



University of Baltimore Law Review

Volume 22
Issue 1 Fall 1992

Article 5

1992

Comments: The Public Policy Doctrine and Tax Logic: The Need for Consistency in Denying Deductions Arising from Illegal Activities

Charles A. Borek
University of Baltimore School of Law

Follow this and additional works at: <http://scholarworks.law.ubalt.edu/ublr>

 Part of the [Tax Law Commons](#)

Recommended Citation

Borek, Charles A. (1992) "Comments: The Public Policy Doctrine and Tax Logic: The Need for Consistency in Denying Deductions Arising from Illegal Activities," *University of Baltimore Law Review*: Vol. 22: Iss. 1, Article 5.
Available at: <http://scholarworks.law.ubalt.edu/ublr/vol22/iss1/5>

This Article is brought to you for free and open access by ScholarWorks@University of Baltimore School of Law. It has been accepted for inclusion in University of Baltimore Law Review by an authorized administrator of ScholarWorks@University of Baltimore School of Law. For more information, please contact snolan@ubalt.edu.

COMMENTS

The Public Policy Doctrine and Tax Logic: The Need for Consistency in Denying Deductions Arising from Illegal Activities

I. INTRODUCTION

In 1981 Anthony J. Accardo and fifteen others were the subjects of a criminal prosecution in Florida under the Racketeer Influenced & Corrupt Organizations Act (RICO).¹ Mr. Accardo spent nearly a quarter of a million dollars in legal fees defending himself.² In 1982 he was acquitted.³ From a tax standpoint, this was an unfortunate development for Mr. Accardo; if he had been found guilty he could have properly taken a business expense deduction for his monumental legal fees.⁴

This seemingly odd result stems from the fact that § 162(a) of the Internal Revenue Code (hereinafter Code) provides a deduction for *all* ordinary and necessary expenses incurred in carrying on *any* business.⁵ While legal fees are deductible if incurred in the business of racketeering,⁶ no such deduction is available to one who is acquitted of being a racketeer.⁷ What appears to be an unjust outcome

1. *Accardo v. Commissioner*, 94 T.C. 96, 96 (1990), *aff'd*, 942 F.2d 444 (7th Cir. 1991), *cert. denied*, 112 S. Ct. 1266 (1992).

2. *Id.* at 98.

3. *Id.*

4. *Accardo v. Commissioner*, 942 F.2d 444, 448 (7th Cir. 1991), *cert. denied*, 112 S. Ct. 1266 (1992). The government conceded that the other defendants who were found guilty of RICO offenses could properly claim deductions for their legal expenses because they were found to be in the business of racketeering. *Id.*

5. I.R.C. § 162(a) (1988).

6. Although this issue was not decided by the court, the Internal Revenue Service conceded this point. *Accardo*, 942 F.2d at 448. This concession is likely based on the seminal case of *Commissioner v. Tellier*, 383 U.S. 687 (1966), in which the Supreme Court held that legal fees incurred in the unsuccessful defense against criminal charges may be deducted under I.R.C. § 162 if related to the taxpayer's business.

7. *Accardo*, 942 F.2d at 448. The court explains that Mr. Accardo refused to divulge the true nature of his business, citing the Fifth Amendment privilege against self-incrimination in response to the government's interrogatories. *Id.*

(allowing an expense deduction to convicted criminals while disallowing favorable tax treatment of the same expense for those who are acquitted of crimes) occurs because the Code is designed to tax incomes, not punish wrongdoing.⁸

The idea that tax deductions may properly accrue to those who operate illegal enterprises dates back to the adoption of the first federal tax code in 1913.⁹ It soon became clear, however, that this result was unpalatable to the courts, which developed what has come to be known as the "public policy doctrine."¹⁰ Throughout much of this century, the judiciary has used this doctrine to deny deductions which would otherwise be allowed under the Code.

The majority of cases making reference to the public policy doctrine have involved the general business expense deduction provided in I.R.C. § 162.¹¹ Once the public policy doctrine had been fully developed by the courts, therefore, it was logical that Congress chose to codify it by amending § 162 to preclude certain deductions emanating from illegal activities.¹² Section 162, however, is not the only deduction provision found in the Internal Revenue Code. Section 165, for example, provides a deduction for losses sustained by the taxpayer.¹³ While recognizing that the public policy doctrine as applied to § 162 has been legislatively abrogated regarding that section,¹⁴ the Internal Revenue Service (hereinafter "Service") and the courts

8. *See infra* notes 17-23 and accompanying text (explaining the debate concerning deductions from illegal income).

9. Senator Williams, the floor manager of the 1913 Revenue Act, commented that "the object of this bill is to tax a man's net income; . . . not to reform men's moral characters . . ." 50 CONG. REC. 3849 (1913). During the floor debates, Senator Sterling twice attempted to amend the business deduction language so that only expenses incurred in lawful or legitimate enterprises would be allowed such a deduction; both attempts were rejected. *Id.* at 3849-50.

10. *See infra* part III. (explaining the development of the "public policy doctrine").

11. The language of § 162(a) of the 1986 Code (the current version of the tax statutes) was formerly contained in § 23(a) of the 1939 Code. Since the language in the two provisions is identical, all references will be to the 1986 Code. In both incarnations, the provision allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ." I.R.C. § 162(a) (1988).

12. The amendments were accomplished by adding several new subsections to § 162 of the Code. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified as amended in I.R.C. § 162(c), (f), (g) (1988)).

13. I.R.C. § 165(a) (1988). Although business-type deductions could fall under other sections of the Code (e.g., § 212, which allows an individual to deduct the cost of producing income or maintaining income-producing property, I.R.C. § 212(1), (2) (1988)), this Comment will focus on §§ 162 and 165, as these sections are the most likely to be involved in an application of the public policy doctrine to deny a deduction.

14. *See infra* note 83 and accompanying text.

have sought to apply a distinguishable version of the doctrine to other business deductions, particularly those claimed under § 165.

This Comment begins by outlining the rationale behind allowing deductions related to illegal activity, demonstrating that the Code was intended to be blind to the legal status of a taxpayer's business. The evolution of the public policy doctrine is then explored from its judicial inception to legislative codification in I.R.C. § 162. From this analysis comes the conclusion that the public policy doctrine, as limited by various Supreme Court decisions, is coextensive with the limitations now found in § 162. If this premise is accepted, claimed deductions relating to a business should only be disallowed on the basis of public policy when they fall into a category articulated by one of the limiting provisions of that section.

II. DEDUCTIONS FOR RACKETEERS

Few would argue with the notion that income from illegal activities should be subject to taxation; were this not the case, nefarious individuals could avoid taxation merely by choosing to earn their living outside the bounds of the law. The Code itself averts this disaster by declaring that "all income from whatever source derived" is to be included as gross income¹⁵ and used in the calculation to arrive at taxable income. The issue at hand, therefore, is not whether illegal income should be taxed, but whether a *higher* burden of taxation should be imposed on individuals obtaining income through illegal means. This would be accomplished, for example, by denying deductions based on the illegal nature of the source of these deductions or of the sources of income to which they relate.¹⁶

As noted, the Code permits a deduction for expenses incurred in carrying on "any trade or business."¹⁷ Before this language was first enacted in 1913,¹⁸ it was proposed that "trade or business" be

15. I.R.C. § 61(a) (1988). Because of this expansive language, the government has been able to make use of the tax laws to obtain convictions when it is difficult to get evidence of the crimes used to obtain the unreported income. See, e.g., Rich Exner, *Reputed Smut King Convicted of Tax Evasion*, UNITED PRESS INT'L, Nov. 17, 1987.

16. Tax liability is determined by application of a rate to taxable income. Taxable income is "net" income because it is arrived at by subtracting deductions from gross income; applying the rate to gross income, will therefore, result in a higher tax burden.

17. I.R.C. § 162(a) (1988).

18. Tax Act of 1913, ch. 16, § IIB, 38 Stat. 114, 167. Note that although § IIB of the 1913 Act provided that any *lawful* income was to be taxed, the term "lawful" was deleted from the statute in 1916. See Tax Act of 1916, ch. 463, § 5(a), 39 Stat. 756, 759.

modified by the words "legitimate" or "lawful" so as to disallow deductions arising out of a trade or business carried on in violation of the law.¹⁹ These proposals were rejected for at least two reasons. Using illegal gambling operations as an example,²⁰ Senator McCumber pointed out during consideration of the legislation that taxing winnings while disallowing a deduction for losses would amount to taxing the same income twice.²¹ Secondly, it was emphasized in the floor debates that the tax legislation was meant to be blind to the character of both the taxpayer and their means of obtaining income.²² As a result, language permitting deductions for both legitimate and illegitimate enterprises was adopted and has remained unchanged through three subsequent overhauls of the Code.²³

There remains, moreover, the unanswered question of whether Congress possesses the power to impose a tax on the *gross* income of an illegal business, a result achieved by denying the deduction of expenses. This particular taxing power of Congress is established by the Sixteenth Amendment, which authorizes a tax on "incomes."²⁴ Although the Supreme Court has never directly considered the issue,²⁵ the accepted view is that the term "incomes" as used in the Sixteenth Amendment refers only to *net* income.²⁶

19. See *supra* note 9.

20. Senator Sterling's chief concern, apparently, was subjecting the illegal gambling industry to a higher tax burden. See 50 CONG. REC. 3849-50 (1913).

21. *Id.* at 3850. Double taxation occurs whenever an expenditure results in income to one party without a corresponding deduction to the other party.

22. "The law does not care where he got it from, so far as the tax is concerned." *Id.* at 3849 (remarks of Senator Williams in response to proposals that deductions related to illegal businesses should not be allowed).

23. Although portions of the Code undergo minor changes and technical corrections nearly every year, major revisions of the Code were undertaken in 1939, 1954, and 1986; these codifications are commonly referred to as the 1939 Code, the 1954 Code, and the 1986 Code. The "current" Code is the 1986 Code.

24. U.S. CONST. amend. XVI.

25. In *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), the Court stated that the term "income" as used in I.R.C. § 61(a) (referring to "gross income") was being used in its "constitutional sense." *Id.* at 432 (citing H.R. REP. NO. 1337, 83d Cong., 2d Sess., at A18 (1954)). This statement should not be interpreted as meaning that "income" as used in the Sixteenth Amendment means gross income, however, because the focus of the discussion in *Glenshaw Glass* was on the *definition* of gross income, not in the propriety of taxing the same. To date the Court has not specifically addressed the latter issue.

26. See Note, *Taxability of Gross Income Under the Sixteenth Amendment*, 36 COLUM. L. REV. 274 (1936), wherein the author asserts that, although deductions are accepted to be matters of legislative grace, "[t]he cases under the post-Amendment statutes have consistently proceeded on the assumption that . . . deduction of capital costs is necessary to arrive at income resulting from sales." *Id.* at 280. There is no specific indication of how the drafters meant the term to be defined. *Id.* at 276-78. Nonetheless, the author posits that the "legislative grace" accorded to Congress in allowing deductions is limited to those deductions not necessary to acquiring income. *Id.* at 280-81.

Indeed, certain members of Congress expressed a belief that taxing gross income might be beyond the scope of their constitutional authority when they rejected a proposal made in 1951 by Senator Kefauver to impose a special gambling tax.²⁷ The concern of the opponents to Senator Kefauver's idea was that taxing the gross incomes of those convicted of crimes might amount to an unconstitutional interference with state police powers by using a federal statute to impose punishment for violations of state law.²⁸ The same concern was earlier addressed by the Supreme Court in *United States v. Constantine*,²⁹ in which the Court concluded that a higher tax on illegal income amounts to a penalty imposed upon the wrongdoer and that the federal government has no power to penalize taxpayers for violations of state laws.³⁰ The Court concluded that federal income tax law is not intended as a penal statute, but rather as a revenue-producing measure.³¹

III. THE DEVELOPMENT OF THE PUBLIC POLICY DOCTRINE UNDER § 162

Despite the dicta in *Constantine* and demonstrated congressional reluctance to draw a distinction between deductions emanating from legal and illegal enterprises, the lower courts went about exploring methods to effectuate disallowance of the latter variety. The earliest case disallowing a deduction for public policy reasons was based on the notion that allowing a deduction amounted to condoning the activity giving rise to the expense.³² Since Congress had made clear that all businesses were subject to the same tax scheme, however, this rationale was destined to be short-lived. Subsequently, the courts began to focus on the statutory words "ordinary and necessary" as

27. Opponents of the Kefauver proposal suggested that the distinction for tax purposes between income from legal and illegal sources "may raise a serious constitutional question" by making the application of federal tax law dependent on the laws of the states. 97 CONG. REC. 12239-40 (1951).

28. *Id.*

29. 296 U.S. 287 (1935).

30. *Id.* at 295-96; see also *Nichols v. Coolidge*, 274 U.S. 531, 541 (1927) ("[U]nder the mere guise of reaching something within its powers Congress may not lay a charge upon what is beyond them.").

31. *Constantine*, 296 U.S. at 295-96.

32. The earliest vestige of the public policy doctrine in the U.S. seems to be contained in *Backer v. Commissioner*, 1 B.T.A. 214 (1924), in which the court held that to allow a deduction stemming from an illegal activity would amount to recognizing the activity as legitimate. *Id.* The actual origin of the public policy doctrine, though, has been traced to the British case of *Commissioners of Inland Revenue v. Warnes & Co.*, 2 K.B. 444 (1919). E.g., Comment, *Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning With the Internal Revenue Code*, 72 YALE L.J. 108, 108 n.1 (1962).

a means to restrict the deductions available to illegal enterprises.³³

In *Commissioner v. Textile Mills Securities Corp.*,³⁴ for example, the Third Circuit denied a deduction for any payments made pursuant to a contract which was found to be void for public policy reasons.³⁵ The court noted that payments made pursuant to a contract rendered void on public policy grounds could not be considered "ordinary" and thus were not deductible under the statute.³⁶

Within three years, however, the Supreme Court explicitly rejected the Third Circuit's interpretation of the "ordinary and necessary" language of the statute. In *Commissioner v. Heininger*,³⁷ the Court found that expenditures need only be "appropriate and helpful" to fall within the ambit of the statute.³⁸ In *Heininger*, the taxpayer had been selling false teeth through mail order advertise-

33. I.R.C. § 162 provides that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ." I.R.C. § 162(a) (1988). There is apparently no meaningful legislative history regarding exactly what Congress meant when it used the phrase "ordinary and necessary." *Raymond Bertolini Trucking Co. v. Commissioner*, 736 F.2d 1120, 1122-23 (6th Cir. 1984).

34. 117 F.2d 62 (3rd Cir. 1940), *aff'd*, 314 U.S. 326 (1941).

35. *Id.* The court held that a contract calling for a domestic corporation to lobby for favorable legislation relating to foreign business interests was against public policy. As such, payments made pursuant to the contract were not properly deductible. *Id.*

36. *Id.* at 65 ("[T]he payment of moneys [sic] for carrying out a purpose contrary to public policy is by no means ordinary."). Interestingly, the court also decided that payments for the purpose of lobbying could not be "necessary" either, because lobbying for legislation can never be shown to proximately cause its passage, given the free will of the legislative body. *Id.*

In a concurring opinion, Judge Clark identified three possible meanings of the term "ordinary." The first was the dictionary definition (customary, usual or normal); the second was a definition borrowed from tort concepts (foreseeable). The third definition seemed most likely to Judge Clark to have been intended by Congress: a category of expenses which includes no practices falling below the standards to which the courts have given their approval. *Id.* at 73 (Clark, J., concurring).

37. 320 U.S. 467 (1943).

38. *Id.* at 471. The Court reasoned that if an expense is of the type which the taxpayer would normally be expected to pay under the circumstances, and the expenditure is made in good faith, reasonable as to amount, and can be viewed as appropriate and helpful to the business, then there is no question but that it is "ordinary and necessary" within the meaning of the statute. *Id.*

The term "ordinary" has generally been accepted to distinguish only between items currently deductible and those representing capital expenditures. *See, e.g., Mason and Dixon Lines, Inc. v. United States*, 708 F.2d 1043 (6th Cir. 1983). That the term "necessary" encompasses "only the minimal requirement that the expense be 'appropriate and helpful' for 'the development of the [taxpayer's] business'" has been firmly established in tax jurisprudence. *Commissioner v. Tellier*, 383 U.S. 687, 689 (1966) (quoting *Welch v. Helvering*, 290 U.S. 111, 113 (1933)).

ments.³⁹ The expenses sought to be deducted were legal fees incurred in opposing a "fraud order" issued by the Post Office.⁴⁰ Although Heininger ultimately failed in his attempt to obtain an injunction against the Post Office, the Court found that a good faith defense against a fraud charge was no different than a defense against a malpractice or breach of contract claim; since the action taken by the Post Office threatened to destroy the taxpayer's business, the expenses of a defense were held to be both ordinary and necessary.⁴¹

In the present context, however, the *Heininger* decision is notable less for its holding than for its dicta. In reconciling its holding with previous cases in which deductions were denied for expenses such as penalties for violation of statutes and payments made to influence the awarding of government contracts, the Court recognized that the language of § 162⁴² could legitimately be read to exclude certain deductions "in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct."⁴³ Thus while *Heininger* rejected the conclusion that expenses of an illegal enterprise were per se not "ordinary and necessary,"⁴⁴ it established a standard by which to judge the validity of the disallowance of a deduction on public policy grounds.⁴⁵ Pursuant to this standard, it was left to the courts to define exactly what would constitute "frustrating sharply defined policies" such that a deduction should be disallowed.

The Fourth Circuit's attempt to do so in *Lilly v. Commissioner*⁴⁶ by resurrecting the rationale of *Textile Mills* was rejected by the Supreme Court.⁴⁷ Thomas and Helen Lilly, who operated an optical

39. *Heininger*, 320 U.S. at 469.

40. *Id.*

41. Although the Court noted that the continued existence of the taxpayer's lawful business was being threatened, *id.* at 472, nowhere else in the opinion is a distinction made between the treatment of lawful and unlawful enterprises. It would appear, therefore, that the inclusion of the reference to a "lawful business" was inadvertent on the part of Justice Black.

42. The Court was actually dealing with § 23(a) of the 1939 Internal Revenue Code; as indicated in note 11, *supra*, however, all references will be to the current Code. Section 162(a) of the current Code is identical to § 23(a) of the 1939 Code. See I.R.C. § 162(a) (1988); I.R.C. § 23(a) (1939).

43. *Heininger*, 320 U.S. at 473 (emphasis added).

44. The current interpretation of these terms is that "ordinary" merely distinguishes capital expenditures from those which are currently deductible; "necessary" encompasses only the minimal requirement that the expense be appropriate and helpful to the development of the taxpayer's business. *Commissioner v. Tellier*, 383 U.S. 687, 689 (1966).

45. Subsequent to *Heininger*, the tax court and other federal courts began using this phrase as the touchstone of nondeductibility. See, e.g., *Commissioner v. Pacific Mills*, 207 F.2d 177, 182 (1st Cir. 1953).

46. 188 F.2d 269 (4th Cir. 1951), *rev'd*, 343 U.S. 90 (1952).

47. *Lilly v. Commissioner*, 343 U.S. 90, 95 (1952).

shop,⁴⁸ attempted to deduct commissions paid to eye doctors who referred their patients to the Lillys' shop to purchase eyeglasses.⁴⁹ In ostensibly following the *Heininger* rationale, the Fourth Circuit disallowed the deduction on the basis that the arrangement amounted to an illegal agreement for a secret consideration in the context of a confidential relationship.⁵⁰ Such an agreement was therefore void on the basis of public policy: "We certainly will not lend the force of any opinion of this court to sanction, as an 'ordinary and necessary' expense of the optician's business, the making and carrying out of such unconscionable and reprehensible contracts for secret kickbacks to a doctor."⁵¹

The Supreme Court rejected this interpretation of *Heininger*,⁵² noting that the judiciary need "voice no approval of the business ethics or public policy involved" in determining that such payments are ordinary and necessary within the meaning of the tax statute.⁵³ Specifically, the national or state policies referred to in *Heininger* must be "evidenced by some governmental declaration of them."⁵⁴ Furthermore, it must be the *payment* of the expense which contravenes the governmental declaration, not the nature of the underlying obligation;⁵⁵ the fact that the underlying obligation may not be enforceable because it represents a contract in contravention of public policy is of no event in analyzing the deductibility of an expense. Thus in *Lilly* the Court made clear that a mere violation of the law was not enough "frustration" of public policy to warrant the denial of a deduction.

Seven years elapsed before the Court articulated exactly what *would* meet the disallowance standard in *Heininger*. In *Tank Truck*

48. *Lilly*, 188 F.2d at 270.

49. *Id.*

50. *Id.* at 271 (citing 6 WILLISTON ON CONTRACTS 4907 (rev. ed.)).

51. *Id.*

52. *Lilly v. Commissioner*, 343 U.S. 90 (1952).

53. *Id.* at 97.

54. *Id.*

55. The tax court had held, as a matter of law, that the *contracts* pursuant to which the payments were made violated public policy. *Lilly v. Commissioner*, 14 T.C. 1066, 1086 (1950), *aff'd*, 188 F.2d 269 (4th Cir. 1951), *rev'd*, 343 U.S. 90 (1952). The Fourth Circuit, in affirming the tax court decision, based its holding on a finding that the contracts were "unconscionable and reprehensible." *Lilly*, 188 F.2d at 271. In contrast, the Supreme Court opinion focused on the payments themselves, noting that the continuance of the payments were "as essential to [the Lillys' business] as were their other business expenses" because, without such payments, doctors would discontinue referrals. *Lilly*, 343 U.S. at 94. The Court expressed no concern over whether the contracts themselves could have been enforced, which is exactly the basis on which the lower courts reached their decisions.

Rentals, Inc. v. Commissioner,⁵⁶ the Court found that a state policy reflected by the imposition of monetary penalties for specific types of conduct would be thwarted by allowance of a deduction for the payment of those penalties.⁵⁷ The test enunciated by Justice Clark, writing for a unanimous Court, was that the nondeductibility of an expense rested upon the severity and immediacy of the frustration that would follow from allowing the deduction.⁵⁸ In cases where the expenditure itself is prohibited by law, public policy would most clearly be frustrated by allowing a tax deduction for the payment.⁵⁹ The payment of a penalty imposed by the State was viewed by the Court as being only slightly less remote, and well within the parameters of frustration contemplated by *Heininger* and its progeny.⁶⁰ Because allowing a deduction for the payment of a penalty would reduce its "sting," public policy was deemed to prohibit such a result.⁶¹ Pursuant to the Court's language in *Tank Truck Rentals*, therefore, the only two categories of claimed deductions which were recognized as frustrating public policy sufficiently to warrant disallowance were illegal payments and the payment of penalties imposed by the government.

These strict limitations on the use of the public policy doctrine thus stated were reiterated and clarified by Justice Douglas in *Commissioner v. Sullivan*.⁶² Sullivan operated an illegal gambling enterprise in Chicago.⁶³ The tax court held that payments for wages and rent could not be deducted because they represented expenditures made in connection with illegal acts.⁶⁴ The Supreme Court rejected this rationale on the basis of the *Heininger* and *Lilly* decisions.⁶⁵ In so doing, Justice Douglas attempted to set out objective standards for determining the deductibility of expenses emanating from an illegal enterprise. The analysis must begin with the proposition that any expenditures made to conduct the business itself are presumed to be deductible.⁶⁶ Such expenses only become nondeductible on the

56. 356 U.S. 30 (1958).

57. *Id.* at 36-37.

58. *Id.* at 35.

59. *Id.*

60. *Id.*

61. *Id.* at 35-36.

62. 356 U.S. 27 (1958).

63. *Id.* at 28.

64. *Mesi v. Commissioner*, 25 T.C. 513 (1955), *rev'd*, 241 F.2d 558 (7th Cir. 1957), *rev'd sub nom. Commissioner v. Sullivan*, 356 U.S. 27 (1958).

65. The "'fact that an expenditure bears a remote relation to an illegal act' does not make it nondeductible." *Commissioner v. Sullivan*, 356 U.S. 27, 29 (1958) (quoting *Commissioner v. Heininger*, 320 U.S. 467, 474 (1943)).

66. Justice Douglas based his reasoning on the fact that excise taxes on wagers were deductible pursuant to a Treasury Department regulation: "The policy

basis of public policy if: (1) the deduction itself is a device to lessen the economic effect of a penalty imposed by statute,⁶⁷ or (2) the deduction would contravene a federal policy *expressed in a statute or regulation*.⁶⁸

It is clear from both *Sullivan* and *Commissioner v. Tellier*,⁶⁹ decided eight years later, that the Court felt that the focus of the analysis must be on the payment of the expense, not the conduct giving rise to it.⁷⁰ In *Tellier*, the underlying transaction giving rise to the expense was a taxpayer's defense against criminal charges.⁷¹ Expenditures for such a defense are certainly not, and could not be, prohibited by statute.⁷² Since the expenditures themselves did not violate a statute and did not constitute the payment of a penalty, the deduction did not frustrate public policy and was legitimate if the payments were helpful in the conduct of the taxpayer's business.⁷³

that allows as a deduction the tax paid to conduct the business seems sufficiently hospitable to allow the normal deductions of the rent and wages necessary to operate it." *Id.* at 28-29. The same conclusion would undoubtedly have been reached in the absence of a regulation on the basis that expenditures used to conduct a business are "ordinary and necessary" within the definition set out in *Heininger*. *Id.* at 29.

67. *Id.* This is the same test used in *Tank Truck Rentals*. See *supra* notes 56-61 and accompanying text; see also *Hoover Motor Express Co. v. United States*, 356 U.S. 38, 40 (1958) (holding that penalties arising from inadvertent violations of state laws are no more deductible than those arising from wanton and willful violations).

68. *Sullivan*, 356 U.S. at 29.

69. 383 U.S. 687 (1966).

70. The reasoning found in both *Sullivan* and *Tellier* give rise to this conclusion. In the former case, Justice Douglas cited his earlier opinion in *Commissioner v. Textile Mills Sec. Corp.*, 314 U.S. 326 (1941), for the proposition that payments which contravene federal policy are nondeductible. *Sullivan*, 356 U.S. at 28. In *Textile Mills*, disallowance of a deduction was founded on the basis that the specific payment at issue (lobbying expenses) were prohibited by regulation. *Textile Mills*, 314 U.S. at 337. In *Tellier*, Justice Stewart's focus was on whether the *payment* made for legal defense against criminal charges constituted "proscribed conduct." *Tellier*, 383 U.S. at 694. In these cases, therefore, the Court did not analyze the propriety of disallowance with reference to some intrinsic violation of public policy due to the taxpayer's unlawful conduct; rather, the analysis focused on whether the payment of the expense itself violates a prohibition found in a statute or regulation.

That this is a correct reading of these decisions was reiterated by the Sixth Circuit in *Raymond Bertolini Trucking Co. v. Commissioner*, 736 F.2d 1120 (6th Cir. 1984). In that case, a deduction was sought for "kickback" payments made by subcontractors relating to a construction project. *Id.* at 1121-22. In holding that such payments were a "cost of doing business like any other," the court focused on the legality of the payment, noting that the payment was not prohibited by law in the applicable jurisdiction. *Id.* at 1125.

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

72. *Id.* at 694 (noting that there is a constitutional right to counsel).

73. *Id.* at 689.

Because the criminal charges against the taxpayer found their source in his business activities as a securities dealer, they were both ordinary and necessary and therefore deductible notwithstanding any public policy argument to the contrary.⁷⁴

Thus, the judicial formulation of the public policy doctrine which culminated in *Tellier* contained discernable parameters. In keeping with the literal requirements of the Code, it was acknowledged that all ordinary and necessary business expenses were presumed deductible, regardless of the legal or illegal nature of the business.⁷⁵ It is only in specific, narrowly drawn circumstances that allowance of a deduction will be considered to so sharply frustrate public policy that an exception will be read into the Code. Through the *Tellier* line of cases, the only such circumstances recognized were when the payments themselves are illegal or represent the payment of a fine imposed by the government.⁷⁶

Subsequent to the judicial formulation of the public policy doctrine, Congress chose to codify the doctrine as part of the Tax Reform Act of 1969 by amending I.R.C. § 162.⁷⁷ The legislative body's intent was to codify the prior formulation of the courts.⁷⁸ While the Senate Report accompanying the bill which accomplished the codification hints at a fear on the part of the legislature that the courts may not have been effectively restrained in their views of public policy absent statutory clarification,⁷⁹ the language of the amendment merely recognized by statute a public policy exception

74. *Id.* at 689-90.

75. "We start with the proposition that the federal income tax is a tax on net income, not a sanction against wrongdoing. That principal has been firmly imbedded in the tax statute from the beginning." *Id.* at 691.

76. *See* *Mason and Dixon Lines, Inc. v. United States*, 708 F.2d 1043 (6th Cir. 1983) (allowing a trucking company convicted of weight violations to deduct the "liquidated damage" assessed against it by the State of Virginia). At least one case went so far as to suggest that *Tellier* has abrogated the public policy doctrine altogether. *See* *Finger v. United States*, 257 F. Supp. 312, 314 (D.S.C. 1966).

77. *See supra* note 12 and accompanying text.

78. The Senate Report accompanying the bill indicates that the legislation "represents a codification of the general court position" in regard to fines or penalties. S. REP. No. 91-552, 91st Cong., 1st Sess., at 274 (1969).

79. The Senate Report begins by noting that "there is no statutory provision setting forth a general 'public policy' basis for denying deductions which are 'ordinary and necessary' business deductions." *Id.* at 273. The discussion concludes by stating that "public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions." *Id.* at 274; *see also* *Mazzei v. Commissioner*, 61 T.C. 497, 506 (1974) (Sterrett, J., dissenting) (arguing that although the codification directly affects only § 162, "it does seem to call for judicial restraint" in the context of other deduction sections as well).

coextensive with that already recognized by the judiciary. Consistent with the cases analyzed above, I.R.C. § 162 was amended to add provisions explicitly disallowing deductions for the payment of penalties⁸⁰ as well as for payments which themselves violate the law.⁸¹ Furthermore, the legislative history of the enactment makes it clear that Congress intended its codified version of the public policy doctrine to completely occupy this area of the tax law.⁸² Acknowledging this, the Service issued regulations providing as follows: "A deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowable under section 162 shall not be denied on the grounds that allowance of such a deduction would frustrate a sharply defined public policy."⁸³ Since the codification was consistent with the *Tellier* line of cases,⁸⁴ the action by Congress did not change the public policy doctrine in any way but merely limited further development of the doctrine under I.R.C. § 162. The remaining portion of this Comment discusses the propriety of continued development of the doctrine under other sections of the Code, particularly § 165.

IV. DEDUCTIONS UNDER § 165

Section 165 of the Code allows a deduction for any loss not compensated by insurance.⁸⁵ If the loss claimed is one of property,

80. I.R.C. § 162(f) provides that "[n]o deduction shall be allowed under [§ 162(a)] for any fine or similar penalty paid to a government for the violation of any law." I.R.C. § 162(f) (1988). A further provision was added to deny a deduction for the "penalty" portion of treble damage awards for violations of antitrust laws. I.R.C. § 162(g) (1988).

81. Section 162(c)(2) of the Code provides in part:

No deduction shall be allowed under [§ 162(a)] for any payment . . . made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a State . . . which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business.

I.R.C. § 162(c)(2) (1988).

Section 162(c)(3) disallows deductions for kickbacks, rebates, or bribes made by providers of services for which payment is provided for under the Social Security Act. I.R.C. § 162(c)(3) (1988).

82. "The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive." S. REP. NO. 91-552, 91st Cong., 1st Sess., at 4 (1969).

83. Treas. Reg. § 1.162.1(a) (1969). The tax court has also acknowledged the abrogation of prior contrary case law by the 1969 amendments. *See, e.g.,* *Brizell v. Commissioner*, 93 T.C. 151, 166 (1989) ("Subsequent to the enactment of section 162(c)(2), however, the cases [suggesting a broader public policy limitation] lack continuing vitality.").

84. *See supra* notes 37-74 and accompanying text.

85. I.R.C. § 165(a) (1988). "Loss" under this section generally means a loss

§ 165 gives rise to a deduction in the amount of the taxpayer's adjusted basis in the property.⁸⁶ The public policy doctrine as analyzed above in the context of I.R.C. § 162 has been recognized to apply to loss deductions claimed under § 165 since at least 1959. In that year the tax court decided *Richey v. Commissioner*,⁸⁷ holding that a theft loss claimed under I.R.C. § 165 was disallowed on public policy grounds.⁸⁸ In *Richey* the petitioner was attempting to engage in a scheme to counterfeit United States currency when he was duped by his cohorts;⁸⁹ the court disallowed the deduction because it was related to illegal activity on the part of the taxpayer.⁹⁰

Because the property loss in *Richey* consisted of the taxpayer's genuine currency, the rationale of the holding can be reconciled with the line of cases under I.R.C. § 162. The "payment" in this case was the money the taxpayer had turned over to his confederates for the purpose of effectuating the counterfeiting activity.⁹¹ As such, the situation was analogous to a payment made in violation of the law which would preclude a deduction under the categories established under § 162.⁹²

Subsequent to the Supreme Court's opinion in *Tellier*, the tax court had an opportunity to revisit the issue in a case factually similar to *Richey*. In *Mazzei v. Commissioner*,⁹³ the court again disallowed a theft loss deduction claimed by a defrauded would-be counterfeiter.⁹⁴ As in *Richey*, the holding could be reconciled with the *Tellier* line of cases by analogizing the loss to an illegal payment. In *Mazzei*, however, the tax court for the first time asserted that the public policy doctrine developed under § 162 was not applicable to cases arising under § 165.⁹⁵ If this premise is accepted, the door is left

incurred in a trade or business or transaction entered into for profit, as well as losses of property due to some casualty, such as fire, storm, etc. *Id.* § 165(c).

86. *Id.* § 165(b).

87. 33 T.C. 272 (1959).

88. *Id.* at 276-77.

89. *Id.* at 273-74.

90. *Id.* at 276-77.

91. *Id.* at 273.

92. Section 162(c)(2) disallows deductions for payments which would be illegal "under any law of the United States, or under any law of a State" I.R.C. § 162(c)(2) (1988).

93. 61 T.C. 497 (1974).

94. *Id.* at 502.

95. *Id.* Judge Quealy's opinion stated that "[w]hile it is also recognized that the Supreme Court in *Commissioner v. Tellier*, 383 U.S. 687 (1966), may have redefined the criteria for the disallowance on grounds of public policy of an otherwise deductible business expense under section 162(a), *we do not have that type of case.*" *Id.* (emphasis added). The opinion goes on to distinguish the present case from *Tellier* by stating that the relationship of the illegality

open for the development of a new version of the public policy doctrine specifically applicable to § 165 and unrestrained by the earlier line of cases and Code amendments.

Examples demonstrating that the Service and the courts have bought into this notion abound. In Rev. Rul. 77-126,⁹⁶ the Service addressed the issue of whether contraband seized by the government and thereby forfeited by the taxpayer could give rise to a deductible loss.⁹⁷ In reaching the conclusion that public policy would preclude such a deduction, the Service expressed its opinion that "the rules for disallowing a deduction under § 165 of the Code on the grounds of public policy were not limited by Congress, but remain the same as they were before [the 1969 amendments to § 162]."⁹⁸

The specific issue presented in Rev. Rul. 77-126 was whether a § 165 loss should be allowed for the taxpayer's basis in gambling devices seized by the government under § 7301 of the Code.⁹⁹ According to the Service, the policy which would be frustrated by allowing such a deduction was that embodied in the statute making possession of coin-operated gambling devices unlawful.¹⁰⁰

The forfeiture at issue could be analogized to a government-imposed penalty designed to discourage specific conduct—in this case, the possession of property for which special excise taxes had not been paid. Since such penalties constitute one category of items held nondeductible as business expenses in the public policy cases under § 162,¹⁰¹ the ruling is clearly reconcilable with both the common law and codified versions of the doctrine.¹⁰² The "payment" in this case would consist of the taxpayer's economic loss represented by the adjusted basis of the property; as such, it is as much a penalty as is a direct monetary assessment and would have been disallowed under both § 162(f)¹⁰³ and *Tank Truck Rentals*.¹⁰⁴

to the payment was more direct than in the latter case. *Id.* Nonetheless, it is clear that the court was persuaded by the distinction between the Code sections: "The ultimate question for decision in this case is whether considerations of public policy should enter into the allowance of a theft loss under section 165(c)(3)." *Id.*

96. Rev. Rul. 77-126, 1977-1 C.B. 47.

97. *Id.* at 48.

98. *Id.*

99. *Id.* I.R.C. § 7301 authorizes the seizure of certain property subject to excise tax when the tax remains unpaid. I.R.C. § 7301 (1988).

100. Rev. Rul. 77-126, 1977-1 C.B. 48.

101. See discussion *supra* notes 56-61 and accompanying text.

102. *Stephens v. Commissioner*, 905 F.2d 667, 672 (2d Cir. 1990) ("Congress can hardly be considered to have intended to create a scheme where a payment would not pass muster under Section [162], but would still qualify for a deduction under Section 165.").

103. I.R.C. § 162(f) provides: "No deduction shall be allowed . . . for any fine or

That the Service implicitly relied on this logic is revealed in the following assertion:

Allowing the taxpayer in the instant case to deduct the losses resulting from the forfeiture of the gambling devices would frustrate sharply defined public policy that makes it unlawful for owners of coin-operated gambling devices to possess such devices *because the deduction would soften the sting of, and thus frustrate, the sanction of seizure and forfeiture.*¹⁰⁵

While not explicitly adopting the suggested analogy to penalties, the Service used the same language which Justice Clark used to support the denial of deductions for penalty payments in *Tank Truck Rentals*.¹⁰⁶ This parallel language suggests a parallel justification for disallowing the deduction. Thus, while indicating that it does not consider itself restrained by the earlier development of the public policy doctrine under § 162, the Service explicitly relies on a similar rationale in reaching its conclusion.

In an opinion issued the same year, the tax court reached a similar conclusion, although the basis for its rationale is slightly less clear. In *Holt v. Commissioner*,¹⁰⁷ the court was confronted by a taxpayer who was engaged in the business of purchasing, transporting, and selling marijuana.¹⁰⁸ At the time of his arrest, the taxpayer's truck and horse trailer, which were used in his business, as well as his inventory of marijuana, were seized by police.¹⁰⁹ Holt claimed a § 165 loss deduction in the amount of his adjusted basis in these items.¹¹⁰

Stating that "[i]t would clearly be contrary to public policy to allow a deduction for such forfeitures,"¹¹¹ the court explained that "[i]f loss deductions were allowed in this case, the government would in effect be carrying a portion of the loss inflicted by the government

similar penalty paid to a government for the violation of any law." I.R.C. § 162(f) (1988).

104. See discussion *supra* notes 56-61 and accompanying text.

105. Rev. Rul. 77-126, 1977-1 C.B. 47 (emphasis added).

106. Justice Clark's opinion stated that the "[d]eduction of fines and penalties uniformly has been held to frustrate state policy in severe and direct fashion by reducing the 'sting' of the penalty prescribed by the state legislature." *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30, 35-36 (1958) (citations omitted).

107. 69 T.C. 75 (1977), *aff'd*, 611 F.2d 1160 (5th Cir. 1980).

108. *Id.* at 76.

109. *Id.* at 77.

110. *Id.*

111. *Id.* at 80.

on the petitioners because of Holt's illegal activities."¹¹² As in the earlier Revenue Ruling, this statement seems to indicate that the legitimate public policy reason for denying the deduction is that the forfeitures amount to a penalty, and allowance of such a deduction would reduce the penalty's sting.¹¹³

Following in the footsteps of the Service, however, the court injects a degree of ambiguity into its rationale when it asserts that there is a "sharply defined national policy against the sale of marijuana"¹¹⁴ evidenced by the severe criminal penalties imposed on the taxpayer.¹¹⁵ Thus, while correctly recognizing the public policy principle behind disallowing deductions for penalties, the court seems to also base its reasoning on the idea that allowing deductions related to the sale of marijuana would be against public policy because the activity itself is illegal.¹¹⁶ Again, this rationale is distinct from that used to formulate the public policy doctrine under § 162 and, in fact, is directly inapposite to the holding in *Sullivan*.¹¹⁷

The Fifth Circuit replicates the same confused rationale of *Holt* in *Wood v. United States*.¹¹⁸ In *Wood*, the taxpayer had used proceeds from the sale of drugs to invest in a real estate development project.¹¹⁹ After the government seized the real property thus acquired, the taxpayer claimed a loss deduction under § 165.¹²⁰ As in *Holt*, the Fifth Circuit first lays the foundation for finding that the forfeiture is nondeductible as a penalty:

The legislative history of [the forfeiture statute] reveals that the forfeiture provision was designed to reach drug traffickers "where it hurts the most" and to augment "the traditional criminal sanctions of fines and imprisonment." . . . Allowing a loss deduction would certainly "take the sting" out of a penalty intended to deter drug dealing.¹²¹

112. *Id.*

113. The justification used in *Holt* conjures up the language used in *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958), where Justice Clark characterized a proposed deduction for the payment of a fine as taking the "sting" out of the penalty. See *supra* note 106.

114. *Holt*, 69 T.C. at 79.

115. The court notes that Holt was sentenced to ten years in prison and fined \$30,000. *Id.* at 80.

116. The court states that "[i]t would clearly be contrary to public policy to allow a deduction" for forfeitures related to the sale of marijuana. *Id.*

117. See discussion *supra* notes 62-68 and accompanying text. Under I.R.C. § 162, it is not due to the nature of the *business* that the public policy doctrine forecloses a deduction, but rather the nature of the deduction itself. *Commissioner v. Sullivan*, 356 U.S. 27, 28-29 (1958).

118. 863 F.2d 417 (5th Cir. 1989).

119. *Id.* at 418.

120. *Id.* at 419.

121. *Id.* at 421-22 (citations omitted).

Once again, however, the court supplements its analysis by further stating that "the public policy embodied in this nation's drug laws is *not enhanced* by allowing a tax deduction to offset a forfeiture."¹²² Although this statement is certainly true, whether or not the allowance of a deduction would enhance other non-tax statutory schemes had never before been recognized as a basis for disallowance. Indeed, *Sullivan* would have been wrongly decided had such a broad standard prevailed. What seems to have escaped the court was that the case before it was brought to determine tax liability, not punishment under criminal statutes.¹²³

Nonetheless, in a case factually similar to *Wood*, the Fourth Circuit cited the *Wood* decision as standing for the proposition that "allowing a deduction for forfeited assets would violate the 'sharply defined national policy against' *drug trafficking*."¹²⁴ As was the case in *Holt*, this premise is clearly contrary to the direction given by *Sullivan* and other cases defining the public policy doctrine as it relates to I.R.C. § 162. Thus we see emerging an application of the public policy doctrine not only distinct from, but in fact directly contrary to the earlier cases.

Evidence of this new line of thinking can be found in the context of other types of deductions claimed under I.R.C. § 165. In Rev. Rul. 82-74,¹²⁵ the Service was confronted with a situation in which the taxpayer, the owner of a commercial building, paid an arsonist to burn the building down.¹²⁶ Upon collecting the insurance proceeds, the taxpayer reduced the amount received by his adjusted basis in the building and claimed the amount paid to the arsonist as a business expense.¹²⁷

As correctly pointed out in the ruling, the amount paid to the arsonist would be disallowed as an illegal payment.¹²⁸ For the same reason, the payment to the arsonist could not be added to the taxpayer's basis in the property to determine the amount of gain resulting from collection of the insurance proceeds. The Service, however, again focused on a source of public policy distinct from

122. *Id.* at 421.

123. "[T]he federal income tax is a tax on net income, not a sanction against wrongdoing." *Commissioner v. Tellier*, 383 U.S. 687, 691 (1966).

124. *Smith v. Commissioner*, No. 90-1143, 1991 U.S. App. LEXIS 18741, at *4 (4th Cir. Aug. 15, 1991) (citing *Wood v. United States*, 863 F.2d 417, 420-22 (5th Cir. 1989) (emphasis added)). Although Congress had in fact enacted a separate provision to preclude deductions related to drug trafficking, I.R.C. § 280E (1988), the *Smith* court makes no reference to that Code section but instead seems to rely on non-tax laws against such activity.

125. 1982-1 C.B. 110.

126. *Id.*

127. *Id.*

128. *Id.*

that accepted by the courts regarding § 162. Rather than pointing out that payments made in violation of the law cannot be deducted by reason of the public policy doctrine set out in cases such as *Sullivan*, the Service referred instead to the public policy embodied in the "statutory scheme regarding arson and insurance fraud."¹²⁹

Similarly, in *Blackman v. Commissioner*¹³⁰ the taxpayer set fire to his own house in the course of a domestic dispute.¹³¹ The tax court correctly noted that gross negligence on the part of the taxpayer will bar a casualty loss deduction under § 165.¹³² Since the court held that the taxpayer's conduct was grossly negligent,¹³³ no further rationale was necessary to deny the deduction. Nevertheless, the court felt compelled to invoke an additional public policy justification for denying the deduction, stating that "allowing the petitioner a deduction would severely and immediately frustrate the articulated public policy of Maryland against arson and burning."¹³⁴ Unlike the line of cases decided under § 162, the court did not focus on the "payment" involved, but on the underlying illegal activity. While paying lip service to the test developed under § 162, the court again seems to be going in a different direction.¹³⁵

This emerging notion that the public policy doctrine is distinct as between one deduction section of the Code and another is unsupported by either logic or law. When interpreting tax statutes, the structure and policy of the Code as a whole, or what one commentator refers to as the "tax logic" of the Code,¹³⁶ must be considered, for "the tax code is just that—a code, not merely a series of unrelated enactments."¹³⁷ Courts should endeavor, therefore, to reconcile the logic of a given Code section with that embodied in related Code sections. The failure to do so allows room for intolerably inconsistent results under the two Code sections. Suppose, for example, a thief enters an unlicensed and illegally operated drinking establishment

129. Rev. Rul. 82-74, 1982-1 C.B. 110, 111.

130. 88 T.C. 677 (1987), *aff'd*, 867 F.2d 605 (1st Cir. 1988).

131. *Id.* at 679.

132. *Id.* at 681 (citing *Heyn v. Commissioner*, 4 T.C. 302, 308 (1966)).

133. *Id.* at 682.

134. *Id.*

135. Judge Sterrett made the following observation in his dissent to *Mazzei*: "[W]e apparently pay lip service to the Supreme Court by stating 'that to allow the loss deduction would constitute an immediate and severe frustration of the clearly defined policy' Unfortunately, . . . we fail to discuss precisely how that frustration will occur." *Mazzei v. Commissioner*, 61 T.C. 497, 506 (1974) (Sterrett, J., dissenting). Judge Sterrett's comments would appear to have continuing relevance in light of the *Holt* and *Blackman* line of cases.

136. See Michael A. Livingston, *Congress, The Courts, and The Code: Legislative History and the Interpretation of Tax Statutes*, 69 TEX. L. REV. 819 (1991).

137. *Id.* at 826.

and steals the jukebox and all the liquor. While the owners could properly deduct the expense of replacing the alcohol held for illegal sale, under prevailing interpretations it would be deemed offensive to public policy to allow them to recover the cost of the jukebox via a § 165 loss deduction. Another example might involve a professional hitman whose car is stolen while "on the job." While the gangster would arguably be able to deduct the cost of his bullets, the public policy doctrine would not tolerate a deduction for the theft of his automobile.¹³⁸ The notion that Congress would have intended to erect an absolute public policy barrier to deductions under one Code section while at the same time narrowing the use of public policy to deny a deduction for arguably similar types of expenses under a related Code section defies logic and common sense. To so interpret these provisions is to render the Code nothing more than a series of unrelated revenue measures.

That an expense legitimately deductible under I.R.C. § 162 may not pass muster under § 165 because of the currently inconsistent application of the public policy doctrine reflects a Machiavellian approach to tax law which, while perhaps viscerally satisfying, mocks the integrity of tax jurisprudence. At last, however, the courts in at least one circuit have moved in the direction of recognizing that the public policy doctrine as applied to § 162 is intrinsically connected to public policy analysis under other deduction sections of the Code.¹³⁹

138. Judge Sterrett suggests similar analogies in his dissent to the *Mazzei* decision: Had petitioner contracted pneumonia on his New York excursion, would the majority also deny him a medical expense deduction [because the expense was incurred in the course of an illegal activity]?

Or assume that customers on the premises of the bookmaking establishment involved in *Sullivan* were robbed by an outside intruder. Would the majority deny them a theft loss because they were engaged in an illegal activity?

Mazzei v. Commissioner, 61 T.C. 497, 507 (1974) (Sterrett, J., dissenting).

139. This development was foreshadowed by at least one earlier tax court opinion. In *Medeiros v. Commissioner*, 77 T.C. 1255 (1981), the taxpayer incurred personal liability for failing to withhold employment taxes on behalf of his corporation. *Medeiros* argued that the payment of the taxes entitled him to a loss deduction under § 165(a) for losses incurred in a trade or business. *Id.* at 1258. The Service argued that the amount was nondeductible by reason of § 162(f), which denies a business deduction for fines or penalties paid to the government, *id.* at 1259, and alternatively that any deduction should be disallowed on public policy grounds. *Id.* at 1262. While the court denied the deduction because it found § 162 to be applicable, Judge Drennen observed that "[t]here is some question whether the public policy doctrine retains any vitality since the enactment of [the 1969 amendments]. If [the amendments were] intended to supplant the public policy doctrine, in all likelihood [the amendments] would disallow deductions under sec. 165(c)(1) . . ." *Id.* at 1262 n.8.

In *Stephens v. Commissioner*,¹⁴⁰ the taxpayer had been convicted of defrauding a company and sought to deduct his restitution payments as losses under § 165.¹⁴¹ Interestingly, the Service itself argued that the deduction was barred, not by public policy under § 165, but by § 162(f).¹⁴²

In resolving the issue, the tax court first found that § 165 was indeed the applicable section in determining whether the restitution payments could be deducted.¹⁴³ Accepting the validity of the Service's analogy to the public policy doctrine codified in § 162, however, the court analyzed the deductibility by reference to that section.¹⁴⁴ Due to the particular factors surrounding the case,¹⁴⁵ the court found that the restitution payment was analogous to a fine or penalty paid to the government which would be precluded from deduction by § 162(f);¹⁴⁶ as a result, the payment was likewise held to be barred under § 165.¹⁴⁷

While the Second Circuit reversed the holding of the tax court,¹⁴⁸ the appellate court's reasoning implicitly accepts the logic represented in the lower court's opinion.¹⁴⁹ The Second Circuit was compelled to reverse because it did not believe the restitution payment to be sufficiently similar to a fine or penalty.¹⁵⁰ It recognized, however, that "the public policy considerations embodied in Section 162(f) are highly relevant in determining whether the payment . . . was deductible under Section 165."¹⁵¹

V. CONCLUSION

The holding in *Stephens* reflects the rational conclusion that Congress cannot have intended public policy to mean one thing when applied under § 162 and quite another under § 165.¹⁵² Otherwise, the

140. 93 T.C. 108 (1989), *rev'd*, 905 F.2d 667 (2d Cir. 1990).

141. *Id.* at 111.

142. *Id.* The Service did, in fact, argue in the alternative that the deduction ought to be barred by a more general notion of public policy if its primary argument failed. *Id.*

143. *Id.* at 112.

144. *Id.*

145. The court noted, among other things, that the restitution payment was ordered in lieu of an additional prison term. *Id.* at 113.

146. *Id.*

147. *Id.*

148. *See Stephens v. Commissioner*, 905 F.2d 667 (2d Cir. 1990).

149. *Id.* at 670-72.

150. *Id.* at 672-73.

151. *Id.* at 672.

152. *Stephens v. Commissioner*, 905 F.2d 667, 672 (2d Cir. 1990) ("Congress can hardly be considered to have intended to create a scheme where a payment would not pass muster under Section [162], but would still qualify for a deduction under Section 165.'").

tax logic of the Code is completely ignored in an attempt to use the tax laws for a purpose for which they were never intended.¹⁵³ It is time that the tax court and other circuits follow the lead of the Second Circuit in this regard. In light of the argument propounded in *Stephens*, it appears that the Service has finally come to its senses; the inconsistent application of the public policy doctrine will remain a danger, however, until the judiciary follows suit.

Congress could rectify this situation by amending the Code to place the public policy limitations now contained in § 162 in a separate section of their own, making the limitations applicable to the Code as a whole. This is exactly the legislative method used when Congress decided that drug dealers should not find refuge in the Code by obtaining tax benefits related to their illegal activities.¹⁵⁴ The failure of the legislative body to affirmatively act to create a single statutory public policy doctrine applicable to the entire Code should not, however, be viewed as an indication of a contrary intent. Rather, its failure to so act may be explained by the fact that the class of persons who would benefit by such legislation are, by definition, criminals. In a time when calls for tax relief for both individuals and legitimate businesses are omnipresent, it is not hard to imagine why a legislator may hesitate to promote a bill which would assist only nefarious entrepreneurs in obtaining tax justice. Nonetheless, the integrity of tax jurisprudence requires that determinations regarding deductibility be made within the framework of the Code, rather than with reference to a taxpayer's culpability under criminal law.¹⁵⁵

Charles A. Borek

153. See *supra* notes 17-23 and accompanying text.

154. I.R.C. § 280E (1988).

155. It has been noted that "[m]oral turpitude is not a touchstone of taxability,' and that no 'fall-out' from the 'cloud' created by some of the questionable practices of [a taxpayer] should be allowed to permeate [judicial] thinking respecting the legal issues involved" in determining the deductibility of expenses. *James E. Caldwell & Co. v. Commissioner*, 24 T.C. 597, 615 (1955) (Bruce, J., dissenting) (quoting *Commissioner v. Wilcox*, 327 U.S. 404, 408 (1946)). Thus "[i]t is not the petitioner's culpability, but his liability that determines his right to the deduction." *Id.* at 618 (citations omitted).