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PRE-GROSS INCOME ADJUSTMENTS AND THE PUBLIC POLICY DOCTRINE – HAS *PITTSBURGH MILK* TURNED SOUR?

RICHARD H. HUNT, JR.*

INTRODUCTION

Though it is generally agreed that the sixteenth amendment authorizes Congress to levy income taxation upon gross income,[1] the federal income tax, as conceived and first drafted by Congress and as continued to the present date, imposes taxation on net income.[2] Despite Congress' continued commitment to the net income tax, the courts continue to remind us that the statutory deductions by which gross income is reduced to net, or taxable, income are acts of legislative grace.[3] As such, deductions may be taken away by Congress. Moreover, taxpayers claiming the benefit of statutory deductions must demonstrate compliance with the terms on which Congress has conditioned the privilege.

Though deductions from gross income might have been conceived simply to reduce gross income to the net income base to which the rate was to be applied, it was eventually recognized that, viewed as a system of economic sanctions and rewards, the income tax has a potential for either supporting or frustrating a variety of social and economic goals. This view of the tax spawned

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1. The sixteenth amendment to the Constitution gave Congress the power "to lay and collect taxes on incomes, from whatever source derived," without apportionment among the States. U.S. CONST. amend. XVI.

2. The sixteenth amendment neither prohibited a tax on gross income nor sanctioned one on net income; however, Congress, by specifically providing for deductions, has chosen to tax "net income." "'Entire net income,' 1913, 1916 Acts; 'net income,' 1918-1938 Acts, I.R.C. 1939; 'taxable income,' I.R.C. 1954." Diamond, *The Relevance (or Irrelevance) of Public Policy in Disallowance of Income Tax Deductions*, 44 TAXES 803, 805 n.15 (1966). In fact, an oft-quoted statement by Senator Williams at the time the Revenue Act of 1913 was enacted, states the object of the income tax as "to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon 'futures,' but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year." 50 CONG. REC. 3849 (1913).

3. *See* New Colonial Ice Co., Inc. v. Helvering, 292 U.S. 435, 440 (1934); Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943). For other cases citing the proposition that deductions are a matter of legislative grace, *see* cases cited at 4A J. MERTENS, LAW OF FEDERAL INCOME TAXATION (1972 ed.), §25.03 n.16.3.

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the suggestion that a statutory deduction should be viewed not only as a mechanical means for reducing gross income, but also as a "subsidy" by the federal government for the activities associated with the deductible expenditures. If those activities were inimical to sharply defined social or economic policies of the state or federal government, allowance of federal income tax deductions for those expenditures could be seen as contributing to the frustration of those policies.

The idea that deductions ought not be allowed where their economic effect might tend to frustrate public policy found a willing advocate in the Commissioner, who readily saw that the disallowance of deductions on grounds of public policy could have a positive effect in enhancing the public revenues. Under his sponsorship, and beginning with the early case of *Sarah Backer*,[4] the courts began to fashion the "public policy" doctrine as a "judicial gloss" on the deduction statutes.[5] Grounded upon the judicial presumption[6] that Congress could not have intended that its laws be construed in a manner which might frustrate national or state policies, the doctrine found general acceptance in all courts by 1950.[7] Though diverse approaches by the courts tended to give the doctrine an amorphous quality,[8] the Supreme Court, in several decisions from 1943 to 1966, provided some direction for and, fortunately, established some limitations in the use and application of the doctrine.[9]

This article considers a particular application of the public policy doctrine which the Supreme Court has never had occasion to consider: whether public purpose considerations may be invoked to disallow adjustments which by their nature are accounted for as offsets in the calculation of gross income. Such adjustments, spoken of hereinafter as "pre-gross income adjustments," clearly lie outside that area identified with legislative grace; though Congress might take away the statutory deductions which reduce gross income to net income, the courts have never sanctioned the argument that Congress, acting under authority of the sixteenth amendment, could lay an income tax on gross receipts, or gross sales.[10] To the contrary, the courts have assiduously avoided

4. Sarah Backer, 1 B.T.A. 214 (1924).

5. Jerry Rossman Corp. v. Commissioner, 175 F.2d 711, 713 (2d Cir. 1949) (Hand, J.).

6. "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." Sarah Backer, 1 B.T.A. 214, 217 (1924).

7. For a discussion of the cases developing the public policy doctrine, see text accompanying notes 15-41 *infra*.

8. Public policy has been described as "a very unruly horse, . . . [W]hen you get astride it you never know where it will carry you." Richardson v. Mellish, 2 Bing. 229, 252, 130 Eng. Rep. 294, 303 (1824) (Burrough, J.). Felix Frankfurter described public policy as a "portmanteau" phrase, which contains a "miscellaneous assortment of ideas." *See* Diamond, *supra* note 2, at 803 n.3 (citing Frankfurter, "Self Willed Judges and the Judicial Function" in A. WESTIN, AN AUTOBIOGRAPHY OF THE SUPREME COURT 450 (1963)). Diamond states: "It is because of this unruliness and its portmanteau character that 'public policy' has been a troublesome concept in the tax field from its very beginning and has spawned so much litigation and critical comment." Diamond, *supra* note 2, at 803 n.2.

9. See text accompanying notes 15-41 *infra*.

10. See note 2 *supra*.

giving approval to the "creation" of fictional income for taxation, or to the application of the income tax to receipts representing a return of capital.[11]

An examination of case law supports the argument that the public policy doctrine, having arisen in the tax law as a judicial gloss on the deduction statutes, was always intended to have a scope of application limited, at the top, by gross income. Nevertheless, the Commissioner has contended at various times that pre-gross income adjustments should also be limited by the public policy doctrine. While the courts have generally rejected this view, there have been some exceptions. Until recently those exceptions have not seemed significant enough to call for an article focusing on this narrow question.

Since the Tax Reform Act of 1969,[12] which codified public purpose limitations on section 162 deductions from gross income, the Commissioner has mounted a concerted effort to extend the scope of the public policy doctrine to the area of pre-gross income adjustments. As part of this effort he has adopted regulations, withdrawn acquiescences and substituted nonacquiescences to old decisions, and launched a broad based and vigorous campaign to relitigate issues long considered settled. Moreover, at least one recent Tax Court opinion[13] gives evidence that his persistent efforts have produced some judicial doubts as to the principles that dictate opposite tax results for illegal payments depending upon whether they are classified as above or below the gross income line.[14]

In the author's view, the application of the public policy doctrine so as to disallow pre-gross income adjustments is fraught with serious constitutional problems. Of perhaps equal importance, such application leads to a general blurring of the fundamental distinctions between pre-gross income adjustments and deductions from gross income, thus creating distortions in the law affecting many other issues. The purpose of this article, therefore, is to examine this rather narrow aspect of the public policy doctrine and to set forth support for the author's view that its scope is, and should continue to be, limited to deductions from gross income.

THE PUBLIC POLICY DOCTRINE AS DELINEATED IN DECISIONS OF THE SUPREME COURT

Between 1940 and 1970, the Commissioner's efforts to broaden the scope of the public policy doctrine met with considerable success. A body of law developed approving the disallowance of deductions, otherwise allowable under the terms of the statutes, on grounds of public policy. The public policy doctrine developed principally in three major areas: (1) fines, penalties and damage payments; (2) expenses incurred in connection with criminal activities; (3) bribes (governmental and commercial) and kickbacks.[15]

11. For a discussion of the Commissioner's attempts to disallow pre-gross income adjustments on public policy grounds, see text accompanying notes 43-121 *infra*.

12. Tax Reform Act of 1969, Pub. L. 91-172, tit. IX, §902, 83 Stat. 648 (1969), 1969-3 C.B. 147 (codified at I.R.C. §§162(c), (f), and (g)).

13. James Alex, 70 T.C. 322 (1978).

14. See text accompanying notes 197-204 *infra*.

15. For an analysis of the decisional law in these areas, *see* Diamond, *supra* note 2, at 803;

These three categories of expenditures represent, for the most part, claims of deductions as ordinary and necessary expenses paid in the conduct of a trade or business. The cases in these areas reflect the tension between congressional intent to tax only net income and judicial refusal to "presume that the Congress, in allowing deductions for income tax purposes, intended to encourage a business enterprise to violate the declared policy"[16] of the state or federal government. While an exhaustive examination of all decisions reflecting the application of public policy considerations to deny deductions is beyond the scope of this article, a brief survey of the major Supreme Court decisions is necessary in order to delineate the scope of the doctrine.

Fines, Penalties and Damages Payments

In *Tank Truck Rentals, Inc. v. Commissioner*,[17] the taxpayer, a corporation which leased a fleet of tank trucks with drivers to motor carriers for transportation of bulk fuels, violated state maximum weight limits for motor vehicles. During the year in question, the taxpayer paid fines and costs for those violations and sought to deduct the payments as "ordinary and necessary" business expenditures.[18] The company demonstrated that it could not have operated profitably if it had complied with state law. Affirming the Tax Court and the Third Circuit in disallowing the deduction claimed, the Supreme Court engrafted the public policy doctrine onto the statutory term "ordinary and necessary." The Court stated: "A finding of 'necessity' cannot be made however, if allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof."[19]

Finding a clearly expressed policy, evidenced by penal statutes enacted to protect highways from damage and to ensure public safety, the Court reasoned that "to allow the deduction . . . would but encourage continued violations of state law by increasing the odds in favor of noncompliance."[20] Reflecting the emerging philosophy that a tax deduction should be viewed as a federal "subsidy" for the activity furthered by the expenditure, the Court summarized the decisional precedents with approval as follows: "Deduction of fines and penalties uniformly has been held to frustrate state policy in severe and direct

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Lamont, *Controversial Aspects of Ordinary and Necessary Business Expense*, 42 TAXES 808 (1964); Lindsay, *Tax Deductions and Public Policy*, 41 TAXES 711 (1963); Paul, *The Use of Public Policy by the Commissioner in Disallowing Deductions*, 1954 U. SO. CAL. TAX INST. 715; Tyler, *Disallowance of Deductions on Public Policy Grounds*, 20 TAX L. REV. 665 (1965); Note, *Public Policy and Federal Income Tax Deductions*, 51 COLUM. L. REV. 752 (1951); Note, *Deduction of Business Expenses: Illegality and Public Policy*, 54 HARV. L. REV. 852 (1941); Note, *Income Tax Deductibility of Expenses Relating to Illegal Activity*, 19 TAX L. REV. 109 (1963); Comment, *Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code*, 72 YALE L.J. 108 (1962).

16. Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 35 (1958).
17. *Id.*
18. I.R.C. §162(a).
19. 356 U.S. at 33-34.
20. *Id.* at 35.

fashion by reducing the 'sting' of the penalty prescribed by the state legislature."[21]

Expenses Incurred in Connection with Criminal Activity

In applying the test whether the allowance of the deduction would "frustrate sharply defined national or state policies proscribing particular types of conduct,"[22] the courts typically analyzed the relationship of the expense for which a deduction was claimed to the taxpayer's illegal activities.[23] As the Supreme Court noted in *Commissioner v. Heininger*,[24] "It has never been thought . . . that the mere fact that an expenditure bears a remote relation to an illegal act makes it nondeductible."[25] In *Heininger*, the Court approved a deduction for legal fees and costs incurred by a dentist in his unsuccessful effort to resist an administrative action by the Post Office Department to deny him access to the United States mails for his mail order business. The action was predicated upon an administrative finding of fraudulent practices in the dentist's advertising claims. The Court, noting that the dentist was threatened with the total destruction of his business, refused to hold that legal expenses incurred in resisting the governmental action were not ordinary and necessary. Analyzing the federal statute violated by the taxpayer, the Court found that the statute's purpose was not to deter persons charged with violations from employing counsel to assist in presenting a bona fide defense to a proposed fraud order. The Court reasoned that to allow the deduction of the litigation expenses would not frustrate the purpose of the act.

In *Commissioner v. Tellier*,[26] some twenty-three years later, the Court again considered the question of the deductibility of attorney's fees, this time in a situation where the fees were incurred in maintaining an unsuccessful defense to criminal charges including securities fraud, mail fraud, and conspiracy. Finding the fees to have been incurred in connection with the taxpayer's business,[27] the Court again concluded that their deductibility did not frustrate any sharply defined national policy.[28] Concluding that Congress had neither provided for nor intended the disallowance of those deductions by authorizing punishment for violation of the laws in question, the Court refused to distort the income tax laws to reach such a result.

21. *Id.* In another case dealing with the violation of state maximum weight laws by interstate carriers, Hoover Motor Express Co. v. United States, 356 U.S. 38 (1958), although the violations were inadvertent, the Court found the payment of the fines was not "necessary" to the operation of the taxpayer's business, and thus no deduction was permissible. The Court would have disallowed the deduction even if the taxpayer had acted with all due care and without willful intent since allowance would have directly and severely frustrated state policy.

22. 356 U.S. at 33.

23. Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. at 33-34. *See* Commissioner v. Heininger, 320 U.S. 467, 474 (1943).

24. 320 U.S. 467 (1943).

25. *Id.* at 474.

26. 383 U.S. 687 (1966).

27. The fees were conceded by the Commissioner to be ordinary and necessary. *Id.* at 689.

28. The act of employing a lawyer to help in one's defense when faced with serious criminal charges does not offend public policy, the Court noted. Rather than being proscribed conduct, the right to employ counsel is constitutionally given. *Id.* at 694.

In its decisions, the Supreme Court particularly rejected the concept that an illegal business activity was to be denied all business deductions and thus was to be taxable on its gross income. In *Commissioner v. Sullivan*,[29] the taxpayers operated a Chicago bookmaking establishment in violation of Illinois law. The state statute specified that the acts performed by taxpayers' employees, as well as the payment of rent for the illegal use of the premises, were also illegal. Based on that statute, the Tax Court approved disallowance of deductions for wages and rent. Affirming the Seventh Circuit Court of Appeals' reversal of the Tax Court, the Supreme Court stated:

> If we enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts, while all other business would be taxable on the basis of net income. If that choice is to be made, Congress should do it. The amounts paid as wages to employees and to the landlord as rent are "ordinary and necessary expenses" in the accepted meaning of the words.[30]

Noting that the Treasury Regulations under the Internal Revenue Code of 1939 made the federal excise tax paid on wagers by persons engaged in the lottery business deductible as an ordinary and necessary business expense,[31] the Court found recognition in those regulations "of a gambling enterprise as a business for federal tax purposes."[32] A federal policy which allowed a deduction for the tax paid to conduct a gambling business was seen by the Court as "sufficiently hospitable" to allow normal deductions for wages and rent in that business.[33] Since the activities for which the deductions were claimed did not contravene federal policy and since the denial of the salary and rent deductions would render the business taxable on its gross income, the Court declined to enforce the state policy to the extent of denying the deductions.[34]

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29. 356 U.S. 27 (1958).
30. *Id.* at 29.
31. TREAS. REG. 118, §39.23(a)(1) (enacted under Int. Rev. Code of 1939).
32. 356 U.S. at 29.
33. *Id.*
34. In a separate category of public policy cases which one author termed as not made up of *true* public policy cases, Tyler, *Disallowance of Deductions on Public Policy Grounds*, 20 TAX L. REV. 665, 670 (1965), certain expense were denied deductibility on the basis of a long-standing Treasury regulation. Textile Mills Securities Corp. v. Commissioner, 314 U.S. 326 (1941), involved the deductibility of lobbying expenses which were not illegal under state or federal law, but for which a specific Treasury Regulation denied deductibility. TREAS. REG. 74, §262 (1928) (now TREAS. REG. 1.162-20 (1965)). Finding that the Treasury Regulations were sufficient expression of public policy to support disallowance of the expense in question, the Supreme Court reversed the Third Circuit Court of Appeals holding that the deduction was proper, and denied the deductibility of the lobbying expense as an "ordinary and necessary" expense. In a later case concerning deductibility of lobbying expenses, Cammarano v. United States, 358 U.S. 498 (1959), the Court reaffirmed its *Textile Mills* holding that the Treasury Regulation's interpretation of "ordinary and necessary" as excluding amounts spent to influence legislation constituted an expression of a sharply defined national policy. Moreover, the Court found tacit approval of those regulations by Congress since the statutory provisions underlying them had been repeatedly reenacted by Congress without any criticism of the policy expressed in the regulations.

Bribes and Kickbacks

By contrast, the decisions in the area of bribes and kickbacks reveal a judicial leaning in the direction of disallowance, in some cases even where the payment did not violate a specific state law.[35] The Supreme Court set an example of restraint, however, in *Lilly v. Commissioner*.[36] In that case the taxpayers were opticians who paid fees to eye doctors for referrals of patients needing prescription eyeglasses. The taxpayers claimed deduction for the referral fees, which were paid pursuant to an established custom in the industry, as ordinary and necessary business expenses.

Reversing the Fourth Circuit, which had affirmed disallowance of the deductions by the Tax Court, the Supreme Court observed that the referral fee payments were "of common or frequent occurrence in the type of business involved," and "reflected a nationwide practice."[37] The Tax Court had made no contrary findings of fact. Moreover, the payments themselves violated no federal or state law.[38]

Though expressly denying any approval of the business ethics reflected in the payment of the referral fees, the Supreme Court upheld the taxpayers' deduction of those fees. Recognizing that the practice had been widely condemned by organized professional associations, the Court concluded that the standards which those organizations espoused "do not, however, in themselves constitute the 'sharply defined national or state policies' the frustration of which may, as a matter of law, preclude . . . deductibility."[39] In so deciding, the Court confirmed that as a prerequisite to the denial of deductions under the public policy doctrine the public policy offended by the expenditure in question would have to be evidenced by a governmental pronouncement of the policy.

Whatever uncertainties might have existed in the pre-1969 decisional scope of the public purpose doctrine, a common thread linking the decisions is the principle that the public policy exception applies only to deductions traditionally held to be extensions of legislative grace. Given, as the Supreme Court had observed in *United States v. Sullivan*[40] and other cases,[41] that Congress could tax gross income under the sixteenth amendment, the courts have strongly resisted the notion that Congress can tax gross receipts under that amendment.[42] Accordingly, those adjustments to gross receipts which occur

35. *See* Dixie Machine Welding & Metal Works, Inc. v. United States, 315 F.2d 439, 1963-1 U.S. Tax Cas. ¶9355 (5th Cir. 1963), *cert. denied*, 373 U.S. 950 (1963).

36. 343 U.S. 90 (1952).

37. *Id.* at 93.

38. The Court said that had the payments violated state or federal law, "it could be argued that the outlawed expenditures, by virtue of their illegality, were not ordinary and necessary business expenses . . . ." *Id.* at 95.

39. *Id.* at 97.

40. United States v. Sullivan, 274 U.S. 259 (1927) (taxing *profits*, not gross receipts, from liquor traffic in violation of the National Prohibition Act).

41. *See* Helvering v. Independent Life Ins. Co., 292 U.S. 371 (1934); Tyee Realty Co. v. Anderson, 240 U.S. 115 (1916); Stanton v. Baltic Mining Co., 240 U.S. 103 (1916).

42. *See* 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §5.10 (1974 ed.), for a discussion of the distinction between receipts and income.

prior to arriving at gross profit are clearly regarded by the courts as falling outside the constitutional reach of Congress.

THE PUBLIC POLICY DOCTRINE AND PRE-GROSS INCOME ADJUSTMENTS

Although the Supreme Court played an active role in developing the public policy doctrine as a basis for the disallowance of deductions, it has never directly considered whether pre-gross income adjustments could be disallowed solely on the basis that their allowance would frustrate sharply defined public policy. Nevertheless, during the last thirty years the question has arisen in two distinct contexts in the lower courts. Since Congress did not address this question in its 1969 and 1971 public policy legislation, an examination of the earlier decisions is an appropriate prelude to a discussion of the controlling legal principles.

Decisions Under Wartime Price Control Laws

The earliest decision on an issue resulting from the Commissioner's attempt to disallow a pre-gross income adjustment on grounds of public policy is *Lela Sullenger,*[43] a case which involved wartime price controls. In that case, the Commissioner had refused to permit the petitioner to include as cost of goods sold the excess over the Office of Price Administration's (O.P.A.) ceiling price paid by petitioner for meats which he resold to customers during the years in question. The Commissioner argued that the amounts paid in excess of the O.P.A. prices were, in reality, nothing more than a "bribe" to the petitioner's suppliers, calculated to induce them to sell meats to petitioner at the O.P.A. ceiling price. Consistent with this highly theoretical approach, the Commissioner argued that those excess amounts, or "bribes," should be considered comparable to deductions, the allowance of which, in the circumstances of this case, would frustrate clearly defined public policy.

The court found that the amounts in question were actually part of the negotiated price of meats, and thus constituted a portion of cost of goods sold. Since the petitioner was not claiming those amounts as a business deduction, the Tax Court concluded that the beginning premise of the Commissioner's argument was unsound, and held for the petitioner:

> Section 23 makes no provision for the cost of goods sold, but the Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income. No more than gross income can be subjected to income tax upon any theory .... It is unnecessary to discuss cases involving deductions, since this case does not involve any deduction.[44]

Three years later the Tax Court followed the *Sullenger* decision in the case of *Benjamin Weisman* involving a similar fact situation.[45] On appeal to the

43. 11 T.C. 1076 (1948).
44. *Id.* at 1077.
45. Benjamin Weisman, 10 T.C.M. (CCH) ¶18,293 (1951), *aff'd,* 197 F.2d 221 (1st Cir. 1952).

First Circuit, the Commissioner challenged the *Sullenger* rule maintaining that expenditures for purchases, to the extent they were in violation of price control laws, may not be claimed either as an offset to gross income or as a deduction from gross income in computing taxable income. A constitutional issue was framed with the Commissioner contending that disallowance of such illegal purchase prices was permitted by the Constitution while the taxpayer contended that such a disallowance of any portion of cost of goods sold would contravene the sixteenth amendment. Moreover, the Commissioner asserted and the taxpayer denied that Congress intended that payments in excess of lawful O.P.A. prices would not constitute offsets to gross income in the computation of tax liability.

The First Circuit avoided passing on the constitutional questions raised, resting its decision for the taxpayer on the ground that Congress had never intended that such over-ceiling payments be disallowed as cost of goods sold. In support of its conclusion, the court pointed to two specific enactments which indicated that Congress was aware of the device of disallowing illegal costs in computing tax liability as a means of procuring compliance with price control legislation.[46] In the Stabilization Act of 1942[47] Congress took cognizance of this deterrent by authorizing the President to disallow excessive wage payments in calculating costs and bases for tax purposes. Also, the Defense Production Act of 1950,[48] another price stabilization measure enacted by Congress under its war powers, expressly authorized the President to prescribe the extent to which any payment made in violation of established price ceilings should be disregarded in determining costs or expenses for any purpose, "including bases in determining gain for tax purposes."[49]

Thus convinced that Congress was familar with the disallowance device as a deterrent and could have used it but chose not to in the Emergency Price Control Act of 1942,[50] the court concluded that Congress had not intended to disallow the illegal portion of the purchase price of goods as cost of goods sold in computing tax liability. Moreover, the court saw a "serious constitutional question" implicit in disallowing items representing the cost of goods sold.[51] "It must be remembered that we are construing a tax measure and not a penal statute," the court noted. "Furthermore, it is a tax on income and not a tax on gross receipts which is under consideration here."[52] Viewing the question in this light, the First Circuit was unwilling to infer that Congress intended the disallowance of the over-ceiling portion of the purchase price as cost of goods sold.

A special concurring opinion written by Judge Magruder expressed concern that the majority had implied that Congress could not have constitutionally provided for the disallowance of excess purchase price in the computation of

46. 197 F.2d at 222-23.
47. Stabilization Act of 1942, ch. 578, §5, 56 Stat. 767 (1942).
48. Defense Production Act of 1950, ch. 932, tit. IV, §405, 64 Stat. 807 (1950).
49. *Id.*
50. Emergency Price Control Act of 1942, ch. 26, tit. I, §4, 56 Stat. 28 (1942).
51. 197 F.2d at 224.
52. *Id.* at 223.

cost of goods sold.[53] He opined that such a provision, if included in the Emergency Price Control Act of 1942, would have been valid as an additional sanction for the violation of that law. By comparison, he noted, penal sanctions already provided in that Act were much more onerous than the disallowance of over-ceiling prices in the cost of goods sold for purposes of computing income tax liability. If Congress had chosen such a sanction to be enforced as part of the revenue laws, Judge Magruder asserted that this course would not have caused the sanction itself to come into conflict with the sixteenth amendment.[54] In this respect, he seemed to draw a distinction between measures which Congress could enact as part of the income tax laws under the sixteenth amendment and non-tax legislation imposing sanctions enforceable by tax administrators.

Having thus recorded his views on the constitutional questions, Judge Magruder then agreed with the conclusion of the majority that Congress had neither imposed nor implied the sanction which the Commissioner was attempting to implement in the case under consideration, noting "[i]t is not for the Commissioner or the courts to add a further sanction which Congress did not choose to provide."[55]

Judge Magruder's opinion was quite likely motivated by concern that the majority opinion might have inadvertently prejudged an important issue not before the court, namely, the validity of those provisions of the Stabilization Act of 1942 and the Defense Production Act of 1950 which expressly authorized disallowance, in calculating costs and bases for income tax purposes, of the illegal excess of prices paid for wages and goods. He clearly believed that the question, when presented in a future case,[56] would be governed by different considerations than those involved in construing the general income tax laws.

A similar issue concerning cost of goods sold arose in the Fourth Circuit, in *Hofferbert v. Anderson Oldsmobile, Inc.*[57] In this case, the taxpayer, a used car dealer, had purchased automobiles for amounts in excess of ceiling prices determined by the price administrator under the Emergency Price Control Act of 1942. As was to be repeated in the later *Weisman* case in the First Circuit, the litigants raised constitutional issues resulting from the Commissioner's disallowance of the over-ceiling portion of petitioner's purchase price as cost of goods sold. While the court noted the constitutional issue, as well as the conflicting views of the parties relating to the distinctions between "cost" and "deductions," it rested its decision for the taxpayer squarely on the ground that Congress intended to tax as income from the sales in question only the difference between the sales price and the actual cost of the goods sold, even though part of that cost was incurred unlawfully. In reaching this conclusion, the court scrutinized the Internal Revenue Act and the Treasury Regulations thereunder and found no indication that the term "cost" was intended to be understood in

53. *Id.* at 224-26.

54. *Id.*

55. *Id.* at 226.

56. That issue was presented to the Tax Court in Weather-Seal Mfg. Co., 16 T.C. 1312 (1951), *aff'd per curiam*, 199 F.2d 376 (6th Cir. 1952). See text accompanying notes 66-81 *infra*.

57. 197 F.2d 504 (4th Cir. 1952).

other than its ordinary economic sense.[58] Next examining the Emergency Price Control Act itself, the court noted that while the Act provided both civil and criminal penalties for its violation, it was silent as to the tax consequences of any such violation.[59]

Based on the absence of any provision in the Act imposing cost disallowance as a sanction for violations, and in light of its interpretation of the meaning of "cost" under the Internal Revenue Act, the court declared itself unwilling to "read into" the Internal Revenue laws or the price control laws a provision which would result in disallowance of any portion of cost of goods sold in the computation of gross income.[60]

The *Sullenger* issue came before the Fifth Circuit in four cases; the first to be decided was *Commissioner v. Guminski*.[61] In a short opinion the Fifth Circuit held that the taxpayer was entitled to include as cost of goods sold, the portion of the cost of meat purchased which was in excess of applicable price ceilings established under the Emergency Price Control Act of 1942. The court announced that it was in agreement with, and would follow, the *Weisman* and *Anderson Oldsmobile* decisions by the First and Fourth Circuits. The other three cases, involving similar issues, were decided in *per curiam* affirmances following *Guminski*.[62]

Although the Emergency Price Control Act of 1942 did not contain provisions calling for the disallowance as cost of goods sold of the illegal portion of the purchase price of goods, the Act did contain a provision which authorized the President to prescribe "the extent to which any wage or salary payment made in contravention of such regulations shall be disregarded . . . in determining the costs or expenses of any employer for the purposes of any other law or regulation."[63] Pursuant to this provision in the Act, the President issued an Executive Order[64] which included a directive to all governmental agencies "in determining the costs or expenses of any employer . . . for the purpose of calculating deductions under the Revenue Laws of the United States"[65] to disregard any wage or salary payment in contravention of the Executive Order or the Act itself.

In *Weather-Seal Manufacturing Co.*,[66] the question before the Tax Court was whether the petitioner could include as part of cost of goods sold amounts which it had paid as direct cost labor wages in excess of price ceilings prescribed under the Emergency Price Control Act of 1942. The taxpayer asserted that the Executive Order discussed above had used the term "deductions," which term excluded wages falling in the category of cost of goods sold. The

58. *Id.* at 505-506.
59. *Id.* at 506.
60. *Id.*
61. 198 F.2d 265 (5th Cir. 1952).
62. Commissioner v. Conner, 199 F.2d 369 (5th Cir. 1952); Commissioner v. Baum, 199 F.2d 267 (5th Cir. 1952); Commissioner v. Gentry, 198 F.2d 267 (5th Cir. 1952).
63. Stabilization Act of 1942, ch. 578, §5, 56 Stat. 767 (1942).
64. Exec. Order No. 9250, 1942-2 C.B. 92.
65. *Id.* at 93.
66. 16 T.C. 1312 (1951), *aff'd per curiam*, 199 F.2d 376 (6th Cir. 1952).

Commissioner had disallowed the unlawfully excessive amount of wages as an adjustment of any kind in computing income tax liability.

Petitioner contended that the Commissioner had acted without authorization under the law and the Executive Order or, in the alternative, that the Executive Order and the law itself were both in conflict with the sixteenth amendment.

The petitioner's position clearly jeopardized the legislative purpose underlying the Act. If the Tax Court were to restrict the disallowance of illegal wages to that category of wages deductible from gross income under section 23(a)(1)(A) of the 1939 Code[67] and exclude from the scope of the Executive Order those direct cost wages properly accounted for in cost of goods sold, a loophole would be carved in the Price Control Act by the creation of a class of wages immune from the sanction prescribed by the law. On the other hand, if the Tax Court were to construe the Act and Executive Order as treating all wages equally thereunder, the petitioner's sixteenth amendment claim would threaten the validity of both the Executive Order and the Act. Thus, in 1951, with the nation in the throes of the Korean conflict, the Tax Court was confronted with a direct challenge to an emergency measure enacted by Congress under its war powers in an effort to maintain a stable national economy. Though the law in question in *Weather-Seal* had been enacted years before during World War II, the case at bar would very likely stand as precedent for similar issues which would inevitably arise under statutes enacted during the Korean conflict that were similar in purpose and content to the Emergency Price Control Act of 1942.

In this context, the Tax Court reached a desirable result by upholding the validity of the Act and Executive Order without excluding direct cost wages from the scope of the tax sanction intended to enforce wage ceilings.[68] Unfortunately, in reaching that result it produced an opinion which warped both doctrine and logic.

The court first dealt with the petitioner's claim that the Executive Order intended to disallow unlawful wages only to the extent that they fell within the category ordinarily allowed as deductions from gross income. The taxpayer had asserted that since the wages in question were paid for direct labor, properly included in cost of goods sold, they were not of a nature which would fall within the scope of the Executive Order. The court dealt with this assertion directly by stating, "[i]n our opinion no such differentiation was actually intended or even implied."[69] While the court might well have stopped at this point, it went further, presumably in an effort to avoid the constitutional question through statutory construction and by resorting to analogous decisional principles.

Agreeing with the petitioner that the Executive Order "had in mind section 23(a)(1)(A)," the court noted that that section permitted a "reasonable allow-

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67. Int. Rev. Code of 1939, ch. 247, tit. II, §211(a), 53 Stat. 867 (1939) (now I.R.C. §162(a)).

68. 16 T.C. at 1318.

69. *Id.*

ance" for compensation for services.[70] The court then proceeded to interpret the Act and Executive Order as declaring that, as a matter of law, salaries paid in contravention thereof shall not constitute reasonable compensation under section 23(a)(1)(A). Next, the court announced the rule, not seen before in tax decisions, that all claims of deductions for compensation paid, whether they constitute business expenses or direct labor charged to cost of goods sold, may be reviewed by the court to determine whether the amount paid is reasonable. The court concluded its puzzling sequence by declaring that the unlawful wage payment in question was "not deductible as a business expense because it did not constitute reasonable compensation."[71]

The court thus engaged in doctrinal distortion by applying a statutory principle applicable to deductions, that the courts must scrutinize a compensation allowance for reasonableness, to compensation claimed as part of cost of goods sold.[72] Then the court engrafted upon that principle a legal fiction: compensation which is illegal is, as a matter of law, "unreasonable" compensation. Having thus identified the "illegal" wages in question as "unreasonable," the court concluded that they were not allowable.

In summary, the court subjected the claimed allowance for wages to the conditions set forth in section 23(a)(1)(A) because they constituted compensation (thus refusing to recognize their separate status as pre-gross income adjustments), found them unreasonable because they were illegal, and concluded that being unreasonable in amount, they were not allowable. Having thus fashioned the rule that direct labor wages are subject to the same tests prescribed for compensation deductions under section 23(a)(1)(A), the court swept aside the petitioner's argument by assuming that the argument suggested, which it did not, that the courts may not scrutinize pre-gross income adjustments to determine whether they are properly characterized as compensation[73] and substantiated as to amount.

70. *Id.*

71. *Id.*

72. See text accompanying notes 74-75 *infra.*

73. The *Weather-Seal* court, in support of its reasoning, relied upon two decisions which had allowed an adjustment to cost of goods sold. In the 1940 case of Majestic Securities Corp., 42 B.T.A. 698 (1940), *aff'd*, 120 F.2d 12 (8th Cir. 1941), the court scrutinized the amount paid by the petitioner, a price well in excess of market value, for certain securities from a bank controlled by shareholders of petitioner. In the later sale of the securities petitioner claimed a loss. Finding that the excess amount of purchase price was paid for a purpose other than acquisition of the securities, and that the interests of purchaser and seller were not adverse (and not arm's length), the court adjusted petitioner's cost basis for the securities to the prevailing market price at the time of acquisition. The *Weather-Seal* court also relied upon a 1951 Fifth Circuit opinion, American Pitch Export Co. v. Commissioner, 188 F.2d 721 (5th Cir. 1951), in which an actual inventory available after the close of the taxable year and prior to filing the return was required to be used in place of an estimated inventory. The latter had the effect of increasing the cost of goods sold and *reducing* taxable income from sales. The *Weather-Seal* court relied upon these cases as its authority for applying a reasonableness test to wages. Both decisions are readily distinguishable from *Weather-Seal.* In *Majestic Securities,* the court made a factual inquiry into the purchase price of the securities and found it to be in excess of market price. Further, the court made the factual determination that the amount paid for the securities was for purposes other than purchase. In *American Pitch Pine,* the estimated inventory, which was determined to be inaccurate, was replaced by an actual in-

Though the *Weather-Seal* decision might have reached a just and desirable result, it is doctrinally incorrect and is not supported by previous case law, including the two decisions cited in the opinion.[74] The courts have always been authorized to examine payments for which tax benefits are claimed to determine the amount of the payment, if and when it was paid, and to whom. Moreover, the courts may examine the nature of the payment, and the relevant facts and circumstances, to determine its true nature. It should not be suggested, and indeed it was not argued by the taxpayer in *Weather-Seal*, that payments constituting pre-gross income adjustments are immune from such scrutiny. However, *Weather-Seal* would establish an entirely different principle: that all compensation whether constituting direct cost labor reflected as a pre-gross income adjustment, or "overhead" labor deductible from gross income, is subject to the "reasonableness" requirement of section 23(a)(1)(A) of the 1939 Code and section 162(a) of the 1954 Code.

This view is incorrect. Since business deductions under section 162 are matters of legislative grace, Congress is authorized, and has elected, to condition deductions for wage payments on their reasonableness in amount, a test which requires a comparison of the wages in question with those paid by others in similar industries and circumstances. However, Congress has not legislated any such condition to the allowance of wages which are accounted for in the computation of gross income. Thus, while the reasonableness of direct cost compensation may be admissible as evidence of the compensatory nature of a given payment, it does not constitute, of itself, a basis for disallowance of the payment. In reaching its result in *Weather-Seal*, however, the Tax Court held otherwise.[75]

Weather-Seal and *Pedone v. United States*[76] should be and generally have been given little credence as authority beyond their own peculiar facts and circumstances.[77] There can be no doubt that the mechanism adopted by the

ventory count. The court determined that the taxpayer used an estimated inventory when an actual count was available. These factual determinations were far different from the determination made by the *Weather-Seal* court that, as a matter of *law*, the wages in question were unreasonable and therefore not allowable.

74. See note 73 *supra*.

75. *Weather-Seal* has been cited in one case (outside of the area of price control legislation) as authority for the principle that direct labor wages may be disallowed to the extent they are unreasonable in amount. In R. J. Reynolds Tobacco Co., 15 T.C.M. (CCH) ¶21,841 (1956), *aff'd*, 260 F.2d 9 (4th Cir. 1958), the Tax Court had occasion to examine and reaffirm *Weather-Seal* and found it applicable in that case. There excessive compensation was paid to employees in petitioner's buying and manufacturing operations as well as to employees of an unrelated corporation. The court, quoting extensively from *Weather-Seal*, found that the payments were in the essence of compensation for personal services rendered, whether considered as a §162 deduction or as a labor cost, and "might be disallowed as a deduction in computing taxable net income to the extent that they were unreasonable in amount." *Id.*, ¶21,841 at 846.

76. 151 F. Supp. 288 (Ct. Cl.), *cert. denied*, 355 U.S. 829 (1957).

77. *Weather-Seal* has been cited in a limited number of decisions as authority for the proposition that pre-gross income adjustments are subject to the same tests as deductions under §162. In Sidney Zehman, 27 T.C. 876 (1957), *aff'd per curiam*, 253 F.2d 424 (1958), a case arising under the Defense Production Act of 1950, direct labor costs in excess of wage ceilings were paid by a partnership. Despite arguments by petitioners that the wage law was

court in *Weather-Seal,* if not limited to the circumstances surrounding that decision, could seriously erode the concept of gross income as the barrier beyond which Congress cannot go in levying income taxes. In the author's view, that mechanism will continue to be so limited. In practice, the Tax Court has assigned *Weather-Seal* an extremely narrow scope and has shown no inclination to view it as general authority for interjecting public policy considerations into the area of pre-gross income adjustments.[78]

The court's own view of the narrow scope of *Weather-Seal* is demonstrated in the opinion by the manner in which the court distinguished *Sullenger.* The primary basis for that distinction was that "no authority was found [in *Sullenger*] to deny the taxpayer the use of its actual cost despite the fact that the portion thereof in controversy was paid in contravention of the O.P.A. price."[79] This indication that *Weather-Seal* was intended to be restricted as precedent to its peculiar circumstances, that is, a statute and executive order clearly establishing disallowance as a sanction for violating federal price regulations, represented no new thinking on the part of the Tax Court. Three years earlier in *Sullenger,* the Commissioner had suggested another convenient fic-

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either inapplicable or unconstitutional, the Tax Court, deferring to the *Weather-Seal* decision, subjected the wages to a reasonableness test, holding that the wages were business expenses under §23(a)(1)(A) and deductible if reasonable in amount. To the same effect, see Solon Decorating Co., 16 T.C.M. (CCH) ¶22,273 (1957), *aff'd per curiam,* 253 F.2d 424 (6th Cir. 1958), Harold Binder, 12 T.C.M. (CCH) ¶19,692 (1953). *Weather-Seal* was relied upon as authority in four other decisions, not involving the Defense Production Act. In G.E. Fuller, 20 T.C. 308 (1953), petitioner attempted to include confiscated whiskey in his cost of goods sold, thus decreasing his taxable income. The Tax Court, refusing to allow as part of cost of goods sold items which were not available for sale or actually sold by petitioner by reason of confiscation, cited *Weather-Seal* as general authority for this proposition.

In Estate of Edwin H. Johnson, 42 T.C. 441 (1964), *aff'd,* 355 F.2d 931 (6th Cir. 1965), the taxpayer argued that §267(a) was not applicable to disallow losses between related taxpayers because the difference between the cost and the amount realized represented cost of goods sold. Petitioners claimed that the disallowed amounts were not deductions within the meaning of §267(a)(1) but rather were a part of cost of goods sold, and that to tax the latter was unconstitutional. The court, citing *Weather-Seal* and noting that the effect of applying §267(a)(1) was not to tax gross receipts, but only to keep petitioners from reducing other income by that loss, held that §267(a)(1) applied to disallow the loss.

In National Biscuit Co., 29 T.C. 409 (1957), the Commissioner argued that vacation pay of hourly workers, which was part of cost of goods sold, was not a deduction within the meaning of §23, the predecessor to §162, and therefore not a deduction for purpose of the Korean War Excess Profits Tax. The Tax Court, using the Commissioner's position in *Weather-Seal* against him, held that vacation pay constituted a deduction for purposes of the Excess Profits Tax. Commenting that compensation, in determining gross income, is not relieved of the conditions of (1) "ordinary and necessary," (2) reasonableness, and (3) "for personal services actually rendered," which conditions were expressly stated in §23, the court found that compensation is, by definition, within the meaning of "deduction" as used in §23, even though properly included in cost of goods sold.

In *Reynolds Tobacco,* discussed in note 57 *supra,* the Tax Court reaffirmed and applied *Weather-Seal,* finding that "direct cost" wages paid to employees, constituting a part of cost of goods sold, could be disallowed to the extent they were unreasonable in amount. The case was decided in a memorandum opinion, and appealed to the Fourth Circuit by the Commissioner on other issues. The ruling here discussed was not considered on appeal.

78. *See* cases relying on *Weather-Seal* cited in note 77 *supra.*

79. 16 T.C. at 1320.

tion to the Tax Court as a basis for a decision adverse to the taxpayer. There the court was urged that to view the over-ceiling portion of the purchase price as a "bribe" to induce the seller to sell goods to the petitioner at the O.P.A. ceiling price.[80] Had the Tax Court accepted this idea, the "bribe" would have been reclassified from cost of goods sold to a deduction subject to disallowance on public policy grounds. But the *Sullenger* court refused to fragment the purchase price on the basis of a convenient fiction, noting that "the Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income . . . ."[81]

Had the Tax Court intended *Weather-Seal* as general authority for extending the public policy doctrine into the area of pre-gross income adjustments, it had an excellent opportunity to do so in the milk rebate cases,[82] the first of which came before the court five years after *Weather-Seal* was decided. However, as will be discussed, the Court showed no such inclination.

Decisions Under State Price Regulation Laws

While the federal anti-inflation laws discussed above feature price ceilings designed to curb wage-price spirals, state price regulations producing tax controversies prior to 1969 were more typically concerned wth maintaining price floors, usually to maintain stable markets for in-state industries. Thus, where state pricing laws were violated in a transaction, it was typically the seller of goods and not the buyer whose disregard of the law eventually led to conflict with the Commissioner. While the O.P.A. cases reveal a purchaser seeking tax benefit for amounts illegally paid, the state pricing law cases typically involve the seller seeking to recover illegal rebates and discount payments as an offset to gross sales.

In *Polley v. Westover*,[83] a refund suit before a United States district court in California, the taxpayers were partners in a wholesale liquor business. Competition among wholesale liquor dealers was intense, and there existed throughout the industry a trade custom of offering cash rebates against the invoice price of liquor for quantity purchases. A rule issued by the state liquor authorities regulated such discounts,[84] but the competitive atmosphere led to almost universal violation of the regulation. The State Board enforced the rule "only sporadically," but on one occasion applied it to the taxpayers, imposing a three-

80. 11 T.C. at 1077.

81. *Id.*

82. See text accompanying notes 83-115 *infra*. It should be noted that, stated in the reverse, the fictional "bribe" argument advanced by the Commissioner in *Sullenger* is also equally applicable, in theory, in rebate cases. Moreover, precedents existed for applying the *Weather-Seal* "reasonableness" theory, with at least no greater misapplication of logic and doctrine, to cases involving the purchase of goods. *See* Majestic Securities Corp. v. Commissioner, 42 B.T.A. 698 (1940), *aff'd*, 120 F.2d 12 (8th Cir. 1941).

83. 77 F. Supp. 973 (S.D. Cal. 1948).

84. In September, 1939, the State Board of Equalization adopted a rule which provided certain restrictions on discounts, including a provision that "quantity discounts may be based on sales and deliveries to one purchaser with twenty-four (24) hours only." *Id.* at 975.

day license suspension.[85] The rule itself was suspended five years after its adoption. The applicable statute provided only that no wholesaler shall "give secret rebates or make any secret concessions" to a retail dealer.[86] The district court found that the trade custom as to discounts which was followed by the taxpayers was a matter of common knowledge in the trade and was known to the State Board.

During 1941, customers of the taxpayers received $17,532.26 as discounts for quantity purchases. In their partnership return, the taxpayers deducted such discounts as sales expenses. The Commissioner disallowed such deductions on the ground that they were not allowable under section 23(a) of the 1939 Code.

The district court did not consider in its conclusions of law whether the discounts in question were adjustments to gross sales, deductible in arriving at gross income, or business expenses to be deducted from gross income in arriving at taxable income. There is no indication that the taxpayers advanced the former as alternative grounds for allowance of the deduction. Instead, the litigants and the court appear to have addressed themselves to the specific grounds for disallowance raised by the Commissioner based upon a claim for deduction in the taxpayers' return, and they threfore proceeded to test the claim for deduction against the public policy doctrine. Applying the public policy criteria and citing *Commissioner v. Heininger*,[87] the court concluded that the allowance of an income tax deduction for such payments would not frustrate any well-defined national or state policy.[88] Then, almost as if by afterthought, the court found that:

> Failure to allow this deduction would result in taxing the plaintiffs on amounts which they did not receive, and which, by agreement, they were not entitled to receive, because they agreed in advance with the retail dealers to reduce the purchase price of liquor by the amount of the cash payments.[89]

As later recognized by the Tax Court, the district court in *Polley* did not consider whether the discounts in question were "deductions to arrive at gross income," or "deductions from gross income."[90] Any distinction between the two classifications was made moot in that case by the court's approval of the deductions. Nevertheless, the district court did conclude that the practical effect of a contrary holding would have been the creation of income where, in fact, none had been received or claimed by the taxpayers.[91] This conclusion, though it appeared to have been overshadowed in the opinion by the public policy issue, has been given primary emphasis by the courts considering the same question in later cases.[92] Moreover, there is no indication in the opinion as to how the

85. *Id.*
86. *Id.* at 974.
87. 320 U.S. 467 (1943).
88. 77 F. Supp. at 976.
89. *Id.*
90. Tri-State Beverage Distrib., Inc., 27 T.C. 1026, 1030 (1957).
91. 77 F. Supp. at 976.
92. See text accompanying notes 94-98 *infra*.

district court would have disposed of *Polley* had it found the discounts in question to be in violation of sharply defined state policy. In that event, the court would have found its conclusions under section 23(a) of the 1939 Code to be in conflict with its other conclusion that a denial of the deduction would have the effect of creating income which the taxpayer never received or claimed a right to receive. Only then would the court have been forced to consider whether the public policy test could be applied to adjustments to gross sales in calculating gross income.

The next case involving whether the public purpose policy may be applied to determine allowability of pre-gross income adjustments was *Pittsburgh Milk Co.*[93] The company, a milk dealer licensed under the Milk Control Law of Pennsylvania, gave rebates to customers in willful violation of the Pennsylvania Milk Control Law and minimum price orders of the Milk Control Commission. Such rebates were paid pursuant to informal agreements between the company and some, though not all, of its clients. Those agreements were intended to violate the state law by effecting net prices for milk at rates below the minimum prices prescribed by law. The company went to elaborate lengths to conceal the rebate agreements as well as the actual payment of the rebates from the state authorities; rebate agreements were informal; the customers were billed, and they remitted to the taxpayer the full price required by state law; and the company used third parties as conduits for passing the rebate payments to its customers. The Commissioner disallowed the deductions, presenting the Tax Court with the question of what tax effect, if any, should be given to the rebates which the corporation had made in willful violation of the state milk control law.

The taxpayer argued that the rebates should be treated as allowances in reduction of the corporation's gross sales, on the theory that the milk was actually sold for agreed net prices, and in the alternative, that such allowances should be recognized as deductions from gross income, for ordinary and necessary business expenses in the nature of advertising or sales promotion expenses. The Commissioner countered that the milk was sold for the list prices fixed by the Milk Control Commission since those were the prices used in entering the sales on the corporation's books. He further contended that the allowances could not be recognized in computing tax liability unless they met the qualifications prescribed in section 23(a) of the 1939 Code for deductions from gross income. He argued that they could not so qualify under the circumstances since the allowance of such deductions would frustrate the sharply-defined policy of the Commonwealth of Pennsylvania.

Addressing the factually incorrect characterization of the rebates as "advertising expenses" in the company's books and income tax return, the court restated the settled principle that when book entries do not accurately reflect income, the actual facts will govern in determining the taxability of a transaction.[94] The court found that the corporation sold milk to its customers at net prices previously agreed upon which were determined by reducing the pre-

93. 26 T.C. 707 (1956).
94. *Id.* at 715.

scribed list prices of the Milk Control Commission by the agreed rates of allowance.[95] On that finding, the court concluded:

> We are here dealing with the taxation of income. Under both the Sixteenth Amendment and the Internal Revenue Code, the tax is imposed only on "income," and not upon every conceivable type of receipt. Where gains, profits, and income derived from the sale of property are involved, the tax is computed with respect to "the amount realized therefrom" (citation omitted), and such realized amount must be based on the actual price or consideration for which the property was sold, and not on some greater price for which it possibly should have been, but was not, sold.[96]

Citing its decision in *Sullenger*,[97] the court stated: "no more than the actual gross income can be subjected to income tax, in any amount."[98]

As to the fact that the petitioner's customers had remitted the full invoice price including the previously agreed, but illegal, discount, the court found this to be of no consequence since the taxpayer did not acquire the excess discount beneficially or under any claim of right, but received it merely as a deposit which was to be returned in all events.[99] Though the court made extensive findings of fact as to the public policy issue, it failed to reach that issue due to its conclusion that the rebates in question were deductions from gross sales in the computation of gross income.

The court admonished against an overly broad interpretation of the opinion, warning that it would not stand as authority for treating all allowances, discounts and rebates made by a seller as adjustments of the selling price. The facts and circumstances of the transaction and not the terminology employed would govern future cases, the critical inquiries being the intent of the parties and the purpose or consideration for which the allowance was made.[100]

In two subsequent cases, the Commissioner attempted both to distinguish *Pittsburgh Milk* and to convince the Tax Court to overrule it. In *Rosedale Dairy Co.*,[101] decided in 1957, the issue again involved customer rebates paid by a milk dealer in willful violation of state minimum price laws. On facts so similar to those in *Pittsburgh Milk* that the Commissioner did not attempt to distinguish the two cases, Tax Court Judge Rice held that the amount of the rebates which the company received and subsequently refunded to its customers "did not constitute income to it when originally received and should not have been included by it in computing and reporting its gross income."[102] With a sense of irony, the Judge cited as authority for his holding the Tax Court's decision in *Tri-State Beverage Distributors, Inc.*,[103] a case in which the Com-

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95. *Id.*
96. *Id.*
97. 11 T.C. 1076 (1948). See text accompanying notes 43-44 *supra*.
98. 26 T.C. at 715.
99. *Id.* at 716.
100. *Id.* at 716-17.
101. 16 T.C.M. (CCH) ¶22,793 (1957).
102. *Id.*, ¶22,793 at 1123.
103. 27 T.C. 1026 (1957).

missioner had successfully argued that identical rebates constituted adjustments of the sales price, and not deductions from gross income.

In *Harmony Dairy Co.*,[104] decided in 1960, the Tax Court was again confronted with a dispute involving the same Pennsylvania Milk Control law which had been dealt with in *Pittsburgh Milk.* Like the Pittsburgh Milk Company, the taxpayer, a corporation licensed under the Act as a milk dealer, entered into informal understandings with certain customers pursuant to which the customers paid the invoiced legal "list" prices but received rebates in previously agreed-upon amounts from the company. Also like Pittsburgh Milk Company, the corporation used a third party conduit to cover its illegal acts and employed deceptive bookkeeping practices to account for the rebates. Unlike Pittsburgh Milk Company, which acknowledged the illegality of its rebate payments, Harmony Dairy denied that its rebate practices violated Pennsylvania law.[105]

The Commissioner urged that the circumstances of this case should distinguish it from *Pittsburgh Milk,* not only because Harmony Dairy had denied the illegality of its rebates but also because it had not established in the record that the rebates were made pursuant to informal agreements with the customers.[106]

The court swept aside as insignificant the question of whether Harmony's rebates actually violated state law citing the Supreme Court's oft-quoted remark from *Commissioner v. Wilcox*: "[M]oral turpitude is not a touchstone of taxability."[107] As to the Commissioner's insistence that Harmony had not proven the prior agreements with its customers, the court disagreed, finding that the rebates had been paid pursuant to prior understandings between Harmony and its customers.[108]

Again the Commissioner urged that *Pittsburgh Milk* had been incorrectly decided and urged the court to overrule the decision. As in *Rosedale Dairy,* the court reconfirmed its adherence to *Pittsburgh Milk* and held that the amounts ultimately rebated to the customers did not constitute income to Harmony when initially received by it and were properly used to reduce its gross sales in determining gross profits for federal income tax purposes.[109]

Reflecting a determined commitment to have the *Pittsburgh Milk* doctrine overruled or limited, the Commissioner brought two further cases to the Tax Court involving the allowance of rebates made in violation of state milk price control laws. Both cases involved violations of regulations and orders of the New Jersey Office of Milk Industry (OMI).

In *Atzingen-Whitehouse Dairy, Inc.*,[110] a New Jersey licensed milk dealer,

104. 19 T.C.M. (CCH) ¶24,203 (1960).

105. As to that denial, however, the court found that Harmony's customers knew that the "net" price, after deducting the agreed rebate, would be less than the minimum price provided by the Milk Control law. *Id.*, ¶24,203 at 584.

106. *Id.*, ¶24,203 at 586.

107. 327 U.S. 404, 408 (1946).

108. 19 T.C.M. (CCH) ¶24,203 at 587.

109. *Id.*

110. 36 T.C. 173 (1961).

under pressure from competitors who engaged in similar practices, entered into agreements with selected customers pursuant to which portions of the invoice price of petitioner's milk products were rebated to those customers. The effect of such rebates was to reduce petitioner's selling price of milk products below the minimum price prescribed by the OMI. The facts of the case reveal only slight variations from the *Pittsburgh Milk* fact pattern. Most of the customers received cash rebates and signed a voucher therefor.[111] The usual amount of deception occured in petitioner's bookkeeping practices, and, as in the other milk rebate cases, the rebates were booked as "selling expenses-sales promotion." In its tax return, petitioner claimed deductions for the rebates as an ordinary and necessary business expense, again classified as "selling expenses-sales promotion." The deduction of the rebates as so classified was disallowed by the Commissioner. Nevertheless, Judge Raum stated in his opinion that the issue in the case was not whether such discounts were ordinary and necessary business expenses deductible from gross income in arriving at net income, but whether the net discounts should have been included in petitioner's gross income in the first instance. Rejecting the Commissioner's urging that *Pittsburgh Milk* be overruled, Judge Raum cited the *Rosedale* and *Harmony* decisions as confirming *Pittsburgh Milk* and announced that the court was not disposed to reopen the issue.[112] Judge Raum also pointed to the Commissioner's inconsistent position taken in *Tri-State Beverage Distributors, Inc.*[113]

Bloomingdale Dairy Co., Inc.,[114] decided in a memorandum opinion filed simultaneously with the opinion in *Atzingen-Whitehouse*, raised no substantial variation in the fact pattern from the milk rebate cases which preceded it. The record at trial reflected cash rebates paid to petitioner's customers which had the effect of lowering the price of petitioner's milk products below the minimum prices set by the New Jersey OMI. It was a consistent practice of the petitioner to pay the cash rebates to the customers at the same time that the customers paid petitioner the full invoiced legal price. The petitioner sought a tax allowance for its rebate payments by including such amounts in cost of goods sold in the computation of gross income. Concluding that the only question for decision was identical with the rebate issue decided that same day in *Atzingen-Whitehouse Dairy, Inc.*, Judge Raum held for the petitioner in a six-line opinion.[115]

Prior to 1967, the cases involving application of the public policy doctrine to pre-gross income adjustments involved customer rebates and discounts made by businesses engaged in selling products. In *Allen Schiffman*,[116] however, the Tax Court considered whether illegal rebates and discounts of insurance premiums by an insurance broker to his customers were excludable from the

111. Some customers, presumably out of concern for state prosecution, refused to sign receipts, which produced a substantiation issue in the case that was resolved by the court in the taxpayer's favor. *Id.* at 181-82.

112. *Id.* at 181.

113. 27 T.C. 1026 (1956).

114. 20 T.C.M. (CCH) ¶24,803 (1961).

115. *Id.*

116. 47 T.C. 537 (1967).

broker's gross income or constituted deductions from gross income. The insurance broker contended that such rebates and discounts were adjustments to the purchase price of the insurance (that is, the premium), and thus were excludable from the broker's gross income under the *Pittsburgh Milk Co.* and *Atzingen-Whitehouse Dairy* decisions. The Commissioner sought to distinguish those cases on the ground that the rebates and discounts there in issue were adjustments agreed to between buyer and seller, whereas in *Schiffman* the insurance company, though a principal in the transaction, was not a party to the adjustment.

The court refused to distinguish the milk rebate cases on these grounds; rather, it applied the claim of right doctrine as the basis of its decision:

> [W]e think that the fundamental consideration is whether the customer paid or was required to pay such amounts to petitioner, so that it could be said that he received them under a claim of right or turned his back on income to which he was otherwise entitled. It cannot be gainsaid that the arrangements were made by petitioner prior to his sales of insurance. At the moment of sale and billing, his customer was not required to pay and petitioner had no claim to the amount of the discount (which he never received) or the rebate (which he received but was immediately required to refund).[117]

The court also distinguished *United Draperies, Inc.*[118] and *Boyle, Flagg & Seaman, Inc.*,[119] two cases involving kickbacks to employees of the purchaser, noting that those cases involved situations where the petitioner's agreement to pay rebates to the employees was "independent of its agreement with its purchasers fixing the selling price of the products sold."[120] The amounts paid in those cases were paid for a consideration separate from the selling price of the seller's products.

Thus, although recognizing that its holding "may offer a safe haven for violators of State laws,"[121] the court held that the rebates and discounts in *Schiffman* were adjustments to the selling price of the insurance, and thus were not includable in the broker's gross income.

Analysis of the Pre-1969 Cases

The holdings in *Pittsburgh Milk, Rosedale, Harmony, Atzingen-Whitehouse*, and *Bloomingdale* not only are consistent with each other, but also are consistent with other cases based on pre-1969 law not involving considerations of the public policy doctrine.

The rebates in the milk cases are analogous to trade discounts which are available to customers at the moment of invoicing and which are not contingent upon future acts of the customer, such as early payment of the invoice,

117. *Id.* at 541.
118. 41 T.C. 457 (1964), *aff'd*, 340 F.2d 936 (7th Cir. 1964), *cert. denied*, 382 U.S. 813 (1965).
119. 25 T.C. 43 (1955).
120. 47 T.C. at 542.
121. *Id.*

or the future purchase of specified quantities of merchandise.[122] Such trade discounts have consistently been held to be properly deducted from gross sales in arriving at gross income.[123] Reminiscent of the court's admonition in *Pittsburgh Milk* that mere terminology does not control, the Board of Tax Appeals held in *American Lace Manufacturing Co.*[124] that a seven percent discount offered by the petitioner to its customers for payment within ten days was actually a trade discount, properly deducted from gross sales. In that case the facts showed that the customers consistently claimed the discounts without objection by the petitioner and without regard to the time of payment. Under those facts, the Board found that the so-called cash discount should be treated for tax purposes as a trade discount.

Unlike the trade discount, the true cash discount is contingent upon acts of the taxpayer's customer subsequent to the issuance of the invoice: for example, the payment of the account receivable on or before a stipulated date. For that reason, the courts have consistently refused to allow taxpayers to deduct reserves representing taxpayers' estimates of cash discounts to be taken in the subsequent year.[125] The same result is seen in cases involving merchandise return allowances.[126] In both situations, the courts have based their decisions on the fact that the taxpayer's liability for the refund or discount does not arise until the occurrence of certain events in the subsequent year, that is, the early payment of the account receivable or the return of merchandise.

The cash discount and return allowance cases reflect an adherence to general principles of tax accounting and to principles related to maintaining the integrity of the taxable year as the period for calculating tax liability.[127] They do not, however, in any way ignore or undermine the fundamental distinctions between deductions from gross income and pre-gross income adjustments.

In at least one case which was decided during the period of the milk rebate decisions, the distinctions between pre-gross income adjustments and deductions from gross income were advanced by the Commissioner and accepted by the Tax Court as the basis for decisions in his favor. *Tri-State Beverage Distributors, Inc.*,[128] a corporate excess profits case under the 1939 Code, involved facts strikingly similar to those in *Pittsburgh Milk*, though it dealt with differ-

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122. For a discussion of trade discounts and how they are distinguished from cash discounts, *see e.g.*, San Diego Transit-Mixed Concrete Co., 21 T.C.M. (CCH) ¶25,534 at 750 (1962); Albert C. Becken, Jr., 5 T.C. 498, 505 (1945); American Cigar Co., 21 B.T.A. 464, 499 (1930); and American Lace Mfg. Co., 8 B.T.A. 419, 420 (1927).

123. See cases cited in note 122 *supra*. *See also* William H. Kenner, 33 T.C.M. (CCH) ¶32,816 (1974), and Allen Schiffman, 47 T.C. 537, 541 (1967).

124. 8 B.T.A. 419 (1927). *Cf.* Stein-Bloch Co., 23 B.T.A. 1162 (1931) (discounts were contingent upon time of payment and thus could not be treated as trade discounts).

125. *E.g.*, Shapleigh Hardware Co. v. United States, 81 F.2d 697 (8th Cir. 1936); Farmville Oil & Fertilizer Co. v. Commissioner, 78 F.2d 83 (4th Cir. 1935); Leonard v. United States, 7 F. Supp. 295 (Ct. Cl. 1934); Miami Valley Coated Paper Co., 28 T.C. 492 (1957); Albert C. Becken, Jr., 5 T.C. 498 (1945); Stein-Bloch Co., 23 B.T.A. 1162 (1931); American Cigar Co., 21 B.T.A. 464 (1930), *aff'd on other grounds*, 66 F.2d 425 (2d Cir. 1933); Ederheimer-Stein Co., 2 B.T.A. 711 (1925); M.I. Steward & Co., 2 B.T.A. 737 (1925).

126. Ertegun v. Commissioner, 531 F.2d 1156, 1161 (2d Cir. 1976).

127. Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944).

128. 27 T.C. 1026 (1957).

ent legal issues. The petitioner, an Illinois wholesale liquor dealer, was forced by intense price competition to give price discounts to its customers.[129] The court suggested, but did not expressly find due to an unclear record, that either "the distillers or a fair trade law required the petitioner to sell liquor at the list price."[130] The discounts were not dependent in any way upon promptness of payment or quantity of merchandise purchased. The petitioner sought to have the price discounts eliminated from the computation of his excess profits net income for the base period years, under a statutory provision permitting the exclusion of amounts representing "abnormal deductions."[131] The term "abnormal deductions," appearing in section 711(b)(1)(J) of the 1939 Code, referred to statutory deductions or deductions allowable under section 23(a).[132] The petitioner argued that the discounts in question constituted deductions from gross income under section 23(a), predecessor to section 162(a), and relied on the district court decision in *Polley v. Westover*.[133] The Commissioner, on the other hand, argued that the discounts were not deductions from gross income but adjustments to the sales price in calculating gross income and thus were not to be included in a calculation of "abnormal deductions."

The Tax Court, though acknowledging that the rebates in the *Polley* case had been tested by that court under section 23(a), considered that case inapposite since the court had not actually decided whether the discounts in question constituted deductions *from* gross income or deductions *to arrive at* gross income.[134]

In support of his contention that the discounts in question were pre-gross income adjustments and not deductions under section 23(a), the Commissioner urged the *Pittsburgh Milk Co.* decision as precedent. Deciding for the Commissioner, the court concluded "the discounts involved herein . . . are essentially of the same nature as those involved in *Pittsburgh Milk Co.* . . . Accordingly, we hold that the discounts involved herein are deductions to arrive at gross income. They are not deductions from gross income or deductions within the meaning of section 711(b)(1)(J)."[135]

In the more recent case of *B.C. Cook & Sons, Inc.*,[136] the distinction between a deduction and a pre-gross income adjustment was again pivotal, this time in the context of an issue involving the application of sections 1311-1314 of the

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129. The price discounts, which petitioner allowed to its customers in amounts up to about 10% of the list price, varied from time to time and between customers, but the percentage was always known to the customer at the time of sale. *Id.* at 1028.

130. *Id.*

131. Int. Rev. Code of 1939, ch. 10, §3, 55 Stat. 18 (1941).

132. Colorado Milling & Elevator Co., 17 T.C. 1280, 1285 (1952), *appeal dismissed*, 205 F.2d 551 (10th Cir. 1953); Crow-Burlingane Co., 15 T.C. 738, 752 (1950), *appeal dismissed per stipulation*, 192 F.2d 574 (8th Cir. 1951); Universal Optical Co., 11 T.C. 608, 621 (1948).

133. See text accompanying notes 83-92 *supra*.

134. 27 T.C. at 1030. See text accompanying notes 90-92 *supra*. Since the court, in *Polley*, found the deductions allowable under §23(a), the same result would have been obtained in that case from the court's finding that the discounts there in question constituted adjustments to gross sales.

135. 27 T.C. at 1031.

136. 65 T.C. 422 (1975), *aff'd*, 584 F.2d 53 (5th Cir. 1978).

1954 Code to an otherwise barred taxable year. From 1958 to 1965, an employee of the petitioner fruit dealer had engaged in a continuous scheme of embezzling of petitioner's funds by causing petitioner's checks to be written to a fictitious payee and then intercepting the funds. The employee had characterized the fictitious payee as a seller of fruit to the petitioner, and, as a consequence, the petitioner innocently included the embezzled amounts in its tax returns for the years 1958 to 1965 as part of cost of goods sold.

When the petitioner discovered the embezzlement in 1965, it claimed the entire amount embezzled as a theft loss deductible under section 165. In a notice of deficiency issued in 1965, the Commissioner disallowed that part of the embezzlement deduction attributable to embezzlements during the years 1958 to 1961 as being barred by the statute of limitations. Litigation ensued and the Tax Court determined that the embezzlement deduction was allowable in its entirety as a deduction in 1965.[137]

Following the decision of the Tax Court, the Commissioner served another statutory notice upon the petitioner invoking sections 1311-1314 and seeking, in effect, an adjustment which would disallow the inclusion of the embezzlement amounts in cost of goods sold during the otherwise barred years. In the tortuous course of tracking through these code sections, the court arrived at the pivotal question of whether the circumstances of the adjustment came within the meaning of section 1312(2). The court concluded that although the previous Tax Court decision had allowed a deduction for petitioner's 1965 taxable year, it was not a deduction "which was erroneously allowed to the taxpayer for another taxable year" within the meaning of the statute.[138]

In a lengthy opinion, the court delineated a "crucial distinction" between basis and cost of goods sold on one hand, and deductible expenses on the other hand.[139] Observing that the mitigating provisions of sections 1311-1314 were drafted by Congress with great precision, the court noted that the term "deduction," which appears several times in section 1312, is never used in connection with errors relating to gross income, such errors being associated instead with the terms "inclusion," "exclusion," and "omission." Thus, the court concluded that Congress intended to use the term "deduction" in section 1312 as a term of art including only deductions from gross income in arriving at taxable income.[140]

In summary, the decisions reveal a clear recognition by the courts of the nature of pre-gross income adjustments and of the fundamental distinctions between such adjustments and statutory deductions from gross income. Giving appropriate effect to those distinctions has, on some occasions, led courts to results which they would have clearly preferred to avoid. The *Cook* case gives an illustration of this where the end result gave the taxpayer a double tax benefit for funds lost by embezzlement.

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137. B.C. Cook & Sons, Inc., 59 T.C. 516 (1972).

138. 65 T.C. at 428. Section 1312(2) authorizes the adjustment sought by the Commissioner if the effect of the previous Tax Court decision had been to allow "a deduction or credit which was erroneously allowed to the taxpayer for another taxable year." I.R.C. §1312(2).

139. 65 T.C. at 428.

140. *Id.* at 430.

Unquestionably, cases involving illegal purchases and payments have provided the courts with their greatest temptation to ignore the distinctions between deductions and pre-gross income adjustments. In nearly all decisions in which the courts have rejected the Commissioner's arguments for disallowing pre-gross income adjustments on grounds of public policy, the majority opinions have carefully disclaimed any condonation of the illegal acts in question. Nevertheless, with the sole exception of the nearly unique situation dealt with by the Tax Court in *Weather-Seal* and the Court of Claims in *Pedone*, the courts have consistently recognized in cases arising under pre-1969 law that pre-gross income adjustments are not subject to disallowance on grounds of public policy, even though the result is an "assymmetrical treatment of above and below the line illegality."[141]

LEGISLATIVE PREEMPTION OF THE PUBLIC POLICY DOCTRINE

In the Tax Reform Act of 1969,[142] Congress enacted sections 162(c), (f), and (g) of the Internal Revenue Code as its own expression of the public policy doctrine and thus preempted an area of the law which, until then, had been delineated almost entirely by decisions of the courts.[143] The legislation, which had its beginnings in a 1965 study by the Joint Committee on Internal Revenue Taxation,[144] included provisions limiting the deduction of bribes and kickbacks, fines and penalties, and treble damage payments under the antitrust laws.

It seems clear that Congress intended the 1969 legislation to replace the entire existing body of decisional law relating to the disallowance of deductions on grounds of public policy. The Senate Finance Committee stated, "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. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions."[145]

With such a clear expression in the Senate Report that the 1969 legislation was intended to supercede all of the existing decisional law involving disallowance of deductions on grounds of public policy, one wonders why Congress failed to incorporate language to that effect in the statute itself. Only future decisions will tell whether the courts will fully implement Congress' uncodified intention that the prior decisional doctrine be completely dismantled.[146]

141. James Alex, 70 T.C. 322, 332 (1978).

142. Tax Reform Act of 1969, Pub. L. 91-172, tit. IX, §902, 83 Stat. 648 (1969), 1969-3 C.B. 147 (codified at I.R.C. §§162(c), (f), (g)).

143. Exceptions to this were in the areas of gambling losses and government bribes. I.R.C. §165(d), which limits the deduction of losses from wagering transactions only to the extent of gains from those transactions, was originally enacted in 1934. *See also* wage and price control legislation enacted during World War II and the Korean War, *e.g.*, Stabilization Act of 1942, ch. 578, §5(a), 56 Stat. 767 (1942); Defense Production Act of 1950, ch. 932, tit. IV, §405, 64 Stat. 807 (1950).

144. Staff Study of Income Tax Treatment of Treble Damage Payments Under the Antitrust Laws for the Joint Committee on Internal Revenue Taxation (Nov. 1965).

145. S. REP. No. 91-552, 91st Cong., 1st Sess. (1969), 1969-3 C.B. 423, 597.

146. Some courts have interpreted the public policy doctrine as establishing a test for

There is certainly no indication, either in the 1969 Act itself or in the committee reports, that Congress intended to overrule the earlier decisions which had precluded the disallowance of pre-gross income adjustments on public policy grounds. All three subsections added to section 162 by the Tax Reform Act of 1969 incorporate as their key operative clause the language, "no deduction shall be allowed under subsection (a) . . . ."[147] No other code section was amended by the public policy legislation contained in the Act. Thus, the Act itself specifies that its limiting public policy provisions operate only upon "deductions." Supplementing that unambigous expression of intent, the Senate Finance Committee explained the problem necessitating the legislation in the following manner:

> At the present time there is not [sic] statutory provision setting forth a general "public policy" basis for denying deductions which are "ordinary and necessary" business deductions. Nevertheless, a number of business expenses have been disallowed on the ground that the allowance of these deductions would be contrary to Federal or State "public policy."[148]

The foregoing seems clearly to confirm that Congress had no thought of extending the operation of its 1969 public policy provisions to pre-gross income adjustments. Had it so intended, there is ample evidence elsewhere in the Code that Congress knew and had previously used appropriate language to implement such a purpose.[149] Moreover, it is proper to assume that Congress was familiar with the body of decisional law which draws fundamental distinctions with constitutional overtones[150] between deductions and pre-gross income adjustments, including several opinions in which the court expressly attributes to Congress an awareness of such distinctions.[151] Last, and perhaps most obvious, had Congress intended to enact limitations affecting the computation of gross income, it would not have chosen to codify such legislation in section 162, a section of the Code historically dedicated to business deductions from gross income.[152]

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deductions entirely separate from the term "ordinary and necessary," *e.g.*, Frederick Steel Co., 42 T.C. 13 (1966), *rev'd on other grounds*, 375 F.2d 351 (6th Cir.), *cert. denied*, 389 U.S. 901 (1967). Others incorporate the public policy doctrine as a part of the interpretation of that term, *e.g.*, Textile Mills Sec. Corp. v. Commissioner, 314 U.S. 326, 339 (1941); Dixie Machine Welding & Metal Works Inc. v. United States, 315 F.2d 439, 1963-1 U.S. Tax Cas. ¶9355 (5th Cir. 1963), *cert. denied*, 373 U.S. 950 (1963); Joe Money Machinery Co. v. United States, 1961-1 U.S. Tax Cas. ¶9418 (N.D. Ala. 1961); Sarah Backer, 1 B.T.A. 214 (1924). The impact of the 1969 legislation on those deductions will probably not be uniform in the future decisions.

147. I.R.C. §§162(c), (f), (g).

148. S. Rep. No. 552, 91st Cong., 1st Sess. (1969), 1969-3 C.B. 423, 596.

149. *See, e.g.*, I.R.C. §§1312, 1382(a), 6501(e)(1)(A)(i).

150. See text accompanying notes 43-62 *supra*.

151. *See, e.g.*, Lela Sullenger, 11 T.C. 1076 (1948), discussed at text accompanying notes 34-35 *supra*, and B.C. Cook & Sons, Inc., 65 T.C. 422 (1975), discussed at text accompanying notes 136-140 *supra*.

152. The Treasury seems to acknowledge this point, since in interpreting the 1969 legislation as affecting the computation of gross income, it amended its regulations under §61. See Treas. Reg. 1.61-3(a), T.D. 7285, 1973-2 C.B. 163, and text accompanying notes 167-171 *infra*.

In 1971, Congress again amended section 162(c) of the Code relating to bribes and illegal kickbacks.[153] Congress broadened the heading of section 162(c) to read "Illegal Bribes, Kickbacks, and Other Payments," restated and broadened the scope of the provision disallowing deductions for bribes and kickbacks,[154] and added a provision denying deductions for kickbacks, rebates, bribes, and referral fees for goods or services, payment for which is to be made under the Social Security Act or from federal funds approved under the Act.[155] Except for the latter section, the 1971 amendment was given retroactive effect to the enactment date of the 1969 Act.

As for its purpose in amending the provision disallowing deductions for bribes and kickbacks, the Senate Finance Committee explained:

> Present law also provides that no tax deduction is to be allowed for payment of illegal bribes or kickbacks where, as a result of the payment, there is successful criminal prosecution. If the bribe or kickback does not constitute a criminal act (presumably even if there is a loss of license), or if the taxpayer is not successfully prosecuted, the deduction is not disallowed under this provision.
>
> The committee has become concerned that these provisions, enacted in 1969, may in some cases unduly restrict the denial of deductions.[156]

Again, as in the 1969 Act, Congress failed to refer to pre-gross income adjustments in the legislation, or in the committee explanation.[157] Thus, though intending to broaden the scope of the provision dealing with kickbacks and bribes, Congress clearly intended no extension of its application beyond the area of statutory deductions. This view is further confirmed in the Senate Finance Committee report: "The committee continues to believe that the determination of when a deduction should be denied should remain under the control of Congress. However, the committee has concluded that the area in which deductions are denied should be expanded somewhat beyond the limits set in 1969."[158]

THE COMMISSIONER'S PUBLIC POLICY REGULATIONS

On December 6, 1972, the Commissioner published a package of proposed regulations, purportedly "to conform the Income Tax Regulations . . . under sections 61, 162, 212, and 471 of the Internal Revenue Code of 1954 to section 902 of the Tax Reform Act of 1969."[159]

First, with respect to section 162, the only code section actually amended by

153. Pub. L. No. 92-178, tit. 111, §310(a), 85 Stat. 525 (1971) (codified at I.R.C. §162(c)).
154. *Id.*
155. *Id.*
156. S. REP. No. 92-437, 92d Cong., 1st Sess. (1971), 1972-1 C.B. 559, 599.
157. The amendment creating §162(c)(3), relating to Medicare- and Medicaid-related kickbacks, did use the word "rebate," and presumably was intended to operate upon rebates otherwise characterized as deductions. Pub. L. No. 92-178, tit. 111, §310(a), 85 Stat. 525 (1971).
158. 1972-1 C.B. at 599.
159. PROPOSED TREAS. REG. §§1.61-3, 1.162-1, 1.162-18, 1.162-21, 1.212-1, 1.471-3, 37 Fed. Reg. 25936 (1972).

the two acts which the regulations purport to interpret, final amended regulations were adopted on February 20, 1975[160] affecting three paragraphs.[161] The regulations acknowledge the congressional intent to supercede all prior decisons involving the disallowance of deductions on grounds of public policy. Implementing that intent, Treasury Regulation section 1.162-1 provides:

> 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 deduction would frustrate a sharply defined public policy. See section 162(c), (f) and (g) and the regulations thereunder.[162]

Amendments to Regulation section 1.162-18 set forth the interpretations of Code section 162(c) as amended by the 1969 and 1971 acts,[163] while Regulation section 1.162-21 sets forth interpretations of section 162(f)[164] dealing with fines and penalties.

The final regulations also contain amendments to Regulation section 1.212-1.[165] The thrust of this amendment was to conform the test of section 212 deductions for expenses incurred in the production of income to the new standards enacted by Congress for testing business deductions under section 162. Though Congress did not specifically amend section 212 in 1969 and 1971, it seems clear that the public policy doctrine in effect prior to 1969 was applicable to deductions under section 212 as well as section 162.[166] Thus, amendments to the regulations under section 212 seem consistent with congressional intent.

In addition to amendments to the regulations under sections 162 and 212, the Commissioner also amended regulations under both sections 61 and 471 of the Code.[167] The amendment to Regulation section 1.61-3(a) provides that "gross income is determined without subtraction of . . . amounts which are of a type for which a deduction would be disallowed under section 162(c), (f), or (g) in the case of a business expense."[168] Consistent with this interpretation of section 61, the amendment to Regulation section 1.471-3 provides that the

160. T.D. 7345, 1975-1 C.B. 51.

161. TREAS. REG. §§1.162-1 (relating to business expenses), 1.162-18 (relating to illegal bribes and kickbacks), 1.162-21 (relating to fines and penalties), T.D. 7345, 1975-1 C.B. 51.

162. TREAS. REG. §1.162-1, T.D. 7345, 1975-1 C.B. 51.

163. TREAS. REG. §1.162-18, T.D. 7345, 1975-1 C.B. 51. These regulations are examined in Meltzer, *Are Proposed Kickback Regulations an Unwarranted Extension of the Code?*, 38 J. TAX. 166 (1973); Note, *Federal Income Taxation—Public Policy and the Deductibility of Kickbacks Under §162((c)(2)*, 35 OHIO ST. L.J. 686 (1974).

164. T.D. 7345, 1975-1 C.B. 51, *amended by*, T.D. 7366, 1975-2 C.B. 64.

165. A new subparagraph (p) titled "Frustration of Public Policy" was added to TREAS. REG. §1.212-1, T.D. 7345, 1975-1 C.B. 51.

166. A search of §212 revealed no cases in which the public policy doctrine was used to disallow a deduction under that section.

167. Amendments to TREAS. REG. §1.61-3(a) proposed on December 6, 1972, as part of the "package" to conform the regulations to the "public policy" legislation in 1969 and 1971 (see note 159 *supra*), were separately adopted in final form on September 19, 1973, in T.D. 7285, 1973-2 C.B. 163, while the proposed amendment to TREAS. REG. §1.471-3 (Inventories at Cost) was finalized along with the rest of the same package on February 20, 1975. T.D. 7345, 1975-1 C.B. 51.

168. TREAS. REG. 1.61-3(a), T.D. 7285, 1973-2 C.B. 163.

"cost" of inventories shall not include any amount which is of a type for which a deduction would be disallowed under section 162(c), (f), or (g), and regulations thereunder, in the case of a business expense. In the introductory notes to Treasury Decision 7345, the Commissioner offers the explanation that the amendments to the regulations under sections 61 and 471 are designed to prevent the congressional intent as embodied in the 1969 and 1971 public policy legislation from being circumvented by the allowance under those sections of deductions which Congress explicitly denied by its amendments to section 162.[169]

In the author's view, the final regulations under both sections 61 and 471 represent clearly unwarranted and unauthorized extensions of Congress' 1969 and 1971 public policy legislation amending Code section 162. Moreover, they are in irreconcilable conflict with virtually all relevant decisions based on pre-1969 law. The clear thrust of these regulations is to accomplish by administrative fiat that which both the courts and the Congress had clearly and deliberately refused to attempt, that is, the extension of the public policy doctrine to the area of pre-gross income adjustments.

Regulation section 1.61-3(a), as now amended, clearly defies the Tax Court decisions in the milk rebate cases.[170] In Revenue Ruling 77-244,[171] the Commissioner dramatized the effect of the new section 61 regulation by applying it in a factual context so similar to the facts in *Pittsburgh Milk* as to render the two cases indistinguishable. Thus, although the rebates described in the ruling were properly cast as subtractions from gross sales in determining gross income, Regulation section 1.61-3(a) nevertheless called for those subtractions to be subjected to the tests prescribed in Code section 162(c)(2), which resulted under the assumed facts in their disallowance as an adjustment in the computation of gross income.

RELEVANT DECISIONS UNDER THE NEW LAW

Having originally nonacquiesced in the *Pittsburgh Milk* decision,[172] the Commissioner shifted his ground and acquiesced[173] after the last two milk rebate cases[174] were decided adversely to his position in April, 1961. However, after the adoption of his final regulations interpreting and supplementing Congress' public policy legislation, the Commissioner was prepared to relitigate the question of the public policy doctrine as applied to pre-gross in-

169. T.D. 7345, 1975-1 C.B. 51.

170. Curiously, while the amendment to TREAS. REG. §1.61-3(a) was adopted (apart from the rest of the public policy amendments) on September 19, 1973, T.D. 7285, 1973-2 C.B. 163, the Commissioner continued to acquiesce in the *Pittsburgh Milk* decision until 1976. *See* 1976-2 C.B. 3 where the Commissioner withdrew his acquiescence in Pittsburgh Milk Co., Atzingen-Whitehouse Dairy, Inc., Lela Sullenger; and 1977-1 C.B. 2, where the Commissioner withdrew his acquiescence in Allen Schiffman.

171. Rev. Rul. 74-244, 1977-2 C.B. 58.

172. 1959-1 C.B. 6.

173. 1962-2 C.B. 5.

174. Atzingen-Whitehouse Dairy, Inc., 36 T.C. 173 (1961), Bloomingdale Dairy Co., Inc., 20 T.C.M. (CCH) ¶24,803 (1961).

come adjustments. In anticipation of the trial of his first case[175] he withdrew his acquiescence in the *Pittsburgh Milk* decision on August 16, 1976, substituting a nonacquiescence.[176]

The Sobel *Case*

The first case decided involving the Commissioner's renewed effort to apply the public policy standards to pre-gross income adjustments was *Max Sobel Wholesale Liquors.*[177] In that case, the petitioner was a California corporation engaged as a liquor wholesaler in the San Francisco Bay area. Petitioner was licensed under the California liquor laws by the Department of Alcoholic Beverage Control of the State of California. California law required that liquor wholesalers file, or "post," each month the selling prices for liquor and wine to be sold by them. Sales at prices varying from the posted prices constituted violations of California law. The prices posted by the wholesalers were "suggested" by producers and importers, and a wholesaler who refused to post and sell at such suggested prices ran the risk that the supplier would terminate his right to distribute the products.

Notwithstanding the posted prices, wholesale dealers in the San Francisco Bay area, including the petitioner, offered credits, discounts, and rebates to preferred customers in order to keep their business. Petitioner utilized a "credit" arrangement with select customers whereby the purchase of stated quantities of specific brands, at posted prices would entitle the customer to a "credit" with which the customer could acquire additional spirits without further consideration.

The Tax Court viewed such arrangements as rebates "in kind," indistinguishable from cash rebates, and stated the issue for decision as "whether such rebates, regardless of form, come within the scope of section 162(c)."[178]

The court's first inquiry was whether the rebates constituted an illegal bribe, kickback, or other illegal payment otherwise deductible under section 162(a).[179] Reviewing the milk rebate decisions and finding those cases factually indistinguishable, the court concluded that the payments in question were not deductions, but reductions of gross income.[180]

The Commissioner argued that *Pittsburgh Milk* had been overruled by the United States Supreme Court in *Tank Truck Rentals v. Commissioner*[181] as well as in *Commissioner v. Tellier.*[182] Finding both contentions "wholly lacking in merit,"[183] the court also commented on the inconsistency of the Commis-

175. Max Sobel Wholesale Liquors, 69 T.C. 477 (1977).
176. 1976-2 C.B. 3.
177. 69 T.C. 477 (1977).
178. *Id.* at 481-82.
179. *Id.* at 482.
180. *Id.* at 483.
181. 356 U.S. 30 (1958).
182. 383 U.S. 687 (1966).
183. 69 T.C. at 484. The Commissioner's argument that *Tank Truck Rentals* overruled *Pittsburgh Milk* had been raised and rejected by the Tax Court in Harmony Dairy Co., 19 T.C.M. (CCH) ¶24,203 (1960).

sioner's argument with his tax policy relating to *Pittsburgh Milk* as expressed during previous years. The court noted that the Commissioner had announced his acquiescence in *Pittsburgh Milk* after the Supreme Court's decision in *Tank Truck Rentals*.[184] Moreover, he had not withdrawn his acquiescence in *Pittsburgh Milk* until ten years after the Supreme Court had decided *Tellier*.

The court next considered the Commissioner's contention that the 1969 and 1971 public policy legislation had overruled *Pittsburgh Milk* and related decisions. Concluding that the legislation dealt only with deductions while *Pittsburgh Milk* involved exclusions from gross income, the court refused to infer that Congress had intended to overrule those decisions.[185] To the contrary, the court attributed to Congress knowledge of the milk rebate decisions at the time it enacted the 1969 legislation and reasoned that had Congress intended to overrule those decisions it would have done so with specificity and not by implication. Finding no evidence of such congressional intent in either the statute or the committee reports, the court confirmed the continuing vitality of *Pittsburgh Milk* and related decisions.[186]

Having thus reconfirmed *Pittsburgh Milk*, the court examined the Commissioner's new regulations under sections 61 and 471. It avoided a decision on the validity of the regulations by assuming without deciding that they were valid but announced that it would interpret both regulations so as to confine them to an extremely narrow scope of operation:

> In our opinion, assuming the validity of the regulations, the rule stated would not apply in the case before the Court. Depending upon the nature of the business, the cost of goods sold may include material, labor, and overhead. There may be certain expenses of a dual character which may be chargeable either to overhead in the cost of goods sold or deducted as administrative or sales expense. In any event, the Court would limit the regulations as to preclude the deductibility of an illegal payment charged to overhead in the cost of sales *of the type* which might otherwise be deductible as administrative or sales expenses. A typical example would be a bribe given for the purpose of obtaining goods or for the purpose of expediting its delivery to the taxpayer for manufacture and resale.[187]

The petitioner had included as part of its cost of goods sold amounts representing the cost of inventory given to customers in consideration of the "credits." Applying its restrictive interpretation of the Commissioner's new regulations, the court held that such costs did not constitute an overhead or indirect expense charged to the cost of sales and thus were not "of a type" for which a deduction would be disallowed under section 162(c)(2).[188] Accordingly, it held the rebates in question to be proper and allowable deductions from gross sales when tested under the Commissioner's regulations.

The decision in *Sobel* was reviewed by the entire Tax Court. Judge Dren-

184. 1959-1 C.B. 6.
185. 69 T.C. at 484-85.
186. *Id.*
187. *Id.* at 485.
188. *Id.*

nen wrote a dissenting opinion, with Judges Fay, Dawson, and Wiles concurring with his dissent.[189] The four dissenting judges did not disagree with any of the principles expressed in the majority opinion, but indicated they would have reached a different conclusion under the somewhat peculiar facts of the case on grounds not considered by the majority. Pointing out that the "additional" merchandise was delivered to petitioner's customers at no additional charge in satisfaction of the credits recorded in petitioner's "black book," they would have disposed of the case on the ground that these subsequent transactions did not constitute "sales."[190] Citing with apparent approval the *Sullenger*[191] and *Hofferbert*[192] decisions for the principle that the cost of goods sold is properly deducted from gross receipts to prevent the taxation of "more than gross income," the dissent nevertheless argued for an exception under the peculiar facts in *Sobel*: "But surely the cost of merchandise that is not sold but is in fact given away, under whatever scheme may be devised, should not enter into the computation of profit or gross income from the disposition of merchandise in a transaction that produces no gross receipts."[193]

In support of the conclusion he would have reached in *Sobel,* Judge Drennen cited a line of decisions[194] holding that the cost of merchandise withdrawn from inventory for the personal use and benefit of the merchant may not be included in the cost of goods sold. Judge Drennen concluded that while the "cost" of the merchandise given in satisfaction of the credit might be a cost of doing business to the petitioner, he would have required petitioner to prove its deductibility in some way other than by adding it to the cost of goods sold.[195]

Significantly, the dissent expressed no disapproval of the *Pittsburgh Milk* decision, but found it to be distinguishable from *Sobel* on its facts.[196]

The Alex *Case*

The second post-1969 case involving the application of the public policy doctrine to pre-gross income adjustments resulted in a victory for the Commissioner that was greater than he had sought. In *James Alex,*[197] a case before the Tax Court involving facts similar to those in *Schiffman,*[198] the Commissioner sought only to distinguish *Schiffman* on its facts, yet a sharply divided court[199] decided instead to overrule *Schiffman.* In *Alex* the petitioner was a licensed California life insurance agent for Jefferson National Life Insurance

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189. *Id.* at 486.
190. *Id.* at 487.
191. Lela Sullenger, 11 T.C. 1076 (1948).
192. Hofferbert v. Anderson Oldsmobile Inc., 197 F.2d 504 (4th Cir. 1952).
193. 69 T.C. at 487.
194. *Id. See* Demor, Inc., 27 T.C.M. (CCH) ¶29,257 (1968); Appeal of P.P. Sweeten, 3 B.T.A. 37 (1925). *See also* City Ice Delivery Co. v. United States, 176 F.2d 347 (4th Cir. 1949).
195. 69 T.C. at 488.
196. *Id.*
197. 70 T.C. No. 29 (May 24, 1978).
198. Allen Schiffman, 47 T.C. 537 (1967).
199. Judge Wilbur wrote a concurring opinion in which Judges Drennen, Dawson, Simpson, Sterrett, and Wiles concurred. Of the seven judges who dissented, four wrote separate opinions.

Company (Jefferson). Under the terms of his agreement with Jefferson, petitioner saw an opportunity to maximize his agency commissions by adopting a scheme for rebating or discounting premiums to the customer so that, in net effect, the customer could obtain the first two years coverage with little or no cash outlay. He developed two separate plans, one involving a rebate of the commission to the customer and the other involving a discount of a substantial part of the premium. Both plans represented violations of California's insurance laws.

The issue for decision was whether the rebates and discounts given by petitioner constituted a downward adjustment to petitioner's gross income, or were business expenses deductible under section 162. Petitioner conceded that if the latter were the case, such deductions would be disallowed by section 162(c)(2).

In the majority opinion, written by Judge Tannenwald, the court reaffirmed the conclusion it had announced in *Sobel*: section 162(c) did not change the principle established in earlier cases, that discounts or rebates from the purchase price are generally treated as price adjustments and thus are exclusions from gross income. Reviewing those earlier cases, the court recognized that in all but *Schiffman* the discount or rebate was arranged by the seller directly with the buyer. In *Schiffman*, however, the court had concluded that the issue did not turn on whether the rebates or discounts resulted from dealings between buyer and seller[200] and had permitted customer rebates and discounts of insurance premiums to be treated as exclusions from gross income.

In a nine-to-seven decision grounded completely on policy considerations and marked by sharp dissents, the court held that the petitioner's discounts and rebates to customers were not properly excluded from gross income, but would have to stand the test as business deductions. In reaching this decision, the court felt compelled to recede from its ruling in *Schiffman* which had extended the *Pittsburgh Milk* doctrine to rebates of commissions between agents and principals:

> After careful consideration, we now think that any claim of exclusion from gross income, based upon an adjustment to the purchase price resulting from a discount or rebate, should at most be available only to the buyer or the seller and that our decision in *Schiffman* is inconsistent with this principle and should be overruled.[201]

Thus, from *Alex* emerged the principle that if the person giving the discount or rebate is not the seller, but a commercial middleman, there can be no selling price to which any adjustment as to him might be applied. Thus, any tax benefit to such person must come by way of a deduction from gross income if available under the statutes.

In a concurring opinion,[202] Judge Wilbur compared the *Schiffman* rule to

200. In fact, the *Schiffman* case had turned on the court's application of the claim of right doctrine. *See* 47 T.C. at 541, and text accompanying note 209 *infra*.

201. 70 T.C. No. 29 at 2873.

202. *Id.* at 2874.

the principle represented by *Jack Williams*,[203] a case in which a real estate salesman buying real estate from his employer and receiving commissions therefor was required to treat those commissions as gross income rather than as an adjustment to the purchase price. He noted a great inconsistency between the *Williams* and the *Schiffman* decisions. In the latter the taxpayer had been permitted to exclude commissions which he had rebated to customers.

Ultimately, the concurring opinion, like the majority opinion, revealed that it was primarily policy-based:

> Indeed petitioner's interpretation would, at the minimum, potentially remove virtually all commission income from the scope of section 162(c)(2). This would be anomalous in the extreme since the kickback of commission income was a significant if not predominant part of the evil Congress perceived in enacting section 162(c)(2).
> The asymmetrical treatment of above and below the line illegality is no tribute to judicial logic. It should be narrowly circumscribed.[204]

The dissenting opinions objected to the decision on various grounds. Judge Raum considered that *Schiffman*, though a close case, had been correctly decided and should not be overruled.[205] Judge Quealy noted, with irony, that the majority had gratuitously overruled *Schiffman* when the Commissioner had not asked the court to do so,[206] in a case involving a taxable year during which *Schiffman* not only represented the rule of the Tax Court, but was acquiesced in by the Commissioner.[207] Under those circumstances, he would not have overruled *Schiffman* unless Congress had so intended, which, he concluded, was not the case.

Judge Goffe objected to overruling the *Schiffman* case, particularly in view of the failure of the Commissioner to contend for such a result, on grounds that it unfairly deprived the petitioners of the opportunity to defend the *Schiffman* decision and offended the doctrine of *stare decisis*. He pointed out that the *Schiffman* decision had never been criticized in any court opinion since it had been entered eleven years earlier; that it had been acquiesced in by the Commissioner until shortly before the *Alex* case arose; and that the Commissioner had not asked for it to be overruled. Judge Goffe asserted that under such circumstances, the petitioner had every right to rely on *Schiffman* as reflecting the law on the subject in the Tax Court.[208]

Judge Goffe also pointed out that the majority overruled *Schiffman* without even discussing the claim of right doctrine upon which the *Schiffman* court had expressly rested its conclusions. Analyzing that doctrine himself, he concluded that the petitioner had no claim of right to the commissions which he had agreed to rebate or discount: "I strongly oppose warping the claim of right

203. 64 T.C. 1085 (1975).
204. 77 T.C. No. 29 at 2878.
205. *Id.* at 2879.
206. *Id.*
207. *Acquiesced in*, 1967-2 C.B. 3; *nonacquiesced in*, 1977-2 C.B. 2.
208. 77 T.C. No. 29 at 2881.

doctrine in favor of respondent when he didn't ask for it to construct phantom income and a phantom deduction that must be denied under section 162(c)."[209]

A fourth dissenting opinion was written by Judge Chabot, and reflected four points of disagreement.[210] First, the majority's stated reason for its decision, that is, an opposite decision would "open the door to wholesale evasion of the purposes of section 162(c)," was wholly unsubstantiated in the record. During the eleven years since the *Schiffman* decision had been entered, the mischievous potential which the majority attributed to it had not been demonstrated before any court.

Second, in deciding *Schiffman,* the court had not been impressed by the Commissioner's effort to distinguish that case from the milk rebate cases. Judge Chabot contended that the *Alex* majority did not explain why now, in *Alex,* it considered such a distinction justified. The main thrust of his opinion was to point out the lack of any effort by the majority to support its decision on other than policy-oriented grounds. The latter ground, namely, "the floodgate to abuses" argument, Chabot considered to be unsupported.

Third, the decision produced bad law which might distort results in unrelated issues involving distinctions between gross income adjustments and business deductions. Fourth, the *Ostheimer*[211] and *Williams*[212] cases had been distinguished in the *Schiffman* decision, and neither the majority nor concurring opinions in *Alex* gave any reason for rejecting the court's earlier analysis of those cases.

The *Alex* decision, now on appeal to the Ninth Circuit, seems difficult to justify. Though the majority rested its decision, in language conveying almost a sense of urgency, on the assertion that a contrary decision would open the door to wholesale evasion of the purposes of section 162(c), the Commissioner's failure to seek the overruling of *Schiffman* would lead one to discount the threat of such abuses. Also significant is the fact that the *Schiffman* decision preceded the amendment of section 162(c) in the Tax Reform Act of 1969 by two years and the expansion of that subsection in the Revenue Act of 1971 by four years. If Congress considered the *Schiffman* decision a threat to the policy underlying section 162(c), neither the statute nor the committee reports reflect any such concern. In the absence of congressional objection to the *Schiffman* decision, the policy grounds relied on by the court seem conjectural at best, and the court's unsolicited reversal of *Schiffman* without opportunity for debate by the litigants seems unduly harsh.

As for the reliance placed on the *Ostheimer*[213] and *Williams*[214] cases in

209. *Id.* at 2882.

210. *Id.*

211. Ostheimer v. United States, 264 F.2d 789 (3rd Cir.), *cert. denied,* 361 U.S. 818 (1959).

212. Jack Williams, 64 T.C. 1085 (1975).

213. Ostheimer v. United States, 264 F.2d 789 (3rd Cir.), *cert. denied,* 361 U.S. 818 (1959). Petitioner, a life insurance agent, received commissions on premiums which he had placed on the lives of his partner, key employees, and children. Although petitioner argued that the commissions constituted rebates and, as such, reduced the price of the policies, the court found that since state law prohibited the rebating of insurance commissions, the payments could not have constituted rebate. Rather, the commissions were gross income to the taxpayer.

214. In Jack Williams, 64 T.C. 1085 (1975), petitioner, a real estate salesman, received

Judge Wilbur's concurring opinion, there would seem to be real distinctions between the facts in those cases and those before the court in *Alex. Ostheimer* and *Williams* represented no new law in the Tax Court. The same principles had been established prior to *Schiffman*, as reflected in *Commissioner v. Daehler*[215] and *George E. Bailey*.[216] The latter decisions were advanced by the Commissioner and distinguished by the Tax Court in *Schiffman* with the following explanation:

> In those cases, it can at least be maintained that the taxpayer did receive something as compensation in connection with his employment, namely, the excess of the fair market value of the item over what he paid for it. By way of contrast, petitioner herein neither realized nor could have realized anything beyond the amount he actually reported as income.[217]

The foregoing analysis, relied upon by the *Schiffman* court as a rationale for distinguishing the principles reflected in the *Ostheimer* and *Williams* cases, seems valid, at least to the author. Yet Judge Wilbur's concurring opinion in *Alex* reversed the view reflected in the above-quoted excerpt from *Schiffman* with only the following explanation:

> It is difficult to see how "commissions" on [sic] "discounts" must be included in gross income when a partner, your children, or even the salespersons themselves are the purchasers, but may be excluded where a typical customer is involved. If the former is includable, *a fortiori*, so is the latter.[218]

The policy and doctrinal bases for decision in *Alex* are now being examined by the Ninth Circuit Court of Appeals. However that court might evaluate the issues, the case is, in Judge Raum's words, a close one,[219] and further litigation in other courts might well be expected before the issue can be considered settled.

CONCLUSION

It seems clear that the Commissioner will continue and probably expand his effort to impose public policy considerations as a limitation upon the allowance of pre-gross income adjustments. The unexpected proportions of his success before the Tax Court in *Alex* can only serve to encourage probes into other aspects of this question.[220]

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commissions on each consummated sale arranged by him. He purchased property for his account and received, in that year, a commission on those transactions. In the same year petitioner reacquired property from a third person to whom he had originally sold the property. He argued that in both instances the commissions he received were excluded from income, constituting a reduction in the purchase price of the property. The Tax Court held that the amounts in quetion were compensation for services.

215. 281 F.2d 823 (5th Cir. 1960), *rev'g*, 31 T.C. 722 (1959).

216. 41 T.C. 663 (1964).

217. 47 T.C. 537, 542 (1967).

218. James Alex, 70 T.C. at 322.

219. *Id.* at 2879 (Raum, J., dissenting).

220. The case of Haas Brothers, Inc., docket No. 5219-76, is currently awaiting decision in the Tax Court.

It is highly unlikely that any court would conclude that Congress intended to deal with the subject of pre-gross income adjustments in the public policy provisions of the Tax Reform Act of 1969,[221] or in the 1971 Amendments.[222] The statutory language itself, its placement in the Code, and the committee explanations all make it quite clear that Congress intended the scope of its legislation to be coterminous with the concept of deductions from gross income.

With the exception of emergency legislation enacted under its war powers during World War II and the Korean conflict,[223] Congress has never attempted to apply the income tax beyond the traditional and supposed constitutional barrier of gross income.

If Congress did not intend, in its 1969 and 1971 public policy legislation, to change existing decisional law relating to the allowance of pre-gross income adjustments, questionable conclusions may be reached as to the validity of (1) Regulation section 1.61-3(a), providing that gross income may not be reduced by payments which would not qualify for deduction under the public policy provisions of section 162, and (2) Regulation section 1.471-3(a), providing that cost of goods sold may not be increased by payments not qualifying for deduction under those same provisions. Except for *Weather-Seal* and related cases, which subsequent decisions reveal to be limited as precedent to the unusual wartime wage and price control statutes there involved, the decisions under pre-1969 law confirm gross income as the upper limit for application of the public policy doctrine. Clearly, then, the regulations in question are not consistent with, or declaratory of, the existing decisional law.

In announcing the adoption of the final regulations, Treasury Decision 7345 suggests that changes in the regulations under section 61 and section 471 were necessary in order that the congressional intent underlying the 1969 and 1971 amendments to section 162 would not be frustrated by the allowance of items under section 61 and section 471 which would be subject to disallowance under section 162. It is reasonable to presume that Congress would have enacted legislation in 1969 and 1971 to correct the uneven application of the public policy doctrine to above and below-the-line items (1) if it considered such legislation to be within its constitutional authority, and (2) if it had decided, as a matter of legislative policy, to apply the federal income tax beyond the traditional limit of gross income. Congress having taken no such measures, one must conclude that the regulations in question are wholly without statutory authorization. In the author's view, they raise the very constitutional issues which Congress, since the adoption of the sixteenth amendment, has seen fit to avoid.

The *Sobel* case represents the first occasion for judicial scrutiny of those regulations. Although in that case the Tax Court assumed without deciding their validity, it emasculated them with an extremely narrow construction.[224]

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221. See note 142 *supra*.

222. See note 153 *supra*.

223. See text accompanying notes 48-82 *supra*.

224. While technically *Sobel* dealt only with an adjustment to cost of goods sold, and thus involved only Treasury Regulation §1.471-3(d), it seems clear that the Tax Court would limit the scope of Treasury Regulation §1.61-3(a) to the same extent.

According to this construction, the regulations could apply only to those "borderline" items which reasonably could be classified either in an "above-the-line" category or a "below-the-line" category.[225]

In principle, the application of the public policy doctrine to such borderline items seems reasonable. Presumably, the same result could be reached in a future case before the Tax Court, even if the *Sobel* court had declared the regulations invalid on their face, by a judicial finding that the borderline item in question was properly classified as a deduction from gross income and not as a pre-gross income adjustment. Moreover, had the court interpreted the regulations literally, as subjecting *all* items adjusting gross income to the public policy tests of section 162, it would have found it necessary to determine their validity by considering and deciding the obvious constitutional question which they raise. The avoidance of such constitutional issues by construction, even strained construction, has long been accepted as sound judicial policy.

The *Sobel* and *Alex* decisions prompt the inquiry whether the *Sullenger* and *Pittsburgh Milk* line of decisions are still operative. If the Commissioner's regulations might be analogized to a fifth column effort to infiltrate and undermine the vitality of *Pittsburgh Milk* and *Sullenger, Sobel* represents a frontal assault on those decisions. Not only did the Commissioner argue that Congress had impliedly overruled *Pittsburgh Milk* in its 1969 and 1971 legislation, but he also resurrected the argument, rejected earlier by the Tax Court in the *Harmony Dairy* case,[226] that *Pittsburgh Milk* had been overruled by the Supreme Court decision in *Tank Truck Rentals*. The *Sobel* court noted that the Commissioner had withdrawn his nonacquiescence in *Pittsburgh Milk* and substituted an acquiescence after the Supreme Court's decision in *Tank Truck Rentals*. The court, considering the *Tank Truck Rentals* and *Tellier* arguments together, rejected both positions as "wholly lacking in merit."

It is significant that the four dissenters in *Sobel* advanced no criticism whatsoever either of the *Pittsburgh Milk* or *Sullenger* decisions, but instead acknowledged the continuing vitality of both. They argued as the basis for their dissent that a taxpayer should not be allowed to report as cost of goods sold the cost of merchandise which was not sold by the taxpayer but given away. Their reference here was to the fact that the petitioner had "given" merchandise to its customers in satisfaction of "credits," receiving no additional consideration.[227] Since the merchandise had not been sold, the dissenters would have required the petitioner to establish any right to tax benefit for its cost "in some way other than by including it in the cost of goods sold."

The *Alex* decision terminates, at least in the Tax Court, the "*Schiffman* extension" of the *Pittsburgh Milk* rule. At the same time, the majority opinion clearly reconfirms that the 1969 and 1971 legislation has not devitalized *Pittsburgh Milk* and other cases in that line. After *Alex*, the exclusion from gross income of amounts rebated back to the purchaser pursuant to a previous agreement is available (at least in the Tax Court), only to a principal in the trans-

225. Max Sobel Wholesale Liquors, 69 T.C. 477, 485 (1977).

226. *Id.* at 483. Harmony Dairy Co., 19 T.C.M. (CCH) ¶24,203 (1960).

227. 69 T.C. at 486-88 (Drennan, J., dissenting).

action, that is, to the seller and not to an agent. When the seller's agent, by agreement entered into prior to the transaction, returns a portion of his commission to the purchaser, he must, if *Alex* becomes general law, include the full amount of the commission in gross income and look to section 162 for deduction of the rebated amount. If the rebate arrangement runs afoul of section 162(c)(2), he will lose his deduction and thus will experience phantom income. While *Alex* will confine the future scope of application of the *Pittsburgh Milk* doctrine to rebates and discounts between principals, it does nothing to devitalize the *Pittsburgh Milk* ruling itself.

In view of the consideration given in this article to the *Weather-Seal* line of cases, it seems appropriate to conclude with an evaluation of its status in the current law. It is of interest that the Tax Court's interpretation of the regulations under sections 61 and 471 does not reflect an adherence to the rule in *Weather-Seal*. Accordingly, direct labor compensation, properly chargeable to cost of goods sold, will not be isolated as a special class of pre-gross income adjustments which may be disallowed on grounds of public policy. Though the *Sobel* case did not involve such direct labor charges, there is little doubt that, viewed as a separate class of expenditures, they would not fall within the narrow scope of operation to which the Tax Court will restrict the Commissioner's regulations.

The *Weather-Seal* decision has admittedly influenced the outcome of several cases decided subsequently by the Tax Court. One of the doctrinal anomolies resulting from the application of *Weather-Seal* is seen in the *Reynolds Tobacco* case where, in a memorandum decision,[228] Judge Fisher cited *Weather-Seal* as authority for his holding that direct cost wages may be disallowed to the extent they are found unreasonable in amount. His holding, which the author believes to be incorrect, was reviewed neither by the entire Tax Court nor by the Fourth Circuit on appeal, and should not be considered as the settled law on this issue in the Tax Court or in any other court jurisdiction.

It is of interest to note that in more recent post-war price control legislation Congress has not attempted to legislate or authorize disallowance of the over-ceiling portion of wages or price payments as a part of the price control legislative package. Apparently, Congress is satisfied with the disallowance mechanisms of section 162(c). At the same time, one notes the Commissioner's national policy of applying Regulation section 1.471-3 to disallow, as cost of goods sold, the over-ceiling portion of amounts paid as rent, wages, or prices in violation of the Economic Stabilization Act of 1970 and Executive Order 14660 issued thereunder.[229] Curiously, the *Weather-Seal* decision is not relied on by the Commissioner as its authority for Revenue Ruling 72-236.[230]

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228. 15 T.C.M. 810 (1956). See note 57, *supra* for a discussion of *Reynolds Tobacco*.

229. This latter point should now be considered inoperative in light of the Tax Court's interpretation of the regulations announced in *Sobel*. With respect to items properly classified as part of cost of goods sold, *Sobel*, *Sullenger* and related decisions continue to assure their allowance in computing gross income.

230. Revenue Ruling 72-236, 1972-1 C.B. 41, addresses the question whether amounts of wages, salaries, rent, and price payments in excess of the amount permitted under Executive Order 11640 (issued pursuant to the Economic Stabilization Act of 1970), are deductible as

There is no present indication of intention on the part of the Internal Revenue Service to recant from the position it advocated in *Sobel* and *Alex.* In fact, a third case, involving similar issues, has already been tried and is awaiting decision in the Tax Court.[231] This decision, and the Ninth Circuit's disposition of *Sobel* and *Alex,* will have considerable influence upon the Commissioner's future policy in this area.[232]

It will no doubt continue to discomfit some jurists that the law dictates opposite results for payments which violate the public policy concepts articulated in section 162, depending upon whether such payments are classified as above the gross income line or below it. However, it is the author's view that such "asymmetrical treatment of above and below the line illegality"[233] is not, as one Tax Court judge has implied, a malfunction of judicial logic. To deny, for any reason, an allowance properly accounted for as an offset to gross income, is tantamount to taxing income when none has been earned. The taxation of gross sales or gross receipts under the guise of income taxation is not authorized by the sixteenth amendment. It is a credit and not an embarrassment to the judiciary that the fundamental and necessary distinctions between pre-gross income adjustments and deductions have been preserved intact, particularly against the ever-present temptation produced by the public policy cases to permit such distinctions to erode and be forgotten.

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business expenses under IRC §162(c)(2). Neither the Economic Stabilization Act nor the Executive Order provided (as had their wartime predecessors) that amounts illegally paid would be disregarded in calculating cost for tax purposes. However, both the law and the Executive Order prescribed fines for violations.

Applying the provision of §162(c)(2), the ruling concludes that the illegally excessive portion of a payment for rent, wages or goods is not allowable as a business deduction under §162. It goes further, however, and noting Treasury Regulation §1.471-3 (then only proposed but later adopted without change), concludes that no illegal rent, wage or price may be included in cost of goods sold.

231. Haas Bros., Inc., Tax Court, docket no. 5219-76.

232. Should the Ninth Circuit affirm the Tax Court's decisions in *Sobel* and *Alex,* the Commissioner may well seek a conflicting decision in another circuit. It should seem unlikely that the Commissioner would seek to obtain such a decision in the First, Fourth, Fifth and Tenth Circuits in light of decisions in those courts affirming and approving of the *Sullenger* decision, in which the fundamental issue was identical to that in *Pittsburgh Milk.*

233. *See* James Alex, 70 T.C. 322 (1978).