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Deductions--Insurgent Proxy Expenditures [*Central
Foundry Co.*, 49 T.C. No. 25 (Dec. 18, 1967)]

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to maintain, to better, to extend, and to replenish the corporate organization.⁴⁷ In addition, it has been pointed out that as a corporation grows "it serves important public consumer needs [and] becomes in reality a quasi-public institution"⁴⁸ For these reasons corporations are accorded special tax treatment under the federal income tax laws. It follows then that any business organization enjoying corporate tax status has met the test of being a quasi-public institution serving important consumer needs.

Since the non-professional service corporation has been awarded corporate tax status,⁴⁹ there is little reason to deny professional corporations the same tax status, since they too can be said to be quasi-public institutions serving important consumer needs. Because the professional corporation and the ordinary business corporation do serve the same ends in fulfilling these important consumer needs, they are not inherently different and, therefore, should not be treated differently under the federal tax laws.

JAN HORBALY

INTERNAL REVENUE — CORPORATE DEDUCTIONS — INSURGENT PROXY EXPENDITURES

Central Foundry Co., 49 T.C. No. 25 (Dec. 18, 1967).

Proxy contests have become a part of the corporate way of life.¹ Such contests have not only increased in frequency, but also in expense.² Because of the increasing cost of proxy contests, both management and the insurgent stockholders have sought to shift the burden of proxy expenditures to the corporate treasury through reimbursement,³ or to the federal government as an individual tax deduction.⁴ The Tax Court in *Central Foundry Co.*⁵ has now indicated that ousted management as well as the successful insurgents can obtain reimbursement for expenses incurred in a proxy contest from the corporate treasury. Thereafter, the expenses may be deducted by the corporation as an ordinary and necessary business expense.⁶

⁴⁷ J. SEILMAN, SEILMAN'S LEGISLATIVE HISTORY OF THE FEDERAL INCOME TAX LAWS, (1861-1938) at 948 (1938) (Remarks of Senator Simmons).

⁴⁸ H. BALLANTINE, CORPORATIONS § 7, at 25 (rev. ed. 1946).

⁴⁹ *Foreman v. United States*, 232 F. Supp. 134, 137 (S.D. Fla. 1964). See text accompanying notes 28 & 29 *supra*.

The petitioner in *Central Foundry Co.* was a publicly held corporation trading on the New York Stock Exchange. In 1959 a proxy contest developed between a group of insurgent stockholders (the committee), and incumbent management.⁷ The committee prevailed at the 1959 annual meeting, placing four of their nominees on the seven man board of directors. In the fall of 1959 the new board called a special shareholders' meeting at which time the stockholders by an 8 to 1 vote ratified the reimbursement from the corporate treasury of the proxy expenses of ousted management and the committee.⁸ On its corporate income tax return for 1959 Central deducted as ordinary and necessary business expenses the proxy costs of management and the committee. The Commissioner of Internal Revenue initially asserted a deficiency for the total amount of the deduction. He conceded later that the deduction for management's expenses was proper, but maintained that

¹ See *Locke Mfg. Cos. v. United States*, 237 F. Supp. 80, 87 (D. Conn. 1964).

² See E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL 3, 487 (1957). In the 1954 New York Central Railroad proxy fight both sides expended a total of \$2,159,000; the 1955 Montgomery Ward contest cost management \$766,000; and in the recent M-G-M proxy fight, the known and estimated expenses of management and the insurgent groups were \$300,000. See Machtinger, *Proxy Fight Expenditures*, 19 CASE W. RES. L. REV. 212, 218 (1968).

³ See, e.g., W. FLETCHER, PRIVATE CORPORATIONS § 2052.3 (perm. ed. rev. 1967). The cited source points out that a corporation's board of directors may expend reasonable sums from the corporate treasury for the solicitation of proxies where the expenditures are in the interest of the intelligent exercise of judgment by its shareholders. See *Steinberg v. Adams*, 90 F. Supp. 604 (S.D.N.Y. 1950), suggesting that reimbursement is confined to the actual, reasonable and bona fide expenses of successful contestants.

⁴ INT. REV. CODE OF 1954 § 212(1)-(2) provides:

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year —

- (1) for the production or collection of income;
- (2) for the management, conservation or maintenance of property held for the production of income

⁵ P-H TAX CT. REP. & MEM. DEC. (49 P-H Tax Ct.) ¶ 49.25 (Dec. 18, 1967) [hereinafter cited as ¶ 49.25].

⁶ INT. REV. CODE OF 1954 § 162(a) provides: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business"

⁷ In 1958 the committee had begun a solicitation of proxies for its slate of directors. Management responded with its own solicitation. The committee abandoned its efforts for the 1958 annual meeting because of an action by the Securities Exchange Commission (SEC) alleging violations of its proxy rules under section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(n)(a) (1964), by both the committee and management. ¶ 49.25 at 169.

⁸ The amounts included were: \$63,542.63 expended by ousted management for legal services, services of public relations consultants, services of professional proxy solicitors and other incidental expenses; \$95,726.40 representing the committee's expenditures for similar expenses. ¶ 49.25 at 172.

the deduction for the proxy expenses of the insurgents was not. The Tax Court held that the payment of the insurgents' expenses was like that of former management's expenses and, therefore, deductible as an ordinary and necessary business expense under section 162(a) of the *Internal Revenue Code of 1954*.⁹

Prior to *Central Foundry Co.* a successful shareholder in a proxy contest could deduct the expenses he incurred as an ordinary and necessary expense related to his income producing activities under section 212 of the *Internal Revenue Code*.¹⁰ Similarly, the expenses incurred by a corporation in support of its existing management in a proxy contest were deductible under section 162(a).¹¹ Under both sections the basic requirement for deductibility is that the expenses are ordinary and necessary and proximately related to the income producing activities of the taxpayer.¹²

The classic definition of "ordinary and necessary" was stated by Justice Cardozo in *Welch v. Helvering*.¹³ Cardozo said an ordinary expense is "a variable affected by time and place and circumstance. 'Ordinary' in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often."¹⁴ The crucial question is whether the payments were normal in the particular business.¹⁵ It can be successfully argued that Central's payments were ordinary, to the extent that reimbursement of successful insurgents' proxy expenses from the corporate treasury is not uncommon;¹⁶ but the question still remains

⁹ *Id.* at 176.

¹⁰ *Graham v. Commissioner*, 326 F.2d 878 (4th Cir. 1964), *acquiesced in*, Rev. Rul. 64-236, 1964-2 CUM. BULL. 64; *accord*, *Surasky v. United States*, 325 F.2d 191 (5th Cir. 1963), *partially acquiesced in*, Rev. Rul. 64-236, 1964-1 CUM. BULL. 64-65. The Commissioner indicated he will follow *Surasky*, but not to the extent that deductible proxy expenses need not be proximately related to the production or collection of income.

¹¹ *Locke Mfg. Cos. v. United States*, 237 F. Supp. 80 (D. Conn. 1964). The Commissioner has indicated he will follow the decision in *Locke*. Rev. Rul. 67-1, 1967-1 CUM. BULL. 7.

¹² Treas. Reg. § 1.212-1(c) (1957) provides that expenses, to be deductible from gross income, must bear a proximate relationship to the production of taxable income or maintenance of property for the production of income. Section 162(a) of the *Internal Revenue Code*, except for the provision relating to business, is to be construed *in pari materia* with section 212. See S. REP. NO. 1631, 77th Cong., 2d Sess. 88 (1942); H.R. REP. NO. 2333, 77th Cong., 2d Sess. 75 (1942).

¹³ 290 U.S. 111, 112 (1933).

¹⁴ *Id.* at 113-14.

¹⁵ See *Deputy v. Dupont*, 308 U.S. 488 (1939).

¹⁶ See, e.g., W. FLETCHER, *supra* note 3. In the cases allowing reimbursement, e.g., *Steinberg v. Adams*, 90 F. Supp. 604 (S.D.N.Y. 1950), the courts have carefully limited their language to reimbursement of successful insurgents. Several writers, how-

whether they were necessary. Cardozo felt that "[w]e may assume that the payments . . . were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. . . . He [petitioner] certainly thought they were, and we should be slow; to override his judgment."¹⁷

The Tax Court in *Central Foundry Co.* assumes the reimbursement expense is ordinary, and shows its necessity and proximate relation to the business of Central on the theory that the committee suggested significant policy changes,¹⁸ which purportedly would benefit the corporation.¹⁹ The court compared the benefit received by the corporation to the benefit a corporation receives from a successful derivative suit, and in addition argued that if the payment of incumbent management's expenses qualified as a deduction (as conceded by the Commissioner) because they were proximately related to the business of the corporation, the payment to the committee should receive treatment at least as favorable.²⁰

In essence the Tax Court in *Central Foundry Co.* has suggested that the proximate relationship requirement under section 162(a) is satisfied if: (1) the contest is realistic; (2) the primary beneficiary of the contest will be the corporation; and (3) the challenging shareholders are successful.

The last, however, seems to be the determinative element. As Chief Justice Drennen pointed out in his dissent, it is doubtful if this is a proper criterion.²¹ Drennen's point is further sharpened by recognizing that if the insurgents had been unsuccessful, or only partially successful, they probably would not have been entitled to deduct the expenses they incurred under section 212,²² yet, they may have presented realistic policy questions for shareholder consideration, and the benefit to the corporation may well have been

ever, have suggested that reimbursement should be available to all insurgents on the theory that criticism of management's policies, even if unsuccessful, is beneficial to the corporation. See Friedman, *Expenses of Corporate Proxy Contests*, 51 COLUM. L. REV. 951, 958 (1951); Machtinger, *supra* note 2, at 218.

¹⁷ 290 U.S. at 114; *accord*, Commissioner v. Heininger, 320 U.S. 467 (1943).

¹⁸ The committee, among other things, suggested that a former president of the corporation be reinstated to his prior office, that Central's by-laws be amended to institute cumulative voting, that Central expand its production and sale of highly profitable fibre pipe, that a curtailed research and development program be resumed, and that an idle plant be reactivated to produce missiles and rockets. ¶ 49.25 at 170-72.

¹⁹ *Id.* at 175.

²⁰ *Id.*

²¹ *Id.* at 177.

²² Machtinger, *supra* note 2, at 224-25.

as great as if they had won.²³ Success or failure is a weak test of proximity, especially since "[t]he only benefit which appears is that which the insurgents have conferred on themselves in taking over the control of the corporation."²⁴

Furthermore, it is questionable whether the test of proximity can be met on the basis of the derivative suit analogy. In such suits the corporation is permitted to deduct amounts paid to reimburse the successful shareholder on the theory that the subject of the action is proximately related to the corporation, and the results achieved in the litigation were beneficial to it.²⁵ However, not only is the corporation a party defendant in the stockholder suit, but the substance of such a suit is to enforce a corporate cause of action.²⁶ As such, the successful derivative action is much more closely related to the business activities of a corporation than a successful proxy contest. In the former the corporation reimburses the shareholder who has theoretically benefited the corporation through the derivative suit. In the latter the shareholder by supporting reimbursement through ratification is merely speculating that the new management group will initiate policies superior to those of the ousted management. Nevertheless, whether the new policies will beneficially affect the income producing activities of the corporation is purely conjecture at the time of reimbursement.

Furthermore, the Tax Court's argument that since the former management's expenses are deductible, those of the insurgents should be, overlooks the fact that management is only entitled to reimbursement because of its fiduciary relationship to the shareholders.²⁷ To fulfill this fiduciary duty management "may with perfect propriety make such expenditures from the corporate treasury as are reasonably necessary to inform the stockholder of the considerations which the directors deem sufficient to support the wisdom of the policy advocated by them and under attack."²⁸ The purely beneficial owner of a corporation has no such duty, and it is difficult to determine how his challenge of corporate policy is, as

²³ See E. ARANOW & H. EINHORN, *supra* note 2, at 514-16.

²⁴ Note, 36 CORNELL L.Q. 558, 564 (1951).

²⁵ Shoe Corp. of America, 29 T.C. 297, 305 (1957).

²⁶ Shenberg v. DeGarmo, 61 Cal. App. 2d 326, 143 P.2d 74 (1943).

²⁷ Hall v. Trans-Lux Daylight Pictures Screen Corp., 20 Del. Ch. 78, 81, 171 A. 226, 227 (Ch. 1934).

²⁸ *Id.* See 4A MERTENS, FEDERAL INCOME TAXATION § 25.54 (1966), where it is asserted that the cost of defending a suit against a corporation as well as the legal fees of the parties of a stockholder's suit are deductible as an ordinary and necessary business expense.

management's expenditures would be, proximately related to the business of the corporation.²⁹ Indeed, the disgruntled stockholder need not resort to an expensive proxy contest to challenge corporate policy but has other avenues available to present his views. Not only is the derivative suit possible, but also the proxy provisions of the Securities Exchange Act of 1934 permit the stockholder to make proposals through the use of management's proxy solicitations.³⁰

Thus, in holding that a corporation may deduct its reimbursement of a successful insurgent group's proxy expenses, *Central Foundry Co.* suggests a liberal reading of section 162(a) of the *Internal Revenue Code*. The court indicates that the proximity of the expense to the corporate business is no longer crucial and, if necessary, can be satisfied on the theory that the insurgents' success itself manifests a corporate benefit proximately related to the business of the corporation. The wisdom of the de-emphasis of the proximity test, however, is questionable; and, as previously indicated, success itself does not necessarily establish proximity³¹ nor does the fact that incumbent management's expenses were deductible.³² From the decision in *Central Foundry Co.* it would appear that the only time a successful insurgents' proxy expenses would not be deductible by the corporation would be when the stockholder is motivated by purely personal reasons.³³ Such an abrogation of the proximity test probably will not be sanctioned by the Commissioner,³⁴ and it

²⁹ See *Shoe Corp. of America*, 29 T.C. 297, 305 (1957). It has been held that before the expense can be deductible there must have been a duty to act, or an obligation to fulfill. *Thomas Flexible Coupling Co. v. Commissioner*, 158 F.2d 828, 830 (3d Cir. 1946). *Mertens* well states the principle: "An expenditure may not be deductible even though expedient or highly commendable from an ethical standpoint Normally, an expenditure is not 'ordinary' if no liability exists" *MERTENS, supra* note 28, at § 25.09. When the insurgent stockholders in *Central Foundry Co.* incurred their expenses they were not acting for the corporation, but either to promote their own income producing property or to promote their own interests. The proxy expenditures of the insurgents were not made to satisfy a corporate liability and as such would not be deductible under the preceding authority.

³⁰ 15 U.S.C. § 78(n)(a) (1964) and rule 14a-8 promulgated thereunder, 17 C.F.R. § 240.14a-8 (1967), provide that a security holder entitled to vote at a shareholders' meeting may submit a proposal to management accompanied by notice of intention to present the proposal for action at the meeting. Management, if it is a proper proposal, shall include it in its proxy statement and identify and provide means by which the solicited security holder can indicate his approval or disapproval of the matter. See *SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948).

³¹ See text accompanying notes 21-24 *supra*.

³² See text accompanying notes 27-29 *supra*.

³³ See *Dyer v. Commissioner*, 352 F.2d 948 (8th Cir. 1965), where the court denied the plaintiff the deduction of expenses incurred in a proxy contest because the taxpayer was engaged purely in a personal crusade against corporate management.

³⁴ See note 10 *supra*.

is questionable if such an approach is needed since the *Internal Revenue Code* already has significant provisions for the deduction of proxy expenses by corporations³⁵ as well as by the successful insurgent stockholder.³⁶

Regardless of the criticism offered, *Central Foundry Co.* has established a basis for the favorable tax treatment of corporate proxy expenses. The successful insurgent taxpayer now has the option to elect taking an individual deduction under section 212, or to seek reimbursement from the corporate treasury and allow the corporation to take the deduction while forcing the beneficial owners of the corporation to bear all of the proxy expenses when the benefit, if any, to be achieved from the new management group is not yet certain.³⁷

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³⁵ See note 6 *supra*.

³⁶ See note 4 *supra*.

³⁷ See Note, *supra* note 26, at 563-64, stating:

The change in corporate policy to be effected by insurgents can hardly be accepted as a benefit, for whether the change in policy will eventually prove beneficial or detrimental to the corporation is conjectural. If it be argued that there was a benefit to the corporation in that its policies, after the election reflected the view of a majority of the shareholders . . . the answer is simple: a corporation always reflects the views of a majority of the shareholders