University of Miami Law Review

Volume 6 | Number 4 Article 20

6-1-1952

Taxation -- Public Policy -- Deduction of "Kickbacks" as Ordinary and Necessary Business Expenses

a state with favorable tax conditions. The case seems to be another step in the attempt to eliminate multiple taxation of movable tangibles, and also to eliminate payment under protest and its consequent bothersome and expensive litigation for recovery.

TAXATION—PUBLIC POLICY—DEDUCTION OF "KICKBACKS" AS ORDINARY AND NECESSARY BUSINESS EXPENSES

Plaintiffs, opticians, deducted as ordinary and necessary business expenses "kickbacks," paid to doctors who prescribed the glasses, of one-third of the retail price. *Held*, that such deductions are not contrary to public policy unless they frustrate some national or state policy which has been defined by some governmental declaration. *Lilly v. Commissioner of Internal Revenue*, 72 Sup. Ct. 497 (1952).

The Internal Revenue Code[1] provides that in computing net income there shall be allowed as deductions from gross income all the ordinary[2] and necessary[3] expenses paid or incurred during the taxable year in carrying on any trade or business. Certain limitations upon this general provision, recognizing public policy, have been set forth. Criminal fines and penalties are not deductible because to do so would in effect permit the taxpayer to mitigate the punishment of the law.[4] Legal fees spent in behalf of defending suits for violations of state and federal statutes have been disallowed as not being "ordinary and necessary," while money spent in defending tort actions has been allowed.[5] Commercial bribes have been disallowed as not being "necessary" because the payor has an adequate remedy at law, and to allow such accessions would be against public policy.[6] Similarly, sums paid by a corporate taxpayer under contingent fee contracts are not allowed, since such sums are paid in execution of contracts which are void as against public policy.[7]

The instant decision,[8] one of first impression, demonstrates the Supreme Court's reluctance to permit lower courts to decide at their discretion what

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1. INT. REV. CODE § 23 (a) (1) (A). 43 STAT. 269 (1924), 26 U.S.C. § 23(2) (1) (1940).

2. 4. MERTON, LAW OF FEDERAL INCOME TAXATION § 25.07 (Rev. ed. 1948) ("Ways of conduct and forms of speech prevailing in the business world will usually furnish a reliable guide in determining whether the particular expense is an ordinary expense of the business.").

3. Welch v. Commissioner, 290 U.S. 111 (1933) ("Ordinarily, an expense will be considered necessary where the expenditure is appropriate and helpful in the development of the taxpayer's business.").

4. Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178 (2d Cir. 1931); Great Northern R.R. v. Commissioner 40 F.2d 372 (8th Cir.), *cert. denied*, 282 U.S. 855 (1930).

5. Kornhauser v. United States, 276 U.S. 145 (1928); Helvering v. Hampton, 79 F.2d 358 (9th Cir. 1935).

6. Kelley-Dempsey & Co. v. Commissioner, 31 B.T.A. 351, 355 (1934).

7. Commissioner v. Textile Mills Securities Corp. 314 U.S. 326 (1941).

8. Lilly v. Commissioner, 72 Sup. Ct. 497 (1952).

constitutes an existing public policy. The court based its rationale upon the theory that in the absence of a plain indication of policy through long governmental practice or statutory enactments, or of violations of obvious ethical or moral standards, courts should not assume to declare such "kickback" contracts contrary to public policy. In the years in which the plaintiffs made such deductions there was no declared public policy proscribing such payments as illegal. The court feels that such public policy is a matter to be dealt with by legislation.[9]

Prior to this decision taxpayers have had no reliable test to follow in determining what expenses are against public policy and hence non-deductible. The instant case presents a well-defined test which can be followed by taxpayers and courts alike in determining such controversies. More and clearer tests of this nature are needed to provide the taxpayer with a workable "yardstick" to use in measuring his liability under our complex Revenue Code.

9. Today, such legislation has been adopted in the following states: CAL. BUS. & PROF. CODE §§ 650, 652 (1951); N.C. Laws, 1951 c. 1089, §§ 21, 23; WASH. REV. STAT. ANN. § 10185-14 (1949).