BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HOWARD AUTOMOBILE COMPANY)

Appearances:

For Appellant: Orville R. Vaughn, its attorney

For Respondent: W.M. Walsh, Assistant Franchise Tax Commissioner; James J. Arditto, Franchise Tax Counsel

O P I N I O N

This appeal is made pursuant to Section.25 of the Bank and Corporation Franchise *Tax* Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Howard Automobile Company to a proposed assessment of additional tax in the amount of $635.56 for the taxable year ended December 31, 1938.

In its return of income for 1937 Appellant deducted from gross income the amount of $5,279.44, representing legal expenses in connection with certain litigation, and $10,000, representing a subscription to the Golden Gate International Exposition. The Commissioner disallowed the deductions and levied his proposed assessment accordingly. We are concerned herein with the question of the propriety of his action in so doing.

Legal Expenses

During 1937 the Appellant paid $5,279.44 as its share of attorney fees and expenses incident to the defense of an action for damages brought against it, together with two other corporations and seven individuals, by Edmond E. Herrscher. It was alleged in the action that the defendants conspired to defame the character of the plaintiff and to injure him both financially and socially. Appellant claimed this amount as a deduction under Section 8(a) of the Bank and Corporation Franchise Tax Act, which permits the deduction of

"All the ordinary and necessary expenses paid or incurred during the income year in carrying on business . . ."

The Commissioner takes the position that the amount of the legal expenses is not deductible as an ordinary and necessary business expense since Appellant was not named a defendant as a result of any ordinary and necessary activity relevant to its trade or business, the cause of action being not proximately related to the ordinary and proper conduct of Appellant's business.

There does not appear to be any substantial difference of opinion between the Appellant and the Commissioner as to the applicable principle of law. Each relies in part upon Kornhauser v. United States, 276 U. S. 145, holding that fees paid to an attorney for successfully defending an action for an accounting instituted by a former pastner of the taxpayer were deductible as ordinary and necessary business expenses. This and similar cases, such as Citron-Byer Co., 21 B.T.A. 308; Matson Navigation Co., 24 B.T.A. 14; and International Shoe, 38 B.T.A. 81; See also Commissioner of Internal Revenue v. Continental Screen Co., 58 F. (2d) 625; and Commissioner of Internal Revenue v. Heinger, 88 L. Ed. (Adv. Ops.) 197, stand for the proposition that legal expenses in connection with litigation are deductible if the action was directly connected with or proximately resulted from the business of the taxpayer.

For the purpose of showing the nature and extent of the charges made against it, Appellant offered in evidence a copy of the first amended complaint filed in the action in question. The plaintiff alleged therein that the defendants Charles S. Howard, Charles S. Howard, Jr., and Lindsay Howard became vindictive and hostile toward him as a result of his activities as attorney for the wife of Charles S. Howard in a divorce proceeding instituted by her and that those defendants, together with the other named defendants, thereafter conspired and acted to defame the character of the plaintiff and to bring ruin to him both financially and socially, The complaint alleges that Appellant and its two corporate co-defendants, Howard Automobile Company of Los Angeles and Charles S. Howard Company, were at all times mentioned therein under the control of the individual defendants Charles S. Howard, Charles S. Howard, Jr., and Lindsay Howard on account of the ownership by these individuals of the majority of the corporate stock, and on account of their control of the Board of Directors of the corporations,, It is specifically alleged of the Appellant that many of the payments made to the defendants Kerrigan and McCarthy and other moneys expended by the defendants Howard in carrying out the conspiracy were made by the defendants Charles S. Howard,

Charles S. Howard, Jr., and Lindsay Howard through the Appellant and the other two corporate defendants by means of checks issued by each of the corporations and moneys paid out by each of the corporations under the direction and pursuant to the orders of the defendants Charles S. Howard, Charles S. Howard, Jr., and Lindsay Howard. While in many instances it is alleged generally that "the defendants" conspired or took certain action in furtherance of the conspiracy directed against the plaintiff, it seems clear that by reason of the nature of the charges, the three corporations could have participated in the alleged conspiracy only to the extent of furnishing, by way of loan or otherwise, the funds used in the furtherance thereof. The action of Herrschcr v. Howard was subsequently dismissed for want of prosecution on motion of the defendants under Section 583 of the Code of Civil Procedure.

The Appellant attempts to bring itself within the rule of the cases above cited by showing that while its principal business is that of an automobile distributor, its business also includes the lending of money, its articles of incorporation authorizing it to do so, As respects the necessity of the expenditure in question, it points to the fact that the defense of the action was essential to prevent the loss of business as a result of damage to its reputation and public good will consequent to adverse public reaction to the accusations of the complaint, It sets forth specific instances of such public reaction, one of which consisted of the refusal of a customer of long standing to continue the purchase of automobiles from it.

We have been given no information by Appellant as to any activities or any transactions entered into by it which led to its being named as a defendant in the action. The plaintiff alleged therein that it advanced funds for the performance of the acts involved in the alleged attempt of the defendants to defame and ruin him. While Appellant states that its business includes the lending of money, it has not offered any evidence or even stated that it did in fact loan or otherwise furnish funds to the defendants Howard for the purposes set forth in the complaint or for any other purpose. It has not pointed to any business activity entered into by it which is in any way connected with the action, In fact, we are completely in the dark as to what, if anything, Appellant did to have itself named as a defendant. All we know is that the complaint alleges the advancing of funds by Appellant for the purposes set forth therein, which as heretofore mentioned, involved not any ordinary business activity of the Appellant, but an attempt to injure the plaintiff by reason of the personal hostility and vindictiveness of the defendants Howard toward him, The direct expenditure of its funds for the purposes set forth in the complaint would

clearly not be activity falling within the ordinary and proper conduct of its business* The activity alleged in the complaint to have occurred relates basically to a personal controversy between the plaintiff and the defendants Howard rather than to the business affairs of the Appellant. The fact that the filing of the action had an adverse public reaction which proved injurious to Appellant's business does not of itself establish the propriety of the deduction in question. Since the defendants Howard are the principal owners of Appellant any personal activity of theirs which resulted *in* a public reaction adverse to them might well injure Appellant's business even though the Appellant had taken no part in the activity.

In view of the foregoing considerations, we do not believe that the Appellant has met the burden of proof resting upon it of establishing the unreasonableness of the action of the Commissioner in determining that the legal expenses did not constitute ordinary and necessary business expenses within the meaning of Section 8(a) of the Act.

Subscription to Golden Gate International Expesitcn

Appellant subscribed and paid the sum of $10,000 to the Golden Gate International Exposition. This amount was also deducted by Appellant as a business expense for that year pursuant to Section 8(a) of the Act. The Commissioner disallowed the deduction on the ground that the subscription was an investment in anticipation of profits, and that the amount thereof was therefore not deductible as a business expense, but, if at all, as a loss to be taken in 1939 or 1940 when the Exposition closed and it was definitely known that the investment was worthless.

We believe that the deduction was properly taken. It appears that the subscription was made without any hope of its recovery from profits of the Exposition, Appellant believed, and reasonably so, that the Exposition by bringing many people to the San Francisco Bay Region, where its activities were conducted, would increase its business. Since the subscription could reasonably be expected to result in a direct benefit to Appellant's business commensurate with the expenditure, rather than the result merely in some indirect or remote benefit such as that resulting from the maintenance of good will, the amount paid may properly be regarded as a business expense rather than a non-deductible donation or contribution. Old Mission Portland Cement Co. v. Helvering, 293 U. S. 289; Morgan Construction Co. v. United States, 18 F. Supp. 892.

In Commissioner of Internal Revenue v. The Hub, 68 F. (2d) 348, a deduction was upheld for a subscription of stock in a nonprofit corporation formed to bring new and varied

industries into the area in which the taxpayer was engaged in business. The Court determined that the expenditure partook "more of the nature of an expenditure for advertising than of a capital expenditure," and that the extremely slight, if any, possibility that the subscriber to the stock would ever get back any part of the money "is not sufficient to deprive the taxpayer of an otherwise proper deduction for expenses." Hirsch-Weis Manufacturing Co., 14. B.T.A. 796, and Matson Navigation Co., 24 B.T.A. 14, are also authority for the allowance of the deduction, The former concerned a deduction for a contribution by a Portland firm to the Chamber of Commerce of that City for a drive to attract tourists to Oregon and to emphasize the State's resources and facilities for industrial expansion. The deduction was allowed upon the bases that the business of the taxpayer was increased by reason of the activities of the Chamber of Commerce and that the contribution was made for purposes connected with business of the taxpayer and represented a benefit flowing directly to it as an incident to its business. The Matson case upheld the deduction as a business expense of an amount paid to Californians, Inc., a nonprofit corporation, whose primary purpose was advertising the advantages of California, the Board finding that the contribution was motivated primarily by business considerations and that the Company received definite tangible advantages therefrom.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the action of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of Howard Automobile Company to a proposed assessment of additional tax in the amount of $635.56 for the taxable year ended December 31, 1938, pursuant to Chapter 13, Statutes of 1929, as amended, be and the same is hereby modified as follows:

Said Commissioner is hereby directed to allow the deduction from gross income of the amount of $10,000 claimed by said Company under Section 8(a) of said Act as an ordinary and necessary business expense; in all other respects the said action of the Commisioner is hereby sustained.

Done at Sacramento, California, this 11 day of May, 1944, by the State Board of Equalization.

R. E. COLLINS, Chairman

WM. G. BONELLI, Member

GEORGE R. REILLY, Member

HARRY B. RILEY, Member

J. H. QUINN, Member

ATTEST: DIXWELL L. PIERCE, Secretary