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Federal Income Taxation: Legal Expenses of Criminal Litigation as Ordinary and Necessary

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FEDERAL INCOME TAXATION: LEGAL EXPENSES OF CRIMINAL LITIGATION AS ORDINARY AND NECESSARY

The note immediately following, dealing with the deductibility for federal income tax purposes of legal expenses incurred by a taxpayer in defending himself against criminal charges, went to print before publication by the United States Supreme Court of its decision in Commissioner v. Tellier, *34* U.S.L. WEEK *4297 (U.S. March 22, 1966). Indeed, at the time the note was written it was not anticipated that the Court would decide the* Tellier *case during its October term. It may be conjectured that the Court decided the case too promptly after argument because no dissents were registered. Unanimous decisions by the Court in federal income tax cases are infrequent.*

The Court's holding is that legal expenses are deductible even though incurred by a taxpayer in defending himself against criminal charges, and even though his defense is unsuccessful. The taxpayer, Tellier, had paid and deducted legal expenses of 22,224.20 dollars in defending against charges on which he was convicted and sentenced to prison.

*In his note, Mr. Evans has analyzed the traditional position of the Commissioner of Internal Revenue opposing deductions for such expenses, the widely varying attitudes of the Tax Court and the several circuit courts of appeal, and the views of commentators on the subject. He concludes, on the basis of thorough research and cogent reasoning, that such deductions should be allowed. His conclusion, and the reasoning to that conclusion, are vindicated fully by the Court's decision that these expenses are deductible under Section 162(a) of the Internal Revenue Code of 1954 as "ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business."**

Under section 162(a) deductions are permitted for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[1] Questions which arise concerning the phrase "ordinary and necessary" are

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1. INT. REV. CODE OF 1954.

many and varied, but it is doubtful if any is as knotty as that involving legal expenses incurred in criminal litigation.[2]

In all types of criminal litigation it is universally held that a successful defense will render the legal expenses deductible.[3] The questioned conduct, however, must be directly related to or proximately result from the carrying on of any trade or business.[4] If the taxpayer is unsuccessful in his defense, the Commissioner has consistently disallowed any deduction for legal expenses. This ruling has been sustained by the vast bulk of judicial authority.[5] The single exception had been in the area of criminal antitrust litigation,[6] but in 1962 the Internal Revenue Service reversed itself,[7] and deductions for legal expenses involving criminal antitrust litigation are now similarly disallowed.

In cases of civil liability arising from the conduct of the taxpayer's business, deductions for legal expenses are allowed without regard to the success or failure of the taxpayer's defense.[8] This is true even for legal expenses paid in connection with the unsuccessful defense of a proceeding culminating in the imposition of a fraud penalty.[9] Thus, if the litigation is civil, the legal expenses incurred may be deducted, although the questioned conduct may also subject the taxpayer to criminal prosecution;[10]

2. See INT. REV. CODE OF 1954, § 212(3). "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year . . . in connection with the determination, collection, or refund of any tax." This is the first statutory recognition of legal expenses as deductions. *Quaere.* Could a taxpayer who had been convicted of criminal tax evasion deduct the expenses of the litigation under this provision?

3. See, *e.g.*, Hopkins v. Commissioner, 271 F.2d 166 (6th Cir. 1959); John W. Clark, 30 T.C. 1330 (1958).

4. *Ibid.*

5. See, *e.g.*, Peckham v. Commissioner, 327 F.2d 855 (4th Cir. 1964); Acker v. Commissioner, 258 F.2d 568 (6th Cir. 1958); Tracy v. United States, 151 Ct. Cl. 618, 284 F.2d 379 (1960); Port v. United States, 143 Ct. Cl. 334, 163 F. Supp. 645 (1958); Estate of Morris I. Ritholz, 22 CCH Tax Ct. Mem. 649 (1963); Alfred B. Cenedella, 21 CCH Tax Ct. Mem. 209 (1962); Sol Schwaber, 19 CCH Tax Ct. Mem. 142 (1960); Thomas A. Joseph, 26 T.C. 562 (1956); Simon Bloom, 7 CCH Tax Ct. Mem. 517 (1948); M. J. Donnelly, 7 CCH Tax Ct. Mem. 839 (1948); Estate of John W. Thompson, 21 B.T.A. 568 (1930); *cf.* Tellier v. Commissioner, 342 F.2d 690 (2d Cir. 1965), *cert. granted*, 382 U.S. 808 (1965); Commissioner v. Schwartz, 232 F.2d 94 (5th Cir. 1956).

6. Rev. Rul. 11880, 1944 CUM. BULL. 93.

7. Rev. Rul. 62-175, 1962-2 CUM. BULL. 50.

8. See, *e.g.*, Kottemann v. Commissioner, 81 F.2d 621 (9th Cir. 1936); Robert S. Howard, 32 T.C. 1284 (1959); Harry Dunitz, 7 T.C. 672 (1946), *aff'd on another issue*, 167 F.2d 223 (6th Cir. 1948); Hal Price Headley, 37 B.T.A. 738 (1938); Citron-Byer Co., 21 B.T.A. 308 (1930).

9. Hopkins v. Commissioner, 271 F.2d 166 (6th Cir. 1959).

10. John W. Clark, 30 T.C. 1330 (1958).

as in *John W. Clark*[11] where the taxpayer was allowed to deduct attorney's fees in connection with a settlement of civil liability for assault.[12]

A. Purpose, Intent, and Interpretation

The purpose of income tax legislation is to raise revenue. It is not contrived as further punishment for those who violate criminal statutes, which prescribe their own punishment whether it be in the nature of a fine, imprisonment, or both. To use tax legislation as a further punishment for criminal violators is to abort the purpose for which it was intended. As Member Sternhagen of the Board of Tax Appeals so succintly stated in his dissenting opinion in *Burroughs Bldg. Material Co.*,[13] "the revenue act was not contrived as an arm of the law to enforce State criminal statutes by augmenting the punishment which the state inflicts."

In disallowing deductions for legal expenses incurred in the unsuccessful defense of a criminal prosecution involving the taxpayer's trade or business, the courts are applying section 162(a) as though it were intended to encourage moral reform. This is an erroneous application. Section 162(a) simply was not passed for the purpose of reforming the morals of the business world.

Writers in the field have, for many years, attacked the courts' application of the statute as a tool for moral reform.[14] Randolph Paul, commenting on this, said:[15]

> As exploration of relevant Congressional debates indicates, Section 23(a)(1)(A) [now section 162(a)] is not an essay in morality, designed to encourage virtue and discourage

11. *Ibid.*

12. Whether such expenses are, in fact, incurred because of conduct in which the taxpayer has engaged while carrying on his business is another matter, and is often the subject of controversy.

13. 18 B.T.A. 101, 105 (1929).

14. See, *e.g.*, Arent, *Inequities in Non-Deductibility of Fines, Penalties, Defense Expense,* 87 J. ACCOUNTANCY 482 (1949); Brookes, *Litigation Expenses and the Income Tax,* 12 TAX L. REV. 241 (1957); Keesling, *Illegal Transactions and the Income Tax,* 5 U.C.L.A.L. REV. 26 (1958); Paul, *The Use of Public Policy by the Commissioner in Disallowing Deductions,* U. So. CALIF. 1954 TAX INST. 715; Reid, *Disallowance of Tax Deductions on Grounds of Public Policy—a Critique,* 17 FED. B.J. 575 (1957); Stapleton, *The Supreme Court Redefines Public Policy,* 30 TAXES 641 (1952); Note, *Deduction of Business Expenses: Illegality and Public Policy,* 54 HARV. L. REV. 852 (1941); Comment, *Business Expenses, Disallowances, and Public Policy,* 72 YALE L.J. 108 (1962).

15. Paul, *The Use of Public Policy by the Commissioner in Disallowing Deductions,* U. So. CALIF. 1954 TAX INST. 715, 730-31.

> sin . . . . Nor was it contrived to implement the various regulatory statutes which Congress has from time to time enacted. The provision is more modestly concerned with 'commercial net income'—a businessman's net accretion in wealth during the taxable year after due allowance for the operating costs of the business . . . . There is no evidence in the Section of an attempt to punish taxpayers . . . when the Commissioner feels that a state or federal statute has been flouted . . . . When Congress has wished to deny tax deductions as a means of reinforcing the sanctions of other federal statutes, it has done so deliberately and explicitly.

In 1913 when what is now section 162(a) was being discussed in committee there was some objection to its liberality. A proposal was made to limit the deduction to "any legitimate trade or business," but this proposal was rejected.[16] Senator Williams, who was in charge of the income tax sections of the act, commented on the proposal to limit the deduction to legitimate businesses and the purposes, generally, of Congress in passing income tax legislation.[17]

> [T]o 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. (Emphasis added.)

The fact remains that the phrase "any trade or business" has remained unchanged. The phrase has never been limited or qualified in any manner.

The word *any* standing alone is important, and more particularly important when coupled with the stated intent of the statute as expressed by Senator Williams. The word does not qualify the phrase "trade or business"; rather, the use of the word clearly indicates that no qualification was intended. The phrase means exactly what it says, namely, "*any* trade or business"; it doesn't mean "only some" trades or businesses. If Congress had meant something else, or had meant to limit the deduction, it could have said, *as suggested and rejected*, "any *legitimate* trade or busi-

16. 50 Cong. Rec. 3850 (1913).
17. 50 Cong. Rec. 3849 (1913).

ness." Or, as a further limitation Congress could have said, "any trade or business with a *legitimate purpose.*" Congress used neither of these phrases, nor any other; Congress said "*any* trade or business."

B. Grounds for Disallowance

Although Congress has placed no qualifying phrases or words in section 162(a), the Commissioner, who has repeatedly been sustained by the courts, has done what Congress refused to do. Disallowance has been sustained on two grounds: (1) that the legal expenses are not ordinary and necessary as it is neither ordinary nor necessary to violate the law[18] and (2) that to allow the deduction would frustrate public policy.[19]

The argument that the expense is not ordinary and necessary has been afforded little sympathy by the Supreme Court. Of legal expenses incurred by a taxpayer in his unsuccessful attempt to resist the issuance of a fraud order the court said,[20] "to say that this course of conduct and the expense which it involved were extraordinary or unnecessary would be to ignore the forms of speech prevailing in the business world." The Court has also declared that salary payments to employees engaged in running the taxpayer's illegal gambling business may be deducted as ordinary and necessary expenses.[21] The pronouncements by the Supreme Court have, for all intents and purposes, laid to rest the argument that legal expenses incurred in criminal litigation involving the taxpayer's business are not ordinary and necessary.

The remaining ground for disallowance is public policy. This argument is more forceful, but even it is subject to qualifications, which the courts have apparently ignored when invoking this doctrine.

In *Commissioner v. Heininger*[22] the Supreme Court dealt at length with the use of public policy as a ground for disallowance, and in so doing laid down certain rules. The Court said that expenses which are ordinary and necessary may nevertheless be non-deductible if to allow the deduction would "frustrate

18. See, *e.g.,* National Outdoor Advertising Bureau, Inc. v. Helvering, 89 F.2d 878 (2d Cir. 1937).

19. See, *e.g.,* Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178 (2d Cir. 1931).

20. Commissioner v. Heininger, 320 U.S. 467, 472 (1943).

21. Commissioner v. Sullivan, 356 U.S. 27 (1958).

22. 320 U.S. 467 (1943).

sharply defined national or state policies."[23] The Court did not leave the determination of what constituted a frustration of public policy to the whim of the Commissioner or the courts, rather they said that "the policies frustrated must be national or state policies *evidenced* by some declaration of them."[24] As Randolph Paul pointed out, Congress has always been explicit when it intends income tax legislation to be used to supplement sanctions imposed by other federal statutes. Section 162(a) contains no such declaration, rather it is broad and sweeping in its terms—"*any trade or business.*" The courts, nevertheless, in the face of the requirement in *Heininger* of some declaration, have repeatedly invoked the public policy argument in disallowing the deduction.

Chief Judge Lumbard in his concurring opinion in *Tellier v. Commissioner*[25] argued that public policy now required that the deduction be allowed. "In my opinion, there is no present basis for the claim that such disallowance is consistent with public policy; on the contrary, it seems clear to me that public policy now requires us to allow the deduction."[26] This argument was based on the recent recognition by the courts[27] and Congress[28] of the need for counsel by an indigent defendant. Chief Judge Lumbard took note of the fact that the Criminal Justice Act,[29] passed by Congress in 1964, provides compensation for counsel of an indigent defendant without regard to the outcome of the trial. This he analogizes with deduction of legal fees by a defendant who bears the cost of his defense.[30]

> If the compensation of counsel under the Criminal Justice Act does not depend on the success of the defense, it would seem to follow that the allowance of the deduction should not depend on the outcome in cases where the defendant is able to and does assume the financial burden of defending against criminal charges.

23. *Id.* at 473.
24. *Ibid.* (Emphasis added.)
25. 342 F.2d 690 (2d Cir. 1965), *cert. granted,* 382 U.S. 808 (1965).
26. Tellier v. Commissioner, 342 F.2d 690, 695 (2d Cir. 1965), *cert. granted,* 382 U.S. 808 (1965).
27. Gideon v. Wainwright, 372 U.S. 335 (1963); Johnson v. Zerbst, 304 U.S. 458 (1938).
28. Criminal Justice Act, 18 U.S.C. § 3006A (1964).
29. 18 U.S.C. § 3006A (1964).
30. Tellier v. Commissioner, 342 F.2d 690, 696 (2d Cir. 1965), *cert. granted,* 382 U.S. 808 (1965).

The use of public policy as a ground for disallowance has lead to anomalous results. Fines imposed for violation of state maximum weight laws by truckers—whether inadvertent[31] or not[32]—are not deductible as ordinary and necessary. Similarly deductions for legal expenses incurred in defense of a criminal prosecution are not deductible because, the courts have held, to allow these deductions would frustrate public policy.[33] On the other hand rental payments made by a "bookmaking" establishment and salaries paid to the employees of the gambling house are deductible as ordinary and necessary.[34] Also deductible are gifts and entertainment provided by a corporation to public officials, even though in contravention of state law.[35] To allow these deductions, according to the courts, would not frustrate public policy.

In short, legal expenses are being equated with the payment of fines and penalties, which seems totally illogical. Fines and penalties are imposed because of some conviction for violation of a penal law, whereas legal expenses are incurred to determine if a violation has in fact occurred. Placing a stigma on the cost of a bona fide defense, which is an integral part of our system of justice, gives the act of hiring of counsel an undertone of illegality. If the courts feel compelled to equate the cost of a bona fide defense with illegal activity, surely legal expenses are at least on a par with, and are as ordinary and necessary as salary payments to employees engaged in carrying on an illegal gambling business. Decision by analogy is unnecessary however, if the courts simply apply the statute as it reads and was intended to be read.

C. Criminal Conduct Not Involving Antitrust

The courts in holding legal expenses incurred in an unsuccessful defense of a criminal prosecution involving the conduct of the taxpayer's business non-deductible, often indicate that the question had been well-settled from its inception.[36] The Tax Court in *Thomas A. Joseph*[37] emphasized the uniformity of the

31. Hoover Motor Express Co. v. United States, 356 U.S. 38 (1958).
32. Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958).
33. Cases cited note 5 *supra*.
34. Commissioner v. Sullivan, 356 U.S. 27 (1958).
35. Dukehart-Hughes Tractor & Equip. Co. v. United States, 341 F.2d 613 (Ct. Cl. 1965). See 17 S.C.L. Rev. 600 (1965).
36. See, *e.g.*, Thomas A. Joseph, 26 T.C. 562 (1956).
37. 26 T.C. 562 (1956).

courts in sustaining the commissioner's disallowance, and in so doing, the court cited several earlier decisions, including *Sarah Backer*[38] and *Burroughs Bldg. Material Co.*[39] A review of these early cases and one decided in the same year as *Thomas A. Joseph* is illuminating.

In *Sarah Backer* the petitioners were the executors of the estate of George Backer. Backer was called by an investigating committee of the legislature of the State of New York in the so-called "Lockwood Investigation."[40] Backer was asked if he had ever made "pay-offs" to one Brindell, a labor union official, and he answered that he had not. Later in his testimony Backer admitted to making "pay-offs" to other unidentified union officials. Backer was indicted for perjury and subsequently tried. The trial resulted in a deadlocked jury and the charges were dismissed. The legal expenses incurred by Backer were deducted as an ordinary and necessary expense of his construction business.

In sustaining the Commissioner's disallowance of the deduction the Board of Tax Appeals held that the expenses were not ordinary and necessary, but rather were personal expenditures and thus non-deductible. The court reasoned that the crime of perjury was personal in nature and in no way could it have arisen from carrying on a trade or business.

The decision is interesting due to the court's discussion of public policy as a ground for disallowing deductions incurred in an unsuccessful defense of a criminal prosecution involving the business of a taxpayer. The court intimated that a distinction may exist between a crime *malum in se* and one *malum prohibitum*. "We must regard this as written into every statute, especially as to such common crimes as are prohibited generally throughout the land—those *mala in se*, which have immemorially been regarded as contrary to public welfare."[41] Inasmuch as the case was decided on the ground that the expense was personal, this discussion is mere *obiter*, but it betrayed the Board of Tax Appeals' tacit recognition that the question was not open and shut.

Some five years later Member Sternhagen, who had dissented in *Backer*, again registered a strong dissent in *Burroughs Bldg.*

38. 1 B.T.A. 214 (1924).

39. 18 B.T.A. 101 (1929), *aff'd*, 47 F.2d 178 (2d Cir. 1931).

40. This committee investigated the practice of labor union officials of calling strikes in the midst of large construction jobs and demanding a "pay-off" before calling the strike off.

41. 1 B.T.A. 214, 216 (1924).

Material Co.,[42] a portion of which has been cited above. Sternhagen's dissents coupled with the majority's intimation in *Backer* that the nature of the crime should be the determining factor in disallowing deductions for legal fees in criminal litigation clearly indicates that the early cases had not settled the controversy as a matter of course.

As late as 1956 the Court of Appeals for the Fifth Circuit in *Commissioner v. Schwartz*[43] went out of its way to discuss the deductibility of legal expenses incurred in defense of a criminal prosecution involving the conduct of the taxpayer's business—a question not before the court—and refused to rule on it. After commenting on several earlier cases disallowing the deduction, the court remarked:[44] "we do not pass upon the validity of the premise thus accepted as it is not contraverted." If the question had been as well settled as *Thomas A. Joseph* indicates the court in *Schwartz* would have certainly approved the earlier cases. The court, on the contrary, refused to grant approval to the cases disallowing the deduction, making it clear that the problem had not long since been put at rest.

Although the majority of courts have disallowed the deduction there has remained an air of dissention over the validity of the disallowance.

D. Antitrust

It is interesting to note that the deductions claimed for attorneys fees in the unsuccessful defense of criminal antitrust violations have been handled differently from other criminal violations by the Internal Revenue Service. It is for this reason that criminal antitrust and the rules governing deductibility of expenses in defense of this type prosecution requires special attention.

The early cases (those prior to *Commissioner v. Heininger*) had fairly well established that legal expenses incurred in an unsuccessful defense of a criminal antitrust statutes brought by either a state government or the federal government were nondeductible.[45] The same result followed where the suit was settled

42. 18 B.T.A. 101, 103 (1929).

43. 232 F.2d 94 (5th Cir. 1956).

44. 232 F.2d 94, 99 n.9 (5th Cir. 1956).

45. Gould Paper Co. v. Commissioner, 72 F.2d 698 (2d Cir. 1934), (federal action); Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178 (2d Cir. 1931).

by the taxpayer and the government,[46] or where the taxpayer pleaded *nolo contendere*.[47] The only questionable area prior to the *Heininger* case was where the suit was brought by private individuals.[48]

In *Foss v. Commissioner*[49] the taxpayer was the principal shareholder of the American Blower Company and similarly had large holdings in a competing company. Minority stockholders of the Blower Company brought a bill in equity charging the taxpayer with violation of the Sherman Antitrust Act, and sought to enjoin him from voting his stock. The District Court granted both remedies to the plaintiffs, but the Court of Appeals for the Second Circuit vacated that portion of the order granting the injunction. The taxpayer deducted the expenses he had incurred in the suit, and the Board of Tax Appeals sustained the Commissioner's disallowance of the deduction. The Court of Appeals for the First Circuit, reversing, allowed the taxpayer to deduct the litigation expenses.

Some two years later the Court of Appeals for the Second Circuit in *National Outdoor Advertising Bureau, Inc. v. Helvering*,[50] although faced with a deduction involving government and not private action, expressly rejected, by obiter dictum the First Circuit's holding in the *Foss* case.

The focal point of any discussion concerning the deduction of legal fees incurred in an unsuccessful defense of a criminal antitrust prosecution is the decision of the Supreme Court in *Commissioner v. Heininger*.[51] Shortly after *Heininger* the Tax Court decided *Longhorn Portland Cement Co.*[52] The Bureau of Internal Revenue, following these two cases, issued G.M.C. 24377,[53] which ruled that legal expenses incurred in an unsuccessful defense of criminal antitrust litigation *were* deductible as ordinary and necessary expenses of doing business.

In *Commissioner v. Heininger* the taxpayer, a dentist, was engaged in making and selling false teeth through the mail. The

46. Gould Paper Co. v. Commissioner, 72 F.2d 698 (2d Cir. 1934).

47. El Camino Refining Co., 11 P-H Tax Ct. Mem. 669 (1942).

48. *Compare* National Outdoor Advertising Bureau, Inc. v. Helvering, 89 F.2d 878 (2d Cir. 1937), *with* Foss v. Commissioner, 75 F.2d 326 (1st Cir. 1935).

49. 75 F.2d 326 (1st Cir. 1935).

50. 89 F.2d 878 (2d Cir. 1937).

51. 320 U.S. 467 (1943).

52. 3 T.C. 310 (1944).

53. Rev. Rul. 11880, 1944 CUM. BULL. 93.

taxpayer sent circulars and advertisements through the mail proclaiming the virtues of his product. The Postmaster General determined that some of the language contained in the circulars was misleading and some false. Based on this finding he issued a fraud order prohibiting the Chicago Postmaster from paying any money orders drawn to the taxpayer and directing him to stamp all letters addressed to the taxpayer "fraudulent," and to return the letters to the senders. The taxpayer, faced with the destruction of his business, sought to enjoin the Postmaster General. The taxpayer succeeded in the District Court, but on appeal the order of the District Court was overturned.[54] The taxpayer deducted the legal expenses he had incurred in his effort to resist the fraud order.

The Commissioner, whose ruling was affirmed by the Board of Tax Appeals, disallowed the deduction as not constituting an ordinary and necessary expense of business.[55] The court of appeals reversed.[56]

In affirming[57] it was necessary for the Supreme Court to arrive at two determinations, (1) that the expense incurred was ordinary and necessary and (2) that the deduction of the expense would not violate any sharply defined public policy.

In finding that the expense was ordinary and necessary the Court said:

> For respondent to employ a lawyer to defend his business from threatened destruction was 'normal'; it was the response ordinarily to be expected. . . . Since the record contains no suggestion that the defense was in bad faith or that the attorney's fees were unreasonable, the expenses incurred can also be assumed appropriate and helpful, and therefore 'necessary'. . . . He was placed in a position in which not only his selling method but also the continued existence of his lawful business were threatened with complete destruction. So far as appears from the record respondent did not believe, nor under our system of jurisprudence was he bound to believe, that a fraud order destroying his business was justified by the facts or the law. . . . To say that this course of conduct and the expenses which it involved were

54. Farley v. Heininger, 70 App. D.C. 200 (1939), *rev'd,* 105 F.2d 79 (D.C. Cir. 1939), *cert. denied,* 308 U.S. 587 (1939).

55. S. B. Heininger, 47 B.T.A. 95 (1942).

56. Heininger v. Commissioner, 133 F.2d 567 (7th Cir. 1943).

57. Commissioner v. Heininger, 320 U.S. 467 (1943).

> extraordinary or unnecessary would be to ignore the forms of speech prevailing in the business world.[58]

In determining that the deduction would not frustrate public policy the Court said:

> The single policy of these sections is to protect the public from fraudulent practices committed through the use of the mails. It is not their policy to impose personal punishment on violators. . . . Nor is it their policy to deter persons accused of violating their terms from employing counsel to assist in presenting a bona fide defense to a proposed fraud order.[59]

The Court then went on to say that "to deny the deduction would attach a serious punitive consequence to the Postmaster General's finding which Congress has not expressly or impliedly indicated should result from such a finding."[60]

It is very interesting to note the Court's reading of the statute regarding the lawful or unlawful character of the expense and the position of the Internal Revenue Service as stated in its brief in the *Heininger* case.

> The language of section 23(a) [now section 162(a)] contains no express reference to the *lawful* or *unlawful* character of the business expenses which are declared to be deductible. And the brief of the government in the instant case expressly *disclaims* any contention that the purpose of tax laws is to penalize illegal business by taxing gross instead of net income. (Emphasis added.)[61]

The following year in *Longhorn Portland Cement Co.*[62] the Tax Court, following *Commissioner v. Heininger*, allowed the taxpayer to deduct legal expenses it had incurred in arranging a settlement with the state of Texas for alleged civil antitrust violations.

It is to be noted that neither *Heininger* nor *Longhorn* involved a taxpayer who had unsuccessfully defended a criminal prosecution. Both cases involved civil liability although the taxpayer in *Longhorn* was faced with statutory penalties.

58. *Id.* at 471-72.
59. *Id.* at 474.
60. *Id.* at 474-75.
61. *Id.* at 474.
62. 3 T.C. 310 (1944).

From 1944 through 1962 no cases arose in the criminal antitrust area due to the Commissioner's ruling in G.C.M. 24377, cited above, but in 1962 the Internal Revenue Service reversed itself.[63] This was due to the antitrust suits which arose involving the electrical equipment manufacturers and the subsequent convictions of the companies and their officers. In Revenue Ruling 62-175[64] the Service ruled that legal expenses paid or incurred in unsuccessfully defending a prosecution for a criminal violation of the Sherman Antitrust Act are not deductible as an ordinary and necessary expense of business. Two years later the Service followed 62-175 with Revenue Ruling 64-224,[65] in which it declared that expenses incurred in an unsuccessful defense of a criminal violation of antitrust statutes brought by governmental authorities are not deductible, while expenses incurred in unsuccessfully defending private actions are deductible.

E. Mandate For Change: Tellier v. Commissioner[66]

The decision by the court of appeals for the second circuit represents a marked departure from past authority. The court, sitting *en banc*, unanimously ruled that legal expenses incurred by a taxpayer in unsuccessfully defending himself against a criminal prosecution *are* deductible as ordinary and necessary. The decision is not final however, as certiorari has been granted.

The taxpayer was tried and convicted of violations of the fraud sections of the Securities Act of 1933.[67] In his unsuccessful defense the taxpayer incurred legal expenses which he deducted. The Tax Court, adhering to its earlier decisions, sustained the Commissioner and disallowed the deduction.[68] The Court of Appeals for the Second Circuit reversed.

The court based its decision on three grounds: (1) the purpose of the Internal Revenue Code is taxation and not moral reform,[69] (2) the expenses of the taxpayer were in fact ordinary and necessary,[70] and (3) to allow the deduction did not frustrate public policy.[71]

63. Rev. Rul. 62-175, 1962-2 CUM. BULL. 50.
64. *Ibid.*
65. Rev. Rul. 64-224, 1964-2 CUM. BULL. 52.
66. 342 F.2d 690 (2d Cir. 1965), *cert. granted,* 382 U.S. 808 (1965).
67. § 17, 48 Stat. 84 (1933), as amended 15 U.S.C. § 77q(a) (1958).
68. 22 CCH Tax Ct. Mem. 1062 (1963).
69. 342 F.2d 690, 692 (2d Cir. 1965), *cert. granted,* 382 U.S. 808 (1965).
70. *Id.* at 693.
71. *Id.* at 694.

The court notes at the outset that there is nothing in the statute which dictates or even suggests such a disallowance. In discussing section 162(a) and its purpose, the court referred to the committee discussions relating to business losses, and in particular, those made by Senator Williams, cited above, which make it clear that the allowance of such deductions was not intended to be prohibited.

The court then turned to the discussion of the meaning of the phrase "ordinary and necessary." The court cited and discussed *Commissioner v. Heininger*, noting that the Supreme Court had never rendered a decision which lent any support to the proposition that legal fees incurred in an unsuccessful defense of a criminal prosecution are not deductible, and saying "in fact the Court has cast doubt on the rule by what it has said with respect to the reasons ordinarily given to justify the existence of the rule." The court concluded that the expense was "ordinary and necessary,"[72] and said:

> [T]o the extent that the equation of illegality with extraordinary and unnecessary is not question begging, it is applying special meaning to 'ordinary and necessary' which are not applied in other connections. So long as the expense arises out of the conduct of the business and is a required outlay it ought to be considered ordinary and necessary.[73]

The court also dealt with the critical issue of public policy, relying heavily on what the Supreme Court had said in *Lilly v. Commissioner*[74] in regard to public policy. The court in *Tellier* noted that the Supreme Court had laid down the requirement of governmental declaration of public policy which it stated had never been done, and further stated that it doubts that such a statement of public policy would be valid in the face of the sixth amendments guaranty of the right to counsel.[75]

The court concluded: "we hold that legal expenses are deductible where they arise out of and are immediately or proximately connected with, and are required for, the conduct of a trade or business."[76]

The court's decision in *Tellier* is the culmination of a long and hard fought battle. After years of following what was in the

72. *Id.* at 693.
73. *Id.* at 694.
74. 343 U.S. 90 (1952).
75. 342 F.2d 690, 694 (2d Cir. 1965), *cert. granted,* 382 U.S. 808 (1965).
76. *Id.* at 695.

first place a judge-made rule, one court has finally unequivocally taken the position long advocated by Randolph Paul and others.[77] The *Tellier* decision points up the weakness and inconsistency which followed the rule disallowing the deduction.

F. Conclusion

The state of the law today is virtually what it was prior to the Supreme Court's decision in *Commissioner v. Heininger*, with the glaring exception of the Second Circuit's decision in *Tellier*. In antitrust suits the Internal Revenue Service has come "full circle," while in regard to other criminal violations, it has persisted in maintaining that no deduction for legal expenses should be allowed. The Supreme Court is now faced with the arduous task of unravelling the web as woven by the courts and the Service over the past forty years. At the very least the Court can at last settle an area of the law which for too long has been the subject of controversy and conjecture. At the very best, the Court can apply the statute as it reads, and as it was intended to be read, by affirming the decision of the Court of Appeals for the Second Circuit in *Tellier v. Commissioner*.

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77. See note 14 *supra*.