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INCOME TAX LITIGATION: THE ARENA FOR MORALS?

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I. INTRODUCTION

"Moral turpitude is not the touchstone of taxability."[1] "The mere fact that an expenditure bears a remote relation to an illegal act . . . [does not] . . . make it nondeductible."[2] The Federal income tax laws are not intended ". . . to penalize illegal business by taxing gross income instead of net income."[3] Are these remarks realities in life? After cursory examination of the case law involving income taxes and the violation of other laws, federal and state, it can be argued that moral turpitude and concomitant penalties are indeed recognized by the courts in dealing with income tax problems.

This article has two principal objectives. First, to analyze the income tax treatment of illegal expenditures in general. Second, to explore the argument that Congress may not constitutionally deny the allowance of any expenditure which is a part of cost of goods sold and represents, therefore, a return of capital as opposed to income.

The decisions dealing with illegal expenditures illustrate the fact such expenditures have caused a considerable amount of confusion in Federal income tax law. One underlying cause of the confusion has been said to be ". . . emotional antagonism to

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

2 Commissioner v. Heininger, 320 U.S. 467, 474 (1943); Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958); Commissioner v. Sullivan, 356 U.S. 27 (1958).

3 Commissioner v. Heininger, 320 U.S. 467, 474 (1943); United States v. Sullivan, 274 U.S. 259 (1927); Commissioner v. Sullivan, 356 U.S. 27 (1958).

the illegal nature of the activities. . . ."[4] Another underlying cause may be traced to semantic difficulties which arise in application of technical terms and concepts set forth in the Internal Revenue Code. Tax language has its own special meanings which may or may not agree with the meanings ascribed to the same language by economists, businessmen, accountants, or even a general practitioner of the law.

How does the term "illegality" fit into the tax picture and what effect does it have upon the technical terms and concepts of Federal income tax law? A hypothetical situation should serve as a vehicle to examine the ramifications of the term in the context of Federal income taxes. Let us assume the existence of a respectable printing company, Black & White Printers, Inc. This company was faced with a shortage of its basic raw material —paper—during the recent Korean conflict. The Defense Production Act of 1950[5] placed a ceiling price on paper. In order to continue in business, Black & White was confronted with two alternatives: paying over-ceiling prices for the paper, or obtaining control of a paper manufacturer through purchase of such a business. Each of these alternatives raises interesting tax consequences but before exploring the possible consequences in detail, note that this simple hypothetical situation with its two alternatives can involve a number of technical tax terms such as "income", "capital", "deduction", "cost of goods sold", "legality", and "illegality". The precise meaning of these terms is somewhat clouded within the tax law and certainly these terms have particular meanings to businessmen, accountants, economists, and others. Such other groups may or may not define the terms in a manner consistent with the tax law or with each other. Further, and more important, such other groups may well use their own definitions as a basis for economic decision and the question is immediately raised as to whether the tax definitions are realistic in terms of a market society.

Before pursuing the tax consequences of the two alternatives posed above, it is helpful, as an introduction to those consequences, to examine very briefly the taxation of illegal income. Although Black & White is engaged in a legal business, if they were involved in an illegal business, would their income be subject to Federal income tax in the first place?

[4] Keesling, "Illegal Transactions and The Income Tax," 5 U.C.L.A. L.Rev. 26 (1958).

[5] 50 U.S.C.A. App. 308, 64 Stat. 798.

II. TAXATION OF ILLEGAL INCOME

The 1913 Income Tax Act defined "gross income" as including the gains, profits and income derived from transactions of any "lawful" business.[6] The word "lawful" was omitted from the subsequent income tax legislation. Since that time, the Treasury Department has not hesitated to tax all incomes of illegal businesses, transactions, and activities. The omission of the word "lawful" in the subsequent Acts has been treated as an indication of Congressional intent to tax all incomes regardless of the legality or illegality of the business or activity from which derived.[7]

In *United States v. Sullivan*,[8] the taxpayer was convicted of fraudulently failing to file an income tax return reporting income from an illegal liquor business. In order to sustain the conviction, it was imperative to determine whether illegal income was required by law to be reported. The court rejected the argument that illegal income was not taxable with this statement:

> We see no reason to doubt the interpretation of the act or any reason why the fact that a business is unlawful should exempt it from paying the taxes that, if lawful, it would have to pay.[9]

Consequently, it is well settled today that all income derived from illegal or legal businesses, transactions or activities are subject to federal income taxes.[10] Gross income has been held to include, among others, receipts from bootlegging operations and other illegal liquor dealings,[11] gambling,[12] extortion,[13] usury,[14]

6 38 Stat. 167 (1913).

7 United States v. Stafoff, 260 U.S. 477, 479 (1922); Rutkin v. United States, 343 U.S. 130 (1952); See dissenting opinion of Justice Burton in Commissioner v. Wilcox, 327 U.S. 404, 419 (1946).

8 274 U.S. 259 (1927).

9 Id. at p. 263.

10 Johnson v. United States, 318 U.S. 189; United States v. Sullivan, 274 U.S. 259; Vol. 1, Merten's, Law of Federal Income Taxation, s. 6A.13. See cases cited, infra, notes 11-20. For collection of cases on illegal income, See 43 ALR 799, 51 ALR 1026, 166 ALR 89.

11 United States v. Stafoff, 260 U.S. 477 (1922); United States v. Sullivan, supra note 8; Steinberg v. United States, 14 F.2d 544 (2d Cir. 1926); Carnahan v. Commissioner, 9 T.C. 1206 (1947); Green v. Commissioner, 11 BTA 185 (1928); Schultzer v. Commissioner, 18 BTA 444 (1929).

12 Commissioner v. Sullivan, 356 U.S. 27 (1958); Johnson v. United States, 318 U.S. 189; Cohen v. Commissioner, 9 T.C. 1156 (1947); Carnahan v. Commissioner, 9 T.C. 1206 (1947); Mill v. Commissioner, 5 T.C. 691 (1945); Silver v. Commissioner, 42 BTA 461 (1940); Huntington v.

abortions,[15] bribery,[16] kickbacks and commercial bribery,[17] ransom for kidnapping,[18] sales in excess of ceiling prices,[19] and forms of graft and swindling.[20]

It has been suggested that the government's recognition of illegal operations for income tax purposes is the equivalent of putting the government in partnership with the criminals; that such recognition gives the activity a status of respectabiliy; but, to adopt a policy of not taxing income from illegal operations would place a premium on illegal enterprises.[21] If such a policy were adopted, it has been intimated that some states would prohibit activities which are presently legal in order to accord their participants preferential exemption.[22] There is no logical reason to treat incomes differently based upon the legality or illegality of its source.[23]

Commissioner, 35 BTA 835 (1937); Weiner v. Commissioner, 10 BTA 905 (1928).

13 Rutkin v. United States, 343 U.S. 130 (1952); United States v. J. J. Moran, 236 F.2d 361 (2d Cir. 1956); Kahn v. Commissioner, 210 F.2d 247 (10th CA, 1954); Humphreys v. Commissioner, 125 F.2d 340 (7th Cir. 1942).

14 Barker v. Magruder, 95 F.2d 122 (D.C. 1938).

15 Karger v. Commissioner, 13 TCM 661 (1954); Dorn v. Commissioner, 6 TCM 848 (1947).

16 Chadeck v. United States, 77 F.2d 961 (5th Cir. 1935); United States v. Comerford, 64 F.2d 28 (2d Cir. 1933).

17 Lilly v. Commissioner, 343 U.S. 90 (1951); United States v. Bruswitz, 219 F.2d 59 (2d Cir. 1955); Sommers v. Commissioner, 14 TCM 793 (1955).

18 Humphreys v. Commissioner, 125 F.2d 340 (7th CA, 1942).

19 Kentucky Distributing Co. v. Commissioner, 17 T.C. 312 (1951); U. S. Packing Co. v. Commissioner, 14 TCM 778 (1955); Leiser v. Commissioner, 11 TCM 932 (1952); Petit v. Commissioner, 10 TC 1253 (1948).

20 Cohen v. Commissioner, 176 F.2d 394 (10th Cir. 1949); Akers v. Scofield, 167 F.2d 718 (5th Cir. 1948); cert den 335 U.S. 823 (1949); Chadeck v. United States, 77 F.2d 961 (5th Cir. 1935); United States v. Iozia, 104 F.Supp.846 (S.D.N.Y. 1952).

21 Keelsing, "Illegal Transactions and the Income Tax", 5 U.C.L.A. L.Rev. 26, 29 (1958).

22 Id. at p. 31, see note 32.

23 "There is no illusion about the payment of a tax exaction. Each tax, according to a legislative plan, raises funds to carry on government. The purpose here is to tax earning and profits less expenses and losses. If one or the other factor in any calculation is unreal, it distorts the liability of the particular taxpayer to the detriment or advantage of the entire tax-paying group." Higgins v. Smith, 308 U.S. 473, 476 (1940). Cf. Stone v. White, 301 U.S. 532, 537 (1938).

It does not make any difference whether Black & White Printers engage in a lawful or unlawful business. Their income will be taxed either way under the income tax laws. To return, however, to our principal problem, recall that Black & White Printers still need to obtain a supply of paper in order to remain in business. If they choose the alternative of paying blackmarket prices, what Federal income tax consequences ensue? This depends upon the manner in which they treat the over-ceiling expenditure. First, they may consider handling such an outlay as a "deduction" i.e. an ordinary and necessary expense of doing business which is subtracted from gross income.

III. EFFECT OF ILLEGALITY ON DEDUCTIONS

Since illegal income of a taxpayer is included in his gross income, it might seem to naturally follow that illegal expense incurred in producing any income (legal or illegal) ought to be allowed as a deduction. As a matter of fact, however, this is not the law. Illegal expenditures have been consistently disallowed as deductions.[24] A few expenses which have been disallowed, among others, are: fines and penalties;[25] rent, salaries and expenses of bookmaking enterprises;[26] bribery and protection payments;[27] expenses of abortionists;[28] obsolesence of property formerly legal which has been outlawed;[29] salary payments in

[24] For other materials, see Lurie, "Deductability of Illegal Expenses", 11 NYU Tax Institute, 1189 (1952); Stapleton, The Supreme Court Redefines Public Policy, 30 Taxes 641 (1952); note, 54 Harv.L.Rev. 852 (1941) for analysis and collection of cases; annot. 175 ALR 370; 27 ALR 2d 498.

[25] Hoover Motor Express Co. v. United States, 356 U.S. 38 (1958); Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958); Standard Oil Co. v. Commissioner, 129 F.2d 363 (7th Cir. 1942).

[26] Mesi v. Commissioner, 25 T.C. 513 (1955); Silberman v. Commissioner, 44 BTA 600 (1941); Slavin v. Commissioner, 43 BTA 1100 (1941). Contra. Commissioner v. Sullivan, No. 119, 356 U.S. 27 (1958), held rent and wages of bookmaker were allowable as ordinary and necessary expenses. But see also Commissioner v. Doyle, 231 F.2d 635 (7th Cir. 1956).

[27] Burroughs Bldg. Materials Co. v. Commissioner, 47 F.2d 394 (10th Cir. 1949); Stralla v. Commissioner, 9 T.C. 801 (1947); Caldwell v. Commissioner, 47 BTA 168 (1942); Maddas v. Commissioner, 40 BTA 572 (1939), aff'd 114 F.2d 548 (3d Cir. 1940).

[28] Karger v. Commissioner, 13 TCM 661 (1954).

[29] Clark v. Haberle Crystal Springs Brewing Co., 280 U.S. 384 (1930).

excess of ceiling prices;[30] and political influence payments.[31]

What is the basis for disallowing illegal expenses as deductions? The Internal Revenue Code does not contain any provision, either expressly or impliedly, which prescribes that the legality or illegality of an item is determinative of its deductibility.[32] The disallowance has been the product of the Treasury Department and judicial decisions.

The Commissioner's usual argument is that ". . . deductions are a matter of legislative grace and as such should be narrowly construed."[33] It is undisputed that Congress has the power to allow or deny an expense as it chooses in determining "taxable income" from gross income.[34] But, as pointed out, Congress has remained neutral in regard to the "legal vs. illegal" test for expenditures. Notwithstanding this, the Treasury Department and Courts have made this distinction between legal deductions and illegal deductions.

Under the general rule that deductions are to be allowed only if there is a specific statutory provision or authority therefor,[35] a successful attempt has been made to establish that there is no authority for the deduction of illegal expenses. The reasoning applied is that only "ordinary and necessary" business expenses are specifically authorized. An illegal expense is not one which is "ordinary and necessary" to the operation of the tax-

30 Pedone v. United States, 151 F.Supp. 288 (Ct. Cl. 1957); N. A. Woodward Co. v. Kavanaugh, 102 F.Supp. 9 (DC Mich. 1952), aff'd 202 F.2d 154; Weather-Seal Mfg. Co. v. Commissioner, 16 T.C. 1312 (1951).

31 Easton Tractor & Equipment Co. v. Commissioner, 35 BTA 189 (1936); New Orleans Tractor Co. v. Commissioner, 35 BTA 218 (1936).

32 Commissioner v. Heininger, 320 U.S. 467 (1943); Lilly v. Commissioner, 343 U.S. 90 (1951); Ellery v. Commissioner, 7 T.C. 407 (1944). But see, Textiles Mills Securities Corp. v. Commissioner, 314 U.S. 326 (1941).

33 New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934); Commissioner v. Sullivan, 356 U.S. 27 (1958); Reiling, "Practical Legal Aspects of Accounting", 30 Taxes 1028 (1952), which suggest three exceptions of which cost of goods sold is one. For an argument against this rule, see, Griswold, "An Argument Against the Doctrine That Deductions Should Be Narrowly Construed As a Matter of Legislative Grace". 56 Harv.L.Rev. 1142-47 (1943).

34 Helvering v. Independent Life Ins. Co., 292 U.S. 371, 381 (1934), where the court used the following language: "Unquestionably Congress has power to condition, limit, or deny deductions from gross income in order to arrive at the net that it chooses to tax. . . ."

35 Vol. 4, Merten's, Law of Federal Income Taxation, § 25 (1956).

payer's business.[36] Therefore, it is not deductible. This reasoning ignores the fact that in an illegal business, it is quite "ordinary and necessary" to incur fines, penalties and protection obligations. It is not disputed that such payments are not a normal nor ordinary and necessary expense of a lawful business. But, the test which is applied to deductions is not what would be ordinary and necessary in a lawful business, but one which is commonly incurred in the trade or community of the particular taxpayer.[37] A "necessary" expense need not be essential, but appropriate and helpful to the taxpayer's business.[38] From the point of view of a taxpayer engaged in an illegal business, is it not ordinary for him to be fined and is it not helpful, if not essential, to his business to make protection payments?

The argument which usually sustains the disallowance of illegal expenses is that the allowance of a deduction for an illegal expenditure would "frustrate public policy."[39] The reason given is that the allowance of such expense will, through the reduction of tax liability, benefit and encourage participation in the illegal activity, contrary to the law which prohibits such activity.[40] The Supreme Court affirmed the disallowance of an illegal expense:

> . . . in order that the tax deduction consequences might not frustrate sharply defined state policies proscribing particular types of conduct.[41]

In order to make this test more certain, it was later further limited to:

> . . . sharply defined national or state policies proscribing particular types of conduct, evidences by some governmental declaration thereof.[42]

36 Hoover Motor Express Co. v. United States, No. 95, 356 U.S. 38 (1958); Tank Truck Rentals Inc. v. Commissioner, No. 109, 356 U.S. 30 (1958).

37 Welch v. Helvering, 290 U.S. 111 (1933); see Featherson, "Custom and Usage as Elements in Determining Tax Liability", 12 N.Y.U. Tax Inst. 563 (1954).

38 Commissioner v. Heininger, 320 U.S. 467 (1943); supra, note 35.

39 Supra, notes 24-31.

40 In Tank Truck Rental, Inc. v. United States, 356 U.S. 30 (1958), the Court said: "To allow the deduction sought here would but encourage continued violations of state law by increasing the odds in favor of non-compliance. This would only tend to destroy the effectiveness of the state's maximum weight laws." Also stated: "Deductions of fines and penalties uniformly have been held to frustrate state policy . . . by reducing the 'sting' of the penalty."

41 Commissioner v. Heininger, 320 U. S. 467 (1943); Lilly v. Commissioner, 343 U.S. 90 (1952).

42 Ibid. Also see Tank Truck Rentals, Inc. v. United States, 356 U.S. 30 (1958).

But in *Tank Truck Rentals, Inc. v. United States,*[43] the Supreme Court was reluctant to lay down an absolute standard or test and added this reservation:

> This is not to say that the rule as to frustration of sharply defined national or state policies is to be viewed or applies in any absolute sense.[44]

In applying the frustrations of sharply defined national or state public policy tests, the courts have drawn a distinction between expenses which are illegal per se, the deduction of which is disallowed, and the "legitimate" expenses of an illegitimate business, the deduction of which is allowed.[45] This distinction turns upon the intricate refinements of the state or national law as to inherent legality of illegality of the particular expense involved.[46]

Since the Black & White Printers is a legal business, but the blackmarket payments are illegal by federal law, let us examine the cases dealing with illegal expenses of legal business as a deduction from gross income.

IV. ILLEGAL EXPENSES OF LEGAL BUSINESS

The most recent decisions of the Supreme Court dealing with illegal expenses of legal business were handed down on March 17, 1958. In *Tank Truck Rentals, Inc. v. Commissioner,*[47] the taxpayer, in the legitimate business of trucking, paid $41,060.84 in fines for 718 wilful and 28 innocent violations of the state maximum weight laws during 1951. The Supreme Court, in denying these fines as deductions, stated:

> A finding of 'necessity' cannot be made, however, if allowance of the deductions would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof.[48]

43 356 U.S. 30 (1958).

44 Ibid. The Court gave the reason that: "The flexibility of such a standard is necessary if we are to accommodate both the Congressional intent to tax only net income and the presumption against Congressional intent to encourage violation of declared public policy."

45 Tank Truck Rental, Inc. v. United States, op. cit. note 42; Hoover Motor Express Co. v. Commissioner, 356 U.S. 38 (1958); Commissioner v. Sullivan, 356 U.S. 27 (1958); Cohen v. Commissioner, 176 F.2d 394 (10th Cir. 1949); Comeaux v. Commissioner, 10 TC 201 (1948).

46 Cf. Meisi v. Commissioner, 25 TC 513 (1955).

47 356 U.S. 30 (1958).

48 Id. at p. 30. See also Commissioner v. Heininger, 320 U.S. 467, 473 (1943).

The reasoning of the Supreme Court was that:

> . . . to allow the deduction sought here would but encourage continued violations of state law by increasing the odds in favor of noncompliance. This could only tend to destroy the effectiveness of the State's maximum weight laws.[49]

The Court intimated that there was a distinction between an act which is itself prohibited, and an act or expense of an illegal business, when they said:

> Certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute. . . If the expenditure is not itself. an illegal act, but rather the payment of a penalty imposed by the State because of such act, as in the present case, the frustration attended upon deduction would be only slightly less remote, and would clearly fall within the line of disallowance.[50]

Hoover Motor Express Co. v. United States,[51] a companion case of *Tank Truck Rental, Inc.*, also involved the deductibility of fines paid for maximum weight law violations. The Court applied the "frustration of policy" rule in disallowing the deduction, but gave the following as an additional reason for its holding:

> Wholly apart from possible frustration of state policy, it does not appear that payment of the fines in question was 'necessary' to the operation of petitioner's business. This, of course, prevents any deduction.[52]

Note that the expenditures involved were the direct result of an illegal act, but not themselves prohibited. Under the authority of these two cases, it would appear the Black & White's payments in excess of ceiling prices would not be allowed as an "ordinary and necessary" business expense.

In *Weather-Seal Mfg. Co.*,[53] wage payments were made in excess of ceiling prices. The taxpayer claimed them as part of his cost of goods sold rather than as a deduction because they were direct labor costs.[54] The Tax Court held that the wages constituted compensation for personal services and were therefore controlled by the "deduction" section of the Code and since

49 Id. at p. 35.

50 Ibid.

51 356 U.S. 38 (1958).

52 Id. at p. 39. Court cited Deputy v. duPont, 308 U.S. 488 (1940) as this authority.

53 16 T.C. 1312 (1951).

54 The cost of goods sold concept will be examined more fully, infra.

such payments violated the ceiling price they should not be allowed as a deduction. The basis for denying the deduction was that the payment directly violated a sharply defined and declared national policy. It will appear in subsequent discussion that the Court was, by all definitions and tests, clearly right in its analysis and position here.

The frustration of public policy rule applies not only to illegal expenditures, but to expenditures which are contrary to general public policy. In *Easton Tractor & Equipment Co. v. Commissioner,*[55] commissions were paid to an agent for the sole purpose of using his personal influence with the state government to makes sales to the state's road department. The company deducted the commissions paid, but the Commissioner disallowed them. The Board took the position that the contracts between the company and the agent would be void and unenforceable in the courts as being against public policy. Consequently, the commissions were disallowed as a deduction. The Board said that:

> . . . such commissions having been paid on an agreement void and unenforceable because of its being in direct contravention of positive law, did not constitute such an ordinary and necessary expense as contemplated by the applicable statute. . . .[56]

The Government's right to legislate free of lobbying influences have been placed on the same plane. In *Textile Mills Securities Corp. v. Commissioner,*[57] the expenses of lobbying and propaganda paid by an agent employed to secure legislation from Congress authorizing the recovery of German properties seized during the World War were claimed as deductions. The Supreme Court, in affirming the Commissioner's denial of this item as a deduction, was able to find in its own pronouncements condemning "insidious influences through legislative halls," sufficient expression of national policy to entitle the Treasury to rely thereon in drawing a line between legitimate business expenses and those arising from contracts to which the law gives no sanction because they violate public policy. The Court stated:

> . . . there is no reason, why, in absence of clear Congressional action to the contrary, the rule-making authority cannot employ the general policy in drawing a line between legitimate business expense and those arising from that family of contracts to which the law has given no sanction. The exclusion of the

[55] 35 B.T.A. 189 (1936).

[56] Id. at p. 191.

[57] 314 U.S. 326 (1941).

> latter from "ordinary and necessary" expenses certainly does no violence to the statutory language. The general policy being clear it is not for us to say that the line was too strictly drawn.[58]

Since the Black & White Printers, as a legal business, will not be able to treat blackmarket payments as "ordinary and necessary" business expenses, i.e. as a deduction from gross income, would the tax consequences be any different if they were engaged in an illegal business?

V. "LEGITIMATE" EXPENSES OF AN ILLEGITIMATE BUSINESS

The concept of "legitimate expenses of an illegitimate business" was first introduced in a case of an operator of a "horseroom."[59] Strangely, the taxpayer was allowed to deduct the wages of his gambling table operators, but was disallowed his protection expenses. The Court, itself, acknowledged that "the distinction may at first seem nebulous." Nevertheless, the doctrine was introduced.

The Tax Court, in two other cases,[60] again applied this doctrine. This time the distinction was drawn between legitimate and illegitimate expenses as being those made in the actual production of income and those made for the purpose of perpetrating a violation of state law. They applied the frustration of public policy test in denying the expenses which were deemed not "legitimate". It is difficult to accept this distinction that expenditures for the purpose of perpetrating a violation of state law are different from those made in the operation of a business which is prohibited by state law.

In this area, up to a certain point, the government is applying the income tax laws consistently. They are recognizing illegal income and also recognizing some expenses in connection with the production of the illegal income. The test which they are using is that the expense must meet the ordinary and necessary test of a lawful business, not what is ordinary and necessary in an unlawful business.

The legitimate expense of an illegitimate business has been approved and sustained by the Supreme Court. In *Commissioner*

[58] Id. at p. 339.

[59] G. A. Comeaux, 10 T.C. 201, aff'd Cohen v. Commissioner, 176 F.2d 394 (10th Cir. 1949).

[60] See Stralla, 9 T.C. 801 (1947) and Kjar, CCH Memo Dec. 12, 114-E, P-H Memo T.C. par. 41, 446 (1941).

v. Sullivan,[61] which involved the operation of illegal gambling enterprises, the question presented to the Supreme Court was whether the amounts paid to lease the premises and hire employees were deductible. The taxpayer received income from bookmaking establishments in Chicago and under Illinois law, both the business and the payments for rent and wages were illegal. The Tax Court denied all the expenses, but the Supreme Court allowed the rent and wage deductions. In so holding, the Court said:

> The policy that allows as a deduction the tax paid to conduct the business seems sufficiently hospitable to allow the normal deductions of the rent and wages necessary to operate it.[62]

One of the reasons given by the Court was that:

> If we enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts, while all other businesses would be taxable on the basis of net income. If that choice is to be made, Congress should do it.[63]

The standard employed by the Court to determine the "legitimate" expenses of an illegal business was that:

> . . . amounts paid as wages to employees and to the landlord as rent are 'ordinary and necessary expenses' in the accepted meaning of the words. This is enough to permit the deduction, unless it is clear that the allowance is a device to avoid the consequences of violations of law, as in Hoover Motor Express Co. v. United States. . . .[64]

The Supreme Court ignored the fact that the wages and rent payments were expressly prohibited and illegal under Illinois law. Thus, this case supports the rule that if an expense item is one generally thought of as being ordinary and necessary, the legal or illegal nature of the business is immaterial. It definitely affirms the doctrine of legitimate expenses of an illegitimate business.

In the *Lilly v. Commissioner* case,[65] the issue related to the deductibility of "kickback" payments made by an optician to doctors for the referral of business. The kickbacks were allowed

[61] 356 U.S. 27 (1958).

[62] Id. at p. 29.

[63] Ibid.

[64] Ibid.

[65] 343 U.S. 90 (1951).

as being ordinary and necessary expenses. The Court in so holding, stated:

> The transactions from which they arose were of common or frequent occurrence in the type of business involved. They reflected a nation-wide practice. Consequently, they were 'ordinary' in the generally accepted meaning of the words . . . The payments were likewise 'necessary' in the generally accepted meaning of that word. It was through the making of such payments that petitioners had been able to establish their business.[66]

The Court expressly stated that they did not voice approval of the business ethics or public policy involved, but since this did not frustrate a public policy evidenced by some governmental declaration, there was no authority to disallow the kickbacks as a deduction.

In the course of their opinion,[67] the Court quoted with approval from the Circuit Court decision in *Heininger v. Commissioner*,[68] as follows:

> Without this expense, there would have been no business. Without the business, there would have been no income. Without the income, there would have been no tax. To say that this expense is not ordinary and necessary is to say that that which gives life is not ordinary and necessary.[69]

That statement would be applicable in almost all illegal expense situations to a limited degree. It is apparent that the courts have drawn a distinction between expenses, which are themselves prohibited by a declared national or state policy, and those which are commonly accepted to be ordinary and necessary .expenses. If the expense is the latter, the legal or illegal nature of the business is immaterial in determining its deductibility.

As far as public policy is concerned, it is difficult to say that an expense of a racketeer, gambler or bootlegger does not do violence to the law which prohibits the business. Of course, one may repair to Congress to remedy this situation.

By way of summary, therefore, it can be said that if Black & White Printers were an illegal business, the question of the deductibility of the blackmarket payments would depend upon whether the courts considered such payments were made for the purpose of perpetrating a violation of another law or whether

[66] Id. at p. 93.

[67] Id. at p. 94.

[68] 133 F.2d 567 (7th Cir. 1943).

[69] Id. at page 570.

they were ordinary and necessary expenses of a business which is prohibited by law. Since the test of the latter appears to be whether or not such expenses would be allowed a legal business, clearly they would not be allowed as a deduction and the income tax law is thereby consistent.

VI. DEDUCTIONS vs. COST OF GOODS SOLD

Black & White Printers can with certainty predict that if they claim the excess payments over-ceiling as a deduction, the Commissioner will disallow the deduction and prevail in court. If we assume, however, that the blackmarket price was expended for an item which was purchased for the purpose of resale, the cost of the item would constitute the cost of the goods sold. This then would not be a "deduction", but an offset against gross receipts.[70] Would the illegality prevent Black & White from making this offset? In order to examine the law in this regard it is first necessary to explore the semantic and practical distinctions between the terms "deductions" and "cost of goods sold".

Traditionally, the basic distinction between cost of goods sold and deductions is based upon their respective business functions. To the businessman, the cost of goods sold represents capital assets or inventories which have been converted into money through sale. The businessman and accountant carry inventories or cost of goods purchased on the balance sheet as a part of the current assets. This is considered a part of the working capital. When the item is sold, the cost of the item sold is subtracted from the sales price on the profit and loss statement to determine their gross profit. All businessmen and accountants operate upon the premise that there is no gain or profit until at least the cost of the item sold, (cash outlay in the inventories) is restored. Only then, do they consider that there has been a gain or profit. The gross profit is not considered their ultimate net gain derived from their business.

The items usually included in the cost of goods sold are: (1) the purchase price of the goods bought and put into inventories, (2) the freight and drayage charges on incoming merchandise purchased, and (3) supplies consumed or added to the goods. If the business is not a manufacturing concern, but just a merchandising business, direct labor costs are not normally

[70] Infra, note 105. 4 Merten's, Law of Federal Income Taxation § 25.47, "The cost of an inventory item . . . is in the nature of a capital expenditure which is recoverable through an offset against the sales prices."

included. In a manufacturing concern, the direct and indirect labor costs are included as well as a proportion of the overhead expenses.

Accountants define cost of goods sold as:

> The purchase price of goods bought, plus the cost of storage, and transportation and delivery to the point where they are to be used, and other costs pertaining to their acquisition and receipt.[71]

The Treasury Department's definition is consistent with that of the accountants; in fact it is almost identical. Its definition of costs of goods sold includes the purchase price, transportation and other necessary charges incurred in acquiring possession of the goods. Treasury Regulations also provide that the "cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer."[72]

The Courts have cited accounting authority and have approved of the latter's definition of cost of goods sold. They sustained the argument that the cost of goods sold includes the invoice purchase price, plus freight in, hauling and unloading charges and commissions for acquiring possession of the goods purchased.[73] The Courts have defined cost as meaning:

> . . . the price or part of it paid by the buyer to the seller, as consideration for the sale of goods; . . . that which is actually paid for goods; . . . *that which has to be given for a thing in order to procure it,* especially the price paid. [emphasis supplied][74]

[71] Kohler, A Dictionary for Accountants, 2d ed., 1957, p. 145; MacFarland & Ayers, Accounting Fundamentals, 2d ed., 1947, p. 40; Lasser's Standard Handbooks for Accountants, §§ 9.10 and 9.11 (1956).

[72] Treasury Regulation, § 1.61-3, adopted T.D. 6272 (1957).

[73] May, Stern & Co. v. Commissioner, 20 BTA 241 (1930); John L. Denning & Co., Inc., 17 T.C. Memo 878, par. 48, 277, P-H Memo T.C. 48-878. See Reiling, "Practical Aspects of Accounting", 30 Taxes 1028 (1952).

[74] City Ice Delivery Co. v. United States, 176 F.2d 347, 352 (4th Cir. 1949). In Jones v. Herber, 198 F.2d 544 (10th Cir. 1952), the Court stated: "Nowhere in the Internal Revenue Act or in the Treasury Regulations, is there any intimation that the word 'cost' as used in the act and in those regulations is to be denied its actual, economic and ordinary meaning, and is to include only costs that are legally paid, or as to exclude costs actually paid in excess of those prescribed in the Emergency Price Control Act of 1942." Id. at 545. See Hofferbert v. Commissioner, 197 F.2d 504 (4th Cir. 1952). But contra, see dissenting opinion in Guminski v. Commissioner, 198 F.2d 265 (5th Cir. 1952), which stated: "The taxing authorities should not be compelled to recognize a merchandise 'cost' the payment of which is expressly proscribed and denounced as a crime by federal law, 'cost', as used in the Treasury Regulation . . . means 'lawful cost'." Id. at 266.

Deductions, according to business usage, do not represent any capital asset. They represent the cost in money necessary to operate a business other than in the acquisition of capital assets and inventories. Deductions generally include salaries, selling and shipping expenses, losses, and other items not directly related to the purchase or production of merchandise. In income tax meaning, deductions mean those items specifically provided for in Section 162 as subtractions from gross income in determining taxable income. The accountants describe deductions as the "cost of *selling* the goods, such as salaries and commissions paid to salesmen, delivery expense, store supplies and advertising"[75] (Emphasis supplied). To put it another way, deductions are the expenses incurred in converting the inventories from current assets into money or accounts receivables.

The Courts have consistently stated that there is a distinct difference between cost of goods sold and deductions for purposes of federal income tax. Cost of goods sold are not "deductions" and are not subject to "legislative grace".[76]

Recently, however, this distinction was ignored by the Court of Claims. In *Pedone v. United States,*[77] the taxpayer was engaged in the lathing and plastering business. He paid his employees more than the wages provided by the Wage Stabilization Act.[78] He treated the over-ceiling wage payment as a part of his cost of goods sold, but the Commissioner disallowed this treatment. The Court of Claims, in a refund suit, sustained the Commissioner. The Court said:

> There is no doubt that in the ordinary case the wages of the persons who work on the product sold are subtractable from the sale price, in determining taxable income. Whether the subtraction is made in this column or that column, or this schedule or that schedule, of the income tax form, does not, in the normal case, affect the amount of the tax.[79]

The taxpayer argued that the cost of goods sold must be

[75] See, MacFarland & Ayers, Accounting Fundamentals, 2d ed. 1947, p. 40.

[76] Sullenger, 11 T.C. 1076 (1948); Davis v. United States, 87 F.2d 323 (2d Cir. 1937); Hofferbert v. Anderson Oldsmobile, 197 F.2d 504 (4th Cir. 1952); 2 Merten's, Law of Federal Income Taxation, § 16.17; vol. 4, § 25.47.

[77] 151 .F.Supp. 288 (Ct.Cl., 1957).

[78] Defense Production Act of 1950, 64 Stat. 798, 803-812, as amended.

[79] 151 F.Supp. at 291.

allowed as a matter of right, but the Court rejected this argument by saying:

> If the 16th Amendment gives the Government leeway to refuse to treat as a substractable cost of goods a perfectly lawful wage or salary actually, because the Government rightfully concludes that it is unreasonably large, it would seem that, a fortiori, the Government could accord similar treatment to payments made in violation of law or public policy.[80]

Observe that taxpayer was attempting to classify as cost of goods sold, an item—wages, albeit excess wages—which we have seen is normally classified as a deduction. Further, note that the three items which are normally considered the elements of cost of goods sold in a merchandising business [(1) purchase price of goods, (2) freight and drayage charges on the same and (3) supplies consumed or added to the goods] would each have to be enlarged considerably in prima facie meaning if they were to encompass over-ceiling wage payments. In a manufacturing business direct labor is admittedly a part of cost of goods sold. But what constitutes cost of goods sold in a lathing and plastering business? Such a business is neither a manufacturing enterprise nor is it a merchandising business in the more average sense of either term. Therefore, the *Pedone Case* presents an unusually difficult case in this regard. In a personal service business does *any* aspect of cost of goods sold exist?

The larger questions which come to the fore at this juncture, however, are how the cost of goods sold concept may be more specifically defined in a complex modern society wherein cost accounting includes more indirect costs with purchase price, and assuming an item is agreed by economists et al to be a part of cost of goods sold can Congress constitutionally exclude it from cost of goods sold and thereby, in effect, levy a tax on capital. Or, to put the problem in slightly different terms—can Congress constitutionally deny the subtraction of cost of goods sold from gross receipts?

VII. IS THERE A CONSTITUTIONAL PROHIBITION AGAINST DENYING THE SUBTRACTION OF COST OF GOODS SOLD FROM GROSS RECEIPTS?

In discussing the constitutional question involved, bear in mind that Congress, under Article I of the United States Con-

[80] Id. at 292.

stitution, has the power to tax gross receipts if it so desires.[81] This right to tax gross receipts is limited to the exent that it must be apportioned among the several states according to population, unless the Sixteenth Amendment gave Congress the power to tax capital as well as income without apportionment. Whether Congress *ought* to impose a tax on gross receipts and capital is not within the scope of this article. The Question involved is whether Congress can, under the Sixteenth Amendment, disallow the subtraction of the cost of goods sold and consequently, impose the tax upon the return of capital as well as upon gains and profits?

In order to determine the answer to this question, it is necessary to determine the meaning of the word "income" as used in the Sixteenth Amendment,[82] and compare it with the meaning of "gross income" as used in the Code.[83]

It is generally agreed that the Sixteenth Amendment is not the source of Congress' power to tax incomes.[84] But, it is the source of their power to tax incomes without apportionment among the several states.[85] The Sixteenth Amendment provides:

> The Congress shall have power to lay and collect taxes on incomes from whatever source derived without apportionment among the several states, and without regard to any census or enumeration.[86]

[81] Under the original Constitution, Congress has the power to tax incomes, but subject to the apportionment requirements of the Constitution, Art. I, § 2(3) and Art. I, § 9(4).

[82] For discussion of the use of the words in the Sixteenth Amendment, see Sen. Rep. No. 2140, Part 2, 76th Cong. 3d Sess., p. 33.

[83] For an argument that gross income is not income, see Redord, "Gross Income is Not Income," 35 Taxes 851 (1957).

[84] Source of Congress' power to tax incomes is U.S. Const., Art. I, § 8. See Bowers v. Kerbaugh Empire Co., 271 U.S. 170 (1926). The amendment neither conferred nor enlarged the taxing powers, Metcalf v. Mitchell, 269 U.S. 514 (1926); Evans v. Gore, 253 U.S. 245 (1920); 1 Merten's, Law of Federal Income Taxation, § 4.07.

[85] The 16th Amendment did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on incomes. Eisner v. Macomber, 252 U.S. 189 (1920); Brushaber v. Union Pac. R. R. Co., 240 U.S. 17; Stanton v. Baltic Mining Co., 240 U.S. 103 (1916). For discussion, see, Morrow, "The Income Tax Amendment," 10 Col. L.Rev. 379 (1910).

[86] U. S. Const., Amend. XVI.

This Amendment does not define,[87] nor does it affect, the generic concept of income.[88] Income as used in the 16th Amendment must be determined by its meaning in the "common speech".[89] For this purpose, the Supreme Court has defined income:

> . . . as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets.[90]

The essence of income is that it is:

> . . . essentially a gain or profit in itself of exchangeable value, proceeding from capital, severed from it, and derived or received by the taxpayer for his separate use, benefit and disposal.[91]

Although there is considerable theoretical difficulty in determining the difference between income and capital, there is substantial agreement that amounts received as a return of capital or investment are not income within the general meaning of that term and may not be taxed under the Sixteenth Amendment.[92]

87 Supra, note 77.

88 Supra, note 77. Peck & Co. Inc. v. Lowe, 247 U.S. 165 (1918); Metcalf v. Mitchell, 269 U.S. 514 (1926). In Independent Life Ins. Co., 17 BTA 757, it is said that there is nothing in the history immediately preceding the 16th Amendment to give support to a more expansive use of the word "income" that was considered in the Pollack case. In Eisner v. Macomber, 252 U.S. 189, 206 (1920), the Court said: "A proper regard for its genesis, as well as its very clear language, requires also that this amendment shall not be extended by loose construction so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real or personal. The limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the Courts."

89 Eisner v. Macomber, 252 U.S. 189 (1920); United States v. Safety Car Heating & Lighting Co., 297 U.S. 88 (1935). But, it has been said that the meaning of "income" is not controlled by the language of accountants and economics. Brown Shoe Co. v. Commissioner, 133 F.2d 582 (8th Cir. 1943); Helvering v. Edison Bros. Shoes, Inc., 133 F.2d 575 (8th Cir. 1943).

90 Eisner v. Macomber, supra, note 86; Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918); Stratton's Independence v. Howbert, 231 U.S. 399 (1913); United States v. U. S. Safety Car Heating & Lighting Co., 297 U.S. 99 (1935).

91 Eisner v. Macomber, 252 U.S. 207 (1920).

92 Southern Pac. Co. v. Lowe, 247 U.S. 330 (1918); See also Burnet v. Logan, 283 U.S. 404 (1931); Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918); U. S. v. Safety Car Heating & Lighting Co., 297 U.S. 88 (1936); 1 Merten's, Law of Federal Income Taxation, § 5.06.

In *Doyle v. Mitchell Brothers Co.*,[93] the Supreme Court was presented the question of determining what was "income" for purposes of the Excise Tax Act of 1909. The Solicitor General argued that a conversion of capital into money always produced income; that for purposes of the Act, the term "gross income" was the equivalent to "gross receipts"; and that the entire proceeds of the sale of timber should be treated as gross income. The Supreme Court rejected the argument that gross receipts equalled gross income, stating:

> In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.[94]
>
> . . . when the act took effect, plaintiff's timber lands, with whatever value they then possessed, were a part of its capital assets, and subsequent change of form by conversion into money did not change the essence.[95]

Although the *Doyle Case* was not bound by the Sixteenth Amendment, it illustrates the proposition that the cost of property is capital and as such, must be restored to the seller before a sale can product a gain or profit, which is the subject of the income tax law.

In *Commissioner v. Pennroad Corporation*,[96] the issue was whether a settlement was taxable as income even though it did not completely compensate the injured party for its loss. The Court held that the settlement could not be included in gross income until the capital loss incurred had been restored. The Court stated:

> The capital which Pennroad lost was not restored by the settlement. . . . In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.[97]

The Circuit Court expressed its opinion that the income tax

93 247 U.S. 179 (1918).

94 Id. at p. 185. See also, Eisner v. Macomber, supra note 83; Hays v. Gauley Mountain Coal Corp., 247 U.S. 189 (1918).

95 247 U.S. at 186.

96 228 F.2d 329 (3d Cir. 1955).

97 Id. at p. 331.

laws ought to be applied realistically and reality forbids the imposition of a tax on losses.[98]

Congress, unfortunately, did not use the language of the Sixteenth Amendment when it enacted the subsequent income tax laws. Instead, they used the terms "gross income" and "taxable income".[99] But it is quite clear that:

> Congress cannot by any definition [of income] it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which it alone derives its powers to legislate and within those limitations alone that power be lawfully exercised.[100]

Gross income is defined as "all income from whatever source derived".[101] Taxable income is defined as "gross income, minus the deductions allowed by this chaper. . . ."[102] One thing is certain, gross income cannot constitutionally include capital. Under the Code, gross income is the starting point in determining what is taxable income. In *Winkler v. United States*,[103] the Circuit Court held that the losses paid out by a bookmaker should be excluded from gross income. They reasoned that:

> The justification for excluding returns of capital from gross incomes goes deeper than mere treasury regulations and rests ultimately upon constitutional concepts. There is a general agreement that amounts received as a return of capital or investment are not income within the general meaning of that term and may not be taxed under the Sixteenth Amendment.[104]

98 Id. at p. 332, where the Court stated: "to hold to the contrary in the instant case is to treat loss as gain. Reality forbids the imposition of tax in the instant case."

99 Int. Rev. Code 1954, § 61; Int. Rev. Code 1954, § 63.

100 Eisner v. Macomber, 252 U.S. 189, 206 (1920). See Anderson Oldsmobile v. Hofferbert, 102 F.Supp. 902 (D.C. Md. 1952), where the Court stated: "The taxpayer cannot deny his receipts of income on the ground that it resulted from illegal transaction, but neither can Congress find the existence of income where there is none by reason of illegality." Cf. United States v. Sullivan, 274 U.S. 259 (1927).

101 Int. Rev. Code 1954, § 61.

102 Int. Rev. Code 1954, § 63.

103 230 F.2d 766 (1st Cir. 1956).

104 Id. at p. 770. The Court in its opinion compared the bookmaker to a business wherein they stated: "in a certain sense a bookmaker may be likened to a merchant, one major difference being that instead of selling articles at a price exceeding the cost, the bookmaker, in effect, utilizes the laws of probability in such a way to enable him to sell a certain undeterminate amount of money." See 1 Merten's, Law of Federal Income Taxation, § 5.06.

The term gross income is not synonymous with the term gross receipts.[105] Gross receipts is a broader term in meaning and included within it are receipts which may constitute capital as well as income. Since capital may not be constitutionally taxed as income,[106] it can only follow that gross income is something less than gross receipts. If the taxpayer deals in something other than merchandise or products, it is quite possible that gross income may be the equivalent of gross receipts. In that case, there would be no constitutional prohibition against taxing the gross receipts, but there would be no cost of goods sold involved either.

The Supreme Court has rejected the argument that gross income is gross receipts when goods are sold by the taxpayer. In its own language, the Supreme Court stated:

> We must reject . . . the broad contention submitted in behalf of the government that all receipts—everything that comes in—are income within the proper definition of the term 'gross income'.[107]

It is well accepted that Congress in general intended gross income to be co-extensive with the word income as used in the Sixteenth Amendment.[108] The primary limiting point deals with capital; since it may not be taxed under the Amendment, it certainly cannot be taxed by a definition of Congress. Therefore, when the cost of the merchandise or product sold is involved, Congress cannot constitutionally tax gross receipts because that would, in part, be a tax upon the return of capital.[109]

105 Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918); Hays v. Gauley, supra note 91; Southern Pac. Co. v. Lowe, supra note 84. See 1 Merten's, Law of Federal Income Taxation, § 5.10.

106 It should be pointed out once again that Congress can tax capital and gross receipts under the Constitution if they apportion the tax among the several states according to population. See, supra, note 73. But not under the 16th Amendment.

107 Southern Pac. Co. v. Lowe, 247 U.S. 330, 335 (1918). In Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918), the Court stated that "Gross income is not equivalent to gross receipts." See 1 Merten's, Law of Federal Income Taxation, § 5.10.

108 See Rutkin v. U. S., 343 U.S. 130 (1952).

109 In Sullenger, 11 T.C. 1076 (1948), the Tax Court flatly stated "no more than gross income can be subjected to income tax upon any theory." The Supreme Court has repeatedly stated: "Constitutionally, the only thing that can be taxed by Congress is 'income'. The tax is not, never has been, and could not constitutionally be upon gross receipts." Doyle v. Mitchell Bros. Co., supra note 85; Southern Pac. Co. v. Lowe, supra note 85; See Anderson Oldsmobile v. Hoffer-

Since capital may not be taxed under the 16th Amendment and since cost of goods sold represents a return of capital, the legality or illegality of the expenditure would be immaterial in regard to its subtracting from gross receipts if it constituted part of the cost of goods sold.[110] Congress cannot deny this exclusion from gross receipts by use of the rules "frustration of public policy" or "as matters of legislative grace", because what the Constitution exempts, Congress cannot include.[111]

Another argument used by the Courts in allowing the exclusion of cost of goods sold from gross receipts is that:

> . . . as an economic and mathematical truism, gain or profit which constituted gross income cannot be determined without deducting the cost of the goods sold from the gross selling price.[112]

Now, at this juncture let us return to Black & White Printers and the possible tax treatment afforded them (a) when they utilize over-ceiling payments as part of cost of goods sold, and (b) when they purchase stock in a supplier during an "OPA period" in order to procure paper, subsequently selling this interest at a loss. Is such a loss to be allowed as a "cost of goods sold" item—thereby enabling taxpayers to utilize the expenditure (vis a vis the "loss") as a one year offset against gross income, or is this a capital expenditure so that the money spent (i.e. the "loss") can only be used as a capital loss and offset against capital gains?

VIII. EFFECT OF ILLEGALITY ON THE COST OF GOODS SOLD

If the illegal expenditure constitutes part of the cost of goods sold, there is a line of cases decided under the Emergency Price

bert, 102 F.Supp. 902 (D.C. Md. 1952). 4 Merten's, Law of Federal Income Taxation, § 25.47, states: "the cost of goods sold is in the nature of a capital expenditure which is recoverable through an offset against the sales price."

110 See infra, § VIII, Effect of Illegality on the Cost of Goods Sold, page 22.

111 See supra, text at page 19 and footnote 92. See also Davis v. U. S., 87 F.2d 323 (2d Cir. 1937), where the Court distinguished between certain deductions to which the taxpayer was entitled as a matter of fundamental law and those which rested on legislative grace. It included in the former such items as the cost of goods sold, ordinary and necessary expenses incurred in the receipt of gross income, depletion and depreciation.

112 Anderson Oldsmobile, Inc. v. Hofferbert, 102 F.Supp. 902, 905 (D.C. Md. 1952).

Control Act of 1942, which hold that such payments are properly allowed in determining gross income.[113] The rules of ordinary and necessary expense, and frustration of public policy, do not affect the cost of goods sold since the former apply only to the statutory *deductions* under section 162.

The leading case is *Sullenger*,[114] where the taxpayer paid over-ceiling prices for meat which he bought for resale. He offset the cost of the meat from the gross receipts in determining gross income. The Commissioner argued that the payments were not really cost of goods sold, but were "bribes". He contended they were deductions and as such, are allowed as a matter of legislative grace and not of right and to allow these would be contrary to public policy. The Court rejected the Commissioner's arguments and allowed them as costs of goods sold. The Tax Court reasoned:

> The trouble with his [Commissioner's] argument is that its major premise is unsound. The amounts in question were actually, as the stipulations show, a part of the cost of goods sold and are not being claimed by this petitioner as a deduction under section 23. Section 23 makes no provision for the cost of goods sold, but the Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income. No more than gross income can be subjected to income tax upon any theory. The income from a business which is wholly illegal was held subject to income tax in United States v. Sullivan, 274 U. S. 259. Nevertheless, it was necessary to determine what that income was, and the cost of an illegal purchase of liquor was subtracted from proceeds of the illegal transaction which were subject to income tax in that case. This is not a case of penalties provided for violation of the O. P. A. regulations . . . No authority has been cited for denying to this taxpayer the cost of goods sold in computing his profit, which profit alone is his gross income for income tax purposes. It is unnecessary to discuss cases involving deductions, since this case does not involve any deduction.[115]

113 A few of these cases are: Sullenger, 11 T.C. 1076 (1948); Guminski, 10 TCM 173 (1951) aff'd 198 F.2d 265 (5th Cir. 1952); Herber v. Jones, 103 F.Supp. 210 (D.C. Okla. 1951); Anderson Oldsmobile Inc. v. Hofferbert, 102 F.Supp. 902 (D.C. Md. 1952); Commissioner v. Weisman, 197 F.2d 221 (1st Cir. 1952). See, Krekstein, "Deductibility of Over-Ceiling Payments." 6 NYU Tax Inst. 703 (1947), for discussion of the Emergency Price Control Act of 1942.

114 11 T.C. 1076 (1948).

115 Id. at p. 1079.

In *Anderson Oldsmobile Inc. v. Hofferbert,*[116] the taxpayer was in the business of buying and selling used cars. He paid more than the ceiling price for the cars and claimed them as part of his cost of goods sold. The Commissioner denied the excess amount over ceiling. The Court held that the cost of goods sold, even though it included expenditures which violated the OPA and consequently illegal, must be allowed. The Court reasoned:

> . . . as an economic and mathematic truism, gain or profits which constitutes gross income cannot be determined without deducting the cost of the goods sold from the gross selling price. The deductions so made in the computation is a necessary one under section 22 to determine gross income and is definitely different and distinct from the deduction authorized by section 23 to be made from gross income to determine net income.[117]

The Court gave the following reason for rejecting the frustration of public policy rule:

> It may properly shock the conscience of the court to find an otherwise respectable businessman in flagrant violation of valid laws enacted for public good in war time, but this does not justify applying the somewhat uncertain contours of public policy in the purely mathematical computation of what constitutes income. The taxpayer cannot deny his receipts of income on the ground that it resulted from illegal transactions; but neither can the Commissioner find the existence of income where there is none by reason of illegality.[118]

Herber v. Jones,[119] involved payments in excess of ceiling prices for used cars. The Court allowed the purchase price as an offset against gross receipts as cost of goods sold. In so holding, they stated:

> Congress by the Sixteenth Amendment to the Constitution, was empowered to lay and collect taxes on incomes, from whatever source derived. . . . Gross income, for the purposes of this action, includes gains and profits derived from the sales of automobiles in question. Money actually paid, although in excess of the prevailing ceiling price, for the purchase price of an article cannot be classified as a gain, profit or income.[120]

If the violations of ceiling prices were incurred for the purpose of acquiring goods for resale, the illegality will not affect its

[116] 102 F.Supp. 902 (D.C. Md. 1952).

[117] Id. at page 905.

[118] Id. at page 908.

[119] 103 F.Supp. 210 (D.C. Okla. 1951).

[120] Id. at 214; Conclusion of Law IV of the Court.

allowance as a part of cost of goods sold. The Commissioner finally acquiesced and so stated in a 1952 ruling.[121]

The effect of OPA violations under the 1942 Act is now settled but does this same rule prevail in other areas of illegality?

In *James P. McKenna*,[122] the Commissioner sought to tax a race-track bookmaker on his total receipts. The Board held that the gross income which was taxable from bookmaking operations was the actual gain. They held that the taxpayer must be allowed to apply his losses against his total receipts since he operated on a modified parimutual basis. The amounts allowed were pay-offs to bettors, scratches, and called-off bets. The Board stated that the statutory deductions were not involved, but only the computation of gross income. They concluded:

> . . . that the actual gain or profit derived from the taxpayers operations in laying wagers on horses racing under his system of handbooks—known as bookmaking—is the aggregate of his receipts less the amounts paid out to bettors . . . The formula just given will represent the actual gains to the taxpayer and as such constitute "gross income" within the meaning of section 213(a) of the Revenue Act of 1918.[123]

In another Board of Tax Appeals case,[124] which involved illegal importing and selling distilled spirits, the Commissioner asserted a deficiency upon the amount of gross receipts from sales. The Board distinguished between the expenses incurred in the purchase and acquisition of the liquor and those necessitated by the illegality of the transaction. It denied the latter type of deductions, but recognized that the cost of goods sold should be allowed in determining gross income. In regard to gross income, the Board stated:

> . . . while we are required to compute gross income in the same manner whether the taxpayers business be legal or illegal, we do not allow the same deductions in computing taxable income.[125]

121 I.T. 4104, 1952-2 Cum. Bull. 71. The burden is now on the taxpayer to prove the actual payments in excess of OPA ceiling prices. Naffco v. Fahs, 126 F.Supp. 794 (D.C. Fla. 1954); Roybark v. United States, 218 F.2d 164 (9th Cir. 1955). Cf. Harris v. United States, 125 F.Supp. 175 (D.C. Ga. 1953). Had the Government confiscated the illegal purchased goods, the taxpayer is denied its cost as an expense or as part of the cost of goods sold because the goods are no longer available for resale. Fuller v. Commissioner, 20 T.C. 308 (1953).

122 1 B.T.A. 326 (1925).

123 Id. at p. 333.

124 Kjar, ¶ 41,446 P-H B.T.A. Memo p. 972 (1941).

125 Id. at page 978.

Black & White Printers may, therefore, successfully claim the illegal payments in excess of ceiling price, if such payments constitute a part of the cost of goods sold. Seemingly, illegality of the payments has no effect upon their allowability as a part of cost of goods sold.[126] But, this is not a truly settled issue since the majority of cases on this point involved the Emergency Price Control Act of 1942.[127] Under the Defense Production Act of 1950,[128] Congress has expressly authorized the President to impose tax restrictions for enforcement purpose. Quere as to the constitutionality of such restriction?

Now, let us assume that Black & White Printers do not want to make direct over-ceiling payments and utilize such over-ceiling amounts as a deduction (which would be promptly disallowed), and there is some doubt in regard to utilizing such over-ceiling payments as an offset against gross receipts utilizing the cost of goods sold. Black & White Printers decide, therefore, to purchase the controlling stock in their major paper suppliers. In so doing, they pay, in effect, a premium for the stock. This premium later becomes a "loss" when the emergency ends and the stock is sold. What is the tax treatment of this "loss" or "premium payment".

IX. EFFECT OF LEGAL STOCK PURCHASES TO ACQUIRE GOODS

If Black & White Printers had purchased stock in a paper manufacturing company for the sole purpose of acquiring the scarce paper and later sold the stock at a loss, the loss would normally be treated either as a business expense or as part of the cost of the goods purchased. Such a stock purchase is considered an incident of carrying on their business, not an investment, because it is a step in the process of acquiring merchandise.[129]

[126] But see the dissenting opinion in Commissioner v. Guminski, 198 F.2d 265 (5th Cir. 1952), wherein it is stated: "I am opposed to an exterpretation of the tax laws which will enable a taxpayer to gain a tax advantage by violating the price stabilization laws, thus placing himself in a better position than had he obeyed the law."

[127] 50 U.S.C.A. App. 3; 56 Stat. 23.

[128] 50 U.S.C.A. App. 308; 64 Stat. 798. This act was suspended February 6, 1953, by E.O. 10434, 18 Fed. Reg. 809.

[129] For an interesting discussion of this characterization of stock losses, see, Bierman, "The Chameleon Concept: Security Losses As Ordinary Business Expenses," 12 N.Y.U. Tax Inst. p. 1119 (1954).

In *Western Wine & Liquor Co. v. Commissioner*,[130] a Nebraska liquor wholesaler purchased 2550 shares of stock in a supplier (the American Distilling Co.) in order to keep its own distributing business going during the war. This stock carried with it a right to purchase liquor at inventory cost. After the taxpayer had exercised his whiskey rights, they sold the stock at a loss of $154,149. The difference between the purchase price and sale price was treated as part of the cost of the whiskey. The Commissioner contended it was a short-term capital loss. The Tax Court, in holding that this was properly treated as cost of the whiskey purchased, stated:

> We think this taxpayer acquired the Distilling Stock as an incident to the conduct of its business and not for investment, and that it held the stock only long enough to acquire the whiskey and then sold it to reduce the cost of the whiskey as much as possible. In the circumstances, and as contended by taxpayer, the sale of the securities became an incident of the business. The loss was not a capital loss of taxpayer.[131]

The same result was reached by the Tax Court even though the taxpayer purchased stock to circumvent the OPA ceiling-prices. In *Hoffman Lumber Co.*,[132] the taxpayer agreed to purchase stock in addition to the OPA ceiling price for lumber. The stock was purchased at $100 per share, but the taxpayer had to give the lumber company an option to purchase the stock back at $1.00 per share. The taxpayer was required to buy one share per 10,000 ft. of lumber purchased. The option was exercised and the taxpayer treated the $99 per share loss as a part of the cost of goods sold. The Tax Court in sustaining the taxpayer stated:

> The stock purchase transaction was an obvious sham to circumvent the OPA price regulations. As to both transactions, that is the lumber and shingles, the evidence permits of no other conclusion than that the petitioner paid the disputed amounts as over-ceiling prices on the purchase of the materials. As such they constituted a part of the cost of goods sold.[133]

It appears, superficially, that Black & White Printers will receive the same tax treatment whether they legally purchase

[130] 18 T.C. 1090 (1952), appeal dismissed (8th Cir 6-17-53). See also, Clark, 19 T.C. 48, appeal dismissed (6th Cir. 6-18-53); Hogg v. Allen, 105 F. Supp. 12 (D.C. Ga.) aff'd 214 F.2d 640 (5th Cir. 1954).

[131] 18 T.C. at 1099. Also see Palm Beach Liquors, Inc., T.C. pT617 CCH.

[132] Para. 52,174 P-H Memo T.C. (1952). See also, Y. M. Young Co., para. 52,250 P-H Memo T.C. (1952).

[133] Id. at page 52-509.

stock to obtain the paper or illegally pay over-ceiling prices and in both cases utilize the premiums paid as a part of cost of goods sold. But, this is not necessarily true!

In *Sackstein v. Commissioner*,[134] the taxpayer had difficulty getting enough meat at OPA prices to carry on his business. United Meat Company agreed to supply him with meat if the taxpayer would purchase their stock and, in addition, pay further amounts to meet the anticipated losses of United in proportion to the amount of meat purchased. The stock and additional payments of the taxpayer totaled $7,219 and he treated these expenditures as part of the cost of the meat. The Commissioner argued and the Tax Court held, that the payments were not part of the cost of the goods sold nor even ordinary and necessary expenses (a possible deduction), but a capital expenditure. The taxpayer argued that this was a device to circumvent the OPA price regulations, and was really the cost of the meat. The Tax Court, in rejecting the taxpayer's argument, stated:

> These payments were in addition to the top price permitted by the OPA laws. If they are to be added as a part of the cost of the meat, then the total cost was in excess of a lawful price and it would be difficult to distinguish the transaction from a "black market" purchase. If that were true, then United really represented a scheme devised to avoid the letter of the law at the same time violating its spirit. Improper motives and illegal acts should not be lightly imputed, especially where another more logical interpretation of the testimony can be made.[135]

In essence, the Tax Court ignored what really transpired. It was clear that this was nothing other than an indirect payment for the purchase of meat in violation of the ceiling-prices.

Since the Tax Court has put a very high burden upon the taxpayer to persuade it that a stock purchase is made as an incident of carrying on his business, rather than as an investment, a taxpayer cannot predict with any degree of accuracy the possible tax consequences of such a transaction.

Therefore, from a tax standpoint, the Black & White Printers can, with reasonable certainty, predict that "black market" pay-

[134] 14 T.C. 566 (1950). This case may not be controlling because the Hoffman Lumber Co., supra note 79, was decided 2 years later on same issue. But, this case still stands for the Tax Court's reluctance to call a stock loss a part of the cost of the goods purchased when it is a device to circumvent the law. See, Jaeger, ¶ 50,306 P-H Memo T.C. (1950), failed to prove payments for stock should be included as part of the cost of meat purchased.

[135] Id., at page 568.

ments, when treated directly as cost of goods sold, will be allowed. If they were to purchase stock in a supplier in order to obtain the same paper which they could buy on the "black market", they cannot, with any reasonable certainty, predict the tax treatment of a possible loss on the sale of such stock. In this situation, illegality receives complete tax relief while legality is not accorded the same clear relief under the present income tax laws.

X. CONCLUSION

Under the Internal Revenue Code, there are no provisions establishing the effect which illegality shall have upon deductibility. As a result, the Treasury Department and the Courts have created the doctrine of "frustration of public policy", and the concepts of "illegality" and "legitimate expenses of an illegitimate business", in deciding the allowability of deductions in this area.

These concepts have resulted in unequal tax treatment. The deductibility of an expenditure does not depend upon the nature of the illegal act, but upon the type of business involved. If the taxpayer is engaged in a business which has a commodity for sale, or in the case of bookmakers and gamblers, calculated losses, the test of "illegality" is not applied to the cost of the commodity. Only those expenditures not directly attributable to the cost of a commodity are the ones subject to the illegality test. Thus, there is inequality among those involved in illegal activities.

No one will contend that a taxpayer ought to benefit tax wise from his illegal conduct, nor feel sorry for him when his "immoral" deductions are disallowed. But, the tests have gone further. It is quite possible for a taxpayer engaged in a legal business, following a legal course of action, to be denied his expenses which would have been allowed had he been engaged in illegal activities rather than legal activities or if he had chosen to directly violate some law connected with his legal business. It is at this point that the income tax laws need readjustment. Such a result encourages rather than discourages noncompliance with the law. It also "frustrates" the Treasury Department's policy of disallowing deductions which "frustrate public policy". It is true that a person ought not be allowed to benefit from immoral conduct, but is income tax litigation the proper arena for such moral determination?