Haenn Novelty Co. v. Commissioner, 2 T.C. 1173 (1943)

Payments to a company's president, beyond normal interest, labeled as 'financing charges' based on a percentage of net profits, are not deductible as ordinary business expenses if such payments are not typical in similar businesses, especially when the financing agreement is terminable.

Summary

Haenn Novelty Co. sought to deduct payments made to its president, Joseph Haenn, under a financing contract. These payments, exceeding 6% interest on borrowed money, were disallowed by the Commissioner as ordinary and necessary business expenses. The Tax Court upheld the Commissioner's decision, reasoning that while necessary, the payments were not 'ordinary' because a profitable company would not typically agree to pay a lender, who is also the president, an additional financing charge of 25% of its annual net profits on top of the legal interest rate. The contract's terminable nature also weighed against the deduction.

Facts

In 1937, Haenn Novelty Co. entered into a financing contract with its president, Joseph E. Haenn. Joseph Haenn borrowed money from a bank at an interest rate not exceeding 3.5% using his personal collateral. He then loaned the funds to the company at a 6% interest rate. In addition to the interest, the company paid Joseph Haenn significant 'financing charges' based on a percentage of the company's net profits, amounting to $15,900.47 in 1939, $30,883.48 in 1940, and $37,024.63 in 1941. The Commissioner allowed the deduction of the 6% interest but disallowed the additional financing charges. The financing agreement was terminable by either party with written notice.

Procedural History

The Commissioner of Internal Revenue disallowed the deduction for payments made to Joseph E. Haenn exceeding 6% on borrowed money. Haenn Novelty Co. petitioned the Tax Court, arguing that these payments were ordinary and necessary business expenses. The Tax Court upheld the Commissioner's determination.

Issue(s)

Whether the financing charges paid by Haenn Novelty Co. to its president, Joseph E. Haenn, in addition to interest, are deductible as ordinary and necessary business expenses under Section 23(a) of the Internal Revenue Code.

Holding

No, because while the financing charges may have been 'necessary,' they were not 'ordinary' within the meaning of Section 23(a) of the Internal Revenue Code,

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considering the company's profitability, financial strength, and the terminable nature of the financing agreement.

Court's Reasoning

The court relied on *Deputy v. du Pont, 308 U.S. 488 (1940)*, which defined

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