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with the unrecorded federal tax claim. Although *Speers* to a limited extent represents an erosion in favor of state and local governments of the effectiveness of the unrecorded federal tax lien, its effect upon distributions to general creditors of the bankrupt is nonexistent. Of course, the Government can avoid the whole *Speers* problem entirely by recording its lien before bankruptcy in accordance with § 6323 of the Internal Revenue Code. If the Government should, as a matter of policy, decide that the effect of *Speers* upon the federal revenue is great enough to warrant recordation in all cases, then the result of *Speers* will be simply the elimination of the secret aspects of the federal tax lien.

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TAXATION–LEGAL FEES IN UNSUCCESSFUL CRIMINAL DEFENSE HELD DEDUCTIBLE AS BUSINESS EXPENSES

In *Commissioner v. Tellier*[1] the Supreme Court was presented with the argument that legal fees incurred in the unsuccessful defense of a criminal charge arising out of taxpayer's business, though they meet the literal requirements of § 162(a), are not deductible because deduction would reward criminal activity. Taxpayer in *Tellier* was engaged in the business of underwriting and selling securities. He was convicted and fined $18,000 for violating the fraud section of the Securities Act of 1933,[2] the mail fraud statute,[3] and conspiracy to violate both of these statutes.[4] In his defense taxpayer incurred and paid approximately $23,000 in legal fees, and he sought to deduct this expenditure as an "ordinary and necessary" business expense under § 162(a) of the Internal Revenue Code.[5] The Commissioner disallowed the deduction and was sustained by the Tax Court on the ground that "public policy" bars the deduction of legal expenses incurred in defense of acts found to be criminal.[6] The 2d Circuit en banc unanimously reversed[7] and the Supreme Court agreed, holding that such expenses are "ordinary and necessary" within the

[1]86 Sup. Ct. 1118 (1966).
[2]48 Stat. 84 (1933), as amended 15 U.S.C. § 77q(a) (1954).
[3]18 U.S.C. § 1341 (1948).
[4]18 U.S.C. § 371 (1948).
[5]Int. Rev. Code of 1954, § 162(a), "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."
[6]Walter F. Tellier, 32 P-H Tax Ct. Mem. 1207 (1963).
[7]Tellier v. Commissioner, 342 F.2d 690 (2d Cir. 1965).

meaning of § 162(a) of the Internal Revenue Code, hence fully deductible because no sharply defined public policy is frustrated by allowing the deduction.[8]

The Internal Revenue Code of 1954 allows a deduction for "all the ordinary and necessary expenses" incurred in carrying on a trade or business.[9] Judicial interpretation of the statutory language "ordinary and necessary" requires only that the expenditure be directly connected with or proximately result from the taxpayer's business,[10] that the expenditure be common and accepted in that type of business,[11] and that the expenditure be appropriate at the time or helpful to the taxpayer.[12] In short "ordinary" has been construed to mean "normal" or "common" among similarly situated businessmen, and "necessary" has been construed to mean "helpful" or "appropriate" to the maintenance of the taxpayer's business.[13] Cardozo in applying the statutory language to legal fees said:

> Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.[14]

Although the Code imposes no general requirement that business expenses be lawful or arise out of lawful activities,[15] the judiciary has developed a "public policy" exception to the Code language denying the deduction of otherwise "ordinary and necessary" expenses if

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[8]86 Sup. Ct. 1118 (1966).

[9]Int. Rev. Code of 1954, § 162(a).

[10]*E.g.*, Kornhauser v. United States, 276 U.S. 145, 153 (1928).

[11]*E.g.*, Lilly v. Commissioner, 343 U.S. 90, 93 (1952); Commissioner v. Heininger, 320 U.S. 467, 471 (1943); Deputy v. duPont, 308 U.S. 488, 495 (1940).

[12]*E.g.*, Lilly v. Commissioner, *supra* note 11, at 93-94; Commissioner v. Heininger, *supra* note 11, at 471.

[13]See, *e.g.*, Lilly v. United States, 348 U.S. 90 (1952); Deputy v. duPont, 308 U.S. 488 (1940); Welch v. Helvering, 290 U.S. 111, 113-14 (1933); Kornhauser v. United States, 276 U.S. 145 (1928). Commissioner v. Tellier, *supra* note 1, at 1120 provides:

> The principal function of the term ordinary in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset.

[14]Welch v. Helvering, *supra* note 13, at 114.

[15]Commissioner v. Heininger, *supra* note 11, at 474; 50 Cong. Rec. 3849 (1913).

such expenditures arise out of or are related to unlawful activities.[16] Of course some expenditures, particularly those illegal or unethical in themselves, may validly be disallowed as extraordinary if they are uncommon or unaccepted ways of doing business.[17] The underlying reason for disallowing expenditures associated with illegal activity is that the allowance of a deduction will, through the consequent reduction of tax liability, benefit, hence encourage, illegal activities.[18] Although such reasoning has merit, it fails to recognize that a basic goal of the federal tax system is conformation of tax liability solely to the ability to pay.[19] To accomplish this the tax should be measured by net, rather than gross income. No matter how large the gross from business activities may be, if there is no net income, there is, at least theoretically, no greater ability to pay than there would have been if the activities had not been engaged in.[20] The denial of otherwise "ordinary and necessary" business expense deductions results in measuring tax liability in terms of gross income, contrary to a basic principle of our tax system.[21]

The judiciary early formulated rules as to the tax deductibility of litigation expenses. No deduction is allowed for legal expenses if they are incurred in purely personal litigation.[22] However, legal expenses incurred in maintaining or defending a civil action arising out of the

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[16]See, *e.g.*, United States v. Worcester, 190 F. Supp. 548 (D. Mass. 1961); Dixie Mach. Welding & Metal Works, Inc. v. United States, 315 F.2d 439 (5th Cir. 1963); N. A. Woodworth Co. v. Kavanaugh, 202 F.2d 154 (6th Cir. 1953).

[17]See, *e.g.*, United Draperies, Inc. v. Commissioner, 340 F.2d 936 (7th Cir. 1964), where it was held: "the record reveals nothing inherent in the nature of petitioner's drapery enterprise which serves to endow such payments with a character of ordinariness they would not otherwise possess. In reaching this conclusion we do so apart from consideration of the morality or legality of the practice." *Id.* at 938, but compare the dissent which felt that the "kickback" payments were ordinary and necessary within the meaning of the applicable regulations. The dissenting justice stated: "the methods used by the taxpayer in the instant case should be prohibited," but that this result should be attained by Congressional action and not by court edict. *Id.* at 938. See also Reid, *Dissallowance of Tax Deductions on Grounds of Public Policy—A Critique*, 17 Fed. B.J. 575, 582-83 (1957).

[18]*E.g.*, Jerry Rossman Corp. v. Commissioner, 175 F.2d 711 (2d Cir. 1949).

[19]See Keesling, *Illegal Transactions and the Income Tax*, 5 U.C.L.A. L. Rev. 26, 35 (1958).

[20]*Ibid.*

[21]*Ibid.*

[22]See United States v. Gilmore, 372 U.S. 39, 49 (1963), where the Court held that "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal'" within the meaning of § 162(a).

conduct of business have uniformly been held deductible.[23] Moreover, taxpayers have uniformly been allowed to deduct legal fees incurred in the successful defense of a criminal action where the acts arose out of the conduct of their business. Successful defenses include acquittal,[24] dismissal,[25] nolle prosequi,[26] and favorable consent decrees.[27] Until *Tellier* the lower courts had uniformly disallowed the deduction of legal fees incurred in the unsuccessful defense of criminal actions where the acts arose out of the conduct of business.[28]

This disallowance was first established in *Burroughs Bldg. Material Co. v. Commissioner*[29] in 1932 by the same Circuit that later abrogated it. Taxpayer had claimed deductions for fines imposed and legal fees incurred in a criminal prosecution for antitrust violations. *Burroughs* disallowed the deduction of the fines and legal fees, reasoning that public policy requires that "illegal" acts not be sanctioned by the courts, and concluded: "If the fines and costs cannot be deducted, the legal expenses . . . should naturally fall with the fines themselves." [30] The court overlooked an important distinction between fines and legal fees in arriving at its conclusion, as have courts following this precedent. The amount of a fine, in theory, represents an appropriate exaction for unlawful conduct. Although disallowing deduction of a fine may be necessary to sustain its punitive effect,[31] litigation expenses are, in theory, of no concern to the criminal law. Their disallowance creates an additional penalty not called for by the statutory violation. Further, the amount of legal expenses varies with the time spent in conducting the defense rather than with the severity of the crime; thus the denial of the deduction may be unduly harsh in relation to the statutory penalty.[32]

The application of a broad "public policy" rationale in disallowing business deductions was considerably restricted in 1943 by the Supreme

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[23]See, *e.g.*, Foss v. Commissioner, 75 F.2d 326 (1st Cir. 1935); John W. Clark, 30 T.C. 1330 (1958).

[24]Commissioner v. People's-Pittsburg Trust Co., 60 F.2d 187 (3rd Cir. 1932).

[25]Commissioner v. Shapiro, 278 F.2d 556 (7th Cir. 1960).

[26]Morgan S. Kaufman, 12 T.C. 1114 (1949).

[27]National Outdoor Advertising Bureau, Inc. v. Helvering, 89 F.2d 878 (2d Cir. 1937).

[28]See, *e.g.*, Bell v. Commissioner, 320 F.2d 953 (8th Cir. 1963); Acker v. Commissioner, 258 F.2d 568 (6th Cir. 1958); Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178 (2d Cir. 1931); Anthony Cornero Stralla, 9 T.C. 801 (1947).

[29]47 F.2d 178 (2d Cir. 1931).

[30]*Id.* at 180.

[31]*Cf.* Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958).

[32]See Note, 51 Colum. L. Rev. 752, 757 (1951).

Court in *Commissioner v. Heininger*.[33] The Court held that a business expense deduction may be disallowed only when permitting the deduction would "frustrate sharply defined national or state policies proscribing particular types of conduct." [34] *Lilly v. Commissioner*[35] added a further restriction when it allowed business expense deductions for kickback payments by opticians to doctors for glasses prescribed by the doctors because there was no clear frustration of a public policy "evidenced by some governmental declaration." The Court suggested such declarations should be left to "the province of legislatures." [36] Finally, the "test of nondeductibility always is the severity and the immediacy of the frustration resulting from allowance of the deduction." [37]

The Supreme Court has found "frustration of sharply defined policy" in only 2 types of otherwise "ordinary and necessary" business expenses: (1) criminal fines,[38] (disallowed in order not to frustrate legislative policy by reducing the 'sting' of the prescribed penalty); (2) lobbying expenditures,[39] (disallowed on the ground that expenses incurred in influencing legislation or securing government contracts should not receive governmental sanction in any form).[40]

Moreover, the Supreme Court has continually emphasized that the intent of Congress in providing for deduction of ordinary and necessary business expenses was, except where specifically provided otherwise,[41] to tax *net* income regardless of its source, rather than to "reform men's moral characters." [42] Thus, in 1958 the Court in *Commissioner v. Sullivan*[43] held payments for rent and employees' salaries in the conduct of an illegal gambling enterprise were deduct-

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[33]320 U.S. 467 (1943).

[34]*Id.* at 473.

[35]343 U.S. 90 (1952).

[36]*Id.* at 97.

[37]Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 35 (1958).

[38]Hoover Motor Express Co. v. United States, 356 U.S. 38 (1958).

[39]Cammarano v. United States, 358 U.S. 498 (1959); Textile Mills Sec. Corp. v. Commissioner, 314 U.S. 326 (1941).

[40]See Note, 67 Harv. L. Rev. 1408 (1954). These holdings are now embodied in § 162(e)(2) of the Int. Rev. Code of 1954. § 162(e)(2) states that the § 162 deduction is disallowed "For any amount paid or incurred . . . in connection with any attempt to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums."

[41]*E.g.*, Int. Rev. Code of 1954, § 165(d) which limits the deduction of wagering losses to the amount of wagering gains.

[42]50 Cong. Rec. 3849 (1913) (cited in *Tellier supra* note 8, at 1121); Commissioner v. Sullivan, 356 U.S. 27, 29 (1958); Commissioner v. Heininger, 320 U.S. 467, 474 (1943).

[43]356 U.S. 27 (1958).

ible, even though the payments violated the applicable state penal statute. *Sullivan* reasoned that amounts paid as wages and rent are "ordinary and necessary expenses" in the accepted meaning of those words and that to disallow them "would come close to making this type of business taxable on the basis of its gross receipts, while all other business would be taxable on the basis of net income. If that choice is to be made, Congress should do it." [44] As a result of *Sullivan*, the Justice Department recommended to Congress a bill disallowing expenses incurred by businesses violating state and federal statutes.[45] The proposal was never enacted. A few years earlier Congress had considered a bill disallowing expenses resulting from illegal gambling and rejected it on the ground that the Internal Revenue Code is not intended to penalize or prohibit unlawful activities.[46]

These recent rejections by Congress coupled with the Supreme Court decisions in *Heininger* and *Lilly* seem to endorse neutrality in the administration of the tax statutes where illegal conduct is invoked as a basis for disallowing business deductions. In any case the frustration doctrine announced in *Heininger* requires only that allowance of a deduction not frustrate sharply defined public policy, that is, more than frustration of vague or general policy is required.

The attitude with which the pre-*Tellier* lower courts have approached the issue presented in *Tellier* is illustrated by Learned Hand's statement that to allow deduction of counsel fees for an unsuccessful defense would tend to "subsidize the obduracy of those offenders who were unwilling to pay without a contest and who therefore added impenitence to their offense." [47] Such reasoning is especially inappropriate when applied to vague statutes regulating trade practices, in which neither the Government nor the defendant can in any real sense be said to know the requirements of the law before the courts declare it.[48] As a result of Hand's language and of dictum in *Heininger*,[49] it has been suggested that the deduction be allowed only where the criminal defense is asserted in good faith.[50] This suggestion

[44] *Id.* at 29.
[45] H.R. Rep. No. 7394, 86th Cong., 1st Sess. (1959).
[46] 97 Cong. Rec. 12230-44 (1951).
[47] Jerry Rossman Corp. v. Commissioner, 175 F.2d 711, 713 (2d Cir. 1949).
[48] See Comment, 72 Yale L.J. 108, 135 (1962).
[49] 320 U.S. 467, 471. "Since the record contains no suggestion that the defense was in bad faith or that the attorney's fees were unreasonable, the expenses incurred in defending the business can also be assumed appropriate and helpful, and therefore 'necessary.'"
[50] McDonald, *Deduction of Attorney's Fees for Federal Income Tax Purposes*, 103 U. Pa. L. Rev. 168, 180 (1954).

has been criticized for the administrative difficulties it presents, since a test based on the good faith of the defense would seem to place an impossible burden on the courts, the Internal Revenue Service, and the taxpayer.[51] Moreover, it is difficult to know what, short of a defense that itself violates the law, is a bad faith defense. Perhaps Hand's contention has merit where the crime is malum in se. In making no reference to either the nature of the crime for which the taxpayer was convicted, or the merits of the defense presented, the Supreme Court apparently rejected by implication both of these distinctions. But the Commissioner, who has long espoused the view rejected in *Tellier*, will in all probability continue to use such distinctions to disallow these deductions.[52]

The 2d Circuit in holding contrary to long established precedent remarked:

> There has been no 'governmental declaration' of any 'sharply defined' national or state policy of discouraging the hiring of counsel and the incurring of other legal expense in defense against a criminal charge. In fact it is highly doubtful whether such a public policy could exist in the face of the Sixth Amendment's guaranty of the right to counsel.[53]

Both the 2d Circuit's and the Supreme Court's reasoning are related to decisions defining the defendant's constitutional right to counsel. The Court stated that no public policy is offended when one faced with serious criminal charge employs a lawyer to help in his defense. To the contrary, "in an adversary system of criminal justice, it is a basic of our public policy that a defendant in a criminal case have counsel to represent him." [54] But the reasoning in *Tellier* may not be sound. Late in its opinion the Court assumed the issue to be whether there is a public policy to deter the employment of counsel. Surely no such policy exists. The real issue is whether there is a public policy against deducting litigation expenses incurred in unsuccessfully defending a criminal charge. The Court merges these 2 issues by presupposing that a denial of the deduction would deter the employ-

[51]Comment, 72 Yale L.J. 108, 134 (1962).

[52]"During the oral arguments before the Court, the question arose as to whether a person engaged in bank robbing as a trade or business could deduct his legal fees in fighting prosecution. A liberal reading of the Court's opinion could lead to a 'yes' answer. Under the rationale of *Sullivan*, it is apparent that the business itself does not have to be legal. However, it remains to be seen if *Tellier* can be stretched that far." 24 J. Taxation 300 (May 1966).

[53]Tellier v. Commissioner, 342 F.2d 690, 694 (2d Cir. 1965).

[54]Commissioner v. Tellier, *supra* note 1, at 1122.