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Costs of Unsuccessful Criminal Defense Are Deductible "Ordinary and Necessary" Business Expenses—*Tellier v. Commissioner**

Taxpayer, a broker and underwriter, was convicted for violations of the Securities Act of 1933[1] and the federal mail fraud statute,[2] and

* 342 F.2d 690 (2d Cir. 1965), *cert. granted*, 34 U.S.L. WEEK 3102 (U.S. Oct. 12, 1965) (No. 351) (hereinafter cited as principal case).

1. 15 U.S.C. § 77q(a) (1964).
2. 18 U.S.C. § 1341 (1964).

for conspiracy to violate those statutes.[3] He claimed a deduction for the legal expenses incurred in his defense. The Commissioner's disallowance of the deduction was sustained by the Tax Court.[4] On appeal to the Court of Appeals for the Second Circuit sitting en banc, *held*, reversed.[5] Legal expenses incurred in an unsuccessful defense against criminal charges arising out of a trade or occupation are deductible "ordinary and necessary" business expenses.

In section 162(a) of the Internal Revenue Code of 1954, Congress has provided for the deduction from gross income of "ordinary and necessary" business expenses.[6] The courts have superimposed upon this provision a limitation requiring disallowance of a deduction for expenses incurred in derogation of public policy.[7] Relying upon these two criteria, courts have consistently disallowed deductions for legal expenses incurred in an unsuccessful criminal defense.[8] In the principal case, the Second Circuit determined for the first time that the denial of these deductions is required neither by the "ordinary and necessary" test of section 162 nor by public policy.[9]

3. 18 U.S.C. § 371 (1964). The taxpayer was convicted on a thirty-six count indictment alleging that he had defrauded some twelve hundred purchasers of debentures issued by Alaska Telephone Corporation. See United States v. Tellier, 19 F.R.D. 164 (E.D.N.Y. 1956).

4. Walter F. Tellier, 32 P-H Tax Ct. Mem. 212 (1963).

5. As the question presented by the appeal had previously been considered settled by Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178 (2d Cir. 1931), it was felt that the entire circuit bench should vote on the decision to overrule the prior categorical holding. Tellier v. Commissioner, 342 F.2d 690, 692 n.3 (2d Cir. 1965). Chief Judge Lumbard, joined by Judges Waterman and Kaufman, wrote a concurring opinion emphasizing that recent decisions giving broad scope to the sixth amendment right to counsel indicate a public policy in favor of allowing a deduction for the expenses incurred by a business in defending against criminal charges, without regard to the ultimate outcome.

6. INT. REV. CODE OF 1954, § 162(a).

7. See, *e.g.*, Cammarano v. United States, 358 U.S. 498 (1959); Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958). See also Treas. Reg. § 1.162-18(d) (1960).

8. The rule disallowing the legal expenses of an unsuccessful criminal defendant was first suggested in Sarah Backer, 1 B.T.A. 214 (1924). For subsequent cases, see Lindsay, *Tax Deductions and Public Policy*, 41 TAXES 711 (1963); Note, 74 HARV. L. REV. 1409 (1961). Although the rule has been consistently stated, the results of the cases have been confused and conflicting when courts have been forced to deal with legal expenses incurred in government action not clearly "criminal," or in criminal litigation in which the final determination was not entirely adverse to the taxpayer. Thus, the Tax Court has disallowed the attorneys' fees incurred in unsuccessfully resisting an action to revoke a professional license when revocation resulted from a criminal conviction. Thomas A. Joseph, 26 T.C. 562 (1956). The deductibility of the legal expense of unsuccessfully resisting an antitrust attack has arbitrarily hinged on whether the action was civil or criminal. Rev. Rul. 64-224, 1964-2 CUM. BULL. 52. Likewise, although the legal expense of defending against civil liability for taxes was deductible even when a penalty for fraud was assessed, Hopkins v. Commissioner, 271 F.2d 166 (6th Cir. 1959), the expenses incurred in defending a tax-evasion indictment were not deductible where the defendant pleaded *nolo contendere*, despite a later finding by the Tax Court that there had been no fraudulent evasion during the years in question. Bell v. Commissioner, 320 F.2d 953 (8th Cir. 1963). This situation has long been criticized by the commentators. See the works cited in the principal case, 342 F.2d at 694 n.13.

9. Principal case at 695.

In rejecting an unbroken line of authority, the court has corrected a long-standing legal anomaly. Consistent application of section 162 demands that legal expenses be held both "ordinary" and "necessary" whether incurred in civil or criminal litigation and regardless of the final determination. In non-criminal contexts, the Supreme Court has held that an expenditure is "ordinary" if it is customary.[10] It is clearly customary for a person engaged in a trade or business to incur legal expenses in connection with any criminal prosecution arising from that trade or business, irrespective of the outcome of the litigation. The Supreme Court has also held in non-criminal contexts that an expense to be "necessary" need only be helpful to, or proximately resulting from, the taxpayer's business.[11] Certainly, this broad characterization includes expenses incurred even in unsuccessfully defending business activities.[12] Nevertheless, prior to the principal case courts had consistently refused to apply these standards to the legal expenses of an unsuccessful criminal defendant, holding that it was neither "ordinary" nor "necessary" for the guilty to incur expenses in their defense.[13] Such a position unreasonably assumes that defendants, unlike judges, can predict the results of criminal cases.[14]

Having found the legal expenses of the unsuccessful criminal defendant to be "ordinary and necessary," the *Tellier* court also rejected the government's contention that to allow a deduction for such expenses would be contrary to public policy.[15] The continual acceptance of this contention by courts prior to *Tellier* is difficult to justify; indeed, two different but related considerations would seem to support the *Tellier* court. First, it is not at all clear that any public policy considerations require disallowance. Although courts have held that allowance of the deduction would subsidize the defense of criminals and encourage criminal activity,[16] it is also arguable that disallowance places an additional premium on successfully resisting prosecution, thus tending to protract litigation and inhibit compromises between prosecutor and defendant. Moreover, disallowance mistakenly assumes that the expenses of presenting a defense are an additional

10. Deputy v. DuPont, 308 U.S. 488 (1940).

11. Kornhauser v. United States, 276 U.S. 145 (1928). The definitions of "ordinary" and "necessary" set forth in *DuPont*, *supra* note 10, and *Kornhauser*, *supra*, were applied by the Supreme Court in Commissioner v. Heininger, 320 U.S. 467 (1943), holding deductible the legal expenses incurred in a civil action in which the taxpayer unsuccessfully resisted a fraud order of the Postmaster General. The Court expressly declined to comment on the situation in which legal expenses are incurred in an unsuccessful criminal defense.

12. *Cf.* Commissioner v. Heininger, *supra* note 11.

13. See, *e.g.*, Bell v. Commissioner, 320 F.2d 953 (8th Cir. 1963).

14. See Comment, 72 YALE L.J. 108, 135 (1962).

15. Principal case at 693-94.

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

criminal sanction.[17] Disallowance is also inconsistent with the well-established deduction allowed the taxpayer against whom the government has successfully enforced civil penalties for unlawful business behavior.[18] Second, even if it is conceded *arguendo* that public policy might be frustrated by allowing the deduction, courts require that, in order to be the basis for disallowance, the policy must be sharply defined by governmental declaration.[19] This requirement is not met in the principal case. There exists no statute or regulation which discourages a defendant from incurring expenses in attempting to show that his behavior was not criminal. In fact, recent congressional action recognizes a policy in favor of paid legal counsel for all criminal defendants.[20] Indeed, as Chief Judge Lumbard pointed out in his concurring opinion in the principal case,[21] the constitutional guarantees of the right to counsel, which are in no way contingent upon the presentation of a successful defense, would seem almost totally to preclude the definition of a public policy against the exercise of that right.[22]

The decision in the principal case should not be interpreted as calling for an end to judicial disallowance of deductions on public policy grounds. Indeed, it would be a discredit to judicial common sense to suggest that Congress should have to codify specifically its intention not to encourage policy violations.[23] Neither should the decision be arbitrarily limited. Implicit in the opinion is a rejection of suggestions that the deduction be disallowed if the defense is asserted in bad faith or if the crime is *malum in se*.[24] More-

17. See Burroughs Bldg. Material Co., 18 B.T.A. 101, 105 (1929) (dissenting opinion); compare Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958), disallowing a deduction for fines, the criminal sanction prescribed by law.

18. *Cf.* Commissioner v. Heininger, 320 U.S. 467 (1943).

19. Lilly v. Commissioner, 343 U.S. 90 (1952). In *Lilly*, the taxpayer, an optician, was allowed a deduction for "kickbacks" he had made to physicians recommending his services. The practice was widespread and, although condemned by state and national medical associations, was not in violation of any state law. The Supreme Court held that in order to be the basis of disallowance, "the policies frustrated must be national or state policies evidenced by some governmental declaration of them." *Id.* at 97.

20. See the Criminal Justice Act, 18 U.S.C. § 3006A (1964).

21. 342 F.2d at 695-96 (concurring opinion). See Brookes, *Litigation Expenses and the Income Tax*, 12 TAX L. REV. 241, 267 (1957). Compare Cammarano v. United States, 358 U.S. 498 (1959), holding that an expense incurred by a business in exercising a constitutional right is not necessarily deductible.

22. *Cf.* Gideon v. Wainwright, 372 U.S. 335 (1963); Johnson v. Zerbst, 304 U.S. 458 (1938).

23. *But see* 65 COLUM L. REV. 1111 (1965).

24. The suggestion in McDonald, *Deduction of Attorneys' Fees for Federal Income Tax Purposes*, 103 U. PA. L. REV. 168 (1954), that a deduction should be allowed only when the criminal defense is asserted in good faith, has been harshly criticized for the administrative difficulties it presents. Comment, 72 YALE L.J. 108, 134 (1962). The Tax Court originally indicated that disallowance was required only where the taxpayer was convicted of a crime *malum in se*. Sarah Backer, 1 B.T.A. 214 (1924). None of the later cases draws this distinction. By making no reference to either the nature of the crimes

over, the *Tellier* court's holding that unsuccessful criminal defense fees are "ordinary and necessary" business expenses, read in conjunction with the Supreme Court's allowance of a deduction for the operating expenses of an illegal gambling establishment although payment of the expenses was an independent criminal offense,[25] may indicate that even an illegal business should be allowed a deduction for attorneys' fees incurred in an unsuccessful criminal defense. However, the public policy limitation on deductibility is of necessity administered on a case-by-case basis.[26] It cannot be supposed that the Commissioner, having so long espoused the rule rejected in *Tellier*, will readily allow the deduction when it is sought by an illegal business or a professional criminal.

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for which the taxpayer was convicted or the merits of the defense he presented, the court in the principal case implicitly rejected both of these distinctions.

25. Commissioner v. Sullivan, 356 U.S. 27 (1958).

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