

Denying Deductions Based on Public Policy

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Fraud and accounting abuses are constantly making headlines.¹ These stories have monopolized the news for years now, sounding less like scandals and more like business as usual. Many of us can't keep track of which companies have been accused of committing which offenses.

Perhaps the only constant in those sordid tales is New York Attorney General Eliot Spitzer. Known for untangling intricate corporate webs spun to deceive regulators, shareholders, and the public, Spitzer has emerged as a modern-day financial superhero. He recently brought the nation's largest insurance company to its knees, although as we'll see, it's not clear just how crushing a blow Spitzer delivered.²

The New York gubernatorial hopeful and his cadre of federal regulators settled pending litigation against insurance colossus American International Group (AIG). In the settlement, AIG acknowledged its misconduct and adopted far-reaching internal reforms. Triaging at least five years of falsified financial statements, AIG will restate earnings by more than \$3.5 billion and has agreed to pay more than \$1.6 billion in restitution and penalties. Investors will receive \$700 million in disgorgement. Policyholders will receive \$375 million. State worker compensation funds will receive \$344 million.

Moreover, AIG will pay penalties of \$100 million each to the state of New York and to the Securities and Exchange Commission, and \$25 million to the Department of Justice. The \$1.6 billion settlement doesn't resolve the pending case against AIG's CEO Maurice "Hank" Greenberg or the case against AIG's former CFO. AIG's \$1.6 billion settlement is the largest amount ever

paid by any financial services company in U.S. history, nearly double last year's \$850 million settlement paid by Marsh & McLennan.

Although \$1.6 billion is a lot of money by any measure, it isn't so staggering when viewed against the value of AIG. AIG's market capitalization exceeds \$172 billion, and its profits last year exceeded \$11 billion.³ With such large numbers, some may wonder if even a \$1.6 billion settlement stings as much as was intended. Indeed, on the day following the settlement's announcement, AIG's stock rose by over 1 percent. Evidently, Wall Street isn't too concerned about a paltry \$1.6 billion drop in profit at this gargantuan company.

AIG will evidently take the position that most — if not all — of the payments are deductible. A company press release stated that the settlement payment will result in an after-tax charge of \$1.1 billion.⁴ That tax efficiency should come as no surprise. When a business settles litigation, it usually does so expecting the settlement payments to be deductible.⁵ And usually they are.

Congressional Limits

There are only a few circumstances in which settlement payments are not deductible. Section 162(f) bars a deduction for any fine or similar penalty paid to a government for a violation of law. In light of those limits, perhaps the most important tax question regarding the AIG settlement is whether AIG can legitimately deduct the fines paid to the SEC, the Justice Department, and the state of New York.

On the surface, section 162(f) may preclude a deduction for the \$225 million of "fines" paid to the various governments and governmental agencies. The language of section 162(f) is brief and may appear to be relatively straightforward, but it has developed enough explanatory authority over the years that how AIG's whopping payments stack up to the deduction authorities may not be so clear-cut. Reflecting on the roots of the seemingly clear language of section 162(f) can help practitioners understand more of this increasingly important code section.

Reformist History

Section 162(f) was enacted as part of the Tax Reform Act of 1969, along with a series of other broad changes to section 162.⁶ In addition to the disallowance of a deduction for a fine or similar penalty under subsection (f), Congress enacted three other deduction disallowances to section 162. All four changes were made under the guise

¹Ian McDonald and Kara Scannell, "AIG Agrees to \$1.6 Billion Settlement," *The Wall Street Journal*, Feb. 9, 2006, p. C8.

²Ian McDonald and Liam Plevin, "AIG Accord May Lighten Its Wallet, but the Stock May Be Poised to Gain," *The Wall Street Journal*, Feb. 10, 2006, p. C1.

³*Id.*

⁴*Id.*

⁵Wood, "Tax Deductions for Damage Payments: What, Me Worry?" *Tax Notes*, Jan. 16, 2006, p. 243.

⁶P.L. 91-172 (1969).

of codifying the notion that payments against public policy shouldn't be deducted.

First, Congress added subsection (g), attacking treble damages paid in Clayton Act antitrust actions. A taxpayer who is convicted (or who pleads guilty or *nolo contendere*) in such a criminal proceeding cannot deduct two-thirds of the treble damages paid, because that represents the penal portion of the payment.⁷ In fact, the legislative history provides that subsection (g) denies a deduction only for "hard-core violations," for which intent has clearly been proven in a criminal proceeding.⁸

Second, Congress addressed illegal payments to government officials under subsection (c)(1). Before 1969, no deduction was allowed for bribes to foreign officials if the payment would have been unlawful under U.S. law had that law been applicable. Although Congress had generally assumed that analogous payments to U.S. government officials were not deductible, the 1969 changes made that clear. Moreover, in contrast to the rule for antitrust payments, Congress did not require a criminal conviction to make payments nondeductible, believing those types of payments to be sufficiently contrary to public policy by themselves to justify the denial of the deduction.

Third, under subsection (c)(2) Congress further increased the scope of illegal payments for which a deduction is denied. Under that subsection, a deduction is not available for illegal bribes and kickbacks to persons other than government officials. As with the antitrust rule, the deduction is denied only if the taxpayer is convicted (or pleads guilty or *nolo contendere*) in a criminal proceeding.

Those four provisions deny deductions in situations in which Congress believes public policy has been violated. Interestingly, the Senate noted that those provisions were intended to be all-inclusive.⁹ Indeed, besides those four circumstances, the term "public policy" is not sufficiently defined (or perhaps even definable) to justify disallowing a deduction under section 162.

Taken as a whole, the legislative history suggests a clear mandate: Public policy considerations (outside of the rules enunciated in those four subsections) should not be a factor used to determine, in whole or in part, whether a deduction should be allowed. Yet, there has been a nagging ambiguity for nearly 40 years about how and whether public policy considerations should apply. With some consistency, the IRS has been asserting, and the courts have been expanding, the public policy doctrine to deny taxpayers' deductions.

Origin of the Species

Before 1969, the public policy doctrine had evolved from a hodgepodge of cases. The most prominent was *Commissioner v. Tellier*.¹⁰ *Tellier* questioned whether expenses incurred by the taxpayer in the unsuccessful defense of a criminal prosecution qualified for a deduc-

tion under section 162 as an ordinary and necessary expense in carrying out his trade or business.

Tellier was involved in the securities underwriting and securities trading business. In 1956 he was charged with violating the fraud section of the Securities Act of 1933. *Tellier* was convicted and spent over four years in prison. As part of his unsuccessful defense, *Tellier* incurred and deducted his legal fees. The IRS denied the deduction.

The IRS didn't question whether *Tellier's* legal fees had their origin in his securities business. The fees clearly did relate to his business. In fact, just three years before this case, the Supreme Court announced in *United States v. Gilmore*¹¹ that the origin and character of the claim — not its potential consequences on the taxpayer — controls whether the character of an expense is business or personal. Moreover, the IRS didn't even question that *Tellier's* legal expenses were ordinary and necessary. In fact, the Court noted that *Tellier's* legal fees would be deductible under section 162 if that section were applied as it existed in 1966.

The IRS, however, sought to add an intent-driven overlay to the seemingly clear language of the code, seeking to deny *Tellier's* deduction on the basis of public policy. The IRS didn't believe that *Tellier* should be allowed a deduction for defending himself (and his business), because he had broken the law. The Court, however, succinctly pointed out that the code does not concern itself with the lawfulness of the income it taxes. History is full of the IRS's attempts to tax income from criminal enterprise, from Al Capone to John Gotti to Jack Leona Helmsley.¹² Income from criminal activities is taxed at the same rate as income from legitimate sources.¹³

Illegality Is Taxing

In *Commissioner v. Sullivan*,¹⁴ the Supreme Court allowed the taxpayer to deduct rent and wages paid by an illegal gambling operation. The rent and wage payments were plainly illegal under state law. Similarly, in *Lilly v. Commissioner*¹⁵ the Court upheld deductions claimed by opticians for amounts funneled to doctors who prescribed eyeglasses sold by the opticians, even though the Court disavowed the ethics of the opticians and the affront their conduct represented to public policy. Tax, it would seem, is simply a different matter. Professional criminals should be able to deduct business expenses just like everybody else.

The Supreme Court has only rarely disallowed a deduction for public policy reasons. In fact, the Court has done so only when allowing a deduction would "frustrate sharply defined national or state policies proscribing particular types of conduct."¹⁶ There must be a

¹¹372 U.S. 39 (1963).

¹²See Doc 2004-9184, 2004 TNT 84-36.

¹³See *United States v. Sullivan*, 274 U.S. 259 (1927); *Commissioner v. Sullivan*, 356 U.S. 27 (1958); *James v. United States*, 366 U.S. 213 (1961).

¹⁴356 U.S. 27 (1958).

¹⁵343 U.S. 90 (1952).

¹⁶*Commissioner v. Henninger*, 320 U.S. 467, 474 (1943).

⁷Section 162(g).

⁸S. Rep. No. 91-552, section 903 (1969).

⁹*Id.*

¹⁰383 U.S. 687 (1966).

governmental declaration of the conduct¹⁷ and a review of the severity and immediacy of the frustration.¹⁸

The Court in *Tellier* had to confront those confines. After reviewing the pertinent authorities, the Supreme Court allowed Tellier to deduct his legal fees. It found that no public policy was offended when a man faced with serious criminal charges employs a lawyer to help him with his legal defense. According to the Court, a legal defense is an accused's constitutional right. It is axiomatic that legal counsel must be made available.

Tellier lost his criminal trial but won his tax case. Even though Tellier won his tax case when he eventually had his day in court, the decision makes readily apparent that the scope of the public policy doctrine was clouded at that time. Decrying bright lines, determining whether public policy considerations would enter the picture became more akin to an unpredictable facts and circumstances test. That created uncertainty, despite the Supreme Court's forays into the public policy doctrine.¹⁹ Unfortunately, the case law, including *Tellier*, did little to provide general rules with which taxpayers could reasonably self-determine when a deduction was available when public policy considerations were involved.

Recognizing that uncertainty and the detrimental effects it was having (on taxpayers, the IRS, and the courts), Congress provided firmer rules in the Tax Reform Act of 1969. The legislative history to the 1969 law seems definitive. It states that the changes made to section 162 codified the public policy doctrine and that the changes were intended to provide an all-inclusive regimen for disallowing a deduction under the rationale of public policy.

However, at times — arguably on far too many occasions — both the IRS and the courts still enter the public policy morass, evidently forgetting that Congress usurped their respective public policy powers almost 40 years ago. Today, limitations on deductibility based on claims that a deduction violates public policy are still frequently asserted. The strength and reach of those assertions are uncertain.

Lawful Kickbacks?

In 1984, 15 years after Congress enacted the changes to section 162, the IRS argued that a deduction could be denied based on a violation of public policy. The case, *Bertolini Trucking Company v. Commissioner*,²⁰ involved a deduction for the payment of lawful kickbacks. Bertolini was a subcontractor for the construction of a shopping mall in Ohio. After work began, the president of the general contractor, Mr. Festa, approached Bertolini, demanding a kickback. Bertolini understood that further work was conditioned on making the kickback, so he made several of those payments.

Notably, in making those payments, Bertolini did not violate state or federal law, nor was he subject to the loss of any license or privilege to engage in contracting work. Bertolini deducted the kickback payments as ordinary and necessary expenses of his trade or business. Both the commissioner and the Tax Court disallowed the expenses. The IRS didn't openly object to the deduction on public policy grounds, and the Sixth Circuit confirmed that public policy was not a legitimate reason to deny Bertolini a deduction.

To alter the appearance of its objection, the IRS asserted that although the payment was necessary, it was simply not ordinary. The IRS's "ordinary" argument looks and smells remarkably like a covert public policy argument.

The Sixth Circuit spent most of its opinion reviewing the two schools of thought surrounding the ordinary requirement. The IRS argued that "ordinary" was something that is "normal" or "habitual."²¹ Bertolini argued that the ordinary requirement existed only to distinguish between expenditures that are currently deductible and those that must be capitalized.²²

Walk the Line

Walking a fine line, the appellate court noted that those two arguments are not mutually exclusive. Indeed, to an extent, it found both theories to be correct. The court attempted to reconcile them using common sense (what a concept in a tax case!). Waffling like a politician, the court declined to take a position regarding which school of thought was correct.

The crux of the Sixth Circuit's attempted compromise was that there must be some normal, logical connection between a taxpayer's business and the expenditure. It was "obvious" to the court that such a connection existed in this case, because Bertolini could not have remained as the subcontractor if it had not made the payments. That is "but for" causation, known to every first-year law student. The kickback was just a cost of doing business.

Interestingly, in the last paragraph of the opinion, *after* the court stated that the payments were deductible, it restated the axiom that the IRS could not disallow Bertolini's deduction on public policy grounds. After all, the Sixth Circuit said, Congress precluded the IRS from that type of behavior when it enacted the changes to section 162 in 1969. That reiteration more than suggests that the court was keen to the underlying public policy currents in the IRS's arguments. Sometimes, sheep's clothing cannot obscure the wolf within.

Less than a year later, another subcontractor *at the same mall construction site* also appeared before the Sixth Circuit, attempting to reverse the Tax Court's denial of a deduction for kickback payments to Festa, the same slimy general contractor. The facts in *Car-Ron Asphalt Paving Co., Inc. v. Commissioner*²³ are virtually identical to those in *Bertolini*. There was one substantive difference,

¹⁷*Tellier* at 694, paraphrasing *Lilly* at 97.

¹⁸*Tellier* at 694, paraphrasing *Tank Truck Rentals v. Commissioner*, 356 U.S. 30, 35 (1958).

¹⁹*Tank Truck Rentals v. Commissioner*, 356 U.S. 30, 35 (1958); *Commissioner v. Sullivan*, 356 U.S. 27 (1958); *Lilly v. Commissioner*, 343 U.S. 90 (1952); *Commissioner v. Henninger*, 320 U.S. 467 (1943).

²⁰736 F.2d 1120 (1984).

²¹See *Deputy v. du Pont*, 308 U.S. 488 (1940).

²²See *Tellier*, 383 U.S. 687 (1966).

²³758 F.2d 1132 (1985).

and it was sufficient for the Sixth Circuit to distinguish *Bertolini* and uphold the denial of a deduction for kickback payments.

Car-Ron didn't have to review the entire opinion to know that it was in trouble. Before the court even reached its analysis to distinguish *Bertolini*, it had made several foreboding comments. For example, although the kickback payments made by Car-Ron were legal under Ohio law and the IRS conceded as much, the court noted that the kickback payments were "not devoid of criminal conduct." The foreshadowing continued when the court then described in detail Festa's criminal prosecution for failure to report the income from the kickbacks.

Of course, that Festa didn't report the income should have had no bearing on whether the payments are deductible to Car-Ron. Having failed to win over the Sixth Circuit in *Bertolini*, the IRS took a more aggressive tack. In *Bertolini*, the Service argued that the kickbacks were not ordinary. In *Car-Ron*, the IRS asserted that the kickback payments were neither ordinary *nor* necessary. That substantive change in attack hardly seems to be sufficiently big artillery to topple precedent from exactly the same court on virtually identical facts.

Indeed, referring back to *Tellier*, the Sixth Circuit noted that the "necessary" element of a deduction imposes only "a minimal requirement that the expense be appropriate and helpful for the development of the taxpayer's business."²⁴ That definition would appear to cement the availability of the deduction for Car-Ron, wouldn't it? Not so fast.

In fact, the court then made an illogical leap, stating that the kickbacks given in return for granting subcontracting work were not appropriate and were not helpful to the business. Instead, they were just a *cost* of the business. Surprisingly, the court didn't factor into its brief analysis the demonstrated fact that Car-Ron's continued mall construction business was *conditioned* on making the kickbacks. It's hard to understand how the payments were *not* appropriate and helpful to the operation of the business, whatever one thinks of business ethics. The payments were *essential* to Car-Ron retaining its contract at the mall construction site. Yet tax deductions were denied.

Old Public Policy Law

All of that smacks of a kangaroo court. The court appears to have known the decision it wanted to make and then found a way to reach its goal. Although the court acknowledged that the kickbacks were legal business payments under state law, it noted that courts "should never construe general language in tax statutes in a manner that rewards graft and corruption." That only "promotes dishonesty." That certainly smells like public policy to me.

Of course, it's hard not to agree that courts (and the tax law for that matter) should not promote dishonesty, graft, or corruption. But the court clearly sought to interpret section 162 in a way that Congress expressly made obsolete. The court did the IRS's bidding by

reinvoking a tenor of moral outrage to a subject meant to be objective and mechanical.

Even more puzzling is that the court distinguishes a nine-month-old decision from its own circuit involving some of the same players and arising on virtually identical facts. That suggests that taxpayers (and the IRS) should not place too much reliance on this somewhat aberrant decision.

Expanding Horizons

Reflections on the interrelationship between public policy concerns and section 162(f) have continued. In *Jon T. Stephens v. Commissioner*,²⁵ the taxpayer defrauded his employer, Raytheon. He was sentenced to five years in prison and ordered to pay a fine. However, the court gave Stephens a choice: He could make restitution to Raytheon for the amount he embezzled (plus interest), and in return the court would change his prison sentence to probation. Stephens agreed. In a related proceeding, Stephens had already paid tax on the receipt of the embezzled funds,²⁶ so he deducted the restitution payment. Nevertheless, the IRS challenged the deduction.

In the Tax Court, Stephens asserted that the restitution payment was deductible under section 165(c)(2). That section allows an individual to deduct any uncompensated investment losses. The IRS, however, asserted that a deduction was disallowed by section 162(f). In the alternative, the IRS argued that if the governing provision was indeed section 165, public policy considerations should prevent a deduction.

The Tax Court had no trouble determining that the governing code section was "clearly" section 165. According to the court, Stephens's restitution payment was not an ordinary and necessary business expense, but rather was part of a transaction entered into for profit. After that, the Tax Court saw little controversy remaining. Even though section 162(f) did not apply, the Tax Court noted that the considerations involved in applying section 162(f) extend to the determination of deductibility under section 165(c)(2). Thus, the court followed a typical section 162(f) analysis, determining that Stephens could not deduct the payment because it arose in his criminal conviction.

Stephens appealed to the Sixth Circuit, which reversed, allowing Stephens to deduct the restitution payment. The appeals court evidently believed that absent an application of the public policy doctrine, Stephens was entitled to the deduction. The court construed the question in the case to be whether the deduction for restitution of embezzled funds "so sharply and immediately frustrates a governmentally declared public policy that the deduction should be disallowed." No sheep's clothing there.

The Sixth Circuit fully acknowledged that Congress codified the public policy doctrine in 1969 and that the codification was intended to be all-inclusive. However, the codification related only to section 162. As for section 165, the doctrine is alive and well, and continues to

²⁴*Tellier*, 383 U.S. 687, 689.

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

²⁶See Tax Court docket number 42216-86.

evolve. Even though the public policy doctrine survived congressional codification under section 162, the court noted that allowing Stephens a deduction under section 165(c)(2) would not severely and immediately frustrate public policy. Moreover, if Stephens could not claim a deduction, the result would be a double sting because he had already paid taxes on the embezzled funds.

Interestingly, the court justified the application of the public policy doctrine by analogizing the situation before it to one arising under section 162(f), the one section to which the public policy doctrine can no longer apply.²⁷ The court also observed that section 162(f) did not bar Stephens from claiming a deduction. Stephens's restitution payment was primarily a remedial measure designed to compensate Raytheon. It was not a fine or similar penalty. Moreover, Stephens's payment was made to his former employer, not to the government.

That focus on the patently private payee should be sufficient to bar the application of section 162(f) and allow the deduction. Yet the court hedged its conclusion about the government payment, noting that the fact that a payment is made to a private party will not always insulate a restitution payment from the public policy exception of section 165.

What's Love Got to Do With It?

In *Blackman v. Commissioner*,²⁸ the taxpayer was in the midst of a bitter love triangle. After his employer transferred him to a new city, his wife returned to their former home with their children. Some time later, Blackman returned to their former home and found another man living with his wife. Neighbors confirmed that the paramour had been there on previous occasions when Blackman was out of town on business.

Blackman left and the paramour remained at his house. But over the next few days, Blackman returned to the house several times. He quarreled with his wife and asked her if she wanted a divorce. When his wife left the house after one fight, Blackman gathered up some of her clothes, put them on the stove, and set them on fire. Blackman claimed that he put out the fire and left the house. In fact, the fire department put out the fire after the house burned down.

Blackman was charged with arson and served two years probation without verdict. He deducted over \$97,000 as a casualty loss under section 165(c)(3) on his 1980 return. That section allows losses from property arising from fire, storm, shipwreck, or other casualty. Although the IRS did not dispute the fact that the loss originated from a fire, it did argue that because the taxpayer intentionally set the fire, allowing a deduction would frustrate public policy. Once again, the IRS made no attempt to cloak its moral compass.

The Tax Court agreed, noting that at a minimum, Blackman was grossly negligent in not putting out the fire. Moreover, the court asserted that allowing a deduc-

tion would severely and immediately frustrate an articulated public policy against arson. If the court needed any other nails in the unappealing taxpayer's coffin, it noted that the state had a public policy against domestic violence. With a resounding strike of its gavel, the court refused to encourage couples to settle their disputes through fire.

The Sting

In *Raymond Mazzei v. Commissioner*,²⁹ the taxpayer entered into a conspiracy to produce counterfeit U.S. currency. However, his coconspirators had no intention of scamming others with counterfeit currency. Instead, they intended to defraud only Mazzei. When Mazzei provided his alleged coconspirators with thousands of dollars that he believed were going to be duplicated in a secretive currency reproduction process, his alleged coconspirators predictably disappeared with his money.

On some level, you have to admire Mazzei's pluck. He did not slink away and hide his greed and his stupidity. Instead, he contended that he incurred a theft loss under either section 165(c)(2) or 165(c)(3). Not surprisingly, the IRS argued that allowing Mazzei a deduction would be contrary to public policy.

There is some authority here. In a similar case, *Luther M. Richey Jr. v. Commissioner*,³⁰ a taxpayer was not allowed a deduction for a counterfeiting scheme held to be contrary to public policy. Mazzei attempted to distinguish *Richey*, arguing that in *Richey* the taxpayers were *actually* counterfeiting currency, not simply being duped.

Indeed, Mazzei had done nothing more than *attempt* to undertake a counterfeiting scheme. Literally, he was the victim (and not the perpetrator) of a crime, in that the currency he wanted to duplicate was stolen. Unfortunately for Mazzei, the court was not sympathetic. The fact that Mazzei had been swindled did not help him. The court still considered his acts to be criminal and considered his acts to clearly violate public policy.

The court noted that *Tellier*³¹ set the standard for the disallowance of a deduction based on grounds of public policy. It then said that *Tellier* controls only for purposes of section 162, and does not apply to Mazzei's case. So far, that reasoning and its projected conclusion appear consistent with (and similar to) *Stephens*³² and *Blackman*,³³ discussed above.

Yet interestingly, the court failed to mention that Congress codified the public policy doctrine under section 162 in 1969, five years before its decision. However, because *Tellier* was decided under section 162 and *Mazzei* was decided under section 165, that oversight presumably would have not changed the outcome.

²⁹61 T.C. 497 (1974).

³⁰33 T.C. 272 (1959).

³¹383 U.S. 687 (1966).

³²905 F.2d 667 (1990).

³³88 T.C. 677 (1987), *aff'd without opinion*, 867 F.2d 605 (1st Cir. 1988).

²⁷See also *Richard A. Ginsburg v. Commissioner*, T.C. Memo. 1994-272, Doc 94-5678, 94 TNT 115-5.

²⁸88 T.C. 677 (1987), *aff'd without opinion*, 867 F.2d 605 (1st Cir. 1988).

Restitution Policy

In *Russell Spitz v. Commissioner*,³⁴ the taxpayer was the secretary-treasurer of Odin Corp. and the owner of 33 percent of its shares. Odin was a building contractor, and Spitz was convicted of theft in association with building a house for Mr. Fosshage. As part of his punishment, the court ordered Spitz to pay \$5,000 in restitution to Fosshage as a condition of probation.

Spitz deducted that \$5,000 payment on his return, and the IRS denied the deduction. Spitz paid the tax and brought suit for a refund in district court. Among the IRS's many arguments was that section 162(f) barred a deduction because the \$5,000 payment was a fine or similar penalty paid to a government for violation of the law.

The court disagreed with the IRS's application of section 162(f). In fact, the court found that the \$5,000 payment was neither a fine nor a penalty because it was payment of an amount due and owing. Of course, it was also not paid to a government because the ultimate recipient was Fosshage.

In the alternative, the IRS argued that a deduction should be denied because allowing a deduction would frustrate the defined state policy against theft by a contractor. Going back to those halcyon days before the Tax Reform Act of 1969, there's no question that the case represents yet another public policy attack by the IRS. Although the court did not address the codification of the public policy doctrine, it quickly disposed of the IRS's argument, noting that the agency failed to establish in what way restitution of stolen funds frustrates state policy.

It's a dangerous statement, suggesting that this is somehow a contest of degree, and that the reach of the public policy doctrine may depend on whose ox is being gored, on how badly the ox gets it, or on both. Since 1969, none of that should matter.

Interestingly, such *dicta* about restitution and public policy surely didn't matter to Spitz. I say that because the court just said no to the IRS in a big way. In *Spitz*, the IRS had asked for summary judgment on the issue of the deduction.

Not only did the court completely disagree with the IRS's arguments and refuse to grant the IRS summary judgment, but on its *own* initiative, it also granted summary judgment for Spitz, allowing him the deduction. Even though the court was taxpayer-friendly, it unfortunately did not reject the public policy argument the way

Congress intended. In fact, the dark cloud on the decision is that the court *accepted* the legitimacy of the IRS's public policy argument, and then reasoned why the doctrine did not apply. Because of the congressional mandate, the court should have dismissed the argument as an anachronism rather than attempting to rationalize an answer.

Conclusion

Congress enacted legislation 37 years ago that was supposed to stabilize the peripatetic case law which the IRS seeks to deny deductions based on considerations of public policy. Those historic vagaries had long made it difficult for taxpayers and the IRS to determine with any certainty whether a deduction for trade or business expenses is allowable. Congress realized the problem and announced that its changes to section 162 were intended to be all-inclusive for deductions that might be questioned under the public policy doctrine.

Yet, as we have seen, the IRS has subsequently (and consistently) challenged taxpayers overtly and sometimes covertly with public policy arguments. I am not sure which arguments are more objectionable — those with or without the sheep's clothing. Both contradict an express congressional mandate.

Perhaps it is not all that surprising that here and there the IRS might fail to adhere to an all-inclusive codification of the public policy doctrine. The IRS has a job to do, and rightly or wrongly, it is hardly surprising that arguments about public policy occasionally creep in. However, even allowing for the IRS's myopia with public policy considerations, it happens too often and too consistently, given that Congress addressed the subject.

Moreover, the courts also do not have spotlessly clean hands in what sometimes seems to be a roundabout attack proscribed by the 1969 legislation. When a court fails to adhere to the codification of the public policy doctrine, it is far more troublesome than the actions of an arguably overzealous IRS.

The migration of the unclear public policy standards from section 162 to section 165 seems like an end run. I believe it circumvents the all-inclusive nature of the congressional changes. Moreover, it has reopened the door to uncertainty, to the kind of case-by-case analysis that Congress sought to preclude. I do not believe that Congress could reasonably have expected that outcome when it addressed the issue in its 1969 legislation.

In any event, practitioners need to be aware that the public policy doctrine remains alive and well outside the scope of section 162, and that the reports of its death have been greatly exaggerated. Like a wolf in sheep's clothing, perhaps there is no telling under which section it may creep up next.

³⁴432 F. Supp. 148 (1977).