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The Impact of Public Policy upon Income Tax Deductions

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COMMENTS
THE IMPACT OF PUBLIC POLICY UPON
INCOME TAX DEDUCTIONS

The tax liability of an individual and corporate taxpayer is reduced by the deduction from gross income of those amounts which constitute ordinary and necessary expenses incurred in the pursuit of a trade or business. However, although it may be assumed that this requisite is met, deductibility is not necessarily guaranteed, for an additional limitation may be imposed by the court-made "public policy doctrine." As the principal difficulty created by this doctrine is determining its applicability to individual cases, the primary purpose of this Comment will be an attempt to determine the limits of public policy insofar as it is applicable to federal income tax deductions.

I. PUBLIC POLICY LIMITATIONS UPON BUSINESS DEDUCTIONS

A. Historical Development

The origin of the public policy doctrine is obscure, primarily because its application has never been confined to one exclusive field of law. It appears that its application to the tax field originated in Section 162(a) of the Internal Revenue Code of 1954 (formerly section 23(a)(1)(A) of the 1939 Code). This section was substantially the same in the Tariff Act of 1913, 38 Stat. 114, 167 (1913), and now reads as follows:

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, including—
(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;
(2) traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and
(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

As what is "ordinary and necessary" varies in accordance with the nature of businesses, the type of activity in which the taxpayer is engaged is material. See 4 Mertens, Law of Federal Income Taxation § 25.09 (1954).

The "public policy doctrine" is solely the product of case law. See National Brass Works v. Commissioner, 182 F.2d 526, 530 (9th Cir. 1950):

It is true that neither the tax statute nor the treasury regulations condition deductibility upon the lawful character, either directly or remotely, of the expenditure made. . . . But, in the nature of things, public policy must narrow the field of allowable deductions which rest as they do upon legislative indulgence.


Although each case must turn on its own facts, . . . the test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction. The flexibility of such a standard is necessary if we are to accommodate both the congressional intent to tax only net income, and the presumption against congressional intent to encourage violation of declared public policy.

4 See Winfield, Public Policy in the English Common Law, 42 Harv. L. Rev. 76 (1929).
England. Apparently, the first judicial pronouncement in the United States regarding public policy limitations upon tax deductions appeared on the state level in 1921. The doctrine first appeared in the federal tax field in a series of Board of Tax Appeals cases (from 1924) which disallowed the deduction of certain expenses. Still later, the doctrine appeared in terms of "legislative intent" and in the application of the "ordinary and necessary" business expense test. Implicit in the doctrine was the idea that an expense could be deducted only if the business was legitimate. Conversely, illegal businesses received harsh tax treatment in that almost any expense would be considered in furtherance of the unlawful enterprise and, accordingly, denied deduction. Recent decisions have modified this

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5 See Note, 59 Yale L.J. 161, 162 n.4 (1950). See also Inland Revenue Commissioners v. Warnes & Co., Ltd., (1919) 2 K.B. 444. In answer to the question of whether or not a penalty could be deducted which had been imposed for carrying on a trade in an unlawful manner, Scrutton, L. J., epitomized the inextricable reasoning of resorting to the basis of public policy:

I confess that to the question so stated it seems to me that the obvious answer is "Of course he cannot." But as Lord Macnaghten once said in the House of Lords, the clearer a proposition is the more difficult it often is to find authority in support of it; and when one comes to state the reasons why that obvious answer should be given perhaps it is not so easy as saying "Of course he cannot." Commissioners of Inland Revenue v. Alexander von Glehn & Co., Ltd., (1920) 2 K.B. 553, 571.

6 In People ex rel. Konigswald v. Wendell, 198 App. Div. 956, 189 N.Y. Supp. 550 (1921), the majority in a per curiam decision disallowed a claimed gambling loss deduction on relator's state income tax return on the basis of public policy. The dissent expressed its disapproval in citing Matter of Lampson, 161 N.Y. 511, 56 N.E. 9 (1900), quoting from that case:

... the public policy of the state is evidenced in the public acts of its legislative body, and is defined and applied in the decisions of its courts," and "it is better to adhere to the plain language of the law than to resort to the unsafe ground of inference, or of public policy.

7 See Wolf Mfg. Co., 10 B.T.A. 1161 (1928); Great Northern Ry., 8 B.T.A. 225 (1927), aff'd, 40 F.2d 372 (8th Cir.), cert. denied, 282 U.S. 855 (1930); Columbus Bread Co., 4 B.T.A. 1126 (1926); Norvin R. Lindheim, 2 B.T.A. 229 (1925); Sarah Backer, 1 B.T.A. 214 (1924). Dictum of the Supreme Court at an early stage appeared to have a profound influence on allowance of deductions. In reply to the allegation that a deduction should be had for bribery if claimed, Justice Holmes remarked: 

... it will be time enough to consider the question when a taxpayer has the temerity to raise it." (Emphasis supplied.) See United States v. Sullivan, 274 U.S. 219, 264 (1927).

8 Clarke v. Haberle Crystal Springs Brewing Co., 280 U.S. 384 (1930). In effect the principle of public policy is applied when the courts speak in terms of "legislative intent" because the views of the public are reflected in the legislative acts.


10 See Humphreys v. Commissioner, 125 F.2d 340, 343 (7th Cir.), cert. denied, 317 U.S. 637 (1942); H.S. Anderson, 35 B.T.A. 10, 11 (1936):

It is now established without any conflicting decisions that the illegality of the occupation or the transactions in which a taxpayer engages deprives him of any claim to the use of losses or expenses in reducing his taxable net income.
view by recognizing the principle that illegal businesses do to some extent have expenses which do not per se frustrate a state or national policy. However, since deductibility is not dependent solely upon the legitimacy of the business, there are still instances where deductions in legal businesses are denied.

Prior to the 1954 Code, considerable effort was devoted to defining the concept of public policy as a bar to deductions. In fact, a proposed statute considering the problem was drafted by the American Law Institute. The suggested provision was at most a codification of the fundamental ideas developed by prior case law.

It was the purpose of the statute to disallow a deduction for any expenditure which was itself illegal or contrary to public policy, or made in discharge of an obligation in the nature of a fine or penalty imposed by law which, if allowed as a deduction, would clearly frustrate the legislative policy imposing the obligation. Conversely, the proposed statute would allow deduction of an expenditure made in payment of a fine or penalty which was compensatory in nature and unavoidable in the normal pursuit of a lawful enterprise. Unfortunately, however, no public policy provision was included in the 1954 Code; thus, the contemporary taxpayer must rely on case-law development in determining public policy questions concerning deductible expenditures.

13 See pp. 236-48 infra.
15 ALI Fed. Income Tax Stat § X154(i), May 1952 Draft. The proposed statute read as follows:

Public Policy. — No deduction shall be allowed for any disbursement which is — (1) itself illegal or contrary to public policy; or (2) made on account of an obligation in the nature of a fine or penalty imposed by law and not primarily for compensatory damages nor unavoidable in normal conduct of the taxpayer's lawful gainful activity, if the deduction of the disbursement for tax purposes would clearly frustrate a policy of the legislation imposing the obligation.

16 See Comments, ALI Fed. Income Tax Stat § X154(i), pp. 282, 286, May 1952 Draft. However, apparent difficulty was expressed with the proposed statute in view of the inconsistency in public policy application illustrated by prior decisions. See Comments, supra at 286-87.
18 See Comments, supra note 15, at 287.
19 However, section 162(c) is closely analogous to a "public policy provision."
B. Treatment in Legitimate Businesses

1. Statutory Violations

   a. Violation of Wage and Price Regulations

      (1) Payment for wages.—In an effort to control inflation during war years, Congress passed legislation determining maximum wage stabilization, often delegating the rate-setting to administrative agencies. Under regulations promulgated pursuant to these statutes, the Commissioner disallowed the deduction of excess wages paid in contravention of the statutes. In protesting against the disallowance, taxpayers made arguments that the wages constituted part of the cost of goods sold; it was also contended that, inasmuch as the taxpayer sold services, the wages represented a return of capital, disallowance of which would constitute imposition of a tax on gross receipts in violation of the sixteenth amendment of the federal constitution. The courts, however, rejected these arguments and found that wages constituted neither a part of the cost of goods sold nor a return of capital. Specifically, the approach has been taken that labor costs are deductible only to the extent that they do not contravene the regulatory statutes.

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21 Pedone v. United States, supra note 20; Gilmore v. United States, 131 F. Supp. 581 (N.D. Cal. 1955); Sidney Zehmar, supra note 20; Weather-Seal Mfg. Co., supra note 20. See also I.T. 4105, 1912-2 Cum. Bull. 93; Treas. Reg. 111, § 29.23 (a)-16 (1943). Even if the wages did constitute part of the cost of goods sold, they could still be disallowed. The court in Weather-Seal Mfg. Co., supra, expressed the view that the Commissioner had the power to juggle the "not so sacrosanct" item of cost of goods sold to fit the situation, citing as examples: American Pitch Pine Export Co. v. Commissioner, 188 F.2d 721 (5th Cir. 1951); Majestic Sec. Corp. v. Commissioner, 120 F.2d 12 (8th Cir. 1941).

22 The correctness of this approach was seriously questioned in the dissenting opinion in Pedone v. United States, 151 F. Supp. 288, 292 (Ct. Cl. 1957). There the view was taken that a tax on gross receipts is unconstitutional, and that, under the sixteenth amendment, the return of capital (i.e., cost) must be allowed as a deduction from gross receipts before the income tax is levied. Southern Pac. Co. v. Lowe, 247 U.S. 330 (1918). Gross income (to which the tax is applied) is determined by subtracting from gross receipts the cost of goods sold. This view is premised upon the cost of goods sold representing return of capital. The cost of producing an item for sale usually consists of materials, labor, and certain other costs, the varying proportions of these ingredients depending upon the nature of the item produced. With regard to the cost of materials the Commissioner cannot disallow any part of their cost, based on one of two theories: (1) materials constitute a part of the cost of the goods sold and there is no statutory provision in the Code regulating their deductibility;
(2) Payment for materials.—The question of whether allowance of a deduction for materials purchased in violation of maximum price regulations would frustrate the policy of the price regulations has not received considerable attention in the courts. By statutory interpretation, the courts distinguished price violations for materials from violations of wage stabilization regulations on the ground of legislative intent. As there was specific statutory authority authorizing disallowance of excess wage payments and no comparable authority existed for material price violations, the plain inference was that the full cost of materials should be deductible regardless of maximum price violations. Moreover, courts were reluctant to uphold the Commissioner's disallowance because of the constitutional question of taxing gross receipts.

(3) Labor law violations.—The Walsh-Healey Public Contracts Act regulates the employment of minors and also prescribes minimum wage and overtime wage rates. Violation of the child labor provision of the act subjects an employer to a penalty and liquidated damages, with the result that deduction of these amounts is denied on the basis and (2) the cost of an item produced for sale is beyond the Commissioner's scimitar of disallowance under the sixteenth amendment.

With regard to labor costs properly constituting a constituent part of the cost of producing an item for sale, the dissent in the Pedone case concluded that such labor costs should also be beyond the Commissioner's scimitar of disallowance under the sixteenth amendment. 151 F. Supp. at 297.

If the dissent's conclusion is correct, the constitutionality of section 162(a) of the 1954 Code is questionable. This section provides that salaries, wages, and other compensation are deductible only to the extent that they are reasonable in amount. Under a literal reading of the section, labor costs properly constituting a constituent of cost of goods sold would be allowed only to the extent they are reasonable in amount. Excessive labor costs are disallowed. This interpretation would result in a reduction of cost of goods sold and consequently a tax levied to some extent upon gross receipts or return of capital. The constitutionality of the section could, however, be sustained (assuming the dissent's argument is correct) by construing the section to be applicable only to those labor costs which are remotely or indirectly connected with the cost of producing goods or rendering services; labor costs directly connected would be awarded the same treatment as materials.

24 Commissioner v. Weisman, 197 F.2d 221 (1st Cir. 1952); Hofferbert v. Anderson Oldsmobile, Inc., 197 F.2d 104 (4th Cir. 1952); Clark v. United States, 107 F. Supp. 554 (N.D. Tex. 1951); Lela Sullenger, 11 T.C. 1076 (1948).

25 See p. 236 supra.

26 Commissioner v. Weisman, 197 F.2d 221 (1st Cir. 1952). However, Rev. Rul. 56-180, 1956-1 Cum. Bull. 94, specifically sanctioned a deduction of payments made in violation of the Defense Production Act of 1950, as amended, and which are not certified for disallowance to the Internal Revenue Service by the Economic Stabilization Agency or its authorized components. When a violation of a price regulation statute occurred, the administrative office would forward the information to the Internal Revenue Service for purposes of disallowing the deduction.


28 Lela Sullenger, 11 T.C. 1076 (1948) at 1077: Section 23 makes no provision for the cost of goods sold, but the Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income.

of public policy. However, payments for minimum wage and overtime violations, even though termed liquidated damages, are deductible.

Similarly, violation of the provisions of the Fair Labor Standards Act relating to minimum wage and overtime violations does not preclude deduction of amounts paid, as such payments are compensatory, not penal, in nature. Further, payments to satisfy an award of the National Labor Relations Board have been regarded as proper subjects of deduction.

b. Violation of SEC Regulations.—Section 16(b) of the Securities Exchange Act of 1934 was enacted to prevent economic gain obtained through abuse of a fiduciary relation with a corporation listed on a national exchange. Specifically, this section requires payment to the corporation of profits realized by an "insider" through trading within a six-month period in non-exempt equity securities of the corporation. The operation of section 16(b) presents the problem of deductibility of this payment by the insider for income tax purposes.

There is no dispute that the payment received by the corporation constitutes taxable income. Not so clear, however, is the allowance of the deduction to the fiduciary. Initially, the Tax Court decided against tax relief for the fiduciary on the basis that allowance of the deduction to the fiduciary results in "double taxation" of the same funds; however, "double taxation" has not been a successful argument for defeating the disallowance. Aluminum Co. of America v. United States, 67 F.2d 172, 175 (3d Cir. 1933); Cream of Wheat Co. v. County of Grand Forks, 253 U.S. 325, 330 (1920). The courts effectively avoid this argument by tagging the payment a "penalty." See cases cited note 42 infra.
deduction would frustrate the efficacy of section 16(b). For a period of five years it appeared that this problem was settled. However, in 1956 the Tax Court interpreted the earlier decisions as holding that the payment would not per se frustrate the statute. The 1936 case, however, was distinguished from previous decisions in two respects, viz., (1) the taxpayer’s firm, an investment banking firm in which he was a senior partner, dealt in the shares of a corporation in which the taxpayer was a shareholder and director, and (2) the taxpayer paid to the corporation the maximum amount for which he could be liable under section 16(b). The court, in holding that allowance of the deduction would not frustrate section 16(b), emphasized two significant factors: (1) the violation was unintentional and in the normal course of the investment banking business; and (2) the fiduciary taxpayer in paying over the profit to the corporation was motivated by a desire to protect the reputation of his firm and to avoid litigation expenses.

c. Antitrust Violations.—Deductions for fines or settlements for violations of state antitrust laws have been consistently disallowed. There is, however, no express authority for disallowance of fines or settlements for federal antitrust violations. Disallowance apparently follows, in view of the similarity between antitrust violations and violations of other federal statutes where disallowance has been established. Moreover, there seems to be no valid distinction between the deduction treatment accorded state antitrust violations and federal antitrust violations. Regarding recovery of treble damages in private litigation, the main emphasis has been placed upon the taxation of the payments to the plaintiff, rather than the deduction by the defendant. Although there are theories to the contrary, it is

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43 Robert Lehman, 25 T.C. 629 (1955); William F. Davis, Jr., 17 T.C. 549 (1951); William L. Dempsey, 10 CCH Tax Ct. Mem. 936 (1951); I.T. 4069, 1952-1 Cum. Bull. 28 (which further provides that the amount cannot be added to the basis of securities retained).
44 Laurence M. Marks, 27 T.C. 464 (1956) (specifically referring to William F. Davis, Jr., supra note 42).
47 See authorities cited notes 21, 30, 42 supra. Compare the treatment of attorney’s fees incurred in antitrust suits. See p. 243 infra.
probable that such payments or settlements are not the proper subjects of deduction.48 One theory would treat treble damages (or a compromise payment in settlement) as liquidated damages, allowing deduction, possibly on an allocation basis.49

d. Fines, Penalties, and Settlement Payments.—Generally, courts disallow deduction of fines and penalties incurred in the course of a trade or business on the ground of public policy.50 The theory for denial rests upon the fact that, if the amount were allowed, there would be a remittance of a portion of the fine or penalty, thereby lessening the effect of the statute penalizing the taxpayer’s conduct.51 Often, however, the offender will negotiate a settlement in lieu of the fine or penalty. Recognizing the similarity of penalties to such settlements, courts generally have proclaimed the latter non-deductible52 on the ground that they reflect the payment of a penalty. However, such payments may be deductible if the taxpayer in making the settlement was motivated by reasons other than the enforcement of the penalty assessment.53 Settlement payments in lieu of liability incurred in violation of price regulations must be distinguished. Formerly, these settlement payments were not deductible regardless of whether the violation was innocent or willful.54 The theory of disallowance was that such payments were in essence penalties which, if allowed, would frustrate the purpose of the price regulating statutes.

49Ibid. The author also suggests the possibility of capitalizing the expense over a given period where the violating taxpayer is paying over profits made at the expense of the plaintiff.
51Consider the reasoning of the American Law Institute in the Comments of ALI Fed. Income Tax Stat. § XI54 (i) 282, 286, May 1952 Draft:
While the payment of a fine is neither an illegal disbursement nor one contrary to public policy (the activity which gave rise to the fine may be contrary to public policy, but its payment is not), deduction of the disbursement would frustrate public policy in that the Government would then be bearing part of the fine.
53The test universally employed to determine the applicability of the doctrine to any such claimed deduction is whether the sums claimed were paid as penalties.” Commissioner v. Longhorn Portland Cement Co., 148 F.2d 276, 277 (5th Cir.), cert. denied, 326 U.S. 728 (1945) (dictum). Cf. Jerry Rossman Corp. v. Commissioner, 175 F.2d 711 (2d Cir. 1949); “other reasons” include, e.g., desire to avoid unfavorable publicity. But see Laurence M. Marks, 27 T.C. 464 (1956).
However, present authority rejects this view, holding settlement payments for *innocent* violations to be deductible as ordinary and necessary expenses. The decision departing from the earlier view was *Jerry Rossman Corp. v. United States,* which held that, since the violation was innocent, and the Administrator of the Emergency Price Control Act of 1942 accepted payment of the overcharge from the taxpayer without instituting suit for treble damages, deduction of the payment would not frustrate the policy of the act.

2. Attorney's Fees Incurred in Litigation

The deductibility of attorney's fees depends largely upon the nature of the activity or transaction which created the necessity for incurring such fees and also upon the outcome of the litigation. If the litigation involves the contest of a fine or penalty and the outcome is unsuccessful, the taxpayer's attorney's fees are accorded the same tax treatment as the fine or penalty and denied deduction.

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55 American Brewery, Inc. v. United States, 223 F.2d 43 (4th Cir. 1955); Commissioner v. Pacific Mills, 207 F.2d 177 (1st Cir. 1953); National Brass Works, Inc. v. Commissioner, 182 F.2d 526 (9th Cir. 1950);* Jerry Rosman Corp. v. Commissioner,* 175 F.2d 711 (2d Cir. 1949); Milton S. Kronheim & Co., v. United States, 163 F. Supp. 629 (Ct. Cl. 1958); Farmers Creamery Co., 14 T.C. 879 (1950). Inasmuch as the decisions were opposite to the rulings promulgated, the Commissioner issued Rev. Rul. 54-204, 1954-1 Cum. Bull. 49, wherein it was declared that payments made to the federal government in settlement of claims for alleged O.P.A. overcharges would be deductible if the violation was neither willful, intentional, nor the result of the taxpayer's failure to take practical precautions.

However, the cases cited pertain only to price violations in relation to materials. Since payment of wages in violation of maximum wage regulations has been held non-deductible, see p. 236 supra, it is questionable whether settlements for wage violation would be allowable; although if they were innocently made, the Rossman case would probably be followed. As this legislation has been repealed, the question is now moot.

56 175 F.2d 711 (2d Cir. 1949). But see Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958); Hoover Motor Express Co. v. United States, 316 U.S. 18 (1942). The Rossman decision does not necessarily overrule the decisions represented by Commissioner v. Longhorn Portland Cement Co., 148 F.2d 276 (5th Cir.), cert. denied, 326 U.S. 728 (1945). The theory of Rossman and subsequent decisions is that an *ad hoc* approach will be taken to determine if frustration on any policy would occur in the allowance of the deduction. In comparing legal expenses of an unsuccessful defense and the imposition of a fine, the court stated:

Each may "frustrate the sharply defined policies" of a statute; that will depend upon how one views their deterrent effect. We hold therefore that in every case the question must be decided *ad hoc.* 175 F.2d 711, 713.

With no precise criterion available, it would appear that the form and name of the payment (e.g., fine, penalty, or settlement payment) will no longer be controlling, but that the frustration will be determined by the effect on the governmental declaration (i.e., statute) imposing the penalty or fine. In essence, this coincides with the latest view expressed by the Supreme Court. See Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958).


58 Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178, 180 (2d Cir. 1931). The Burroughs case after having disallowed the attorney's fees (in connection with non-deductible fines and penalties) on the ground of not being ordinary and necessary, added at 180: "The disallowance may properly rest . . . on the grounds of public policy." However, a different approach was taken in *Sarah T. Backer,* 1 B.T.A. 214 (1924), by the in-
Conversely, if the taxpayer successfully contests such fine or penalty, his attorney’s fees are deductible.\(^6\)

If attorney’s fees are incurred in connection with the defense of criminal charges, the fees will be deemed personal in nature\(^6\) or, in more familiar terms, not ordinary and necessary.\(^6\) Furthermore, fees spent in contesting prosecution under the criminal section of the 1954 Code are denied deduction if the taxpayer is found guilty.\(^6\) On the other hand, attorney’s fees expended in an effort to settle back taxes admittedly due, as distinguished from an unsuccessful attempt to prevent criminal prosecution for income tax evasion, have been held deductible.\(^6\)

The successfulness of the litigation does not always control the issue of deductibility. If preservation of the business depends upon resisting civil enforcement of the law, attorney’s fees incurred for that purpose will be deductible notwithstanding defeat, provided that allowance of such deduction would not conflict with some “sharply defined public policy.”\(^4\) The theory supporting this conclusion rests upon the fact that nothing could be more “ordinary or necessary” than the preservation of the enterprise.\(^6\) Moreover, where the activity

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\(^6\) See \textit{4 Mertens, \op. cit. supra note 1, S.25.50.}

\(^6\) See \textit{Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178 (2d Cir. 1931); C.W. Thomas, 16 T.C. 1417 (1951); Estate of John W. Thompson, 21 B.T.A. 568 (1930), appeal dismissed, 62 F.2d 1082 (8th Cir. 1933); Sanitary Earthenware Specialty Co., 19 B.T.A. 641 (1930); B.E. Levinstein, 19 B.T.A. 99 (1930); Simon Bloom, 7 CCH Tax Ct. Mem. 517 (1948).}

\(^6\) See \textit{Acker v. Commissioner, 258 F.2d 568 (6th Cir. 1958), aff’d on other grounds, 361 U.S. 87 (1959); Port v. United States, 163 F. Supp. 645 (Ct. Cl. 1958).}

\(^6\) \textit{Commissioner v. Schwartz, 232 F.2d 94 (5th Cir. 1956); accord, Greene Motor Co., 5 T.C. 314 (1945).} To an even greater extremity, attorney’s fees incurred in settling a \textit{civil} claim for attempted rape were held deductible, since the particular act out of which the claim arose was closely related to the taxpayer’s business (interviewing prospective women employees in their home). \textit{John W. Clark, 30 T.C. 1330 (1958).}

\(^6\) \textit{Commissioner v. Heininger, 320 U.S. 467 (1943).}

\(^6\) \textit{Heininger v. Commissioner, 133 F.2d 570 (7th Cir. 1943):}

\begin{itemize}
  \item Without this expense, there would have been no business. Without the business, there would have been no income. Without the income, there would have been no tax.
  \item To say that this expense is not ordinary and necessary is to say that that which gives life is not ordinary and necessary.
\end{itemize}
giving rise to litigation is integrally connected with the trade or business, the test of deductibility is satisfied, regardless of the outcome of the litigation. The cost of litigation for defending a malpractice suit and a breach of fiduciary relationship action were allowed without regard to the outcome, inasmuch as the transactions arose directly from the operation of the taxpayer's trade or business. Also, legal fees incurred in defense of a Sherman Act prosecution are deductible even though the taxpayer is found guilty.

Another distinction may be made on the basis of the parties to the suit. If the taxpayer is involved in a controversy with a party other than the government, allowance of a deduction for attorney's fees, even where the taxpayer is unsuccessful, does not necessarily frustrate public policy. But where the government is the other party, public policy is more likely to be frustrated by allowance of the deduction, particularly where the litigation is decided in favor of the government. Accordingly, it has been suggested that defending an action against the government is considerably different from defending against a private wrongdoing arising in the course of business.

3. Influence Payments

a. Political and Lobbying Payments.—Amounts spent to influence legislative bodies or for political favors have consistently been disallowed. One theory advanced for this disallowance is that it is inappropriate for the government to bear any of the cost of influencing legislation. Other theories advanced are that such payments (1) can never be recognized as an ordinary and necessary business expense, and (2) cannot be an ordinary and necessary business expense.
pense if made in violation of national or state policies. However, absent a fact situation tainted with exertion of influence, courts are more likely to find such expenditures deductible. For instance, recognition is given to institutional advertising campaigns designed to keep one's name before the public and promote goodwill, provided no influence is intended and a legitimate purpose is being served.

b. Protection Payments and Bribes.—Analogous to payments made for political favors or lobbying are those made for the purpose of "protecting" the legitimate business or interests of the taxpayer against threatened violence or other harassing tactics, such as malicious prosecution. Although made in the course of business, such "protection payments" have been disallowed as deductions, either on the theory that they do not constitute ordinary and necessary business expenses or that allowance of a deduction for such would frustrate public policy. This result probably is desirable, for denial of deduction for protection payments may encourage the taxpayer to resort to the proper source of law and order to solve his difficulties.

Similar to protection payments, bribes are sometimes made to influence the judgment of an individual dealing with the taxpayer's business. In such an instance, the public policy doctrine has been used to disallow the deductions.

In the area of rebates, kickbacks, and discounts, rather than attack these expenditures as bribes, the courts have apparently carved out an exception to the public policy doctrine, by relying upon the existence of a well-established custom in the industry or by char-

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79 E.g., a letting of contracts on a competitive bid basis.
80 Alexandria Gravel Co. v. Commissioner, 95 F.2d 615 (5th Cir. 1938); Estate of Joseph H. Scobell, 47 B.T.A. 971 (1942).
83 Cf. Kerrigan Iron Works, Inc., 17 T.C. 566 (1951), where the court disallowed a payment to quiet labor troubles because it was characteristic of a bribe. See Kelley-Dempsey & Co., supra note 79.
85 The Commissioner has attempted to characterize the expenditure as a bribe in order to claim it as in violation of any appropriate state statute. Eugene Richardson, 16 CCH Tax Ct. Mem. 518, 526 (1957), aff'd in part and rev'd in part, 264 F.2d 400 (4th Cir. 1959).
characterizing the payments as adjustments to reflect the true price between the parties. Thus kickbacks to ships’ chandlers are not attacked as bribes, but are allowable as deductions inasmuch as the kickback is the vogue of the chandlering business. In the milk industry, a deduction is allowed for discounts from list price given in violation of minimum price regulations. While the fact that the industry customarily gives these discounts is probably significant, primarily the courts reason that, as the amount of the discount is known at the time of the agreement, the true sales price will be reflected by the net price, not the higher, fictitious list price.

Sliding over the public policy argument with little difficulty, courts point out that, although there are extensive violations in this field, there are other appropriate measures for punishing the violators. Although the above circumstances have never before justified circumvention of the public policy doctrine, the decisions allowing these discounts indicate that, if the policy frustrated does not possess a sufficient degree of importance, deduction will be allowed.

The liquor industry has been accorded similar tax treatment. Although liquor allowances and discounts do not usually violate a regulation or statute, the reason which often justifies their deduction lies in the necessity of meeting competition in price wars.

Allowance of kickbacks, discounts, and rebates are subject to some limitations, however. Where there is a specific statute expressly prohibiting a rebate, a payment made in direct violation of the statute may frustrate public policy. Also, whatever the amount

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86 Id. at 716.
88 Tri-State Beverage Distributors, supra note 87. A cash payment for a quantity purchase is not classed as a "secret rebate" if it is a customary and widespread practice in the industry, and accordingly is deductible. Polley v. Westover, 77 F. Supp. 973 (S.D. Cal. 1948).
of the remittance, it must be disclosed to the Internal Revenue Service.\(^{90}\)

c. Improper Payments to Officials or Employees of Foreign Countries.—Prior to the effective date of section 162(c) (September 3, 1958), bribes or other improper payments to officials or employees of foreign countries or its political subdivisions were not considered “ordinary and necessary” business expenses.\(^{91}\) However, where the foreign government itself demanded or acquiesced in the payment, a deduction was allowed.\(^{92}\) Presently, an indirect or direct bribe, rebate, or kickback to a foreign official or employee\(^{93}\) is illegal where the payment would be unlawful under the “laws of the United States” —if such laws were applicable to the payment and the official at the time the expense was paid or incurred.\(^{94}\) (The “laws of the United States” includes only federal statutes, judicial interpretations thereof, and appropriate regulations.\(^{95}\) ) Today, the fact that foreign law permits, demands, or acquiesces in the payment is immaterial.\(^{96}\)

4. Losses

a. Gambling.—When the losses of a gambler exceed his gains, a deduction is sometimes sought. Prior to the 1934 Code the legality or illegality of gambling in the state where the loss occurred seemed to control the question of deductibility. Where a state sanctioned gambling, courts permitted deduction of gambling losses incurred in that state over and above gambling gains.\(^{97}\) Conversely, losses were

\(^{90}\) See Stanley Rosenstein, 32 T.C. 230 (1959). This requirement stems from a longstanding custom entitling the Treasury Department to the name of the payee.


The provision is to apply only with respect to expenses paid or incurred after the date of enactment of the bill. But it is specifically provided that no inference is to be drawn from enactment of this provision, where payments prior to its effective date are involved. As to such payments, therefore, existing rules as laid down, for example in Commissioner v. Heininger (320 U.S. 467 (1943)); Lilly v. Commissioner (343 U.S. 90 (1952)); and, more recently, Commissioner v. Sullivan (356 U.S. 27 (1958)), would continue to apply.


\(^{93}\) 1958-3 Cum. Bull. 917; 1 CCH 1960 Stand. Fed. Tax Rep. ¶ 11,271. The theory was that since legal recourse was not available to the taxpayer, it would be difficult to claim that the expenses were not ordinary and necessary.

\(^{94}\) See definition Treas. Reg. § 1.162-18(c) (1960).

\(^{95}\) Int. Rev. Code of 1914, § 162(c). See Treas. Reg. § 1.162-18 (1960). However, a deduction may be disallowed because its allowance would frustrate a governmentally declared policy without regard to section 162(c) or this section. Treas. Reg. § 1.162-18(d) (1960). Thus, a payment may frustrate a nationally defined public policy without regard to section 162(c). See Commissioner v. Sullivan, 356 U.S. 27 (1958); Lilly v. Commissioner, 343 U.S. 90 (1952); Commissioner v. Heininger, 320 U.S. 467 (1943).

\(^{96}\) Supra note 94.


disallowed if the activity was not tolerated by state laws.\textsuperscript{88} The decisions also required a showing that the transaction (where not connected with a trade or business) was entered into for profit.\textsuperscript{89}

In 1934 the code changed the previous law by providing for the deduction of gambling losses only \textit{to the extent} of gambling gains in the taxable year.\textsuperscript{90} In construing this provision the courts concluded that, not only is it immaterial whether the transaction was entered into for profit, but legality of gambling in the state is no longer decisive of the issue.\textsuperscript{91} Consequently, the excess of gambling losses over gambling gains for either an illegitimate or a legitimate business will be denied.\textsuperscript{92} This treatment met with the approval of the American Law Institute in its tentative drafting of the 1954 Code,\textsuperscript{93} and has generally prevailed in later decisions.\textsuperscript{94}

\textbf{b. Net Operating Losses.—}Obviously, the operating losses arising from the operation of a legitimate business are deductible in accordance with the net operating loss provisions of the code.\textsuperscript{95} This result does not necessarily follow when certain specific losses, e.g., gambling, are sought to be deducted as part of net operating loss. The rule appears to be that nothing can be utilized as a net operating loss deduction if it could not be taken as a deduction in the year it was

\textsuperscript{88} E. F. Simms, 28 B.T.A. 988 (1933); M. Rea Gano, 19 B.T.A. 518 (1930) (sum paid in settlement of gambling debt disallowed); M. L. Heide, 2 B.T.A. 451 (1921); Appeal of Mitchell M. Frey, Jr., 1 B.T.A. 338 (1921). Where the taxpayer is unable to segregate losses incurred in states where gambling is legal from losses in states where gambling is illegal, the entire amount will be disallowed. E. F. Simms, supra.

\textsuperscript{89} Beaumont v. Helvering, 73 F.2d 110 (D.C. Cir. 1934), cert. denied, 294 U.S. 715 (1935); Citizens & Southern Nat’l Bank v. United States, 14 F. Supp. 915 (Ct. Cl. 1936); E. F. Simms, supra note 98; Appeal of Mitchell M. Frey, Jr., supra note 98.

\textsuperscript{90} 48 Stat. 680, 689 (1934), 26 U.S.C.A. § 23(g) (1940) (section 23(g) of the Internal Revenue Code of 1934 is now section 165(d) of 1954 Code).

\textsuperscript{91} Humphrey v. Commissioner, 162 F.2d 833 (5th Cir.), cert. denied, 332 U.S. 817 (1947). Section 23 of the Revenue Act of 1934 (now Int. Rev. Code of 1954, § 165 (d) ) provides:

\begin{quote}
In computing net income there shall be allowed as deduction: . . . (g) Wagering losses. Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.
\end{quote}

The main purpose of the section was to bring about conformity by limiting deductions for legalized gambling to the same as would be allowed for illegal gambling. See H.R. 704, 71d Cong., 2d Sess. 22 (1934); S. Rep. 518, 71d Cong., 2d Sess. 25 (1934).

\textsuperscript{92} See Skeeles v. United States, 95 F. Supp. 242 (Ct. Cl.), cert. denied, 341 U.S. 948 (1951). Moreover, there is no distinction between a professional and an amateur gambler in the disallowance of the “excess” losses. See Roy T. Offutt, 16 T.C. 1214 (1951). The Skeeles case is also decisive of the point that the amount cannot be deducted under section 23(e)(1) of the 1939 Code as a business loss, since section 23(h) is the more specific and will control over a general section purporting to cover the same situation.

\textsuperscript{93} See American Law Institute, Tentative Draft, op. cit. supra note 51, at 283.

\textsuperscript{94} E.g., Roy T. Offutt, 16 T.C. 1214 (1951). See also Winkler v. United States, 230 F.2d 766, 776 (1st Cir. 1956) where Offutt and Skeeles, 95 F. Supp. 242 (Ct. Cl. 1951), are distinguished, but admitting that a professional gambler cannot deduct legal net gambling losses against other forms of income under section 23(h) of the 1939 Code.

\textsuperscript{95} Int. Rev. Code of 1954, § 172.

\textsuperscript{96} Roy T. Offutt, 16 T.C. 1214 (1951).
This rule would have particular application to gambling losses, since they are deductible only to the extent of gambling gains in the taxable year.\textsuperscript{108}

c. Losses Proximated by Legislative Action.—Governmental legislative action often has resulted in losses to legitimate businesses. In some instances losses are occasioned as a direct result of the legislation; in other cases, as a collateral result.

In \textit{Western Wine \\& Liquor Co.},\textsuperscript{109} a liquor dealer sustained a loss through the sale of stock held in a distillery. Because of a shortage in the supply of whiskey occasioned by governmental regulation, the taxpayer had acquired the stock in order to buy pro rata quantities of whiskey from the distillery. The Tax Court held the loss deductible as a part of the cost of the whiskey acquired rather than as a capital loss.

In contrast, prohibition during the 1920’s caused most breweries to become obsolete. When a deduction was sought for that obsolescence, the Supreme Court denied the deduction on the ground that Congress did not intend tax relief to result from the passage of the eighteenth amendment.\textsuperscript{110}

No discussion of public policy was raised in either of the above examples, although each case conceivably could have been decided under the public policy doctrine. In any event, the two cases are not in conflict as one apparent distinction exists. The loss in the first case was only an \textit{incidental and collateral} effect of the legislation; but in the second the resulting obsolescence was the very object of a constitutional amendment. Consequently, it could be theorized that a loss directly resulting from governmental action will be denied deduction while one incidentally occasioned by governmental action will be allowed.

C. Treatment in Illegitimate Businesses

There is no express provision in the 1954 Code disallowing deductions for expenditures which are illegal per se or incurred in the

\textsuperscript{107}Skeels v. United States, 95 F. Supp. 242 (Ct. Cl.), cert. denied, 341 U.S. 948 (1951); Roy T. Offutt, 16 T.C. 1214 (1951). See Black Dome Corp., 5 CCH Tax Ct. Mem. 415 (1946), where an expense found to be personal was not allowed as a part of a net operating loss deduction since it could not be taken during the regular taxing period.

\textsuperscript{108}However, nothing would prevent the carry-over or carry-back to another taxable year of the net operating loss occasioned by the "legitimate" operating expenses of a gambling business.

\textsuperscript{109}18 T.C. 1090 (1952). See also Charles A. Clark, 19 T.C. 48 (1952).

\textsuperscript{110}Clarke v. Haberle Crystal Springs Brewing Co., 280 U.S. 384 (1930); Renziehausen v. Lucas, 280 U.S. 387 (1930). The court, through Justice Holmes, spoke in terms of "congressional intent."
pursuit of an unlawful business;[111] rather, the treatment is founded upon case law.[118] Generally, illegal expenditures have been categorized by the courts according to the nature of the expenditure.[112]

1. Operating Expenses

In producing income, whether by legitimate or illegitimate means, certain expenses necessarily arise. For example, rent and wages are commonplace in the life of both legal and illegal businesses. No serious contention could be made that these expenses of a legal business should be disallowed (assuming they meet the statutory test of deductibility), but the question is not easily resolved where the business itself is illegal.[114] Recently, the position was taken by the Supreme Court in Commissioner v. Sullivan[115] that allowance of a deduction of rent and wages for an illegal gambling business would not frustrate any state policy, notwithstanding a state law making those payments illegal. Previously, the position was taken that, if the business was illegal, allowance of the deduction would frustrate the policy of the law proscribing such businesses.[117] It is submitted

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111 In referring to the distinction between the lawful or unlawful character of a business expense, the court in Heininger v. Commissioner, 133 F.2d 567, 570 (7th Cir.), aff'd, 320 U.S. 467 (1943), stated:

"Congress has not said that discrimination shall be made. Neither has the Department had the hardihood to make such a material change by way of its regulations. If this change is to be made and the policy altered, let Congress do it. Congress would need only to add the word "legal" before the word "trade" in the third line of Section 23(a)(1).

We are asked in the guise of construing the words "ordinary and necessary" to amend the statute. In other words, to engage in a little judicial legislation. We decline the invitation."


112 See National Brass Works v. Commissioner, 182 F.2d 526, 530 (9th Cir. 1950), portion quoted in note 2 supra. See also Annot., 27 A.L.R.2d 498, 503 (1953).


114 See Keesling, supra note 111; 4 Mertens, Federal Income Taxation § 25.131 (1954); Schwartz, Business Expenses Contrary to Public Policy; An Evaluation of the Lilly Case, 8 Tax L. Rev. 241 (1953).

115 The Court reasoned that if a federal excise tax could be deducted by those in the business of accepting wagers, so should the rent and wages be allowed. See Rev. Rul. 54-219, 1954-1 Cum. Bull. 51.

that the *Sullivan* case more fairly represents the present view concerning deductibility of "legitimate" expenditures of illegal businesses.\textsuperscript{118}

2. Fines and Penalties

A legitimate business is not permitted a deduction for fines or penalties when incurred in the scope of business;\textsuperscript{119} a fortiori an illegitimate business is accorded the same treatment.\textsuperscript{120}

3. Attorney's Fees Incurred in Litigation

If rent, wages, and salaries constitute deductible expenses for an illegitimate business,\textsuperscript{121} it could be argued that attorney's fees incurred in defense of a prosecution for conducting such a business should be allowed on the theory that this is an ordinary and necessary expense.\textsuperscript{122} However, the courts generally take the position that such attorney's fees are not deductible when the taxpayer is found guilty.\textsuperscript{123} Should he be acquitted, attorney's fees expended for his defense are deductible,\textsuperscript{124} as no policy would be frustrated in defending against false charges.

In view of *Commissioner v. Sullivan*,\textsuperscript{125} which allowed an illegal business a deduction for ordinary operating expenses, a strong argument would exist in favor of deductibility of attorney's fees incurred in defending the legality of a business. For the sake of consistency, it could be argued that criminal prosecution is a normal operating hazard, that defense is necessary to the preservation of the enterprise,\textsuperscript{126} and that such expenditure would be ordinary and necessary. Whether this argument will be accepted in the future is dependent upon whether *Commissioner v. Sullivan* is extended to its logical conclusion.

\textsuperscript{118} Commissioner v. Sullivan represents the case law authority but future legislation may possibly make these expenditures non-deductible. See pp. 258-59 infra.

\textsuperscript{119} See pp. 240-41 supra.

\textsuperscript{120} Anthony Correro Stralla, 9 T.C. 801 (1947); Harry Wiedetz, 2 T.C. 1262 (1943).


\textsuperscript{122} Also, it seems that attorney's fees incurred in the furtherance of the business would be accorded the same treatment.


\textsuperscript{124} C. W. Thomas, 16 T.C. 1417 (1951); Anthony Correro Stralla, 9 T.C. 801 (1947). See MacCrowe's Estate v. Commissioner, 240 F.2d 841 (4th Cir. 1964).


\textsuperscript{126} This argument is essentially the theory of Commissioner v. Heininger, 320 U.S. 467 (1943).
4. Bribes and "Protection" Payments

Because of the public interest in maintaining the integrity of public officials and law enforcement agencies, courts consistently disallow deductions for sums paid by illegal enterprises for protection against arrests and criminal prosecutions as well as bribery of public officials.207 Similarly, an illegal business paying "tribute" money to another illegal operator can claim no deduction.208

The deductibility of such payments has been treated previously:209 section 162 (c) of the Code makes no distinction between legal and illegal businesses.

5. Losses

a. Gambling.—Frequently, courts give obeisance to the principle that illegality alone does not warrant a more stringent application of the tax laws than that accorded legal enterprises.210 Consequently, illegal businesses are allowed the same deduction for gambling losses under section 165 (d) of the 1954 Code as legitimate businesses; i.e., the loss is deductible to the extent of gambling gains.211 As stated previously, this result has been achieved through court interpretation of the congressional intent in enacting section 165 (d), according indiscriminant treatment to gambling losses regardless of the legality of gambling in the state in which the loss arose.

b. Net Operating Losses.—On the theory that income from illegal operations is taxed in the same manner as income from legal enterprises,212 it would appear that the loss provisions of the code would apply with equal force.213 Although there are no cases in point, one Board of Tax Appeals decision disallowed a loss arising from the opera-

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207 See, e.g., G. A. Comeaux, 10 T.C. 201 (1948), aff’d sub nom., Cohen v. Commissioner, 176 F.2d 394 (10th Cir. 1949). In deciding against deductibility, the courts have probably taken into account sub silentio the public policy of preserving the integrity of public officials.

208 See Cohen v. Commissioner, 176 F.2d 394, 400 (10th Cir. 1949).

209 See pp. 244-46 supra.


But these considerations of civic morals, however potent they should be in the Legislature or with prosecuting officers, who are required to choose and not abuse their weapons against crime, the courts are bound to administer the law as it is found, regardless of considerations of morals, policy, or taste, suitable for the legislative or executive branches. Our duty and our only power is to ascertain what the Legislature means by what it has said, and then enforce what was said.

211 See pp. 246-47 supra.


213 See Steinberg v. United States, 14 F.2d 564 (2d Cir. 1926).
tions of an illegal business. It seems that this position is inconsistent with that taken by the Supreme Court in Commissioner v. Sullivan. Under the reasoning of the Sullivan case a net operating loss deduction should be allowed to an illegal enterprise, at least insofar as it consists of "legitimate" items, such as rent, wages, and salaries.

c. Investments and Governmental Confiscation.—Frequently, illegal enterprises sustain losses occasioned by governmental confiscation of property or investments. Courts consistently disallow a deduction sought for such losses, reasoning that allowance of the deduction would give the taxpayer a remittance in the form of tax relief, thereby frustrating the efficacy of the law authorizing the confiscation.

Under this theory, deductions have been denied for losses occasioned by governmental confiscation of enemy alien property, an investment in an illegal night club, and an investment in a counterfeit money business. However, in one case the taxpayer was allowed a deduction for a loss of an illegal investment where his participation had been obtained fraudulently.

125 Lawrence A. Wagner, 30 B.T.A. 1099 (1934). N.B. This was not a net operating loss case. However, if a loss is not deductible in the year incurred, it may not be used as a net operating loss. See pp. 247-48 supra.

126 See pp. 215-18 infra.


128 For example, assume a year's gambling operations as follows:

| Gambling gains | $1,000,000 |
| Gambling losses | $950,000 |
| Gross Income | $50,000 |
| Less expenses: Rent, wages, and salaries | $90,000 |
| Net operating loss | ($40,000) |

Note that a profit exists before the legitimate overhead expenses cause a net loss for the year. Often, however, allocating operating expenses can be considerably more difficult than the illustration implies.

129 Fuller v. Commissioner, 213 F.2d 102 (10th Cir. 1954); Hiram E. Bowles, 13 CCH Tax Ct. Mem. 510 (1954); Andrew Kjar, P-H B.T.A. Mem. Dec. $ 41,446 (1941).


132 Luther M. Richey, Jr., 33 T.C. No. 31 (1959).

133 Curtis H. Muncie, 18 T.C. 849 (1952). Deduction was allowed to the victim of a "Spanish prisoner" swindle where the taxpayer lost his chances for sharing in wealth and his capital investment in an attempt to free a prisoner south of the border. The Commissioner's argument was that allowance of the deduction would frustrate foreign policy since the swindling operation was against the law in Mexico. However, the Tax Court held that, as the loss was treated as theft under Mexican law, it should be allowed.

But cf. Reg. § 1.162-18, proposed 9-24-59, adopted 1-26-60 in T.D. 6448, where a deduction will not be allowed for a kickback or a bribe to an official or employee of a foreign country when such payment would frustrate a governmentally declared policy of the United States, or the payment would be a violation of United States laws, if such were applicable. This regulation also appears at 25 Fed. Reg. 677 (1960).
II. The Advent of Lilly v. Commissioner\textsuperscript{143}

A. The First Stepping Stone: Commissioner v. Heininger

Although decided nine years before the Lilly case,\textsuperscript{144} Commissioner v. Heininger\textsuperscript{145} shaped certain fundamental principles in the tax field which made a later decision necessary in order to fix the dimensions of the public policy doctrine. In Heininger the very existence of a business depended upon incurring certain expenditures. Because of its fraudulent operations, the taxpayer's mail order business was being closed down by order of the Postmaster General. To resist the order, the taxpayer spent large sums for legal fees and expenses. The Commissioner, who was upheld by the Board of Tax Appeals,\textsuperscript{4} denied deduction of such fees and expenses because of the inherent illegal operation of the business for which the sums were expended. This approach was rejected by the Court of Appeals,\textsuperscript{147} and by the Supreme Court.\textsuperscript{148} Two distinct points were clarified by the Supreme Court. First, it is \textit{not} essential that the business or expenditure be for any legal purpose before an expense may be characterized as ordinary and necessary; \textit{i.e.}, the mere fact that an expenditure bears a remote relation to an illegal act does not make it non-deductible. Secondly, the public policy doctrine was limited in application to the situation where allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct.\textsuperscript{149} The Court reasoned that no public policy would be frustrated in this instance as the efficacy of the fraud order would remain unimpaired by allowance of the deduction. Rather than use the code as a punitive device in the absence of a clear congressional intent to that effect, the Court noted that a separate criminal statute existed which could be used if punishment should be given.\textsuperscript{150}

Until Lilly v. Commissioner,\textsuperscript{151} courts relied upon the Heininger
case for the proposition that public policy must be "sharply defined" before frustration results from the allowance of the deduction. 118

B. Lilly v. Commissioner: Its Effects and Consequences

1. General Considerations

The Lilly decision 119 characterized the nature of the public policy which must be "frustrated" by allowance of a deduction. Kickbacks to oculists, who referred patients to the taxpayer-optician for the fitting of glasses, were sought to be deducted as ordinary and necessary business expenses. These kickbacks were disclosed to the patient only upon request. Agreeing with the Tax Court, 120 the Court of Appeals 121 disallowed the claimed deduction on the ground that the doctor owes a fiduciary duty to his patient, and that the agreement for rebates is inconsistent with this obligation. Further, the court noted that these practices were not consistent with the policies of the state medical society or its national counterpart.

The Supreme Court rejected these views, 122 reasoning that "the policies frustrated must be national or state policies evidenced by some governmental declaration of them." 123 Relying heavily upon Heininger, the Court concluded that public opinion alone is insufficient for the application of the public policy doctrine. Another basis of the Court's decision may be found in its recognition of the widely-established and customary practice of kickbacks in this type of business. This perhaps would explain prior decisions allowing deductions for discounts in the milk and liquor industries usually given in violation of state price regulations, 124 as well as allowance of deductions of kickbacks in the ship chandling business. 125 Thus, a strong argument could be made in favor of deductibility by showing a universal and established practice of making the type of payment claimed for tax purposes.

118 E.g., Jerry Rossman Corp. v. Commissioner, 175 F.2d 711 (2d Cir. 1949); Polley v. Westover, 77 F. Supp. 973 (S.D. Cal. 1948); Greene Motor Co., 5 T.C. 314 (1941).
119 343 U.S. 90 (1952).
120 14 T.C. 1066 (1950). The Tax Court's opinion demonstrated the need for clarity, as the bar of public policy was seemingly applied upon the ethical judgment of the court.
121 14 T.C. at 1079-86. This approach was criticized by the dissent. 14 T.C. at 1088.
122 188 F.2d 269 (4th Cir. 1951).
123 343 U.S. 90 (1952).
124 Id. at 97. In Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 34 n.6 (1958) the Court leaves open the question of whether a statute is required in order to constitute a governmental declaration, implying that it may take other forms.
125 The practicality of the Lilly doctrine was immediately relied upon by the Commissioner in allowing fee-splitting between surgeons, provided the transaction would fit within the principles of the Lilly case. I.T. 4096, 1952-2 Cum. Bull. 91.
126 See p. 245 supra.
127 See p. 245 supra.
2. The Post-Lilly Era

In the light of the more recent decisions, Commissioner v. Sullivan\(^{160}\) and Tank Truck Rentals, Inc. v. Commissioner,\(^{161}\) the status of the present law is uncertain. The Lilly and Sullivan cases applied the public policy doctrine independently of the "ordinary and necessary" test.\(^{162}\) However, in Tank Truck Rentals, the Court stated that an expense could not be necessary "if allowance of the deduction would frustrate sharply defined national or state policies prescribing particular types of conduct, evidenced by a governmental declaration thereof."\(^{163}\) Such language indicates that the two tests are applied concurrently rather than independently. Thus, while the pre-Lilly cases, which applied the "ordinary and necessary" test without regard to public policy considerations, are not necessarily disturbed by Lilly and Sullivan,\(^{164}\) Tank Truck Rentals confuses the issue considerably. Moreover, while Sullivan is troublesome in the foregoing respect, it also creates problems of its own.

a. The Sullivan and Tank Truck Rental Cases.—Aside from representing the law governing deductibility of rent and wages of illegal gambling enterprises, the Sullivan\(^{165}\) case also seems to represent a departure from the Lilly rule.\(^{166}\) To illustrate: the Supreme Court tacitly admits that payment of the rent and wages constituted a violation of Illinois state law.\(^{167}\) This much alone has usually been a sufficient ground for disallowance.\(^{168}\) Yet, the opinion places no emphasis on frustration of state policy; federal policy is mentioned and disposed of as not being frustrated. However, in Tank Truck Rentals, Inc. v. Commissioner,\(^{169}\) decided the same day,\(^{170}\) the entire


\(^{162}\) Accordingly, a determination of whether an expense is ordinary and necessary is first made; then, the public policy doctrine is employed.

\(^{163}\) 356 U.S. at 33-34.

\(^{164}\) See Lurie, Deductibility of "Illegal" Expenses, 11th Annual N.Y.U. Institute on Federal Taxation 1189, 1205 (1953).

\(^{165}\) The Sullivan case involved the deductibility of rent and wages (the so-called "legitimate" items) of an illegal gambling establishment paid in violation of state law.

\(^{166}\) The inconsistency of the Sullivan reasoning has been noted by other writers. See Note, 5 N.Y.L.F. 208, 213 (1959); Note, 33 St. John's L. Rev. 150, 156 (1958).

\(^{167}\) 356 U.S. at 28.

\(^{168}\) See p. 257 supra.

\(^{169}\) 356 U.S. 30 (1958). Fines imposed for operating trucks in violation of state maximum weight laws were sought as deductions. It was recognized that the company would operate at a loss if it conformed to the law. Consequently, violations were deliberately made because it was "commercially impractical" to do otherwise. In some states, the violations were unintentional.

\(^{170}\) Hoover Motor Express Co. v. United States, 356 U.S. 38 (1957) was also decided the same day as Tank Truck Rentals and Sullivan. The facts and result of Hoover were identical to that in Tank Truck Rentals, except that all of the violations in Hoover were
basis for disallowance of a deduction for fines and penalties was the frustration of state policy. The question immediately arises: why was the deduction allowed in Sullivan not found to frustrate state policy after the Court recited the statute violated? It is no answer to say "the fact that an expenditure bears a remote relation to an illegal act does not make it non-deductible," as no remote relation exists; the expenditure was directly violative of the state statute. The statement by the Court, "any inference of disapproval of these expenses as deductions is absent here," is indicative of its attitude that the payments did not violate any state policy.

The premise could be accepted that state policy simply was not frustrated, notwithstanding that the payment did in fact violate a state statute. In essence, this view means that the court will determine the purpose of the statute in order to find a frustration in connection with an illegal activity. Thus, the position taken in the Sullivan case may be that the statute under consideration is to be examined together with its concomitant illegal activity (i.e., gambling) in order to determine the frustration. As such, no frustration was found according to the "remote connection test" enunciated in Heininger. The difficulty with this view is that it will never be known in advance just when a policy evidenced by governmental declaration will be frustrated.

Still another interpretation (possibly the most logical) of Sullivan is indicated by the following language:

inadvertent. Nevertheless, the Court felt that frustration existed in that the state statute made no distinction between innocent and willful violations.


175 The Tax Court in Sam Mesi, 25 T.C. 513 (1955), rev'd, 242 F.2d 518 (7th Cir. 1957), circuit aff'd sub. nom., in Commissioner v. Sullivan, 356 U.S. 27 (1958), after first setting out the applicable statutes, one of which was cited in Commissioner v. Sullivan, supra, states:

Pursuant to these sections of the criminal code of the State of Illinois, the payment of the wages in question in and of itself constituted an illegal act. . . . Certainly, it would be a clear violation of public policy to permit the deduction of an expenditure, the making of which constitutes an illegal act. 25 T.C. at 522.

It should be remembered that, even though this reasoning was reversed in the Seventh Circuit, 242 F.2d 518 (1957), on the authority of Commissioner v. Doyle, 231 F.2d 635 (1956), and Sullivan v. Commissioner, 241 F.2d 46 (1957) (both Seventh Circuit opinions), the fact remains that the payment would still be in contravention of the state statute. The Sullivan Case was affirmed by the Supreme Court, 356 U.S. 27 (1958).


176 This view was taken in Brown, The Supreme Court 1957 Term, 72 Harv. L. Rev. 77, 116 (1958).

177 Although the holding in Sullivan, if narrowly construed, is limited to state statutes the principle could be extended to all to federal statutes and administrative rulings.

178 Viz., the fact that an expenditure may bear a "remote relation" to the illegal act does not necessarily make it non-deductible. 320 U.S. at 474.
Deductions are a matter of grace and Congress can, of course, disallow them as it chooses. At times the policy to disallow expenses in connection with certain condemned activities is clear. It was made so by the Regulations in *Textile Mills Corp. v. Commissioner*, 314 US 326. Any inference of disapproval of these expenses as deductions is absent here: The Regulations, indeed, point the other way, for they make the federal excise tax on wagers deductible as an ordinary and necessary business expense. This seems to us to be recognition of a gambling enterprise as a business for federal tax purposes. The policy that allows as a deduction the tax paid to conduct the business seems sufficiently hospitable to allow the normal deductions of the rent and wages necessary to operate it.\(^{177}\)

Thus, it would appear that the Court is saying that if an illegal business is recognized as an object of the federal taxing power,\(^{176}\) a deduction will be allowed for those expenses which do not frustrate federal policy, notwithstanding state policy to the contrary.\(^{179}\) Even though uniformity may be achieved through the application of the public policy doctrine according to federal policy frustration, state policy will be ignored to the extent it is contrary to federal law. The decision leaves open the question of what the result will be when there is no expression of federal policy on the subject. Will the Court then resort to ascertaining the congressional intent in search of federal policy, or will state policy control the deduction?

Yet another basis for the holding in *Sullivan* may be found in the following language:

That [the amounts are ordinary and necessary] is enough to permit the deduction, unless it is clear that the allowance is a device to avoid the consequence of violations of a law. . . .\(^{180}\) (Emphasis added.)

As applied to the facts in *Sullivan*, it is clear that the claimed deductions, i.e., rent and wages, were not the consequence of the statutory violation; therefore, deduction would follow.

A new approach to the application of the public policy doctrine is indicated by the above language, *viz.*, the deduction will be dis-

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\(^{177}\) 356 U.S. at 28-29.

\(^{176}\) Compare this view with the treatment accorded gambling losses. See pp. 246-47, 251 supra. It should be noted that Senator Kefauver strongly opposed the passage of the federal excise tax on gamblers for the reason that it may elevate them into such a respectable position that they would be accorded almost "legal" treatment. See note 13 supra. Ironically, the Commissioner's allowance of deduction of a federal excise tax to illegal gamblers was made the basis of the Court's holding that illegal gamblers should be entitled to a deduction of other "legitimate" expenses, *viz.*, rent, wages, and salaries. See pp. 251-52 supra.

\(^{179}\) Note the following language of Sullivan: " . . . or otherwise contravenes the federal policy expressed in a statute or regulation. . . ." 356 U.S. at 29 (Emphasis added.). This view is analogous to the doctrine of the supremacy of federal law, *viz.*, when there is an inconsistency between federal and state law, the former will control.

\(^{180}\) Id. at 29.
allowed where it constitutes a scheme (i.e., "device") by the taxpayer to avoid the consequences of his violation of a specific law. Previously, the generally-accepted test of deductibility turned upon whether a federal or state policy would be frustrated by allowance. Consequently, it would appear that the force of a statute would be impaired if a deduction were allowed for the very act which the statute proscribes. The distinction between this "new approach" and the one previously employed is that the Sullivan approach views frustration from the standpoint of a scheme to avoid the penal or remedial consequences of a statutory violation as opposed to the prior view which was whether allowance of the deduction would frustrate the efficacy of the statute. Applying this new approach to the companion case of *Tank Truck Rentals, Inc. v. Commissioner,* it is readily seen that the allowance of a deduction of fines incurred would operate as a frustration, since what is sought to be deducted is the consequence of the violated statute. Whether or not the Sullivan case has definitely enunciated this new approach is uncertain; it remains for the Court to clarify the matter in future decisions.

b. Proposed Code Amendment.—A recent legislative recommendation from the Department of Justice to Congress has been incorporated in a bill that would add a new code section disallowing expenditures for rent, wages, or salaries incurred or paid in violation of federal or state law. Should these recommendations be enacted, there would be a reversal of the Supreme Court ruling in *Commissioner v. Sullivan,* which allowed to the taxpayer who was engaged in an unlawful enterprise deductions for rent and wages. However, the anticipated code section would not embrace all criminal expenditures, but only those pertaining to "rent, wages, or salaries." Consequently, the field of deductibility would be limited only to a certain extent, for it is conceivable that an illegal business may still have expenditures that would escape the bar of public policy, yet fail to be covered by the new section.

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184 The Court seemingly makes no distinction on the basis of whether the violation itself was inadvertent or intentional. 356 U.S. at 36.
185 46 CCH Taxes On Parade No. 25, Part I, at 3 (June 3, 1959); H.R. 7394, 86th Cong., 1st Sess. (1959) provides as follows:

Sec. 274. Criminal Expenditures.

No deduction otherwise allowable under this sub-title shall be allowed for any amount paid or incurred for rent, wages, or salaries if under any statute of the United States in which such amount is paid or incurred, the payment of such amount constitutes a crime punishable by fine or imprisonment or both.

Deductions are a matter of legislative grace and may be disallowed if the prescribed code requirements are not met. Thus, no constitutional question is involved.
Assuming the enactment of the proposed code section, a problem of interpretation may arise. It would probably be argued that by Congress' express disallowance of rent, wages, and salaries, there is an implied allowance of other like expenditures. The vulnerability of the proposal to such an argument illustrates the undesirability of piecemeal codification of the public policy doctrine.

c. Payola Deductions.—The next development in the field of public policy will probably reflect public reaction to the recent "payola," or undercover payments, made by record distributors in an effort to get their records broadcast. Presently, there is no express statute making payola a federal crime, although numerous proposals are in the making. Consequently, it may be questionable whether the payments could be disallowed under the public policy doctrine, since there is no governmental declaration of that policy. Were the payments to be considered in the nature of a bribe, disallowance may follow. However, the cases disallowing bribery payments were decided before Lilly v. Commissioner during a period when governmental declaration of policy was not a requirement of the public policy doctrine. Under Lilly and Heininger, a payment which is merely offensive to public opinion and not violative of law is allowed.

III. The Use of the Code—Taxation or Reformation?

Apart from the difficulty of determining the bounds of the public policy doctrine, one question remains: Should the code be employed to reform the illegal elements of society, or should it remain merely a revenue-gathering device?

The often-quoted phrase "moral turpitude is not a touchstone of taxability" is usually found in arguments that the code should exist for purposes of taxation only. It has been expressed that the code since its inception has not been a device for reformation of men's characters, the theory being that law enforcement should be

183 This would be nothing more than the application of the axiom expressio unius, i.e., the express mention of one is the implied exclusion of others.
185 See pp. 244-46, 251 supra.
186 143 U.S. 90 (1922).
187 The deductibility of payola may turn on the outcome of charges filed against the record distributors by the Federal Trade Commission; the complaints allege that "payola" constitutes an unfair trade practice. Wall Street Journal, Friday, February 12, 1960, p. 2.
188 Commissioner v. Wilcox, 327 U.S. 404, 408 (1946).
189 Paul, The Use of Public Policy by the Commissioner in Disallowing Deductions, 1954 Major Tax Problems 713, 737-42, advocates the Code for purely taxing purposes, not for compelling conformity in state jurisdictions. Thus, each state should be left to enforce its own laws without federal intervention. See 43 Cornell L.Q. 725, 727 (1958).
sought under other legislative powers, and not intermingled with the revenue-gathering power of Congress. Moreover, considerable strength is found in the argument that the indirect enforcement of local law by federal taxing devices would produce two undesirable effects, viz., a tendency of relaxation of enforcement of local law by local authorities, and an increasing encroachment of federal jurisdiction into state areas.

To the contrary, however, is the view that the increasing threat of crime should be combated with every available weapon, one extremely effective weapon being the broad use of the public policy doctrine to deny the criminal a tax deduction for expenditures, whether made for fines or for "legitimate" expenses. The reason for using the taxing power in this manner would be, of course, to discourage the existence of criminal activities by minimizing the profits to be reaped from such activities.

One policy, although expressed on an administrative level, is that all expenses incurred in connection with illegal enterprises will be disallowed. There is little doubt that the expense disallowance would be constitutional, for while Congress may only tax gross income under the sixteenth amendment, there are no restrictions as to the deductions it may disallow. Consequently, should Congress ever wish to avail itself of the opportunity, the claimed deductions of illegal enterprises could be disallowed for federal income tax pur-

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192 Under its other legislative power where Congress has the power to regulate an activity directly, it may use the taxing power for that purpose. McRay v. United States, 195 U.S. 27 (1904); Veazie Bank v. Fenno, 75 U.S. (8 Wall.) 533 (1869). Where Congress has no other legislative powers, the exercise of the taxing power may result in incidental regulation of an activity, provided that the regulatory feature does not appear on the face of the taxing act. Rottschaefer, Constitutional Law § 117 (1939). However, if the purpose of the taxing statute is clearly regulatory on its face and not a subject within regulatory powers of Congress, it will be held unconstitutional. Child Labor Tax Case, 219 U.S. 20 (1922). See generally Corwin, The Constitution and What It Means Today 26-30 (1958).


195 It is readily seen that the civil and criminal penalties in the code would furnish no deterrent to one already operating an illegal enterprise.


197 See address by The Honorable Herbert Brownell, Jr., 78 A.B.A. Rep. 334, 338 (1953). The absurdity of allowing deductions for criminal activities has been expressed in these terms: "Theoretically, under the tax laws as they are now enforced, a professional killer would be entitled to deduct from gross receipts paid for an assassination, the price of his machine gun and his ammunition and the cost of transportation to and from the place of murder." A.B.A., Special Crime Study Commission on Organized Crime, Final Report 55 (1950).


199 See New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934). These are deductions from gross income.
poses. While a harsher application of the code in this respect would to some extent curtail the operation of illegitimate businesses, one might question whether it would be worth the loss of tax dollars that would result from the new enforcement policy. However, the indirect fostering of illegality by inaction cannot be justified merely because illegality yields taxable income.

Malcolm Lee Shaw

\[\text{Cf. United States v. Kahriger, 345 U.S. 22 (1953), to the effect that an occupational tax on persons engaged in the business of accepting wagers is a valid exercise of the federal taxing power and does not invade the police power of the states as given in the tenth amendment.}\]

\[\text{The following attitude was adopted by Baker, supra note 194, at 217:}\]

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\text{The gambling racket is possibly the largest industry, from the standpoint of volume of business, rapidity of turnover, and magnitude of profit, presently operating in the United States, yet it is permitted to exist without keeping financial records, or at best the most meager of records, except such as it may have been successful in keeping to itself. The Department has been content to accept returns, together with payment of the tax admitted to be due, totally lacking in data from which to permit verification of the accuracy thereof. Veiled reference to income from "speculation" or from "investments" is about as far as the record will bear. But the honest taxpayer, from fear he may omit some trumpery dividend payment, is required to detail not only the name of each corporation from which he received such a payment but also the address of its office and the amount so received. The corporate taxpayer, or the individual engaged in operating a legitimate enterprise, well knows the cost and labor of keeping the complete financial records demanded of him, and the response of the Department if such records are not letter perfect!}\]