to prison for his activities in fraudulently securing the financing. The wife, mother, and sister-in-law of the swindler had pledged all their personal assets to Pepper and Siegel (who were at the time acting for the benefit of all creditors), and they knew that the assets were of no substantial value. In fact, a check and note given as part of this pledge were dishonored. In the light of these facts it is little wonder that a final accounting of the corporation by the trustee in bankruptcy showed liabilities in excess of $625,000 and no assets capable of liquidating these debts. The debt which existed at the time it was purchased by the attorneys was worthless and could not qualify as a bad debt deduction.

The report of this case does not indicate why the Commissioner did not contend thta the debt represented a capital asset upon which the taxpayer could not take a loss until there had been the required "sale or exchange."[27] Certainly the debt seems to fit the statutory definition of "capital assets" which includes all things except those expressly enumerated.[28]

Assuming for the moment that the debt could be considered a capital asset, how might it have been treated here? As mentioned above, the general requirement is that no deduction can be taken on a capital asset until there has been a sale or exchange. Since there was no sale or exchange in this case, no such loss would be available. There is one situation by which this asset may have been converted into an ordinary loss even in the absence of this "sale or exchange" requirement. If it can be said that the taxpayer voluntarily abandoned this property and considered it

[25]5 MERTENS, LAW OF FEDERAL INCOME TAXATION § 30.03 (1956).
[26]Caroline D. Thompson, 22 T.C. 507 (1954). For a complete discussion of the effect of obtaining a debt known to be worthless see Standard Oil Co. of New Jersey v. Commissioner, 11 T.C. 843 (1948).
[27]3B MERTENS, LAW OF FEDERAL INCOME TAXATION § 22.91 (1958).
[28]INT. REV. CODE OF 1954, § 1221. See also §§ 1232, 1235, 1241 which list exceptions to the "capital asset" category.

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as worthless, then an ordinary loss might be claimed.[29] "In contrast to a capital transaction which in the event of loss produces a capital loss, an abandonment of property results in an ordinary loss because of the absence of a sale or exchange."[30] Whether there has been an abandonment of property depends upon the intention of the owner, coupled with the act of abandonment, both to be ascertained from all the facts and circumstances.[31]

Two elements cast doubt on any treatment of this debt as an abandoned asset. First, it may be that the debt is not a capital asset at all for the same reason that it is not a deductible bad debt—it had no value at the time it was obtained.[32] Certainly it would be stretching the usual concept of "asset" to include within that term a thing *known* to have no market value. Even if we can justify the fact that this debt was known to be valueless at the time it was acquired, there is still a second problem—was it abandoned? Certainly there is no statement in the facts which would justify a conclusion that the taxpayers voluntarily abandoned this property. If we pass the first hurdle by determining that the debts are assets, but fail to find an abandonment there would be no taxable transaction. The taxpayers would have on their hands an asset of questionable value upon which would result in no tax consequences until there was either a sale or some act indicating an abandonment. This would have defeated any possible claim for a tax deduction by the attorneys prior to a sale or abandonment.

Thus limited, the Tax Court had but one alternative—either allow the deduction as an ordinary and necessary business expense or disallow it on any grounds. It is submitted that upon the facts and law applicable, the decision of the court was correct in allowing these payments as a deduction of an "ordinary and necessary" business expense.

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[29]See Internal Revenue Regulation 118, Section 39.23 (e)-3(a). This regulation also requires some unforseen cause by reason of which the property has been prematurely abandoned. The cases indicate that its application has been limited largely to abandoned real property.
[30]3B MERTENS, LAW OF FEDERAL INCOME TAXATION § 22.93 (1958).
[31]Talche Mines, Inc. v. U.S., 218 F.2d 491 (9th Cir. 1954).
[32]No cases have been found in which the court discussed the question of whether an "asset" must have some actual value. This proposition is submitted as a plausible theory.