Florida Law Review

Volume 6 | Issue 1 Article 7

March 1953

Federal Income Taxation: Disallowance of Deduction on Ground of Public Policy

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as the validity of prohibiting Sunday newspapers or radio and television broadcasts has never arisen at the appellate level. Florida, however, removed itself from this arena in 1941 by specifically exempting the operation of motion picture theaters from the prohibitions of its Sunday laws.[32]

Prediction at this early stage of the practical effects of the instant decision requires caution. From one standpoint it marks another federal limitation upon state police power as previously understood. Furthermore, inasmuch as the more recent trend of regulation of the moving picture industry has been liberal anyhow, this further move of the Supreme Court may have the effect of actually stirring up a dying fire, with resultant effects unfortunate for an industry policing itself well today and steadily improving the quality of its productions. On the other hand, censorship of moving pictures on the basis of sectarian religious beliefs should be nipped in the bud; literal acceptance of human descriptions of miracles can hardly be regarded as essential to religion generally, much less to desirable standards of morality. Application of free speech protection to moving pictures is a logical and desirable step, and the widely desired demise of waning blue laws would constitute another apt illustration of the principle that moral advancement cannot be firmly attained by legislating the populace into what some conceive as goodness.

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FEDERAL INCOME TAXATION: DISALLOWANCE OF DEDUCTION ON GROUND OF PUBLIC POLICY

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

Petitioners, opticians, regularly paid "kickbacks" to prescribing physicians in return for business passed to them in the sale of eyeglasses. The Commissioner of Internal Revenue disallowed the attempted deduction of kickbacks from gross income under Section 23 of the Code[1] and asserted a tax deficiency. The Tax Court[2] and the

[32]FLA. STAT. §855.01 (1951), enacted as Fla. Laws 1941, c. 20450.

[1]INT. REV. CODE §23 (a) (1) (A): "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."

[2]14 T.C. 1066 (1950).

Court of Appeals[3] affirmed the Commissioner, and the Supreme Court of the United States granted certiorari.[4] HELD, if expenditures contrary to public policy are not deductible, that is so only if such policy is sharply defined. Judgment reversed.

The right to deduct expenses does not exist in the absence of statutory authorization.[5] Each case must be decided on its own merits.[6] If an expense frustrates sharply defined national and state policies proscribing particular types of conduct, it may not be considered "ordinary and necessary."[7] Practically any reasonable expenditure which has benefited business has been held deductible,[8] even if it arises only once in a lifetime,[9] provided the transaction involved is one of frequent occurrence in the type of business in which the expense was incurred.[10] Litigation expenses have been allowed;[11] but deductions of agents' lobbying fees in connection with unfavorable legislation,[12] or fines or penalties incurred in violating governmental enactments,[13] have not been permitted. Nor is a taxpayer convicted

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[3]188 F.2d 269 (4th Cir. 1951).

[4]342 U.S. 808 (1950).

[5]New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934); Lincoln Elec. Co. v. Commissioner, 162 F.2d 379 (6th Cir. 1947); Merchants Bank Bldg. Co. v. Helvering, 84 F.2d 478 (8th Cir. 1936); O'Laughlin v. Helvering, 81 F.2d 269 (D.C. Cir. 1935); Barbour Coal Co. v. Commissioner, 74 F.2d 163 (10th Cir. 1934); Underwood v. Commissioner, 56 F.2d 67 (4th Cir. 1932). But see 61 So. AFR. L. J. 194 (1944).

[6]Welch v. Helvering, 290 U.S. 111 (1933); City Ice & Coal Delivery Co. v. United States, 176 F.2d 347 (4th Cir. 1949); Friedman v. Delaney, 75 F. Supp. 568 (Mass. 1948); Johnson v. United States, 45 F. Supp. 377 (S.D. Cal. 1941), *rev'd on other ground*, 135 F.2d 125 (9th Cir. 1943).

[7]Commissioner v. Heininger, 320 U.S. 467 (1943).

[8]See A. Harris & Co. v. Lucas, 48 F.2d 187 (5th Cir. 1931).

[9]Deputy v. du Pont, 308 U.S. 488 (1940); *cf.* Kornhauser v. United States, 276 U.S. 145 (1928).

[10]Deputy v. du Pont, 308 U.S. 488 (1940); Hales-Mullaly, Inc. v. Commissioner, 131 F.2d 509 (10th Cir. 1942).

[11]Commissioner v. Heininger, 320 U.S. 467 (1943); Kornhauser v. United States, 276 U.S. 145 (1928) (dictum lists examples of deductible expenses); Kales v. Commissioner, 101 F.2d 35 (6th Cir. 1939); see S.M. 4078, V-1 CUM. BULL. 226 (1926).

[12]Textile Mills Securities Corp. v. Commissioner, 314 U.S. 326 (1941); T.D. 4626, XV-1 CUM. BULL. 61 (1936).

[13]Commissioner v. Longhorn Portland Cement Co., 148 F.2d 276 (5th Cir. 1945); Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178 (2d Cir. 1931) (state anti-trust law); Great Northern Ry. v. Commissioner, 40 F.2d 372 (8th Cir. 1930) (Federal Safety Appliance Act); Bonnie Brothers v. Commissioner, 15 B.T.A. 1231 (1929) (Volstead Act); Appeal of Columbus Bread Co., 4 B.T.A. 1126 (1926) (state

under a federal or state criminal statute permitted deduction for his attorney's fees,[14] although the deduction is allowed if he is acquitted.[15]

Among expenses held not deductible have been payments made to influence a party precinct captain to obtain state printing contracts,[16] payments by the secretary of a bankrupt corporation to its creditors for the purpose of strengthening his personal credit standing,[17] amounts paid to secure the relocation of a highway to avoid abandoning land,[18] and amounts paid to induce a competitor to discontinue the use of a trade name similar to that of the taxpayer.[19] These are examples of judicial support of disallowances by the Bureau of Internal Revenue even when no prosecution by the Government had occurred; they rest on the ground that such expenditures are contrary to the best interests of the public.[20]

Expenses must be both ordinary and necessary.[21] The words are to be given their everyday meaning.[22] Normalcy of such an expense in the particular business,[23] its appropriateness and helpfulness,[24] the fact that it saved the life of the business for a time,[25] the fact that similar expenses arise in similar situations,[26] and the fact that it was incurred in the usual course of operations,[27] all have been considered by the courts in determining whether a deduction shall be allowed under Section 23 (a) (1) (A).

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anti-trust law); *accord,* Scioto Provision Co. v. Commissioner, 9 T.C. 439 (1947) (violation of OPA price regulations).

[14]Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178 (2d Cir. 1931); Estate of Tompson v. Commissioner, 21 B.T.A. 568 (1930); see 5 BROOKLYN L. REV. 72 (1935).

[15]Citron-Byer Co. v. Commissioner, 21 B.T.A. 308 (1930).

[16]Rugel v. Commissioner, 127 F.2d 393 (8th Cir. 1942).

[17]Welch v. Helvering, 290 U.S. 111 (1933).

[18]Seufert Brothers Co. v. Lucas, 44 F.2d 528 (9th Cir. 1930).

[19]J. I. Case Co. v. United States, 32 F. Supp. 754 (Ct. Cl. 1940).

[20]See Note, 54 HARV. L. REV. 852, 858 (1949).

[21]Deputy v. du Pont, 308 U.S. 488 (1940); Giurlani v. Commissioner, 119 F.2d 852 (9th Cir. 1941); see 18 TEXAS L. REV. 353, 354 (1940).

[22]Hochschild v. Commissioner, 161 F.2d 817 (2d Cir. 1947); Giurlani v. Commissioner, 119 F.2d 852 (9th Cir. 1941).

[23]Deputy v. du Pont, 308 U.S. 488 (1940); Hill v. Commissioner, 181 F.2d 906 (4th Cir. 1950); Giurlani v. Commissioner, 119 F.2d 852 (9th Cir. 1941).

[24]Commissioner v. Heininger, 320 U.S. 467 (1943); Blackmer v. Commissioner, 70 F.2d 255 (2d Cir. 1934).

[25]Commissioner v. Heininger, 320 U.S. 467 (1943).

[26]Amtorg Trading Corp. v. Commissioner, 65 F.2d 583 (2d Cir. 1933).

[27]Hotel Kingkade v. Commissioner, 180 F.2d 310 (10th Cir. 1950).

The instant case held that expenses, once they are determined to be ordinary and necessary, are nondeductible only if they frustrate sharply defined national or state policies evidenced by some governmental declaration thereof. No change has been made in the restricted concept of nondeductibility of expenses that of themselves involve illegality. "We do not have before us the issue that would be presented by expenditures which themselves violate a federal or state law or were incidental to such violations."[28] The broad concept of *ad hoc* administrative creation or identification of public policy through exercise of the taxing power, however, has at least been temporarily limited by the case. The Court voiced no approval of the business ethics of kickbacks or the public policy involved, merely satisfying itself that such expenses were ordinary and necessary.[29] The Court was very likely influenced by the fact that legislation outlawing the practice had recently been passed in North Carolina, where the action arose.[30] In the instant case the amount involved,[31] the fact that doctors receiving payments from petitioner included them in their taxable income, and the nationwide prevalence of the practice,[32] all received the Court's attention; but the opinion emphasized that customs of organized professional associations do not of themselves constitute sharply defined national or state policies.[33]

The decision should increase predictibility; but it may cause a loss of uniformity, since the deductibility of a particular expenditure will depend upon whether the legislature of that particular jurisdiction has declared such expenditures against public policy. This case recognizes the province of legislatures to "translate progressive standards of professional conduct into law,"[34] and state legislatures may follow its lead with appropriate enactments. It might be well for the legislatures to state clearly the implication of the instant decision that violation of sharply defined national or state policy precludes deductibility as a matter of law. In the absence of an overriding federal

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[28]At p. 94.

[29]At p. 93.

[30]N.C. GEN. STAT. §90.255 (1951). Other states have similar statutes, *e.g.*, CAL. BUS. & PROF. CODE §§650, 652 (1951); WASH. REV. CODE §19.68.010 (1952).

[31]$124,107.78, between 56% and 72% of petitioners' taxable income.

[32]At p. 93; *accord*, United States v. American Optical Co., 97 F. Supp. 71 (N.D. Ill. 1951); see Snell, *Some Principles of Medical Ethics Applied to the Practice of Opthamology*, 117 A.M.A.J. 497, 499 (1941).

[33]At p. 97.

[34]*Ibid.*