

Before any part of MOP's claim would be subordinated in connection with dividends paid by NOTM, it would have to be found that the loans forming the basis for this part of the claim were for the purpose of permitting, or at least necessary to, the dividend payments, and not for some other purpose, such as the refunding of previous capital expenditures for improvements and betterments. Rather, MOP's claim should have been subordinated to the amount of NOTM's unwarranted dividends and the subordination should have been clearly based on the payment of the dividends rather than the loans.<sup>41</sup>

The test of whether an independent management would have consented to the intercorporate transactions provides needed protection for creditors and public stockholders of subsidiaries. Its underlying concept of a strict fiducial bond is in step with the increasing judicial recognition of the separation between corporate ownership and control<sup>42</sup> and the consequent duty owed by management to stockholders. Flexibly applied to require responsible management for the subsidiary, the *Deep Rock* doctrine can equitably resolve the conflict of interests in the holding company structure.

## TAX DEDUCTION OF THE EXPENSES OF MISMANAGEMENT BY FIDUCIARIES\*

CONGRESS, seeking to tax an approximation of "net" rather than "gross" income, has long allowed a tax deduction for "ordinary and necessary" business expenses, now embodied in Section 23(a) (1) of the Internal Revenue Code.<sup>1</sup> At first, "business" was construed to include any activity entered into for gain.<sup>2</sup> But recently judicial interpretation became more

41. Cf. *Indiana Service Corp.*, SEC Holding Company Act Release No. 7054, December 14, 1946: "[U]tilities states that there is no evidence that such advances were made in whole or in part for dividend purposes. While Utilities contends this, we do not believe that there is any necessity to trace cash since the point is that the dividends should not have been paid." *Id.* at 33-4.

42. See BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 69-125 (1932).

\* *Commissioner v. Josephs*, 168 F.2d 233 (8th Cir. 1948), *cert. denied*, 335 U.S. 871 (1948).

1. The Revenue Act of 1913, 38 STAT. 167, § IIB, allowed as a deduction "the necessary expenses actually paid in carrying on any business." By 1918 the present form was fixed: "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 . . ." 40 STAT. 1066, § 214 (a) (1) (1918), INT. REV. CODE § 23(a) (1).

2. O.D. 537, 2 CUM. BULL. 175 (1920) (expenses having reasonable relation to collection of income due an estate are deductible from gross income of estate), *revoked*, I.T.

rigid: in 1941 the Supreme Court disallowed the deduction of payments made in the management of a taxpayer's own investments, on the ground that such an activity was not a "business."<sup>3</sup> This decision was nullified when in 1942 Congress added Section 23(a) (2) to the Internal Revenue Code, to allow the deduction of "ordinary and necessary" expenses "paid . . . for the production . . . of income or for the management . . . of property held for the production of income," whether or not connected with the taxpayer's business.<sup>4</sup> Yet two recent circuit court decisions, for differing reasons, have denied to non-professional fiduciaries deductions which their professional counterparts have been granted.

The distinction between the two types of fiduciaries for tax purposes originated prior to the passage of 23(a) (2), in cases dealing with a trustee's deduction of amounts paid to terminate a suit alleging mismanagement. On the one hand, the taxpayer was allowed deductions for such expenses where his fiduciary activities were of a scope large enough to constitute a regular business.<sup>5</sup> But where the fiduciary activity was only occasional, the deduction was denied on the ground that the settlement was not related to a "business."<sup>6</sup>

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3492, 1941-2 CUM. BULL. 187 (1941); O.D. 877, 4 CUM. BULL. 123 (1921) (rent of office and cost of clerical help deductible from private investment income if reasonably related to production or collection of that income), revoked, I.T. 3452, 1941-1 CUM. BULL. 205 (1941). For discussion of these and other early liberal Bureau constructions, see Brodsky and McKibbin, *Deduction of Non-Trade or Non-Business Expenses*, 2 TAX L. REV. 39, 40-1 (1946).

Cf. *Flint v. Stone-Tracy*, 220 U.S. 107 (1911) (Corporation Tax Law of 1909).

3. Apparently the announced policy of the Bureau was applied inconsistently, for a conflict appeared among the circuits on the question whether management of a taxpayer's own securities was a "trade or business." *Higgins v. Comm'r*, 111 F.2d 795 (2d Cir. 1940) (not a business); *Kales v. Comm'r*, 101 F.2d 35 (6th Cir. 1939) (business); *DuPont v. Deputy*, 103 F.2d 257 (3d Cir. 1939) (business).

The conflict was settled by the Supreme Court's decision in *Higgins v. Comm'r*, 312 U.S. 212 (1941) (not a business). Two immediately following cases confirmed the Court's strict interpretation, *City Bank Farmers Trust Co. v. Helvering*, 313 U.S. 121 (1941) (trustee managing investments not engaged in business); *United States v. Pyne*, 313 U.S. 127 (1941) (executor managing investments not engaged in business).

See discussion in Nahstoll, *Non-Trade and Non-Business Expense Deductions: Section 23(a)(2) of the Internal Revenue Code*, 46 MICH. L. REV. 1015 *et seq.* (1948); Brodsky and McKibbin, *supra* note 2, at 41; Comment, 34 CALIF. L. REV. 212 (1946).

4. "In computing net income there shall be allowed as deductions . . . in the case of an individual, all 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." Revenue Act of 1942, § 121, 56 STAT. 819 (1942), INT. REV. CODE § 23(a) (2).

The courts have often referred to the *Higgins* case as directly responsible for the enactment of Section 23(a) (2), *e.g.*, *McDonald v. Comm'r*, 323 U.S. 57, 61 (1944); *Bowers v. Lumpkin*, 140 F.2d 927, 928 (4th Cir. 1944), *cert. denied*, 322 U.S. 755 (1944).

5. *John Abbott*, 38 B.T.A. 1290 (1938); *Bishop Trust Co.*, 47 B.T.A. 737 (1942).

6. *Stuart v. Comm'r*, 84 F.2d 368 (1st Cir. 1936), *aff'g* 32 B.T.A. 574 (1935), *cert. denied*, 299 U.S. 575 (1936); *Stephen H. Tallman*, 37 B.T.A. 1060 (1938).

While the courts might well have interpreted the broad wording of 23(a) (2) as abolishing this distinction, they have not done so. In *Edward W. Clark*,<sup>7</sup> the Tax Court held that expenses were deductible as "paid for the production of income" only when actually prerequisite to production of income,<sup>8</sup> and excluded from this category the expense of defending a suit for mismanagement. This thesis was undermined by dicta in *Trust of Bingham v. Commissioner*,<sup>9</sup> where the Supreme Court, allowing deduction of expenses incurred in the management of income-producing property stressed that 23(a) (2) should be interpreted *in pari materia* with the provision of 23(a) (1) permitting business deductions.<sup>10</sup> In *Julius A. Heide*,<sup>11</sup> the Tax Court, applying the *Bingham* reasoning to compromise settlements of mismanagement suits, discarded its *Clark* rule on the ground that a professional fiduciary is allowed a deduction for such expenses under 23(a) (1).<sup>12</sup> The Court of Appeals for the Second Circuit, however, was not swayed by the *Bingham* dicta. Although refraining from a return to the *Clark* rule, that court reversed the Tax Court's *Heide* decision, opining that expenditures occasioned by the trustee's negligence could not be construed as "ordinary and necessary" for the production of income.<sup>13</sup> Assuming that the compromise settlement indicated Heide's negligence,<sup>14</sup> the court held that the resulting expense could not be deducted for tax purposes. The negative implication was that in the absence of negligence or wilful misfeasance expenses incurred in defending mismanagement suits would be deductible, even though the expenses were not prerequisite to the production of income.

Regardless of the merits of its negligence theory, the Second Circuit seems to have attached undue significance to Heide's compromise settlement. A compromise legally settles neither rights nor liabilities.<sup>15</sup> If deductibility is to depend on the question of negligence, therefore, the issue should normally be raised *de novo* when a deduction is sought,<sup>16</sup> and not inferred, as in the *Heide* opinion, from the mere fact of the compromise settlement.

7. 2 T.C. 676 (1943).

8. "Obviously the expense [\$1250 expended in defense of suit for mismanagement] was not paid or incurred 'for the production or collection of income.' No income was produced by the expenditure, nor was any collected." *Edward W. Clark*, 2 T.C. 676, 679 (1943). Cf. Samuel E. Jacobs, T.C. Memo. Op., Dkt. No. 108681 (1943).

9. 325 U.S. 365 (1945); see 58 HARV. L. REV. 1254; 1 TAX L. REV. 105 (1945).

10. 325 U.S. 365, 373 (1945).

11. 8 T.C. 314 (1947).

12. *Id.* at 317.

13. *Comm'r v. Heide*, 165 F.2d 699 (2d Cir. 1948).

14. "[T]he expenses so deducted . . . should not be such as he interposes himself, as little so, when his attention has flagged as when he has been deliberately unfaithful to his trust." *Id.* at 701.

15. *Waltz v. Ellinghouse*, 165 F.2d 596, 601-3 (8th Cir. 1948), and cases there cited.

16. Cf. *Levitt & Sons v. Nunan*, 142 F.2d 795 (2d Cir. 1944); *International Shoe Co.*, 38 B.T.A. 81, 95 (1938). *But cf.* *Jerry Rossman Corp.*, 10 T.C. 468 (1948); *Comm'r v.*

Perhaps because of the practical difficulties inherent in such a *de novo* trial of an issue already settled amicably by the parties, the Court of Appeals for the Eighth Circuit rejected the *Heide* rule in *Commissioner v. Josephs*.<sup>17</sup> But instead of following the Tax Court's interpretation of the *Bingham* dicta, the court in effect reverted to the *Clark* rule. A deduction for compromise settlement of a mismanagement suit, it held, could not be allowed because the expenses did not stem from conditions which "stand in the path of" the production of income.<sup>18</sup>

Both the *Heide* and *Josephs* decisions, which rest on strict constructions of "ordinary and necessary expense paid for production of income," seem contrary to the clear intent of Congress in its enactment of a section specifically designed to supplement 23(a) (1).<sup>19</sup> Under 23(a) (1), which similarly permits deduction of "ordinary and necessary expenses paid or incurred in carrying on a trade or business," expenses of defending suits for mismanagement by a professional fiduciary have been deductible even where stemming from negligent or fraudulent breach of fiduciary duty.<sup>20</sup> The only litigation

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Longhorn Portland Cement Co., 148 F.2d 276 (5th Cir. 1945), *cert. denied*, 326 U.S. 728 (1945).

17. 168 F.2d 233 (8th Cir. 1948), *reversing* 8 T.C. 583 (1947), *cert. denied*, 335 U.S. 842 (1948).

*Josephs*, primarily engaged in the scrap iron business, had agreed to serve as co-administrator of a friend's estate, on condition that he should receive compensation for his services. Nine years later, several of the heirs, disgruntled with the management of the family business, charged the administrator with neglect, and asked damages of \$300,000. The dispute was settled by agreement, *Josephs* paying \$10,000 in full settlement of any liability he might have. *Josephs* sought to deduct this \$10,000, plus \$1,500 attorneys' fees paid in connection with the litigation.

The dispute originated with a petition asking for an accounting and other relief filed by the heirs. Since *Josephs* had entered upon his office as administrator with the expectation of realizing income and the expenses were a direct result of his activity as administrator, the Tax Court regarded it as immaterial that after the controversy arose, he agreed to forego the compensation and fees to which he was entitled in order to promote a settlement, 8 T.C. 583 (1947). The Eighth Circuit did not question this interpretation, *Comm'r v. Heide*, 168 F.2d 233 (8th Cir. 1948).

18. "[I]t was not enough that an expense be incurred in carrying on the trust; . . . to be allowable as incurred for the production of income, the expense must be one resulting 'from conditions which stand in the path of' the production of income." 168 F.2d 233, 237 (8th Cir. 1948).

19. Note 22 *infra*.

20. *Kornhauser v. United States*, 276 U.S. 145 (1928) (accounting); *Central Trust Co. v. Burnet*, 45 F.2d 922 (D.C. Cir. 1930) (fraud); *Great Island Holding Corp.*, 5 T.C. 150 (1945), *acq.*, 1945 CUM. BULL. 3 (1945) (mismanagement); *John Abbott*, 38 B.T.A. 1290 (1938) (mismanagement); *Henry F. Cochrane*, 23 B.T.A. 202, 208 (1931) (mismanagement); I.T. 1853, II-2 CUM. BULL. 124 (1923) (amounts paid to compromise action for breach of fiduciary duty deductible); O.D. 1091, 5 CUM. BULL. 139 (1921) (same). *Cf.* S.M. 4078, V-1 CUM. BULL. 226 (1926) (malpractice); *Anderson v. Comm'r*, 81 F.2d 457 (10th Cir. 1936) (negligence); *International Shoe Co.*, 38 B.T.A. 81 (1938), *acq.*, 1938-2 CUM. BULL. 17 (1938) (conspiracy to injure); *Helvering v. Hampton*, 79 F.2d 358 (9th Cir. 1935) (fraud), where the court stated: "We cannot agree that private wrongdoing in

payments for which deductions have been disallowed despite direct relation to a business activity are those incurred by way of statutory fine or penalty, a decision based on "public policy."<sup>21</sup> Thus both the *Heide* and *Josephs* decisions would have been contrary to the line of precedent if those cases had involved professional fiduciaries.

Congress having inserted Section 23(a) (2) in the Internal Revenue Code to remedy the inequitable treatment of non-business income under the then existing law,<sup>22</sup> the expenses of innocent mismanagement by a casual,

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the course of business is extraordinary within the meaning of the taxing statute allowing deductions for 'ordinary and necessary expenses.'" *Id.* at 360.

Amounts paid in settlement of any liability for mismanagement occasionally have been held deductible as losses not compensated by insurance or otherwise, under Section 23(e) (individuals) or Section 23(f) (corporations), *e.g.*, *Robert S. Farrell*, 44 B.T.A. 238 (1941); *Bishop Trust Co.*, 47 B.T.A. 737 (1942). But the "loss" argument more often is dismissed summarily, *Kornhauser v. United States*, 276 U.S. 145, 152 (1928); *Levitt & Sons v. Nunan*, 142 F.2d 795, 798 (2d Cir. 1944); *Hales-Mullaly v. Comm'r*, 131 F.2d 509, 512 (10th Cir. 1942); *B. M. Peyton*, 10 B.T.A. 1129 (1928).

21. At first the Treasury took the position that payments of statutory fines imposed for negligence or delinquency were deductible, L.O. 926, 1 CUM. BULL. 241 (1919). But at present no amount paid as a statutory fine or penalty is deductible as an "ordinary and necessary expense," *e.g.*, *Jerry Rossman Corp.*, 10 T.C. 468 (1948) (Emergency Price Control Act); *Comm'r v. Longhorn Portland Cement Co.*, 148 F.2d 276 (5th Cir. 1945), *cert. denied*, 326 U.S. 728 (1945) (state anti-trust act); *Standard Oil v. Comm'r*, 129 F.2d 363 (7th Cir. 1942), *cert. denied*, 317 U.S. 688 (1942), *rehearing denied*, 319 U.S. 784 (1943) (Sherman Act); *Universal Atlas Cement Co.*, 9 T.C. 971 (1947) (state anti-trust act); Note, 54 HARV. L. REV. 852 (1941).

But attorneys' fees and other expenses of such suits now are deductible, whether or not the defense is successful, *Comm'r v. Heininger*, 320 U.S. 467 (1943); *Comm'r v. Longhorn Portland Cement Co.*, *supra*, *acq.*, 1944 CUM. BULL. 18 (1944); *Universal Atlas Cement Co.*, *supra*; *Lynch, Legal Expenses as Deductions from Income*, 12 FORD. L. REV. 8 (1943); Note, 57 HARV. L. REV. 109 (1943).

22. "Under existing law taxpayers are allowed to deduct expenses incurred in connection with a trade or business. Nontrade or nonbusiness income, however, is also subject to tax. It would therefore be equitable to provide for the deduction of expenses incurred in the production of such nontrade or nonbusiness income." Statement of Randolph Paul, Tax Adviser to the Secretary of the Treasury, *Hearings before Committee on Ways and Means on Revenue Revision of 1942*, 77th Cong., 2d Sess. 80, 88 (1942).

"The existing law allows taxpayers to deduct expenses incurred in connection with a trade or business. Due partly to the inadequacy of the statute and partly to court decisions, nontrade or nonbusiness expenses are not deductible, although nontrade or nonbusiness income is fully subject to tax. The bill corrects this inequity by allowing all of the ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. Thus, whether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income, it is allowable." H.R. REP. No. 2333, 77th Cong., 2d Sess. 46 (1942). See further, 88 CONG. REC. 6376 (1942); *Brodsky and McKibbin*, *supra* note 2.

Thus the Treasury sought to have Congress remove the inequity created by its own labor. If it had permitted the continuance of a liberal interpretation of "business," see note 2 *supra*, no problem would have arisen. This type of governmental nearsightedness has been roundly criticized. See Maguire, *Federal Revenue—Internal or Infernal?*, 21 TAXES 77,

or non-professional, fiduciary under 23(a) (2) should receive the same treatment accorded the similar expenses of a professional fiduciary under 23(a) (1). The House and Senate reports indicate that "ordinary and necessary" as used in 23(a) (2) should be interpreted by the judicial test applied under (23)(a) (1), that the expenses "must be reasonable in amount and bear a reasonable and proximate relation to" the production of income.<sup>23</sup> And the Supreme Court has declared that 23(a) (2) provides for a class of non-business deductions coextensive with the business deductions allowed by 23(a) (1), in that "ordinary and necessary" is to be similarly construed.<sup>24</sup>

The inequity which Congress intended to eliminate becomes apparent when one considers the fairly common court practice of appointing an individual and a trust company to act as co-administrators of an estate. If a suit for innocent mismanagement arises and is settled, then the professional trust company can deduct its payments, while the individual, carrying on what for him is an isolated transaction, can not. Once the requirement is made that the "non-business" expense be directly prerequisite to the production of income if it is to be deductible, the casual trustee loses deductions not only for expenses in terminating a mismanagement suit, but possibly also for the expenses of determining income tax liability<sup>25</sup> and even for the costs incurred in successfully defending a mismanagement suit.

There is no public policy which forbids deduction of mismanagement expenses. Fiduciary negligence would not be encouraged: few fiduciaries would be delinquent solely because, if sued and held liable, they could get a tax deduction partially offsetting their loss. Even if there were a temptation, it would not justify different treatment for casual as opposed to professional fiduciaries. There should be no distinction made here in view of the clear Congressional intent to make connection with the taxpayer's "business" immaterial.

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123 (1943); Griswold, *An Argument Against the Doctrine that Deductions Should Be Narrowly Construed As A Matter of Legislative Grace*, 56 HARV. L. REV. 1142, 1147 (1943). The *Josephs* and *Heide* cases indicate that the Bureau is now fighting its way towards the re-establishment of at least part of the inequity it so recently asked Congress to remove.

23. H.R. REP. No. 2333, 77th Cong., 2d Sess. 75 (1942); SEN. REP. No. 1631, 77th Cong., 2d Sess. 88 (1942). This test was subsequently promulgated by the Treasury Department as a guide to the interpretation of Section 23(a) (2), U.S. Treas. Reg. 111, § 29.23(a)-15 (1942).

24. *Bingham v. Comm'r*, 325 U.S. 365, 374 (1945). See p. 783 *supra*.

25. Expenses of determining income tax liability are at present deductible, provided that the litigation arises from a transaction which was originally entered into for profit. *Howard E. Cammack*, 5 T.C. 467 (1945); *Charles N. Manning*, 3 T.C. 853 (1944), *aff'd*, 148 F.2d 821 (6th Cir. 1945); U.S. Treas. Reg. 111, § 29.23(a)-15 (1945).