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PROVISIONS DENYING A DEDUCTION FOR ILLEGAL EXPENSES AND EXPENSES OF AN ILLEGAL BUSINESS SHOULD BE REPEALED

by

Douglas A. Kahn[*]
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ABSTRACT

The federal income tax law denies a deduction for illegal expenses, for any expense (legal or otherwise) of an illegal business that is trafficking in controlled substances, for losses incurred in an unlawful activity, and for bribes, kickbacks, and rebates connected with the Medicare or Medicaid program. In this Article, the authors first describe the current treatment of those items by the tax law. The Article next explains that the current treatment constitutes a penalty for the taxpayer whose deduction is denied, and then explores why such a penalty is bad policy and conflicts with the traditional purposes and goals of punishing wrongful behavior. The principal objection to the penalty imposed by the tax law's denial of deductions for business and profit-oriented expenses is that the manner in which the size of the tax law's penalty is determined is completely arbitrary and bears no relationship to the seriousness of the crime or the conditions under which it was committed. Another objection to the penalty is that it would be litigated in a civil tax suit in which the taxpayer would lack the protections and rights accorded to criminal defendants even though it constitutes a punishment for criminal behavior. The penalty is especially harsh as applied to the legal expenses of a

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* Paul G. Kauper Professor of Law, University of Michigan. We would like to thank Professor Eve Brensike Primus for her insights into United States v. Janis, 428 U.S. 433 (1976), Professor Martin J. McMahon, Jr. for a discussion of what expenses are illegal, and Professor Jerry Israel for insights into the law of bribery. We also thank Professor Rebecca Eisenberg for raising the question of whether the denial of a deduction could be justified as a type of sin tax.

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marijuana business under a more stringent Code provision given the decriminalization of marijuana by many states. The Article also contends that the denial of a deduction for unlawful medical expenses conflicts with the principle allowing the patient a deduction for whatever treatment the patient chooses so long as it is based on a bona fide effort to deal with the illness. The authors recommend that Congress act to eliminate all of these tax penalties.

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I. INTRODUCTION

Currently, the tax law denies a deduction for business expenses that violate a federal or state law (but only if the state law is generally enforced). In addition, losses, including business losses, cannot be deducted if they arise out of an illegal activity. For example, medical expenses are denied a deduction if they are illegal. Kickbacks, bribes, and rebates given in connection with the Medicaid or Medicare program are nondeductible. Any expenses, legal or not, incurred in connection with the conduct of a business of selling a controlled substance that is prohibited by federal law (or by the law of the state in which the business is conducted) cannot be deducted.

It is the contention of the authors that all of those provisions should be repealed and that there should be no restriction on the deductibility of an expense because of its illegality or its connection with an illegal activity. The authors will show in this Article that the current treatment is bad policy and not in accord with the traditional rationale for meting out punishment.

Part II of this Article describes the current tax treatment of illegal expenses and illegal businesses. Part III sets forth the reasons for the authors' contention that those provisions are inappropriate. Part IV sets forth the authors' conclusions.

II. CURRENT TAX TREATMENT OF ILLEGAL EXPENSES AND BUSINESSES

Prior to 1969, the principal basis for denying a deduction for illegal expenses was the common law doctrine that no deduction is allowable if it would frustrate public policy.[1] The Court's denial of a deduction was not grounded on the construction of a Code provision, such as the requirement that an expenditure be an ordinary and necessary business expense to be deductible. Rather, even if the expense was an ordinary and necessary business expense, a deduction was disallowed if its allowance would frustrate a sharply defined public policy.[2] For the doctrine to apply, the national or state policy that would be frustrated must have been evidenced by a governmental declaration and not merely by the mores of the community.[3] In *Tank Truck Rentals v. Commissioner*,[4] the Supreme Court stated that it is not sufficient to deny a deduction where the expenditure incidentally impacts a governmental policy; the courts must weigh the degree of severity of frustration that the allowance of a deduction would cause. The Court further stated that if the expenditure in question is illegal under a state law, "the frustration of state policy is most complete and direct."[5] Despite this broad language, in a companion case that was decided the same day as *Tank Truck Rentals*, *Commissioner v. Sullivan*,[6] the Supreme Court allowed a deduction for rent paid by an Illinois bookmaker even though the payment of that rent for the use of a bookmaking establishment was itself illegal under Illinois statutory law. The *Sullivan* decision was overturned by legislation adopted in 1969 and is discussed below.

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1. *See, e.g.*, Commissioner v. Heininger, 320 U.S. 467, 473 (1943) ("The Bureau of Internal Revenue, the Board of Tax Appeals, and the federal courts have from time to time, however, narrowed the generally accepted meaning of the language used in [s]ection 23(a) in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct.").
2. *Id.*
3. *See* Lilly v. Commissioner, 343 U.S. 90, 97 (1952). Despite that limitation, some courts appear to have denied a deduction because of a distaste for what was done even if no governmental mandate was violated. *See, e.g.*, United Draperies, Inc. v. Commissioner, 340 F.2d 936 (7th Cir. 1964) (disallowing a deduction for a lawful kickback).
4. 356 U.S. 30, 35 (1958).
5. *Id.*
6. 356 U.S. 27 (1958).

A major change took place in 1969 when Congress adopted the Tax Reform Act of 1969,[7] in which Congress amended section 162(c) of the Code. As amended,[8] section 162(c) denies a deduction for the following expenditures:

Section 162(c)(1) denies a deduction for an illegal payment made directly or indirectly to a government official or employee if the payment is a bribe or kickback, or if the payment is made to an official or employee of a foreign government if the payment is illegal under the Foreign Corrupt Practices Act of 1977.[9]

Section 162(c)(2) denies a deduction for any payment (other than one covered by section 162(c)(1)) that "constitutes an illegal bribe, an illegal kickback, or other illegal payment under any law of the United States, or any law of a State" if that state law is generally enforced.

Section 162(c)(3) denies a deduction for bribes, rebates, and kickbacks made in connection with the conduct of Medicare or Medicaid programs. This provision does not require that the bribe, rebate or kickback be illegal.

The Senate Report to the Tax Reform Act of 1969 stated that those amendments replace the common law frustration of public policy doctrine and are exclusive.[10] In other words, after 1969, there is no denial of a deduction for business expenses on common law public policy grounds. Consistent with that legislative history, regulations explicitly provide that "[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."[11]

In addition to adding section 162(c), the Tax Reform Act of 1969 also added section 162(f) to the Code, which denies a deduction for a fine or similar penalty paid to a government for the violation of any law.[12] That provision essentially codifies the holding of *Tank Truck Rentals*.[13]

The common law doctrine denying a deduction for frustration of public policy applied to expenditures that otherwise would have been deductible.[14] The amount paid to purchase an item to be resold is not

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7. P. L. No. 91-172, § 902(b)–(c), 83 Stat. 487, 710 (1969).

8. Subsequent amendments to section 162(c) were made in 1971, 1976, and 1982. The statement in the following text above of the substance of section 162(c) is the current version of that provision and reflects those subsequent amendments.

9. Pub. L. No. 95-213, 91 Stat. 1494 (1977).

10. S. REP. NO. 91-552, at 274 (1969).

11. Reg. § 1.162–1(a).

12. The 1969 Act also added section 162(g) denying a deduction for two-thirds of treble damages awarded in an antitrust case in certain circumstances.

13. *See supra* text accompanying note 4.

14. *See, e.g.*, *Heininger*, 320 U.S. at 468.

deductible; instead, the cost is included in the item's basis (or included in the taxpayer's cost of goods sold for his inventory) and offsets the amount realized on its sale in determining the amount of gain realized.[15] The question arose as to whether an illegal expenditure to purchase an item could be included in the cost of the item when it was sold and thereby offset revenue received from that sale. In a 1948 decision, a majority of the Tax Court held in *Sullenger v. Commissioner*[16] that an amount paid to purchase meat that was subsequently resold was included in the taxpayer's cost of goods sold even though part of the amount paid for the meat violated a federal law. The meat was purchased at a time when the price of goods was subject to controls established by an agency of the government (the OPA). The taxpayer paid an amount for meat that was greater than the permitted price. The government contended that the amount paid in excess of the permitted figure could not be included in the cost of the meat when the taxpayer sold it. The majority of the Tax Court (only one judge dissented) held that the entire amount paid for the meat, including the portion that was in excess of the permitted figure, is included in the taxpayer's cost of goods sold. The IRS initially acquiesced in that decision,[17] but subsequently withdrew that acquiescence and substituted a nonacquiescence.[18] Consistent with that nonacquiescence, the Treasury later promulgated a regulation stating that illegal expenditures are not included in the cost of goods sold.[19]

By its terms, the denial of a deduction for illegal business expenses in section 162(c)(2) applies only to expenses that otherwise would be deductible as business expenses.[20] Capital expenditures are not deductible as business expenses.[21] However, Regulation section 1.471-3(f) provides that the cost of goods sold does not include an item which is of a type that would be disallowed as a deduction under section 162(c), (f), or (g) and the regulations thereunder in the case of a business expense.[22] In essence, the regulation has expanded the statutory reach of section 162(c) to capital expenditures. Consequently, a capital expenditure that is made in violation of a state or federal law is not added to an item's basis and so the recovery of that expenditure on a sale of the item will be taxed.

While section 162(c) is the exclusive source of denying a deduction for an illegal business expense, to what extent can the frustration of public

15. I.R.C. § 263A(a)(1)(A), (b)(2).
16. 11 T.C. 1076 (1948), *nonacq.* 1976-2 C.B. 4.
17. 1952-2 C.B. 3.
18. 1976-2 C.B. 4.
19. Reg. § 1.471–3(f).
20. I.R.C. § 162(c)(2) ("No deduction shall be allowed under subsection (a) [of this Code section] . . . .").
21. *See* I.R.C. § 263.
22. Reg. 1.471–3(f).

policy doctrine be applied to deny a deduction that is otherwise allowable under a Code provision other than section 162? For example, most allowed losses (including business losses) are deductible under section 165.[23] Can the frustration of public policy doctrine be applied to a loss otherwise deductible under section 165? In Revenue Ruling 77-126,[24] the Commissioner ruled that the frustration of public policy doctrine does indeed apply to losses under section 165. The courts have also followed that view.[25] In *Holmes Enterprises, Inc. v. Commissioner*,[26] the sole shareholder and president of the taxpayer (a corporation) was caught carrying marijuana in an automobile owned by the corporation. The automobile was seized by the United States and forfeited to it. Although the automobile was used by the corporation for business purposes, the Tax Court denied the corporation a deduction for the forfeiture under section 165 because the deduction would frustrate a sharply defined national policy against the possession and sale of marijuana.[27] Additionally, in *Stephens v. Commissioner*,[28] both the Tax Court and the Second Circuit agreed that the frustration of public policy doctrine does apply to deductions claimed under section 165, although they disagreed as to how that policy is to be construed.

While section 162(f) denies a deduction for a fine or penalty paid to a government for a violation of a law, that provision would not have been applicable in the *Holmes* case. Section 162(f) applies only to prevent a deduction under sections 162 and 212; it does not apply to losses under section 165.[29] Although section 162(f) would not directly apply to the forfeiture in *Holmes,* the principle underlying that provision could be used as a public policy ground for denying a deduction. Courts have held that that the common law principle of denying a deduction for an item when the deduction would

23. *See, e.g.*, Holt v. Commissioner, 69 T.C. 75, 78 (1977), *aff'd per curiam*, 611 F.2d 1160 (5th Cir. 1980) ("We think that the items involved are properly characterized as loss items and would be deductible, if at all, under section 165.").

24. 1977-1 C.B. 47. In that ruling, the taxpayer failed to pay federal taxes that were due on gambling devices that the taxpayer owned and operated. The failure to pay those taxes made the taxpayer's use of the equipment illegal. The federal government seized the devices, and they were forfeited to the government. The Commissioner ruled that the frustration of public policy doctrine prevented the taxpayer from obtaining a deduction under section 165 for the loss of the equipment. *See also*, Rev. Rul. 81-24, 1981-1 C.B. 79.

25. *See, e.g.*, *Holt*, 69 T.C. at 78.

26. 69 T.C. 114 (1977).

27. Since the public policy ground for denying a deduction applies to section 165, the court might have characterized the forfeiture as a fine and held that it would contravene public policy to allow a deduction for a fine.

28. 93 T.C. 108 (1989), *rev'd*, 905 F.2d 667 (2d Cir. 1990).

29. I.R.C. § 162(f) ("No deduction shall be allowed under subsection (a) [of this Code section] . . . .").

frustrate public policy applies to deductions claimed under section 165.[30] In *Tank Truck Rentals*, which was decided prior to the adoption of section 162(f), the Supreme Court held that no deduction is allowed for the payment of a fine because it would contravene public policy to allow the deduction. If the court in *Holmes* had treated the forfeiture as a fine that would just have been another avenue to apply the public policy doctrine.

Section 212 permits a deduction for expenses incurred in producing or collecting income, expenses incurred to manage, conserve, or maintain property that is held for the production of income, and expenses incurred in the determination, collection, or refund of any tax.[31] Section 212 applies to the same type of expenses as are covered by the business expense deduction of section 162 except that the section 212 expenses are not incurred in the conduct of a trade or business. Consequently, section 212 is said to be *in pari materia* with section 162. In that regard, Regulation section 1.212-1(p) states that an expense otherwise allowable under section 212 will be disallowed if the expenditure is of a type for which a deduction would be disallowed under section 162(c), (f), or (g) and the regulations thereunder in the case of a business expense. In light of the connection between sections 162 and 212 and the fact that the statutory denial of a deduction for illegal expenditures is applied to section 212, it seems virtually certain that the common law frustration of public policy doctrine does not apply to section 212.

An interesting illustration of how far the courts have gone in applying the frustration of public policy doctrine is *Mazzei v. Commissioner*.[32] In that case, the taxpayer was induced to give $20,000 cash to several persons to put the bills through a box that he believed would create duplicate bills. Instead, they stole the taxpayer's money. A majority of the Tax Court denied the taxpayer's claim for a theft loss deduction on the ground that it is against public policy to grant a deduction for a loss suffered by a person engaged in a counterfeiting scheme. Five judges dissented because they felt that the deduction would not frustrate public policy as the doctrine was defined in *Tank Truck Rentals*.

Generally, subject to a floor,[33] medical expenses are allowable as itemized deductions.[34] According to the regulations, however, medical expenditures are not deductible if they violate a federal or state law.[35] Amounts

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30. *See e.g.*, *Stephens*, 93 T.C. at 111-112.

31. I.R.C. § 212(1)–(3)

32. 61 T.C. 497 (1974). *See also* Richey v. Commissioner, 33 T.C. 272 (1959).

33. Generally, only the amount of medical expenses that exceeds 10 percent of the taxpayer's adjusted gross income is deductible. I.R.C. § 213(a). For years prior to 2017, the floor for certain elderly taxpayers is 7.5 percent of adjusted gross income. I.R.C. § 213(f).

34. I.R.C. § 213.

35. *See* Reg. § 1.213–1(e)(1)(ii), (e)(2).

paid for an operation that is illegal are not deductible.[36] While medicine and drugs typically are deductible as medical expenses, the regulations provide that the deduction applies only to items that are legally procured.[37]

In the absence of a statutory denial, the legal expenses of an illegal business are deductible.[38] In the 1981 Tax Court decision of *Edmondson v. Commissioner*,[39] the question arose whether the denial of a deduction for illegal expenses in section 162(c)(2) prevents the deduction of the legal expenses of a business that was illegal to operate. *Edmondson* involved a taxpayer who was in the illegal business of selling amphetamines, cocaine, and marijuana. The Tax Court held that the legal expenses incurred in conducting that illegal business are deductible under section 162(a). Such expenses were held to be ordinary and necessary.

Congress was displeased with that decision and responded by adding section 280E to the Code. Section 280E disallows a deduction or credit for any expenses paid or incurred in carrying on a trade or business if that business consists of trafficking in controlled substances listed in Schedule I or II of the Controlled Substances Act of 1970 (CSA),[40] if that business is prohibited by federal law or by the law of a state in which the business is conducted.[41] Marijuana is included in Schedule I of the CSA, and the conduct of dispensing, manufacturing or distributing marijuana violates federal law even if it is permitted by state law. So, section 280E disallows a deduction or credit for the business expenses of a business manufacturing or selling marijuana even when that business is lawful under the law of the state in which it operates.[42] The quotation below from the report of the Senate Finance Committee on this provision illustrates why Congress adopted it:

> There is a sharply defined public policy against drug dealing. To allow drug dealers the benefit of business expense deductions at the same time that the U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to

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36. Reg. § 1.213–1(e)(1)(ii).
37. Reg. § 1.213–1(e)(2).
38. *See* Accardo v. Commissioner, 942 F.2d 444 (7th Cir. 1991).
39. 42 T.C.M. (CCH) 1533, 1974 T.C.M. (RIA) ¶ 81,623.
40. Pub. L. No. 91-513, § 202 84 Stat. 1236, 1247–50 (1970). Among the five schedules of drug classifications under the CSA, Schedule I lists the most dangerous drugs, with no ascribed medical benefit, followed by the other schedules in descending order.
41. I.R.C. § 280E.
42. *See, e.g.*, Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner, 128 T.C. 173 (2007); Olive v. Commissioner, 139 T.C. 19 (2012).

> other legal enterprises. Such deductions should be disallowed on public policy grounds.[43]

In disallowing a deduction or credit for the legal expenses of drug businesses, Congress made no distinction between those businesses that are operating legally under state law and those that are not. So long as the drug in which they are trafficking is a controlled substance prohibited under either Schedule I or II, it will be an illegal business under federal law and its expenses will be disallowed. The statutory requirement of "trafficking" has not proved to limit the reach of the statute. It has been held to mean no more than to be engaged in commercial activity with that drug such as marketing it.[44]

Since section 280E denies deductions and credits, it would not seem to cover capital expenditures which are added to basis and are not deductible. However, as noted above, the denial of deductions for illegal expenses of section 162(c)(2) has been expanded by regulation to capital expenditures.[45] One might have expected that section 280E would be given similarly expansive treatment. To the contrary, because of a concern over constitutional validity, the Senate Finance Report states unequivocally that the provision does not apply to the cost of goods sold. Specifically, the report reads:

> All deductions and credits for amounts paid or incurred in the illegal trafficking of drugs listed in the Controlled Substances Act are disallowed. To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill.[46]

As a consequence of excluding cost of goods sold from the reach of the statute, there is an incentive for taxpayers engaged in the covered drug businesses to classify as much of their lawful expenditures as capital expenditures (as contrasted to ordinary business expenses) as they possibly can validate. This circumstance is the opposite of what usually exists.

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43. S. REP. NO. 97-494, vol. 1, at 309 (1982). Note that while the lawful capital expenditures of a covered drug business are included in cost of goods sold, their unlawful capital expenditures are excluded from cost of goods sold because of the extension of section 162(c)(2) to capital expenditures by Regulation section 1.471-3(f).

44. *See, e.g.*, *Californians Helping*, 128 T.C. at 182 (defining "trafficking" under the Code as including supplying of medical marijuana); *Olive*, 139 T.C. at 38 (holding that a California medical marijuana dispensary's dispensing of medical marijuana pursuant to California law was "trafficking" within the meaning of section 280E.).

45. Reg. § 1.471–3(f).

46. S. REP. NO. 97-494, vol. 1, at 309.

Typically, taxpayers seek to maximize the amount of their expenditures that can be treated as business expenses, but not in this case. The IRS has provided guidance for determining which expenditures can be capitalized and the method of accounting for inventory for the purposes of section 280E.[47] The problem of making that determination is discussed in a recent article by Debra Sanders and Susan Gill.[48]

The problems that section 280E poses for businesses conducting a marijuana operation in a state where it is legal are daunting. There is a growing trend to legalize marijuana at least for some purposes. Currently, 23 states plus the District of Columbia allow the use of marijuana for medical purposes. In four of those states plus the District of Columbia, recreational use of marijuana is also legal.[49] It is widely expected that more states will decriminalize marijuana as a result of state ballot initiatives in the 2016 elections.[50] The denial of a deduction for the ordinary expenses of conducting a marijuana business makes those businesses taxable on their gross income, and that can make it extremely difficult for them to break even after payment of federal taxes.[51]

III. Reasons For Repeal

The income tax is a tax on net income.[52] For that reason, business expenses are deductible. The denial of a deduction for an illegal expense incurred in producing income means that that taxpayer is being taxed on gross

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47. C.C.A. 2015–04–011 (Jan. 23, 2015). Note that while the lawful capital expenditures of a covered drug business are included in cost of goods sold, their unlawful capital expenditures are excluded from cost of goods sold because of the extension of section 162(c)(2) to capital expenditures by Regulation section 1.471-3(f).

48. Debra Sanders & Susan Gill, *Guidance on Inventory Methods for Medical and Recreational Marijuana Businesses*, 122 J. TAX'N 218 (2015).

49. Erwin Chemerinsky, Jolene Forman, Allen Hopper & Sam Kamin, *Cooperative Federalism and Marijuana Regulation*, 62 UCLA L. REV. 74, 77, 85–89 (2015) [hereinafter Chemerinsky et al., *Cooperative Federalism*]. Delaware decriminalizes private use of marijuana under a law that takes effect on December 18, 2015. *State Medical Marijuana Laws*, NAT'L CONFERENCE OF STATE LEGISLATURES (Sept. 14, 2015), http://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx (an updated, online survey of state law).

50. *See, e.g.*, BRUCE BARCOTT, WEED THE PEOPLE: THE FUTURE OF LEGAL MARIJUANA IN AMERICA 313–14 (2015) [hereinafter BARCOTT, WEED THE PEOPLE].

51. *See, e.g.*, Jack Healy, *Marijuana Merchants Face Another Federal Obstacle: High Taxes*, N.Y. TIMES (N.Y. ed.), May 10, 2015, at A17 (citing among other examples, the Northwest Patient Resource Center, a Seattle marijuana dispensary, which in 2014 earned $53,369 in profits, but because of prohibited deductions, owed $46,340 in federal taxes).

52. Commissioner v. Tellier, 383 U.S. 687, 691 (1966).

income instead of net income. The denial of the deduction constitutes a penalty for the taxpayer's wrongdoing. As the Supreme Court stated in the *Tellier* decision:

> We start with the proposition that the federal income tax is a tax on net income, not a sanction against wrongdoing. That principle has been firmly imbedded in the tax statute from the beginning. One familiar facet of the principle is the truism that the statute does not concern itself with the lawfulness of the income that it taxes. Income from a criminal enterprise is taxed at a rate no higher and no lower than income from more conventional sources. "[T]he fact that a business is unlawful (does not) exempt it from paying the taxes that if lawful it would have to pay."[53]

The Revenue Act of 1913[54] was the first tax law enacted after the adoption of the Sixteenth Amendment. As noted in the *Tellier* opinion, several amendments were proposed to the bill that became the 1913 Act that would have denied a deduction for the losses of an illegal business. Those amendments were rejected. In the words of Senator Williams on the Senate floor:

> The object of this bill is to tax a man's net income, that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters, that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon futures, but the tax is framed for the purpose of making the man pay upon his net income his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way.[55]

Concededly, the tax law has moved away from the sentiments expressed above and now does tax illegal activities differently from lawful ones. An examination of the merits of the current treatment shows that it is ill advised. Before describing why this treatment is bad policy, let us first explore whether the denial of a deduction constitutes a penalty.

A basic principle of income taxation is the concept of equity—horizontal equity and vertical equity. Horizontal equity dictates that persons

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53. *Id.*
54. Pub. L. No. 63-16, § II(A)(1), 38 Stat. 114, 166.
55. *Tellier*, 383 U.S. at 691 (quoting 50 CONG. REC. 3,849 (1913)).

having the same income should pay the same tax, and vertical equity dictates that persons having disparate incomes should pay a different tax that bears a reasonable relationship to the disparity in their incomes. One problem with applying the equity principle is that it requires a determination of what constitutes equal or unequal incomes. The income in question is net income, not gross receipts or gross income, and so the thorny issue of what items are properly taken into account in determining net income is not resolved by those principles. But the one item that clearly should be taken into account is the expense incurred in producing the income. If taxation were based on gross income instead of on net income, there would be a higher tax on businesses with high costs than on those with low costs. Consider the following illustration:

X operates a business which produced gross revenue of $1,000,000 in Year One. To produce that revenue, X incurred $300,000 in expenses, and so he netted a profit of $700,000. Y operated a business that also produced gross revenue of $1,000,000 in Year One. However, Y incurred expenses of $800,000 to produce that revenue and so netted a profit of only $200,000. If no deduction were allowed for the expenses incurred by the two businesses, they would each pay a tax on $1,000,000 and each would pay the same amount of tax as the other. Under any reasonable standard, X and Y are not in the same income position or have the same ability to pay taxes. Perhaps the reason that Y's expenses are so much greater than X's is that the nature of Y's business requires greater expenditures or perhaps X is just more efficient than Y. Regardless of the reason, those two should not be paying the same amount of tax, and the allowance of a deduction for business expenses prevents that from occurring. Instead, X will pay tax on $700,000 and Y will pay tax on $200,000.

If, in the illustration above Y's expenses were unlawful, Y would not be permitted to deduct them and Y would be taxed on income of $1,000,000. Although Y has $500,000 less profit than X, Y will pay a much larger tax than X. Clearly, the tax law is punishing Y. Since Y's actions are illegal, presumably some governmental entity will punish her for her behavior. In addition to whatever punishment is meted out to Y for her unlawful behavior, the federal government will add to that penalty by overtaxing her.

Not only does the current tax law deny a deduction for illegal expenses,[56] it also precludes an illegal expenditure made to purchase an item from being included in the item's basis.[57] So, on a sale of the item, the taxpayer is taxed on the entire amount that she receives including the amount that represents a recovery of her cost of purchase. This means that the taxpayer is taxed on her gross receipts; she is not even allowed to limit her recognition to her gross income.

56. *See supra* Part II.
57. *See supra* notes 45–47 and accompanying text.

The fact that the denial of a deduction for illegal expenses (and a denial of basis for an illegal purchase) is a penalty does not by itself mean that it is bad policy. Y is a wrongdoer. What is wrong with the federal government adding to the sanctions imposed on her by increasing her tax burden? Let us now turn to that question in the context of the various provisions denying a deduction.

A. *Illegal Business Expenses Under Section 162(c)(2)*

A basic principle of determining the punishment for an offense is that there should be a rational relationship between the severity of the punishment and the seriousness of the offense. In the words of W.S. Gilbert in a lyric for the musical *The Mikado*, "let the punishment fit the crime."[58] Other factors (such as provocation or the wrongdoer's past behavior) can be taken into account to mitigate or aggravate the degree of culpability of the wrongdoer. It would be totally unacceptable to have the severity of punishment turn on purely arbitrary factors. To take an extreme example, the public would be aghast if legislation were to provide that the punishment for a crime depended on whether it rained on the day that sentencing was pronounced. If it doesn't rain that day, the sentence is five years imprisonment; if it rains once that day, ten years; and if it rains twice that day, 15 years. Similarly, it would be unacceptable to make the years of incarceration depend upon the length of the wrongdoer's foot. It is, of course, unthinkable that such ridiculous standards would ever be employed, and they would be invalidated if they were adopted.

Yet, while the punishment imposed by denying a deduction for illegal expenses is not as obviously absurd as those examples, it is almost as arbitrary.

The amount of cost suffered for a denial of a deduction is the additional amount of income tax that the taxpayer will incur. The amount of that tax depends upon two factors: (1) the amount of the expense that is denied a deduction, and (2) the marginal tax rate of the taxpayer at which the additional taxable income will be taxed. Neither of those factors has any bearing on the degree of culpability of the action taken by the taxpayer. The size of the penalty imposed by denying a deduction is based on conditions no more relevant to determining the seriousness of the crime than is the condition of the weather on sentencing day or the size of the taxpayer's foot. The following examples illustrate the arbitrariness of denying a deduction for illegal expenses.

X and Y each operates similar businesses. Each earns $400,000 in gross receipts in Year One. Each has $300,000 of illegal expenses that would be deductible in determining taxable income were it not for the denial of a deduction by section 162(c)(2). The nature of the income that X and Y earned

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58. W.S. GILBERT, THE MIKADO OR THE TOWN OF TITIPU 37 (London G. Bell and Sons, Ltd. 1911).

and the illegal expenses they incurred are essentially the same. Neither is more culpable than the other. Both X and Y will report $300,000 more income than they otherwise would have reported. At X's marginal tax rate, X pays a tax of $75,000 on the additional $300,000 of income (an effective tax rate of 25 percent). Y, however, had net operating loss carryovers from prior years.[59] As a consequence of that carryover loss deduction, Y pays a tax of only $3,000 on the additional $300,000 of income (an effective tax rate of 1 percent). X and Y committed the same acts, earned the same amount of revenue from those acts, and have identical degrees of culpability. Yet, the tax law, because of the mechanical way in which it applies its penalty, punishes X with a penalty that is 25 times greater than the penalty it imposes on Y.

The State of Erehwon has several horse racing businesses operating in its jurisdiction. A small but vocal group of citizens of Erehwon oppose horse racing and lobby for the state to ban it. To placate those citizens, the state makes it illegal to pay rent for an establishment for the purpose of conducting horse racing. The penalty for paying rent in contravention of the law is a fine of $25, and Erehwon does enforce that fine. Z operates a horse racing business in Erehwon. Z rents the establishment at which the racing takes place at an annual rental of $600,000. For Year One, Z has net winnings of $800,000, and so Z has a net profit of $200,000 before paying the $25 fine to the state. However, because her payment of the rent is illegal, Z cannot deduct the cost of the rent and must pay income tax on her $800,000 of gross income. Let us assume that that $800,000 is taxed at an effective rate of 30 percent for a tax of $240,000. Consequently, after taxes, Z has suffered a $40,000 loss. Clearly, Z cannot continue to conduct that business on that basis. The point is that while the state considers the offense to be of a very minor nature and imposes a small penalty, the federal government imposes a large penalty (effectively an $180,000 fine) without any regard to whether the federal government considers the offense to be a serious one or not.

M, a racketeer, pays $50,000 to an assassin to eliminate a competitor. Let us assume that that is a customary expense in M's business. The tax law punishes M by denying him a deduction for that payment, which otherwise would be an ordinary business expense deduction. R operates an illegal gambling business and pays rent of $600,000 per year for the premises. Under state law, the payment of that rent is itself illegal. The tax law punishes R by denying her a business expense deduction for the rent she paid. A comparison of the purposes of the payments made by M and R shows that M's payment was far more heinous. M made a payment to kill a human being. R merely paid rent to operate an illegal gambling operation. Yet, the tax law punishes R far more severely than M. R is denied a deduction of $600,000, and M is denied a deduction of only $50,000.

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59. Section 172 permits certain net losses (referred to as a net operating loss) to be carried forward and deducted in subsequent years.

The point of those examples is to show that the operation of the penalty imposed by section 162(c)(2) has no relationship to the extent of how evil or heinous the act of the taxpayer was. When a jurisdiction imposes a penalty for an act, it makes a determination of how seriously it regards the offense, how heinous the crime is, and the past history and condition of the wrongdoer. By adopting section 162(c)(2), Congress has chosen to increase the jurisdiction's penalty on purely mechanical criteria without any regard to whether the additional penalty is warranted. Consider one more illustration:

G is a public official of the State of Erehwon. G is entrusted with the task of choosing the contractor to build and repair roads in the state. L is a contractor who puts in a bid to build and repair the state's roads. G tells L that she will not receive the contract unless she gives G a bribe of $200,000. L's business has had a downturn recently and if L fails to secure this contract, she will have to liquidate. So, L pays G the bribe. The crime is discovered and both G and L are convicted and punished. Both committed a crime and both should be punished, and the state did so. But, not satisfied with whatever punishment the state imposed and without regard to how severe that punishment might have been, the federal government adds to the punishment by denying L a deduction for the bribe she paid. Between G and L (and both are culpable), it is obvious that G's acts are the more heinous. G violated a public trust and G instigated the crime by soliciting the bribe. Yet, the government adds a penalty to only one of the two, and the one it penalizes is L, the less culpable of the two. G must include the bribe in his income, but that is not a penalty. G's tax is the same as the tax paid by anyone who earns income whether legally or not. The only one that is penalized is L because she is denied a deduction for her payment. This result reflects the arbitrary manner in which the penalty applies.

The government agencies enforcing the law prohibiting such bribes often do not prosecute the payor either out of sympathy for the duress under which she acted or in exchange for her testifying against the payee.[60] In such cases, it is especially inappropriate for the tax law to punish the payor when the state or federal agency that is charged with enforcing the law has chosen not to punish her. This situation can arise in any case in which the enforcing agency has granted immunity to a wrongdoer.

It should be noted that the impact of the penalty imposed by denying a deduction is influenced by the amount of revenue that the illegal payment produces. If the illegal payment produces a very large amount of revenue for the taxpayer, the penalty will not prevent the transaction from producing a large profit. On the other hand, if the illegal payment produces a relatively small amount of revenue, the penalty could make the transaction a net loss. As

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60. The payment by the payor would not be deductible because of section 162(c)(1) which denies a deduction for a bribe paid to a government official that is illegal regardless of whether the crime is generally enforced.

designed, the penalty imposed by section 162(c) does not take that consideration into account.

While the authors' principal objection to section 162(c)(2) is its arbitrary operation, there is another reason to object to that provision. When someone is accused of a crime, the accused is provided with a number of protections and rights that are not available in civil actions. By making the punishment of an unlawful act an item of federal tax law, the issue will arise in the context of civil tax litigation. In those cases, the taxpayer will be deprived of some of the protection and rights that are available to criminal defendants. For example, evidence obtained by an illegal search or seizure, whether obtained by a federal or a state agent, cannot be put into evidence in a criminal trial against that defendant.[61] However, evidence illegally obtained by a state agent can be put into evidence in a federal civil tax trial.[62] If the federal government wishes to add to the penalty imposed for a criminal act, it should provide the safeguards that are available to persons accused of those offenses.

Let us consider this issue from a different perspective. If the government were to allow a deduction for an illegal expense of an unlawful business, would that implicate the government in the illegal activity? Putting it differently, is the government subsidizing the illegal payments by sharing the cost? For example, if M opens a business that offers to kill people for a fee, M will incur both legal and illegal expenses in operating that business. The cost of bullets and poison are legal expenses and can be deducted by M under current law. The wages that M pays to hired assassins to carry out the contracts are illegal expenses and are not deductible under current law. If, instead, the government were to allow M to deduct those wages, is it effectively paying a part of that cost?

The answer is no. The government has decided to tax illegally earned income. The Supreme Court upheld the taxation of illegal income in *United States v. Sullivan*.[63] While a subsequent Supreme Court decision held that, unlike other illegally obtained funds, embezzled funds are not included in income,[64] the Supreme Court overturned that position in its 1961 decision in *James v. United States*.[65] Subsequent to the *James* decision, all illegally obtained income is taxable.

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61. *See* Mapp v. Ohio, 367 U.S. 643, 660 (1961) (expanding the exclusionary rule established under the Fourth Amendment to the states as well as the federal government).

62. United States v. Janis, 428 U.S. 433 (1976) (allowing evidence illegally obtained by a state agent to be used in a civil tax case and expressly disagreeing with the prior contrary holding of *Suarez v. Commissioner*, 58 T.C. 792 (1972)).

63. 274 U.S. 259, 264 (1927).

64. Commissioner v. Wilcox, 327 U.S. 404, 410 (1946).

65. 366 U.S. 213, 221 (1961).

The justification for taxing illegal income is that those who earn income illegally should share in bearing the costs of government to the same extent as honest residents. There is no good reason to exempt criminals from paying taxes. But, they are to be taxed on their profits, the same as everyone else. They can only be taxed on their profits if their expenses are taken into account. The deduction for business expenses is not a governmental subsidy. It is an essential element of the measurement of the profits earned by a business, whether it is a lawful or unlawful business, and whether the expense itself is legal or not. In the example of M's assassination business, the illegal wages that M pays are no less an element of his profits than the legal expenses of purchasing bullets and poison. Moreover, if the government is willing to share in the spoils of an illegal business by taking a share of the income it produces, it ill behooves it to be squeamish about sharing the costs of conducting the business. In for a penny, in for a pound.

Business expenses and profit-oriented expenses are deductible only if they are "ordinary and necessary."[66] The words "ordinary and necessary" are terms of art used in the Code. One might question whether illegal expenses should be denied on the ground that they are not ordinary and necessary as required by sections 162(a) and 212 (the business expense deduction provision and the provision for the deduction of profit oriented expenses).

The short answer to that question is that if an illegal expense is not deductible because it is not ordinary and necessary, then there is no role for section 162(c)(2) to play. There is no need to have a provision denying a deduction for an item that already is not deductible. The only time that the section 162(c)(2) denial of a deduction becomes relevant is when the expense would otherwise be an allowable business expense. Moreover, it appears that Congress believed that illegal expenses could be deductible (i.e. could be ordinary and necessary) or it would not have enacted section 162(c).

An examination of the meaning and application of the term ordinary and necessary shows that many illegal expenses will satisfy those requirements.

The word "ordinary" and the word "necessary" have each been given its own meaning. The landmark Supreme Court case that first defined those two terms is *Welch v. Helvering*.[67] In that case, Justice Benjamin Cardozo defined the term "ordinary" as meaning that the expense not be unique in the experience of the group or community of which the taxpayer is a member.[68] Despite that language, there are indications in the opinion that the Court regarded the function of the word "ordinary" as merely serving to distinguish capital expenditures from current expenses. Subsequent Supreme Court cases have indicated that the word "ordinary" merely separates capital expenditures

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66. *See* I.R.C. §§ 162(a), 212.
67. 290 U.S. 111 (1933).
68. *Id.* at 114.

from current expenses.[69] In *Tellier*, the Court said, "The principal function of the term 'ordinary' in [section] 162(a) is to clarify the distinction, often difficult, between those expenses which are currently deductible and those that are in the nature of capital expenditures."[70]

While the broad language of the *Welch* case suggests that the term should require that the expense be a customary one,[71] there is no logical reason why an unusual expense should be nondeductible. For example, X, who is engaged in a business, arrives at a completely novel concept for increasing profits. X expends funds to carry out that project which is successful. There is no reason to deny X a deduction for those expenses merely because he was original and creative.

Moreover, in *Commissioner v. Sullivan*, the Supreme Court allowed a deduction to an illegal business (a bookmaker) for the rent he paid on his bookmaking establishment even though state law made it illegal to pay that rent.[72] The Court had to have deemed the payment to be ordinary and necessary even though it was illegal.[73]

In addition, illegal expenses are commonplace for illegal businesses and therefore qualify as ordinary even under the narrowest construction of that term. It would be strange to treat illegal expenses of an illegal business as ordinary but to deny a deduction for the illegal expenses of a lawful business on the ground that they are not commonplace to a lawful business.

The word "necessary" was defined by Justice Cardozo in the *Welch* case as meaning no more than "appropriate and helpful."[74] It has been so construed ever since that decision. For example in *Tellier*, the Supreme Court said, "Our decisions have consistently construed the term 'necessary' as imposing only the minimal requirement that the expense be 'appropriate and helpful' for the development of the [taxpayer's] business."[75] Also, note again that the illegal payment of rent in the *Sullivan* case was held to be deductible and so was deemed helpful and appropriate. [76]

One might question whether an illegal expenditure can be appropriate. As to illegal expenses of an unlawful business, they would be appropriate to the conduct of that business. As to the illegal expenses of a lawful business,

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69. *See, e.g.*, *Tellier*, 383 U.S. at 689; Commissioner v. Lincoln Sav. and Loan Ass'n, 403 U.S. 345, 353 (1971).

70. *Id.*

71. For an example of a case in which the court seized on that meaning to reach a result it desired, see *United Draperies, Inc. v. Commissioner*, 340 F.2d 936 (7th Cir. 1964), which disallowed a deduction for a lawful kickback).

72. *Sullivan*, 356 U.S. at 28.

73. *Sullivan* was decided eleven years before Congress added section 162(c)(2) to the Code.

74. *Welch*, 290 U.S. at 113

75. *Tellier*, 383 U.S. at 690.

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

the minimal function accorded to that requirement makes it unlikely that it will be applied to prevent the deduction of those expenses. It would be strange to permit a deduction for the illegal expenses of an unlawful business but deny them to a lawful business.

The government does seek to reduce purchases of certain items by imposing so-called "sin taxes" on them. The excise taxes on tobacco and alcohol are examples of sin taxes. Could the denial of a deduction for illegal expenses be justified as a kind of sin tax to make that expenditure more costly? Even if so characterized, it would be an arbitrary and inappropriate tax. Sin taxes are applied to specified items at a specific rate. The denial of a deduction for illegal expenses applies to any expenditure that is unlawful under federal or state law without any consideration of whether the activity warrants congressional attention. The governing body that made the activity illegal established a sanction that it deemed appropriate to deter it. What justification can there be for the federal government to add to that sanction without any consideration as to whether any additional imposition is warranted? The arbitrariness of the imposition of the tax is exacerbated by the fact that the amount of "tax" depends upon the income tax bracket of the taxpayer.

B. Illegal Bribes and Kickbacks to Government Officials and Employees

Section 162(c)(1) denies a deduction for illegal bribes and kickbacks made to a government official or employee.[77] The statute also denies a deduction for a payment made to an official or employee of a foreign government that is unlawful under the Foreign Corrupt Practices Act of 1977.[78] This provision seems unnecessary since a deduction for such payments would have been disallowed by section 162(c)(2) if section 162(c)(1) had not been adopted.

The same objections to the denial of a deduction for illegal payments (section 162(c)(2)) that are described in Part III.A. of this Article apply equally to this provision. The denial of a deduction constitutes a penalty for an unlawful act for which the jurisdiction involved has already designated a punishment that it deems appropriate. The additional penalty imposed by the denial of a deduction operates arbitrarily in that the amount of the sanction depends upon the size of the payment and the marginal tax bracket of the taxpayer. In addition, there is a failure to provide the taxpayer with the protections and safeguards afforded to criminal defendants.

It is true that the government has an interest in the size of a bribe or kickback paid to government officials since the size can influence the extent to which the official or employee will cooperate. But it is not just the size of

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77. The provision also applies to an illegal bribe or kickback to an employee or official of any agency or instrumentality of a government.

78. *See supra* note 9.

the payment that determines the amount of the sanction and its significance. It also depends upon the marginal rate of the taxpayer. Moreover, the influence of the penalty on behavior depends upon both the size of the payment and the amount of revenue it produced. The denial of a deduction for a large payment will have less effect on a taxpayer who earned a large amount of revenue from the payment than it will have on one who earned much less. Consider the following example:

K paid an illegal bribe of $100,000 to a government official. As a consequence, K obtained a government contract that produced a net profit of $3,000,000. T also paid a government official an illegal bribe of $100,000. As a consequence, T obtained a government contract that produced a net profit of $200,000. While section 162(c)(1) denies the same amount of deduction to each taxpayer, the penalty is not a deterrent for K to engage in the transaction since K will earn so much more than the additional tax liability. On the other hand, the denial of a deduction to T will have a substantial impact. There is no reason to penalize T more severely than K merely because her venture was less profitable.

Moreover, if the federal government wishes to penalize the payment of bribes, the size of the bribe is not the only item that should be taken into account. The entire circumstances surrounding the event and the past behavior of the payor should influence the severity of the punishment. It is bad policy to focus exclusively on the size of the payment. Criminal law is better suited to take those considerations into account than does the mechanical application of the tax law.

C. Kickbacks, Rebates, and Bribes Under Medicare and Medicaid

Section 162(c)(3) denies a deduction for kickbacks, rebates, and bribes arising in connection with services performed under Medicare or Medicaid. This provision applies regardless of whether the kickback, rebate, or bribe is illegal. To the extent that this provision applies to illegal kickbacks, rebates, or bribes, it is subject to the same objections that are described in Part III.A.–B. to the denial of deductions to other illegal expenses. However, there is more to be said in defense of the provision to the extent that it applies to lawful payments.

The government has an economic interest in preventing such payments because they will increase the cost of providing medical services for which the government is charged. Nevertheless, the authors contend that the provision is flawed and should be replaced. The denial of a deduction is too mechanical a penalty. It fails to take into account any of the surrounding circumstances that can make the act more or less culpable. If Congress wishes to deter the payment of such kickbacks, rebates, or bribes, it should make them illegal (to the extent not already done) and provide for a more nuanced standard of punishment.

D. Expenditures in Connection with the Illegal Sale of Drugs

Section 280E denies a deduction for all expenses paid or incurred in connection with the trade or business of trafficking in certain controlled substances.[79] This provision applies to all such expenses regardless of whether they are legal under state law or not. So, anyone conducting a business of marketing or producing a Schedule I controlled substance cannot deduct any of the expenses of conducting that business.

This provision is the most objectionable of all of the ones discussed in this Article. The denial of a deduction for even lawful business expenses obviously is a penalty. Congress had made it unlawful to manufacture, create, distribute, or dispense a controlled substance without complying with the Controlled Substances Act. Congress can set whatever penalty it deems appropriate for violating that provision. There is no justification for having an additional penalty imposed that has such an arbitrary structure.

One reason that section 280E is even more inappropriate than the other provisions denying deductions is because the principal business to which this provision applies is the marijuana business, since that is the only Schedule I controlled substance that can be marketed legally under the law of a number of states. There is considerable controversy over the proper characterization of marijuana in America today, and there is ambivalence in the government's responses to that controversy. The majority of Americans now live in states that have legalized the production and sale of marijuana at least for certain purposes.[80] But the federal government continues to list marijuana as a Schedule I controlled substance and make its manufacture or sale illegal. Consequently, a marijuana business can operate legally for state law purposes and yet be unlawful under federal law. This dichotomy makes for conflicting rules which make it especially difficult for a business to navigate.

The situation is further complicated by the fact that the federal government itself has sent conflicting signals to the public. On the one hand, the federal government makes it illegal to engage in the marijuana business and adds the additional sanction of denying a deduction for all of its expenses. On the other hand, the Department of Justice has officially announced that it will not prosecute marijuana businesses if certain criteria are satisfied.[81] There

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79. As used in the statute, controlled substance refers to drugs listed in Schedules I and II of the Controlled Substances Act. *See supra* note 40.

80. *See* BARCOTT, WEED THE PEOPLE, *supra* note 50, at 6.

81. In a series of memoranda, dated October 19, 2009, June 29, 2011, August 29, 2013, February 14, 2014, and October 28, 2014, the Justice Department announced that it would not enforce the CSA prohibition against marijuana in states that decriminalized marijuana use, so long as the states do not allow marijuana use that violates federal priorities. The memoranda list eight federal enforcement priorities to guide the states: (1) preventing distribution of marijuana to minors, (2) preventing revenue from sale of marijuana going to criminal enterprises, (3) preventing diversion

is no indication as yet that the IRS will not deny deductions for the business expenses of the businesses that satisfy those conditions.

The federal government needs to resolve this dilemma. It should either leave the treatment of marijuana entirely to the determination of each state or it should take the subject completely out of the hands of the state and resolve it at the federal level. The current mixture of authorization and prohibition rules is intolerable, demonstrating the inappropriateness of denying expenses for a business whose illegality is under serious question.

A marijuana business that is operating lawfully under state law is put in a terrible position by section 280E: it will be taxed on its gross income. Unless it has low expenses, imposition of the additional tax could cause the business to operate at a net loss; it cannot last long producing yearly losses. Even if the business can break even or produce an after-tax profit, the burden of complying with that penalty will reduce its capacity to serve its customers.[82] Some members of Congress may be pleased to have the provision hamper marijuana businesses, but it is such an indirect and confusing way to address the problem that a better solution should be found.[83] To illustrate how anomalous it is to single out the trafficking in drugs for this treatment, compare it to the deductions permitted for other illegal activities.

X owns and operates a business which he calls Murder, Inc. To conduct his business, he purchases bullets and poisons. Under the law of the state in which X resides, the purchase of those items is legal regardless of the purpose to which the purchaser intends to use them. X is permitted to deduct the cost of those items from his taxable income. Contrast the treatment of X

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of marijuana from states where it is legal to other states, (4) preventing marijuana activity from being used as a cover for trafficking of illegal drugs, (5) preventing violence and the use of firearms in marijuana activity, (6) preventing marijuana-impaired driving and other adverse public health consequences, (7) preventing growing of marijuana on public lands, and (8) preventing marijuana possession and use on federal property. As long as states have adequate measures to prevent these eight outcomes, the Justice Department indicates that the federal government will not interfere with state legalization of marijuana. Chemerinsky et al., *Cooperative Federalism*, *supra* note 49, at 77–79, 86–90. *See e.g.*, U.S. Dep't of Justice, Office of the Deputy Attorney Gen., *Memorandum for all United States Attorneys: Guidance Regarding Marijuana Enforcement* (Aug. 29, 2013), http://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf.

82. *See supra* note 51 and accompanying text.

83. It is a truism that overloading the voluntary self-assessment tax code with non-tax related incentives interferes with taxpayer compliance. "We also see the tax laws excessively used, again and again, to promote a wide variety of social and economic objectives. The result: tax base erosion, shifting of the tax burden, added complexities, and further fueling of taxpayer frustration." *Simplification of the Tax System: Hearing Subcomm. on Oversight of the Comm. on Ways & Means, U.S. H.R.*, 108th Cong. 28 (2004) (statement of Mortimer M. Caplin, former U.S. Commissioner of Internal Revenue Service).

with the tax law's current treatment of Y who operates a marijuana business in a state where it is lawful to do so. Y is denied a deduction for her lawful expenses of paying rent for her premises and for the payment of wages to her employees. While the authors view that it is proper to allow X a deduction, it is a bizarre system that allows X a deduction while denying Y one for expenses of such an everyday aspect.

One consequence of section 280E is that the illegal drug business is penalized by taxing it far more severely than other illegal activities are taxed, in that all expenses are denied a deduction, not just illegal ones. Whatever might be said for treating the illegal drug business as worse than other illegal activities, and even that is questionable, it is inappropriate to include marijuana in that category given the conflict in this country over the question of whether marijuana should be lawful. This conflict of views exists in the public at large and is reflected in the manner in which governments have dealt with the subject. Almost half of the states have legalized the use of marijuana at least for some purposes. The federal government itself reflects the conflicting views of the harmfulness of marijuana in its treatment of the subject. While continuing to list marijuana as a controlled substance whose manufacture and distribution is illegal, the Department of Justice has stated that it will not prosecute under that provision if certain criteria are satisfied. The conflict among the rules concerning its legality and the ambivalence with which governments have approached this problem, makes marijuana an especially poor target for such harsh treatment by the tax law.

E. Illegal Medical Expenses

As previously noted,[84] the cost of an illegal operation and the cost of medicines or drugs obtained illegally are not deductible. The question of whether that treatment is appropriate raises different issues than those that apply to the other provisions discussed in this Article.

There are commentators who contend that the deduction for medical expenses is a kind of subsidy in which the federal government is bearing part of the cost.[85] If that view were correct, then it would be reasonable for the government to declare that it will not subsidize and bear part of the cost for illegal expenses. If accurate, the subsidy characterization would distinguish the medical expense deduction from a deduction of a business expense which does not entail a subsidy by the government.

To the contrary, there are commentators who contend that the medical expense deduction is not a government subsidy, but rather can be justified as

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84. *See supra* notes 34–37 and accompanying text.

85. William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 309–310 (1972) [hereinafter Andrews, *Personal Deductions*].

an appropriate reduction for measuring disposable income.[86] In this Article, we will not examine the competing arguments for those conflicting conclusions. However it is the view of the authors that the medical expense deduction is not a subsidy. If it is not a subsidy, the question of whether illegal medical expenses should be deductible turns on the view one has as to the proper function of that deduction.

Even if the medical expense deduction is not a governmental subsidy, it is not related to the production of income, and so the case for its deductibility is more attenuated than is the case for business expenses. Consequently, there is a stronger case for denying a deduction for illegal medical expenses than for business expenses. Before turning to that question, it is useful to consider the scope of the medical expense deduction and what that tells us about its underlying principles.

The tax law does not establish standards for the type of treatment that can qualify for a medical expense deduction. There is no requirement that the treatment be provided by licensed medical practitioners. "The determination of what is medical care depends not on the experience, qualifications, and title of the person rendering the service, but on the nature of the services rendered."[87] So, for example, the cost of attending sessions with a Christian Science practitioner is a deductible medical expense.[88] The cost of attending meetings of Alcohol Anonymous is deductible.[89] The cost of attending a behavior modification program to cease smoking is deductible. [90] The cost of attending a weight reduction program is deductible if the taxpayer needs to lose weight because of an illness (and obesity is deemed to be an illness).[91] The expenses incurred by members of a Navajo tribe for "sings" performed by Navajo medicine men to deal with a victim of cancer are deductible medical expenses.[92]

A fundamental underlying principle of the medical expense deduction is that the decision as to the type of treatment a taxpayer will seek for his illness is left entirely to the taxpayer. The government will not place any restraints or conditions on that decision. The taxpayer need not choose the least expensive treatment. The taxpayer can choose a treatment in a distant city so long as his principal purpose in doing so is to obtain treatment for his illness as contrasted

86. *See e.g.*, Andrews, *Personal Deductions*, *supra* note 85, at 354–75; Jeffrey H. Kahn, *Personal Deductions—A Tax "Ideal" or Just Another "Deal"?,* 2002 L. REV. M.S.U.-D.C.L. 1 (2002).

87. Brown v. Commissioner, 62 T.C. 551, 554 (1974), *aff'd per curiam*, 523 F.2d 365 (8th Cir. 1975).

88. Rev. Rul. 55-261, 1955-1 C.B. 307.

89. Rev. Rul. 63-273, 1963-2 C.B. 112.

90. Rev. Rul. 99-28, 1999-1 C.B. 1269.

91. Rev. Rul. 2002-19, 2001-1 C.B. 779.

92. Tso v. Commissioner, 40 T.C.M. (CCH) 1277, 1980 T.C.M. (RIA) ¶ 80,399.

with a personal objective such as visiting a relative. The taxpayer can choose a treatment that is not respected by the medical profession.

The authors believe that this deference to the choice of the taxpayer should extend to illegal procedures. There are other sanctions available for responding to unlawful expenditures. So long as the primary purpose of the expenditure is to deal with a medical condition, the nature of the treatment or its legality should be of no concern to the government.

Consider some examples. Martha suffers with cancer, and has been told that modern medicine can do nothing for her and that she has only a few months to live. Martha learns that there is an expensive drug that some claim can cure her condition, but the federal government has determined that the drug has no benefit and can cause harm. The federal government has made the distribution or purchase of the drug illegal. In desperation, Martha purchases the drug. Despite the illegality of the purchase, the authors have concluded that it is desirable to allow Martha a deduction for the cost of trying to deal with her illness.

Another example is the purchase of marijuana for medicinal purposes. It is established that the use of marijuana can relieve symptoms of some diseases.[93] A large number of states have legalized the production and use of marijuana for that purpose. The IRS has ruled that the cost of purchasing marijuana for medicinal purposes is not deductible even if purchased in a state in which it is lawful and even though purchased pursuant to a doctor's prescription.[94] Given the division of authority between federal and state governments, it is inappropriate for the federal government to counteract a state policy on such a controversial issue.

The authors believe that in applying the medical expense deduction provision, the federal government should not interfere with a patient's decision as to what treatment will best deal with his illness. That has been a basic principle of the manner in which the medical expense deduction has operated, and the illegality of a treatment does not justify a departure from that principle.

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93. Despite the acceptance of the medical community as to some benefits of medical marijuana, the classification of marijuana as a Schedule I drug in the CSA prohibits marijuana for any medical use. *See* JONATHAN P. CAULKINS, ANGELA HAWKEN, BEAU KILMER & MARK A. R. KLEIMAN, MARIJUANA LEGALIZATION: WHAT EVERYBODY NEEDS TO KNOW 94–100 (2012). *See also* Penny Whiting et al, *Cannabinoids for Medical Use: A Systematic Review and Meta-analysis*, 313 J. AM. MED. ASS'N 2456–73 (2015); Kevin P. Hill, *Medical Marijuana for Treatment of Chronic Pain and Other Medical and Psychiatric Problems: A Clinical Review*, 313 J. AM. MED. ASS'N 2474–83 (2015).

94. Rev. Rul. 97-9, 1997-1 C.B. 77.

F. *The Common Law Frustration of Public Policy Doctrine*

As noted previously, the common law doctrine of denying a deduction for expenditures or losses if the deduction would frustrate a sharply defined public policy no longer applies to business expenses or to profit-oriented expenses.[95] However, the IRS and the courts have continued to apply the doctrine to losses, including business losses.[96]

Before examining the question of whether the doctrine should be applied to deny a deduction for business losses, let us first consider section 162(f), which denies a deduction for a fine or penalty paid to a government for a violation of a law. A fine or penalty can be incurred in connection with a business. Are there reasons why the arguments for allowing a deduction for illegal business expenses should not apply to this provision as well? After all, the payment of a fine or penalty is not illegal and so allowing a business expense deduction seems even less objectionable.

To the contrary, there are different considerations at play in determining whether a fine or pecuniary penalty that is incurred in connection with a business should be deductible. A governmental body imposes a fine or penalty as a sanction for a violation of a law. The size of the sanction is designed to deter the prohibited behavior. The size of the penalty presumably has been calibrated according to the methods of the criminal law, unlike the mechanical nature of tax application. The concern over allowing a deduction for a fine or penalty is that the resulting reduction of tax liability will reduce the impact of the sanction and thereby interfere with its role as a deterrent.[97] This consideration puts the issue in an entirely different light from the question of whether to allow a deduction for other business expenses. For that reason, the authors consider the question of the appropriateness of section 162(f) distinct from the issues discussed in this article and thus we have not addressed that issue.

Let us now turn to the question of allowing a deduction for a business loss when the loss arises in connection with the conduct of an illegal act. Take the case of *Holmes Enterprises, Inc. v. Commissioner* discussed earlier.[98] The president and sole shareholder of a corporation was caught transporting marijuana in a car owned by the corporation. The automobile was forfeited to the government. The corporation was denied a deduction for its loss of the vehicle on the ground that the deduction would frustrate public policy. The corporation suffered the loss of a business item. It is an additional punishment to the corporation to deny it a deduction for that loss. For reasons stated

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95. *See supra* notes 10 and 11 and accompanying text.

96. *See supra* notes 24–28 and accompanying text.

97. That concern was the basis of the Supreme Court's decision in *Tank Truck Rentals*. *See supra* note 4.

98. *See supra* note 26.

previously in connection with the denial of a deduction for illegal business expenses, it is inappropriate to deny the deduction on public policy grounds.

The same reasons that lead us to conclude that illegal business expenses should be deductible apply with equal force to business losses incurred in connection with an illegal activity.

The public policy exception to deductibility has been applied in nonbusiness areas. It has been applied to deny a deduction for a personal theft loss where the theft occurred in connection with a counterfeiting scheme.[99] We are inclined to the view that the legality of the circumstances in which the theft occurred should not obscure the fact that the taxpayer suffered a theft loss. However, there are other considerations here. The question arises as to the function of the theft loss deduction. If it is viewed as a government subsidy of the victim's loss, it is reasonable for the government to decline to subsidize losses incurred in connection with illegal activity. If, on the contrary, the deduction is viewed as a proper reflection of disposable income then one can question whether the denial of the deduction is an additional penalty that is subject to the same objections as discussed in connection with illegal business expenses. Concededly, however, even if the theft loss deduction is not a subsidy, a business expense deduction is far more integral to the measurement of taxable income than the theft loss deduction and so the case for allowing the latter is not as strong.

As to the proper characterization of the function of the theft loss deduction, commentators have conflicting views. We will not engage in that debate and instead leave that question open.

The public policy exception has been employed to deny a personal casualty loss deduction when the casualty arose from an illegal act of the taxpayer.[100] Once again, the view of the function of the casualty loss deduction as either a government subsidy or not is relevant to the resolution of this issue, and we will not address that question.

IV. CONCLUSION

The denial of a deduction for illegal business expenses constitutes a punishment that is applied on arbitrary standards and should be repealed. Moreover, litigating a punitive provision in a civil tax proceeding denies to the taxpayer some of the protections and rights granted to criminal defendants. The denial of a deduction for lawful kickbacks, bribes, and rebates connected with Medicare and Medicaid is less objectionable, but nevertheless should be replaced by a more nuanced punishment. The denial of a deduction for all business expenses, lawful or not, of a business trafficking in a controlled

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99. *See supra* note 32.

100. *See* Blackman v. Commissioner, 88 T.C. 677 (1987), *aff'd without published opinion*, 867 F.2d 605 (1st Cir. 1988).

substance has no plausible merit whatsoever and should be repealed. This is especially evident for marijuana businesses given decriminalization by many states, at least partially accepted by the federal government, yet treated more harshly than other strictly illegal enterprises. While the denial of a deduction for illegal medical expenses is more defensible, it nevertheless is undesirable in that it conflicts with the principle of permitting the taxpayer the option of choosing whatever procedure the taxpayer prefers to deal with his illness. Finally, the common law doctrine of denying a deduction for expenditures that would frustrate public policy should not be applied to business losses. To accomplish the objectives proposed in this Article, Congress would need to repeal section 162(c) of the Code. In addition, because of the common law doctrines denying a deduction for illegal expenses and losses, Congress would need to enact a Code provision to the effect that a deduction for a loss or expense that would otherwise be allowable shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy.