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Confidence Schemes: Theft Loss Deductions, Restitution, and Public Policy

Steven F. Friedell

CONFIDENCE SCHEMES: THEFT LOSS DEDUCTIONS, RESTITUTION, AND PUBLIC POLICY

STEVEN F. FRIEDELL[†]

INTRODUCTION

May courts legitimately impose their public policy views to override statutory commands? For example, if a taxpayer is tricked into giving money to thieves in the mistaken belief that they are helping him purchase counterfeit money, may courts deny the taxpayer a loss for theft that is allowed by statute? Similarly, even though the Internal Revenue Code ("IRC") allows a deduction for casualty losses, may courts disallow a deduction for a lost truck when the driver contributed to the accident by speeding and by driving while intoxicated? Problems of this kind also arise outside the income tax context. For example, may courts deny tort relief to a person who is injured while committing a criminal act even though the pertinent comparative fault statute apparently allows partial recovery? Even if a legislature expected courts to exercise judgment in these matters, how are judges to know where to draw the line?

This Article focuses on some of these problems in the field of federal income tax. It suggests that when part of the IRC appears to direct a particular outcome, courts are prone to error when they override that command by imposing a penalty based on the judges' moral condemnation of a party's behavior. It would be better for courts to employ the statute's intrinsic set of public policies to guide their decision making. In some instances, the results will not change because of other overlooked provisions

[†] Professor, Rutgers Law School. My thanks to Jay Feinman and Doug Kahn for their helpful comments and to Rutgers law librarian David Batista for valuable assistance.

in the statute. However, adherence to the legislature's balance of conflicting interests will likely lead to greater coherence and more consistent application of state policies.

Part I of this Article focuses on theft losses suffered by confidence-scheme victims who thought they would profit from counterfeiting or other illegal activity. Courts usually disallow these deductions so as to discourage illegal activity. This Article criticizes such a rationale and suggests instead that a tax deduction would be contrary to state policy in those situations where states in effect penalize victims by denying them restitution from the thieves. Part II discusses the cases that have denied deductions for fines and civil penalties, and explores how these apply to the denial of restitution. Part III assesses the wisdom of disallowing deductions in these cases and suggests that it would make more sense for society to punish the wrongdoer solely in the criminal courts and to allow the would-be counterfeiter a theft loss deduction.

I. TRYING TO "MAKE" MONEY AND OTHER WAYS OF LOSING IT

Some con men convinced Vernon Blick that they had a machine that could reproduce money.[1] The machine was "nothing more than a tin box with a buzzer."[2] Blick convinced his employer, Raymond Mazzei, to invest in the scheme, and the two went together to meet with the con men, bringing large amounts of money in one hundred dollar bills.[3] While engaged in the process of copying the bills, two armed men impersonating police held Mazzei and Blick at gunpoint and placed handcuffs on one of the con men.[4] Mazzei managed to escape, and the two "policemen" and the con men left with the money.[5] In the scheme, Mazzei lost twenty thousand dollars and Blick lost five thousand dollars.[6] Mazzei and Blick reported the incident to law enforcement.[7]

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[1] Mazzei v. Comm'r, 61 T.C. 497, 498 (1974).

[2] *Mazzei*, 61 T.C. at 500. See MARIA KONNIKOVA, THE CONFIDENCE GAME: WHY WE FALL FOR IT . . . EVERY TIME (2016), for an account of confidence schemes and the psychological makeup of con artists and their victims.

[3] *Mazzei*, 61 T.C. at 498–99.

[4] *Id.* at 499–500.

[5] *Id.* at 500.

[6] *Id.* at 499.

[7] *Id.* at 500.

Mazzei claimed a theft loss and argued that it was deductible under IRC § 165(c)(2) or (c)(3).[8] With five judges dissenting, the United States Tax Court ruled that the loss was nondeductible as against public policy.[9] There were three opinions favoring the Internal Revenue Service, all based on the idea that counterfeiting was against public policy or that Mazzei had conspired with Blick in violation of the law.[10] The two dissenting opinions argued that allowing a deduction would not encourage counterfeiting, and Mazzei and Blick, despite their evil intent, could not counterfeit money on their own.[11]

Mazzei v. Commissioner[12] is the leading case standing for the proposition that losses under § 165 can be disallowed on public policy grounds.[13] *Mazzei* is part of a line of cases where taxpayers have been denied loss deductions for thefts resulting from schemes to counterfeit money,[14] or to buy stolen money.[15] A split decision that went the other way, *Edwards v. Bromberg*[16]

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[8] *Id.*

[9] *Id.* at 502.

[10] *Id.*; *Id.* at 502–03 (Dawson, J., concurring); *Id.* at 504 (Tannenwald, J., concurring).

[11] *Id.* at 504–05 (Featherston, J., dissenting) (arguing that Mazzei and Blick did not conspire with the con men to counterfeit money because the con men's only intention was to steal); *Id.* at 506–07 (Sterrett, J., dissenting).

[12] 61 T.C. 497 (1974).

[13] *E.g.*, Bilzerian v. United States, 41 Fed. Cl. 134, 139 n.6 (1998); Blackman v. Comm'r, 88 T.C. 677, 680–81 (1987), *aff'd*, 867 F.2d 605 (1st Cir. 1988); Rev. Rul. 81-24, 1981-1 C.B. 79; Chief Counsel Advisory, I.R.S. C.C.A. 200451030, 2014 WL 2915913 (Dec. 17, 2004); MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 16.07[5] (Thomson Reuters ed., 2015); 7 MERTENS LAW OF FEDERAL INCOME TAXATION § 28:155 (2015); *cf.* DOUGLAS A. KAHN & JEFFREY H. KAHN, FEDERAL INCOME TAX: A STUDENT'S GUIDE TO THE INTERNAL REVENUE CODE ¶ 24.1200, at 573 (7th ed. 2016) ("It is possible that the public policy exception continues to apply to deductions allowed for losses . . . ."). *But see* Richard A. Posner, *The Problematics of Moral and Legal Theory*, 111 HARV. L. REV. 1637, 1707 n.146 (1998) (criticizing *Mazzei*'s use of moral belief to decide technical legal issue).

[14] *See, e.g.*, Richey v. Comm'r, 33 T.C. 272, 276–77 (1959). Richey gave $15,000 to Johnson believing that the money would be used to make counterfeit bills; Johnson took the money and did not return. *Id.* at 273.

[15] *See, e.g.*, Lincoln v. Comm'r, 50 T.C.M. (CCH) 185 (1985). Lincoln gave a briefcase containing $140,000 to a man at a train station who was to give him in exchange between $600,000 and $1,000,000 of "stolen money." *Id.* The man went to another part of the station, supposedly to count the money. Two policemen staged a fake arrest of the other man, and Lincoln fled to avoid arrest. *Id.*; *see also* Rev. Rul. 81-24, 1981-1 C.B. 79 (determining that public policy precludes a deduction under IRC § 165(c) for losses incurred by those who burn down their own building).

[16] 232 F.2d 107 (5th Cir. 1956).

involved a taxpayer swindled out of money he mistakenly thought would be bet on a fixed race.[17] The promoter of the scheme embezzled the taxpayer's money and was later prosecuted for failure to report the income.[18] The majority dismissed the public policy argument on the grounds that there was in fact no fixed race and that it would be "Pecksniffian" to deny the taxpayer a deduction when the promoter of the scheme was taxed on the money he embezzled.[19] The dissent argued that having tried to defraud others, the taxpayer "is in no position to call on the Government to bear a part of his loss."[20] None of the opinions in *Mazzei* could distinguish *Bromberg*; the majority did not "feel constrained to follow" it,[21] and the dissenters thought it controlled.[22] This Article suggests that these cases can be reconciled.[23]

The majority and dissenting opinions in *Mazzei* disagree on whether the taxpayer's loss had a "direct relationship" to the illegal act and whether allowing the deduction would severely and immediately frustrate a sharply defined governmental policy.[24] These tests were derived from several United States Supreme Court opinions, and their respective histories reveal their inherent weaknesses.

In a 1943 decision, *Commissioner v. Heininger*,[25] the taxpayer was engaged in a mail order business selling false teeth, and the Postmaster General determined that the taxpayer's advertisements were false or misleading.[26] The Court allowed a business deduction for the taxpayer's attorney fees and other legal costs unsuccessfully opposing the Postmaster General's fraud order.[27] The Court found that the attorney fees and legal expenses were ordinary and necessary business expenses and that a deduction for them would not frustrate

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[17] *Id.* at 109–10.

[18] *Id.* at 111.

[19] *Id.*

[20] *Id.* at 111–12 (Rives, J., dissenting).

[21] Mazzei v. Comm'r, 61 T.C. 497, 502 (1974); *see* Lincoln v. Comm'r, 50 T.C.M. (CCH) 185 n.2 (1985).

[22] *Mazzei*, 61 T.C. at 505 (Featherston, J., dissenting); *id.* at 506 (Sterrett, J., dissenting).

[23] *See infra* notes 75–79 and accompanying text.

[24] *Compare Mazzei*, 61 T.C. at 502, *with id.* at 506–07 (Sterrett, J., dissenting).

[25] 320 U.S. 467 (1943).

[26] *Id.* at 469.

[27] *Id.* at 474–75.

sharply defined national or state policies.[28] The expenses bore only a "remote relation to an illegal act."[29] Moreover, the statute authorizing the Postmaster General to issue fraud orders was intended to protect the public—not to punish violators or to deter accused violators from hiring lawyers to make a bona fide defense.[30] A separate criminal statute punished violators.[31]

Fifteen years later, in *Tank Truck Rentals, Inc. v. Commissioner*,[32] the Court disallowed deductions for fines paid by several states for violating their maximum weight laws, a result codified a few years later in IRC § 162(f).[33] The Court held:

> [T]he test of nondeductibility 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 declared public policy.
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> Certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute. If the expenditure is not itself an illegal act, but rather the payment of a penalty imposed by the State because of such an act, as in the present case, the frustration attendant upon deduction would be only slightly less remote, and would clearly fall within the line of disallowance. Deduction of fines and penalties uniformly has been held to frustrate state policy in severe and direct fashion by reducing the "sting" of the penalty prescribed by the state legislature.[34]

The Court thus established a hierarchy of expenses that frustrated governmental policy. Expenses that violate a statute are most direct; fines and penalties are a close second. However, the Court decided *Commissioner v. Sullivan*[35] the same day as *Tank Truck Rentals*, thus allowing the deduction of rent and wages paid to employees engaged in bookmaking, even though the payment of rent violated state law and the employees acted

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[28] *See id.* at 475.
[29] *Id.* at 474.
[30] *Id.*
[31] *Id.*
[32] 356 U.S. 30 (1958).
[33] 26 U.S.C.A. § 162(f) (West 2014); *Tank Truck Rentals*, 356 U.S. at 31–32.
[34] *Id.* at 35–36 (footnote omitted) (citation omitted).
[35] 356 U.S. 27 (1958).

in violation of state law.[36] The Court did not attempt to reconcile these two cases, and Congress apparently overturned *Sullivan* in 1971 by revising IRC § 162(c)(2), which, among other things, disallows deductions for certain payments that are illegal under state law if the law is generally enforced.[37]

The *Heininger* court noted, with apparent approval, that courts had ruled that taxpayers convicted of crimes are not allowed to deduct attorney fees associated with their criminal defense.[38] However, in 1966, the Court held, in *Commissioner v. Tellier*,[39] that a taxpayer is allowed a business deduction for legal expenses incurred in the unsuccessful defense of a criminal prosecution.[40] Further, the Court concluded, "[W]e can find no warrant for attaching to [the severe punishment imposed on the taxpayer] an additional financial burden that Congress has neither expressly nor implicitly directed."[41]

Despite the Court's reasoning, it is not obvious that the deductions allowed in *Heininger* and *Tellier* do not frustrate governmental policies. Part of the cost of illegal activity is the expense of defending against prosecution. In *Burroughs Building Material Co. v. Commissioner*,[42] Judge Augustus Hand wrote, "If the fines and costs cannot be deducted, the legal expenses incurred in litigating the question whether the taxpayers violated the law and whether fines should be imposed should naturally fall with the fines themselves."[43] He stressed that criminals who employ lawyers in their unsuccessful defense

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[36] *Id.* at 28. The Tax Court found that the payment of wages was also a violation of state law. Mesi v. Comm'r, 25 T.C. 513, 522 (1955), *rev'd in part*, 242 F.2d 558 (7th Cir. 1957), *aff'd sub nom.* Comm'r v. Sullivan, 356 U.S. 27 (1958).

[37] Revenue Act of 1971, Pub. L. No. 92-178 § 310, 85 Stat. 497, 525. For criticism of § 162(c), see Douglas A. Kahn & Howard Bromberg, *Provisions Denying a Deduction for Illegal Expenses and Expenses of an Illegal Business Should be Repealed*, 18 FLA. TAX REV. 207 (2016). The authors distinguish the tax treatment of fines and penalties under § 162(f), as a deduction for these items would reduce the sanction and deterrent.

[38] Comm'r v. Heininger, 320 U.S. 467, 473 n.8. (1943).

[39] 383 U.S. 687 (1966).

[40] *Id.* at 694.

[41] *Id.* at 694–95 (footnote omitted).

[42] 47 F.2d 178 (2d Cir. 1931).

[43] *Id.* at 180. *Burroughs* was cited with apparent approval in *Heininger*, 320 U.S. at 473 n.8. *See also* Jerry Rossman Corp. v. Comm'r, 175 F.2d 711, 713 (2d Cir. 1949); Helvering v. Superior Wines & Liquors, Inc., 134 F.2d 373, 375 (8th Cir. 1943); Nat'l Outdoor Advert. Bureau, Inc. v. Helvering, 89 F.2d 878, 881 (2d Cir. 1937).

were obdurate and "added impenitence to their offence."[44] Going further, in the first reported decision on this issue, the Board of Tax Appeals denied a deduction for successful defense of a charge of perjury in connection with a charge of bribery of a labor leader.[45] The Board concluded that bribery and perjury were not ordinary and necessary acts, and that it would be against public policy to recognize the defense costs as legitimate.[46] Even though the taxpayer was not convicted of perjury, the Board determined that laying oneself open to charge of perjury was also not an ordinary and necessary activity.[47]

The Supreme Court cases discussed above demonstrate the potential inconsistency and fluidity inherent in the task of determining whether a deduction would directly and severely frustrate an important government policy.[48] The best that can be said for the test is that it is flexible, but fails to give taxpayers an adequate means to predict whether a particular expense will be deductible or not.[49] The test bears an uncanny resemblance to that bête noire of tort law, proximate cause, and shares some of its drawbacks. In the latter context, it is useful to remember the observation by a nineteenth-century scholar, "When a court say this damage is remote, it does not flow naturally, it is not

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[44] *Jerry Rossman Corp.*, 175 F.2d at 713.

[45] Appeal of Backer, 1 B.T.A. 214, 217 (1924).

[46] *Id.* at 217.

[47] *Id.*

[48] For a parallel development in England, compare McKnight v. Sheppard, [1999] 1 W.L.R. 1333 (HL) at 1338 (appeal taken from Eng.) (allowing deduction of legal expenses) with Comm'rs of Inland Revenue v. Alexander von Glehn & Co., Ld., [1920] 2 K.B. 553 (AC) at 566 (appeal taken from Eng.) (denying deduction for fines and legal expenses).

[49] Part of the difficulty is defining the public policy that is at stake. If, as asserted in *Heininger*, it were merely to punish those convicted of crimes after assuring the defendants of "constitutional and statutory safeguards appropriate to trial for a crime," then a deduction for legal expenses would seem appropriate. Comm'r v. Heininger, 320 U.S. 467, 474 (1943). However, if the criminal laws were designed in part "[t]o foster the development of personal capacity for responsible decision to the end that every individual may realize his potentialities as a participating and contributing member of his community," then allowing the deduction would be contrary to public policy. Henry M. Hart, Jr., *The Aims of the Criminal Law*, 23 L. & CONTEMP. PROBS. 401, 440 (1958); *see also* United States v. Generes, 405 U.S. 93, 105 (1972) (concluding the concept of proximate cause "has little place in tax law where plural aspects are not usual, where an item either is or is not a deduction, or either is or is not a business bad debt, and where certainty is desirable").

proximate; all they mean, and all they can mean, is, that under all the circumstances they think the plaintiff should not recover."[50]

In deciding whether to allow a deduction in cases like *Mazzei*, we will gain little by mulling over whether the taxpayer's illegal acts were directly or indirectly related to the loss. Courts have learned that such a test in the torts area is vague, amorphous, and invites undesired results.[51] We have no means for measuring how direct an illegal act is to a loss. We can, however, ask whether the illegal act was one of a great many but-for causes of the loss. That is, we can determine whether the loss would probably have occurred even if the taxpayer had changed his behavior to the minimal extent necessary to comply with the law.[52] For example, Mazzei's illegal act was one of the but-for causes of his loss. If Mazzei had acted legally and not sought to make counterfeit money, he would not have incurred a loss. It is another matter to ask whether that illegal act directly or indirectly contributed to his loss. Such a question merely invites a value judgment as to whether we think the taxpayer should be allowed a deduction.

In some situations, the use of the direct/indirect analysis only works to obscure the problem. If a taxpayer builds a house without obtaining building permits and a large forest fire burns everything in its path and destroys the house, the IRS will allow a loss deduction.[53] The Chief Counsel recognized, "[T]he loss would have occurred regardless of whether Taxpayers had obtained the required permits."[54] The Chief Counsel's further observation that "the casualty loss was not directly related to Taxpayers' failure to obtain permits"[55] adds only confusion to the

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[50] Nicholas St. John Green, *Torts Under French Law*, 8 AM. L. REV. 508, 519 (1874).

[51] *See* RESTATEMENT (THIRD) OF TORTS: PHYS. & EMOT. HARM § 29 cmt. e (AM. LAW. INST. 2010).

[52] *See* David W. Robertson, *The Common Sense of Cause in Fact*, 75 TEX. L. REV. 1765, 1768–73 (1997) (explaining that to determine whether a party's negligence was a cause-in-fact of the injury, one must create a counter-factual hypothesis and correct the wrongful conduct "to the minimal extent necessary to make it conform to the law's requirements," and then ask whether the harm would probably still have occurred).

[53] Chief Counsel Advisory, I.R.S. C.C.A. 201346009, 2013 WL 6137595 (Nov. 15, 2013).

[54] *Id.*

[55] *Id.*

analysis. A more challenging case would arise if complying with the building code requirements might have prevented the house from being destroyed. Similarly, the Tax Court allowed a taxpayer to take a casualty-loss deduction for damage to his truck that occurred while the taxpayer was driving under the influence of alcohol.[56] The court held, "In addition, there was no evidence that excess speed or alcohol directly caused petitioner's accident."[57] The directness or indirectness of the speed and alcohol were not the issue. The truck slid off an embankment, but it was not shown that the loss would probably not have occurred had the taxpayer been sober.[58] The opinion provides no guidance as to whether a deduction would be allowed if speeding or drunk driving had been a but-for cause of the accident.

Nor does a court have the tools to measure whether the frustration of governmental policy is severe or merely moderate. If such tools existed, a court ought to allow partial deductions depending on the degree of frustration. Moreover, the requirement that a deduction must not immediately frustrate governmental policy seems out of place. If a deduction would sabotage an important government policy, would a court allow it even if the frustration would not occur right away?[59] In seeking to apply these standards, the courts have instead made judgment calls based on their sense of social policy or morality.[60]

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[56] Rohrs v. Comm'r, No. 14109-08S, Summ. Op. 2009-190, 2009 WL 4723327, at *4 (T.C. Dec. 10, 2009).

[57] *Id.* at *3.

[58] *Id.* at *1–3. The driver's blood-alcohol level was just slightly over the legal limit. *Id.* at *2.

[59] A similar problem occurs in Jewish law. According to some rabbis, a defendant is not liable for harm caused by a wrongful act unless the harm occurs immediately. In applying this rule, however, rabbis engaged in the fiction that some injuries were deemed to occur immediately even when the injury occurred sometime later. *See* Steven F. Friedell, *Nobody's Perfect: Proximate Cause in American and Jewish Law*, 25 HASTINGS INT'L & COMP. L. REV. 111, 125–28, 137–39 (2002).

[60] *See* Mazzei v. Comm'r, 61 T.C. 497, 506 (1974) (Sterrett, J., dissenting) (stating that courts pay "lip service" to the Supreme Court by asserting a deduction would cause immediate and severe frustration to governmental policy without showing how that frustration will occur). In *Jerry Rossman Corp. v. Commissioner*, Judge Learned Hand wrote, "[T]here are 'penalties' and 'penalties,' and that some are deductible and some are not. . . . We hold therefore that in every case the question must be decided ad hoc." 175 F.2d 711, 713 (2d Cir. 1949). Judge Hand found evidence that a deduction for paying the penalty for having innocently violated emergency price control regulations would not frustrate a governmental policy because the Price Control Administrator had accepted payment of the amount of the overcharge as sufficient and did not seek treble damages. *Id.* at 714. Further,

In cases like *Mazzei*, some judges conclude that denying a deduction would strike a blow against counterfeiting.[61] This seems improbable since the victims in these cases were not counterfeiting—they only thought they were.[62] This decision will not likely deter real counterfeiters nor cause those who mistakenly think they are counterfeiting to desist.[63] A confidence scheme's success depends on convincing the victims that they are going to win.[64] If Mazzei thought there was a serious risk of being cheated, he would have withdrawn from the enterprise.

The disallowance of a deduction may be justified by the common law rule of denying individuals defrauded in counterfeit money schemes, like Mazzei, the right to seek restitution.[65] Such claims fail even though the thieves are unjustly enriched. They fail due to the principle stated by Lord Mansfield that no court "will lend its aid to a man who founds his cause of action upon an

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the regulations were "extraordinarily complicated and difficult to comprehend." *Id.* The court recognized, however, that another way of looking at the matter would lead to the opposite conclusion. That is, one could argue that "the more unsparing and relentless was the pursuit of offenders, however innocent they may have been of any willful violation of the regulations, the more solicitous would they become to comply, and the more effective would be the enforcement of the Act" and that the taxpayer could have avoided the overcharges by "more appropriate accounting." *Id.* (internal quotation marks omitted).

[61] *Mazzei*, 61 T.C. at 501 (citing Richey v. Comm'r, 33 T.C. 272, 276–77 (1959)); Lincoln v. Comm'r, 50 T.C.M. (CCH) 185 (1985) (finding that to allow a deduction would encourage attempts to buy stolen money).

[62] *Mazzei*, 61 T.C. at 507 (Sterrett, J., dissenting); *accord* 2 GEORGE E. PALMER, THE LAW OF RESTITUTION 192 (1978) (arguing that, assuming the parties know the law, denial of restitution is just as likely to encourage participation by confidence scheme promoters).

[63] *Cf.* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 32 cmt. d, illus. 11–12 (AM. LAW INST. 2011) ("The potential availability of a claim in restitution between thieves who have fallen out . . . will not—on any realistic appraisal—affect the decision to enter into the transaction, or undermine the deterrent effect of the criminal penalties to which both claimant and defendant are subject in any event."); Andrew Kull, *Restitution's Outlaws*, 78 CHI.-KENT L. REV. 17, 32 (2003) (arguing that it is unlikely that lack of a remedy in restitution has any deterrent effect). Professor Kull was the Reporter for the Restatement (Third) of Restitution and Unjust Enrichment.

[64] *See* KONNIKOVA, *supra* note 2 at 235 ("From the confidence man's perspective, this is the ideal moment to make a killing: pull the plug just when your mark is at his most convinced.").

[65] *See* Chapman v. Haley, 80 S.W. 190, 191 (Ky. 1904). The plaintiff paid $300 for $3,000 of "good money," and the defendant took the money and never returned it. *Id.*; *see also* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT, § 32(3), cmt. d, illus. 13 (AM. LAW INST. 2011); 2 PALMER, *supra* note 62, at 188, 226.

immoral or an illegal act."[66] State courts have not ordered the defrauded party to pay a penalty, but the financial impact of denying restitution is the same as if they had.[67] The common law rule expresses a governmental policy that defrauded parties have placed themselves outside the protection of the law by their criminal or immoral conduct.[68] Although some judges claim that they deny relief solely "to preserve the integrity of the process,"[69] courts will order relief if they determine that the plaintiff was less at fault than the defendant.[70] It would be wrong to think that the courts have simply failed to rule on the parties' rights when the parties are equally at fault.[71] The courts have established a rule of law that theft victims who attempt to participate in counterfeiting schemes cannot get their money back. As the Reporter for the Third Restatement of Restitution has recognized, the denial of restitution is punitive, a form of retributive justice in that the defrauded parties forfeit their

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[66] Holman v. Johnson (1775) 98 Eng. Rep. 1120 (KB) 1121 (appeal taken from Eng.).

[67] If the victim of the confidence scheme were able to recover restitution from the thieves in the year of the theft, there would be nothing to deduct. Denial of restitution makes little practical difference when the thieves cannot be located or when they are judgment proof. But the lack of a civil remedy discourages the fraud victim from pursuing the thieves, and from the victim's point of view, it is as if the law required that their investment in the confidence be forfeited.

[68] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 32(3), cmt. d, § 63, cmt. a (AM. LAW INST. 2011). Judge Rives, dissenting in *Edwards v. Bromberg*, made essentially this point. 232 F.2d 107, 111–12 (5th Cir. 1956) (Rives, J., dissenting). The Restatement describes this as a defense based on the plaintiff's "inequitable" conduct that is available to both equitable and legal claims for restitution. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 63, cmt. a (AM. LAW INST. 2011). The defense does not mean that the defendants have been justly enriched. Rather, "[T]he principle involved is in fact one of judicial forbearance, and its concern is with the disqualification of the claimant rather than the rightful position of the recipient." *Id.* § 63, cmt. a.

[69] Soleimany v. Soleimany [1999] QB 785 at 800 (Eng.).

[70] 2 PALMER, *supra* note 62, at 202. Courts have also allowed restitution if the plaintiff repented and if the illegal act has not been performed. *Id.* at 214.

[71] *Cf.* HENRY M. HART & ALBERT M. SACKS, THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW 500, 515 (William N. Eskridge, Jr. & Phillip P. Frickey eds., 1994) (arguing that a court fashions a rule of law when it denies a plaintiff a remedy because it thinks that it would be better for the legislature to rule on the matter).

entire investment.[72] The denial of relief renders the money irretrievably lost, and a deduction for the loss would reduce this sanction.

One happy consequence of this analysis is that one can reconcile *Edwards v. Bromberg*[73] with *Mazzei* and the other counterfeiting case. It will be recalled that in *Bromberg*, the court allowed a deduction for the losses suffered in a scheme where the taxpayer thought he was betting on fixed horse races.[74] This is consistent with the way courts handle restitution claims made by such victims. In a series of cases, courts ordered restitution where a gang of thieves ran an elaborate confidence scheme to steal money from people who believed they were investing in fixed foot races.[75] The courts said the investors were less at fault than the promoters.[76] Since state law does not penalize these victims by denying restitution, a tax deduction for theft losses does not offend state policy.

The next part of this Article suggests that the denial of restitution suffered by the defrauded taxpayer is a "fine or similar penalty paid to a government" within the meaning of IRC § 162(f). If so, a court faced with a claim for theft loss under IRC § 165 arising from the taxpayer's failed attempt to cheat the public does not need to speculate as to whether a deduction would encourage such acts. The court does not need to look far to find a public policy justification for withholding a deduction. It can be found in IRC § 162(f), which prohibits deducting fines and similar penalties as ordinary and necessary business expenses.[77]

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[72] Kull, *supra* note 63, at 25–26, 32 (2003); *see also* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 63, cmt. a (AM. LAW INST. 2011).

[73] 232 F.2d 107 (5th Cir. 1956). The Government argued that the taxpayer could not claim a loss deduction unless he had first shown that he had tried to obtain restitution from the thief. *Id.* at 111. The court rejected this argument. *Id.*

[74] *Id.* at 108–10.

[75] *See* Hobbs v. Boatright, 93 S.W. 934, 934–35 (Mo. 1906); *see also* Falkenberg v. Allen, 90 P. 415, 416–19 (Okla. 1907).

[76] *See* Stewart v. Wright, 147 F. 321, 322 (8th Cir. 1906); *Falkenberg*, 90 P. 415, 416–17 (Okla. 1907) (victim demanded his money back before the race was held); *see generally Hobbs*, 93 S.W. 934 (Mo. 1906); Lockman v. Cobb, 91 S.W. 546 (Ark. 1905); *see also* PALMER *supra* note 62, at 204–05.

[77] 26 U.S.C.A. § 162(f) (West 2014).

II. OF FINES, PENALTIES, AND "GOVERNMENTS"

Section 162(f) of the Internal Revenue Code ("IRC") provides, "[n]o deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law."[78] These few simple words have led to much litigation involving billions of dollars of potential tax liabilities.[79]

Although § 162(f) only applies to disallow business expenses under § 162, it is generally recognized that the provision applies or is at least "highly relevant" in determining whether a loss will be barred under § 165.[80] As the United States Court of Appeals for the Second Circuit observed, "Congress can hardly be considered to have intended to create a scheme where a payment would not pass muster under [§] 162(f), but would still qualify for deduction under [§] 165."[81] Assuming that to be the case, there

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[78] *Id.*

[79] For a discussion of recent corporate settlements with the Government from companies in various industries for statutory and regulatory violations that total over $65 billion, see Abraham N.M. Shashy, Jr., Sara A. Silverstein & Ariana F. Wallizada, *Beyond Frustration: Section 162(f) and the Deductibility of Fines, Penalties, and Settlement Payments*, 17 FLA. TAX REV. 354–62 (2015).

[80] Stephens v. Comm'r, 905 F.2d 667, 672 (2d Cir. 1990); *accord.* Nacchio v. United States, 824 F.3d 1370 (Fed. Cir. 2016). Fines and similar penalties cannot be deducted under IRC § 212. *See* Treas. Reg. § 1.212-1(p) (as amended in 1975). The legislative history accompanying the 1969 statute was ambiguous about whether courts might use public policy to deny deductions for business expenses that are not specifically disallowed by the statute. Although suggesting that § 162(c), (f), and (g) were intended to be an "all inclusive" list of public policy violations, the Senate's summary of the bill also said, "Public policy, in other circumstances, *generally* is not sufficiently clearly defined to justify the disallowance of dededuction." S. REP. NO. 91-552, at 274 (1969) (emphasis added). Nonetheless, the Treasury Regulations have curtailed the courts' ability to use public policy to further limit business expense deductions. Treas. Reg. § 1.162-1(a) (as amended in 1993) ("A deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowable under [§] 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy."); *see also* Note, *The Judicial Public Policy Doctrine in Tax Litigation*, 74 MICH. L. REV. 131, 132–35 (1975) (arguing that although not arbitrary, the Treasury's view limiting the public policy doctrine to those codified by Congress was not mandated).

[81] *Stephens*, 905 F.2d at 672; *accord Nacchio*, 824 F.3d at 1375. *Contra* Ramos v. Comm'r., 42 T.C.M. (CCH) 924 (1981). The issue seems settled. The plaintiffs in *Nacchio* did not contest the applicability of § 162(f) but contended instead that the payments were compensatory and not a fine or similar penalty. *See* Brief of Plaintiffs in Opposition to the Motion of the United States for Summary Judgment and in Support of Plaintiffs' Cross-Motion for Partial Summary Judgment at 2, Nacchio v. United States, 115 Fed. Cl. 195 (2013) (No. 12-20 T). The IRS takes the view that the public policy exception under § 165 is at least as broad as under § 162(f). Rev. Rul. 77-126, 1977-1 C.B. 47; I.R.S. Priv. Ltr. Rul. 2012-40-007 (Oct. 5,

are two pertinent issues: Can payments to non-governmental entities be treated as fines and penalties, and what makes a legally imposed payment a "fine or similar penalty" as opposed to some other sort of payment?

A. What Does "Paid to a Government" Mean?

On its face, § 162(f) seems to require that only fines and penalties "paid to a government" are nondeductible.[82] If that were so, then a payment to the thieves would not be included. Some courts have indeed read the words literally.[83] However, other courts have held that payments to a nongovernmental entity can be classified as a fine or similar penalty, and thus are not deductible.[84] For example, in *Waldman v. Commissioner*,[85] the United States Tax Court took a pragmatic approach, reasoning that even though the payment was made to the victims of the defendant's grand theft, the State had complete control over the disposition of the funds.[86] This liberal reading is warranted, since the reason for denying deductions for fines and similar penalties is to leave their sting in place.[87] It should not matter, therefore, to whom these payments are made. *Waldman*'s reasoning is pertinent here. The State, by foreclosing

2012). In *Holt v. Commissioner*, the court disallowed a loss deduction on public policy grounds where the taxpayer's truck and other property were forfeited because they were used to transport marijuana. 69 T.C. 75, 80 (1977), *aff'd*, 611 F.2d 1160 (5th Cir. 1980). The court said that it did not need to consider § 162(f). *Id.* at 81. In *Nacchio*, the Government contended that § 162(f) applied to losses under § 165 by virtue of Treas. Reg. 1.165-1(a), which provides that a loss deduction "is subject to any provision of the Code that prohibits or limits [the] deduction." 115 Fed. Cl. 195, 202 (2013); Brief of the United States in Support of its Motion for Summary Judgment at 19, Nacchio v. United States, 115 Fed. Cl. 195 (2013) (No. 12-20 T).

[82] 26 U.S.C.A. § 162(f) (West 2014).

[83] *Stephens*, 905 F.2d at 674 (leaving open the possibility that the public policy exception under § 165 might be broader as compared to § 162(a)); Spitz v. United States, 432 F. Supp. 148, 150 (E.D. Wis. 1977); Allied-Signal Inc. v. Comm'r, 1995 U.S. App. LEXIS 41283, at *27–28 (3d Cir. Feb. 23, 1995) (Nygaard, J. dissenting).

[84] *E.g.*, Allied-Signal, Inc. v. Comm'r, 63 T.C.M. (CCH) 2672, at 46 (1992), *aff'd*, 54 F.3d 767 (3d Cir. 1995); Kraft v. United States, 991 F.2d 292, 298–99 (6th Cir. 1993); Bailey v. Comm'r, 756 F.2d 44, 47 (6th Cir. 1985); Ginsburg v. Comm'r, 67 T.C.M. (CCH) 3091 (1994). Similarly, the IRS has ruled that a charitable contribution paid in lieu of a fine is not deductible. Rev. Rul. 79-148, 1979-1 C.B. 93.

[85] 88 T.C. 1384, 1389 (1987), *aff'd*, 850 F.2d 611 (9th Cir. 1988).

[86] *Id.*

[87] *Id.*

any chance for relief, controls the ultimate disposition of the stolen money and punishes the defrauded victims who otherwise satisfy the usual requirements for restitution.

B. When Is a Payment a Fine or Similar Penalty?

Not all court-ordered payments are fines or civil penalties. Even if paid due to a criminal conviction, the payment might be deemed to be compensation or restitution. The Treasury Regulations provide in pertinent part:

> For purposes of this section a fine or similar penalty includes an amount—
> (i) Paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding;
> (ii) Paid as a civil penalty imposed by Federal, State, or local law . . . ;
> (iii) Paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or
> (iv) Forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty.
> (2) . . . Compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.[88]

The regulation is helpful up to a point but leaves many unanswered questions. For example, when a court orders a criminal defendant to reimburse a victim, is the payment made "pursuant to a conviction" or is it compensatory? Unless the sentencing court specifically directs what the income tax consequences will be,[89] it is impossible to describe the payment as being solely punitive or solely compensatory. The payments compensate victims and often prevent defendants from being unjustly enriched but are also part of defendants' criminal sentence. Trying to determine whether the payment is a fine or compensation is like trying to decide whether light is a wave or a particle. Some courts have determined that the payment was made for the purpose of rehabilitation and deterrence and was

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[88] Treas. Reg. § 1.162-21(b) (as amended in 1975).

[89] *Cf. Bailey*, 756 F.2d at 46–47 (finding that the sentencing court allowed the amount of the fine to be paid in restitution to the victims of the taxpayer's fraud and directed that the funds should retain their status as civil penalties).

therefore a fine or similar penalty.[90] Other courts have found the payment to be compensatory because the defendant's sentence was severe in other respects.[91]

The Internal Revenue Service considers multiple factors in determining whether a settlement payment is deductible.[92] This

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[90] *Waldman*, 88 T.C. at 1388 (holding that, under California law, restitution was for purpose of rehabilitation, deterrence and to enforce the law); Allied-Signal, Inc. v. Comm'r., 63 T.C.M. (CCH) 2672 (1992) (concluding that compensatory or remedial purpose was minimal; payment to a 501(c)(4) fund was made with understanding that the fine would be reduced and was paid for punishment and deterrence), *aff'd*, 54 F.3d 767 (3d Cir. 1995). *Cf.* Nacchio v. United States, 824 F.3d 1370, 1380–81 (Fed. Cir. 2016) (finding that forfeiture was part of the penalty, but oddly reasoning in part that payment was not restitution because it was pegged to Nacchio's profits and not to the victims' losses); Ginsburg v. Comm'r, T.C.M. (CCH) 3091 (1994) (holding that the restitution payments to the county government constitute a fine). *But see* I.R.S. Priv. Ltr. Rul. 2012-40-007 (July 11, 2012) (finding that, under New Jersey law, an order of restitution under a criminal sentence is primarily compensatory).

[91] *E.g.*, Stephens v. Comm'r, 905 F.2d 667, 672–73 (2d Cir. 1990); Nacchio v. United States, 115 Fed Cl. 195, 202 (2014), *rev'd on other grounds*, 824 F.3d 1370, 1378 (Fed. Cir. 2016) (holding that Congress intended for forfeitures in this type of case to be paid with after-tax dollars); Spitz v. United States, 432 F. Supp. 148, 149–50 (E.D. Wis. 1977); Cavaretta v. Comm'r., T.C.M. (RIA) 2010-004 (2010). The Israeli Supreme Court has recently adopted a similar approach. The panel unanimously concluded that the restitution of embezzled funds made in each of two cases before the court that occurred while the criminal trials were pending were compensatory. CA 4157/13 Damari v. Tax Assessor (2015), available at http://elyon1.court.gov.il/files/13/570/041/t09/13041570.t09.pdf (Hebrew). Finding a lacuna in the tax statute, a majority of the panel allowed the taxpayers to offset half of the embezzled income that was earned in a prior year.

[92] In one instance, the IRS Chief Counsel advised area counsel to consider the origin and character of the liability giving rise to the payment, with the proviso that its advice may not be cited or used as precedent:

> If the law is designed to compensate the injured party for its damages, [§] 162(f) is *likely* to be inapplicable. . . . If the law is designed to be punitive or to deter the type of conduct committed by the taxpayer, then the payment is *likely* covered by § 162(f).

Chief Counsel Advisory, I.R.S. C.C.A. 201308027, 2013 WL 653294 (Feb. 22, 2013) (emphasis added). It went on to say:

> In ascertaining the nature of a payment as punitive or compensatory, courts analyze the purpose of the statute requiring the payment or forming the basis of claims that are settled. Both the language of the statute and its legislative history are relevant to this inquiry. If a payment can serve both punitive and compensatory purposes, it is necessary to determine which purpose the particular payment serves. . . . A civil violation, even if it is labeled a penalty, may be deductible if imposed to encourage compliance with the law or as a remedial measure to compensate another party.

Id. Finally the Chief Counsel advised, "[T]he express characterization of a settlement payment by the parties to a settlement agreement also must be considered." *Id.* Authors of a recent study have concluded that at least 13 factors need to be considered to determine the deductibility of a settlement leaves taxpayers and regulators with limited ability to predict the outcome so that the burden of administering the regime is high, imposing additional costs on taxpayers regardless of whether they are allowed a deduction or not.

In any event, the regulations teach that one must classify payments imposed by law as being either compensatory or punitive. The states do not intend to compensate confidence schemes' promoters by denying restitution to the victims. Denying restitution is rather a form of punishment inflicted on these victims, and it ought therefore to be treated as a civil penalty.

Perhaps one would object that while fines and penalties are normally imposed by courts, the "penalty" involved in the denial of restitution is due solely to the courts' inaction. Although the distinction between act and failure to act can have significant legal consequences in other contexts,[93] the situation here is different. The defrauded party has met all of the usual requirements that courts impose for relief when one party has been unjustly enriched at the expense of another. One rightfully expects the courts to act. Their refusal to do so is knowing and willful to the point that one may conclude that the courts' purpose is to make the defrauded party's loss permanent.[94] Denial of restitution amounts to a forfeiture, and forfeitures are best seen as a type of fine or penalty.[95] A tax deduction for the amount forfeited would mitigate its intended impact. Even if the

payment, including "the severity of the conduct giving rise to the investigation or charges, and the facts surrounding that conduct" and "the factual record of negotiations, and the language in the settlement agreement." Shashy, *supra* note 79, at 405.

[93] For example, a stranger has no duty to act, but once a person acts, he must usually act with reasonable care. *See, e.g.*, Satterfield v. Breeding Insulation Co., 266 S.W.3d 347, 374–75 (Tenn. 2008).

[94] *Cf. Satterfield*, 266 S.W.3d at 357 ("[E]ven though the specific negligent act may constitute an omission, the entirety of the conduct may still be misfeasance that created a risk of harm.").

[95] *See* Wood v. United States, 863 F.2d 417, 418–19 (5th Cir. 1989) (holding that although proceeds of drug smuggling were income to the taxpayer, public policy precluded a deduction under IRC § 165 when the proceeds were forfeited to the government because forfeitures are penalties); *see also* King v. United States, 152 F.3d 1200, 1201 (9th Cir. 1998) (following *Wood* so as not to create a circuit split, but expressing uncertainty about its correctness). *Cf.* Kahn & Bromberg, *supra* note 37, at 212–13 (suggesting that it is possible to describe a forfeiture as a fine for purposes of § 162(f)).

defrauded taxpayer were to have difficulty locating the thief or his assets, a tax deduction would undermine the state's policy that the theft loss be absolute and permanent.

However, the matter is complicated because in 1980 the IRS ruled that punitive damages are deductible under § 162(a) if they otherwise satisfy the requirements of being ordinary and necessary business expenses.[96] Punitive damages are intended to deter and punish the wrongdoer and often exceed the amount of any fine or civil penalty that might be leveled for the same conduct.[97] That being the case, how can a court treat the denial of restitution to the victims of confidence schemes any differently—since they, too, are a form of punishment?

One answer is that punitive damages ought to be nondeductible.[98] The Revenue Ruling allowing deductions for

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[96] Rev. Rul. 80-211, 1980-2 C.B. 57. A similar analysis was presented in I.R.S. Tech. Adv. Mem. 79-23-006 (Feb. 27, 1979).

[97] *See* BMW of N. Am., Inc. v. Gore, 517 U.S. 559, 584 (1996). Moreover, garden-variety "compensatory" tort damages are not intended solely to make a victim whole. Such damages are designed in part to deter wrongdoing. *See* Kalavity v. United States, 584 F.2d 809, 811 (6th Cir. 1978); Condemarin v. Univ. Hosp., 775 P.2d 348, 364 (Utah 1989). Further, damages for pain and suffering—the bulk of most damages for personal injury—rest on a fiction that money can compensate for noneconomic loss. *See* McDougald v. Garber, 536 N.E.2d 372, 374–75 (N.Y. 1989). Moreover, even though a tort victim might view compensatory damages for out-of-pocket expenses as a form of corrective justice, from the defendant's point of view, especially to one facing potentially catastrophic damages, the deterrent effect of ordinary tort damages looms largest. *Id.*

[98] For criticism of the current rule, see Kimberly A. Pace, *The Tax Deductibility of Punitive Damage Payments: Who Should Ultimately Bear the Burden for Corporate Misconduct?*, 47 ALA. L. REV. 825, 826, 828 (1996); Catherine M. Del Castillo, Note, *Should Punitive Damages Be Nondeductible? The Expansion of the Public-Policy Doctrine*, 68 TEX. L. REV. 819, 820 (1990) (calling for Congressional reform but asserting that punitive damages do not fall within the literal terms of § 162(f)); K. Todd Curry, Comment, *The Deductibility of Punitive Damages as an Ordinary and Necessary Business Expense: Reviving the Public Policy Doctrine*, 26 SAN DIEGO L. REV. 357, 358–59 (1989) (same); Jennifer J.S. Brooks, *Developing a Theory of Damage Recovery Taxation*, 14 WM. MITCHELL L. REV. 759, 787–89 (1988). The Treasury has proposed that Congress amend the Code to abolish the deductibility of punitive damages. U.S. Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals (Mar. 2014), *available at* www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf, at *101. Similar proposals were made as early as 2000. *See* STAFF OF J. COMM. ON TAXATION, 112TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2012 BUDGET PROPOSAL 330–33 (2011); *See* Shashy, *supra* note 79, at 401. For opposition to any change in the deductibility of punitive damages, see Robert W. Wood, *Why Punitive Damages Should Remain Deductible*, 124 TAX NOTES 149 (July 13, 2009).

punitive damages is short on reasoning and precedent.[99] It may have been based in part on the idea that civil penalties must be "paid to a government," and the punitive damages at issue in that Ruling were paid to a corporation.[100] As we saw above, courts since 1980 have held that the "paid to a government" requirement does not require the government to pocket the money.[101]

Another possibility is that punitive damages differ significantly from the penalty felt by confidence-scheme victims. As some have argued, deductions for punitive damages may be necessary because these damages are sometimes intended to partially compensate injured parties.[102] Similarly, some have argued that deductions for punitive damages are appropriate because it can be difficult to know which portion of a tort settlement is really punitive.[103] Neither of these arguments is of concern here because no part of the unrecovered stolen money is intended to compensate or otherwise benefit the thieves. The denial of relief is entirely punitive.

Finally, the public policy exception may be more limited under § 162 than it is for § 165. The Revenue Ruling allowing a deduction for punitive damages emphasizes the legislative history of the 1969 Act confining public policy exceptions to those specified in § 162. Arguably, a broader use of public policy

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[99] The Ruling relied on the legislative history of the 1969, saying that the additions made to § 162 making certain items nondeductible were all inclusive. Rev. Rul. 80-211, 1980-2 C.B. 57. The Ruling did not explain why punitive damages were not penalties. None of the authorities cited discussed punitive damages. Rev. Rul. 78-210 concerned payment of medical malpractice judgments and settlements and related legal fees and costs. Rev. Rul. 78-210, 1978-1 C.B. 39. Rev. Rul. 69-491 concerned a bank's payment of insurance premiums to cover its officers and directors. Rev. Rul. 69-491, 1969-2 C.B. 22; *see also* Kornhauser v. United States, 276 U.S. 145, 153 (1928) (allowing deductions for legal expenses incurred in the successful defense of a suit by a former partner for an accounting); Mulgrew Blacktop, Inc. v. United States, 311 F. Supp. 570, 572 (S.D. Iowa 1969) (allowing deductions for amounts paid in settlement of a personal injury claim arising out of an employee's use of the taxpayer's automobile and for associated legal fees); Cochrane v. Comm'r, 23 B.T.A. 202, 208 (1931) (allowing a deduction for an amount paid by an attorney for not adequately protecting a client's interest).

[100] The Ruling mentioned that Congress included "fines or similar penalties paid to a government" among the items that may not be deducted. Rev. Rul. 80-211, 1980-2 C.B. 57.

[101] *See supra* notes 83–84 and accompanying text.

[102] Wood, *supra* note 92, at 151–52.

[103] W. Kip Viscusi, *The Challenge of Punitive Damages Mathematics*, 30 J. OF LEGAL STUD. 313, 342–43 (2001).

exemptions is justified with respect to § 165. A deduction under § 162 ensures that tax is imposed on net income, not gross receipts.[104] A public policy exception interferes with this goal. This is not an issue with respect to deductions for theft losses under § 165(c)(3). A deduction for those losses only recognizes that the taxpayer has less wealth and therefore less ability to pay tax.[105]

As suggested above, one can argue that denying a deduction to people like Mazzei is justified so as not to frustrate the states' goal of punishing them for their criminal or immoral conduct by denying them the right of obtaining restitution. However, denying restitution to the defrauded investor in a confidence scheme seems harsh. It is for Congress and the state legislatures to criminalize possession of counterfeit money and the attempt to purchase counterfeit money. Unless the legislature so directs, the courts should not impose forfeiture of the invested dollars as an additional penalty.[106] Moreover, the states' policy regarding restitution involving illegal contracts is subject to change. As noted by the Restatement:

> The range of misconduct for which claimants have historically been subject to equitable disqualification is both vast and intricately qualified, because the judicial power to bar a claim on equitable grounds is essentially exercised ad hoc. The present scope of this barrier to restitution appears to be narrowing somewhat, as courts become less inclined to enforce a moral judgment with civil penalties, or to add an extra-

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[104] *See* Comm'r v. Tellier, 383 U.S. 687, 692 (1966).

[105] *See* KAHN & KAHN, *supra* note 13, at 315 (explaining that Congress granted loss deduction for casualty and theft losses to reflect decline in ability to pay). The allowance of a theft loss deduction is a departure from the Code's disallowance of deductions for personal consumption expenses. IRC § 262(a) (2012); *see* MARVIN A. CHIRELSTEIN & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION 205 (13th ed. 2015). Congress allows these deductions only to the extent they exceed in the aggregate more than ten percent of a taxpayer's adjusted gross income. 26 U.S.C.A. § 165(h)(2) (West 2014). No deduction is allowed for the first $100 of loss. *Id. But see* Robert W. Wood, *Denying Deductions Based on Public Policy,* 110 Tax Notes 1415, 1420 (Mar. 27, 2006) (arguing that use of public policy exceptions under § 165 "circumvents the all-inclusive nature of the congressional changes" made in 1969).

[106] This may be compared to civil forfeiture, which is only by statute. *See, e.g.*, 21 R.I. GEN. LAWS ANN. § 21-28-5.04.2 (West 2015); WASH. REV. CODE ANN. § 69.50.505 (West 2015); *see generally* 37 C.J.S. *Forfeitures* § 9 (2015).

> statutory penalty—in the form of forfeiture of a restitution claim—for conduct that the law already punishes by other means.[107]

Israeli and New Zealand statutes allow parties to an illegal contract the right to obtain restitution, but reserve to the court the discretion to deny it.[108] Other countries are considering reforms.[109] The Israeli legislation was based in part on Jewish law, which generally upholds the validity of contracts made in violation of the law unless there is a pressing need to take protective measures.[110] Jewish law imposes penalties for the criminal acts and requires repentance for the religious violations.[111] In discussing a confidence scheme involving a

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[107] RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 32 cmt. d. (AM. LAW INST. 2011); *see also id.* § 63 cmt. a ("[T]he reach of equitable disqualification must inevitably be open to question, since punishment by forfeiture requires the court to tolerate an unjustified enrichment that the law normally condemns.").

[108] Israeli legislation allows for restitution of benefits conferred under an illegal contract "except to the extent that the court determines that justice requires otherwise." 4 MENACHEM ELON, JEWISH LAW, HISTORY, SOURCES, PRINCIPLES at 1716–17 (1994); *see also* Daniel Friedmann, *Consequences of Illegality Under the Israeli Contract Law (General Part) 1973*, 33 INT'L & COMP. L. Q. 81, 81 (1984); Illegal Contracts Act 1970, s 7(1), (3) (N.Z.) (granting discretion to the court to provide relief, including restitution, but providing that it "shall not grant relief if it considers that to do so would not be in the public interest").

[109] *See* BRITISH COLUMBIA LAW INSTITUTE, BCLI REPORT; NO. 52, REPORT ON RELIEF UNDER LEGALLY DEFECTIVE CONTRACTS: THE UNIFORM ILLEGAL CONTRACTS ACT (2008), *available at* http://www.bcli.org/sites/default/files/legally_defective_contracts_relief.pdf (discussing Canada's proposed uniform statute); SINGAPORE'S LAW REFORM COMMITTEE, RELIEF FROM UNENFORCEABILITY OF ILLEGAL CONTRACTS AND TRUSTS (2002), *available at* http://www.commonlii.org/sg/other/SGLRC/report/R9/9.pdf. In England and Wales, the Law Commission has recommended that reforms should be made through the common law based on a variety of factors and concluding, "Only when depriving the claimant of his or her rights is a proportionate response based on the relevant illegality policies, should the [illegality] defence succeed." THE LAW COMMISSION, THE ILLEGALITY DEFENCE, CONSULTATION PAPER NO. 189 at 147 (2009), *available at* http://www.lawcom.gov.uk/wp-content/uploads/2015/03/cp189_Illegality_Defence_Consultation.pdf; *see also* THE LAW COMMISSION, THE ILLEGALITY DEFENCE, LAW COM NO. 320 (2010), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/229171/0412.pdf (final report to Parliament).

[110] *See* 5 MENACHEM ELON, *Contract*, *in* ENCYCLOPAEDIA JUDAICA 189, 193–94 (2d ed. 2007); RABBI JACOB REISCHER, REPSONSA SHEVUT YA'AKOV 1:145, *translated in* JEWISH LAW (MISHPAT IVRI): CASES AND MATERIALS 114–15 (MENACHEM ELON, BERNARD AUERBACH, DANIEL D. CHAZIN & MELVIN J. SYKES, 1999).

[111] In Jewish law, agreements to sell and formal acquisitions made on the Sabbath, festivals or Yom Kippur, are valid even if part of the performance involves a violation of Torah law. SHULHAN ARUKH, *Hoshen Mishpat* 235:28; *Hilkhot Mechirah* 30:7 (Hebrew), *in* CODE OF MAIMONIDES (Eliyahu Touger trans. Moznaim

purchase of counterfeit money and a staged "police" raid, a contemporary rabbi wrote that a rabbinic court should unwind the transaction and give each side back its "money."[112]

III. REASSESSING THE PUBLIC POLICY DOCTRINE IN INCOME TAX CASES

This article has proposed that cases like *Mazzei* can best be understood as being consistent with state law that in effect imposes a penalty on defrauded taxpayers who participate in illegal schemes by denying them restitution, and that it would violate state policy to allow the taxpayer a deduction for a loss. What if states adopted an approach more like that of Israel or New Zealand, allowing in most cases the defrauded taxpayer party restitution and punishing him criminally for attempt to commit a crime and for conspiracy? If this approach was taken, the case for denying a deduction would be considerably weakened. Of course, if in the year of the loss the thieves could be found and if there was a reasonable prospect that they would make restitution, no deduction would be possible.[113] But in other instances, the change in state law would remove the conflict between the tax code's grant of a theft deduction and state policy.

Publications). The participants in such transactions are flogged, but the sales agreement can be written later. The Jewish courts can as protective measure require that any profit made on the sale be donated to the poor. Rabbeinu Gershom ben Judah (circa 960-1040), *Responsa 9* (Hebrew). By contrast, in those states that enforced Sunday closing laws, courts would dismiss suits for breach of contract if the contract were made on a Sunday. *E.g.*, Patton v. Graves, 224 A.2d 411, 416 (Md. 1966) (holding that an executory contract for the sale of real estate made on a Sunday is unenforceable). Many courts have even denied restitution of money paid or goods delivered. *See* PALMER, *supra* note 62, at 175 (collecting cases); *e.g.*, Foreman v. Ahl, 55 Pa. 325, 331 (1867) (holding that the sale of mules finalized on a Sunday is in violation of divine law and state statute and thus, is void).

[112] Rabbi Yitzhak Zilberstein, CHASHUKEI CHEMED, *Makkot* 142 (Hebrew). The incident in question occurred much earlier, having been told by Rabbi Yosef Yozel Horwitz, the Sabba (old man) of Novardok (1847–1919). *Id.* at 143 n.19. Rabbi Zilberstein wrote:

> If the court thinks it proper to punish the counterfeiters so that they do not continue to deceive the public, then they may do so and leave the money with the purchaser. However, it must be investigated whether the money should be left with him since he was a swindler like them, and might be enabled to cheat others with the counterfeit money.

Id. It is hard to understand why the counterfeit money should be returned to either party since it can only be used to harm the public.

[113] *See* Treas. Reg. § 1.165-1(d)(3).

Indeed, there seems little justification for the blanket rule of American law denying restitution to the defrauded parties. The victims are subject to prosecution for their wrongdoing and there is no need to punish them further. Moreover, by denying restitution, the courts inflict a punishment that is based solely on the amount of money invested. The greater the investor's loss, the greater the punishment, regardless of the harm that the investor intended to cause.[114] Further, denying restitution allows a windfall to the thief who is likely no less culpable than the victim.

One might argue that even if state law were changed to allow restitution, it is another matter to permit a tax deduction to someone who attempted to purchase counterfeit money, shifting part of the loss onto the Government and innocent American taxpayers. However, it has been the long-held view that the income tax system ought to be neutral in allowing deductions for illegal or immoral activities, unless Congress otherwise directs.[115] In rejecting a 1913 amendment that would have limited deductions to those "incurred . . . in the pursuit of any ordinary and legitimate trade or business," Senator Williams, who was in charge of the bill, replied, "In other words, you are going to count the man as having money which he has not got, because he has lost it in a way that you do not approve of."[116] The Code's goal is "not to reform men's moral characters" . . . [but to tax their] net income, [their] actual profit during the year."[117] The criminal law ought to suffice to punish wrongdoers. Although the current Internal Revenue Code

[114] For example, if victim A invests $2,500 in the expectation of buying $25,000 worth of counterfeit money, and victim B invests $5,000 expecting to buy $7,500 of fake money, denying restitution punishes B more seriously than A even though A sought to do more harm to the public. *Cf.* Kahn and Bromberg, *supra* note 37, at 219–21 (illustrating examples of perverse results caused by denying a deduction for illegal expenses).

[115] David I. Walker, *Suitable for Framing: Business Deductions in a Net Income Tax System*, 52 WM. & MARY L. REV. 1247, 1259 (2011).

[116] 50 CONG. REC. 3,850 (1913).

[117] *Id.* at 3,849; *see* Comm'r v. Tellier, 383 U.S. 687, 691–92 (1966).

deviates from Senator Williams's idea in many respects,[118] if it is thought that additional punishment in the form of a higher tax is necessary, it ought to be imposed by Congress, not the courts.

One might argue that people like Mazzei suffered losses through their own recklessness and should be denied a deduction on that ground. The Treasury Regulations provide that willful acts and even willful negligence are indeed grounds for denying a casualty loss deduction.[119] However, these regulations specify that they are not applicable to theft deductions.[120] There is reason for the distinction. By its nature, a casualty loss must be unexpected,[121] and if the taxpayer is seriously negligent or reckless in exposing property to a storm or fire, the loss is not unexpected.[122] But thefts often occur when taxpayers are seriously careless.[123] If a change is due here, it ought to be made by Congress.

When judges override a statute and deny deductions on public policy grounds, they sometimes condemn the taxpayer's conduct in strong moral terms. For example, Mazzei was trying to commit a "serious crime" of counterfeiting.[124] A client facing prosecution was "impenitent" for engaging a lawyer in an unsuccessful defense.[125] As shown by *Tellier*, such moral judgments can induce courts to impose unduly harsh sanctions.[126] Mazzei did not counterfeit any money; guilty parties have a constitutional right to have lawyer. In tort law, some courts have denied recovery to victims of negligence if they were engaged in illegal activity even though the state had a statutory rule of

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[118] 26 U.S.C.A. § 162(c) (West 2014) (disallowing deductions for certain illegal payments is the most obvious example); *see generally* Kahn and Bromberg, *supra* note 37. There are many others where Congress limits deductions for expenses related to the production of income—for example, business expenses must be ordinary and necessary—or allows deductions for expenses unrelated to the production of income—for example, charitable contributions.

[119] Treas. Reg. § 1.165-7(a)(3)(i) (1977).

[120] *Id.* § 1.165-7(a)(6).

[121] Rev. Rul. 72-592, 1972-2 C.B. 101

[122] *See* Treas. Reg. § 1.165-7(a)(3)(i) (stating no deduction if loss is due to willful act or willful negligence).

[123] *See* Ginesky v. Comm'r, 68 T.C.M. (CCH) 1122 (1994); Nichols v. Comm'r, 43 T.C. 842, 886 (1965).

[124] Mazzei v. Comm'r, 61 T.C. 497, 504 (1974) (Tannenwald, J., concurring).

[125] Jerry Rossman Corp. v. Comm'r, 175 F.2d 711, 713 (2d Cir. 1949).

[126] *See generally* Comm'r v. Tellier, 383 U.S. 687 (1966).

comparative fault.[127] Some have denied recovery to a child engaged in illegal activity even though under state law, the child might not have been negligent.[128] In other areas of the law as well, courts have overridden statutory rights based on their moral condemnation of a party's actions only to recognize later that their decisions are improper.[129]

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[127] *E.g.*, Reno v. D'Javid, 369 N.E.2d. 766 (N.Y. 1977) (dismissing claim for medical malpractice for injuries caused during abortion at a time when abortion was illegal); Barker v. Kallash, 468 N.E.2d 39 (N.Y. 1984) (affirming summary judgment dismissing a complaint against a 9-year-old who sold the firecrackers from which gunpowder was extracted and used to construct a pipe bomb). The courts made these determinations despite a New York statute at that time:

> In any action to recover damages for personal injury . . . the culpable conduct attributable to the claimant . . . including contributory negligence or assumption of risk, shall not bar recovery, but the amount of damages otherwise recoverable shall be diminished in the proportion which the culpable conduct attributable to the claimant . . . bears to the culpable conduct which caused the damages.

See Flanagan v. Baker, 621 N.E.2d 1190, 1194 n.5 (Mass. App. Ct. 1993). In *Barker*, the court said that the rule "rests . . . upon the public policy consideration that the courts should not lend assistance to one who seeks compensation under the law for injuries resulting from his own acts when they involve a substantial violation of the law." 468 N.E.2d 39, 63 N.Y.2d at 29. Similar reasoning is used to bar claims for restitution by those engaged in illegal or immoral conduct. *See supra* text accompanying note 67. *But see generally* Dugger v. Arrendondo, 408 S.W.3d 825 (Tex. 2013) (overruling unlawful acts doctrine).

[128] *E.g.*, Oden v. Pepsi Cola Bottling Co. of Decatur, Inc., 621 So. 2d 953, 954–55 (Ala. 1993) (affirming summary judgment for the defendant in which a 14-year old child was killed while attempting to steal soft drinks from machine which tipped over and crushed him; it was not shown that the child was guilty of contributory negligence as this would involve an examination of the child's ability to understand the risk involved); *see generally* Joseph H. King, Jr., *Outlaws and Outlier Doctrines: The Serious Misconduct Bar in Tort Law,* 43 WM. & MARY L. REV. 1011, 1023–24 (2002).

[129] For example, many American courts have followed a rule denying an ocean carrier the statutory right to limit liability if it committed an intentional deviation either by departing from the agreed route or by committing some other breach deemed to be fundamental, even though the statute allows a carrier to limit its liability "in any event." 46 U.S.C. app. § 1304(5) (2000); *see* Gen. Elec. Co. Int'l Sales Div. v. S.S. Nancy Lykes, 706 F.2d 80, 87 (2d Cir. 1983); Jones v. The Flying Clipper, 116 F. Supp. 386, 389–90 (S.D.N.Y. 1953). Some judges applying this doctrine have shown moral outrage at deviating carriers, even treating the carrier as having converted the goods. *Compare* The Citta Di Messina*,* 169 F. 472, 475 (S.D.N.Y. 1909) (finding that shipper has "a right . . . to rescind the contract of shipment and treat the goods as converted") (Hough, J.), *with* The Cabo Villano, 18 F.2d 220, 220 (2d Cir. 1927) ("To denounce the carrier's act or omission [wrongful delivery of goods] as a conversation is probably accurate in terms of common law, but in the admiralty is only calling bad names.") (Hough, J.). More recently, even as courts have recognized that the deviation doctrine conflicts with the statute and will not be extended by analogy to arguably more serious breaches, they have continued to apply it to

These examples support the long-held view that reliance on public policy to override general principles of law is a risky business.[130] This is all the more so when courts override a statutory directive. Courts properly use public policy when interpreting statutes, and the line between interpretation and judicial use of public policy to override a statute is not always clear. For example, the courts' determination that fines and similar penalties cannot be deducted as losses under § 165 seems correct[131] and can be seen both as an interpretation of congressional intent and as judicial law making. Although Congress must be aware that tax law has always involved a significant degree of judicial law making,[132] the regulations curtail the use of public policy for business expenses to those stated in the statute.[133] As suggested above, deductions for theft losses stand on a different footing,[134] and neither the Code nor the regulations prevent the courts from using public policy to limit them. But courts should be cautious about adopting exceptions to loss deductions when not supported by policies founded on state or federal law.

CONCLUSION

Although *Mazzei* is often used to show that courts can disallow loss deductions on public policy grounds,[135] its rationale for denying a theft loss deduction is far-fetched, as it is unlikely that a deduction would encourage counterfeiting. *Mazzei* was

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geographical deviations and wrongful carriage on deck, asserting that the rule "is easy to administer and carriers know the risks." Iligan Integrated Steel Mills, Inc. v. SS John Weyerhaeuser, 507 F.2d 68, 72 (2d Cir. 1974) (declining to apply the deviation doctrine to a carrier's gross negligence in supplying a seaworthy vessel). *See also* B.M.A. Indus., LTD. v. Nigerian Star Line, LTD., 786 F.2d 90, 90 (2d Cir. 1986) (declining to apply the deviation doctrine to criminal misdelivery of cargo).

[130] *See, e.g.*, Feld & Sons, Inc. v. Pechner, 458 A.2d 545, 550 (Pa. Super. Ct. 1983) (quoting Richardson v. Mellish (1824) 130 Eng.Rep. 294, 303).

[131] *See supra* text accompanying note 81.

[132] *But cf.* United States v. Correll, 389 U.S. 299, 306–07 (1967) ("But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. 26 U.S.C. [§] 7805(a). In this area of limitless factual variations 'it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments.' ").

[133] Stephens v. Comm'r, 905 F.2d 667, 672 (2d Cir. 1990).

[134] *See supra* text accompanying note 105.

[135] *See generally* Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956).

also unable to distinguish *Bromberg*. Nonetheless, one can support the results in both of these cases by recognizing that a tax deduction for theft is inappropriate when it subverts a state's punitive policy of denying restitution to confidence-scheme victims. This was true in *Mazzei* but not in *Bromberg*. However, should the states modify the law of restitution so as not to unjustly punish theft victims, the tax consequences ought to change, too.