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

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

I. Introduction

Section 162 of the Internal Revenue Code of 1954\(^2\) 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,\(^2\) 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

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\(^1\) 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.
\(^7\) 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. Commissioner12 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 penalties for violations of state or federal statutes are not deductible, even though the

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9 Id. at 641.
10 Id. at 641, 642.
11 Reid, Disallowance of Tax Deductions of Grounds of Public Policy—A Critique, 17 Fed. B.J. 175, 579 (1957); and see note 63 infra and accompanying text.
12 343 U.S. 90 (1952).
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 590 (7th Cir. 1931); Davenshire, Inc. v. Commissioner, 12 T.C. 958 (1949).
commission of the offense was in connection with carrying on a
business.\footnote{2 CCH 1965 Stand. Fed. Tax Rep. \textsuperscript{ }\textsuperscript{ }\textsuperscript{ }\textsuperscript{ }\textsuperscript{ }\textsuperscript{ }\textsuperscript{ }\textsuperscript{ }\textsuperscript{ }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).}

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. . . .”\footnote{18 See note 8 supra and accompanying text.} The courts have long given effect to implied
governmental declarations of public policy.\footnote{See note 8 supra and accompanying text.} One clear example of
this is the denial of legal expenses incurred in the unsuccessful de-
fense of criminal prosecutions.

\section*{II. Deductibility of Legal Expenses}

As early as 1928,\footnote{19 Kornhauser v. United States, 276 U.S. 145 (1928).} 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 \textit{Burroughs Bldg. Material Co. v.
Commissioner},\footnote{47 F.2d 178 (2d Cir. 1931).} held that the disallowance of such expenses could
properly rest on grounds of public policy.\footnote{Id. at 180.} 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.\footnote{See note 9 supra and accompanying text.}
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.\footnote{Ibid.} The holding in \textit{Burroughs} authoritatively adopted a distinction, earlier
established by the Board of Tax Appeals,\footnote{Ibid.} between successful and
unsuccessful defenses of criminal prosecutions, a deduction being

\begin{itemize}
\item \textit{See note 8 supra and accompanying text.}
\item \textit{See note 9 supra and accompanying text.}
\item \textit{Ibid.}
\item \textit{Wolf Mfg. Co., 10 B.T.A. 1161 (1928); Lindheim v. Commissioner, 2 B.T.A. 229
(1925).}
\end{itemize}
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. In 1943, the Supreme Court in Commissioner v. Heininger 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. The case involved an unsuccessful defense against the issuance of a Post Office Department fraud order, a non-criminal prosecution. 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." 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]." The policies of the postal statutes were held not to be frustrated by allowing the deduction of legal expenses.

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
continued to deny deductions for such expenses. 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. 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 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, with violations of the mail fraud statute, and with conspiracy to violate these statutes. 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.

The Second Circuit reversed the Tax Court and overruled its

[Notes and citations follow]
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.” 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.”

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. The court said that in denying these expenses the tax authorities were following a judge-made rule. 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. . . .” Another bit of legislative history deemed relevant by the court was a portion of the 1951 Congressional Record 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 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 “commercial net income.”

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, 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

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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).
48 Ibid.
49 342 F.2d at 693.
expenses would be contrary to public policy.” 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.” 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. The only distinction preventing Heininger from being directly in point with Tellier is that the prosecution in Heininger was not criminal. 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.” 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.” 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. 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. 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.” 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.

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.

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.

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. Legal expenses, on the other hand, are not a legislative expression of what

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29 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.

30 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 (1965).

31 See note 8 supra.

32 As stated in A law enforcement officer, a fine is not a criminal penalty imposed for a violation of state law, and 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, and much adverse commentary. The post-Burroughs Supreme Court cases of Heinerger, 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 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-

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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) (please 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 & Linnen 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, 212 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 Heinerger, 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).


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."  

The Supreme Court in *Heininger* qualified its allowance of the deduction for legal expenses with requirements of good faith and reasonableness. 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. 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. . . ." 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. The disallowance is based on the same implied public policy, recognized in *Broughs*, against sanctioning any expenditure that would lend encouragement to illegal practices and activities. 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." Also, the allow-

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67 342 F.2d at 694.  
68 See note 28 *supra* and accompanying text.  
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).  
72 See note 8 *supra* and accompanying text.  