BUSINESS EXPENSES, DISALLOWANCE, AND PUBLIC POLICY: SOME PROBLEMS OF SANCTIONING WITH THE INTERNAL REVENUE CODE

In responding to the question of whether a penalty incurred in the conduct of a business could be treated as an expense for income tax purposes, Scrutton, L.J., stated:

I confess that to the question so stated it seems to me that the obvious answer is "Of course he cannot." But as Lord MacNaughten 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."


It has long been established that most business expenses or losses that themselves contravene state or federal regulatory or penal statutes or which result from such violations are not deductible under the business expense provision or other sections of the Internal Revenue Code.1 Toward the end of the


The application of the public policy doctrine to income tax deductions probably originated in England in Inland Revenue Comm'rs v. Warnes & Co., [1919] 2 K.B. 444. Apparently disallowance first appeared in federal tax cases during the 'twenties. See, e.g., Great Northern Ry. Co., 8 B.T.A. 225, aff'd, 40 F.2d 372 (8th Cir. 1927), cert. denied, 282 U.S. 855 (1930); Columbus Bread Co., 4 B.T.A. 1126 (1926). An early dictum of the Supreme Court has had a profound influence on allowance of deductions. In reply to the allegation that a deduction should be had for bribery if claimed by an illegal business, Justice Holmes remarked: "[I]t will be time enough to consider the question when a taxpayer has the temerity to raise it." United States v. Sullivan, 274 U.S. 259, 264 (1927).

Most expenditures have been disallowed under the business expense provision, § 162 of the Internal Revenue Code, which allows deduction of all the "ordinary and necessary" expenses incurred in a trade or business. Although the "ordinary and necessary" language has provided a convenient hook for nondeductibility of business expenditures, the absence of this language in the business loss provision, § 165, has not prevented disallowance on the ground of public policy. See, e.g., Clarke v. Haberle Crystal Springs Brewing Co., 280 U.S. 384 (1930) (denying deduction of losses resulting from adoption of prohibition amendment); United States v. Algemene Kunstzijde Unie, N.V., 226 F.2d 115 (4th Cir. 1955) (confiscation of property seized under the Trading with the Enemy Act not a loss within purview of income tax statute); G.E. Fuller, 20 T.C. 308 (1953), aff'd, 213 F.2d 102 (10th Cir. 1954); Nicholas D. Wusich, 35 T.C. 279 (1960). But cf. Bromberg v. Edwards, 48 Am. Fed. Tax R. 1716 (M.D. Ga. 1955), aff'd, 232 F.2d 107 (5th Cir. 1956), in which the district court, allowing the deduction of a loss from a theft where the taxpayer sent money to a swindler who was allegedly betting on fixed races, observed that "there is no provision in
1958 term, the Supreme Court on the same day handed down three decisions on the public policy exception to income tax deductibility of business expenditures.\(^2\) The importance of these decisions is due only partially to the fact that, in an area involving large numbers of both taxpayers and dollars, Supreme Court decisions were conspicuous by their absence.\(^3\) Equally important were considerations stemming from the state of the law as it had been evolved in the decisions of lower courts and administrative agencies. It may be received learning that the path of the common law resembles rather the gnarled oak than the clean lines of a Brancusi sculpture. In the field of the public policy exception, however, even the outlines of the trees had been lost to view as the result of unchecked proliferation of obscure distinctions.\(^4\)

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The Court did, however, deny a deduction for amounts spent to induce legislation on behalf of enemy aliens in Textile Mills Securities Corp. v. Commissioner, 314 U.S. 326 (1941). Treasury Regulations have long established that expenditures are not deductible as business expenses if incurred or paid for lobbying purposes, promotion or defeat of legislation, or political purposes. See Treas. Reg. § 1.162-15(c) (1) (1959).

Disallowance of political expenditures has not been based on the general public policy exception to the Internal Revenue Code, but upon the existence of the Treasury Regulation. See Cammarano v. United States, 338 U.S. 498 (1959). In addition, non-deductibility of such expenditures raises problems that are distinct from those presented by disallowance of unlawful and immoral expenses. Accordingly, such disallowance will not be discussed in this Comment. For an able discussion of political expenditures and Treasury policy, see Deducting Business Expenses Designed to Influence Governmental Policy As "Ordinary and Necessary": Cammarano v. United States and a Bit Beyond, 69 YALE L.J. 1017 (1960), and Peters, Political Campaign Financing: Tax Incentives for Small Contributors, 18 LA. L. REV. 414 (1958).

3. Before these decisions, the Court had decided only two cases involving disallowance on the ground of public policy: Commissioner v. Heininger, 320 U.S. 467 (1943), and Lilly v. Commissioner, 343 U.S. 90 (1952). These cases involved attorney fees and lawful, though ethically questionable, kickbacks to eye doctors. Although conflicts abounded among the circuits on such items as fines and penalties and sundry illegal expenditures, the Court did not pass upon these items until 1958.

The Court, in Clarke v. Haberle Crystal Springs Brewing Co., 280 U.S. 384 (1930), disallowed a deduction of a business loss resulting from the adoption of the prohibition amendment. Though consistent with the public policy doctrine in spirit, because such losses were widespread and a result of a constitutional amendment, this decision has not been viewed as one based upon the broad public policy exception to the Internal Revenue Code.

Thus, for example, legal expenses and punitive damages incurred in a "private" tort action based upon fraud, malicious prosecution, or breach of a fiduciary duty, have been allowed as ordinary and necessary business expenses. Any moneys paid to the federal or state government, however, whether by virtue of a willful, negligent, or inadvertent violation of a statute or of a tort against the government, are generally denied deduction. But some governmental "penalties" may be deducted, depending on the circumstances of a particular violation, on the purpose of the statute under which they are incurred, or, on whether the court hearing the tax controversy disagrees with the policy of the statute that has been violated. And counsel fees and court costs incurred in defense of all criminal prosecutions have been held non-deductible business expenses if the outcome is adverse to the taxpayer; the same expenses, however, have been allowed, even if the taxpayer's defense is unsuccessful, where the government chooses to prosecute civilly instead of criminally against the identical business activities. And although many of the expenses of a business entirely proscribed by state statutes are disallowed because the deductions would frustrate the policy of such statutes, the "legitimate" expenses of an illegal business, such as the rent, wages, and losses of a gambling enterprise, have nevertheless been fully deductible.

The extent and complexity of this thicket created by the Treasury and the courts is at least in part attributable to the absence of any statement in the Code, in previous revenue acts, and in the Treasury regulations prohibiting the deduction of business expenses on the ground that they contravene public policy as expressed in federal or state statutes. Indeed, the Committee report accom-


9. See, e.g., Kesshaw Metal Co. v. Commissioner, 264 F.2d 561 (3rd Cir. 1959).


12. See, e.g., Doyle v. Commissioner, 231 F.2d 635 (7th Cir. 1956); Comeaux v. Commissioner, 10 T.C. 201, aff'd on other grounds sub nom. Cohen v. Commissioner, 176 F.2d 394 (10th Cir. 1956). But see Albert D. McGrath, 27 T.C. 117 (1956).

panying the 1913 Revenue Act specifically rejected a proposal to limit losses and deductions to those incurred in a legitimate or lawful trade.\(^{14}\) This position was reaffirmed in 1951 when Congress rejected Senator Kefauver's proposal for disallowing deductions under section 162 "for any expense paid or incurred in or as a result of illegal wagering," on the ground that the Internal Revenue Code was not intended to penalize or prohibit unlawful activities; and in 1954 when Congress refused to enact the public policy provision drafted by the American Law Institute.\(^{15}\) Furthermore, although Congress has re-enacted the business expense provisions many times since the public policy gloss was added in 1924, the argument that such re-enactments constitute congressional approval is highly questionable, both because judicial interpretations have generally been conflicting and because no single decision disallowing expenses had, prior

\(^{14}\) The object of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon "futures," but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way.


15. 97 Cong. Rec. 12230-44 (1951) (debate on amendment proposed by Senator Kefauver). Moreover, it was added that the income tax is based on the net income from a business, not on its gross receipts, and that the constitutionality of a gross income tax on gamblers would be dubious. Id. at 12244 (remarks of Senator George). The Kefauver amendment was rejected in favor of the wagering tax, which, although obviously designed to aid state law enforcement authorities, is not itself a repressive fiscal measure. Int. Rev. Code of 1954, §§ 4401-23. See United States v. Kahviger, 345 U.S. 22 (1953).

Before enactment of the 1954 Code, the American Law Institute drafted a statute defining the concept of public policy as a bar to deductions ALI Fed. Income Tax Stat. § X 154(i) (May 1952 Draft). With a few ambiguities, the suggested provision was a rough codification of the rules developed by the Treasury and the courts. See Comments, ALI Fed. Income Tax Stat. § X 154(i) 282-86 (May 1952 Draft). Congress, however, did not discuss the question in enacting the comprehensive revision of the tax laws in 1954. After the Court's decision in Commissioner v. Sullivan, 356 U.S. 27 (1958), the Department of Justice recommended a bill to Congress disallowing expenditures for rent, wages, or salaries incurred in violation of federal or state law. 46 CCH Taxes on Parade No. 25, Part I, at 3 (June 3, 1959) ; H.R. 7394, 86th Cong., 1st Sess. (1959), 105 Cong. Rec. 9167 (1959). However, Congress again refused to add a public policy addendum to the business expense provision of the Code.

In 1960 Congress added a provision to § 162 disallowing deduction of payments made to officials or employees of foreign governments that violate the laws of the United States. Int. Rev. Code of 1954, § 162(3) (c) ; Treas. Reg. § 162-18, 2 CCH Fed. Tax Rep. ¶ 1393 (1962). This provision, although clearly a public policy exception to deductibility, does not indicate congressional approval of the broad use of the public policy disallowance exception, or indeed, any use of the Code for sanctioning undesirable activities conducted in the United States. Under the broad scope of the public policy doctrine judicially and administratively engrafted on § 162, foreign payments that contravene domestic law could easily have been disallowed without any further statutory authorization. Thus, this narrow authorization
to 1954, received approval by the Supreme Court.\textsuperscript{10} In fact, the Court had indicated possible reservations about the sweeping application of public policy rationale in two cases allowing deduction of expenses challenged by the IRS.\textsuperscript{17}

Undaunted by the lack of legislative authority, however, the Treasury early discovered a mandate for extirpating evil in the words of the Code's business expense provision, which, in disarmingly simple language, purports to allow as deductions from gross income "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."\textsuperscript{18}

of disallowance should not be read as an implicit congressional approval of the public policy exception.

However, a committee report accompanying the 1962 Revenue Act indicates that the Senate Finance Committee believes that the proposed amendment to the business expense provision incorporates a public policy exception:

However nothing in your committee's bill is to be construed as allowing a deduction for any expense which is against public policy or which violates the public conscience. Deducting an expense incurred for such purpose under the guise of generating "business goodwill" will not be condoned and under your committee's Amendment is not deductible.

108 CONG. REc. 16843 (Aug. 28, 1962 daily ed.).

16. Although the Court did sanction disallowance in Clarke v. Haberle Crystal Springs Brewing Co., 280 U.S. 384 (1930), and its companion case, Renziehausen v. Lucas, 280 U.S. 387 (1930), these decisions have not been considered as public policy exceptions to deductibility. See note 3 supra.

Distinctions as well as results have multiplied so rapidly that it was and indeed still is difficult to determine the scope of the public policy exception at any given moment. For instance, in 1950 the Tax Court found that wages and salaries of a gambling enterprise were deductible. Doyle v. Commissioner, 13 CCH Tax Ct. Mem. 1171 (1954), aff'd, 231 F.2d 635 (1956). A few years later the Tax Court held the same kind of expenditures violating the same state laws not deductible, without attempting to distinguish or explain its reasons for overruling its previous holding. Albert D. McGrath, 27 T.C. 117 (1956).

17. Lilly v. Commissioner, 343 U.S. 90 (1952), and Commissioner v. Heininger, 320 U.S. 467 (1943). Even these decisions, moreover, did not clarify the boundaries of the doctrine. Compare the Treasury's interpretation of Heininger as allowing deduction of all attorney fees in civil litigation, and some criminal prosecutions, G.C.M. 24377, 1944 Cum. Bull. 93, with Judge Hand's interpretation in Jerry Rossman Corp. v. Commissioner, 175 F.2d 711, 713 (2d Cir. 1949):\

[I]f one rigorously applied the doctrine, a taxpayer could never deduct the payment of fines and forfeitures; and we can see no relevant distinction between them and legal expenses incurred in an unsuccessful effort to prevent their collection. Indeed, to hold otherwise would be to subsidize the obduracy of those offenders who were unwilling to pay without a contest and who therefore added impenitence to their offense; and for this reason in the decisions just cited we held that such legal expenses were never deductible. The Supreme Court overruled this doctrine in Commissioner v. Heininger [sic] . . . ; and the question is as to the scope of that decision. It is possible to read it as distinguishing between the legal expenses of an unsuccessful defence [sic] and the payment of fines or forfeitures. On the other hand, it is also possible to read it as meaning that, whether the claimed deduction be of legal expenses or of fines or forfeitures, its allowance depends upon the place of sanctions in the scheme of enforcement of the underlying act. We think that the second is the right reading . . . .

18. INT. REV. CODE of 1954, § 162. See also id. at § 212.
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The Treasury has argued that expenses incurred in nefarious activities can never be "ordinary or necessary," since it is never "ordinary" or at least "necessary" to violate the law in conducting a business. So stated, this reasoning seems hardly persuasive to an observer whose regard for the accepted meanings of these terms remains unaffected by his desire to realize the good.


20. Although the business expense provision has been a fertile source of litigation, the difficulties arise primarily because the Code expressly disallows the deduction of personal and capital expenditures. 4 MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.02 (1960). Aside from the public policy exception, expenditures genuinely incurred by a taxpayer in profit-seeking activities are rarely disallowed because they are not "ordinary" or "necessary." Since a strict construction of these terms would result in a tax on an amount that might have been earned, and would place the courts and Commissioner in the position of business efficiency experts reviewing the commercial decisions of the taxpayer, a function which they are ill-fitted to perform, the courts have not given any precise content to these terms. See, e.g., Welch v. Helvering, 290 U.S. 111 (1933).

Rather, a determination of whether a particular expense is "ordinary and necessary" depends on the actual practices of businessmen. As stated by Mr. Justice Cardozo, the only guides are "the ways of conduct and the forms of speech prevailing in the business world." Id. at 115. Thus, an outlay is a business expense if it is directly connected with or has proximately resulted from a taxpayer's acquisitive activities. E.g., Kornhauser v. United States, 276 U.S. 145 (1928). An expense is "ordinary" if it is of common or frequent occurrence in the type of business involved, or if it is embraced within the normal overhead or operating expenses of an enterprise. An expense is "necessary" if it is appropriate or helpful to the business. Deputy v. DuPont, 308 U.S. 488 (1940); Welch v. Helvering, 290 U.S. 111 (1933); Commissioner v. People's Pittsburgh Trust Co., 60 F.2d 187 (3rd Cir. 1932); Cannon Valley Milling Co., 44 B.T.A. 763 (1941); B. Manischewitz Co., 10 T.C. 1139 (1948). Under the present treatment of unlawful expenditures, the problem is often cast in terms of whether the expenses are ordinary or necessary. When the Treasury disallows penalties paid for an industry wide practice of violating burdensome maximum weight laws, or even protection payments paid by a gambling establishment to avoid prosecutions, on the ground that it is never "ordinary," or at least "necessary" to violate the law in conducting a business, however, it is clear that the meaning of these terms is distorted to meet the demands of the public policy rationale. It is the fact of illegality and not the ordinary criteria of "ordinary and necessary"—whether such expenditures are generally incurred in the taxpayer's type of business—that is determinative under the public policy rationale. Thus, expenditures involved in the purchase of intoxicating liquors for business purposes are deductible in all places, except in dry states. See Rev. Rul. 55-307, 1955-1 Cum. Bull. 22.

Some courts have recognized that disallowed expenses are often "ordinary and necessary" in the generally established meaning of those terms. E.g., Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178, 180 (2nd Cir. 1931):

It might have been said in Great Northern Ry. Co. v. Commissioner, [8 B.T.A. 225, aff'd 40 F.2d 372 (8th Cir. 1927), cert. denied, 282 U.S. 855 (1930)], that fines for violations of regulations such as were there imposed are not infrequent, are inevitable in any large railroad system, and for that reason may reasonably be allowed as "ordinary and necessary" expenses of the business. It is not easy to distinguish such fines from expenditures incurred in connection with actions to recover for negligence or because of patent infringements, unless one draws an arbitrary line between criminal and civil actions even where the criminal actions relate to matters involving no moral turpitude. Undoubtedly expenditures which are in themselves immoral, such
But the objections to the public policy exception run deeper than the resulting disarray of cases and the torturing of the ordinary language of one of the few Code sections which has thus far escaped the prolixity of the framers of the Internal Revenue Code.

Disallowance of expenses actually incurred in the production of income, regardless of its source, results in a tax on gross rather than net income and is thus inconsistent with a Code geared to the latter concept. The conventional response to this objection is the bromide that all deductions are a matter of legislative grace and that income as defined in the Code is gross receipts less those deductions allowed by Congress. Whatever its theoretical validity, however, this proposition cannot be sustained historically, since Congress has never sought to impose the income tax on any amount greater than that commonly regarded as commercial net income.\textsuperscript{21} And congressional adherence to the concept of net income was strikingly reaffirmed in 1942, with the passage of section 212,\textsuperscript{22} which, by explicitly allowing a deduction for all the ordinary and necessary expenses incurred in the production of income,\textsuperscript{23} overruled a Supreme Court decision denying deductions for expenses incurred in business for bribery of public officials to secure protection of an unlawful business would not have to be allowed in order consistently to justify a deduction of fines paid for violations of law involving no moral turpitude and practically inevitable.

Indeed the Treasury and courts have conceded that some disallowed expenses are at least "ordinary," while relying on the argument that violations of law are never "necessary." Cf., National Outdoor Advertising Bureau v. Helvering, 89 F.2d 878 (2d Cir. 1937); Boyle, Flag & Seamen, Inc., 25 T.C. 43 (1955). But since "necessary" merely means helpful or profit seeking, not "necessary" in any absolute sense, the departure from this meaning is clear. Although helpful, the statutory "hook" of "ordinary" and "necessary" has not proved indispensable. See note 1 supra. But see Bromberg v. Edwards, 48 Am. Fed. Tax R. 1716 (M.D. Ga. 1955), aff'd, 232 F.2d 107 (5th Cir. 1956).

\textsuperscript{21} See Griswold, An Argument Against the Doctrine that Deductions Should be Narrowly Construed as a Matter of Legislative Grace, 56 Harv. L. Rev. 1142, 1147 (1943): Taxation on net, not on gross, income has always been the broad basic policy or our income tax laws.... Net income may be defined as what remains out of gross income after subtracting the ordinary and necessary expenses incurred in efforts to obtain or to keep it.


\textsuperscript{22} Int. Rev. Code of 1939, § 23(a)(2), as amended by Revenue Act of 1942, § 121(a), 56 Stat. 819; Int. Rev. Code of 1954, § 212. The congressional report accompanying the 1942 bill indicates that Congress intended to broaden existing law and thereafter permit the deduction of all the ordinary and necessary expenses incurred in the production of income regardless of whether the expense was incurred in connection with the taxpayer's trade or business. See H. Rep. No. 2333, 77th Cong., 1st Sess. 46 (1942). See also Elsie B. Gale, 13 T.C. 661 (1949), aff'd on other grounds, 191 F.2d 79 (2d Cir. 1951).

\textsuperscript{23} Higgins v. Commissioner, 312 U.S. 212 (1941). See discussion in McDonald v. Commissioner, 323 U.S. 57, 66-67 (1944) (dissenting opinion of Mr. Justice Black).
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activities that did not constitute a trade or business within the purview of section 162. In fact, the very breadth and vagueness of the contours of 162, together with the repeated refusals of Congress to incorporate a public policy restriction on deduction of business expenses, may ultimately reflect a belief that constitutional boundaries would be transgressed by a tax imposed on gross income or gross receipts rather than net income.24

Admittedly the net income concept of tax liability has been modified to some extent by other policies pursued by means of the revenue laws, such as inter-personal equity among taxpayers, business incentives, and promotion of charitable institutions. But in every case save one where Congress has sanctioned departure from the net income standard,25 the tool employed has been allowance rather than disallowance of expenditures. Thus, deductions for medical expenses 26 and charitable contributions 27 reduce the tax base below net income, and the lower capital gains 28 rates have a similar effect. Congress, in other words, where it has attempted to further policies other than the maximization of revenues, has invariably done so by decreasing rather than increasing the tax base. Thus, if the Internal Revenue Code embodies congressional approval of the use of revenue laws to sanction activities that violate public policy, it not only represents a wholly sub silentio policy declaration but also an affirmative acceptance of means that are diametrically opposed to those normally utilized in the Code to achieve social and economic objectives.

Aside from these basic objections, both the Treasury and the courts have neither effectively defined the scope of the public policy doctrine nor revealed intelligible criteria for its application. And, unfortunately, juxtaposition of the three recent Supreme Court opinions fails to reveal the emergence of a coherent rationale. Thus, in Hoover Motor Express Co., Inc. v. United


Although the issue has not been resolved, some authority suggests that the term "income" as used in the sixteenth amendment means net income, not gross income or gross receipts. See Commissioner v. Weisman, 197 F.2d 221 (1st Cir. 1952); Hofferbert v. Anderson Oldsmobile Inc., 197 F.2d 504 (4th Cir. 1952); Lela Sullenger, 11 T.C. 1076 (1948). But see Davis v. United States, 87 F.2d 323 (2d Cir.), cert. denied, 301 U.S. 704 (1937), holding that losses on the sale of stock by an investor, not in the business of buying and selling stock, belonged in the category of deductions that were a matter of legislative grace.

The constitutionality of a gross income tax was a concern of the opponents of the Kefauver gambling tax proposal. See 97 Cong. Rec. 12239-45 (1951).

25. Defense Production Act of 1950, as amended, ch. 275, § 104(i), 65 Stat. 136 (1951). Penalties imposed for various forms of evasion of the income tax are not considered as exceptions to the net income concept, since they are imposed to insure that the tax is in fact based upon net income.

States and Tank Truck Rentals, Inc. v. Commissioner, fines were ruled nondeductible because the state statutes which had been violated were taken as expressions of public policy, while in Commissioner v. Sullivan, the ordinary expenses of an illegal gambling enterprise were held to be deductible, although the expenditures were in direct violation of state criminal statutes. Were the problem posed by these decisions merely one of Euclidean symmetry, the resultant confusions might elicit no more than bemused Socratic queries in the academic halls where the arcane legal mysteries are explored. But the problem is of considerably greater magnitude. For the Supreme Court's formulation of the doctrine is the only standard available to taxpayers in deciding—at the risk of civil or criminal sanctions—whether to deduct a particular expenditure or not, to the Treasury in determining whether to challenge or litigate a given deduction, and to the numerous tribunals that hear tax cases in resolving controversies between taxpayers and the IRS.

This lack of a coherent rationale for the public policy exception may in part be ascribed to the fact that distinct types of expenditures, despite their inherent differences, are disallowed under the same rubric. Fines and payments to the federal, state, or local governments for violations of statutes and ordinances, certain legal fees, illegal expenditures, and the expenses of illegal businesses are all indiscriminately relegated to the limbo of disallowance by invocation of the public policy doctrine. In each case, the formulation of the doctrine is the same: an expenditure, incurred in the course of a trade or business, may not be deducted if allowance of the deduction "would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof." But the problems presented by the various categories, although similar in some basic respects, are by no means identical. As a result, separate consideration of each category is a prerequisite to the formulation of a rational public policy toward income tax deductibility of these expenditures.

Fines and Penalties

Fines and penalties paid for violations of various federal and state statutes have generally been held non-deductible. The Supreme Court did not rule on the question until 1958, when, in Tank Truck Rentals, Inc. v. Commissioner, it unanimously held that fines paid by interstate motor carriers for violations of state maximum weight laws were not deductible business expenses. A better case for the commercial necessity of these expenditures could hardly have been presented. The taxpayer, a trucking company, transported bulk liquids, such as oil and gasoline, throughout many States along the Eastern seaboard. All of those States imposed a uniform maximum weight of 60,000 pounds for vehicles

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operating on its highways, except Pennsylvania, which had a substantially lower limit. Because of the standardized equipment used in the industry, which had to be fully loaded to operate both safely and profitably, the taxpayer, with the rest of the industry, deliberately operated its trucks overweight in Pennsylvania, paying fines whenever violations were detected. In unanimously holding that the fines paid by the taxpayer were not deductible business expenses, the Court reaffirmed the traditional rationale for disallowance: although the payment of fines and penalties is not in itself against public policy, allowance would benefit the taxpayer by remitting part of the sanction in the form of a tax deduction, thus placing the federal government in the position of subsidizing the taxpayer's violation. The rationale, however, is a curious one, for it rests ultimately on the proposition that all of the taxpayer's income belongs to the government, and that whatever the government does not retain is thereby converted into a "subsidy" for the taxpayer.

It has been argued that since the Internal Revenue Code is not concerned with the source of income, it should take a similar neutral attitude toward the reduction of penalties. But the problem cannot be solved so easily. Whether the income tax allows or disallows reduction of penalties, the content of the sanction involved is altered. The question to date has been framed in terms of whether deductions reduce the impact or "sting" of the penalty. But such an argument fails to recognize that disallowance itself increases the burden of the fine by the amount of the additional tax liability. The question to be answered therefore is whether the income tax laws should be used to increase or decrease the monetary sanctions imposed by statutes which themselves say nothing about whether they want additional penalties or not. Disallowance of penalties, in other words, is not solely a matter of taxation, but also necessarily involves the policy of the statute that has been violated.

Some courts, realizing that disallowance of fines and penalties amounts to an additional sanction imposed without warrant of the primary statute which created the offense and monetary sanction for its violation, have questioned the presumption of increasing the penalty and decided the issue of deductibility by looking to the nature of the taxpayer's conduct and the place of sanctions in the scheme of enforcement of the primary statute. Jerry Rossman Corp. v. Commissioner best illustrates this approach. The taxpayer in Rossman, upon learning that he had unwittingly overcharged customers under the Emergency Price Control Act, voluntarily reported his violation to the O.P.A. before being investigated. Since the amount of overcharges could not be returned to ultimate consumers, the Price Administrator ordered that this amount be paid to the government and agreed not to claim the treble recovery available under the

33. 356 U.S. at 32.
34. Id. at 35.
35. E.g., Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178 (2d Cir. 1931).
37. 175 F.2d 711 (2d Cir. 1949).
The Second Circuit, per Judge Learned Hand, held the taxpayer's payment to the Government deductible on the ground that a deduction in these circumstances would not frustrate the policy of the Emergency Price Control Act. The court, finding that the taxpayer had taken all practical precautions to avoid violating the act and that the policy of the Administrator was to settle for only the overcharge if the seller had acted in good faith, reasoned that increasing or imposing an additional penalty on an inadvertent violator could only be "justified by a Draconian School of Penology." Other courts have similarly sympathized with an unwary taxpayer confused by the maze of regulations controlling his economic activities and allowed a deduction as a recompense for his diligence.

Even if sympathy for the "innocent" taxpayer is well founded, the conduct of the taxpayer in violating the primary statute and the fact of compromise or settlement by the responsible authorities are unworkable criteria for reducing or increasing the sanction. Settlement by the enforcement agency or court does not necessarily mean that the violation was unavoidable or that the taxpayer has used due care; more often it may reflect limitations on the time and personnel of the primary authority. Proof of bad faith or want of due care is always difficult because the evidence is peculiarly available to the defendant. Moreover, since some statutes are explicitly aimed at negligent or careless conduct, violations arising out of indifference or carelessness under these statutes may be more significant than willful ones. Similarly, voluntary disclosure of violations does not prove inadvertence or that the offender took all practical precautions. The violator may have confessed his sin only in the expectation of obtaining a settlement for less than the full statutory penalty. The difficulties

38. Id. at 712.
39. Id. at 714.
40. Ibid.
44. "Violations arising out of carelessness or indifference may well be more important in some situations than willful violations." Memorandum to OPA Regional Administrators from Price Administrator Chester Bowles, Jan. 31, 1945.
45. Cf. Jerry Rossman Corp., 10 T.C. 468, 472-73 (1948); Gelfand, Payments to OPA, 27 Taxes 961 (1949). The Tax Court found that "it is not too clear from the evidence that
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inherent in the use of these criteria are compounded by the fact that the taxpayer's conduct in violating a statute is being appraised many years later in a tax proceeding. Furthermore, the numerous tribunals that hear tax cases and the IRS are not the appropriate authorities to determine whether a taxpayer has used good faith or due care in attempting to comply with the myriad of federal, state, and municipal regulations and statutes controlling the activities of businessmen.46

Another test suggested in Rossman is to base deductibility on the role of the monetary sanctions in the enforcement of the primary statute.47 If this standard means that deductibility is to turn on whether the sanctions employed by the responsible authority do in fact deter violators, it would leave far too much discretion to the Commissioner and tax courts; deductibility would vary with the decision-maker's views on deviation and deterrence, subjects on which there is wide-spread disagreement.48 If, on the other hand, the attempted distinction is between those penalties which do in fact deter and those which are not necessary to assure compliance, then the blanket presumption in favor of disallowance under the present law—indulged in by judges less prone to fine the overcharges in question might not have been avoided if the petitioner had adopted other more appropriate accounting methods." 10 T.C. at 472. Moreover, the "unavoidable" violations involved overcharges of over two million dollars. Brief for Pacific Mills as Amicus Curiae p. 1, Rossman v. Commissioner, 175 F.2d 711 (2d Cir. 1949).

46. Congress seems to have given recognition to this view in the Defense Production Act of 1950, as amended, ch. 275, § 104(i), 65 Stat. 136 (1951). After the experience with disallowance by the IRS and the tax courts under the Emergency Price Control Act of 1942, 56 Stat. 23, Congress made disallowance of overcharges depend upon a determination and certification by the appropriate economic stabilization agency charged with enforcement of the D.P.A.

(a) The President shall also prescribe the extent to which any payment made, either in money or property, by any person in violation of any such regulation, order, or requirement shall be disregarded by the executive departments and other governmental agencies in determining the costs or expenses of any such person for the purposes of any other law or regulation, including bases for determining gain for tax purposes.


For some inexplicable reason, this approach has not been extended to other federal or state regulatory statutes.

47. 175 F.2d at 713.

distinctions than Judge Learned Hand—seems implicitly to answer the test
posed in *Rossman* by categorically assuming that additional penalties are al-
ways effective in ensuring compliance.

A policy of allowance, moreover, is often said to be undesirable because de-
duction would affect violators unequally, with an obvious preference for tax-
payers in the high income brackets. The effect of disallowance, though also
unequal, with a preference for violators in low income brackets, is found un-
objectionable. This view assumes that the offender, whether rich or poor,
should feel the loss in approximately the same way. Whatever the inherent
merits of this penalogical theory, it cannot be justified by reference to the
policy of the primary statutes, since these statutes have no progressive system
of fines and penalties. In fact, the only policy expressed is that all violators,
regardless of wealth or income during a particular year, are to be treated
equally. And, the wisdom of progressive sanctioning, which necessarily re-
sults from disallowance of penalties, is questionable when applied to at least
some of the statutes regulating the acquisitive activities of the businessmen.
Although evidence is scant, studies of violations of price control and related statutes
have shown that voluntary compliance is more likely to occur among firms with
rising profits and that frequently the low profit firms establish a pattern of non-
compliance for the industry. If it is assumed that the marginal enterprise
is more likely to initiate noncompliance with some of the economic regulations
involved in tax cases, then the present policy of disallowance, in favoring the
low profit firms, would seem to be particularly inappropriate as a sanctioning
device.

The tax courts have avoided defining a “penalty” for purposes of disallow-
ance, but have been content to accept the labels given by the primary statute.
Thus, for example, some courts have extended the policy of disallowance to all
monetary exactions paid to the government, except those designated taxes.
Where the sanctions of the primary statute involve payments to an individual
rather than the government, however, the tendency is to classify the payments
as “remedial” rather than “penal” and allow their deduction. This verbalistic
distinction between private and public wrongs may produce some curious
results. For instance, because ultimate consumers had a private right of action,
persons who violated O.P.A regulations by overcharges to such consumers
were allowed to deduct amounts paid as treble damages; persons who sold

49. LANE, *The Regulation of Businessmen* 90-95 (1954). The meat industry and
laundries are discussed in KATONA, *Price Control and Business* 241 (1945). But see

Bureau, Inc. v. Helvering, 89 F.2d 878 (2d Cir. 1937).


to middlemen, however, were not permitted to deduct any amounts paid as overcharges because the statute left the power of enforcement in the federal government. The same distinction has been used to differentiate between torts against the government and those against private persons. Although in private actions the community is involved only at the initiation of a party who alleges an unlawful deprivation, considerations of deterrence, prevention, and punishment do, in fact, enter into damage awards which take the nominal form of a compensatory tort or contract remedy. The purpose of exemplary or punitive damages, for example, is admittedly punishment rather than restitution. And, even so-called remedial payments in private actions, while intended to be compensation to the deprived party, are also intended to prevent further violations of the norms of public order. Many payments to the government, on the other hand, have their remedial as well as punitive aspects, as, for instance, the fines involved in *Tank Truck*, which were to be used exclusively for the repair and maintenance of the local highways, and were only sporadically imposed. In fact, at one time the IRS classified these payments as tolls intended to compensate the State for damage done to the highway by overweight motor carriers.

The problem of determining whether a statute is "penal" or "remedial" can perhaps best be seen in the arguments for and against deduction of payments made by corporate officers and directors under section 16(b) of the Securities Exchange Act. Briefly, the purpose of section 16(b) is to "protect the interests of the public by preventing directors, officers and principal shareholders of a corporation ... from speculating in the stock [of such corporation] on the basis of information not available to others." In some respects, payments made under section 16(b) appear to be a penalty for engaging in an unlawful transaction. Thus, liability under the statute is not predicated upon damage either to the corporation or to a shareholder but is imposed in the interest of the public, in order to insure a fair and honest market by frustrating possible use of inside information. Liability is not dependent upon intent or conscious

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54. Standard Oil Co. v. Commissioner, 129 F.2d 363 (7th Cir. 1942); David R. Faulk, 26 T.C. 948 (1956). See *Helvering v. Hampton*, 79 F.2d 358 (9th Cir. 1935).
58. 1956 Annual Tax Fortnightly 598.
wrongdoing and the remedy is not dependent upon any relationship between
the parties to the purchase and sale. Moreover, the right of action is placed in
the corporation whose securities were subject to the dealing, and recovery
goes neither to the shareholder nor to any past security holder but to the
corporation. On the other hand, payments under section 16(b) are not like
ordinary "penalties" paid under regulatory or criminal statutes. Purchases and
sales by a director or officer within a six month period are not declared wrong-
ful in themselves. In fact, the statute applies regardless of whether wrong was
done. It merely takes the profit out of certain proscribed transactions—without adding any amount as a penalty—by requiring the profit to be paid to
the corporation. Arguably the paying over of a profit, though under compul-
sion of law, by one who has done no wrong is more remedial than punitive.
What this discussion of section 16(b) makes clear, however, is that posing the
question of disallowance in terms of whether a statute is penal or remedial
serves only to obfuscate the basic issue as to whether the responsible authority
—in this case Congress or the S.E.C.—intended an additional monetary sanc-
tion imposed for violation of a statute, and whether the practical needs of
enforcement would best be served by adding to the sanctions of the act.

These problems have all stemmed from the fact that the primary statutes do
not reveal the manner in which the sanctions imposed under them should be
affected by the operation of the income tax laws: this is a question which cannot be answered because the legislature that passed the statute and the enforcement authority that imposed the sanction have not considered the issue, or, at least, have not reflected their consideration in materials available to the IRS or the taxpayer. This lack of legislative and administrative concern, at both the federal and state levels, is surprising in view of the widespread aware-
ness of the pervasive effect of the federal income tax on every branch of the
law. Surprising or not, the solution to the problem lies at the level of the
craftsmen who formulate standards of conduct and the modes of assuring
compliance with these standards. The tax treatment of fines and penalties

62. Id. at 149.
63. Ibid.
64. Report of the Securities and Exchange Commission on Proposals for Amending
1st Sess. 38 (1941).
65. "[T]he words 'penal' and 'penalty' have many different shades of meaning, and are
1939).
66. The Tax Court first held such payment nondeductible, on the ground that allowance
would frustrate the policy of § 16(b). Robert Lehman, 25 T.C. 629 (1955); William F.
Davis, Jr., 17 T.C. 549 (1951). The majority of the Tax Court has now decided that such
payments are deductible business expenses, at least where there is an "innocent" trans-
gression of the statute. Laurence M. Marks, 27 T.C. 464 (1956). The IRS has subsequently
adopted the view that a deduction for payments pursuant to § 16(b) will not be denied on the
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should not be left to the IRS precisely because in the final analysis it is not essentially a matter of taxation at all.

Many of the manifold problems encountered in the disallowance of fines and penalties could be obviated if the state legislature or Congress, when they establish the monetary exactions for violations of any primary statute, would include on the face of the act the desired tax treatment of penalties exacted for noncompliance. Or, where an all-or-nothing approach seems too rigid, the legislature could delegate to the agency responsible for enforcing the statute, or the courts, the authority to decide whether the sanctions imposed should be deductible, either by rule or on a case by case basis.68 Such a delegation would allow the agency responsible for the public policy expressed in the statute to appraise the offender's conduct in respect to a particular violation, instead of leaving the issue to be litigated years later in a tax forum. Furthermore, the question of whether the tax laws should increase or decrease a sanction imposed under other statutes would not arise: whether the expenditure is allowed or disallowed, the penalty would be imposed by virtue of the statute which has been violated by the taxpayer. The IRS and the taxpayer would not have to decide whether a statute is punitive or remedial; the question would be decided by the authorities who are responsible for the statute and therefore most familiar with the policies expressed therein. And although this solution allows other federal and state authorities to decide an issue arising under the federal income tax laws, the only justification for the present treatment of fines and penalties is to avoid "frustrating" the supposed policy of the primary statutes; it therefore does not seem unreasonable for the IRS to abide by the articulated policy of the responsible authorities, especially since these authorities can, in fact, determine the tax treatment of these expenditures today simply by manipulating labels—those of "penalty," on the one hand, and "compensation" or "tax" on the other.

Illegal Expenditures

Illegal expenditures are payments made voluntarily by businessmen which are themselves in violation of a regulatory or penal statute or connected with an activity which violates such statutes.69 The public policy purported to be frustrated by the allowance of their deduction is expressed in a statute specifically prohibiting the expenditure, such as a price control law,70 or in a statute prohibiting the specific activity in which they are incurred in the course of an otherwise legal business, such as an anti-bribery or prohibition statute.71

68. For an example of such delegation in respect to one federal regulatory statute, see note 46 supra.
71. E.g., United States v. Winters, 261 F.2d 675 (10th Cir. 1958); R.E.L. Finley, 27
The various notions underlying the public policy doctrine as developed in the area of penalties are carried over to disallow illegal expenditures without any consideration of the differences, both in rationale and consequences, between disallowance of sanctions imposed for a violation of a primary statute and the disallowance of expenditures involved in unlawful activities. The differences, however, are considerable. Although non-deductibility results in an additional sanction in both cases, allowance or disallowance of illegal expenditures does not necessarily operate to increase or decrease the sanctions of the primary statute, as in the field of fines and penalties. Consequently, unlike the area of fines and penalties, a neutral attitude by the income tax law is here possible.

Unlike the area of fines and penalties, furthermore, the scope of the public policy doctrine as applied to illegal expenditures seems limitless. There is nothing in its formulation or rationale to prevent disallowance of all expenditures incurred in any activity which violates a given statute, whether the expenditures constitute the act of violation or not. Thus, for example, conceivably all of the production costs of a company violating the antitrust laws could be disallowed on the theory that the manufacturing of goods to be sold according to the terms of an illegal price fixing agreement contravenes the policy of the Sherman Act. Similarly, Tank Truck's outlays for gas and oil attributable to the unlawful overweight trips in Pennsylvania could be disallowed under the rubric of the public policy doctrine. Theoretically, therefore, literally billions of regulated transactions could be policed through the imposition of sanctions under the income tax laws. But practical considerations concerning the efficient administration of the tax laws and the difficulties involved in actively enforcing many other laws necessarily inhibit such a broad use of the public policy doctrine.

Moreover, when a fine or penalty is disallowed, a violation has already been ascertained by the responsible authorities. But where allegedly illegal expenditures are in issue, often there has been no previous adjudication of guilt, and, as a result, this question, which may pose considerable difficulties,
BUSINESS EXPENSES must initially be decided by the tax authorities. And the difficulties are compounded where, as is often the case, the economic controls transgressed by businessmen are broadly worded and vaguely defined declarations of policy entrusted to administrative agencies to develop standards by rule-making and case by case adjudication. Furthermore, if willfulness is an element of the offense, the difficulty, discussed in connection with penalties, of appraising conduct years after the violation has occurred is present.

Although the public policy doctrine in respect to illegal expenditures has not been administered on a broad scale, the problems envisaged above have nevertheless been encountered. For instance, the expense of wining customers in Oklahoma, when still a dry state, has frequently been disallowed on the ground that the use of liquor for commercial purposes would contravene the policy of the state. The Oklahoma courts, however, have held that the purchase and possession of liquor for personal use or social purposes does not violate any statute, and in 53 years of prohibition, one has yet to be prosecuted or convicted of distributing liquor for business purposes. In United States v. Winters, the Tax Court noted that the statute had never been construed to include the situation before it, but held that this was not determinative of the question of deductibility. Other forums, recognizing these difficulties, have allowed the taxpayer a deduction where, because of the complexity of the primary statute, its policy could not be ascertained.

In Tank Truck, a case concerning penalties, the Supreme Court stated that the public policy rule is not to be applied in any absolute sense, since an accommodation is to be made between the congressional intent to tax net income and the presumption against congressional intent to encourage violations. Given the differences between penalties and illegal expenditures, this language—when considered with the holding that where the expenditure is a penalty or fine imposed because of an illegal act, the expenditure is clearly within the line of disallowance—may reflect an awareness of the special problems involved in utilizing the tax laws to provide an additional sanction in the area of illegal


76. Hughes, The Supreme Court of the United States 231 (1928); Lane, The Regulations of Businessmen 96 (1954); Report of the Attorney General's National Committee to Study the Antitrust Laws (1955).

77. See text at notes 45-46 supra.


79. United States v. Winters, supra note 78.


expenditures. For the kind of statutes enforced, the proportion of violators sanctioned, and the size of the sanction imposed, are primarily determined by the mechanics of the income tax laws, and thus have no relation to the offensiveness of the taxpayer's conduct, the enforcement policy of the responsible officials, and the penalties of the primary statute.

The amount of the sanction imposed by the IRS, of course, will be equal to the increase in tax liability because of disallowance. And this figure will in turn depend on the amounts expended in the prohibited activity and on the taxpayer's profits for the particular year in which the deduction is claimed. That the result of disallowance is often an arbitrary and harsh sanction as compared with those of the primary statute may be illustrated by the following case: Taxpayer was an insurance agent in Illinois, which prohibits payments for soliciting insurance to anyone except licensed insurance brokers. For violation of this statute, the state insurance commission could fine a violator $50—$1,000 for each offense, revoke the seller's license, impose imprisonment, or merely reprimand the seller. As part of a statewide practice of paying commissions to automobile dealers for referring buyers to insurance agents, taxpayer paid $25,000 in one year and $50,000 in another to such dealers for soliciting customers for him. The state insurance commission, upon learning of these expenditures, reprimanded the taxpayer and conditioned his license on no further violations. These rather mild measures were imposed because of the lack of adequate enforcement during the years in question and the competitive conditions in the insurance business as a result of the widespread practice of paying commissions to automobile dealers. Subsequent to the state investigation, the treasury denied the taxpayer a deduction for the $75,000 paid as commissions on the ground that it would frustrate the policy of the statute prohibiting the payments. Assuming the taxpayer was in the fifty per cent income tax bracket, he paid approximately $35,000 more taxes for engaging in these proscribed activities. The tax penalty paid by other taxpayers for engaging in the same activities would depend on their income and losses during the years in question; if, for various reasons, an insurance broker had no taxable income during the year for which the deduction is sought, his penalty for the same offense would be $35,000 less than the insurance broker's described above.

82. Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 33 (1958). This interpretation is supported by another decision rendered by the Court on the same day, Commissioner v. Sullivan, 356 U.S. 27 (1958), in which the expenses of a gambling business proscribed by state law were found to be deductible. See text at notes 135-43 infra. It is contradicted, however, by other language of the Court in Tank Truck:

Certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute. . . . If the expenditure is not itself an illegal act, but rather the payment of a penalty imposed by the State because of such an act, as in the present case, the frustration attendant upon deduction would be only slightly less remote, and would clearly fall within the line of disallowance [sic].

84. Id. at 46.
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But the issue raised by disallowance of these expenditures goes beyond the apparent inequity between offender-taxpayers because of the mechanics of the Internal Revenue Code. The problem lies in the Treasury's view that a proscription articulating a norm of conduct, apart from any relevant context, constitutes the total expression of public policy on the matter. In fact, however, the sanctional provisions of statutes, specifying the actions to be taken when breaches occur, together with the enforcement decisions of the responsible authorities, are as integral a part of the federal or state policy toward these activities as the proscription itself. Furthermore, the mere existence of severe deprivational sanctions in economic regulations does not indicate their actual

85. See Frederick C. Moser, 18 CCH Tax Ct. Mem. 116, 120-21 (1959); Israel Silberman, 44 B.T.A. 600, 603 (1941):

Petitioner's argument in essence is that his gambling operations were only "a little bit" illegal because the penalty of forfeiture of a bet received if a civil action is brought to recover the bet is only a light penalty. The only merit of the argument is its humor. We must proceed here with recognition that without any doubt betting, receiving, and recording bets, letting a booth be used for the same, and assisting any one in doing the same, all were illegal under New York statutes.

Cf. Nicholas Wusich, 35 T.C. 279 (1960). That the policy of disallowance may be inconsistent with the goals of the criminal law is well exemplified by the court's disallowance in this case of payments made in restitution to a bonding company by a taxpayer who had misappropriated bank funds and received a suspended sentence. It was believed that deduction of such restitutionary payments would remove some of the "sting" from the consequences of the taxpayer's wrongdoing. Accord, Casey O'Brien, 36 T.C. 957 (1961).


And see the dissent in United States v. Winters, 261 F.2d 675 (1958):

From these decisions, it does indeed seem logical to conclude that the Oklahoma courts would sustain a criminal charge for serving intoxicating liquor to business guests in one's own home. It is significant for our purposes, however, that as far as we know, no such charge has ever been reported in more than fifty years of prohibition in Oklahoma. It seems only fair to assume, therefore, that at the enforcement level, at least, the prohibition laws have not been construed so severely.

When the Oklahoma law is thus construed in the context of human conduct, it is extremely doubtful that the taxpayer has severely and immediately frustrated any very well defined public policy of Oklahoma with respect to the prohibition laws. As one living in the state since the very inception of the law, and as one claiming some acquaintance with the mores of the community, I certainly cannot say so.

This is not to say the letter of the law is subordinate to its observance so that a law honored in its breach does not reflect public policy. It is to say that the law is interpreted not only by the courts, but also by the mores of the community wherein it is effective. Indeed, the people make the law, and by their conduct construe it to reflect the public policy of the state.

Id. at 681. But see Note, Of Lawyers and Laymen: A Study of Federalism, the Judicial Process, and Erie, 71 YALE L.J. 344 (1961).
use. For instance, the nominal authority of the FCC to terminate a license rather than to renew it has rarely, if ever, been used. Similarly, severe sanctions for unpopular or unenforced legislation, such as many milk price control statutes, although available, are seldom employed. Where severe deprivation sanctions are provided in the primary statute, the decision to invoke them in any case will depend on many factors, most of which would seem to be beyond the institutional capacity of the numerous authorities resolving tax controversies.

The responsible authority may also utilize a variety of sanctions or sanctionsal equivalents to secure compliance, such as cease and desist orders, inspection, licensing, revocation, warnings, informal conferences, and publicity. Indeed, the very choice of given sanctions reflects a community value judgment as to the kind of deprivations that are deemed appropriate for specified conduct in a particular factual setting. When the Treasury disallows deductions of expenditures incurred in a proscribed activity, it thereby alters the response or set of responses deliberately chosen by the responsible agency which presumably will most justly and efficiently maximize formalized community values. Thus, with regard to the insurance commissions, the responsible agency looked beyond the words of a given body of authoritative language in order to discover a realistic factual basis and imposed the sanctions appropriate for this context. Apparently, the state commission determined that invocation of the other available sanctions under the statute would result in a greater value deprivation than the taxpayer's conduct warranted. In contrast, the Treasury regarded itself as the blind instrument of something vaguely called public policy or "the laws" in the dubious sense of the formal proscription—a position which can be justified only by arguments necessarily involving the approval of the maximum punishment possible within the formal requirements of any law for any act which is prohibited by any authority within the society. Such a premise contravenes the basic precepts of democratic society at mid-century.

Because of the uncertainty of the scope and applicability of the public policy doctrine in the area of illegal expenditures and of the substantial cost of disallowance, the taxpayer is sorely tempted to disguise his illegal expenditures as


ordinary business expenses under such innocuous expense headings as advertising, entertainment, public relations, and commissions. Since the number of returns selected for investigation is relatively small compared with the number of returns filed, the effectiveness of disallowance as an enforcement measure thus depends on the criteria employed in determining the returns selected for audit. But the purposes of audit may not coincide with the objectives of the primary statutes. Thus, to the extent the auditing program is directed at the production of additional revenue, deductions of taxpayers in the upper income brackets may well be subject to far more scrutiny than those of taxpayers with smaller taxable incomes. An enforcement policy, however, designed to ferret out violators with substantial income may frequently not accord with the objects of the primary statute.

The difficulty of formulating criteria which would be effective in distinguishing bona.fide discounts, commissions, and entertainment and advertising expenses from illegal expenditures and in detecting the occurrence of innumerable types of statutory transgressions perhaps accounts for the limited selection of primary statutes which receive supplemental enforcement through the tax laws. Thus, apparently because of a higher visibility of possible offenses, the statutes presently selected for supplemental enforcement are characterized by a close connection between the expenditures and the illegal activity, such as price control laws and others prohibiting rebates, commissions, and allowances. Aside from administrative feasibility, however, there is no reason why the statutes selected are in greater need of supplemental enforcement by the IRS than many other statutes. The mere presence of a close relationship between the expenditure and the illegal act is hardly a rational criterion for deciding which of many statutes regulating trade practices should be actively enforced.

The result of the criteria used by the IRS has been the enforcement of proscriptions which are often unenforced in the jurisdiction of their enactment. For instance, the IRS has frequently challenged rebates paid in violation of the Pennsylvania and other state milk control laws. Because of public indifference or dislike for the objects of the regulatory scheme in Pennsylvania—which is primarily to aid dairy farmers in the state—the administrator of the statute, the Milk Control Board, rarely prosecutes for violations of the act.

91. See Lorraine Corp., 33 B.T.A. 1158, 1161 (1936).
92. Spencer, Income Tax Controversies With The Internal Revenue Agent in Charge, 64 Harv. L. Rev. 547, 551 (1951).
93. For obvious reasons the criteria actually employed by the IRS are not publicly known. Bittker, op. cit. supra note 67, at 734.
94. Id. at 734-37.
95. The selection of statutes for active enforcement, passive enforcement, and non-enforcement is generally based upon many variables, the most important of which is community sentiment toward the proscribed activities at any given time or place. See Goldstein, Police Discretion Not to Invoke the Criminal Process: Low Visibility Decisions in the Administration of Justice, 69 Yale L.J. 543 (1960).
although such violations are rampant. Moreover, even when prosecutions do occur, the state courts often do not allow the Board to utilize any of the deprivational sanctions available under the act. But the enforcement policy of the IRS finds these factors irrelevant, and substantial amounts of rebates have been challenged because of the assumed public policy of this statute. Except where inimical to the interests of some larger group, however, the desire of a community to enforce the laws according to its needs and tolerances should be respected. When the responsible officials become aware of apparent offenses and tolerate them by refusing to invoke sanctions, the proscription in question is nominal, not effective law; and enforcement by the IRS in such circumstances amounts to an arbitrary defeat of reasonable expectations.

In many cases, moreover, the use of the tax laws to enforce regulatory statutes has been largely impaired by the apparent distinction between cost of goods sold and business expenses; this is a distinction which is without significance or relevance to the enforcement objectives of the federal or state regulatory legislation, but which supposedly contains constitutional overtones as to the federal income tax laws. Thus, for example, in order to check inflation, both the Emergency Price Control Act of 1942 and the Defense Production Act of 1950 provide that if price ceilings are imposed, regulations stabilizing wages must be issued "at the same time"; the acts, in other words, presuppose simultaneous general control of prices and wages. But the courts, while approving the disallowance of wage payments on the ground that such expenditures do not constitute a part of cost of goods sold or a return of capital, have consistently allowed deductions sought for materials purchased in violation of the maximum price regulations, often on the tenuous ground that there is no specific statutory provision authorizing disallowance, but primarily on the ground that disallowance of expenditures which represent cost of goods sold will result in an unconstitutional tax on gross receipts. Similarly, in cases

98. See id. at 600-02.
100. For an excellent discussion of retroactivity and the law, see Comment, Prospective Overruling and Retroactive Application in the Federal Courts, 71 Yale L.J. 907 (1962).
104. Commissioner v. Weisman, 197 F.2d 221 (1st Cir. 1952).
105. See Hofferbert v. Anderson Oldsmobile, Inc., 197 F.2d 504 (4th Cir. 1952); Commissioner v. Guminski, 198 F.2d 265 (5th Cir. 1952); Clark v. United States, 107 F. Supp.
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involving state minimum price control statutes, sellers who reduce the purchase price by making yearly gifts to purchasers or by rendering free advertising services to them will probably have these amounts disallowed.\textsuperscript{100} Other sellers who reduce the purchase price by giving cash rebates or discounts at the moment of sale, although equally violative of the price control statute, may reduce their tax liability by these amounts because they are deductible from gross receipts.\textsuperscript{107} Therefore, sanctions imposed under the tax laws can be avoided by simply changing the method of violating the primary statute.

As the maintenance of ethical standards may be "frustrated" by granting tax deductions for expenses incurred in violating these standards, the courts have extended the public policy doctrine to disallow morally offensive expenditures, even where no statute specifically declares them unlawful.\textsuperscript{108} Conveniently called "immoral expenditures," this category includes various kinds of influence payments, such as bribes and protection payments, and the fee splitting practices of professional groups. In \textit{Lilly v. Commissioner},\textsuperscript{109} however, the Court sharply restricted the disallowance of immoral expenditures. The taxpayer in \textit{Lilly} had operated an optical business in North Carolina for many years. In computing the net income of his company, the taxpayer deducted payments made to physicians under an agreement by which each physician, after prescribing lenses, would attempt to guide his patient to the optical company for the work of grinding the lenses and furnishing the frames. Although this practice of accepting "kickbacks" from optical companies was not forbidden by any statutory provision, state or federal, and reflected an established and widespread practice, it was frowned upon and considered unethical by the state and national medical associations. The reaction of the Tax Court was characteristic of the traditional attitude of the IRS and the courts. Since the payments sought to be deducted were directly connected with the contracts between the physicians and the optical company, a determination that the contracts contravened public policy would as a matter of law render the payments nondeductible. The absence of statutory law condemning the practice was not in itself, the court believed, sufficient evidence of the absence of such a public policy. And holding that the judicial decisions can also evidence public policy, the court found that innumerable

\begin{itemize}
\item \textsuperscript{100} 554 (N.D. Tex. 1951); Lela Sullenger, 11 T.C. 1076, 1077 (1948). The theory seems to be that the sixteenth amendment is the source of congressional power to tax income, and "income" as used in the amendment means gross rather than net income; accordingly, deductions from gross income in the computation of taxable income may be disallowed as they are a matter of congressional grace. Since the cost of goods is deducted not from gross income but from gross receipts in the computation of gross income, the failure to allow a deduction would result in the tax falling not on gross income, which is permissible, but on gross receipts or return of capital, which is not permitted by the sixteenth amendment.
\item \textsuperscript{106} Cf. Frederick C. Moser, 18 CCH Tax Ct. Mem. 116 (1959).
\item \textsuperscript{107} Atzingen-Whitehouse Dairy, Inc., 36 T.C. No. 17 (1961); Tri-State Beverage Distrb., Inc., 27 T.C. 1026 (1957); Pittsburgh Milk Co., 26 T.C. 707 (1956).
\item \textsuperscript{108} See Excelsior Baking Co. v. United States, 82 F. Supp. 423 (D. Minn. 1949); Kerrigan Iron Works, Inc. 17 T.C. 566 (1951); Kelley-Dempsey & Co., 31 B.T.A. 351 (1934).
\item \textsuperscript{109} 343 U.S. 90 (1952).
\end{itemize}
court decisions have declared contracts such as these to be unenforceable as contrary to public policy.\footnote{110}

The Supreme Court, however, rejected these views, reasoning that the "policies frustrated must be national or state policies evidenced by some governmental declaration of them."\footnote{111} The Court added that the unenforceability of the contracts between the taxpayer and physicians because of some vague notions of public policy is immaterial to the question of disallowance under the tax laws and thereby implied that a mere judicial declaration of public policy alone may not be sufficient. Subsequent cases reveal, however, that the requirement of sharply defined governmental declarations interposed by \textit{Lilly} has not clarified the application of the public policy doctrine to immoral expenditures. Thus, the more offensive forms of commercial bribery are still disallowed although the legality of these expenditures under state law is not put in issue. Rather, the question of whether bribes and other influence payments are deductible seems to turn on the offensiveness of these payments to the tax authorities, regardless of local law.\footnote{112}

\textit{Litigation Expenses}

Although the \textit{Lilly} case seems to require a definite governmental declaration of policy before disallowance, deductibility of legal expenses has been unaffected by this requirement. Presumably, there are no statutes which declare the securing of counsel and the payment of litigation expenses illegal. Nevertheless, although legal expenses incurred in litigation arising from a taxpayer's profit seeking activities are deductible business expenses,\footnote{113} it is a well established principle in tax law that public policy generally requires the disallowance of these expenses whenever the prosecution is a penal or criminal one and the outcome is in any way adverse to the defendant-taxpayer.\footnote{114} The apparent inconsistency between the requirement of \textit{Lilly} and the treatment of legal expenses is in part a result of the Court's ambiguous reasoning in \textit{Commissioner v. Heininger},\footnote{115} decided shortly before \textit{Lilly}. Heininger, a dentist, operated a mail order business in false teeth. The Postmaster General found

\footnote{110. Lilly v. Commissioner, 14 T.C. 1066, 1078-80, 188 F.2d 269 (4th Cir. 1951).}
\footnote{111. 343 U.S. at 97.}
\footnote{115. 320 U.S. 467 (1943).}
that statements made in his advertisements were misleading as well as overly optimistic and issued a fraud order, depriving the taxpayer of the use of the mails. Because a denial of access to the mails meant destruction of his business, the taxpayer engaged counsel and sought to enjoin the enforcement of the fraud order. He was ultimately unsuccessful, and thereafter deducted from his gross income the lawyer's fees and the other expenses incurred in the extensive litigation. The Commissioner disallowed the deduction on two grounds: It is not necessary to conduct a lawful business in an illegal manner, and therefore it is neither "ordinary" nor "necessary" to defend an unnecessary activity; and even if the legal fees were "ordinary and necessary," allowance of the fees would be against public policy, for they were incurred in an unsuccessful effort to frustrate the prohibitions of activities Congress had condemned.110

In reversing, the Supreme Court pointed out that the taxpayer's legal expenses were both "ordinary and necessary" in the commonly accepted meaning of the words. For the taxpayer to employ counsel in good faith to defend his business against the threatened destruction was a normal and appropriate response on his part. A finding, therefore, "that this course of conduct and the expenses which it involved were extraordinary or unnecessary would be to ignore the ways of conduct and the forms of speech prevailing in the business world."117 But the ambiguity arises from the manner in which the Court rejected the Government's public policy argument. If the taxpayer's expenses were to be disallowed, said the Court, it must be because allowing the deduction would frustrate the policy of the statute under which the Government's claim of fraud was sustained. The Court added that the policy of the statute in question was not to impose personal punishment on violators but to protect the public from fraudulent practices, thereby implying that the deduction of the expenses incurred in litigation is somehow related to the punitive policy of the statute against which the taxpayer defends. But the Court also stated, in referring both to the civil statute under which the taxpayer was prosecuted and its criminal counterpart, that it is not the policy of either to "deter persons accused of violating their terms from employing counsel to assist in presenting a bona fide defense to a proposed fraud order."118 Whatever was actually intended, the Heininger case has generally been interpreted to mean that legal fees incurred in an unsuccessful defense are allowable only where the action is a civil one.119 Thus, the expenses of defending against civil actions brought

117. 320 U.S. at 472.
118. Id. at 474.

Before Heininger, legal expenses incurred in an unsuccessful defense of a state or federal antitrust suit, whether civil or criminal, were not deductible. See Commissioner v. Continental Screen Co., 58 F.2d 625 (6th Cir. 1932); Burroughs Bldg Material Co. v. Commissioner, 47 F.2d 178 (2d Cir. 1931). See generally Smith, Deduction by Corporations of
under state anti-trust laws and revenue provisions are deductible, whereas those incurred in unsuccessfully defending against actions brought under the criminal counterparts of these statutes, based on the same unlawful conduct, are not. A problematical situation arises where the taxpayer expends substantial amounts before an indictment is returned in attempting to forestall criminal prosecution, or where the taxpayer compromises the criminal charge without admitting guilt. Where the taxpayer’s efforts are unsuccessful either in avoiding prosecution or in securing an acquittal, most courts have held all of the amounts so expended non-deductible; a few courts, seeing the difficulties posed by these distinctions, have allowed deduction of legal expenses where the civil or criminal charges are compromised.

None of the courts, however, has reconciled the Lilly requirement of a governmental declaration of policy and the disallowance of legal fees. Since it is doubtful that the sharply defined policy of any statute would be frustrated by a rule allowing a deduction for expenditures incurred in defenses against claims by the government, all attorney fees incurred in opposing governmental claims would seem to be deductible under the Lilly rule. This result seems reasonable, since to deny deduction of such expenses is to treat them in the same manner as statutory penalties are presently treated and, in effect, to add to the sanctions provided by the primary statute.

However, it has been asserted that, if all attorney fees were deductible, a purported violator in the high income brackets might indiscriminately spend large sums in opposition to every government action, since the actual cost to the taxpayer would be a small percentage of the amount expended. Individuals and corporations subject to the higher tax rates would thus be given an incentive to resist such claims, regardless of whether they had a good faith defense or not; and this, in turn, would not only hinder the government in securing convictions, but also would lead to increased expenses of investigations and extended trials. But such an assertion fails to explain why disallowance is limited to criminal prosecutions and, in addition, to those criminal prosecutions in which the taxpayer is convicted. If allowance encourages litigation, it does so for civil as well as criminal actions. And allowing a tax deduction for successful defenses would seem to place a premium on successfully resisting the government’s action, thus protracting litigation by inhibiting com-


122. See, e.g., Commissioner v. Shapiro, 278 F.2d 556 (7th Cir. 1960); Commissioner v. Schwartz, 232 F.2d 94 (5th Cir. 1956); Greene Motor Co., 5 T.C. 314 (1945).

123. Concerning resistance to prosecution, see Jerry Rossman Corp. v. Commissioner, 175 F.2d 711, 713 (2d Cir. 1949), and excerpt quoted in note 17 supra.
promises between the government and the taxpayer. Moreover, if allowance tends unduly to favor the high income taxpayer, disallowance necessarily prejudices the defendants with lower incomes.

One middle course that has been suggested is to allow deductions only for defenses asserted in good faith. But a test based on the bona fides of the defense would seem to place an impossible burden on the courts, the IRS, and the taxpayer. Besides the inconsistency of applying this test only to unsuccessful defenses—since a favorable result is not necessarily an evidence of honest and reasonable defense—it is difficult to see what standards are to be used to ascertain whether a taxpayer's unsuccessful defense was in good faith. Is a compromise between the government and the taxpayer evidence of good faith? What of a conviction on only one of many counts brought against the taxpayer, or of a consent decree, guilty plea, or plea of nol l o contendere? Should these be distinguished from the situation where the taxpayer vigorously resists the government's charges, only to learn that the vague statute under which he is prosecuted is construed against him or that his claim of unconstitutionality is rejected?

Even aside from the problems of administration, the public policy grounds for disallowance of legal expenses are questionable. True, the Treasury has argued, sometimes successfully, that it is unnecessary to defend against any actions by the government if one is guilty; any money expended in so doing is wasted and therefore not necessary. Such an argument assumes not only that thrift is or should be potent motive among those who violate the criminal law but also that criminals—unlike judges—can accurately predict the outcome of criminal cases before hearing the evidence. The Treasury's argument, moreover, appears especially inappropriate when applied to vague statutes regulating trade practices, in which neither the government nor the defendant can, in any real sense, be said to know the requirements of the law before it is declared by the courts.

In any case, since the attorney services under discussion are performed before guilt has been established, the ultimate assumption of disallowance of these expenses—that there is an unstated federal policy to deter persons accused of violating the law from employing counsel to assist in presenting defenses to a criminal charge—is dubious. Authoritative declarations are to the contrary. Neither the Internal Revenue Code nor any other statute or governmental declaration repeals the constitutional presumption of innocence in criminal cases. The sixth amendment provides in part:

In all criminal prosecutions . . . the accused shall have the assistance of counsel for his defense . . .

125. McDonald, supra note 114, at 181-82.
127. See text at note 76 supra.
And the refusal of both state and federal courts to award counsel fees to the successful litigant in the analogous field of civil litigation, in contrast to the English system, is premised upon a public policy designed to encourage rather than discourage litigation,\(^{128}\) regardless of the *bona fides* of the action or defense.

**Illegal Business**

The illegal business is distinguished from the situations described above in that a state statute declares the entire business of a taxpayer unlawful instead of prohibiting specified activities of an otherwise lawful business. The most common examples are gambling and bookmaking establishments. It has long been held that the income from illegal businesses is subject to the income tax.\(^{129}\) If there is any virtue in the public policy doctrine that disallows all deductions which frustrate sharply defined governmental policies, then it would seem axiomatic that all of the expenditures of a business whose very existence is repugnant to state policy would be disallowed. And, except for gambling losses which the Code explicitly permits up to the amount of gambling gains,\(^{130}\) some courts have so held, on the theory that any disbursements in furtherance of the unlawful enterprise contravene the policy of the statutes prohibiting the entire business.\(^ {131}\)

\(^{128}\) 6 Moore, *Federal Practice* § 54.70(2) (2d ed. 1953):

The extent to which actual expenses are allowed as costs can have a significant effect upon the encouragement or discouragement of litigation. Advocates of the English practice claim that the allowance of the successful party's legal expenses would only make him whole; that it will discourage the institution of unfounded litigation or the maintenance by groundless defenses, except possibly by financially irresponsible persons, and at the same time will encourage a meritorious suit or defense. The proponents of the American practice claim, however, that the English system deters the bringing of just claims or the maintenance of a just defense as well as unjust ones, because of the fear of being saddled with the opponent's legal expenses. They claim that "every man has an inalienable right to go to law." *Id.* at 1303-04. See also Note, 49 Yale L.J. 699 (1940).

\(^{129}\) See United States v. Sullivan, 274 U.S. 259 (1927). The Court, per Mr. Justice Holmes, could "see no reason . . . why the fact that a business is unlawful should exempt it from paying the taxes that if lawful it would have to pay." *Id.* at 263. It was also stated, however, in reply to the suggestion that a deduction should be allowed for bribery if claimed by an illegal business, "it will be time enough to consider the question when a taxpayer has the temerity to raise it." *Id.* at 264. See note 1 supra.

\(^{130}\) See note 1 *supra*.

\(^{131}\) Before this amendment in 1934, a loss deduction was allowed only if the state permitted or condoned gambling. Francis M. Cronan, 33 B.T.A. 668 (1935); E.F. Simms, 28 B.T.A. 988 (1933); M. Rea Gano, 19 B.T.A. 518 (1930). The present section has been construed to allow losses up to the amount of gain, regardless of the illegality of the enterprise. E.g., Skeeles v. United States, 95 F. Supp. 242 (Ct. Cl. 1951), *cert. denied*, 341 U.S. 948 (1951); Roy T. Offutt, 16 T.C. 1214 (1951). See also Winkler v. United States, 230 F.2d 766, 776 (1st Cir. 1956). But the purpose of this section, which was to *limit* loss deductions for lawful gambling, did not compel this result. See H.R. Rep. No. 704, pt. 1, 73d Cong., 2d Sess. 22 (1934), S. Rep. No. 558, 73d Cong., 2d Sess. 25 (1934).

\(^{131}\) Albert D, McGrath, 27 T.C. 117 (1956); Sam Mesi, 25 T.C. 513 (1955) (see note
Prior to the Supreme Court decision in *Commissioner v. Sullivan*, other courts, taking a closer look at the various expenditures of gambling establishments, distinguished between the "legitimate" expenses of an illegal business, as, for instance, rent and salaries, and the "illegitimate" ones, such as protection payments, attorney fees in defense of the business, and bribes. The former expenses have been allowed deduction, because they are the "integral" expenses of the unlawful business as opposed to the "concomitant" ones—although it is difficult to see how protection payments are any less customary, widespread, or indeed indispensable for gambling enterprises than the payments for rent and wages—or simply because deduction of such expenses does not frustrate sharply defined public policy, which is, of course, merely a statement of the conclusion. Another ground for the allowance of the "legitimate" expenses is that such expenses are not specifically prohibited by any statute, since most statutes outlaw gambling enterprises in broad general terms.

The Treasury, justifiably puzzled by this distinction, argued that some state statutes not only declare the operation of a gambling establishment illegal, but also specifically provide that employees and landlords who assist in the conduct of such businesses are equally guilty of the commission of an illegal act. In the *Sullivan* case the Tax Court upheld the Commissioner in disallowing all the expenses of a bookmaking business because of a more detailed state accessory statute. The court stated that "it is inconceivable that [the taxpayer] should be permitted a deduction for amounts spent to procure the commission of an act outlawed by a state statute ..."

The Supreme Court decided the *Sullivan* case at the same time as *Tank Truck Rentals, Inc. v. Commissioner*, and, unanimously affirming the Seventh Circuit's reversal of the Tax Court, allowed the deduction of the payments for rent and salaries of a bookmaking business. The reasons articulated for deductibility are not only irreconcilable with the rationale of *Tank Truck* but

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133. *E.g.*, Commissioner v. Doyle, 231 F.2d 635, 637 (7th Cir. 1956).
134. *Cohen v. Commissioner*, 10 T.C. 201 (1948), aff'd on other grounds sub nom. *Mesi v. Commissioner*, 176 F.2d 394 (10th Cir. 1949). In referring to the difference between the legal and illegal expenditures of an unlawful business, the Tax Court in this case stated: "The distinction may at first seem nebulous, but it is nonetheless real." 10 T.C. at 207.

Another ground for distinguishing between the deductible and nondeductible expenses of an unlawful business was the "leprous character" of the unlawful business. This characterization was used to justify disallowance of the medical expenses of an abortionist. Joseph Karger, 13 CCH Tax Ct. Mem. 661, 664 (1954).

137. 25 T.C. at 523.
also cast doubt upon the validity of any policy supporting disallowance of illegal expenditures. In referring to the payments for rent and wages, the Court said they were clearly "'ordinary and necessary expenses' in the accepted meaning of those words,"\textsuperscript{139} although \textit{Tank Truck} held that a finding of "necessity" cannot be made if allowance would frustrate sharply defined national or state policies proscribing particular types of conduct.\textsuperscript{140} Why, then, was the deduction allowed in \textit{Sullivan} not found to frustrate the policy of the state statutes that were violated by the payments in question? Quoting from \textit{Heininger}, the Court explained that "the 'fact an expenditure bears a remote relation to an illegal act' does not make it nondeductible."\textsuperscript{141} But no such remote relationship existed in \textit{Sullivan}; the expenditures were \textit{directly} violative of state statutes.\textsuperscript{142} The only plausible distinction between \textit{Tank Truck} and \textit{Sullivan} is found in the difference between the expenditures sought to be deducted: in \textit{Sullivan}, not penalties, but illegal expenditures were the disbursements at issue. Some support for this distinction is found in the Court's statement in \textit{Sullivan}: "That [the amounts are ordinary and necessary expenses in the accepted meaning of those words] 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 . . . ."\textsuperscript{143} As applied to the facts of \textit{Sullivan}, it is clear that the claimed deductions were not the consequence of a statutory violation as were the penalties in \textit{Tank Truck}.

But this rationale would mean that a deduction will be disallowed only where it constitutes a means for avoiding or mitigating the penal consequences of a statutory violation as opposed to the prior more general test of whether allowance would frustrate the policy of the primary statute. This explanation of the \textit{Sullivan} case would thus limit the public policy doctrine to the disallowance of fines and penalties, since only the deduction of these could properly be called a device to avoid the \textit{consequences} of a statutory violation. While one may make a plausible and consistent argument for restricting disallowance to such expenditures, since a "neutral" attitude toward them is not possible,\textsuperscript{144} there is no indication in the \textit{Sullivan} decision that the Court was \textit{sub silentio} overruling a multitude of cases disallowing bribes, legal fees, expenditures in violation of price control laws, and many other forms of illegal expenditures.

\textsuperscript{139} Id. at 29.
\textsuperscript{141} 356 U.S. at 29.
\textsuperscript{142} As the Tax Court stated in its opinion in Sam Mesi, 25 T.C. 513 (1955) (see note 136 \textit{supra}):

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.

The Seventh Circuit did not deny that these payments violated the criminal laws of Illinois. \textit{Sullivan v. Commissioner}, 241 F.2d 46 (7th Cir. 1957).
\textsuperscript{143} 356 U.S. at 29. (Emphasis added.)
\textsuperscript{144} See generally text at notes 35-85 \textit{supra}.
Moreover, the Court's statement in Tank Truck—"the frustration of state policy is most complete and direct when the expenditure for which deductions is sought is itself prohibited by statute"—directly contradicts this explanation of the holding as well as the result in Sullivan. Nor have the lower courts followed such a construction of Sullivan. In fact, since the Sullivan case, in one of the few criminal tax prosecutions in the evidently unsettled area of disallowed deductions, a taxpayer has been convicted of willfully evading the income tax by seeking to deduct expenditures characterized as bribes.

The only other ground relied on by the Court seems unsound. Because gambling enterprises are subject to a federal excise tax, the Court reasoned that such enterprises are therefore recognized as a business for federal tax purposes. Moreover, since the IRS allowed a business expense deduction for amounts paid under the excise tax, there was a federal policy sufficiently hospitable to gambling establishments to allow the deduction of their ordinary and necessary expenses. Besides ignoring a rather direct expression of state policy for a dubious federal one, this rationale abrogates the public policy doctrine altogether, since all businesses subject to the income tax are presumably recognized as a business for federal tax purposes. If the special recognition is to be found, not in the income tax, but in the special excise on gambling enterprises, then the difficulty arises that there is nothing in that act or its legislative background to warrant favorable tax treatment for those enterprises subject to the tax; indeed, Congress expressly disclaimed any intent in enacting the wagering tax to confer legitimacy on gambling enterprises which are unlawful under state law.

The Court also added the following in Sullivan: "If we enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts,

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145. 356 U.S. at 35.
146. See, e.g., Tracy v. United States, 284 F.2d 379 (Ct. Cl. 1960); Casy O'Brien, 36 T.C. No. 98 (1961).
148. The latest foray of the IRS has been to rule that "payola" payments are non-deductible if paid after 1959, when the FTC issued complaints against certain individuals for engaging in such practices. Payments before this date are deductible unless they violate sharply defined state statutes. This ruling ignores the fact that the mere issuance of complaints against persons who received "payola" payments, prior to adjudication of guilt, does not itself constitute an authoritative proscription of such activities. It would not appear that allegations of the FTC are entitled to more respect as a declaration of public policy than the declarations of a court, which, by itself, may not be a sufficient declaration of a "sharply defined" public policy. Rev. Rul. 62-133, 1962-36 Int. Rev. Bull. 5. See notes 111-12 supra and accompanying text.
149. Thus, § 4422 of the 1954 Code explicitly provides that the payment of the wagering tax does not authorize the carrying on of any business in violation of a law of the United States or the law of any state. Int. Rev. Code of 1954, § 4422.
while all other business would be taxable on the basis of net income . . . ."\textsuperscript{150} This is hardly an adequate ground for decision, since disallowance of any business expenditures by reason of public policy results pro tanto in a tax on gross income. But this language, especially when read with the language in \textit{Tank Truck} calling for an accommodation between the congressional intent to tax net income and the presumption against an intent to encourage violations, does indicate that an awareness that a contrary result would have involved approval of a tax on the gross income of gambling businesses figured large among the actual considerations that led to allowance of the bookmaker's expenses. 

A contrary holding in \textit{Sullivan} would have had far reaching effects on the distribution of power between the federal and state governments over gambling and other illegal businesses.\textsuperscript{151} Voluntary compliance with a tax on the gross income of gambling enterprises—under rates which are proportioned to net income, \textit{i.e.}, a taxpayer’s actual increase in wealth during an accounting period—is not likely. Thus, assuming a gross income tax based on present rates, a business with a gross income of $50,000 and actual business expenses of $20,000, would be left with approximately $3,000 after-tax-income. The function of the tax therefore would be to enable federal authorities to prosecute such businesses for income tax evasion and avoidance. There are many possible reasons why the Court would not approve this change in the administration of the federal and state criminal systems. Since the precise elements of the offenses of gambling and lotteries frequently vary from state to state, the Court might well regard these crimes as primarily matters of local concern.\textsuperscript{152} Moreover, it has been alleged that the federal enforcement of local laws tends to free the states from a sense of responsibility for their own conditions. To the extent that gamblers are prosecuted for tax evasion instead of gambling, state

\textsuperscript{150} 356 U.S. at 29.

\textsuperscript{151} Recent opinions show that the Supreme Court was well aware of redistribution of criminal jurisdiction effected through the income tax laws and of the undesirable effects of federal government intervention into the areas of the criminal law traditionally reserved to the states. See \textit{James v. United States}, 366 U.S. 213, 230, 240-42 (1961) (dissent by Mr. Justice Black, joined by Mr. Justice Douglas); \textit{Rutkin v. United States}, 343 U.S. 130, 139-47 (1951) (dissent by Mr. Justice Black, with whom Justices Reed, Frankfurter and Douglas concurred).

\textsuperscript{152} The Senate Crime Committee stated in its Third Interim Report:

\begin{quote}
Any program for controlling organized crime must take into account the fundamental nature of our governmental system. The enforcement of the criminal law is primarily a State and local responsibility.
\end{quote}


And Attorney General Mitchell commented:

\begin{quote}
Experience has shown that when Congress enacts criminal legislation of this type the tendency is for the State authorities to cease their efforts toward punishing the offenders and to leave it to the Federal authorities and Federal courts. That has been the experience under the Dyer Act.
\end{quote}

72 \textit{Cong. Rec.} 6214 (1930). The two excerpts above were quoted in the dissent of Mr. Justice Black in \textit{Rutkin v. United States}, 343 U.S. 130, 142 nn.2, 3 (1952).
BUSINESS EXPENSES

Courts are deprived of the opportunity to use the discretion vested in them by local legislatures to impose sanctions in accordance with the goals and ideas of the local community. Similarly, state prosecutors are deprived of the important function of deciding which local offenders should be prosecuted.\textsuperscript{153} Although the national government's invasion of areas of crime control traditionally reserved to the states is not unknown, such national interventions have generally rested upon specific congressional enactments. Furthermore, most of these national enactments are not designed directly to suppress activities illegal under state law, but to assist state enforcement agencies in the administration of their own statutes. Thus, such excise measures as the narcotics\textsuperscript{164} and wagering taxes\textsuperscript{165} are used as devices for securing publicity of transactions in order to aid the states in the execution of their police powers. In contrast to a gross income tax, these measures do not establish primary federal jurisdiction over activities illegal by virtue of state law.\textsuperscript{156} Finally, the Court might also consider the extent to which the IRS, an agency ostensibly devoted to the problems of raising revenue, is suited to assume the duties of enforcing the criminal laws outside the tax field.

CONCLUSION

Related to one's view of a proper balance between state and national authority is the constitutional question presented by a tax on the gross income of an illegal business: the power to tax gross income at today's income tax rates, if sanctioned by the Court, would permit the national government to accomplish by taxation almost everything that the states may accomplish in the field of criminal law by the exercise of their police power.\textsuperscript{157} Of course, if

\begin{itemize}
  \item \textsuperscript{153} See Schwartz, \textit{Federal Criminal Jurisdiction and Prosecutors' Discretion}, 13 \textit{Law and Contemp. Prob.} 64, 83-86 (1948).
  \item \textsuperscript{154} \textsc{Int. Rev. Code of 1954, §§ 4701-07, 4711-16, 4721-26, 4731-36, 4741-46, 4751-57, 4761-62, 4771-76.}
  \item \textsuperscript{155} \textsc{Int. Rev. Code of 1954, §§ 4401-04, 4411-13, 4421-23.}
  \item \textsuperscript{156} For a discussion of "auxiliary" federal criminal jurisdiction, see generally, Schwartz, \textit{supra} note 153 at 70-87.
  \item \textsuperscript{157} An interesting instance of the expansion of federal jurisdiction through the use of the tax laws and the ingenuity of a federal court is presented by the probation proceedings of Thomas Worcester. Thomas Worcester had participated in a well established and widespread system of corruption of state officials connected with the award of public works contracts in Massachusetts and was convicted by a federal district court of willful income tax evasion for deducting bribes as ordinary business expenses. He was granted probation upon a condition that, "He shall cooperate with, and give full, candid testimony to any national, state, or local prosecutor, grand jury, petit jury, legislative body, legislative committee, or authorized public agency of inquiry concerning any matter directly or indirectly relevant to those matters covered in trial ...." Upon a complaint by the United States District Attorney that the probationer had not cooperated fully with a federal grand jury investigation, the federal district court decided to hold a public revocation hearing to determine whether the probationer had fully cooperated with the grand jury investigation. At this hearing many persons implicated in the statewide bribery were called as witnesses and the hearing generally served the purpose of implementing a state, albeit unenforced, policy against corruption of local officials. Indeed, the federal judge holding the hearing
\end{itemize}
an excise measure can be shown to be in substance an exercise of the taxing power, its collateral effects on the conduct of taxpayers could not be adduced to defeat its constitutionality; incidental regulation and control are inherently and inextricably bound up with any exercise of the taxing power. The fact situation in Sullivan, however, raises the question of whether demonstrable effects might not afford a sufficient basis for holding that what professes to be a tax is in reality something else. The answer furnished by the Supreme Court to date is extremely problematical. The Court on occasion has held a monetary measure of Congress unconstitutional, the rationale being that a federal excise, in form of tax, may in substance be a police regulation so obviously unrelated to any fiscal enterprise as to fall outside the taxing power. More often the Court has approved highly dubious exercises of the federal taxing power, invoking judicial inability to indulge in surmises concerning the objects sought to be attained by lawmakers.

Traditional judicial reluctance to inquire into the motives of the legislature should not, however, foreclose examination of an exaction imposed upon the gross income of gambling and lottery establishments, for the purpose of such legislation can be ascertained with a fair degree of certainty without examining the thoughts and desires of Congressmen. One principal disqualifying factor which should lead a court to conclude that a purported excise is not a tax—at least in the context of United States experience—is a showing that voluntary mass compliance with the excise is highly unlikely. Since the primary purpose of a tax is to raise revenue, with regulation as an incidental effect, the tax aspects of the measure are rather questionable if the inevitable consequence of an excise is large scale evasion of the tax or abandonment of the taxable activity. The other tests traditionally used to distinguish a tax from a penalty seem relevant only as evidence of the necessary result of the excise. Thus, an onerous or burdensome rate of taxation is indicative of a regulatory purpose to the extent that abandonment of the taxable enterprise or evasion of the tax is more likely than payment of the tax. When the criterion between taxability and non-taxability is the illegality of an activity or business under local law, the conclusion that the measure is a penal one does not rest upon the probable motives of Congress, but upon the assumption that the probable result questioned the wisdom of using the federal tax laws and a probation revocation hearing as a basis of federal jurisdiction in matters traditionally of state concern. United States v. Worcester, 190 F. Supp. 548 (D. Mass. 1961), application for prerogative writ denied sub nom. In re Callahan, 285 F.2d 757 (1st Cir. 1960). For an able discussion of the probation revocation hearing of Thomas Worcester, see Note, A Trial Judge's Freedom and Responsibility In Administering Probation, 71 YALE L.J. 551 (1962).


of the so-called tax will be prosecutions for evasion of the measure rather than compliance with it. Under this test, which avoids the problems inherent in the ascertainment of "true" legislative motive, the determination that a tax on the gross income of illegal businesses is primarily a regulatory, and only incidentally a taxing, measure does not seem very difficult.

But the same considerations which apparently led the Court to allow the deductions in *Sullivan* seem to apply in varying degrees to all expenditures disallowed under the rubric of the public policy doctrine. When the Treasury disallows expenditures of a taxpayer because they are illegal under state law, the same regulatory purpose of suppressing unlawful activities and the same invasion of state police power are present. Similarly, the disallowance of fines and penalties, as presently administered, involving as it does the imposition of a special tax on such violations, represents an addition of the IRS and the federal courts to state agencies in the punishment of violators of state, as well as federal, statutes.

In such areas, involving fact situations less extreme than that presented in *Sullivan*, judicial applications of the criteria adumbrated above would necessarily be fraught with difficulty. Thus, given the varied uses of taxing measures and the difficulties involved in predicting their actual effects, decisions in such situations would appear to be beyond the institutional capabilities of courts. More important, the courts' only weapon in this area must necessarily be the ultimate one of a finding of constitutional invalidity. And where, as in *Tank Truck*, the disallowed expenditures do not represent a very substantial proportion of the enterprise's total disbursements and therefore a finding of a regulatory purpose is more difficult, the disproportionate nature of such a response would in all likelihood be determinative.

These considerations indicate the substantial limitations upon judicial capability to police the use of tax laws for regulatory purposes on the basis of considerations of federalism. Similarly, since the due process clause has not been construed to limit the amount of exactions imposed under the taxing power, constitutional arguments would appear to be unavailable in any situation where penalties or expenditures which contravene federal statutes are disallowed. But this is only to say that the resolution of the problems involved are left primarily to the Congress. The question at issue is not limited to a conflict between state and national jurisdiction, but rather concerns the inappropriateness of an undiscriminating utilization of the income tax laws to enforce a multifarious array of penal and regulatory statutes. And this basic difficulty remains the same.

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162. No tax has been held invalid under the Fifth Amendment because based on an improper classification, and it is significant that in the entire one hundred and forty years of its history the only taxes held condemned by the Fifth Amendment were those deemed to be arbitrarily retroactive. Heiner v. Donnan, 285 U.S. 312, 338 (1932) (dissent). See also Nichols v. Coolidge, 274 U.S. 531 (1927).

See Surrey, *Assignments of Income and Related Devices: Choice of the Taxable Person*, 33 Colum. L. Rev. 791, 824 (1933), suggesting that valid due process objections to a taxing measure might be limited to arbitrary and tyrannical situations.
where the responsible authorities being superseded by the IRS are federal as well as state agencies.

The various categories of expenditures disallowed under the public policy rubric, of course, present different considerations and are therefore subject to varied solutions. These solutions, however, must necessarily be partial ones. The basic difficulty created by the disparities between the law and mechanics of taxation and of penal and regulatory statutes remain relevant and indeed central to them all. In the final analysis, therefore, it is an appreciation of this fundamental disparity which must serve as the point of departure for the long overdue reformulation of the public policy exception to the allowance of business expense deductions under the Internal Revenue Code.

163. There are other areas of the law in which prior antisocial behavior, already penalized under another statute or excused sub silentio by enforcement agencies, is taken into account in denying privileges or benefits: e.g., laws governing the granting of licenses, naturalization statutes, habitual criminal statutes, probation and presentence procedures, and voting laws. While a discussion of these laws is beyond the scope of this Comment, it may be suggested that at least some of the sanctions imposed under these laws are, theoretically at least, reasonably related to the objects of the statutes involved. Thus, past criminal behavior seems relevant to a determination of good moral character for purposes of naturalization proceedings. Where past criminal or antisocial behavior is not so related, similar problems concerning excessive sanctions imposed by an authority not primarily responsible for enforcement of the statute proscribing such conduct are raised.