SMU Law Review

Volume 19 | Issue 4 Article 6

1965

Federal Income Tax - Deduction of Legal Expenses - Re-Examination of Public Policy Prohibition

Charles D. Tuttle

NOTES

Federal Income Tax — Deduction of Legal Expenses — Re-examination of Public Policy Prohibition

I. Introduction

Section 162 of the Internal Revenue Code of 1954[1] provides that "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" shall be allowed as deductions in computing taxable income. There is no mention in the tax laws of a possible conflict between public policy and the allowance of deductions.[2] The language of section 162 is generally held to require only that the expenses be helpful to or proximately result from the taxpayer's business,[3] that they be reasonable in amount,[4] and that they be a customary expense of similar enterprises.[5] However, the Internal Revenue Service, the Tax Court, and the lower federal courts for many years have narrowed the generally accepted meaning of section 162 in cases involving expenses considered to be contrary to public policy.[6] On this ground deductions have been denied for fines, penalties, and legal fees incurred in connection with unlawful or undesirable business activities.[7] A basic premise has been that:

> [D]eductions arise by grace of legislative proviso, and both the Commissioner and the courts have taken the position that Congress did not intend to sanction deductions that would mitigate the penalties imposed for transgressions of laws or which would lend encouragement to illegal practices and activities.[8]

The resulting case law created a judicial amendment to section 162

---

[1] Int. Rev. Code of 1954, § 162.

[2] Stapleton, *The Supreme Court Redefines Public Policy*, 30 Taxes 641 (1952). The general prohibition of deductions, Int. Rev. Code of 1954, § 262, states: "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

[3] Welch v. Helvering, 290 U.S. 111 (1933); Kornhauser v. United States, 276 U.S. 145 (1928).

[4] National Cottonseed Prod. Corp. v. Commissioner, 76 F.2d 839 (6th Cir. 1935).

[5] Deputy v. du Pont, 308 U.S. 488 (1940); Welch v. Helvering, 290 U.S. 111 (1933). However, ordinary expenditures need not be habitual or normal, in the sense that they will recur in the life of the taxpayer with any degree of frequency. Welch v. Helvering, *supra*.

[6] 2 CCH 1965 Stand. Fed. Tax Rep. ¶ 1330.562.

[7] *E.g.*, Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958) (fine for overloaded truck); National Outdoor Advertising Bureau v. Helvering, 89 F.2d 878 (2d Cir. 1937) (legal expenses incurred in unsuccessfully defending federal antitrust suit); Great Northern Ry. Co. v. Commissioner, 40 F.2d 372 (8th Cir. 1930), *cert. denied*, 282 U.S. 855 (1930) (fine incurred for violation of Federal Safety Appliance Act).

[8] Stapleton, *The Supreme Court Redefines Public Policy*, 30 Taxes 641 (1952).

to the effect that deductions for "ordinary and necessary" business expenses otherwise allowable will be denied if the expenses violate judicial concepts of civic and business morality.[9] Because the definition of public policy is vague,[10] the judicial rule has tended to create uncertainty in the application of the tax laws.[11]

The Supreme Court, in 1952, made a detailed pronouncement on the deductibility of payments which contravene public policy. *Lilly v. Commissioner*[12] concerned the deductibility of "kickbacks" paid to doctors by retailers of prescription eyeglasses. The Fourth Circuit Court of Appeals had upheld the denial of the deduction by the Commissioner and by the Tax Court, stating that the "process of judicial interpretation [of the Internal Revenue Code] had . . . evolved the rule that no deduction should be allowed as 'ordinary and necessary' which violates sharply defined public policy."[13] On review, the Supreme Court found that these payments met the "ordinary and necessary" requirements of section 162 because they were normal, usual and customary in localities where the taxpayers were engaged in business, reflected a nationwide practice, and had enabled the taxpayers to establish and maintain their business. The Court held that for public policy to preclude the deduction of otherwise ordinary and necessary business expenses, it must be a national or state policy "evidenced by some governmental declaration. . . ."[14] In the years during which the taxpayers paid the kickbacks in question, there was no express declaration of public policy, national or state, proscribing such payments and therefore the deduction was allowed.

In applying the *Lilly* test, the courts have uniformly held that statutes constitute declarations of "sharply defined national or state policies,"[15] the general rule being that "fines and penalities for violations of state or federal statutes are not deductible, even though the

[9] *Id.* at 643.

[10] *Id.* at 641, 642.

[11] Reid, *Disallowance of Tax Deductions of Grounds of Public Policy—A Critique*, 17 Fed. B.J. 575, 579 (1957); and see note 63 *infra* and accompanying text.

[12] 343 U.S. 90 (1952).

[13] Lilly v. Commissioner, 188 F.2d 269, 270 (4th Cir.), *cert. granted*, 342 U.S. 808 (1951).

[14] Lilly v. Commissioner, 343 U.S. at 96, 97.

[15] Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958). "Deduction of fines and penalties uniformly has been held to frustrate state policy in severe and direct fashion by reducing the 'sting' of the penalty prescribed by the state legislature." *Supra* at 35, 36. See, *e.g.*, United States v. Jaffray, 97 F.2d 488 (8th Cir.), *aff'd sub nom. on other grounds*, United States v. Bertelsen & Pertensen Engineering Co., 306 U.S. 276 (1939); Tunnel Ry. Co. v. Commissioner, 61 F.2d 166 (8th Cir. 1932); Chicago, R.I.&P.Ry. Co. v. Commissioner, 47 F.2d 990 (7th Cir. 1931); Davenshire, Inc. v. Commissioner, 12 T.C. 958 (1949).

commission of the offense was in connection with carrying on a business."[16]

Statutes, however, are not the only governmental declarations of public policy to which the courts have given effect. In *Lilly*, the Supreme Court stated that the policies frustrated "must be sharply defined national or state policies evidenced by *some* governmental declaration. . . ."[17] The courts have long given effect to *implied* governmental declarations of public policy.[18] One clear example of this is the denial of legal expenses incurred in the unsuccessful defense of criminal prosecutions.

II. Deductibility of Legal Expenses

As early as 1928,[19] it was well settled that the cost of successfully defending an action at law could be an "ordinary and necessary" expense of conducting a business and deductible as such for federal income tax purposes under what is now section 162. However, in 1931, in the first federal court of appeals case raising the question of deductibility of legal fees for the unsuccessful defense of a criminal prosecution, the Second Circuit, in *Burroughs Bldg. Material Co. v. Commissioner*,[20] held that the disallowance of such expenses could properly rest on grounds of public policy.[21] The public policy referred to by the court was not stated in the tax laws and had no standard definition because it was based on the moral considerations which were the foundation of the judicial amendment to section 162.[22] In an attempt to place the denial on statutory grounds, the court stated that the expenses for an unsuccessful defense against charges arising from statutory violations might be "ordinary" but could not be "necessary" because the law would not recognize the necessity of engaging in illegal actions in the conduct of a business.[23] The holding in *Burroughs* authoritatively adopted a distinction, earlier established by the Board of Tax Appeals,[24] between successful and unsuccessful defenses of criminal prosecutions, a deduction being

[16] 2 CCH 1965 Stand. Fed. Tax Rep. ¶ 1344.316. The general rule holds even for the great body of state and federal regulatory statutes whose violation may involve no moral turpitude and which may inadvertently be violated in the course of business. See, Hoover Motor Express Co. v. United States, 356 U.S. 38 (1958) (fine for overloaded truck).

[17] 343 U.S. at 97. (Emphasis added.)

[18] See note 8 *supra* and accompanying text.

[19] Kornhauser v. United States, 276 U.S. 145 (1928).

[20] 47 F.2d 178 (2d Cir. 1931).

[21] *Id.* at 180.

[22] See note 9 *supra* and accompanying text.

[23] *Ibid.*

[24] Wolf Mfg. Co., 10 B.T.A. 1161 (1928); Lindheim v. Commissioner, 2 B.T.A. 229 (1925).

disallowed in case of an unsuccessful defense.[25] Deduction of legal expenses incurred in civil actions has been uniformly allowed under section 162 without regard to the success or failure of the defense.[26]

In 1943, the Supreme Court in *Commissioner v. Heininger*,[27] indicated that a deduction for legal and related expenses incurred in defending against charges arising from a statutory violation should be allowed as "ordinary and necessary" expenses under what is now section 162, even when the defense is unsuccessful. The Court did, however, qualify its allowance of the deduction by a requirement of good faith on the defendant's part and reasonableness of the fees.[28] The case involved an unsuccessful defense against the issuance of a Post Office Department fraud order, a non-criminal prosecution.[29] The Court stated that "it had never been thought . . . that the mere fact that an expenditure bears a remote relation to an illegal act makes it nondeductible."[30] The Court also declared that "if the . . . litigation expenses are to be denied deduction, it must be because the allowance of the deduction would frustrate the sharply defined policies of . . . [the postal statutes]."[31] The policies of the postal statutes were held not to be frustrated by allowing the deduction of legal expenses.[32]

Despite the *Heininger* holding that legal expenses incurred in defending against charges arising from a statutory violation could be "ordinary and necessary" under section 162, post-*Heininger* cases

---

[25] *Accord*, Peckham v. Commissioner, 327 F.2d 855, 856 n.4 (4th Cir. 1964), discussing MacCrowe's Estate v. Commissioner, 240 F.2d 841 (4th Cir. 1956); Bell v. Commissioner, 320 F.2d 953 (8th Cir. 1963); Hopkins v. Commissioner, 271 F.2d 166, 167 (6th Cir. 1959); Acker v. Commissioner, 258 F.2d 568 (6th Cir. 1958), *aff'd on other grounds*, 361 U.S. 87 (1959); National Outdoor Advertising Bureau, Inc. v. Helvering, 89 F.2d 878 (2d Cir. 1937); Gould Paper Co. v. Commissioner, 72 F.2d 698 (2d Cir. 1934); Commissioner v. Continental Screen Co., 58 F.2d 625 (6th Cir. 1932); Tracy v. United States, 284 F.2d 379 (Ct.Cl. 1960); Port v. United States, 163 F. Supp. 645 (Ct.Cl. 1958). *But see*, Foss v. Commissioner, 75 F.2d 326 (1st Cir. 1935) (attorney's fees incurred by stockholder in unsuccessful defense against a Sherman Anti-Trust Act prosecution by minority stockholders allowed as "ordinary and necessary"). See note 63 *infra* and accompanying text.

[26] Hopkins v. Commissioner, 271 F.2d 166 (6th Cir. 1959); Helvering v. Hampton, 79 F.2d 358 (9th Cir. 1935); John W. Clark, 30 T.C. 1330 (1958); International Shoe Co., 38 B.T.A. 81 (1938); Isaac P. Keeler, 23 B.T.A. 467 (1931).

[27] 320 U.S. 467 (1943).

[28] "Since the record contains no suggestion that the defense was in bad faith or that the attorney's fees were unreasonable, the expenses incurred in defending the business can also be assumed appropriate and helpful, and therefore 'necessary.' " *Id.* at 471.

[29] The prosecution was for violation of 39 U.S.C. §§ 259 and 732 (1958), which authorize the Postmaster General to issue fraud orders.

[30] 320 U.S. at 474.

[31] *Ibid.*

[32] "The single policy of these sections is to protect the public from fraudulent practices committed through the use of the mails. It is not their policy to impose personal punishment on violators. . . ." *Ibid.*

continued to deny deductions for such expenses.[33] The Commissioner and the federal courts have also failed to apply the Supreme Court's definitive declaration in *Lilly*, subsequent cases continuing the disallowance on grounds, inter alia, of public policy.[34] Because there is no express governmental declaration of public policy that would be frustrated by allowing the deduction of legal expenses associated with an illegal act, the Internal Revenue Service and the lower federal courts have followed precedent built on pre-*Lilly* and pre-*Heininger* cases and have thereby given effect to an *implied* governmental declaration of public policy such as was recognized by the Second Circuit in *Burroughs*. The result has been that the tax laws have continued to be used as an instrument of moral reform to discourage illegal activities by denying deductions for any expenses associated with them, even though they may satisfy the statutory requirements for deductibility under section 162.

III. TELLIER V. COMMISSIONER

Tellier v. Commissioner[35] presented the Second Circuit its first occasion since *Heininger* and *Lilly* to re-examine its rule as to deductibility of legal expenses for an unsuccessful defense of a criminal prosecution connected with the carrying on of a trade or business.

The taxpayer was tried and convicted on a thirty-six count indictment charging him with violations of the Securities Act of 1933,[36] with violations of the mail fraud statute,[37] and with conspiracy to violate these statutes.[38] He was fined and sentenced to prison terms. In 1956, the taxpayer claimed a deduction representing expenditures incurred during that year in his unsuccessful defense of the criminal prosecution. The Commissioner disallowed this deduction and his ruling was sustained by the Tax Court.[39]

The Second Circuit reversed[40] the Tax Court and overruled its

[33] See note 25 *supra* and note 63 *infra* and accompanying text. See, *e.g.*, C. W. Thomas, 16 T.C. 1417 (1951); Simon Bloom, 7 T.C.M. 517 (1948); Anthony Cornero Stralla, 9 TC.. 801 (1947); Cohen v. Commissioner, 2 T.C.M. 602 (1943).

[34] See note 25 *supra* and note 63 *infra* and accompanying text. See, *e.g.*, Thomas A. Joseph, 26 T.C. 562 (1956); Estate of Albert MacCrowe, 14 T.C.M. 958 (1955), *rev'd on other grounds*, 240 F.2d 841 (4th Cir. 1956); Union Packing Co., 14 T.C.M. 1188 (1955). The deduction has been allowed where the legal expenses were for the settlement of criminal cases. Commissioner v. Schwartz, 232 F.2d 94 (5th Cir. 1956); Greene Motor Co., 5 T.C. 314 (1945).

[35] 342 F.2d 690 (2d Cir. 1965), *cert. granted*, 382 U.S. 808 (1965).

[36] Securities Act of 1933, § 17, 48 Stat. 84 (1933), as amended, 15 U.S.C. 77q(a) (1958).

[37] Mail Fraud Act, 35 Stat. 1130 (1909), as amended, 18 U.S.C. § 1341 (1958).

[38] Conspiracy Act, 58 Stat. 752 (1944), as amended, 18 U.S.C. § 371 (1958).

[39] Walter F. Tellier, 22 T.C.M. 1062 (1963).

[40] The Second Circuit decided to hear this appeal *en banc* because the problem it pre-

prior decision in the *Burroughs* case. The court refused to "continue to draw any distinction in deductibility between civil and criminal cases or between successful and unsuccessful defenses."[41] The court stated the new rule to be "that legal expenses are deductible where they arise out of and are immediately and proximately connected with, and are required for, the conduct of a trade or business."[42]

The court began its re-examination by stating that the language of section 162 did not dictate the disallowance of a deduction for the expenses of an unsuccessful defense of a criminal prosecution connected with the carrying on of a trade or business, and that no provisions in the tax laws prohibited such a deduction.[43] The court said that in denying these expenses the tax authorities were following a judge-made rule.[44] In order to show that the framers of the tax legislation did not intend that it should be used for purposes of moral reform, the court delved into the legislative history of the original bill and found that the object of the bill was "to tax a man's net income . . . not to reform men's moral character. . . ."[45] Another bit of legislative history deemed relevant by the court was a portion of the 1951 Congressional Record[46] reporting congressional rejection of a proposal for disallowing certain deductions for expenses connected with illegal wagering under section 162. The ground for rejection was that the Internal Revenue Code was not intended to penalize or prohibit unlawful activities. The court then explored relevant congressional debates[47] indicating, in effect, that section 162 is not designed to aid in the enforcement of criminal or regulatory statutes by augmenting the punishment or penalties expressly prescribed, but is more modestly concerned with "commerical net income."[48]

The court concluded that the Supreme Court decisions of *Heininger* and *Lilly* had cast doubt on the efficacy of the reasons ordinarily given in denying deduction,[49] *viz.*, "that the expenses occasioned by unlawful activities are not ordinary and necessary in the conduct of a business and . . . that the allowance of a deduction for such

sented was considered to be authoritatively answered by a prior decision of the court in the *Burroughs* case. It was felt that a re-examination of the principle upon which that case was decided should not be undertaken by less than all of the qualified circuit judges.

[41] 342 F.2d at 695.

[42] *Ibid.*

[43] See note 2 *supra.*

[44] See note 9 *supra* and accompanying text.

[45] See 50 Cong. Rec. 3849 (1913).

[46] 97 Cong. Rec. 12230-44 (1951).

[47] See Paul, *The Use of Public Policy by the Commissioner in Disallowing Deductions, Proceedings,* Tax Inst. Univ. of So. Calif. School of Law 715, 730-31 (1954).

[48] *Ibid.*

[49] 342 F.2d at 693.

expenses would be contrary to public policy."[50] The court cited the *Heininger* case, involving a statutory violation, where the Supreme Court stated that "there can be no doubt that the legal expenses of respondent were directly connected with 'carrying on' his business. . . . It is plain that respondent's legal expenses were both 'ordinary and necessary' if those words be given their commonly accepted meaning."[51] The Court was not dissuaded by arguments that the law cannot recognize that it is necessary to conduct an ordinary lawful business in an unlawful manner and that it is not necessary to defend an unnecessary activity.[52] The only distinction preventing *Heininger* from being directly in point with *Tellier* is that the prosecution in *Heininger* was not criminal.[53] In *Tellier,* the Second Circuit, to clarify its position on expenses associated with illegal activities, stated that "to the extent that the equation of illegality with extraordinary and unnecessary is not question begging, it is applying special meaning to 'ordinary and necessary' which are not applied in other connections."[54] The court went on to declare that "so long as the expense arises out of the conduct of the business and is a required outlay it ought to be considered ordinary and necessary."[55] This holding seems to be in accord with the Supreme Court's interpretation and application of section 162 in *Heininger.*

Having thus disposed of one of the arguments traditionally advanced in support of the "judicial amendment" merely by giving effect to the statutory language and congressional intent, the court turned to the public policy argument. The guide utilized here was the Supreme Court's holding in *Lilly v. Commissioner.*[56] The court concluded that there was "no 'governmental declaration' of any 'sharply defined' national or state policy of discouraging the hiring of counsel and the incurring of other legal expenses in defense against a criminal charge" and that therefore such expenses could not be disallowed.[57]

The court further stated that "it is highly doubtful whether such a policy [discouraging the hiring of counsel and the incurring of other legal expenses in defense of a criminal charge] could exist in the face of the Sixth Amendment's guaranty of the right to counsel."[58] The implication is that even without the *Lilly* rule, the court's

[50] *Ibid.*
[51] 320 U.S. at 470, 471.
[52] *Id.* at 471, 472.
[53] See note 32 *supra* and accompanying text.
[54] 342 F.2d at 694.
[55] *Ibid.*
[56] See note 14 *supra* and accompanying text.
[57] 342 F.2d at 694.
[58] *Ibid.*

opinion at the time of the *Burroughs* case might have been different if the sixth amendment had had its present significance.[59]

IV. Conclusion

In light of post-*Burroughs* developments, *i.e.*, the *Lilly* rule and the clarification of the import of the sixth amendment, the overruling of *Burroughs* was unavoidable. An implied public policy, created by the courts before Congress had acted in the field and before the Supreme Court had given the sixth amendment its present full meaning, can no longer be recognized at the expense of what is now an expressed national public policy.[60]

The rule formerly applied was authoritatively established over three decades ago by the Second Circuit in the *Burroughs* case. This rule was based on a purely judge-made policy of denying any expense which would lend encouragement to illegal practices and activities or mitigate penalties imposed for transgressions of the law.[61] The effect of the rule was to group legal expenses with fines and penalties, although they are clearly distinguishable. The amount of a fine is a legislative expression of what the exaction for wrongdoing should be. In such a case disallowance may be necessary to make the taxpayer actually bear the burden of the fine.[62] Legal expenses, on the other hand, are not a legislative expression of what

[59] As stated in a concurring opinion in *Tellier*, "Since Burroughs was decided, the federal courts have given fuller meaning to the Sixth Amendment." *Id.* at 695. As an illustration of this increased significance, the court cited Gideon v. Wainwright, 372 U.S. 335 (1963) (holding that the provision for counsel in a criminal trial is a fundamental right essential to a fair trial and thus made obligatory on the states by the fourteenth amendment); Johnson v. Zerbst, 304 U.S. 458 (1938) (holding that counsel must be furnished to an accused who is financially unable to retain his own counsel to defend him on federal charges); Powell v. Alabama, 287 U.S. 45, 68-69 (1932) (Court discussion illustrating the absolute necessity of counsel under our legal system). The court also cited the Criminal Justice Act of 1964, 18 U.S.C. § 3006A (1964), which provides for governmental payment of reasonable and necessary defense expenses for a defendant who is found to be financially unable to provide his own counsel to defend against federal actions. Under this act, the right to counsel expenses does not depend upon whether a defendant successfully asserts his innocence. The court concluded that in order to be consistent with this clear manifestation of policy that a defendant be represented by counsel regardless of the ultimate success or failure of his defense, a financially able defendant should be allowed to deduct his ordinary and necessary legal expenses incurred in an unsuccessful defense.

[60] A contrary argument was advanced by the Tax Court, where it was stated that "The fact that an expenditure is in connection with a constitutionally guaranteed right does not require the conclusion that the amount so expended is deductible as an ordinary and necessary expense. . . . Even though the payments of legal fees in the unsuccessful defense of a criminal prosecution may not be as proximately related to the illegal activity as the payment of the fines and penalties involved in the *Tank Truck Rentals* case, such legal expenses flow from the illegal acts." Walter F. Tellier, 22 T.C.M. 1062, 1071 (1963).

[61] See note 8 *supra*.

[62] "Inasmuch as fines are . . . criminal penalties imposed for violations of state laws, their allowance as deductions would have the effect of mitigating the degree of punishment and frustrating the purpose and effectiveness of those laws." Tank Truck Rentals, Inc., 26 T.C. 427, 440 (1956).

the exaction for wrongdoing should be, and it is certainly a non sequitur that the expenses for the defense should be nondeductible merely because the proceeding gives rise to a nondeductible penalty.

Adherence to the *Burroughs* rule seeking to distinguish between civil and criminal liability and successful and unsuccessful defenses has led to anomalous, conflicting and arbitrary results,[63] and much adverse commentary.[64] The post-*Burroughs* Supreme Court cases[65] of *Heininger, Lilly, Johnson v. Zerbst, Powell v. Alabama,* and *Gideon v. Wainwright* shed new light on subjects involved in *Burroughs,* but until *Tellier* its holding had never been re-examined in this new light by an appellate court.

The unanimous holding of the Second Circuit *en banc*[66] in *Tellier* relegates section 162 to its proper function of determining net income. The court stated that distinctions between civil and criminal cases and between successful and unsuccessful defenses will no longer be drawn. Under the *Tellier* rule, all future legal expenses will be held deductible where they arise out of and are immediately and proximately connected with, and are required for, the conduct of a trade or business. This is a simple, workable rule that will ac-

[63] Where the prosecution is classified as criminal and the defendant is found guilty or pleads *nolo contendere,* the legal expenses are disallowed. Bell v. Commissioner, 320 F.2d 953 (8th Cir. 1963) (plea of *nolo contendere* to indictment for tax evasion); Estate of G. A. Buder, 22 T.C.M. 300, *aff'd on other grounds,* 330 F.2d 441 (8th Cir. 1964) (disbarment proceeding classified as criminal); Standard Coat, Apron & Linen Serv., 40 T.C. 858 (1963) (taxpayer finally pleaded *nolo contendere* after obtaining new trial); David R. Faulk, 26 T.C. 948 (1956) (action for defrauding the government). Legal expenses incurred in unsuccessful attempt to avoid a prosecution ultimately resulting in a conviction are not deductible. Tracy v. United States, 151 Ct. Cl. 618, 284 F.2d 379 (1960). But see Commissioner v. Schwartz, 232 F.2d 94 (5th Cir. 1956). Legal expenses in government antitrust actions are disallowed by the Commissioner; whereas such deductions are allowed in private actions. Rev. Rul. 64-224, 1964 Int. Rev. Bull. No. 33, at 13, modifying G.C.M. 24377, 1944 Cum. Bull. 93, under which, following *Heininger,* legal expenses were held deductible when incurred by a corporation convicted in a Sherman Antitrust Act criminal trial. Longhorn Portland Cement Co., 3 T.C. 310, *rev'd on other grounds,* 148 F.2d 276 (5th Cir. 1945). On the other hand, legal expenses incurred by an individual in a successful defense against criminal charges arising from his business are deductible. Commissioner v. Peoples-Pittsburgh Trust Co., 60 F.2d 187 (3d Cir. 1932) (charge of conspiracy to defraud the United States in tax matter). Also, legal expenses incurred in connection with an unsuccessful defense against civil liability are deductible. Hopkins v. Commissioner, 271 F.2d 166 (6th Cir. 1959) (fraud penalty assessed in tax evasion prosecution); John W. Clark, 30 T.C. 1330 (1958) (settlement of a civil liability for assault).

[64] *E.g.,* Arent, *Inequities in Non-Deductibility of Fines, Penalties, Defense Expenses,* 87 J. Accountancy 482 (1949); Brookes, *Litigation Expenses and the Income Tax,* 12 Tax L. Rev. 241 (1957); Keesling, *Illegal Transactions and the Income Tax,* 5 U.C.L.A.L. Rev. 26 (1958); Krassner, *Can a Deduction for Legal Expenses be Against Public Policy?,* 26 Taxes 447 (1948); Reid, *Disallowance of Tax Deductions on Grounds of Public Policy—A Critique,* 17 Fed. B. J. 575 (1957); Stapleton, *The Supreme Court Redefines Public Policy,* 30 Taxes 641 (1952); Comment, *Business Expenses, Disallowances and Public Policy,* 72 Yale L. J. 108 (1962); Note, *Public Policy and Federal Income Tax Deductions,* 51 Colum. L. Rev. 752 (1951); Note, *Deduction of Business Expenses: Illegality and Public Policy,* 54 Harv. L. Rev. 852 (1941).

[65] See cases cited in note 59 *supra.*

[66] See note 40 *supra.*

complish the purpose of the tax legislation and give stability and predictability to the tax law relating to deductibility of legal expenses. The anomalous, conflicting and arbitrary results of past decisions will be avoided under the *Tellier* rule because the only determination to be made on the deductibility of any legal expense will be whether it "arises out of the conduct of the business and is a required outlay."[67]

The Supreme Court in *Heininger* qualified its allowance of the deduction for legal expenses with requirements of good faith and reasonableness.[68] Because the *Tellier* rule will be subject to such a qualification there will be no danger of financially able defendants spending large tax deductible sums on bad faith defenses and thereby throwing a heavier burden on government prosecutions.

Application of the *Tellier* rule would seem to require allowance of a deduction for legal expenses of unlawful businesses, even though only aspects of the business in *Tellier* were unlawful. Salaries, rent, and other expenses of actually earning income in the operation of an illegal business are deductible.[69] That the expense is "ordinary and necessary" in the accepted meaning of the words is enough to permit the deduction "unless it is clear that the allowance is a device to avoid the consequences of violations of a law . . . or otherwise contravenes the federal policy expressed in a statute or regulation. . . ."[70] There is no more justification for the disallowance of attorneys' fees on the ground of public policy in the case of illegal businesses than in the case of those which are legal.[71] The disallowance is based on the same implied public policy, recognized in *Burroughs*, against sanctioning any expenditure that would lend encouragement to illegal practices and activities.[72] While this argument may seem more forceful in the case of an illegal business, the principle is the same. Therefore, application of the *Tellier* rule would require allowance of such expenses. To do otherwise would "put attorneys' fees paid by one convicted of operating an illegal business in the same category as bribes, protection payments, compensation of professional murderers, and sundry other unlawful payments."[73] Also, the allow-

[67] 342 F.2d at 694.

[68] See note 28 *supra* and accompanying text.

[69] 2 CCH 1965 Stand. Fed. Tax Rep. ¶ 1330.

[70] Commissioner v. Sullivan, 356 U.S. 27, 29 (1958). The Court distinguished the *Tank Truck* and *Hoover* cases on the ground that deduction of overweight fines paid by truckers is a device to avoid the consequence of violations of a law. The Court also excepted allowances which would frustrate sharply defined public policy expressed in a statute or regulation, as Textile Mills Corp. v. Commissioner, 314 U.S. 326 (1941).

[71] Brookes, *Litigation Expenses and the Income Tax*, 12 Tax L. Rev. 241, 269 (1957).

[72] See note 8 *supra* and accompanying text.

[73] Brookes, *Litigation Expenses and the Income Tax*, 12 Tax L. Rev. 241, 269 (1957).