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K. Todd Curry

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Comments

The Deductibility of Punitive Damages as an Ordinary and Necessary Business Expense: Reviving the Public Policy Doctrine

Under the judicially created public policy doctrine, the deductibility as a business expense of a payment imposed for a statutory violation turned on whether the payment was penal,¹ or whether it was compensatory. If penal, it was nondeductible, but if compensatory, it was deductible. Congress codified this judicial result in 1969. This Comment argues that Congress should have also codified this penal-compensatory test of deductibility in the case of payments imposed in ordinary civil suits. That is, a payment of punitive damages should not be deductible as a business expense.

I. INTRODUCTION

Section 162 of the Internal Revenue Code² allows deductions for all ordinary and necessary business expenses.³ These deductions have

1. "Penal" as used in this Comment refers to any payment, whether criminal or civil, imposed to punish or deter (or punish *and* deter) a wrongdoer. *See infra* notes 8-9, and note 73 and accompanying text.

2. I.R.C. § 162(a)(1982). The Internal Revenue Code [hereinafter Code] is codified at 26 U.S.C.

3. An expense is "ordinary" if it is "normal, usual, and customary" in the particular industry. *Lilly v. Commissioner*, 343 U.S. 90, 93 (1952). "Ordinary" is also used to distinguish noncapital deductible expenses from capital expenditures, which are not deductible under section 162. *See Commissioner v. Tellier*, 383 U.S. 687, 689-90 (1966).

An expense is "necessary" if it is appropriate and helpful to the development of the business. *Welch v. Commissioner*, 290 U.S. 111, 113 (1933).

been allowed for all businesses since 1918.⁴ Notwithstanding this seemingly broad language, early in the history of the modern income tax, courts created a public policy doctrine by denying deductions for expenses if their allowance would frustrate public policy.⁵ More than forty years after courts created this public policy doctrine, Congress attempted to codify it.⁶ The Internal Revenue Service has interpreted the codified doctrine to allow deductions for punitive damages.⁷

This Comment first reviews the use of the public policy doctrine to deny deductions for fines⁸ and penalties.⁹ Then it reviews the allowance of deductions for compensatory payments imposed both in ordinary civil suits, and for statutory violations. Next, this Comment examines congressional codification of the public policy doctrine in 1969, and it examines Revenue Ruling 80-211,¹⁰ in which the Service interpreted the Code to allow a deduction for punitive damages as an ordinary and necessary business expense.

By allowing a deduction for punitive damages, yet denying a deduction for fines and penalties, Congress has codified an inconsistency that would not have arisen under the pre-codified public policy

In the case of an individual, deductions are allowed for all ordinary and necessary expenses paid or incurred "for the production or collection of income; . . . for the management, conservation, or maintenance of property held for the production of income; . . . or in connection with the determination, collection, or refund of any tax." I.R.C. § 212 (1982). Because the public policy considerations relevant to deductions under section 162 are also relevant to section 212, *see* Treas. Reg. § 1.212-1(p) (as amended in 1975), this Comment's analysis under section 162 should be understood to apply to section 212 as well.

4. *See* 6 J. MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* § 25.01, at 5, 7 n.1 (1988).

5. *See generally* Taggart, *Fines, Penalties, Bribes, and Damage Payments and Recoveries*, 25 *TAX L. REV.* 611 (1970); Gordon, *The Public Policy Limitation on Deductions From Gross Income: A Conceptual Analysis*, 43 *IND. L.J.* 406 (1968); Diamond, *The Relevance (or Irrelevance) of Public Policy in Disallowance of Income Tax Deductions*, 44 *TAXES* 803 (1966); Tyler, *Disallowance of Deductions on Public Policy Grounds*, 20 *TAX L. REV.* 665 (1965); Lamont, *Controversial Aspects of Ordinary and Necessary Business Expenses*, 42 *TAXES* 808, 819-35 (1964); Lindsay, *Tax Deductions and Public Policy*, 41 *TAXES* 711 (1963).

6. Tax Reform Act of 1969, Pub. L. No. 91-172, § 902, 83 Stat. 487, 710-11 (codified as amended at I.R.C. § 162 (1982)).

7. Rev. Rul. 80-211, 1980-2 C.B. 57.

8. "Fines," as used in this Comment, refers to criminal payments imposed to punish or deter (or punish *and* deter) statutory violations. *See* *Middle Atl. Distrib. v. Commissioner*, 72 T.C. 1136, 1143 (1979); 36A C.J.S. *Fines* § 1 (1961).

9. "Penalties," used in a restrictive sense in this Comment, refers to civil payments imposed to punish or deter (or punish *and* deter) statutory violations. *See* *Middle Atl.*, 72 T.C. at 1143; *Southern Pac. Transp. Co. v. Commissioner*, 75 T.C. 497, 651-52 (1980); 70 C.J.S. *Penalties* § 2 (1987).

10. 1980-2 C.B. 57. Revenue Rulings are interpretive pronouncements issued by the Service in important instances. They are binding on the Service, and generally arise as a result of requests for advice by taxpayers or by regional or district internal revenue offices. HARVARD LAW SCHOOL INT'L PROGRAM IN TAXATION, *TAXATION IN THE UNITED STATES* 1267-68 (1963).

doctrine. The Comment examines this inconsistency, and suggests that Congress may be willing to correct it. The Comment also challenges arguments favoring the deductibility of punitive damages, and examines implications of the nondeductibility of punitive damages. This Comment concludes that to correct the inconsistency created by Congress, and to preserve state sovereignty, Congress should deny a deduction, as an ordinary and necessary business expense, for punitive damages.

II. DEDUCTION FOR PENAL PAYMENTS FRUSTRATES PUBLIC POLICY

A. Lower Court Decisions

Though neither the Code nor its regulations referred to a public policy test of deductibility,¹¹ during the 1940s and 1950s, courts frequently invoked public policy to deny deductions for bribes, kickbacks, and other illegal or immoral payments.¹² Courts also denied deductions for fines and penalties. The earliest cases addressing the deductibility of fines and penalties were *Appeal of Columbus Bread Co.*¹³ and *Great Northern Railway Co. v. Commissioner*.¹⁴ In *Columbus Bread*, the taxpayer attempted to deduct the payment of a fine and a penalty imposed as a result of the taxpayer's guilty plea in state antitrust proceedings.¹⁵ In *Great Northern*, the taxpayer attempted to deduct the payment of fines imposed for violations of various federal statutes.¹⁶ In both cases, the Board of Tax Appeals denied the deductions, but stated only that the payments were not ordinary and necessary business expenses.¹⁷ However, the Board cited *Appeal of Backer*¹⁸ as authority for denying the deductions.¹⁹

Backer was the earliest case to deny a deduction for a business expense if its allowance would contravene public policy.²⁰ In *Backer*,

11. Diamond, *supra* note 5, at 806.

12. See Keesling, *Illegal Transactions and the Income Tax*, 5 UCLA L. REV. 26, 33-34 (1958); Lurie, *Deductibility of "Illegal" Expenses*, 11 N.Y.U. INST. ON FED. TAX'N 1189 (1953); Note, *Public Policy and Federal Income Tax Deductions*, 51 COLUM. L. REV. 752, 755-61 (1951).

13. 4 B.T.A. 1126 (1926).

14. 8 B.T.A. 225 (1927), *petition dismissed*, 40 F.2d 372 (8th Cir.), *cert. denied*, 282 U.S. 855 (1930).

15. *Columbus Bread*, 4 B.T.A. at 1127.

16. *Great Northern*, 8 B.T.A. at 263.

17. *Columbus Bread*, 4 B.T.A. at 1128; *Great Northern*, 8 B.T.A. at 264-65.

18. 1 B.T.A. 214 (1924).

19. *Columbus Bread*, 4 B.T.A. at 1128; *Great Northern*, 8 B.T.A. at 265.

20. See Diamond, *supra* note 5, at 806. The concept of a public policy limitation

the taxpayer attempted to deduct attorney fees and other expenses incurred while successfully defending against a prosecution for perjury.²¹ The Board of Tax Appeals stated:

We do not believe that it is in the interest of sound public policy that the commission of illegal acts should be so far protected or recognized that their cost is regarded as a legitimate and proper deduction in the computation of net income under the revenue laws of the United States.²²

Thus, the Board in *Backer* explicitly invoked public policy to deny the taxpayer's claimed deduction. Although the Board was not so explicit in *Columbus Bread* and *Great Northern*, the Board's citing of *Backer* as authority for denying the deductions in those cases indicates that the Board held that public policy proscribed deductions for fines and penalties. In the appeal of the Board's *Great Northern* decision, the Eighth Circuit Court of Appeals revealed the essence of the public policy doctrine when it stated: "It cannot be that Congress intended the . . . [taxpayer] should have any advantage, directly or indirectly, or any reduction, directly or indirectly, of these penalties."²³ After *Columbus Bread* and *Great Northern*, lower courts continued to apply the public policy doctrine to deny deductions for fines and penalties, as well as for payments in compromise of potential liability for fines and penalties.²⁴

B. The Supreme Court: Tank Truck Rentals

The Supreme Court considered the public policy doctrine surrounding the deductibility of fines and penalties in *Tank Truck Rentals, Inc. v. Commissioner*.²⁵ In *Tank Truck*, a corporate taxpayer attempted to deduct the payment of fines imposed on it for

on business deductions appeared in England before appearing in the United States. See *Commissioners of Inland Revenue v. Alexander von Glehn & Co.*, 2 K.B. 553 (1920); *Commissioners of Inland Revenue v. Warnes & Co.*, 2 K.B. 444 (1919).

21. *Backer*, 1 B.T.A. at 215.

22. *Id.* at 217. The Supreme Court later overruled the result (but not the public policy doctrine) of *Backer*. See *Commissioner v. Tellier*, 383 U.S. 687 (1966) (holding that a deduction for legal fees, even when incurred in an unsuccessful criminal defense, does not frustrate public policy).

23. *Great N. Ry. v. Commissioner*, 40 F.2d 372, 373 (8th Cir.), *cert. denied*, 282 U.S. 855 (1930).

24. See, e.g., *Lentin v. Commissioner*, 226 F.2d 695 (7th Cir. 1955) (penalty for violation of federal price control statute), *cert. denied*, 350 U.S. 934 (1956); *Commissioner v. Longhorn Portland Cement Co.*, 148 F.2d 276 (5th Cir.) (settlement of potential liability for penalties for violations of state antitrust laws), *cert. denied*, 326 U.S. 728 (1945); *Burroughs Bldg. Material Co. v. Commissioner*, 47 F.2d 178 (2d Cir. 1931) (fines for violations of state price fixing statute); *Chicago, R.I. & Pac. Ry. v. Commissioner*, 47 F.2d 990 (7th Cir.) (penalties for violations of various federal statutes), *cert. denied*, 284 U.S. 618 (1931); *Davenshire, Inc. v. Commissioner*, 12 T.C. 958 (1949) (settlement of potential liability for penalties for violations of federal child labor statute); *Wiedetz v. Commissioner*, 2 T.C. 1262 (1943) (payment of fine without prosecution).

25. 356 U.S. 30 (1958).

operating its trucks in violation of state maximum weight laws.²⁶ The Court stated that Congress, in allowing various deductions, could not have intended to frustrate declared state policy.²⁷ The Court held that although the nondeductibility of an expense always depends on "the severity and immediacy of the frustration resulting from allowance of the deduction,"²⁸ a deduction for fines and penalties would severely frustrate state policy by reducing the "sting" of the imposed payment, and by encouraging further violations of state law.²⁹

Some commentators, critical of the Supreme Court's reasoning in *Tank Truck*, have argued that allowing a deduction for a penal payment does not *reduce* its "sting" or impact, but rather, disallowance of a deduction for a penal payment *increases* its impact beyond the expectations of the governmental authority imposing it.³⁰ But this argument relies on the existence of an unexpressed intent on the part of the authority imposing the penal payment. For a taxpayer having a twenty-eight percent marginal tax rate, a deductible \$10,000 fine

26. *Id.* at 31.

27. *Id.* at 35.

28. *Id.*

29. *See id.* at 35-36. The Court also noted that allowing deductions even for innocently incurred fines would frustrate state policy, unless the statute distinguished between innocent and willful violations. *Id.* at 36. The Court so held in a companion case to *Tank Truck*, *Hoover Motor Express Co. v. Commissioner*, 356 U.S. 38 (1958).

Some authority appeared to assert that penal payments could be deductible. *See Jerry Rossman Corp. v. Commissioner*, 175 F.2d 711 (2d Cir. 1949). In *Rossman*, the taxpayer attempted to deduct a payment imposed for violations of a federal price control act. *Id.* at 711. Though the court denied that the payments were penal, *id.* at 712, it stated: "[T]here are 'penalties' and 'penalties,' and some are deductible and some are not." *Id.* at 713. Notwithstanding this invitation for courts to allow deductions for some penalties, no other court applied *Rossman* to allow a deduction for a penalty in any context other than where the taxpayer had violated the price control statute.

The *Rossman* court cited no authority for allowing a deduction for a penal payment. Indeed, the Supreme Court noted that the courts had uniformly denied deductions for penal payments. *See Tank Truck*, 356 U.S. at 35-36. Also, the Supreme Court minimized *Rossman* by explaining that the deduction in *Rossman* was proper because the price control statute itself distinguished between willful and innocent violations, and *Rossman Corp.* was an innocent violator. *See id.* at 37.

Apparently, the Court's explanation of *Rossman* was not wholly convincing. In *Marks v. Commissioner*, 27 T.C. 464 (1956), the court, citing *Rossman*, refused to classify a payment in settlement of potential liability for a violation of the Securities Exchange Act as either penal or nonpenal, and allowed a deduction. *Id.* at 468-69. However, the payment represented only the actual profit that the taxpayer had wrongfully realized. *See id.* at 465, 467. Thus, the payment was nonpenal and properly deductible. *See infra* notes 42-46 and accompanying text.

30. *See Diamond, supra* note 5, at 821; *Tyler, supra* note 5, at 667-68; Note, *Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code*, 72 *YALE L.J.* 108, 117 (1962).

would decrease the taxpayer's net wealth by \$7,200, while the same fine, if nondeductible, would decrease the taxpayer's net wealth by the full \$10,000. Accordingly, the increased impact argument asserts that when a governmental authority imposes a \$10,000 fine on a taxpayer having a twenty-eight percent marginal tax rate, it really intends to decrease the taxpayer's net wealth by only \$7,200. If the governmental authority imposed on the taxpayer a thirty day jail term instead of a \$10,000 fine, no one would question whether the authority intended that the taxpayer spend thirty days in confinement. Why then, should one question whether an authority imposing a \$10,000 fine intends to decrease the taxpayer's net wealth by any amount other than \$10,000?³¹

Notwithstanding the decision in *Tank Truck*, the Supreme Court has not always been thoroughly deferential to state interests when interpreting federal tax law. In *Commissioner v. Sullivan*,³² decided the same day as *Tank Truck*, the taxpayer attempted to deduct rent and wage expenses incurred in operating a gambling business.³³ A state statute had declared that not only was the operation of such a business illegal, but the mere payment of the rent expenses for such a business was also illegal.³⁴ The Tax Court denied the deductions, since the expenses were connected with illegal acts,³⁵ but the Supreme Court allowed the deductions.³⁶ The Court distinguished *Tank Truck* on the grounds that unlike the taxpayer in that case, the taxpayer in *Sullivan* was not attempting to avoid the consequences of violations of the law.³⁷

This distinction is sound in that the expenses incurred by the taxpayer in *Sullivan*, though part of or connected with a prohibited act, were not incurred as punishment imposed by the state for engaging in the act. Thus, a federal tax deduction for the expenses did not reduce a state imposed punishment. Nevertheless, the deduction

31. The argument asserting an increased impact from a denial of a deduction may have emanated from *Commissioner v. Heininger*, 320 U.S. 467 (1943). See Tyler, *supra* note 5, at 667. In *Heininger*, the Court held that a denial of a deduction for legal expenses incurred in attempting to enjoin a postal fraud order would "attach a serious punitive consequence" to the Postmaster's finding of guilt, which Congress had not intended. 320 U.S. at 474-75. The Court was not asserting that a denial of a deduction for legal fees would *increase the impact* of a penalty, but was asserting that a denial of a deduction would *create* a penalty, since the postal statute did not intend to punish the taxpayer for hiring counsel. See *id.* at 474. The Court's holding should not be construed to assert that if a government does intend to punish and imposes a \$10,000 fine, then the impact of the fine is increased if the taxpayer's net wealth is decreased by the full \$10,000.

32. 356 U.S. 27 (1958).

33. *Id.* at 27.

34. *Id.* at 28.

35. *Id.*

36. *Id.* at 29.

37. *Id.*

makes the relative cost of engaging in the illegal activity less than it would be without the deduction, resulting in apparent federal approval of the illegal activity. That the Supreme Court ignored this apparent approval of illegal activity indicates that the Court was reluctant, in the absence of statutory authority, to use federal tax law to promote nontax policies, even when legitimate state concerns are thereby subordinated.³⁸

III. DEDUCTION FOR COMPENSATORY PAYMENTS FRUSTRATES NO PUBLIC POLICY

A. Ordinary Civil Suits

Though courts denied deductions for penal payments imposed for statutory violations, they allowed deductions for compensatory payments imposed in ordinary civil suits. An early case that distinguished these two classes of payments was *Helvering v. Hampton*.³⁹ In *Hampton*, the taxpayer attempted to deduct a payment made in settling a judgment against him for fraudulent procurement of a lease.⁴⁰ The Ninth Circuit Court of Appeals allowed the deduction, and distinguished the public policy cases that denied deductions for fines, stating that there was "no analogy" between the payment of a fine for a public offense and the payment of restitution for tortious conduct.⁴¹ Essentially, allowing a deduction for compensatory pay-

38. Compare the decision in *Sullivan* with I.R.C. § 280E (1982) (denying all business expense deductions for enterprises trafficking in illegal drugs).

39. 79 F.2d 358 (9th Cir. 1935).

40. *Id.* at 358.

41. *See id.* at 359. For additional cases allowing business expense deductions for payments of compensatory settlements and judgments, see *James E. Caldwell & Co. v. Commissioner*, 234 F.2d 660 (6th Cir. 1956) (judgment for fraud and conspiracy), *rev'g*, 24 T.C. 597 (1955); *Anderson v. Commissioner*, 81 F.2d 457 (10th Cir. 1936) (compromise of judgment for negligence in operation of an automobile while on a business trip); *Ostrom v. Commissioner*, 77 T.C. 608 (1981) (judgment for fraud); *Vanderbilt v. Commissioner*, 16 T.C.M. (CCH) 1081 (1957) (libel judgment); *Camloc Fastener Co. v. Commissioner*, 10 T.C. 1024 (1948) (settlement of action for breach of contract); *Great Is. Holding Corp. v. Commissioner*, 5 T.C. 150 (1945) (settlement of claim for mismanagement of a corporation); *International Shoe Co. v. Commissioner*, 38 B.T.A. 81 (1938) (settlement of action for wrongful interference with a business); *Howard v. Commissioner*, 22 B.T.A. 375 (1931) (settlement of action for misrepresentation and conspiracy); *cf. Becker Bros. v. United States*, 7 F.2d 3 (2d Cir. 1925) (judgment for patent infringement deductible as a loss); *Appeal of Producers Fuel Co.*, 1 B.T.A. 202 (1924) (settlement for breach of contract deductible as a loss); *Donaghey Real Estate & Constr. Co. v. Commissioner*, 5 B.T.A. 766 (1926) (holding that if the taxpayer had actually paid damages in settlement of a wrongful death suit, a loss deduction would certainly be allowed).

But see O'Brien v. Commissioner, 36 T.C. 957 (1961) (attempting to deny, on public policy grounds, a deduction for any part of a judgment paid to an insurance company

ments incurred in ordinary civil suits frustrated no public policy.

B. Statutory Violations

Interestingly, the courts also allowed deductions for compensatory payments imposed for statutory violations. In *Grossman & Sons, Inc. v. Commissioner*,⁴² the taxpayer attempted to deduct a payment made to the United States in settlement of the government's suit alleging that the taxpayer had violated the False Claims Act.⁴³ Since the government had sought double damages and \$2,000 for each of 100 fraudulent claims submitted by the taxpayer,⁴⁴ the taxpayer's settlement appeared penal in nature. But the Tax Court held that the ultimate settlement payment was compensatory rather than penal, because it represented only the *actual damages* suffered by the government.⁴⁵ Thus, the court allowed the deduction.⁴⁶ Apparently, allowing a deduction for a statutorily imposed compensatory payment frustrated no public policy, just as allowing a deduction for compensatory payments imposed in ordinary civil suits frustrated no public policy.⁴⁷ These results are consistent with the purpose of com-

pursuant to a civil suit (in contract) for fraud, where the taxpayer had also been convicted in criminal proceedings), *aff'd on other grounds*, 321 F.2d 227 (9th Cir. 1963) (pointing out that the Commissioner had already allowed a deduction for the amount actually paid toward the judgment, and there is no need to consider public policy on the question of allowing a deduction for the amount not paid); *Anchor Coupling Co. v. United States*, 427 F.2d 429 (7th Cir. 1970) (payment to settle suit for specific performance of contract to purchase corporate assets held nondeductible capital expenditure, pursuant to I.R.C. § 263), *cert. denied*, 401 U.S. 908 (1971).

42. 48 T.C. 15 (1967).

43. *Id.* at 25.

44. *Id.*

45. *See id.* at 28-29.

46. *Id.* at 34.

47. *See supra* notes 39-41 and accompanying text. For other authority allowing deductions for compensatory payments incurred for statutory violations, see *Commissioner v. Pacific Mills*, 207 F.2d 177 (1st Cir. 1953) (payment in settlement of potential liability for price control violations held nonpenal, thus deductible, since it was calculated to only remove taxpayer's wrongful profit); *Milner Enterprises v. Commissioner*, 65-2 USTC (CCH) ¶ 9612 (S.D. Miss. July 28, 1965) (payment in settlement of suit by United States under Surplus Property Act); I.T. 3762, 1945 C.B. 95 (allowing deduction for payment of award to employees under Fair Labor Standards Act); *see also* I.T. 3627, 1943 C.B. 111 (holding that amounts paid to government by judgment or settlement for violations of Emergency Price Control Act are penal, hence nondeductible; but amounts paid by judgment or settlement to consumers under the Act are compensatory, hence deductible).

But cf. *Faulk v. Commissioner*, 26 T.C. 948 (1956). In *Faulk*, the taxpayer attempted to deduct all or one-half of the double damages it paid to the government for violation of the False Claims Act. *Id.* at 948. The Tax Court held that it was irrelevant whether any of the payment was compensatory, because public policy prohibits a deduction where the taxpayer commits fraud against the government. *Id.* at 951. But the Tax Court repudiated *Faulk* in *Grossman*, 48 T.C. at 31-32, favoring the distinction between compensatory and penal payments. *Id.* at 33. Applying *Grossman* to the facts in *Faulk*, the court should have allowed a deduction for one-half of the double damages, since this amount would represent the actual (compensatory) damages suffered by the government. *See*

pensatory payments, since, unlike penal payments, which are imposed to punish or deter (or punish *and* deter) wrongful conduct,⁴⁸ compensatory payments are imposed only to make an injured party whole.⁴⁹ Thus, no public policy is frustrated if the taxpayer lessens the impact of a compensatory payment with a deduction, as long as the injured party receives payment.

As of 1969, the judiciary had appended the following test of deductibility to the ordinary and necessary test of deductibility provided by section 162 of the Code:

- (1) If a statutory payment was penal, it was not deductible;
- (2) If a statutory payment was compensatory, it was deductible;
- (3) If a payment imposed in an ordinary civil suit was compensatory, it was deductible.

IV. CONGRESS REGAINS CONTROL OF SECTION 162 DEDUCTIONS

A. *The Tax Reform Act of 1969*

Before 1969, the Code provided no general public policy test of deductibility for ordinary and necessary business expenses,⁵⁰ although the judiciary had firmly established such a test.⁵¹ In 1969, Congress ended its silence on the public policy doctrine and passed the Tax Reform Act of 1969.⁵² A portion of the Act amended section 162 to provide that no deduction shall be allowed, as an ordinary and necessary expense, for "any fine or similar penalty paid to a government for the violation of any law."⁵³ Though the legislative history of the Act is ambiguous,⁵⁴ Congress intended to recognize

supra notes 42-46 and accompanying text.

48. *See supra* note 1.

49. 22 AM. JUR. 2D *Damages* § 27 (1988).

50. S. REP. NO. 552, 91st Cong., 1st Sess. 273 [hereinafter Report], *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2310.

51. *See* Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958); *see also* cases cited *supra* note 24.

52. Tax Reform Act of 1969, Pub. L. No. 91-172, § 902, 83 Stat. 487, 710-11 (codified as amended at I.R.C. § 162 (1982)).

53. *Id.* § 902(a), 83 Stat. at 710 (codified as amended at I.R.C. § 162(f) (1982)).

54. The ambiguity stems from a congressional intent to codify the then-existing judicial position on the deductibility of penal payments, *see* Report, *supra* note 50, at 274, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS at 2312, while apparently limiting nondeductibility to criminal fines. *Id.* at 274, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS at 2311-12. But the then-existing judicial rule clearly denied deductions for civil penalties. *Adolf Meller Co. v. Commissioner*, 600 F.2d 1360, 1362 (Ct. Cl. 1979); *see, e.g.,* *Appeal of Columbus Bread Co.*, 4 B.T.A. 1126 (1926). The ambiguity was later resolved. *See* *Southern Pac. Transp. Co. v. Commissioner*, 75 T.C. 497, 652 (1980) (Congress codified the preexisting judicial rule); S. REP. NO. 437, 92d

the then-existing penal-compensatory test of deductibility for statutorily imposed payments.⁵⁵ Thus, a statutorily imposed payment is a nondeductible "fine or similar penalty" if it is penal (meant to punish or deter, or both), but if the statutory payment is only compensatory, it is deductible.⁵⁶

With the Tax Reform Act of 1969, Congress did more than just recognize the penal-compensatory test of deductibility for statutory payments. Congress intended to completely codify the circumstances under which public policy requires a denial of a deduction under section 162. Besides prohibiting a deduction for fines and similar penalties,⁵⁷ Congress denied a deduction for the penalty portion of treble damage payments for antitrust violations,⁵⁸ and denied deductions for various bribes and kickbacks.⁵⁹ The senate report accompanying these amendments to section 162 states: "The provision for the denial of the deductions for payments in these situations which are deemed to violate public policy is intended to be all inclusive."⁶⁰ The Treasury regulation accompanying section 162 is consistent with this statement of congressional intent: "A deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowable under section 162 [as an ordinary and necessary expense] shall not be denied on the ground that allowance of such deduction would frustrate a sharply defined public policy."⁶¹ In addition, in *Raymond Bertolini Trucking Co. v. Commissioner*,⁶² the Sixth Circuit Court of Appeals stated that amended section 162 and its Treasury regulation do in fact require that the Commissioner base denials of deductions for business expenses only on the amended

Cong., 1st Sess. 73-74, reprinted in 1971 U.S. CODE CONG. & ADMIN. NEWS 1918, 1980 (disclaiming any congressional intent to limit nondeductibility to only criminal fines); Treas. Reg. § 1.162-21(b)(iii) (as amended in 1975) (civil penalties are not deductible).

55. See *Southern Pacific*, 75 T.C. at 652.

56. See *Middle Atl. Distrib., Inc. v. Commissioner*, 72 T.C. 1136 (1979); *Huff v. Commissioner*, 80 T.C. 804, 824 (1983); *Southern Pacific*, 75 T.C. at 652; cf. *Grossman & Sons, Inc. v. Commissioner*, 48 T.C. 15 (1967) (pre-1969 case, discussed *supra* text accompanying notes 42-46). Compare Treas. Reg. § 1.162-21(2) (as amended in 1975) (compensatory damages paid to a government do not constitute a fine or similar penalty) with *Standard Oil Co. v. Commissioner*, 129 F.2d 363 (7th Cir. 1942) (compensatory damages for fraud against the United States not deductible), *cert. denied*, 317 U.S. 688 (1942). But see *Waldman v. Commissioner*, 850 F.2d 611 (9th Cir. 1988), *aff'g* 88 T.C. 1384 (1987) (restitution paid to victims, pursuant to conviction for conspiracy, constitutes a "fine or similar penalty paid to a government").

57. See *supra* note 53 and accompanying text.

58. Tax Reform Act of 1969, Pub. L. No. 91-172, § 902(a), 83 Stat. 487, 710 (codified as amended at I.R.C. § 162(g) (1982)).

59. *Id.* § 902(b), 83 Stat. at 710 (codified as amended at I.R.C. § 162(c)(1)-(2) (1982)).

60. Report, *supra* note 50, at 274, reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS at 2311.

61. Treas. Reg. § 1.162-1(a) (as amended in 1988) (relevant portion amended by T.D. 7345, 1975-1 C.B. 51).

62. 736 F.2d 1120 (6th Cir. 1984).

language of section 162,⁶³ and not on public policy grounds.⁶⁴

It thus seems that Congress, in codifying its concept of the public policy doctrine, has preempted the judicial version of the doctrine. This preemption may have an undesirable effect. A business expense deduction that would be properly disallowed under the pre-codified public policy doctrine, as frustrating public policy, would be allowed under the codified doctrine unless specifically proscribed by section 162 as amended. This problem arises with the deductibility of punitive damages.⁶⁵

63. In broad terms, the general subsection and portions of section 162 relating to public policy provide:

(1) In general — A deduction is allowed for ordinary and necessary expenses paid or incurred in carrying on any trade or business, including amounts for salaries and other compensation, traveling expenses, and rentals or other payments required for possession of property not owned by the taxpayer. I.R.C. § 162(a) (1982).

(2) A deduction is not allowed as an ordinary and necessary expense for any illegal bribe or kickback paid to a government entity or employee, nor for any payment unlawful under the Foreign Corrupt Practices Act of 1977. I.R.C. § 162(c)(1).

(3) No deduction is allowed as an ordinary and necessary expense for any bribe or kickback that is illegal under federal law or illegal under a state law that is generally enforced, and where the law subjects the payor to a criminal penalty or the loss of the privilege to engage in a trade or business. I.R.C. § 162(c)(2).

(4) No deduction is allowed as an ordinary and necessary expense for the payment of any kickback, rebate, or bribe made by one who furnishes items or services paid for under the Social Security Act, if the payment is made pursuant to the furnishing of those items or services. (Payments for referrals of customers are included.) I.R.C. § 162(c) (3).

(5) No deduction is allowed as an ordinary and necessary expense for any fine or similar penalty paid to a government for the violation of any law. I.R.C. § 162(f).

(6) No deduction is allowed as an ordinary and necessary expense for two-thirds of any amount paid as damages by judgment or settlement under section 4 of the Clayton Act for antitrust violations. This provision applies only where the taxpayer was also criminally convicted for, or plead guilty or nolo contendere to, antitrust violations. I.R.C. § 162(g).

64. See *Raymond*, 736 F.2d at 1122. For an argument against such a conclusion, see Note, *The Judicial Public Policy Doctrine in Tax Litigation*, 74 MICH. L. REV. 131 (1975).

Interestingly, courts and the Commissioner may still invoke public policy to deny loss deductions under I.R.C. § 165 (1982). See *Farris v. Commissioner*, 823 F.2d 1552 (9th Cir. 1987), *aff'g without opinion* 50 T.C.M. (CCH) 412 (1985); *Holt v. Commissioner*, 611 F.2d 1160 (5th Cir. 1980), *aff'g per curiam* 69 T.C. 75 (1977); *Lincoln v. Commissioner*, 50 T.C.M. (CCH) 185 (1985); *cf.* Treas. Reg. § 1.165-7(a)(3)(i) (as amended in 1977) (denying casualty loss deduction for damage to taxpayer's automobile if caused by taxpayer's willful act or willful negligence). *But see Mazzei v. Commissioner*, 61 T.C. 497, 506 (1974) (Sterrett, J., dissenting) ("[C]ongressional intent could logically be read to remove public policy considerations from the Internal Revenue Code where not specifically included . . ."); *Medeiros v. Commissioner*, 77 T.C. 1255, 1262 n.8 (1981) ("There is some question whether the public policy doctrine retains any vitality since the enactment of sec[ti]on 162(f).").

65. This problem has apparently also occurred where a taxpayer was allowed a deduction for expenses incurred for advertisements that violated the Civil Rights Act of 1964. See Rev. Rul. 74-323, 1974-2 C.B. 40. *But see* Note, *The Judicial Public Policy*

B. Amended Code Permits Deduction for Punitive Damages

The deductibility of punitive damages has never been directly litigated.⁶⁶ But in 1980, the Service issued Revenue Ruling 80-211,⁶⁷ holding that punitive damages are deductible as an ordinary and necessary business expense. In this ruling, a corporate taxpayer desired to deduct a judgment against it for punitive damages for fraud and breach of contract.⁶⁸ The Service concluded that with the Tax Reform Act of 1969,⁶⁹ Congress intended to preempt the pre-codified public policy doctrine.⁷⁰ Since amended section 162 does not specifically proscribe a deduction for punitive damages, the Service held that punitive damages are deductible.⁷¹ Because the Service based its decision on statutory construction and congressional intent, and not on the taxpayer's specific conduct, there is every reason to believe that all punitive damages are deductible, regardless of the circumstances under which they are imposed.

Following congressional amendment of section 162 and the Service's interpretation of that amendment, the following test of deductibility has applied to business expenses that are otherwise ordinary and necessary:

- (1) If a statutory payment is penal, it is not deductible;
- (2) If a statutory payment is compensatory, it is deductible;
- (3) If a payment is incurred in an ordinary civil suit, it is deductible regardless of whether it is penal or compensatory.

V. CONGRESSIONAL INCONSISTENCY

Because the Service correctly determined that congressional failure in 1969 to prohibit a deduction for punitive damages mandates that such a deduction be allowed,⁷² Congress has codified an inconsistency. The purpose of punitive damages is to punish the wrong-

Doctrine in Tax Litigation, 74 MICH. L. REV. 131 (1975) (arguing against the Service's position in Revenue Ruling 74-323, on the grounds that the pre-codified public policy doctrine has not been preempted).

66. But the question was indirectly raised in *International Shoe Co. v. Commissioner*, 38 B.T.A. 81 (1938), where the taxpayer attempted to deduct a payment in settlement of a suit against it for interfering with another business. *Id.* at 88, 95. The suit included a claim for punitive damages. *Id.* at 88. The court allowed the deduction, *id.* at 97, but the settlement amounted to less than the claimed actual (nonpunitive) damages. *See id.* at 88, 95. Thus, it should not be inferred that the deduction represented a deduction for punitive damages.

67. 1980-2 C.B. 57. This ruling was consistent with the Service's position in Priv. Ltr. Rul. 79-23-006 (1979), but inconsistent with its position in Priv. Ltr. Rul. 78-16-021 (1978).

68. 1980-2 C.B. at 57.

69. *See supra* notes 52-59 and accompanying text.

70. *See* 1980-2 C.B. at 57; *see also supra* notes 60-64 and accompanying text.

71. 1980-2 C.B. at 57-58; *see also supra* note 63 (language of section 162).

72. *See supra* notes 60-64 and accompanying text.

doer for improper conduct, and to deter the wrongdoer and others from engaging in similar conduct in the future.⁷³ But fines and penalties serve substantially this same purpose.⁷⁴ In fact, punitive damages are merely fines imposed in private civil suits.⁷⁵ Thus, allowing a deduction for punitive damages reduces their "sting" and their deterrent effect in the same way that allowing a deduction for fines and penalties would.⁷⁶ An inconsistency therefore arises in allowing a deduction for punitive damages while denying a deduction for fines and penalties.⁷⁷ Congress probably did not intend to codify this inconsistency, especially since Congress acknowledges that punishment and deterrence are diluted, and public policy frustrated, whenever a penal payment is deducted.⁷⁸

A. Punitive Damages Under the Precodified Public Policy Doctrine

This inconsistency of allowing a deduction for punitive damages while denying a deduction for fines and penalties did not arise under the pre-codified public policy doctrine, because the deductibility of punitive damages was never litigated under the doctrine.⁷⁹ But if the deductibility of punitive damages had been litigated under the pre-codified doctrine, this inconsistency would not have arisen, because the rationale behind the doctrine would deny a deduction for punitive damages. The Supreme Court best circumscribed the pre-codified public policy doctrine in four cases: *Commissioner v. Heininger*,⁸⁰ *Lilly v. Commissioner*,⁸¹ *Tank Truck Rentals, Inc. v.*

73. W. KEETON, D. DOBBS, R. KEETON & D. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS 9 (5th ed. 1984); RESTATEMENT (SECOND) OF TORTS § 908(1) (1979); 25 C.J.S. *Damages* § 117(1) (1966).

74. See *supra* notes 8-9.

75. *International Bhd. of Elec. Workers v. Foust*, 442 U.S. 42, 48 (1979).

76. See *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

77. The Service implicitly agreed with this conclusion in Priv. Ltr. Rul. 78-16-021 (1978). In this ruling, a professional corporation sought to deduct payments of malpractice judgments and settlements on behalf of the corporation's member physicians. The Service held that the corporation could deduct the payments only to the extent that they compensate plaintiffs. Penalties and punitive damages would be nondeductible. Thus, the Service equated penalties with punitive damages. The Service later reversed its position when it conceded that it could base denials of business expense deductions only on the language of section 162. See *supra* notes 67-71 and accompanying text; see also Priv. Ltr. Rul. 79-23-006 (1979).

78. See Report, *supra* note 50, at 273-74, reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS at 2311.

79. See *supra* note 66 and accompanying text.

80. 320 U.S. 467 (1943).

81. 343 U.S. 90 (1952).

Commissioner,⁸² and *Commissioner v. Tellier*.⁸³ These cases narrowed and applied the test of nondeductibility under the public policy doctrine. A deduction would be denied for an otherwise ordinary and necessary business expense only if its allowance would “frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof.”⁸⁴

In *Heininger*, the taxpayer attempted to deduct legal fees incurred in enjoining enforcement of a mail fraud order issued by the Postmaster General.⁸⁵ The Court held that a deduction would frustrate no public policy because the statutes under which the Postmaster issued the order declared no policy proscribing employment of counsel to enjoin the order.⁸⁶ In *Lilly*, an optician attempted to deduct kickbacks paid to eye doctors.⁸⁷ The Court held that a deduction would frustrate no public policy because no government had declared a policy proscribing payment of these kickbacks.⁸⁸ In *Tank Truck*, the taxpayer attempted to deduct fines imposed for operating its trucks in violation of state maximum weight laws.⁸⁹ The Court held that a deduction would frustrate public policy because the state had statutorily declared a policy of proscribing the operation of overloaded trucks.⁹⁰ And in *Tellier*, the taxpayer attempted to deduct legal fees incurred in an unsuccessful criminal defense.⁹¹ The Court held that a deduction would frustrate no public policy because retention of counsel in criminal cases is not proscribed conduct, but rather, it is constitutionally guaranteed.⁹²

These decisions suggest that the Supreme Court intended to prevent courts and the Commissioner from using federal tax law to declare conduct to be contrary to public policy if neither federal nor state governments had so declared. Indeed, why should tax law concern itself with conduct that has concerned neither federal nor state governments? In the case of punitive damages, the question is whether there is any public policy involved when a state court imposes this private civil punishment.

82. 356 U.S. 30 (1958). See also *supra* notes 25-29 and accompanying text.

83. 383 U.S. 687 (1966).

84. *Tank Truck*, 356 U.S. at 33-34. The test of nondeductibility takes substantially this same form in *Heininger*, 320 U.S. at 473-74, *Lilly*, 343 U.S. at 96-97, and *Tellier*, 383 U.S. at 694.

85. *Heininger*, 320 U.S. at 469-70.

86. See *id.* at 474.

87. See *Lilly*, 343 U.S. at 91-92.

88. See *id.* at 97.

89. *Tank Truck*, 356 U.S. at 31.

90. See *id.* at 34-35. The Court left open the possibility that state policy could be declared by other than a legislature. *Id.* at 34 n.6. Federal policy may be declared by other than Congress. See *Cammarano v. United States*, 358 U.S. 498, 508 (1959) (long-standing Treasury regulation).

91. *Tellier*, 383 U.S. at 688.

92. *Id.* at 694.

As one state supreme court justice has stated, "The general interests of society and welfare of the community, as founded in legislative enactments or their reasonable interpretation, administrative declarations, and judicial determinations in the absence of legislative statement, are the underpinnings of public policy doctrine."⁹³ Thus, given the purpose of punitive damages to punish and deter certain types of conduct,⁹⁴ the existence of punitive damages under state law can be viewed as a declaration by the state that certain conduct is completely contrary to the interest of society. This is true regardless of whether an award of punitive damages may be founded upon a state statute or upon state common law. When a state court imposes punitive damages then, it is applying a public policy of the state, which is to punish and deter certain conduct. Presumably, the state would prefer that federal tax law not frustrate state policy by diluting the punitive and deterrent effects of a punitive damage award through allowance of a business expense deduction.⁹⁵

It follows that the pre-codified public policy doctrine most likely would have denied a deduction for punitive damages. Thus, not only has Congress codified an inconsistency with a Code that allows a deduction for punitive damages, but it has created an inconsistency that did not exist before attempted codification of the public policy doctrine. Congress should correct this inconsistency by treating payments imposed in ordinary civil suits the same as payments imposed for statutory violations. If the payment is meant to punish or deter wrongful conduct, then it should be nondeductible, but if it is meant only to compensate another party, it should be deductible. Accordingly, punitive damages should be nondeductible.⁹⁶

93. Brachtenbach, *Public Policy in Judicial Decisions*, 21 GONZ. L. REV. 1, 3 (1985/86).

94. See *supra* note 73 and accompanying text.

95. See *Tank Truck*, 356 U.S. at 35.

96. This result should apply whether the payment is by judgment or settlement, since denying a deduction for a judgment but not for a settlement would encourage the taxpayer to "pay early and get the deduction." See *S & B Restaurant v. Commissioner*, 73 T.C. 1226, 1234 (1980); see also *McGraw-Edison Co. v. United States*, 300 F.2d 453 (Ct. Cl. 1962) (sums paid in compromise of liability take on the character of the underlying claimed obligation); *Adolf Meller Co. v. United States*, 600 F.2d 1360 (Ct. Cl. 1979) (same).

In case of settlement, only the amount of the payment exceeding the plaintiff's alleged actual damages should be nondeductible, since, unless the parties choose to classify part of the payment as punitive, only that amount is properly termed "punitive." *Cf. Rev. Proc. 67-33*, 1967-2 C.B. 659, 661 (characterization of settlement of action for treble damages under the Clayton Act in determining whether such damages are includible in recipient's gross income).

B. Congress Hinted at Nondeductibility

The legislative history of the Tax Reform Act of 1969⁹⁷ lends support to a denial of a deduction for punitive damages.⁹⁸ As stated earlier,⁹⁹ among the provisions of the Act was a denial of a deduction for a portion of antitrust damages. In that regard, the senate report states:

One question which arises . . . is whether deductions should be allowed for damages paid to a private party in a cause of action in which the successful party is entitled to damages in a greater amount than the economic loss demonstrated by him. Under section 4 of the Clayton Act, *for example*, a person injured by an antitrust violation may sue for damages and recover three times the amount of economic loss established.¹⁰⁰

The report then reasons that a deduction for the penalty portion of an antitrust payment reduces the impact of the payment,¹⁰¹ and the report cites *Tank Truck Rentals, Inc. v. Commissioner*¹⁰² with approval.¹⁰³ Though the report focuses on the Clayton statutory setting, the use of the words "for example" in the above passage, and the absence of language limiting the reasoning to *statutorily* imposed payments, suggests a congressional willingness to apply the same reasoning to deny a deduction for the punitive portion of a payment to a private party imposed in a *nonstatutory* setting. That is, Congress seems willing to deny a deduction for punitive damages.

It might be said that if Congress had believed that a deduction for punitive damages would frustrate public policy, it would have prohibited the deductibility of punitive damages. That is, with the Tax Reform Act of 1969, Congress would have denied a deduction for *all* penal payments paid to private parties, and not just for penal antitrust payments paid to private parties. This would seem especially true since courts would no longer be able to invoke public policy to deny business expense deductions unless statutory authority so provides.¹⁰⁴ But the legislative history of the Act indicates no congressional consideration of private penal payments other than antitrust payments.¹⁰⁵ Consequently, the failure to deny a deduction for punitive damage appears unintentional. This appearance is supported by

97. See *supra* notes 52-59 and accompanying text.

98. The denial of a deduction for punitive damages apparently must come from Congress, not the courts. See *supra* notes 60-64 and accompanying text.

99. See *supra* note 58 and accompanying text.

100. Report, *supra* note 50, at 273, reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS at 2310-11 (emphasis added).

101. *Id.* at 273, reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS at 2311.

102. 356 U.S. 30 (1958); see also *supra* notes 25-29 and accompanying text.

103. Report, *supra* note 50, at 273-74, reprinted in 1969 U.S. CODE & ADMIN. NEWS at 2311.

104. See *supra* notes 60-64 and accompanying text.

105. See Report, *supra* note 50, at 273-75, reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS at 2310-13.

considering that the deductibility of punitive damages has never been litigated, and Revenue Ruling 80-211¹⁰⁶ (allowing a deduction for punitive damages) was not issued until 1980. In contrast, the deductibility of an antitrust payment paid to a private party was addressed in 1964 by Revenue Ruling 64-224,¹⁰⁷ in which the Service permitted the deduction. This ruling drew immediate objections from members of Congress,¹⁰⁸ and the ruling is expressly mentioned in the legislative history of the Tax Reform Act of 1969.¹⁰⁹ Thus, it appears that the absence of any reason to consider the deductibility of punitive damages provides a plausible explanation for Congress' failure to deny a deduction for those damages, even though it denied a deduction for antitrust damages paid to private parties.

VI. IMPLICATIONS OF THE NONDEDUCTIBILITY OF PUNITIVE DAMAGES

A. Response To Arguments Favoring A Deduction For Punitive Damages

One commentator argues that a denial of a deduction for punitive damages is inconsistent with the pre-codified public policy doctrine, and inconsistent with current tax policy.¹¹⁰ The commentator argues that the judicial public policy doctrine denied a deduction only for payments imposed for criminal misconduct.¹¹¹ But this conclusion is clearly contrary to substantial case law, as criminal fines *and* civil penalties were nondeductible.¹¹²

The commentator also argues that since the Supreme Court never mentioned punitive damages in applying the pre-codified public policy doctrine, and mentioned only fines, penalties, and illegal payments as nondeductible, punitive damages must be deductible.¹¹³ Because the deductibility of punitive damages has never been litigated, this silence theory of deductibility not only solicits obiter dictum from the Court, but it expects the Court to predict future tax controversies. A more plausible view of the Supreme Court's intent in cit-

106. 1980-2 C.B. 57; *see* notes 67-71 and accompanying text.

107. 1964-2 C.B. 52.

108. Taggart, *supra* note 5, at 617.

109. *See* Report, *supra* note 50, at 273, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS at 2311.

110. *See* Note, *The Tax Consequences of a Punitive Damages Award*, 31 HASTINGS L.J. 909 (1980).

111. *Id.* at 913.

112. *See supra* note 24 and accompanying text.

113. *See* Note, *supra* note 110, at 913, 915-17.

ing fines, penalties, and illegal payments suggests that the Court cited these expenditures only as previously litigated examples of payments whose deductibility would "frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof."¹¹⁴

The commentator argues that a court searching for a governmental declaration of public policy proscribing a specific conduct may only look to a statute for such a declaration.¹¹⁵ Presumably then, a common law award of punitive damages is not a proper declaration of public policy to warrant a denial of a deduction for punitive damages. But the Supreme Court never stated that only a legislature may declare the requisite public policy for a denial of a deduction. Indeed, the Court expressly left this question open.¹¹⁶

Finally, the commentator points out that taxpayers are entitled to know in advance what conduct will have adverse tax consequences, and this entitlement would be nullified by the nondeductibility of punitive damages since these damages can be imposed for an infinity of wrongdoings.¹¹⁷ This argument is really a veiled attack on uncertainty in state law on punitive damages. A denial of a deduction for punitive damages simply forces wrongdoers to bear the full impact of the punishment. Any uncertainty of consequences is created by state law, and unless unconstitutional, state punitive damage law should not be disturbed by the federal government.

B. *The Use of Tax Laws to Promote Nontax Policies*

A frequent assertion has been that tax laws are intended only to tax net income, and are not intended to be used to promote nontax policies.¹¹⁸ It would then follow that a denial of a deduction for punitive damages would violate this basic rule by promoting a state policy of punishing wrongdoers. This argument attempts to prove too much. Regardless of whether it is improper for the judiciary to use tax law to promote nontax policies without a statutory basis for doing so, Congress currently believes that it is proper for the legislature to promote nontax policies with tax laws. All business expense deductions are disallowed for businesses trafficking in illegal drugs,¹¹⁹ and of course, business expense deductions are disallowed for fines

114. See *Commissioner v. Tellier*, 383 U.S. 687, 694 (1966); *Commissioner v. Heininger*, 320 U.S. 467, 473 (1943).

115. Note, *supra* note 110, at 914.

116. See *supra* note 90.

117. Note, *supra* note 110, at 920.

118. See, e.g., *Commissioner v. Sullivan*, 356 U.S. 27, 29 (1958); *James v. United States*, 366 U.S. 213, 230 (1961) (Black, J., dissenting); *Diamond*, *supra* note 5, at 821-22; Paul, *The Use of Public Policy by the Commissioner in Disallowing Deductions*, UNIV. OF S. CAL. TAX INST. 715, 723-31, 737-42 (1954); Note, *supra* note 30, at 114-15.

119. I.R.C. § 280E (1982).

and penalties,¹²⁰ for various bribes and kickbacks,¹²¹ as well as for antitrust damages.¹²² Additionally, Congress has sat idly by while courts and the Commissioner continue to deny loss deductions under section 165 on public policy grounds.¹²³ Thus, while it is true that more than seventy years ago, Congress expressed a policy of taxing net income without injecting nontax considerations,¹²⁴ this policy has been subordinated with sufficient frequency so as to transform invocations of this policy as a basis for restraint in tax law into mere conclusory statements indicating an unwillingness to use tax law for a particular purpose.

In addition, Congress has broad constitutional powers to tax income. Since adoption of the sixteenth amendment,¹²⁵ only once has an income tax provision been found unconstitutional.¹²⁶ Accordingly, there should be no barrier to denial of a deduction for punitive damages, especially in light of the nondeductibility of fines and penalties.¹²⁷ In contrast, there are constitutional barriers confronting a federal government that attempts to ignore state law and frustrate that law with its own laws.¹²⁸ Accordingly, it may be an infringement of state sovereignty to frustrate state law by reducing state imposed punishment through the federal tax system by allowing a deduction for punitive damages.

C. Effect of Nondeductibility on Lawsuit Settlements

Besides preventing frustration of state policy, a denial of a deduction for punitive damages has another practical effect. The denial would increase the net cost to the taxpayer of a punitive damage payment compared to the cost under current law. Since compensatory payments are fully deductible,¹²⁹ they would be less costly to the taxpayer than punitive payments. Thus, if the taxpayer believes that a punitive award is possible, the taxpayer can afford to attempt to

120. I.R.C. § 162(f).

121. I.R.C. § 162(c)(1)-(3).

122. I.R.C. § 162(g).

123. See *supra* note 64.

124. 50 CONG. REC. 3849-50 (1913); Paul, *supra* note 118, at 723-26.

125. U.S. CONST. amend. XVI. The sixteenth amendment authorized the modern income tax.

126. 1 J. MERTENS, *supra* note 4, § 4.01.

127. I.R.C. § 162(f) (1982); see also *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

128. *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938); U.S. CONST. amend. X. *But see Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528 (1985).

129. See *supra* notes 39-41 and accompanying text.

prevent the award by offering a larger compensatory settlement approaching the plaintiff's actual damages. Since an award of punitive damages must be supported by an underlying cause of action,¹³⁰ if the taxpayer believes that a punitive award is possible, then the plaintiff likely has a valid underlying claim. The ultimate result is that in a whole class of cases where the plaintiff has a valid underlying claim, out of court settlements are more likely to occur because settlement offers approach actual damages. These cases are precisely the cases that most merit out of court settlement, because the courts are best used for cases where liability is unclear.

VII. CONCLUSION

Under the pre-1969 judicial public policy doctrine, the courts applied a penal-compensatory test of deductibility to payments imposed for statutory violations. Payments intended to punish or deter wrongful conduct were nondeductible as ordinary and necessary business expenses, while payments intended to compensate another party were deductible as ordinary and necessary business expenses. Absent from consideration under the judicial public policy doctrine was the application of the penal-compensatory test of deductibility in the case of payments imposed in ordinary civil suits. This void in federal tax law occurred because the deductibility of punitive damages was never directly litigated. Thus, the only application of the judicial public policy doctrine to ordinary civil suits was where the taxpayer sought a deduction for compensatory damages.

Congressional codification of the public policy doctrine in 1969 currently prevents courts and the Commissioner from applying the pre-codified public policy doctrine to deny a deduction for punitive damages, even though consistency, the pre-codified doctrine, and preservation of states' rights all suggest nondeductibility. Because only Congress may correct this defect in the Code, Congress should amend the Code to deny a deduction, as an ordinary and necessary business expense, for punitive damages.

K. TODD CURRY

130. RESTATEMENT (SECOND) OF TORTS § 908 comment c (1979).