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1960

## What are ordinary and necessary business expenses?

John Crawford

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### Recommended Citation

Quarterly, Vol. 06, no. 1 (1960, March), p. 34-38

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maximum—then consideration should be given to dividing the income with other entities, by utilizing trusts, multiple corporations, or having income taxed to low-income members of the family. The Subchapter S election offers a special statutory method of having income taxed to the most advantageous entities.

We should keep in mind that any reductions of taxes we help our clients accomplish by planning save "100-cent dollars"—any costs of the planning are deductible, so are paid with "9-cent" to "80-cent" dollars, depending on tax brackets.



*Durwood L. Alkire*  
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Durwood L. Alkire has a B.A. from the University of Washington and is a partner in our Seattle Office. He is active on committees of the Seattle Chamber of Commerce, the Municipal League of Seattle and King County, and the United Good Neighbor Fund.

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## *What Are "Ordinary and*

*Reviewed by John S. Crawford, Portland*

ONE OF THE RESULTS of high income tax rates has been the importance placed upon the deductibility of expenditures made by individuals as well as by business entities. Ordinary and necessary expenses meet the tests of deductibility. The problem faced by tax practitioners and businessmen is that of distinguishing expenditures which qualify as ordinary and necessary from those which do not. The theme of the subject book is to differentiate for the reader the expenditures which qualify from those which do not and to point up ways of assuring that proper deductions are not lost by careless record keeping or lack of proof. The authors commence with the general rule that Congress intended the income tax laws to tax earnings and



*African safari—is this an ordinary and necessary business expense for an American dairy? Authors William Carson (left) and Herbert Weiner give their answer in a new book reviewed below for Quarterly readers.*

#### *Ordinary and Necessary Expenses*

by William K. Carson, CPA and Herbert Weiner, CPA

The Ronald Press Company, New York, 250 pages

## *“necessary” Business Expenses?*

profits less expenses and losses and proceed to such refinements as the deductibility of a safari in Africa by officers of an American dairy.

The authors state that the purpose of the book is to “present a practical approach to the problem for corporate executives, investors, professional taxmen, and for the many others engaged in all phases of business and professional endeavor who must assume responsibility for the recognition and solution of tax questions.” They go on to do an excellent job of phrasing technical problems and rules in language that the average businessman or accountant can understand and use numerous examples to point up the controversial areas.

Chapter one presents the problem in general. First, the authors

point out that there must be authority for the deductibility of the expenditure. The Internal Revenue Code of 1954 provides the statutory authority at sections 162(a) and 212 for ordinary and necessary expenses not specifically covered in other sections. From the deductible items they move to the nondeductible areas of personal expense, items to be capitalized, those against public policy and those specifically nondeductible by statute.

The five major test areas of any item claimed as a deduction are:

1. Is it a personal expense or does it otherwise fail to meet the "business" requirements of the code?
2. Is it an extraordinary expenditure required to be capitalized?
3. Does it violate public policy?
4. Is it disallowed by one of the statutory provisions designed to prevent unintended benefits?
5. Is it allowable, if at all, under another category of deductions or is it includable in cost of sales?

If the answer to all of the above questions is "no," the item is deductible as an ordinary and necessary expense. After discussing the above test areas generally for some twenty-four pages, the authors apply these tests to specific areas.

Moving from the formal areas of deductibility and nondeductibility, the book discusses the problem of determining whether the form of the transaction reflects its substance. A salary in form may be a dividend in substance. If so, what is deductible in form will be nondeductible in substance and substance controls.

The book is particularly valuable in respect to its discussion of such intangible subjects as public policy and unintended benefits. While the public press is full of comments on the abuses by businessmen and other taxpayers of travel, entertainment, club and promotion expenses, this book is one of the few places where a cool and impartial analysis of the problem areas can be found.

Going from the general areas of introduction, the book moves to a discussion of the application of the five tests to specific problems, in alphabetical order, for 110 pages. From advertising expenses it goes

to compensation for personal services and from there to club dues. The most interesting, as well as the most authoritative, cases are discussed. Educational expenses and employees' benefits, as well as expenses of employees, are covered. Farmers' expenses, fines and penalties, hedging losses and expenses of illegal businesses are discussed. These are only a few examples of the business expenditures to which the five tests have been applied.

It is here that the auditor can see examples of the situations he should be looking for in examining the records of a business. From these examples he can get a feel of whether or not the client is treading on thin ice from a tax viewpoint with certain of its expense policies.

The full time tax man and the person who prepares an occasional return will find the cases cited a valuable aid in locating the complete reasoning of the courts on the particular problems. By using these cited cases as a starting point, other cases as well as rulings in the problem area can be located in the major tax services.

The authors then provide fifty pages of cases on ordinary and necessary expenses. They give a brief statement of the facts and a brief statement of the Court's holding and the reasoning upon which the holding was based.

Most accountants will receive the greatest value from the general discussions and the factual case examples given. On the other hand, persons specializing in tax work and who are familiar with the general principles will find at least two valuable aids. The first, in the form of annotations, has been referred to before. The second area is the benefit of the editorial comments of two experts who have made a concentrated study in a relatively restricted field of income taxation. The authors have made an intensive study of all ordinary and necessary expenses and are in a position to determine if a particular decision on a particular deduction is unduly restrictive or misleadingly broad.

In closing, the authors take thirty-two pages to advise the steps to be taken to obtain the greatest possible tax benefit from expenditures and to avoid the claiming of improper deductions or the disallowance of proper deductions which cannot be proven.

Each of the sections referred to above makes an interesting and valuable evening's reading. A tax man will be a better tax man after

reading it and, perhaps just as important, an auditor will be a better auditor. Both will be in a better position to discuss a client's problems with him and to advise him of better ways to protect the deductions to which he is entitled and of helping him to avoid controversy in areas where expenditures are nondeductible.

Each member of Touche, Ross, Bailey & Smart could probably avoid overlooking deductions in the preparation of his own return by spending a few hours in reading sections of this book.

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## **Clients attend seminar on Linear Programming**

**C**LIENT personnel and TRB&S people from various offices joined the Management Sciences Division at a Linear Programming Seminar given November 18-20 in Detroit. The seminar was organized by Dr. George O'Brien who, together with Dr. Ernest Koenigsberg, gave an introductory session on the first day.

Guest speakers at the seminar were Dr. Abraham Charnes, Research Professor of Applied Mathematics and Economics at Northwestern University, and William W. Cooper, Professor of Economics and Industrial Administration at Carnegie Institute of Technology. The two men are the leading experts on linear programming in this country.

The joint lectures given by Messrs. Charnes and Cooper covered the following topics:

- 1—Planning and assessing the assembly of data for decision making.
- 2—Handling large-scale problems.
- 3—Programming and capital budgeting.
- 4—Internal pricing, costing and delegation models.
- 5—Stochastic and chance constrained programming.
- 6—Constrained games and information measures.
- 7—Concluding observations.

On hand to hear the lectures were Peter Stroh and Philip Whelan, Stroh Brewing Company; Gomer Redmond, Dave Woellner, Howard Ambill, Dennis Price, Herbert Whitecraft, and Harry Raden of the Chrysler Corporation; William Hart of Hamm Brewing Company, James Grace of General Mills, Ralph Hodges of the Mead Corporation, William Mitchener of Parke Davis and Co., Jack Thornby of Pillsbury Company, and Tom Sparrow of the University of Michigan.