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THE LINCOLN ELECTRIC COMPANY CASE *

A "REASONABLE" TAX DEDUCTION MAY BE A SURREPTITIOUS STRIDE TOWARD TOTALITARIANISM

WIRT PETERS **

Most of us are accustomed to accepting taxes, particularly income taxes, as simply a necessary revenue-raising expediency of the government. With a taxpayer’s incipient naivete we confidently believe that the administration of the revenue laws is an independent activity entirely unaffected by any party’s political theories or social policies. As an average citizen we will not be easily persuaded that an obscure insinuation of a single idea into a brief phrase of the tax statute, especially the interpolation of such an innocuous word as reasonable, possibly could be tremendously significant with many, perhaps insidious, implications.

Whenever any consideration is given to any of the other possible aspects of taxation it is usually the general economic results which receive the most attention, such as the abstract effect of taxes upon profits, prices, or wages, and upon theoretical business conditions prospectively. Occasionally, taxes are discussed in their relation to political concepts, and less frequently with reference to social consequences. However, when these possibilities are explored it is usually with hypothetical situations and in the general terms of broad principles. We, nevertheless, nonchalantly believe that if some specific result is desired or a particular policy is to be pursued it will be accomplished publicly and deliberately in the Halls of Congress by the duly elected representatives of a sovereign people.

Seldom has it been possible to consider so many significant implications in connection with the decision of a single comparatively obscure issue as is now presented by the case of The Lincoln Electric Company.

BACKGROUND OF THE CASE

The Lincoln Electric Company manufactures and sells electric arc welding machines, electrodes and welding supplies, with its office and plant in Cleveland, Ohio.

In 1934, in discussion with its employees, there emerged a proposal for an annual bonus. Eighty-five percent of the employees operate on a piece-work rate, scientifically ascertained, fixed and guaranteed for each year and

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the employee is paid in accord with what he produces, without restriction upon
the amount of his production. The base pay of other employees whose
duties are not susceptible of piecework treatment is the same or slightly higher
than the prevailing wage rate paid by manufacturing industries in the com-
munity for similar services. In 1940 the cash bonus paid the employees ap-
proximated 100% of their base pay, about a year's wages.

In 1936, at the suggestion of the Employees' Advisory Board, the com-
pany added an employees' retirement annuity policy which was purchased
from the Sun Life Insurance Company of Canada and premiums were paid
annually after 1936, $400,000 being paid in the year 1940.

By these incentive provisions the company has avoided work stoppages
and other labor troubles. The undisputed evidence shows that in the eight
year period ending in 1941 the productivity of the individual employee,
measured in terms of units produced, increased more than threefold, the
hours of direct labor required to manufacture a given unit was cut in half,
the selling price of its product was reduced by nearly one-half, the dividends
per share of stock were more than tripled and the earned surplus and un-
divided profits doubled.

The Independence Day issue of Newsweek,1 carried an article on
The Lincoln Electric Company summarizing the company's growth and
concluding that the bonus system "... marked the start of one of the most
controversial labor-relations techniques of recent times. Results have been
multiple:

"Lincoln Electric, in union-conscious Cleveland, is completely open shop.
'I've never done anything to fight unions,' Lincoln has said, 'but what have
my workers to gain by joining a union?"

"Various government agencies have attacked the personnel policies of
Lincoln, charging paternalism and tax dodging, among other things. This
has turned Lincoln into one of the harshest critics of the New Deal and a
ravid spokesman for free enterprise. He speaks frequently on such subjects,
writes letters to editors, and makes his views known by word of mouth."

THE TAX PROBLEM PRESENTED

In its Federal income tax return for 1940 the company deducted from
its gross income in determining the amount of its net income upon which
the tax was to be computed, the premium paid during the year for the em-
ployees' retirement annuity policy in the amount of $400,008.84. A similar
deduction for the premium paid in each of the years 1936 through 1939 had
been used in computing the tax net income of the company and has not been
questioned by the Commissioner of Internal Revenue. But, for the year 1940

the deduction was disallowed and additional tax assessed, the deficiency notice explained that the amount of the premium was "... not an allowable deduction within the provisions of Section 23 of the Internal Revenue Code." The contested issue, then, is whether the taxpayer is entitled to the deduction either as additional compensation paid for services actually rendered or as an ordinary and necessary business expense, or not at all.

The applicable statute provides, in part, that in computing the net income of a taxpayer for income tax purposes there shall be allowed as deductions from gross income:

"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 . . ." (emphasis added).

By way of parenthetical explanation, one who is not particularly conversant with the interpretation of tax statutes might believe that according to the ordinary rules of language structure and statutory construction Congress originally might have intended to allow the deduction of all ordinary expenses even though not absolutely necessary, and also all necessary expenses even though not ordinary. But, inasmuch as deductions from gross income have been held to be matters of legislative grace, the statute has been construed strictly against the taxpayer to require an expense to be both ordinary and necessary. Although this alone seems to be a considerable constriction of business expenses which are to be allowed as deductions for tax purposes, with a corresponding limitation upon a businessman's free judgment as to the importance of expenditures, the citations on this point are legion and any disagreement now can be but argumentative.

The Courts' Interpretations

A. The Tax Court's First Decision

In the first hearing of the case before the Tax Court the company protested the Commissioner's assessment of additional tax and contended that the amount paid for the purchase of the annuity contracts was properly deductible in the computation of its net income for tax purposes either (a) as compensation paid for personal services actually rendered, or (b) if not

3. But see An Argument Against The Doctrine That Deductions Should Be Narrowly Construed As A Matter Of Legislative Grace, 56 HARV. L. REV. 1142 (1943): "The matter of a fair allowance of deductions becomes of crucial importance with tax rates at their present level, and it is as much to the interest of the Government as it is of Taxpayers to see that taxes are not imposed on what is not in any fair sense net income of the taxpayer."
(a) In the opinion of the court the amount of the premium was not allowable as a deduction on the basis of compensation for several reasons: First, it was not compensation for services rendered, for neither the employee nor his estate would be entitled to receive anything of value in the future unless he remained in the employ of petitioner and rendered service in that employment over a long term of years. Second, there is an inference in the statute that in order for an expenditure to be deductible as compensation it must have been paid to the employee, the court believing that there must be an immediate correspondence between the deduction by one taxpayer and the taxability to another. Third, the payments were made voluntarily and not pursuant either to a prior agreement or enforceable obligation.

Having held for a variety of reasons that the payment did not qualify as “compensation” the court had no occasion to pass on the question of reasonableness, for in view of the conclusion that the disbursements in dispute did not constitute compensation paid for services rendered, any question of their reasonableness becomes moot.

(b) This brings us to a consideration of petitioner’s further contention that the disbursements are deductible as ordinary and necessary business expenses in that they constitute a cost of maintaining an incentive plan or program. The court then summarily dismissed the argument that the disbursement was ordinary, and says that even if it were ordinary that “necessary” means more than commendable on the part of the employer and generally beneficial to him. The fact that voluntary payments are necessary for the development of the taxpayer’s business in the sense that they are appropriate and helpful does not establish them as necessary within the purview of the statute. In fact, inasmuch as the payments were for services, although falling outside the field of allowable compensation deductions, they may not, therefore, be deducted as ordinary and necessary expenses.

B. The First Appeal to the Circuit Court

On the first appeal the circuit court conceded that the premium payments sought to be deducted were expenses, the taxpayer paid out its money and under no circumstances could it get any of it back, and that the question was only whether they were ordinary and necessary within the Act. The incentive plan adopted by the taxpayer was not extraordinary in the community. As industrial units grow the greater becomes the injury that might flow from labor strife and the greater becomes the necessity for management to seek means to avoid it. The court concluded that, in the light of the concept of ordinary expense developed by Mr. Justice Cardozo, it was

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unable to say that the petitioner's outlay for employee benefit, considering its purpose and the clearly demonstrated effectuation of that purpose through a course of years, was not an ordinary expenditure within the meaning of the statute.

Now, if the expenditure reasonably constitutes an ordinary and necessary expense, it will not be necessary to consider whether it is an allowable deduction as compensation for personal services. In any event the court is not obliged to determine reasonableness as that is concededly within the exclusive province of the Tax Court and it has given no consideration to it in view of its decision that the payments were not allowable deductions for compensation nor as ordinary and necessary expenses. Accordingly, the case was remanded to the Tax Court for disposition in conformity with this decision.

C. The Tax Court's Second Opinion

The second time before the Tax Court, the Commissioner contended that the circuit court having decided that the payments were ordinary and necessary expenses but having refused to consider the question of whether they represented compensation, and, if so, reasonable, that this court now has jurisdiction to pass upon that issue, i.e., the reasonableness of the payments as compensation.

But, it seemed clear to the court that the expenditures had been determined to be allowable deductions as ordinary and necessary expenses under the general provision of the Act regardless of whether when tested under the specific provision of the statute they might still be found to be unreasonable compensation. Accordingly, the Tax Court did not believe it necessary to consider any question of the reasonableness of the contested payments. The Commissioner then appealed this decision.

D. The Second Appeal to the Circuit Court

On the second appeal to the circuit court the court found it necessary to interpret its first opinion, explaining that the deduction authorized on the first appeal was based on the broader ground of ordinary and necessary expenses, which would include items not of a compensatory nature, such as rent, advertising, transportation and communication charges, repairs and other operating charges. Such payments are made proper deductions by the statute, but with respect to them there is no express provision limiting them to a reasonable amount, as there is in the case of payments of compensation.

However, the element of reasonableness is inherent in the phrase “ordinary and necessary.” The taxpayer, and the Tax Court, are incorrect, the court said, in contending that the holding was that the payments were ordinary and necessary expenses and, therefore, deductible in full. The taxpayer has requested a rehearing.

A First Restatement of the Issue

With this background of the case and the extended story of the interpretation of section 23(a)(1) Internal Revenue Code now before us we should restate the issue and consider it for ourselves de novo:

MUST “ORDINARY AND NECESSARY” EXPENSES ALSO BE “REASONABLE”?

Historically, the original income tax acts provided for the deduction of ordinary and necessary expenses. It was not until the Revenue Act of 1918 that the revision written into the statute provided for “reasonable” compensation and the Act has remained unchanged since that time. Obviously, Congress thought that it had not already provided the idea of reasonableness in connection with ordinary and necessary expenses, and that in the revision it was changing the limits of the allowable deduction for only one item: salaries. By thus revising one specific deduction it must have been the intention not to change any of the other deductions. Even if deductions generally are admitted to be matters of legislative grace, such a revision must be construed strictly, and fairly, against the government.

Moreover, for thirty years taxpayers and their counsel have operated their businesses in the belief that if they could demonstrate that an expense was ordinary and necessary to their business, a sufficiently difficult job in itself, they would not also have to sustain the burden of proving its reasonableness. With this belief the government apparently concurred, as evidenced by the lack of cases on the point. After this period of acceptance, the entire life of the Income Tax, even if it now is to be said that Congress intended the words “ordinary and necessary” to imply “reasonableness” it should be a matter of legislative determination whether to enforce that intent by revising the provision so as not to leave anything to implication.

A Second Restatement of the Issue

As an abstract principle we might be able to accept the proposition that ordinary and necessary expenses should also be reasonable in amount. But, the very statement of the principle immediately compels the question: Who shall determine the reasonableness of a business expense? Inasmuch as tax-
ation is not abstract, practical considerations necessitate a restatement of the issue:

SHALL THE JUDGMENT OF A GOVERNMENT AGENT BE SUBSTITUTED FOR THE JUDGMENT OF THE BUSINESSMAN IN DETERMINING THE REASONABLENESS OF ORDINARY AND NECESSARY EXPENDITURES?

It will be argued, of course, that in many branches of the law the citizen is held to a standard of reasonable conduct; even in other sections of the tax statute certain deductions must be reasonable, and, the court must frequently determine what is reasonable; in fact, the court has frequently had to determine what is reasonable compensation ever since that provision was first enacted. It will be said that the government will be liberal in the administration of this new interpretation, and further, that having the court as the final arbiter will effectively shield the taxpayer from any possibly unreasonable action. It may even be admitted, for the sake of argument, that all these things are true, but this is still an entirely unsatisfactory answer to the businessman who believes in individual initiative and comparatively free, competitive enterprise. He is willing to assume the responsibility of attempting to calculate the economic risks, but he must be permitted the free exercise of his own judgment and not have also to try to anticipate what someone not familiar with his problems may decide about the reasonableness of his decisions.

It is axiomatic that hindsight is better than foresight. Many a businessman has regretfully looked back upon some expenditure and admitted that it had been unwise, perhaps even foolish now that the consequences have become apparent, so was it not thereby also “unreasonable”? Even at the time of the expenditure there might be a difference of opinion; boards of directors are not always unanimous in their authorization or approval. In all these situations then, when a tax return is audited by a government agent two or three years after the fact, is it going to require an appeal to the court from the agent’s finding of “unreasonableness” in order to get the expense allowed as a deduction?

Of course, it is assumed that no one will maintain that a businessman can make his decisions without considering the effect of taxation. If the impact of the tax is comparatively certain it can be taken into account as one of the known factors in the calculated risk of doing business. But, a businessman should not be additionally burdened with the uncertainty of even a possible disallowance of an expenditure merely upon a difference of opinion as to what is reasonable in amount. The disallowance of a deduction of an expense which in his best judgment he believed ordinary and necessary to the successful management of his business at the time of the expenditure, with the
consequent assessment of additional tax, might easily convert an ostensible profit for the year into a subsequently determined actual loss.

For example: suppose The Lincoln Electric Company's net income before taxes but after deducting $400,000 for premiums paid on annuity policies was $50,000, and that the cash on hand was $50,000. The tax at 38% would be $19,000, leaving an actual profit of $31,000. Now, if the $400,000 is subsequently disallowed as having been unreasonable, although actually expended, the tax would be calculated on $450,000, which at 38% is $171,000 thus leaving an actual accounting loss and a cash deficit of $121,000.

The results of this example would, of course, follow the disallowance of a deduction, under the assumed facts, for any reason. But, such results should not be possible simply upon a bona-fide difference of opinion as to what is the reasonable amount of an ordinary and necessary expense. Further, inasmuch as a difference of opinion is possible, suppose that the government agent auditing the tax return of a competitor of Lincoln Electric under exactly the same circumstances did not believe the expense to be unreasonable and did not disallow the deduction. Result: Lincoln Electric's loss $121,000, Competitor's profit $31,000. Should this condition be charged to the management, as the stockholders are apt to do after comparing the published results of the operations of the competing companies?

But there is still another dilemma facing the businessman. Even though it appeared that the company had a profit of $31,000 out of which it could pay dividends, would it not be unwise to do so until the tax return for that year was passed and it was finally determined that no deductions were going to be disallowed because they were unreasonable? So, if no deductions were disallowed then obviously the dividends should have been paid and the company was unreasonable in withholding the distribution from its stockholders. Thus, in failing to pay out the dividends the company becomes subject to the penalty tax \textsuperscript{9} for the unreasonable accumulation of surplus, together with possible further stockholder actions.

A Final Restatement of the Issue

And so, the issue gradually clarifies: it obviously is not simply whether a business expense must be reasonable as well as ordinary and necessary: nor is it only one of determining whose judgment shall control the question of reasonableness. It is submitted that the basic issue, the fundamental principle, should be definitely and plainly stated thus:

Your answer to this restatement of the issue will depend not so much on rules of statutory construction as upon your political and social theories and economic concepts. "No one can rightly claim that he should not be regulated in the public interest, or taxed to support necessary government activities." But, fundamentally, free enterprise "is the right of any man to engage in any occupation or business he wants to engage in and to run it as he sees fit so long as he doesn't interfere with the right of others to do the same.

"The great war of ideas today not only in this country but throughout the world is that of the liberty of the individual against the all-powerful totalitarian state, regulating and directing the lives of its citizens. Economic liberty and the liberty of the individual to conduct his own business affairs is only one feature—but an essential feature—of that over-all liberty which permits people to live as they wish to live, which permits people to think as they wish to think, which guarantees religious freedom and freedom of thought, in our churches and in our universities. It is part of the general liberty which permits each community to govern itself in all those matters where it does not interfere with the freedom of other communities." 10

A Concluding Prognosis

The decision in The Lincoln Electric Company case applies the term "reasonable" only to the business expenses covered by section 23(a)(1). However, section 23(a)(2) provides for the deduction of:

(2) Non-trade or non-business expenses.

In the case of an individual, all the 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. (Emphasis added.)

If "ordinary and necessary" implies "reasonable" in section 23(a)(1) is not the same implication inherent in the same phrase when used in the next paragraph of the same subsection, section 23(a)(2)? The Commissioner has already included the idea in the Regulations covering the second paragraph. 11

With the sanction of this present decision the administration of "reasonable" expenses can now be stepped up.

11. Commissioner of Internal Revenue, Regulations 111, 29.23(a)-15(2).
If you find it necessary to travel in order to manage property and you stay at a hotel where the rate is $7.00 a day, you might find that the expense would be determined to have been unreasonable in amount because there were hotel rooms available for less. Then would it be any greater step to apply the same qualification to the other subsections of the same section? Perhaps, then, it might be found unreasonable for one of your political persuasion, in your social position, to incur medical expenses in a hospital with an obstetrician for your wife, you should have sent for your mother-in-law. You will, of course, object that these illustrations are too extravagant, but a step has been taken in the case we have under review, and there is much more to the administration of a revenue act than merely the raising of money.

By the rules of statutory construction it appears that the court has unduly extended the scope of the statute. In any event, the interpretation at this late date which so extends the application has such foreboding practical results that the change should not be made without an adequate public awareness and the opportunity for a legislative expression.