C.G. Smith Woolen Co., 28 T.C. 788 (1957)</p>

To be deductible as a business expense, a payment must be “ordinary and necessary” within the context of the taxpayer’s business, and not primarily for the benefit of individual stockholders. The burden of proof to show that an expense is not deductible falls on the Commissioner of Internal Revenue.

Summary</p>

The case involves a tax dispute over several deductions claimed by C.G. Smith Woolen Co. (Petitioner), including excess profits tax relief, selling commissions, and litigation expenses. The Tax Court ruled in favor of the Commissioner regarding the petitioner’s claim for excess profits tax relief and for the disallowed deductions of state income taxes. However, the court reversed the Commissioner’s disallowance of selling commissions, finding that the commissions were ordinary and necessary expenses of the business. Finally, the Tax Court found the litigation expenses were not deductible because the petitioner failed to show the expenses benefited the company and the burden was on the petitioner to prove the expenses were deductible.

C.G. Smith Woolen Co. sought excess profits tax relief based on a change in the character of its business, specifically a commitment to a new production plan made before January 1, 1940. The company’s operations commenced with continuous improvement of its physical plant. In 1943, the company terminated its contract with a sales agent, Turner-Halsey, and entered into a contract with a partnership composed of Johnston and Smart, providing that the partnership would be the company’s exclusive selling agent for a 3 percent commission. In 1944, a new contract was made with a partnership composed of Johnston and Milliken. A shareholder lawsuit ensued, and the case was settled. The company deducted selling commissions paid to the sales agents and also sought to deduct litigation expenses related to the shareholder suit.

The Commissioner of Internal Revenue disallowed several deductions claimed by C.G. Smith Woolen Co., including the claim for excess profits tax relief, deductions of selling commissions, and litigation expenses. The taxpayer challenged the Commissioner’s decision in the U.S. Tax Court.

1. Whether the petitioner established the existence of a qualifying factor under section 722(b)(4) to claim excess profits tax relief.
2. Whether certain selling commissions were deductible as ordinary and necessary business expenses.
3. Whether petitioner’s deductions for accruals for State income taxes were proper.
4. Whether certain litigation expenses were deductible as ordinary and necessary

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business expenses.

1. No, because the petitioner failed to show that its activities constituted a "commitment" to a change in its business operations before January 1, 1940, as required by the statute.
2. Yes, because the commissions were actually incurred and paid for services performed and were ordinary and necessary business expenses.
3. No, because the accrual of state income taxes was based on improper increases in income, such as the disallowance of selling commissions.
4. No, because the petitioner did not show that the litigation expenses were for the benefit of the company.

The court found that the petitioner's pre-1940 activities did not constitute a "change in position unequivocally establishing the intent to make the change and commitment to a course of action leading to such change." The court noted that the hiring of an experienced man for the purpose of making the operation more profitable was not sufficient, as there was no indication he was hired to make a complete change of operation. The court reasoned that the plans prepared by the experienced man were considered in light of other circumstances and not in a way that established a commitment.

Regarding the selling commissions, the court found that the commissions paid were "ordinary and necessary expenses." The court considered that the commissions paid were not unreasonable, were not paid in proportion to stockholdings (and thus not dividends), and were for services performed. The court noted that the burden of proof was on the Commissioner to establish the disallowance.

As for the State income tax issue, the court agreed with the Commissioner that additional taxes were contingent on the outcome of the federal tax dispute. The disallowance of the selling commissions meant any deduction of additional state taxes was not proper.

With regard to the litigation expenses, the court found that the inference was that the expenses were incurred for the individual stockholders. The court found that "the only possible conclusion is that the remaining legal expenses at issue herein, were incurred strictly for the benefit of the individual stockholders concerned, and are therefore not deductible." The Court highlighted that the petitioner had not rebutted this inference, thus the expenses were not deductible.

This case underscores the importance of precise documentation when claiming business expense deductions. To be considered "ordinary and necessary," expenses must be directly related to the business operations and benefit the business, and they must be reasonable in amount. It also demonstrates the significance of the burden of proof in tax cases. When the Commissioner disallows a deduction, the

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burden is on the Commissioner. This case further emphasizes that the burden is on the taxpayer to provide sufficient evidence that the expense qualifies for a deduction, especially when there is a potential conflict of interest or the appearance of a benefit to individuals rather than the business. Future cases should distinguish the facts to determine if a taxpayer has met the burden of proof.

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