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Taxation—Business Expenses Deduction of Clayton Act Treble Damages

For many years the Commissioner of Internal Revenue has denied, on grounds of public policy, the deduction under section 162 of the Internal Revenue Code of fines and penalties arising from business activities.¹ The Commissioner seemingly reversed himself, however, when he announced in Revenue Ruling 64-224 that treble damages paid by manufacturers to their customers in settlement of suits brought under section 4 of the Clayton Act could be deducted as a business expense.²

In the recent case of Commissioner v. Tellier³ the United States Supreme Court laid down a three part test for non-deductibility that throws doubt on the correctness of Revenue Ruling 64-224. In

¹ 4A MERTONS, LAW OF FEDERAL INCOME TAXATION §§ 25.50-53 (1966). Section 162(a) allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business..." The early cases disallowing deductions for fines and penalties followed a theory that no such expenses were "ordinary and necessary." E.g., Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178, 180 (2d Cir. 1931). Generally, however, "ordinary and necessary" requires only that an expense be directly related to a business and considered "helpful" within the trade as a means of pursuing that business. Commissioner v. Heininger, 320 U.S. 467, 471 (1943); Welch v. Helvering, 290 U.S. 111, 113-14 (1933); Kornhauser v. United States, 276 U.S. 145, 153 (1928). More recent cases attempt to determine if the expense is ordinary and necessary apart from the question of whether allowance of the deduction would be against public policy. Coed Records, Inc., 47 T.C. No. 41, (1967); Tellier v. Commissioner, 342 F.2d 690, 694 (1965), aff'd, 383 U.S. 687 (1966). Separation of the two issues is desirable because it focuses the attention of the court on the policy which is said to require disallowance rather than on the wrongful conduct of the taxpayer. Where the activity that gives rise to a fine is one that is uncommon in a trade, it would still be appropriate to deny a deduction on the grounds that it is not "ordinary and necessary" apart from considerations of policy. United Draperies, Inc. v. Commissioner, 340 F.2d 936, 938 (7th Cir. 1965).

² Rev. Rul. 64-224, 1964-2 CUM. BULL. 52. The Ruling was issued in the wake of the famous "Philadelphia electric cases" in which many of the nation's manufacturers of heavy electrical equipment were found guilty of rigging prices submitted to both public and private utility companies. Under the criminal provisions of the Sherman Act the manufacturing corporations were heavily fined; some 30 corporate executives received fines, and in a few cases, prison sentences. 1800 civil suits were then brought under the Clayton Act, and it has been estimated that at least $300,000,000 has been paid out by the electric companies in settlement of them. See STAFF OF JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, 89TH CONG., 2d SESS., STAFF STUDY OF INCOME TAX TREATMENT OF TREBLE DAMAGE PAYMENTS UNDER THE ANTITRUST LAWS 1-3 (Comm. Print 1965).

Tellier the issue was whether expenses for counsel incurred in a losing fight against a criminal charge growing out of the conduct of a business could be deducted as a business expense. The opinion states that an expense may be disallowed when allowance would frustrate a sharply defined policy of some other state or federal law. Further, the policy that might be frustrated must be one that is evidenced in a governmental declaration. Finally, the frustration which would result from allowance of the deduction must be severe to justify disallowance. In Tellier the deduction was allowed because there is no policy against the employment of counsel that could be frustrated by a deduction. The question this note attempts to answer is whether a deduction for treble damages paid by manufacturers convicted of price fixing should be disallowed under the three part test of Tellier.

Does Allowance Frustrate Sharply Defined Policy of the Clayton Act?

If the treble damages provided by section 4 of the Clayton Act are punitive, i.e., if the policy of section 4 is to deter price fixing, a strong argument can be made that deduction of those damages should not be allowed. The Commissioner continued to maintain that amounts paid for fines and penalties should not be deducted as a business expense, because to do so would reduce the “sting” of the penalty and thereby encourage the taxpayer to violate the statute under which the penalty was imposed. If, however, the purpose of the treble damages of the Clayton Act is to compensate the party injured in his business, the deduction should be allowed, just as compensatory damages paid by a business after judgment in a negli-

6 It has been pointed out that disallowance of a deduction does more than merely protect the policy of the statute that has been violated. When no deduction is given, the burden of the penalty is increased because the taxpayer must pay tax on money that he does not have. Since the economic impact of disallowance can vary greatly on different facts, and since this increase in tax burden may or may not show any relationship to the penalty provided by the statute that has been violated, critics have suggested that the doctrine of disallowance should be abandoned unless the statute that provides the penalty should itself call for disallowance of a deduction. Comment, Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code, 72 Yale L.J. 116-23 (1962); Keesling, Illegal Transactions and the Income Tax, 5 U.C.L.A. L. Rev. 26, 34-40 (1958).
gence suit are deducted. It is also possible that the treble damages of section 4 may serve both punitive and compensatory policies. In this case it would seem that the deduction should be disallowed to prevent frustration of one of the policies of the Clayton Act.

In Revenue Ruling 64-224 the Commissioner takes the position that the treble damages of section 4 of the Clayton Act are compensatory in nature. The legislative history of both the Sherman Act and the Clayton Act supports his position. Sections 1, 2, and 3 of the Sherman Act provide a fine of $50,000 and imprisonment for one year for violation of its provisions, and it is clear that this fine may not be deducted as a business expense. In contradistinction section 4 of the Clayton Act refers to “threefold damages” for “any person who shall be injured in his business or property.” Section 4A of the Clayton Act provides “actual damages” whenever the United States is injured by a violation of the antitrust laws. During the debate Senator Sherman compared the two types of provisions:

It is the second section that gives the civil suit, and that is not to be prosecuted at all by the United States. . . . The first section deals with the public injury to the people of the United States and there the suit is brought . . . to restrain, limit, and control such arrangements as far as they are illegal. The second section gives a private remedy to every person injured. It seems to me the two sections are as distinct from each other as possible.

When asked more specifically if the treble damages of the proposed legislation were penal in nature, Senator Regan said, “This measure is given a civil remedy. It is not in the nature of a prosecution for crime.”

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7 In Cox v. Lykes, 237 N.Y. 376, 143 N.E. 226 (1924) (Cardoza, J.), it was said, “We are to remember that the same provision may be penal as to the offender and remedial as to the sufferer. . . . The nature of the problem will determine whether we are to take one viewpoint of the other.”
13 21 Cong. Rec. 2563 (1890).
14 21 Cong. Rec. 3147 (1890). The provision under discussion became
The case law also provides considerable support for the Commissioner's position that the treble damages are compensatory. In *United States v. Cooper Corp.*, it was said that "the [Clayton] Act envisaged two classes of action—those made available to the government... and, in addition, a right of action for treble damages granted to redress private injury." Cases involving other statutory damages analogous to the treble damages of the Clayton Act frequently stress the compensatory aspect of those damages. In *Overnight Transport Corp. v. Missel* it was held that statutory double damages paid by an employer to an employee for failure to pay required overtime were compensatory. The theory of *Missel* is that the excess over actual damages provided by the statute is supplied not to punish, but to insure that the injured party will not be prevented from attaining an adequate recovery by the cost of a lengthy and complicated suit or difficulty in proving his damages. Section 4 of the Clayton Act may reflect a similar policy in that it provides not only for enhanced damages but for the costs of suit and a reasonable attorney's fee as well. Finally the Commissioner can also point to an older Ruling in which treble damages for payments to private parties under the Emergency Price Control Act of 1942 were held deductible.

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section 7 of the Sherman Act, 26 Stat. 210 (1890). It was taken over, with minor changes, to become section 4 of the Clayton Act in 1914. When the fine under the Sherman Act was increased in 1955 from $5000 to $50,000, committee reports were issued indicating that the only penalties provided by antitrust law were those in the Sherman Act. H.R. Rep. No. 618, 84th Cong., 1st Sess. 2 (1955); S. Rep. No. 70, 84th Cong., 1st Sess. 3 (1955).

15 312 U.S. 600 (1941).
16 Id. at 608.
17 316 U.S. 572 (1942).
18 Id. at 583. The Commissioner also points to *Huntington v. Attrill*, 146 U.S. 657, 686 (1892), holding that statutory damages are not penal in nature for purposes of enforcement of a judgment in a foreign jurisdiction, and to *Brady v. Daly*, 175 U.S. 148, 153 (1899), holding statutory damages not penal for application of a statute of limitations. The force of such cases is greatly reduced by the more recent case of *Testa v. Katt*, 330 U.S. 386 (1947) where it was held that even if the damages provided by a federal statute were considered penal, state courts would have to take jurisdiction over an action brought before them. Where a federal statute is involved, it is no longer necessary to label the damages "compensatory" in order to get a trial in a state court.

20 I. T. 3630, 1943 Cum. Bull. 113. Chiefly because of the precedent of I. T. 3630, the Antitrust Division of the Department of Justice has accepted the viewpoint of the Internal Revenue Service. This acceptance is important because another clue to the policy expressed by statutory damages may be found in the opinion of the administrative agency in charge of enforce-
Cases dealing specifically with Clayton Act recoveries contradict the Commissioner, however, in treating the two-thirds of an award that is in excess of actual damages as punitive in character. In Commissioner v. Glenshaw Glass Corp.,\(^{21}\) where the taxpayer was an injured party who had received a treble damage award, the one-third actual damage was taxable to the recipient because it was compensation for lost income. It was held that the two-thirds excess damages were also taxable to the recipient, even though these damages were punitive. It would seem that whether the actual damages are taxable to the recipient as a replacement of lost income or are considered a tax free return of capital, they are compensatory from the point of view of the party paying the damages. In either event, however, the two-thirds excess would be characterized as penal. Lower court opinions express a theory that these punitive excess damages were made available to multiply the agencies that would help support the act,\(^{22}\) increase public respect for the Sherman Act,\(^{23}\) and provide a "sanction allowed to a private litigant, because of the public interest."\(^{24}\)

The Commissioner's case is further weakened by a surprising inconsistency within Revenue Ruling 64-224 itself. A second holding of the Ruling is that actual damages paid to the government as an injured party under section 4A of the Clayton Act may not be deducted by the taxpayer as a business expense:

Amounts paid in satisfaction of damage claims by the United States under section 4A of the Clayton Act . . . although resembling restitution, are in effect punishment for injury to the public occasioned by the violation of law. . . . The illegality of the act providing the damages. See Jerry Rossman Corp. v. Commissioner, 175 F.2d 711, 713 (2d Cir. 1949). Although the Antitrust Division has expressed willingness to argue that Clayton Act damages are a penalty, it feels that allowance of the deduction will not necessarily encourage potential violators of the Sherman Act to treat the possibility of incurring treble damages as a "business risk." Even if full deduction is allowed, the business suffering judgment will still, if the income tax rate is 50%, be subjected to an irreplaceable loss of 150% on every dollar that is earned in violation of the Sherman Act. STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, STAFF STUDY OF INCOME TAX TREATMENT OF TREBLE DAMAGE PAYMENTS UNDER THE ANTITRUST LAWS, Appendix E (Comm. Print Nov. 1, 1965).

\(^{21}\) 348 U.S. 426 (1955).
\(^{22}\) Kinnear-Weed Corp. v. Humble Oil & Refining Co., 214 F.2d 891, 893 (5th Cir. 1954) (dictum).
\(^{23}\) Maltz v. Sax, 134 F.2d 24 (7th Cir. 1943).
\(^{24}\) Karseal Co. v. Richfield Oil Co., 221 F.2d 358, 365 (1955) (dictum).
DEDUCTION OF TREBLE DAMAGES

... giving rise to the damage combined with the fact that the injury is inflicted upon the Government requires that such payments not be allowed as deductions.

The language of section 4A and section 4 is practically identical. It is a strange result that "actual damages" when paid to the government are punitive and "threefold damages" paid to private litigants are entirely compensatory. In both situations illegality gives rise to damages. If the recoupment of actual damages by the government is "in effect punishment for injury to the public," it does not seem unreasonable to assume that excess damages awarded to private litigants may contain an element of punishment. When the government is injured by an antitrust violation it has the purely punitive provisions of the antitrust statutes at its disposal. If the compensation for actual damages is also punishment, this fact tends to blur the distinction that might otherwise be made between the purely punitive provisions of antitrust laws and the multiple damages of the Clayton Act. Even if the distinction made by the Commissioner is not completely arbitrary, it certainly suggests that if a court were presented with the issue of whether the treble damages of the Clayton Act contain an element of punitive damages designed to protect the public, it might well find that they do.

Is There a Sufficient Governmental Declaration?

If there is a penal policy in the treble damages of section 4 of the Clayton Act, there is a sufficient governmental declaration of that policy in the antitrust statutes to satisfy the second requirement for disallowing a deduction in Tellier. It is only required that the policy be evidenced in some statute or regulation and not that it be explicitly announced or defined. This requirement originated in Lilly v. Commissioner where opticians were disallowed a deduction for kickbacks paid to ophthalmologists who were sending them business. The tax court reasoned that since these payments were considered unethical by the medical profession, to allow their deduction would frustrate a public policy against them. In reversing, the United States Supreme Court refused to allow the tax court to roam

25 For a vigorous defense of the Commissioner, see Lamont, Controversial Aspects of Ordinary and Necessary Business Expense, 42 Taxes 829-832 (1964).
27 343 U.S. 90 (1952).
the moral landscape in search of policy and imposed the requirement that before a policy should be invoked against a deduction, it should be grounded on some official declaration of public law that the acts involved were objectionable. Since the antitrust statutes set out both the prohibited conduct and the remedies available, they should provide sufficient evidence of policy to satisfy the minimal requirement of governmental declaration in *Tellier*.

**Does Allowance of the Deduction for Treble Damages Present a “Severe” Frustation of Antitrust Policy?**

The third requirement in *Tellier* is that the degree of frustration that would result from a deduction be "severe." If there is a penal policy in Clayton Act treble damages, one can argue that to allow a deduction would work a direct and severe frustration of antitrust law. The severity test has been used by the United States Supreme Court, however, not primarily to measure the absolute effect of allowance of a deduction on the policy of the law that has been violated, but rather to balance this harmful effect of allowance against the harmful effect that disallowance will have on the business that has claimed the deduction. This balancing process is necessary because the legislative history of section 162 shows that Congress has been less concerned with protecting the public from

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28 *Id.* at 97.
29 383 U.S. 687, 694.
31 In *Tank Truck Rentals v. Commissioner*, 356 U.S. 30, 35 (1958), the use of the severity test was explained, [T]he test of non-deductability always is the severity and immediacy of the frustration resulting from allowance of the deduction. 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 public policy. It would appear that the destructive effect of disallowance has also been a factor in decisions against the Commissioner on grounds other than the severity test. In *Lilly v. Commissioner*, 343 U.S. 90 (1952), where the requirement of governmental declaration was first announced, the Commissioner attempted to impose a total tax of $49,500 on a net profit of $25,000 for one of the taxable years in question. One writer has called this "taxation of gross income with a vengeance." Paul, *The Use of Public Policy by the Commissioner in Disallowing Deductions*, 1954 So. CALIF. TAX INST. 715, 737-42.
misuse of the expense deduction than it has been interested in establishing a morally neutral concept of net income.\textsuperscript{32}

The awkwardness of the severity test is dramatically illustrated by the conflicting results of two cases decided in 1958 on the same day by the United States Supreme Court. In \textit{Tank Truck Rentals, Inc. v. Comm'r}\textsuperscript{33} the issue was whether fines paid by a trucking firm for violations of weight statutes could be deducted. The Court held that they could not, saying that to allow deduction of a payment that was \textit{itself illegal} would present the most severe form of frustration of other law and that allowance of a fine would present a slightly less severe frustration that could also not be tolerated.\textsuperscript{34}

But in \textit{Commissioner v. Sullivan} payments of rent and wages in the operation of a bookmaking establishment were in issue.\textsuperscript{35} Although a state statute \textit{specifically prohibited} these payments,\textsuperscript{36} the Court held that they could be deducted: "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 business would be taxable on the basis

\begin{footnotesize}
\begin{enumerate}
\item The basic purpose of section 162 is to allow a determination of how much money a business has left over after expenses. In 1913 it was urged in debate on the first income tax bill that only lawful expenses be allowed as deductions and the answer, in the words of Senator Williams, could not have been clearer:

\begin{quote}
[\text{The object of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral character; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon "futures," but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way.}]\textsuperscript{50 CONG. REC. 3849 (1913). See also \textit{Seidman, Legislative History of Federal Income Tax Laws, 1938-1961}, 995-97 (1963). Congress has since repeatedly refused to include a provision in the Code that would generally disallow immoral or undesirable expenses. For a detailed review see Comment, Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code, 72 \textit{Yale L.J.} 111-112 (1962).}
\end{quote}
\item 356 U.S. 30 (1958).
\item Id. at 35.
\item 356 U.S. 27 (1958).
\item Thus bringing the issue squarely within the language of the \textit{Tank Truck Rentals}, which should result in disallowance. This is distinguishable from the situation where deduction of an otherwise legal expense incurred in the pursuit of an illegal business is allowed. \textit{Compare} Commissioner v. Doyle, 231 F.2d 635, 637 (7th Cir. 1956) with Allen v. Commissioner, 283 F.2d 785, 790 (1960).
\end{enumerate}
\end{footnotesize}
of net income. If that choice is to be made, Congress should do it.”
The court then said that only if it were “clear that the allowance is
da device to avoid the consequences of violations of law” should the
deduction be disallowed.\(^7\)

How then would Clayton Act treble damages be treated under
the severity test? On the one hand, allowance of the deduction
certainly permits the taxpayer to “avoid the consequences” of an
antitrust violation, and, if this dictum in \textit{Sullivan} is followed, the
deduction should be disallowed.\(^8\) Where a Clayton Act suit is based
on a prior criminal conviction under the Sherman Act,\(^9\) there is an
appealing argument that the relatively weak provisions of the Sher-
man Act should be buttressed through disallowance.\(^10\) On the other
hand, payment of treble damages can have a heavy impact on a firm.
If this impact is so great as to destroy or seriously impair a firm’s
competitive position,\(^11\) disallowance of the deduction would conflict

\(^7\) 356 U.S. 27, 29 (1958).

\(^8\) \textit{Ibid.}

\(^9\) Where there has been a criminal conviction, there is no doubt that the
guilty parties knowingly entered into a conspiracy to restrain trade and it is
under these circumstances that the deterrence of non-deductibility would be
most useful. In litigation over deductability of damages paid under the
Emergency Price Control Act of 1942 a distinction between willful and
innocent violations was made with the result that deduction was denied
where the violation was willful but allowed where innocent. \textit{Compare}
National Brass Works, Inc. v. Commissioner, 16 T.C. 1051 (1951), \textit{aff’d}, 205
F.2d 104 (9th Cir. 1953) \textit{with} Jerry Rossman Corp. v. Commissioner, 175
F.2d 711 (2d Cir. 1949).

\(^10\) The number of Clayton Act suits has increased greatly in recent years
to the point where they may be considered a major means of enforcement
of antitrust law. Bicks, \textit{The Department of Justice and Private Treble
Damage Actions}, 4 \textit{ANTITRUST BULL.} 5 (1959). If private claimants must
pay income tax on the two-thirds excess damages received, see note 21
\textit{supra}, it would perhaps be desirable to offset this factor deterring claimants
from exercising their enforcement function with a concomitant factor of
non-deductability to deter potential violators. On the other hand, it might
be more desirable in view of the basic policy of encouragement of competi-
tion to encourage claimants by excluding the two-thirds excess from gross
income and allowing deductions by defendants. See generally Loevinger,
\textit{Private Action—The Strongest Pillar of Antitrust}, 3 \textit{ANTITRUST BULL.} 167
(1958).

\(^11\) The Attorney General has recognized the danger of excessive damages
to the competitive positions of firms, especially small firms, in his own suits
on behalf of the United States for actual damages under 4A of the Clayton
Act. In recent suits following the “Philadelphia electric cases” the Attorney
General settled for as much as 10% of total sales with major manufacturers
and as little as 2% from small firms. \textit{Staff of the Joint Committee on
Internal Revenue Taxation, Staff Study of Income Tax Treatment
of Treble Damage Payments under the Antitrust Laws}, 9-11 (Comm.
Print Nov. 1, 1965).
with both the policy of the Internal Revenue Code to tax only net income and the policy of the Sherman Act to encourage competition. If presented with a case where disallowance of the deduction would have a crippling effect on a firm, a court might be motivated, although it could not easily say so, to allow the deduction in order to protect the competitive position of the firm. In this event the court could allow the deduction, as in Sullivan, by stressing the intent of Congress to tax only net income. Such a holding would amount, however, to virtual abandonment of disallowance of deductions for fines and penalties on the grounds of public policy.

CONCLUSION

It is apparent that there is no clear answer to the question whether allowance of the deduction for treble damages frustrates policy of the Clayton Act because it is unclear whether that policy is penal or compensatory. There is, however, a sufficient governmental declaration to justify a decision either way, and if a court were to find a significant penal policy present in the Clayton Act, the first and second tests in Tellier for disallowing a deduction would be met. Furthermore, under the dictum in Sullivan, if a penal policy were found in the Clayton Act, the third test of severity would be met. In view of the ease, however, with which the United States Supreme Court abandoned the position it took in Tank Truck Rentals when it was faced, in Sullivan, with a business that would be destroyed by disallowance, it is possible that a deduction for Clayton Act treble damages might be allowed if necessary to preserve competition. One could argue that since the issues are so uncertain, the Commissioner was well within proper exercise of discretion to grant the deduction in a Revenue Ruling. The better view, however, is that the Commissioner was incorrect to decide a question of such great public interest in a way that forecloses litigation.

HENRY C. McFADYEN, JR.

42 The emphasis of modern antitrust law has shifted from the negative "trustbusting" theme of the early 1900's to a more positive theme of maintaining competition in all possible ways. Penalties which are so great as to damage ability to compete would be self-defeating. See generally Neale, THE ANTITRUST LAWS OF THE UNITED STATES OF AMERICA 29-30 (1962).