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Legal Fees for Unsuccessful Defense to Criminal Prosecution—An "Ordinary and Necessary" Business Expense?

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LEGAL FEES FOR UNSUCCESSFUL DEFENSE TO CRIMINAL PROSECUTION—AN "ORDINARY AND NECESSARY" BUSINESS EXPENSE?

Taxpayer, a securities dealer, was tried and convicted of mail fraud[1] and of fraud under the 1933 Securities Act,[2] and conspiracy to violate these statutes.[3] Thereafter he claimed a tax deduction for legal costs incurred in his defense under the "ordinary and necessary" business expense provision in section 162 of the Internal Revenue Code. The deduction was disallowed by the Commissioner, and this ruling was sustained by the Tax Court. On appeal, the Second Circuit Court of Appeals reversed. *Held*: Public policy does not preclude the deduction of legal expenses incurred in an unsuccessful criminal defense arising out of, proximately connected with, and required in the conduct of a trade or business. *Tellier v. Commissioner*, 342 F.2d 690 (2d Cir.), *cert. granted*, 34 U.S.L. WEEK 3118 (U.S. Oct. 12, 1965) (No. 351).

The Internal Revenue Code was initially framed in 1913 with a purpose to "tax a man's net income" rather than "to reform men's moral characters."[4] Eleven years later the Board of Tax Appeals observed that it was not "in the interest of sound public policy that the commission of illegal acts should be so far protected or recognized that their cost is regarded as a legitimate and proper deduction...."[5] Although this dictum was subsequently approved by many courts, the original purpose of the business expense section was reaffirmed by Congress in 1951 when a proposal disallowing expenses resulting from illegal gambling was rejected on the ground that the Code was not intended to penalize or prohibit unlawful activities.[6] Again in 1954 Congress rejected a proposal which would have codified the disallowance rule.[7] Subsequent to a 1958 Supreme Court decision[8] allowing deduction of lawful expenses of an unlawful business, the Justice

[1] 18 U.S.C. § 1341 (1964).

[2] Ch. 38, tit. I, § 17, 48 Stat. 84; as amended Act of Aug. 10, 1954, ch. 667, tit. I, § 10, 68 Stat. 686; 15 U.S.C. § 77q(a) (1964).

[3] 18 U.S.C. § 371 (1964).

[4] 50 CONG. REC. 3849 (1913) (remarks by Senator Williams).

[5] Sarah Backer, 1 B.T.A. 214, 217 (1924). This appears to be the earliest expression in the United States of public policy considerations in connection with the business expense provision. An earlier appearance of the doctrine was expressed in Great Britain in Inland Revenue Comm'rs v. Warnes & Co., 2 K.B. 444 (1919).

[6] 97 CONG. REC. 12230-44 (1951) (debate on amendment proposed by Senator Kefauver).

[7] See Comments, ALI FED. INCOME TAX STAT. § X 154(i) 282-86 (May 1952 Draft).

[8] Commissioner v. Sullivan, 356 U.S. 27 (1958).

Department recommended to Congress a bill disallowing expenses incurred by businesses violating state or federal statutes.[9] It was not accepted. Although a provision was added in 1960 to section 162[10] disallowing unlawful payments made to officials or employees of foreign governments, this proviso was justified on foreign policy grounds. Moreover, its limited scope negates interpretation as Congressional indorsement of a broad public policy sanction.[11]

In finding that legal costs were deductible as ordinary and necessary expenses, the court in the principal case faced the traditional argument that since it was neither "ordinary" nor "necessary" to operate a business unlawfully, it was unnecessary to incur legal fees. The court cited *Commissioner v. Heininger*[12] to rebut this contention, but *Heininger* may be distinguished because it was a civil action. The fact that *Heininger* was a civil case was not persuasive to the court in the principal case, and it expressly refused "to continue to draw any distinction in deductibility between civil and criminal cases or between successful and unsuccessful defenses."[13] The court in *Tellier* found an expense to be "ordinary and necessary" if it was a required outlay and arose out of the taxpayer's business. This approach parallels the United States Supreme Court's reasoning in *Kornhauser v. United States*,[14] in which legal fees directly connected to or proximately resulting from business activities were held to be "ordinary and necessary" expenses. In adopting this view, the court in the principal case rejected a line of authority under which legal expenses arising out of

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[9] H.R. 7394, 86th Cong., 1st Sess. (1959).

[10] INT. REV. CODE of 1954, § 162(c).

[11] See Comment, 72 YALE L.J. 108, 111 n.15 (1962).

[12] 320 U.S. 467 (1943). Applicable language in *Heininger* includes:

> It is plain that respondent's legal expenses were both "ordinary and necessary" if these words be given their commonly accepted meaning. For respondent to employ a lawyer to defend his business from threatened destruction was "normal"; it was the response ordinarily to be expected.... [T]he expenses incurred in defending the business can also be assumed appropriate and helpful, and therefore "necessary."... It has never been thought... that the mere fact that an expenditure bears a remote relation to an illegal act makes it non-deductible.

Id. at 471, 474. See Note, 13 STAN. L. REV. 92 (1960) for discussion of *Heininger's* effect upon the deductibility of legal fees in unsuccessful criminal defenses connected with business activities.

[13] Tellier v. Commissioner, 342 F.2d 690, 695 (1965). Commentators who believe that *Heininger* applies to criminal as well as civil cases, for example, are J. Miller, *Deductibility of Penalties, Damages, and Counsel Fees in Cases Involving Violations of Non-Tax Laws*, N.Y.U. 8th INST. ON FED. TAX 1286, 1291-92 (1950); H. Smith, *Deductions by Corporations of Expenses of Litigation in Their Defense of Alleged Anti-Trust Violations*, N.Y.U. 8TH INST. ON FED. TAX 646, 650 (1950). Holding *Heininger* to apply only to civil suits are Commissioner v. Schwartz, 232 F.2d 94 (5th Cir. 1956); Longhorn Portland Cement, 3 T.C. 310 (1944), *rev'd on other grounds*, 148 F.2d 376 (5th Cir.), *cert. denied*, 326 U.S. 728 (1954).

[14] 276 U.S. 145 (1928).

activities deemed contrary to public policy were put in the same category as non-deductible penalty assessments.[15] The effect of *Tellier* is to focus attention on the relationship of the expense to the business, without regard to collateral policy considerations.

The argument against allowing deduction of legal costs arising out of a statutory violation is that the deduction frustrates public policy by taking some of the "sting" out of the statutory penalty. This view was previously indorsed by the Second Circuit in *Burroughs Bldg. Material Co. v. Commissioner* in its conclusion that "if the fines and costs cannot be deducted the legal expenses . . . should naturally fall with the fines themselves."[16] However, an important distinction between fines and fees was overlooked in arriving at that conclusion. The amount of a fine, in theory, represents an appropriate exaction for unlawful conduct. Although disallowing its deduction may be necessary to sustain its punitive value,[17] legal costs are of no concern to penal law; their disallowance, therefore, invokes an additional penalty unassociated with the statutory violation. Since the taxpayer in the principal case made no attempt to deduct the *fine* assessed, the statutory policy considerations were satisfied even though the court held the legal expenses to be deductible.

As a general proposition, absent public policy problems, there is little theoretical difficulty in finding a business expense to be "ordinary and necessary."[18] The Supreme Court in *Lilly v. Commissioner*[19] recognized that an otherwise "ordinary and necessary" expense may be disallowed if "sharply defined national or state policies" would be frustrated: "the policies frustrated must be national or state policies *evidenced by some governmental* declaration . . . ."[20] In *Lilly* the

[15] The most authoritative support for this categorization comes from the Second Circuit itself, in Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178 (2d Cir. 1931). Since a resolution of the issue in the principal case in favor of the taxpayer would require a categorical overruling of *Burroughs,* the Second Circuit considered this appeal.

[16] *Id.* at 180.

[17] A counter-argument is that disallowance of deductions for fines or penalties increases the burden of the fine by the amount of the additional tax liability, and since the tax authorities are neutral toward the *source* of income they should also be neutral toward reduction of penalties. In Jerry Rossman Corp. v. Commissioner, 175 F.2d 711 (2d Cir. 1949), the court permitted deduction of a penalty on the ground that a disallowance amounted to an additional sanction unwarranted by the statute violated. *But cf.* Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958).

[18] A broad interpretation is given "ordinary and necessary" since a strict construction would place the courts in the position of reviewing the taxpayer's business decisions—a consideration better suited to business efficiency experts. However, the taxpayer must get by the strict public policy interpretation obstacle before receiving the benefit of this liberal construction.

[19] 343 U.S. 90 (1952).

[20] *Id.* at 97. (emphasis added.)

Commissioner had disallowed deductions for kickback payments by opticians to doctors for eyeglasses prescribed by the doctors. On appeal, the Court held such payments to be deductible because there was no clear evidence of a contrary public policy. In the principal case no clear evidence of a public policy forbidding the hiring of counsel was found, and indeed the validity of such a policy would be doubtful in light of the recent development of the sixth amendment right to counsel.[21]

A question is raised whether the "right to counsel" argument is applicable in the principal case, since counsel had already been employed and paid. The effect of disallowing deduction of the legal costs would be to penalize the taxpayer for exercising his right, rather than to deny it. In any event, it is clear that there is no valid policy against employing counsel. Under *Lilly* this fact would seem to require allowance of a deduction for legal fees.

The holding in *Commissioner v. Sullivan*[22] lends further support to the conclusion reached in the principal case. In *Sullivan* the Supreme Court permitted rents and wages paid in connection with an illegal gambling business to be deducted as an ordinary and necessary business expense. If rents and wages expended in connection with an illegal business are deductible, a fortiori legal costs in connection with such a business should be deductible.

It has also been argued that, if legal expenses are deductible, taxpayers (particularly ones in high income brackets) will be encouraged to spend large sums in opposing governmental actions. This conviction was expressed by Judge Learned Hand in *Jerry Rossman Corp. v. Commissioner*.[23] Judge Hand stated that to permit a deduction would be to "subsidize the obduracy of those offenders who were unwilling to pay without a contest and who therefore added impenitence to their offense; and for this reason . . . we held that such legal expenses were never deductible."[24] To this argument is added the fact that increased litigation results in protracted trials, higher costs of investigation, and

[21] It was proper for the court in the principal case to consider a disallowance of legal fees in connection with a policy against the sixth amendment right to counsel, as the policies expressed by the statutes violated were satisfied by payment of non-deductible fines. See also, Brookes, *Litigation Expenses and the Income Tax*, 12 TAX L. REV. 241, 266-68 (1957); Krassner, *Can a Deduction for Legal Fees Be Against Public Policy?*, 26 TAXES 447 (1948).

[22] 356 U.S. 27 (1958).

[23] 175 F.2d 711 (2d Cir. 1949).

[24] *Id.* at 713. This statement was made in discussion of the scope of the *Heininger* decision, which was considered to overrule the non-deductibility-of-legal-costs doctrine previously accepted by the Second Circuit.

greater demands upon governmental personnel. These arguments are vulnerable. The fear of increased litigation would be as great in civil actions as criminal, yet the current rule disallowing deductions applies only to criminal cases. Also, the further refinement of allowing legal expenses only if the defense was successful puts a premium on winning which contributes to extended litigation.

The court in the principal case justified its decision to abolish all distinctions between civil and criminal, and successful and unsuccessful, defenses partially on the basis that the former rule results in arbitrary, artificial, and conflicting decisions. This argument is sound when one considers that, for example, a taxpayer who pleads *nolo contendere* may not deduct his legal expenses,[25] but the legal expenses leading to an out of court settlement may be deducted.[26]

Is the broad rule adopted by this court desirable? This question has particular significance when it is considered that few criminal violations raise as little public ire as the conviction in the principal case. Should a convicted dope peddler, for example, be permitted to deduct his legal expenses from income derived from narcotic sales? Should a subjective test have been adopted instead? One measure of public sentiment is the penalty assessed for given acts; consequently, it is the legislature's duty to maintain acceptable penal standards. If the maximum penalty for dope peddling is insufficient, it should be increased directly by legislation. Disallowing legal fees effects an additional indirect penalty which has no connection with the statutory policy or public sentiment. The court in the principal case properly ascertained the different functions of penalties and legal fees, and put them in separate categories. This separation should apply regardless of the particular criminal act involved.

In removing the legal costs of unsuccessful criminal defenses from the category of monetary penalties, the court in the principal case exhibited due regard for reason as well as precedent. It is to be hoped that the analysis will have an early acceptance by the other circuits, which now uniformly adhere to the old rule.[27]

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[25] Bell v. Commissioner, 320 F.2d 953 (8th Cir. 1963); Standard Coat, Apron & Linen Serv., Inc., 40 T.C. 858 (1963).

[26] Commissioner v. Schwartz, 232 F.2d 94 (5th Cir. 1956); Greene Motor Co., 5 T.C. 314 (1945); Longhorn Portland Cement Co., 3 T.C. 360 (1944).

[27] Bell v. Commissioner, 320 F.2d 953 (8th Cir. 1963); Fihe v. Commissioner, 265 F.2d 511 (9th Cir. 1958); Acker v. Commissioner, 258 F.2d 568 (6th Cir. 1958); Estate of MacCrowe, 240 F.2d 841 (4th Cir. 1956); Port v. United States, 143 Ct. Cl. 334, 163 F. Supp. 645 (1958).