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CASE NOTES

TAXATION–EFFECT OF PUBLIC POLICY ON INCOME TAX DEDUCTIONS

The petitioners were engaged in the optical business in North Carolina and Virginia in 1943 and 1944. Pursuant to agreements reflecting an established and widespread practice in that industry in those localities, they paid to the doctors who prescribed the eyeglasses which they sold, one-third of the retail sales price received for the glasses. These payments were deducted by petitioners as business expenses in their income tax returns, but the Commissioner of Internal Revenue subsequently disallowed the deduction on the grounds that the payments were made under contracts which were void and unenforceable as against public policy and consequently not deductible as ordinary and necessary expenses. The Tax Court and the United States Court of Appeals for the Fourth Circuit upheld the action of the Commissioner,[1] but were reversed by the Supreme Court of the United States. *Lilly* v. *Commissioner*, 343 U.S. 90 (1952).

The court here was confronted with the problem of what limitation Congress intended to impose with respect to the types of business expenses which may be deducted under the very general language of Section 23 (a) of the Internal Revenue Code.[2] Although there is no statement in the Code or in its accompanying regulations prohibiting the deduction of ordinary and necessary business expenses on the ground that they violate or frustrate "public policy,"[3] the Bureau of Internal Revenue, the Tax Court and the federal courts have from time to time narrowed the generally accepted meaning of the language in Section 23 (a) "in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct."[4]

In previous tax cases involving the question of public policy, the courts

[1] Lilly v. Commissioner of Internal Revenue, 188 F. 2d 269 (C.A. 4th, 1951), aff'g 14 T.C. 1066 (1950).

[2] "SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

"(a) Expenses.–

"(1) Trade or Business Expenses.–

"(A) In General.–All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." Int. Rev. Code § 23 (a) (1) (A), 26 U.S.C.A. § 23 (a) (1) (A) (1948).

[3] Lilly v. Commissioner, 343 U.S. 90, 94 (1952).

[4] Commissioner v. Heininger, 320 U.S. 467, 473 (1943).

have been called upon to rule on the deductibility of a wide variety of alleged "business" expenses, ranging from expenditures for lobbying purposes to fines and penalties paid for law violations.[5] The *Lilly* case differs from the majority of public policy cases in that it involved no violation of a statute or governmental regulation, but only the violation of ethical standards established by organized professional societies.[6]

In arriving at its decision that the so-called "kickbacks" made to oculists in the *Lilly* case were proper business deductions, the Supreme Court first found that they were "ordinary and necessary" business expenses, and secondly, that they did not frustrate any sharply defined national or state policies proscribing particular types of conduct.[7]

The question of what meaning is to be given to the term "ordinary and necessary" has been dealt with by the Supreme Court in earlier decisions. In *Welch* v. *Helvering*[8] the court held that to be ordinary, an expense need not be habitual or normal in the sense that the same taxpayer will have to incur it often. An expense may occur only once in the lifetime of a particular taxpayer, but it is ordinary if it is common and accepted in the business world.[9] This same meaning was given to the term "ordinary" in *Commissioner* v. *Heininger*,[10] and in addition, an expense was said to be "necessary" if it is appropriate and helpful to the business.

In the instant case, the kickback payments were held to be "ordinary" in the generally accepted meaning of that word, in that during the years in question they were normal, usual, customary in size and character, and made under a long-established practice in the optical industry in that locality.[11]

The payments also were held to be necessary in that it was through making such payments that the petitioners had been able to establish their business.[12] In the view of the court, discontinuance of the payments by the petitioners would have meant either that the doctors would in the future refer their patients to competing opticians who continued to make the kickbacks, or that the doctors would go back to their prior practice

[5] For compilations and analyses of public policy cases, consult Schwartz, Business Expenses Contrary to Public Policy, 8 Tax L. Rev. 241 (1953); Eulenberg, Influence of Public Policy on Deductions, 28 Taxes 1189 (1950); Arent, Inequities in Non-Deductibility of Fines, Penalties, Defense Expense, 87 J. of Acctcy. 482 (1949); Deduction of Business Expenses, Illegality and Public Policy, 54 Harv. L. Rev. 582 (1941).

[6] Lilly v. Commissioner, 14 T.C. 1066, 1080 (1950).

[7] Lilly v. Commissioner, 343 U.S. 90, 93, 97 (1952).

[8] 290 U.S. 111 (1933).

[9] Ibid., at 114.

[10] 320 U.S. 467, 471 (1943).

[11] Lilly v. Commissioner, 343 U.S. 90, 93 (1952).

[12] Ibid.

of themselves fitting and selling the glasses.[13] Therefore, continuance of these payments was deemed by the court to be as essential to petitioners as were their other business expenses.

Without questioning the over-all logic and soundness of the decision, one may question the validity of the argument that refusal of the petitioners to continue the payments would have resulted in the doctors referring future patients to competing opticians who continued to make the payments. Such argument would appear to be based on the premise that the competing opticians would have the benefit of a tax deduction for such payments, where as they would not enjoy that benefit if such payments were held to be non-deductible under the law. It is inconceivable that any of the opticians would long have continued to "kickback" one-third of the sales price of the glasses if such payments were not allowed as a deduction in computing the taxable income of the business.

The real importance of the Lilly case lies in the Court's pronouncements with respect to the question of public policy. The groundwork for this decision was laid in the *Heininger* case. There a licensed dentist who sold false teeth through fraudulent mail advertising was permitted to deduct legal expenses incurred in unsuccessfully resisting the issuance by the Postmaster General of a fraud order. The decision hinged on the question of whether or not allowance of the deduction would frustrate the sharply defined policies of the statute under which the Postmaster General was authorized to issue fraud orders.[14] After determining that the policy of the statute was to protect the public from fraudulent practices committed through the use of the mails and not to impose personal punishment on violators, the Court held that to deny the deduction for legal expenses in presenting a bona fide defense would attach a serious punitive consequence to the Postmaster General's findings which Congress had not expressly or impliedly indicated should result from such a finding.[15]

Many courts throughout the country have considered the question of what "public policy" is and have expressed widely varying views as to the answer.[16] In an earlier case not involving income tax, the Supreme Court said that the public policy of a state or nation must be determined by its constitution, laws, and the judicial decisions of its highest courts, not by the varying opinion of laymen, lawyers, or judges as to the demands or interests of the public.[17] The Court's application of this defini-

[13] Ibid.

[14] Commissioner v. Heininger, 320 U.S. 467, 474 (1943).

[15] Ibid.

[16] Words and Phrases (Perm. Ed. 1940), vol. 35, pp. 274–291, contains hundreds of excerpts from court decisions defining the term "public policy."

[17] Hartford Ins. Co. v. Chicago I.C. Railway, 175 U.S. 91, 100 (1899).

tion to the facts in the instant case may be seen in its rejection of the Commissioner's argument that customs and actions of organized professional groups, such as medical associations, may constitute the "sharply defined National or State policies" the frustration of which may, as a matter of law, preclude the deductibility of an expense under Section 23 (a)(1)(A) of the Internal Revenue Code.[18]

What the high court apparently was condemning was any attempt by a governmental bureau or by lower courts to determine public policy in situations where there is no applicable statute or official governmental declaration proscribing particular types of conduct. In this connection it is of interest to note that both the Tax Court and the Circuit Court adopted a highly moral tone in their respective opinions in the *Lilly* case, censuring the doctors who accepted the "kickbacks" for violating the fiduciary relationship of patient and physician, and the opticians for offering the bait of the secret consideration which led to what was termed a "corrupt practice."[19] The Circuit Court cited particular ethical standards of the medical profession which were violated by the practice.[20]

Judge Arundell of the Tax Court wrote a strongly dissenting opinion, based on much the same practical line of reasoning used by the Supreme Court in arriving at its decision.[21]

The decision of the Supreme Court appears to be one of practicality. While voicing no approval of the business ethics involved in the payments,[22] it gave recognition to the practical aspects of taxation and the problems which businesses face in this competitive commercial era. The decision is not subject to the criticism sometimes made, that courts fail to give consideration to the actualities with which tax laws are supposed to deal.[23]

The court took note of the fact that legislation has been passed in re-

[18] Lilly v. Commissioner, 343 U.S. 90, 97 (1952).

[19] Lilly v. Commissioner of Internal Revenue, 188 F. 2d 269, 271 (C.A. 4th, 1951).

[20] Principles of Medical Ethics of the American Medical Association, Chapter III, Art. I, Sec. 5 (1943):

"It is unprofessional to accept rebates on prescriptions or appliances, or perquisites from attendants who aid in the care of patients."

And in Chapter III, Art. VI, Sec. 4:

"When a patient is referred by one physician to another for consultation or for treatment, whether the physician in charge accompanies the patient or not, it is unethical to give or to receive a commission by whatever term it may be called or under any guise or pretext whatsoever."

[21] Lilly v. Commissioner, 14 T.C. 1066, 1087 (1950).

[22] Lilly v. Commissioner, 343 U.S. 90, 97 (1952).

[23] Kelley-Dempsey & Co. v. Commissioner, 31 B.T.A. 35 (1934), criticized in 35 Col. L. Rev. 125 (1935); 4 Mertens, Law of Federal Income Taxation, Sec. 25. 102 (1942 Ed.).

cent years in North Carolina and other States outlawing the practice of optical kickbacks,[24] but this did not affect its decision, since it was concerned with public policy as it existed in 1943 and 1944, when the kickbacks were made.

Since the Supreme Court's decision in the *Lilly* case, the Tax Court has had occasion to pass upon the deductibility of secret payments in the nature of bribes or graft made by one company to the purchasing agent of another company in order to procure a contract.[25] In deciding that the payments were not deductible, the court avoided the question of public policy and made a factual finding that the payments were not to be regarded as normal, usual, nor customary in the business world, or "such as were allowable in *Lilly v. Commissioner*."[26]

The Tax Court apparently was on safe ground in this instance, since the Supreme Court has previously said that the question of whether an expense is directly related to a business and whether it is ordinary and necessary are doubtless pure questions of fact in most instances, and that a decision of the Board of Tax Appeals[27] on these issues should not be reversed by the federal appellate courts, except where a question of law is unmistakably involved.[28]

On the related question of fee-splitting by surgeons, which the Commissioner had been inclined to treat in the same manner as the kickbacks in the *Lilly* case, a new position was assumed which gave recognition to the policy enunciated by the Supreme Court. This new position was set forth in a Bureau ruling[29] to the effect that payments by surgeons under split-fee arrangements would be deductible where they complied substantially with the tests laid down in the *Lilly* case.

TORTS–WIFE ENTITLED TO SUE SPOUSE FOR PERSONAL INJURY

The plaintiff alleged that while she was riding as a guest in the car of the defendant, her husband, he wilfully and wantonly collided with another car, causing injuries to her. The parties were subsequently divorced. The wife brought this tort action which was dismissed in the Superior Court. The Appellate Court affirmed that decision.[1] The Illinois Supreme

[24] N.C. Laws (1951) c. 1089, §§ 21, 23; Remington's Wash. Rev. Stat. (1949) §§ 10185–14; Deering's Cal. Business and Professions Code (1951) §§ 650, 652.

[25] Estate of Lashells, 11 T.C.M. 274 (1952), 52, 086 P-H MEMO T.C. (1952).

[26] Estate of Lashells, 11 T.C.M. 274 (1952), 52, 086 P-H MEMO T.C. (1952).

[27] The Board of Tax Appeals was redesignated the Tax Court of the United States by Act October 21, 1942, ch. 619, title V., § 504, 56 Stat. 957.

[28] Commissioner v. Heininger, 320 U.S. 467, 475 (1943).

[29] I.T. 4096, 1952 Int. Rev. Bull. No. 18, at 3 (1952).

[1] Brandt v. Keller, 347 Ill. App. 18, 105 N.E. 2d 796 (1952).