Welch v. Helvering addresses the difference between business and personal expenses, and the difference between ordinary business deductions and capital expenses. For a pronouncement by our highest court on two such important topics in tax law, its influence has been surprisingly slight. And for good reason.

Thomas Welch and his father owned a grain brokerage business in Minnesota. Their timing was unfortunate. Many Midwestern farmers went under when they failed to adjust to the reemergence of European agricultural production after World War I. Middlemen fared no better; E.L. Welch and Co. went bankrupt in 1922.

Undaunted, Thomas Welch determined to try again. He talked to three Minneapolis bankers. They all told him that, if he ever wanted to be accepted by the business community again, he would have to repay his discharged debts. So, he did. Welch tried to deduct the repayments, but the Commissioner disallowed the deductions.

Before the Board of Tax Appeals and the Eighth Circuit, much was made of the Fifth Circuit opinion in A. Harris & Co. v. Lucas. In *Harris*, a retailer in financial difficulty negotiated a composition with creditors, settling claims for fifty cents on the dollar. After the composition, its suppliers wouldn't trade with it unless they received cash in advance. When A. Harris & Co. consulted with its local banker, the banker advised it to pay off the compromised claims. It did. The Fifth Circuit held the repayments to be ordinary deductions.

Welch, of course, claimed that *Harris* should control; the government claimed that it was distinguishable. The distinction lay in the difference between a federal law bankruptcy and a state law composition with creditors. Federal bankruptcy terminates the bankrupt entity. In contrast, a state law composition with creditors, which is essentially a unanimous agreement of the creditors to settle their claims, leaves the original entity intact.

Repayments of debts discharged in bankruptcy would appear to be more capital than ordinary for two reasons. The first relates to the identity of the payor, and the second relates to the timing of the payment. As to identity, since the bankrupt entity is gone, the entity repaying the debts cannot be the same entity that incurred them. Such repayments of another's debts are hardly ordinary. In contrast, in a composition with creditors, the payor repays its own debt.

As to timing, in a bankruptcy, the payor must be a brand new entity, since the bankrupt entity is gone. Expenses incurred at the creation of a new entity tend to be capital. In contrast, repayments after a composition with creditors are expenses incurred during the life of a continuing entity. In this sense, repayments of debts discharged in a composition with creditors <u>maintain</u> goodwill, while repayments of debts discharged in bankruptcy <u>create</u> goodwill. It was on the basis of these alleged differences between compositions and bankruptcies, and between the Fifth and Eighth circuits, that the case went to the Supreme Court.

Mr. Justice Cardozo wrote the opinion for the Supreme Court. Curiously, he did not mention the conflict between *Harris* and *Welch* below. Instead, he wrote that the expenses were too personal, that they were too bizarre to be ordinary, and that they were capital. On the first two points, he was wrong. On the third, he was right, but he didn't say why.

As to the first two, consider: Welch did not seek advice from ministers; he went to bankers. Bankers don't give personal advice, and they surely don't give bizarre advice. They tell you about the business morays of the community.

The expenses were, however, capital. Clearly, they were intended to influence a stream of earnings which would last far more than one year. However, Cardozo told us none of that. Instead, he said little other than that, since the Commissioner thought that they were capital, they probably were.

The result of a bad opinion was, not surprisingly, confusion. One line of cases denied deductions, following *Welch*. Another allowed deductions, following *Harris*. Still other cases went off on the other strands of Cardozo's opinion, including personal vs. business, bizarre vs. ordinary, capital vs. ordinary, and various combinations of the above.

Carl Reimers Co. v. Commissioner, for example, followed *Welch*. In *Reimers*, an advertising agency attempted to reenter the business in New York after bankruptcy. It discovered that it could not do so without being recognized by the Publishers' Association of New York City. The Publishers' Association would not recognize it unless it repaid its debts. After initially resisting, it repaid the debts. The repayments were held to be capital under *Welch*.

Scruggs-Vandervoort-Barney, Inc. v. Commissioner, by contrast, followed *Harris*. A large retailer in St. Louis established a bank inside its store. The bank folded in 1933. Pursuant to the advice of three St. Louis bankers, the retailer paid off the bank's depositors in merchandise certificates, in order to maintain the good will of the store.

The repayments were held deductible pursuant to *Harris*. Note that the retailer, who was the payor, never went bankrupt.

Harold L. Jenkins touches upon all of the threads of the Cardozo opinion, and then some. Jenkins, better know as Conway Twitty, established a fast food franchise business named "Twitty Burgers," and persuaded his country music friends to invest. Twitty Burgers failed. Conway Twitty repaid his friends, even though he didn't have to.

Twitty's repayments were held to be deductible. First, since the repayments were intended to maintain the reputation of his continuing country music business, they were ordinary under *Harris* and *Scruggs-Vandervoort-Barney*. Second, they were not bizarre. The Tax Court memorandum opinion quotes a country music expert at length to show why such repayments would be more common in this industry than in some others. As to whether the repayments were too personal, the opinion says little. However, the IRS poetic nonacquiescence encapsulates its concern by asking, "Was it business or friendship?"

It cannot be surprising that the subsequent caselaw continues to follow multiple threads. Cardozo's opinion mentioned all of those threads, but gave no indication as to their relative weights. Since the opinion gives us so little guidance, it is hardly cited at all any more for its substantive issues. Instead, it is cited only for a throwaway line on burden of proof, and for the Justice's whining. It is a pity, for the difference between capital expenses and ordinary expenses is just as vexing an issue today as it ever was.

The opinion, however, retains one pernicious effect. Its pronouncements on the nondeductibility of bizarre expenses remain a continuing impediment to innovation in American business. Innovative ideas will likely be considered bizarre by the uncreative dolts in the community, including IRS. Thus, the creative person with a new idea will probably have to try it out with nondeductible dollars. Only when the idea has succeeded, and every clod is doing it, will it be common enough to be deductible.

Of course, if we allow deductions for creative business ideas, abusive scams will probably slip in as well. However, the right balance between encouraging the innovators and policing the scams will best be struck if we address the proper issues. If only Mr. Justice Cardozo had attempted to do so.