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COMMENTS

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CRIMINAL LIABILITY OF PUBLIC ACCOUNTANTS: A LURKING NIGHTMARE?

INTRODUCTION

Litigation against public accountants has vastly increased during the past decade.[1] Although most suits have been civil actions,[2] several recent federal criminal actions involving public accountants may well have the greatest impact upon the profession. In sharp contrast to earlier criminal suits, the cases now involve the largest, most sophisticated international accounting firms. Moreover, the resulting sanctions for those accountants found guilty are no longer limited to fines and probable loss of professional credentials; in December 1974, a partner and a staff member of a large international firm received both jail sentences and fines for their involvement in securities fraud.[3] The threat of such stiff penalties for improper accounting activity may have profound implications upon the role of public accountants in the future.

Criminal cases involving accountants generally evolve from Securities and Exchange Commission (SEC) investigations into allegedly fraudulent schemes. This occurs even though the Commission cannot directly commence a criminal proceeding, but can only refer the matter to the Department of Justice for prosecution.[4] Factors generally considered important in the SEC's recommendation for prosecution include whether the prospective defendants are chronic violators in fraudulent promotions and whether the case involves a "particularly egregious, or currently 'fashionable' promotional scheme."[5] These factors, however, are usually not so important when the prosecution involves accountants; rather, the government's implicit attitude is that because accountants are really financial "experts," they may "prevent many questionable activities before they occur,"[6] and if extremely derelict in their duty, they should face criminal sanctions. Additionally, increased federal prosecution against accountants results from the notoriety and impact of widespread national financial scandals.

Expanding exposure to criminal liability has aroused the accounting profession's ire. The recent conviction of two members of a large firm[7] evoked strong public reaction from the firm's senior partner:

> We are shocked at the verdict and will fully support [the defendants] in their appeal.... We believe the jury didn't understand the complicated accounting and disclosure questions in the case....[8]

This anger within the profession stems primarily from a feeling that courts, basking in the luxury of

[1] A 1973 count showed that more than 500 companies have litigation or claims against accountants. *See* Arthur Andersen & Co. Ann. Rep. 4 (Mar. 31, 1973).

[2] Public accountants' problems with civil liability have received much review. *See generally* S. Kurland, *Accountants' Legal Liability: Ultramares to BarChris,* 25 BUS. LAW. 155 (1969); Marinelli, *The Expanding Scope of Accountants' Liability to Third Parties,* 23 CASE W. RES. L. REV. 113 (1971); Comment, *Two Cases Dealing with CPA's Legal Liability—Analysis: Recommendations,* 10 AM. BUS. L.J. 83 (1972); Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements,* 44 WASH. L. REV. 139 (1968); Note, *Accountants' Liabilities for False and Misleading Financial Statements,* 67 COLUM. L. REV. 1437 (1967).

[3] United States v. Natelli, 527 F.2d 311 (2d Cir. 1975), *cert. denied,* 44 U.S.L.W. 3592 (U.S., Apr. 19, 1976) (No. 75-808). *See also* Wall St. J., Dec. 30, 1974, at 10, col. 1.

[4] Securities Act of 1933 § 20(b), 15 U.S.C. § 77t(b) (1970) [hereinafter cited as Securities Act]; Securities Exchange Act of 1934 § 21(e), 15 U.S.C. § 78u(e) (1970) [hereinafter cited as Exchange Act].

[5] Mathews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases,* 39 GEO. WASH. L. REV. 901, 916 (1971).

[6] Burton, *SEC Enforcement and Professional Accountants: Philosophy, Objectives, and Approach,* 28 VAND. L. REV. 19, 20 (1975).

[7] United States v. Natelli, 527 F.2d 311 (2d Cir. 1975), *cert. denied,* 44 U.S.L.W. 3592 (U.S., Apr. 19, 1976) (No. 75-808).

[8] Statement of Walter E. Hanson, December 14, 1974 in Wall St. J., Dec. 15, 1974 at 10, col. 1. On appeal to the Second Circuit these auditors were aided by amicus curiae briefs from their accounting firm and the American Institute of Certified Public Accountants.

hindsight, misunderstand the public auditor's role in the business community. Accountants, long used to operating in relation to "generally accepted auditing standards" and "generally accepted accounting principles," [9] believe that courts, juries, and prosecutors do not understand how these rules and procedures guide the profession. Hence, some accountants believe that their guilt or innocence is determined in complete disregard of these professional standards. Furthermore, accountants argue that their involvement with any fraudulent scheme should be judged by a more relaxed standard because in most cases the auditor does not share in the fraud's financial spoils. [10] Finally, accountants feel that besides being at odds with professional thinking, court-evolved standards for determining criminal responsibility are vague, and thus leave the man-in-the-field with little guidance on how to avoid criminal liability.

Certainly the heightened specter of criminal sanctions makes the accounting profession wary. A guilty verdict, besides resulting in a fine and/or imprisonment, almost always leads to a revocation of the CPA certificate and license to practice. [11] Unlike the civil liability risk, criminal responsibility is not insurable. It is also arguable that criminal charges against a firm's personnel create more unfavorable publicity than civil suits. Because of these and other concerns, this comment will describe the modern public accountant's role, review the statutory sources of potential criminal sanctions, examine developing case law, and analyze whether adherence to professional accounting standards is relevant when a federal criminal action is brought against an accountant.

The Public Auditor's Function

Public accountants are in the financial information business. Although accounting firms provide many different services, [12] the core of a firm's business is usually auditing, and it is this attesting function which has spawned virtually all of the litigation facing accountants. [13]

Auditing is the process through which independent persons examine financial statements with a view toward expressing an opinion on whether those statements fairly reflect and present the substance of a company's economic transactions. [14] As one auditing textbook explains, auditing is

> the examination of information by a third party other than the preparer or user, with the intent of establishing its reliability, and the reporting of the results of this examination with the expectation of increasing the usefulness of the information to the user. [15]

In theory, the independent auditor's report may prove very useful to financial statement users. [16]

When performing an audit, the public accountant must observe "generally accepted auditing standards" (GAAS). [17] Divided into general standards, [18] fieldwork standards, [19] and standards of reporting, [20]

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[9] These technical accounting terms are more fully discussed at text accompanying notes 17–31 *infra*.

[10] *But see* United States v. Zane, 495 F.2d 683 (2d Cir.), *motion for new trial denied*, 507 F.2d 346 (2d Cir. 1974), *cert. denied*, 419 U.S. 895 (1975), *cert. denied as to motion for new trial*, 421 U.S. 910 (1975), in which two CPA's agreed to certify the existence of a falsely procured certificate of deposit in exchange for a substantial increase in the audit fee.

[11] For example, in Illinois the Department of Registration may cancel or suspend a public accountant's license for being convicted of a felony or being convicted for any crime which involves fraud or dishonesty as an essential element. Ill. Rev. Stat. ch. 110 ½, § 44 (1973). *See, e.g.* Cal. Bus. & Prof. Code § 5100 (West 1974); N. Y. Educ. Law §§ 6509, 6511 (McKinney 1972).

[12] Ordinarily an accounting firm's primary responsibilities are grouped under the subject headings of auditing, tax, and management services.

[13] This analysis does not consider criminal tax evasion charges against an accountant. Int. Rev. Code of 1954, § 7206.

[14] *See* American Institute of Certified Public Accountants, Statement on Auditing Standards No. 1 § 110.01 (1973) [hereinafter SAS No. 1].

[15] W. T. Porter, Jr. & J. Burton, Auditing: A Conceptual Approach 5 (1971).

[16] *Id.* at 4–5.

[17] Technically, "generally accepted auditing standards" (GAAS) only apply to accountants who are members of the American Institute of Certified Public Accounts. SAS No. 1, *supra* note 14, § 150.02. However, as a practical matter, GAAS are used by state licensing boards in setting appropriate standards for accounting work.

[18] The general standards are:

> (1) The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor; (2) In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors; (3) Due professional care is to be exercised in the performance of the examination and the preparation of the report.

SAS No. 1, *supra* note 14, § 150.02.

[19] The standards of fieldwork are:

> (1) The work is to be adequately planned and assistants, if any, are to be properly supervised; (2) There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted; (3) Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statement under examination.

SAS No. 1, *supra* note 14, § 150.02.

[20] The standards of reporting are:

these rules assure that a competent, independent examiner will adequately analyze the client's information system and resulting financial statements, gathering sufficient evidence to render an opinion.

The auditor's report of opinion is an investigation's primary end-product, capturing investor attention and usually furnishing the starting point for any litigation against the auditor. A rather standardized manner of presenting this report has developed so that variations will readily appear.[21] Ordinarily the report's opening or "scope" paragraph tells what the auditor did or did not do in the examination.[22] After reciting the investigation's scope, the auditor then moves to the "opinion" paragraph. This opinion must be either unqualified (often called a "clean" opinion),[23] adverse,[24] qualified,[25] or a statement disclaiming any opinion.[26] Obviously, an unqualified opinion is desired because it carries the auditor's strongest assurance that the financial statements fairly present the underlying economic transactions in conformity with "generally accepted accounting principles" (GAAP).[27]

In conducting an audit and determining the fairness of financial statement presentation, the auditor works within the framework of GAAP. There is no precisely determined codification for GAAP:[28]

> The phrase "generally accepted accounting principles" is a technical accounting term which encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time.[29]

Thus GAAP furnish a "uniform standard" for evaluating financial statement presentation,[30] and "recognize the importance of recording transactions in accordance with their substance,"[31] with appropriate disclosure.

Sources of Federal Criminal Law

Federal criminal actions against public accountants typically arise from the criminal provisions of the Securities Act of 1933[32] and the Securities Exchange Act of 1934.[33] Additionally, the government may utilize the Mail Fraud Act,[34] the Conspiracy Act (Offenses Against U.S.),[35] or the federal false statements statute.[36]

Section 32(a) of the Exchange Act prohibits willful violation of any SEC rule or regulation or willfully and knowingly making a false statement in any filing sent to the Commission.[37] Auditors are exposed to this proviso because the audit report accompanies

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(1) The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles; (2) The report shall state whether such principles have been consistently applied in the current period in relation to the preceding period; (3) Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report; (4) The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report shall contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

SAS No. 1, *supra* note 14, § 150.02.

[21] American Institute of Certified Public Accountants, Statement on Auditing Standards No. 2 §§ 6, 7 (1974) [hereinafter cited as SAS No. 2].

[22] *Id.* §§ 9 & 10. If the auditor's examination were somehow limited such that it might have influenced his ability to form an opinion, that limitation must be disclosed.

[23] *Id.* § 28.

[24] *Id.* §§ 41–44.

[25] *Id.* §§ 29–31.

[26] *Id.* §§ 45–47.

[27] Under the reporting standards, an audit report must state whether the financial statements are presented in accordance with GAAP, consistently applied. *See* note 20 *supra*.

[28] American Institute of Certified Public Accountants, Statement on Auditing Standards No. 5 (1975) [hereinafter cited as SAS No. 5] notes:

> Generally accepted accounting principles are relatively objective; that is, they are sufficiently established so that independent auditors usually agree on their existence. Nevertheless, the identification of an accounting principle as generally accepted in particular circumstances requires judgment. No single source of reference exists for all established accounting principles.

Id. § 5.

[29] *Id.* § 2. For a more extensive analysis of GAAP see American Institute of Certified Public Accountants, Statement of the Accounting Principles Board No. 4 §§ 27–31 (1970).

[30] SAS No. 5, *supra* note 28, § 3.

[31] *Id.* § 7.

[32] Securities Act § 24, 15 U.S.C. § 77x (1970).

[33] Exchange Act § 32(a), 15 U.S.C. § 78ff (1970).

[34] 18 U.S.C. § 1341 (1970).

[35] 18 U.S.C. § 371 (1970).

[36] 18 U.S.C. § 1001 (1970).

[37] Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1970) provides:

> (a) Any person who willfully violates any provision of this chapter, or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or *any person who willfully and knowingly makes*, or causes to be made, *any statement in any application, report, or document required to be filed under this chapter or any rule or regulation* thereunder or any undertaking contained in a registration statement as

SEC filings[38] and is considered a "statement" within section 32(a)'s meaning. If the audit opinion is untrue or misleading with respect to any material fact, then it is a "false statement" subjecting the certifying auditor to criminal sanction. Punishment under section 32(a) can be a fine and/or imprisonment.[39]

Section 24 of the Securities Act provides for criminal penalties if there is a willful violation of any of the Act's provisions or if a person participating in a registration statement willfully makes an untrue statement of a material fact.[40] Since a public accountant's report must accompany registration statements,[41] a false or misleading auditor's report sent along with the registration would violate the provision. Furthermore, if the resulting prospectus is mailed to potential investors while including the false report, there might be a concurrent mail fraud violation. Section 24's use, however, is limited to new offerings; consequently, it has not been used as frequently as section 32(a) of the Exchange Act.

Although not specifically formulated in response to securities fraud, the Mail Fraud Act[42] has been used several times against accountants.[43] Basically, the provision precludes the use of the mails in furtherance of a scheme or artifice to defraud. Since each separate mailing may be viewed as an independent offense, its power as a criminal charge is vast.[44] If an accountant certifies or prepares financial statements, eventually mailed, that he knows or should have known to be false, he may be criminally responsible under this Act.[45]

The federal false statements statute[46] can also be used in a criminal suit against an accountant. It prohibits making a knowing or willful false statement to any federal government department or agency. Ordinarily the auditor's exposure will be limited to statements in the audit report, since both the accounting profession and the SEC agree that financial statements are, in most cases, management representations.[47] Despite its applicability, the

provided in subsection (d) of section 78o of this title, *which statement was false or misleading with respect to any material fact,* shall upon conviction be fined not more than $10,000, or imprisoned not more than two years, or both, except that when such person is an exchange, a fine not exceeding $500,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation. (emphasis added)

[38] For example, an independent public accountant's report of examination must accompany annual 10-K filings sent to the Commission. Exchange Act § 13(a), 15 U.S.C. § 78m(a) (1970).

[39] Either a fine or imprisonment are available penalties, except that if a defendant proves that he had no knowledge of the regulation or rule, he will not be imprisoned.

[40] Securities Act § 24, 15 U.S.C. § 77x (1970) provides:

Any person who willfully violates any of the provisions of this subchapter, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this subchapter, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than $5,000 or imprisoned not more than five years, or both.

[41] Securities Act § 7, 15 U.S.C. § 77g (1970) and Securities Act Schedule A, 15 U.S.C. § 77aa (1970).

[42] 18 U.S.C. § 1341 (1970) provides:

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined not more than $1,000 or imprisoned not more than five years, or both.

[43] United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied,* 397 U.S. 1006 (1970); United States v. Benjamin, 328 F.2d 854 (2d Cir.), *cert. denied,* 377 U.S. 953 (1964).

[44] Milam v. United States, 322 F.2d 104 (5th Cir. 1963); United States v. Interstate Engineering, 288 F. Supp. 402 (D.N.H. 1967). If the auditor mails his client a fraudulent financial statement and the client in turn mails the final reports to others, two offenses would have been committed.

[45] Note, *Federal Criminal and Administrative Controls for Auditors: The Need for a Consistent Standard,* 1969 WASH. U. L. Q. 187, 200.

[46] 18 U.S.C. § 1001 (1970) provides:

Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined not more than $10,000 or imprisoned not more than five years, or both.

[47] The SEC's position was enunciated early in the Commission's life. Interstate Hosiery Mills, Inc., 4 S.E.C.

section has not been frequently used. This may result because section 32(a) of the Exchange Act and section 24 of the Securities Act encompass the alleged criminal activity more directly; however, the false statements act is potentially helpful when the auditor's report accompanies financial statements going to other governmental agencies besides the SEC.

Federal prosecutors may also utilize the Conspiracy Act[48] in suits against accountants. It is a useful prosecutorial tool because, even though the specific requirements of another criminal proviso are not met, the conspiratorial efforts nonetheless constitute a substantive offense. Moreover, a conspiracy charge can easily bootstrap upon the facts of another criminal charge and perhaps reinforce it, yet remain independent.[49]

All of these federal criminal provisions require either some form of "willful"[50] violation or an "intent to defraud."[51] Mere negligence will not activate these sections.[52] Viewed from the professional accountant's perspective, the most important consideration to be determined is the time at which his conduct becomes willful and knowing instead of grossly negligent. A corollary issue is to what extent adherence to professional standards is, or should be, an appropriate defense to such criminal charges. It is on these questions that the tension between the courts and the accounting profession surfaces.

Criminal Cases Against Public Accountants

Even though federal criminal action against accountants is receiving increased attention within the financial community, there have only been a small number of such cases. Perhaps this explains some of the impact that seems to result when these situations arise. Nevertheless, despite the handful of cases, some important concepts have developed.

Apparently the earliest case, *United States v. White*[53] involved a certified public accountant, White, who was charged with mail fraud for preparing false financial statements that were later part of a prospectus mailed to investors. White claimed that he merely took the data from the corporation's books and believed that the figures were true. The government pointed out the following "irregularities" in the figures White compiled: an asset purchased for 25 per cent of its face value was recorded as being worth 87.5 per cent of its face value;[54] normal operating expenses were capitalized as promotion costs to avoid showing a loss; promissory notes that were virtually uncollectible were substantially written up in value, thus suggesting that the company earned income; and irregular and unexplained withdrawals by the company's president which the court termed "thefts"[55] were conveniently disguised as capital deductions.

The government did not, however, show that White actually knew of the falsity in the corpora-

706, 721 (1939); Breeze Corp., 3 S.E.C. 708, 729 (1938). The accounting profession's belief that financial statements are primarily management representations is codified in SAS No. 1, *supra* note 14, § 110.02.

Of course, if the auditor actually prepared false financial statements rather than just examined them, then those representations would properly be attributable to him, and if submitted to a government agency, would expose him to section 1001's liability. *See* Note, *Federal Criminal and Administrative Controls for Auditors: The Need for a Consistent Standard,* 1969 Wash. U. L. Q. 187, 194.

[48] 18 U.S.C. § 371 (1970) provides:

> If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than $10,000 or imprisoned not more than five years, or both.
>
> If, however, the offense, the commission of which is the object of the conspiracy, is a misdemeanor only, the punishment for such conspiracy shall not exceed the maximum punishment provided for such misdemeanor.

[49] The independence of a conspiracy charge from another criminal offense is illustrated in United States v. Zane, 495 F.2d 683 (2d Cir.), *motion for new trial denied,* 507 F.2d 346 (2d Cir. 1974), *cert. denied,* 419 U.S. 895, *cert. denied as to motion for new trial,* 421 U.S. 910 (1975). Two CPA's were accused of, *inter alia,* conspiring to file a false annual form 10-K and with violating section 32(a) of the Exchange Act for filing that false report with the Commission. They were acquitted in a jury trial on the conspiracy charge but found guilty for submitting a false report to the Commission. The Second Circuit refused to find error in this result.

[50] The criminal provisions of the Exchange Act and the Securities Act, as well as the false statements act, contain such language.

[51] The mail fraud statute specifically contains this language. While not explicitly expressed in the federal conspiracy statute, judicial interpretation supplies this element. *See, e.g.,* Ingram v. United States, 360 U.S. 672 (1959); Hyde v. United States, 225 U.S. 347, 359 (1912); Danielson v. United States, 321 F.2d 441 (9th Cir. 1963); United States v. Bufalino, 285 F.2d 408 (2d Cir. 1960).

[52] For an analysis of the state of mind and *mens rea* problems which arise when federal criminal charges are brought against accountants see Note, *Federal Criminal Controls and Administrative Controls for Auditors: The Need for a Consistent Standard,* 1969 Wash. U. L. Q. 187, 189–218.

[53] 124 F.2d 181 (2d Cir. 1941).

[54] The court noted that " . . . White was a very credulous accountant if he believed that accounts bought for only a quarter of their face really had a value of seven-eighths of it." *Id.* at 183.

[55] *Id.* at 185.

tion's records or of anything told to him. Rather, the case rested upon the inference that an accountant of White's experience could not let such blatant irregularities pass without becoming aware of the underlying fraud. Reviewing the sufficiency of the evidence, Judge Learned Hand wrote:

> It is true that all these instances, taken singly, do not prove beyond question that White knew that the statements which he prepared were padded with false entries; but logically the sum is often greater than the aggregate of the parts, and the cumulation of instances, each explicable only by extreme credulity or professional inexpertness, may have a probative force immensely greater than any one of them alone.[56]

Thus, under the *White* approach, the entire set of facts and circumstances surrounding an accountant's relationship can be used to establish an inference of guilt. Underlying this view is the recognition that a public accountant, with acknowledged expertise in financial matters, is sensitive to the existence of fraud or extreme irregularity, and may not blind himself to the economic realities of the situation.

Such judicial feeling was amplified in *United States v. Benjamin.*[57] Howard, a certified public accountant, was engaged to review financial statements and to attest to the client's purported net worth. His first report falsely claimed that certain auditing work was performed and that certain assets existed, when in fact no examination or verification procedures were employed.[58] This was a clear departure from generally accepted auditing standards. Later Howard was sent to investigate a potential acquisition; during this trip Howard's room service and telephone were cut off by the hotel because his client not only could not pay the bill but also refused to make a $200 advance to him. Nevertheless, Howard thereafter issued a report "extolling the prospects of this $8,700,000 company."[59] While reviewing the sufficiency of the evidence for violating the Securities Act,[60] and citing Judge Hand's statements in *White*, the court said:

> [T]he Government can meet its burden by proving that a defendant deliberately closed his eyes to facts he had a duty to see, . . . or recklessly stated as facts things of which he was ignorant.[61]

The court, recognizing the extreme importance that an accountant's certificate can mean to investors[62] and realizing that negligence would not suffice to support a criminal action stated:

> But Congress equally could not have intended that men holding themselves out as members of these ancient professions should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess.[63]

Benjamin thus more fully articulates the rule that reckless disregard for the truth of financial statements may be sufficient to permit imposition of criminal sanctions against public accountants.

Neither *White* nor *Benjamin* discussed whether compliance with professional accounting standards (GAAP and GAAS) would provide an auditor with a defense to criminal charges. Arguably, both cases reflected a broad departure from customary and accepted accounting practices. Yet because the auditors' conduct seemed so deficient and the surrounding circumstances so blatantly fraudulent, the issue was not raised. Furthermore, the auditor's actions in either case distorted and misrepresented several items in the financial statements. This rather gross distortion stands in contrast to several subsequent criminal cases involving accountants where the presentation in the financial statements of one or perhaps two items comprised the basis of the federal criminal allegation.[64] Thus, *White* and *Benjamin* at least furnish some minimum standards, providing that wholesale fabrication of financial statements or intentionally false audit reports may constitute criminal activity.[65] Neither opinion has aroused any

[56] *Id.*

[57] 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964).

[58] *Id.* at 862.

[59] *Id.*

[60] Howard was convicted of conspiring to willfully violate §§ 5(a), 5(c), and 17(a) of the Securities Act, 15 U.S.C. §§ 77(e)(a), 77(e)(c), and 77q(a) (1964). Criminal sanctions for violations of these provisions are presently implemented via § 24 of the Securities Act, 15 U.S.C. § 77x (1970).

[61] 328 F.2d at 862 (citations omitted).

[62] *Id.* at 863.

[63] *Id.*

[64] *E.g.*, United States v. Natelli, 527 F.2d 311 (2d Cir. 1975), *cert. denied*, 44 U.S.L.W. 3592 (U.S., Apr. 19, 1976) (No. 75-808); United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

[65] *See, e.g.*, United States v. Zane, 495 F.2d 683 (2d Cir.), *cert. denied*, 419 U.S. 895 (1974) (absence of proper auditing procedures while certifying a bank certificate of deposit); United States v. Bruce, 488 F.2d 1224 (5th Cir. 1974), *cert. denied*, 419 U.S. 825 (1975) (distorted financial statements in an intrastate securities offering); Getchell v. United States, 282 F.2d 681 (5th Cir. 1960) (allegation that CPA participated in preparing a false investment brochure extolling the company's virtues; conviction for mail fraud reversed since there was no evidence that the

adverse reaction within the accounting profession, perhaps leading to the inference that these decisions are consistent with the profession's thinking.

However, a subsequent case, *United States v. Simon*,[66] has generated strong disagreement from the accounting profession. Three accountants from a leading international firm were charged and found guilty of conspiring to prepare and subsequently certify a false and misleading financial statement.[67] Specifically, the accountants were said to have designed a footnote to Continental Vending Machine Corporation's (Continental) 1962 financial statements which would hide serious looting of Continental carried out by its president.

The footnote dealt with a circuitous and irregular method of financing between Continental, its affiliate Valley Commercial Corporation (Valley), and Roth, a stockholder, director, and officer in both companies.[68] First, Continental would borrow funds from Valley. Second, Valley would borrow from Continental, in most cases immediately transferring the proceeds to Roth who used the funds to finance large margined stock holdings.[69] Continental's balance sheet thus reflected a receivable from, and payable to, Valley which could not be netted because Valley had discounted Continental's notes in order to secure the funds it loaned back to Continental.

Apparently there was evidence that the auditors had been aware of this method of financing since 1958, and had observed the steady increase in the amounts involved without any real inquiry or further examination.[70] In preparing for the 1962 audit the accountants knew that Continental was extremely cash poor,[71] a fact that underscored the need for the $3.5 million Valley receivable to be collectible.[72] The auditors were unable to secure Valley's financial statements, and, before the date of certification, were informed that Roth could not repay Valley. Consequently Valley could not repay Continental. This immediately and seriously undermined Continental's ability to continue as a viable company.

Facing this extremely critical set of facts, the auditors agreed that if adequate collateral were posted,[73] the Valley receivable could be attested to without examining Valley's books. Roth assigned his personal assets to collateralize Valley's borrowing; however, 80 per cent of this collateral consisted of Roth's holding in Continental's stock and securities. Hence, Continental was collateralizing itself.[74]

The controversial footnote, which was drafted by the accountants and had been the subject of much review, merely disclosed that the Valley receivable had been buttressed with Valley's equity in various securities.[75] The government, focusing on the auditors' long awareness of this financing and their consistent failure to inquire into it, felt that they had written this footnote to preserve their professional accounting reputation and to avoid acknowledging a

defendant-accountant used the mails); United States v. Olen, 183 F. Supp. 212 (S.D.N.Y.), *petition for mandamus denied sub nom.* United States v. Cashin, 218 F.2d 669 (2d Cir. 1960). The exact disposition of the criminal charges in United States v. Olen, *supra*, is not known, although one of the defendants eventually submitted his permanent resignation from SEC practice. *In re* Kerlin, CCH FED. SEC. L. REP. (S.E.C. Acct. Series Rel. No. 105) ¶ 72,127 (1966).

[66] United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied,* 397 U.S. 1006 (1970).

[67] The three defendants were found guilty of conspiracy to violate section 32(a) of the Exchange Act, the false statements act, and mail fraud. All three were fined; subsequently, they were fully pardoned by President Nixon. N.Y. Times, Jan. 11, 1973, at 55, col. 1.

[68] Roth owned approximately 25 per cent of Continental and of Valley. 425 F.2d at 799.

[69] This arrangement to siphon out Continental's funds to Roth took on astounding proportions. Over a six-year period Valley advanced $13 million to Roth out of a total borrowing from Continental of more than $16 million. *Id.* at n.3.

[70] In reviewing the Valley receivable the court noted that not only did the amounts involved increase, but that usually there was a paydown just prior to the end of one fiscal year, only to rise again in the next period. This tactic would effectively hide the full extent of the borrowing. *Id.* at 802. At no point did the auditors ever determine whether these loans had been approved by Continental's board of directors.

[71] The daily check float was in excess of $500,000. *Id.*

[72] By certification date, Valley's borrowings totaled $3.9 million. *Id.* at 799.

[73] The auditors requested that satisfactory collateral be posted, a proper legal opinion be obtained, and approval from Continental's board be secured. Not only were the assets chosen for collateral quite unsuitable, but the Continental board disapproved of the loans to Valley. Nevertheless, an unqualified opinion was rendered. *Id.* at 803.

[74] From a financial viewpoint the danger is clear. If the value of Continental stock and debentures dropped due to insolvency fears, then the value of the collateral would, in parallel fashion, decrease. This would act to further heighten insolvency fears and accelerate the process. Eventually this happened when the value of Continental stock plummeted. *Id.* at 805.

[75] The footnote merely recited Valley's "affiliated" relationship, Roth's dual interests in both firms, the rate of interest, and the fact that the debt was secured by marketable securities, currently in excess of the receivable. *Id.* at 800. On the other hand, the government argued that an appropriate footnote, truly reflecting what defendants knew, would have acknowledged Valley's loan to Roth, stated that the Valley receivable was currently uncollectible, and though collateralized, would have disclosed that the bulk of this collateral was Continental securities. *Id.* at 801.

previous error of judgment.[76] More importantly, this non-disclosure really hid the quite serious matter of Continental's continued existence.[77]

In defense, the accountants claimed that their work was performed in conformity with GAAP, adequate auditing steps were carried out, and that there was no duty requiring an auditor to investigate each loan to an affiliate.[78] Essentially, the defense contended that an accountant had to willfully depart from GAAP, knowing the financial statements were false, in order to face criminal liability.

On appeal, the Second Circuit approved the trial court's instruction that the "critical test" was whether Continental's financial statements as a whole fairly presented its true financial position and results of operation.[79] If the financial statements did not "fairly present" these facts, the inquiry would be whether the defendants acted in good faith. While proof of compliance with generally accepted accounting practices was a relevant input to the good faith issue, it was not a controlling factor.[80] Moreover, the court noted that the use of GAAP or certain auditing procedures in any particular circumstance rests on some basic assumptions and observations: "Once he [the auditor] has reason to believe that this basic assumption is false, an entirely different situation confronts him."[81] Here the court felt that Roth's looting of Continental via the Valley receivable, a fact known to the accountants, necessitated full and open disclosure.[82] Hence, when the auditors failed to state all of these facts, the jury could properly infer a lack of good faith:

> The jury could reasonably have wondered how accountants who were really seeking to tell the truth could have constructed a footnote so well designed to conceal the shocking facts.[83]

When the *Simon* court called for "fair presentation" what it really meant was "honest presentation." The core of the case against the auditors was that they certified a financial statement which they knew did not truthfully reflect Continental's economic health because critical facts were not disclosed. Not being an honest presentation, it was irrelevant that the auditors did not personally profit from the fraudulent activity[84] and that all had been "men of blameless lives and respected members of a learned profession."[85] In this context, honesty does not turn on evil intent or bad motive in creating misleading financial statements, but refers to the total presentation which financial statements convey.

After *Simon*, there was widespread feeling within the accounting profession that the case completely swept aside the relevance of adherence to professional standards in assessing criminal liability.[86] The court, however, did not go that far. Rather it implied that if professional standards permitted the accountants to escape disclosing what they knew, then adherence to professional standards was not sufficient.

It might have been possible for the *Simon* court to have used GAAS as a measure in evaluating the accountants' conduct and thus sidestep the adverse reaction. Arguably, GAAS were not fully applied during the Continental audit. This incomplete effort affected all three subgroups of GAAS; neither the general, fieldwork, nor reporting standards were properly applied.

Starting with the general standards, it is questionable whether the auditors were truly independent[87]

[76] *Id.* at 808.

[77] Just before the printer's proof of the 1962 financial statements was ready, the accountants requested payment of the prior year's audit fee. They were given a check, yet told that it would "bounce." *Id.* at 804.

[78] The defendants gathered eight leading accountants to support their defense. For the most part, these witnesses supported the defendant's positions. *Id.* at 805.

[79] *Id.* at 806.

[80] *Id.* at 805. The court quoted the trial court's instructions to the jury concerning the appropriate weight to be given to proof of compliance with accounting standards:

> The weight and credibility to be extended by you to such proof, and its persuasiveness, must depend, among other things, on how authoritative you find the precedents and the teachings relied upon by the parties to be, the extent to which they contemplate, deal with, and apply to the type of circumstances found by you to have existed here, and the weight you give to expert opinion evidence offered by the parties. Those may depend on the credibility extended by you to expert witnesses, the definiteness with which they testified, the reasons given for their opinions, and all the other facts affecting credibility.

Id. at 806.

[81] *Id.*

[82] *Id.* at 806-07.

[83] *Id.* at 807. This statement underscores the inference that juries seem to draw in complex financial fraud cases—how could persons so involved in the company's affairs *not* be aware of the illegal activity?

[84] *Id.* at 808.

[85] *Id.* at 799.

[86] Comment, *Two Cases Dealing With CPA's Legal Liability—Analysis: Recommendations*, 10 AM. BUS. L.J. 83, 86 (1972). *See also* Brief for American Institute of Certified Public Accountants as Amicus Curiae, United States v. Simon, 397 U.S. 1006 (1970), *reprinted in* 129 J. ACCOUNTANCY 69 (May 1970).

[87] Certainly one of the prime reasons why certified financial statements are so useful is because the auditor is independent and without bias in reaching his opinion. It is independence in mental attitude which gives an audit report credibility and differentiates it from a self-serving state-

throughout their examination. They were perhaps biased and had a need to protect their professional reputations because of their failure in earlier audits to disclose Roth's activities. Also, their audits may not have been conducted with due care.[88] This is illustrated in the auditors' failure to bring Continental's problem to the attention of other firm members perhaps less biased, for evaluation and recommendations. A lack of due care also resulted from the auditors' failure to comply with the standards of fieldwork and reporting.

As for the fieldwork standards, there were two compliance violations. First, the auditors did not really obtain sufficient, competent evidence[89] and documentation of the collateral's value[90] or the true value of the Valley receivable. Considering the long history of the Valley receivable which the auditors were aware of, it seems almost inconceivable that they did not vigorously investigate these items. Second, it is open to question whether the auditors properly relied on Continental's system of internal control as a basis for their subsequent testing. For instance, at no time did the accountants determine whether Continental's board of directors ever approved the loan to Valley, a fact that takes on added significance considering the length of time this financing continued. It would seem reasonable to conclude that a wholehearted application of these fieldwork standards would have alerted an independent auditor to the irregularities taking place.

Finally, the disclosure standard of reporting which requires that a lack of informative disclosure be pointed out in the audit opinion was not met. In light of the auditors' long acquaintance with Roth's actions, Continental's severe liquidity problems, and the lack of earlier disclosure, it seems unbelievable that the financial statement gave no indication of how the Valley receivable was collateralized. Yet the audit opinion did not alert a financial statement user to this serious lack of disclosure.

Recently, the Second Circuit Court of Appeals applied the *Simon* rationale in affirming the conviction of two auditors from a major international accounting firm for violating section 32(a) of the Exchange Act. In *United States v. Natelli*,[91] the auditors were charged with creating a deliberately false explanatory footnote. The footnote attempted to reconcile sales and earnings as originally certified with the revised figures submitted in a proxy statement filed with the SEC. The accountants were also charged with knowing that an interim financial statement in the proxy, albeit unaudited, materially misstated and distorted the period's sales and earnings.

The need for an explanatory footnote arose because of the manner in which National Student Marketing Corporation (NSM) originally reported its 1968 results. NSM, in the business of designing and furnishing specialized marketing services for the youth market, felt that the appropriate time to recognize income and sales occurred when the clients committed themselves to the program. The auditors agreed that, to the extent work on a client's program was complete, the same percentage of gross income would be recognized.[92] These "commitments" were not in writing and had not been booked in fiscal 1968; early in the next fiscal period the accountants agreed to retroactively book $1.7 million in purported "commitments" as part of the 1968 figures.[93] Without this adjustment NSM would have shown a large loss for 1968 instead of almost a doubling of profit.[94] This was especially important because NSM's publicly traded securities had risen dramatically in the past few months.[95] No criminal charge was directly based upon this decision to record the 1968 figures in this fashion; however, criminal charges were made based on later events.

After a clean audit opinion for 1968 was issued, the auditors informed NSM that in the future only written contracts would meet their approval. This afterthought about the 1968 "commitments" was justified: within five months after the certification issued, over $1.0 million of these sales were written

ment. *See* note 18 *supra*.

[88] The standard of due care articulates the notion of professionalism and thoroughness to which a public accountant must adhere. *See* note 18 *supra*.

[89] The standards of fieldwork provide an auditor with important guidelines that must be followed throughout an audit. They are somewhat more practical in scope than the general standards. *See* note 19 *supra*.

[90] In confirming the posted collateral's value, the auditors called various banks and brokers, and later received written confirmations. This technique, however, did not disclose the full extent to which Roth's holdings were otherwise pledged as security for various loans. Thus, the collateral was worth even less had Continental attempted to collect. 425 F.2d at 810-13.

[91] 527 F.2d 311 (2d Cir. 1975), *cert. denied*, 44 U.S.L.W. 3592 (U.S., Apr. 19, 1976) (No. 75-808).

[92] The accountants used the percentage-of-completion approach customarily used in construction projects to record the income and costs to date. Here the yardstick was the proportion of time an account executive spent on a project relative to the total estimated time necessary to complete the job.

[93] 527 F.2d at 316. A rather feeble attempt to confirm these "commitments" was termed "haphazard" by the court. *Id.* at 315-16.

[94] *Id.* at 316.

[95] *Id.* at 315.

off NSM's books.[96] The reduction was recorded, in part, as a decrease from NSM's 1969 sales, the balance being accounted for as a decrease in 1968 sales. However, despite these changes, no changes were made to NSM's 1968 earnings. A journal entry which the accountants designed to effect the earnings reduction was netted by them against an unrelated tax credit so that the actual change in profit seemed much smaller and immaterial.[97] This net adjustment thus concealed very important facts about NSM's operations and the real value of its receivables.[98]

In 1969, as part of its ambitious acquisition program, NSM drafted a proxy statement. The auditors attempted to reconcile the 1968 certified results with the restated amounts after the writeoffs and acquisitions.[99] The court observed:

> The earnings summary in the proxy statement included companies acquired after fiscal 1968 and their pooled earnings. The footnote was the only place in the proxy statement which would have permitted an interested investor to see what Marketing's performance had been in its preceding fiscal year 1968, as retroactively adjusted, separate from the earnings and sales of the companies it had acquired in fiscal 1969.[100]

Yet despite the urgent need for disclosure, the footnote did not reflect the write-off of the oral "commitments"; rather the total decrease was improperly deducted from the sales and earnings of the acquired companies. There was no disclosure anywhere that over $1.0 million in previously reported sales were written off. Such presentation violated *Opinion No. 9 of the Accounting Principles Board—Reporting the Results of Operations.*[101]

The proxy also contained an interim financial statement which, while not audited, "was prepared by the Company with the assistance of Peat [the accounting firm] on the same... basis as in the 1968 audited statement."[102] Just prior to printing the interim statement, the senior auditor on the job refused to treat a $1.2 million commitment from Pontiac Motor Division as a sale because there was no legally binding obligation. NSM's chairman immediately claimed to have a commitment from Eastern Airlines for a somewhat comparable amount; the final proxy included the Eastern "sale" but deleted the Pontiac "commitment."[103] Later, immediately before the proxy's filing with the SEC, a new staff auditor on the NSM audit recommended that a further substantial write-off take place, yet the other accountants decided against such action.[104] When the proxy statement was sent to the SEC,

> [t]here was no disclosure that Marketing had written off $1 million of its 1968 sales (over 20%) and over $2 million of the $3.3 million in unbilled sales booked in 1968 and 1969. A true disclosure, which was not made, would have shown that without these unbilled receivables, Marketing had no profit in the first nine months of 1969.[105]

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[96] *Id.* at 316.

[97] Deferred taxes arise because a corporation can report the timing of income and expense items differently for tax purposes than for financial statement presentation. This is ordinary and accepted accounting practice. Here, NSM had a $613,000 loss for tax purposes in 1968. On the financials, however, the auditors had set up an amount for eventual tax liability because of the "commitments." A specialist in the accounting firm determined that since NSM had an operating tax loss carryforward which could be used to offset future income (including any income from "commitments"), there was no need to maintain the deferred tax liability. Brief for Appellant Natelli at 16, United States v. Natelli, 527 F.2d 311 (2d Cir. 1975).

[98] An investor would, of course, be extremely interested in the write-off of the oral "commitments" because it raised important questions about NSM's credibility in reporting sales and earnings. The inquiry would still be important even though the net effect after the tax credit was only $21,000. 527 F.2d at 316-17.

[99] NSM acquired companies on a pooling-of-interests basis. Under this method of consolidating earnings, financial results of the acquired firms are reflected for the whole fiscal period and not just for the period subsequent to acquisition.

[100] 527 F.2d at 317.

[101] *Id.* The opinion sets guidelines for the presentation of extraordinary items in a company's financial statements and provides for the prior period adjustment of certain other items. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, OPINION NO. 9 (1966).

[102] 527 F.2d at 317.

[103] The auditors apparently felt that the letter NSM received from Pontiac did not create a binding obligation. NSM was disturbed about this, even offering to fly the senior auditor to Detroit to meet Pontiac officials. Brief for Appellant Natelli at 27-28, United States v. Natelli, 527 F.2d 311 (2d Cir. 1975). The government contended that the abrupt substitution of the Eastern contract for the Pontiac commitment was done under suspicious circumstances. Although the auditors made some feeble attempts to verify the Eastern "sale," Eastern Airlines was never contacted. Brief for Appellee at 30-31, United States v. Natelli, 527 F.2d 311 (2d Cir. 1975).

Given this seemingly effortless switch of the two contracts, it remains to be seen why NSM did not try to gather sufficient evidence to support inclusion of the Pontiac contract as well. Since the Eastern sale was so easily accepted it probably would not have been all that difficult to upgrade the Pontiac contract. Then, NSM could have shown even more favorable earnings since both items were included. Hence, NSM's sudden retreat from the Pontiac sale might well have been an area the accountants ought to have questioned.

[104] The recommendation called for an additional $320,000 write-off on top of the previously discussed decrease of over $1 million. 527 F.2d at 318.

[105] *Id.*

Reviewing the sufficiency of the evidence marshalled to show the accountants' guilt, the Second Circuit articulated some of the difficulties inherent in most criminal cases against public accountants.[106] Nevertheless, the court discerned a motive for the auditors to conceal the truth about NSM. Like the defendants in *Simon*, earlier improper or mistaken accounting practices, here the initial treatment of the 1968 unbilled receivables, were never rectified. Thus, in order to safeguard their professional reputations and escape criticism, these problems were covered up.[107]

The court first analyzed the evidence concerning the allegedly false footnote accompanying the 1968 certified financials:

> Honesty should have impelled appellant to disclose in the footnote which annotated their own audited statement for fiscal 1968 that substantial write-offs had been taken, after year end, to reflect a loss for the year. A simple desire to right the wrong that had been perpetrated on the stockholders and others by the false audited financial statement should have dictated that course.[108]

The court did not consider it critical that there had been no re-audit for 1968 because "[t]he accountant owes a duty to the public not to assert a privilege of silence until the audited annual statement comes around in due time."[109] Nor was the argument that the disclosure was not material persuasive; the concealment, cloaked as a reduction in pooled earnings of acquired companies, buried NSM's true operating results which would likely have had an impact upon anyone who used those financial statements.[110]

The court then turned to the Eastern contract which it characterized as "a matter for deep suspicion because it was substituted so rapidly for the Pontiac contract."[111] The accountants contended that they had no duty to verify the "sale" because it was included in *unaudited* financial statements.[112] In response, the court noted that it was the auditors, rather than the company, who controlled the figures, as illustrated by the last-minute rejection of the Pontiac contract for inclusion in the interim financials.[113] Furthermore, even though the accountants were not performing an NSM audit, they nevertheless were "associated" with the statements according to their own professional standards[114] and were required to object to anything in those statements known to be materially false. While being "associated" with financial statements does not ordinarily impose a heavy burden on an auditor, the court concluded:

> We do not think this means, in terms of professional standards, that the accountant may shut his eyes in reckless disregard of his knowledge that highly suspicious figures, known to him to be suspicious, were being included in the unaudited earnings figures with which he was "associated" in the proxy statement.[115]

The court also found no error in the trial court's instructions to the jury concerning the requisite knowledge necessary under the indictment.[116] These instructions closely tracked those earlier approved in *Simon*. Under this test, reckless disregard for the truth of the financial statements or deliberately closing one's eyes to obvious economic truths will support an inference of knowledge sufficient to support a criminal charge based upon section 32(a) of the Exchange Act.[117]

Criminal Law and Professional Accounting Standards: Analysis

Accountants are extremely disturbed about these recent criminal cases, especially *Simon* and *Natelli*, and are anxiously awaiting the outcome of several pending actions[118] to see if the trend toward finding

[106] The court prefaced its analysis with the following statement:

> It is hard to probe the intent of a defendant. Circumstantial evidence, particularly with proof of motive, where available, is often sufficient to convince a reasonable man of criminal intent beyond a reasonable doubt. When we deal with a defendant who is a professional accountant, it is even harder, at times, to distinguish between simple errors of judgment and errors made with sufficient criminal intent to support a conviction, especially when there is no financial gain to the accountant other than his legitimate fee.

Id. at 318.

[107] *Id.* at 319.

[108] *Id.*

[109] *Id.*

[110] *Id.* at 319-20.

[111] *Id.* at 320.

[112] Both amicus curiae briefs primarily dealt with the distinction between a professional accountant's audit and non-audit responsibilities. *See* note 8 *supra*.

[113] 527 F.2d at 320.

[114] An auditor is "associated" with unaudited financial statements "when he has consented to the use of his name in a report, document, or written communication setting forth or containing the statements." SAS No. 1, *supra* note 14, § 516.03. If a CPA who is so associated concludes that the financial statements are not in conformity with GAAP, including adequate disclosure, he must insist upon a disclaimer or clearly set forth his reservations. *Id.* § 516.06.

[115] 527 F.2d at 320.

[116] *Id.* at 322-23.

[117] *Id.* at 323.

[118] The Equity Funding case, United States v. Goldblum, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶

criminal liability will continue. Since *Simon,* some accountants have felt that adherence to GAAP and GAAS is irrelevant when criminal charges face them. Similarly, since the defendants in *Natelli* were found guilty for not disclosing information about an unaudited interim financial statement, some accountants truly wonder about the extent of their liability for unaudited statements.

The profession takes a much more restrictive view as to when criminal action against an accountant is justified. As Wallace E. Olson, president of the American Institute of Certified Public Accountants observed: "There is an obvious gap in what the profession thinks and what the courts have said about what constitutes a criminal act."[119]

In taking such a restrictive position, the profession may be compounding its troubles. Financial statement users are demanding more explicit assurance that a company is not engaging in fraud. Thus, when the accountants try to expressly delineate and minimize the limits of their responsibility, the final result may be to polarize further financial statement users. However, it is possible to analyze both *Simon* and *Natelli* in a manner that is more compatible with professional accounting standards and which will reduce the friction between the profession and the courts.

Neither *Simon* nor *Natelli* expressly held that professional accounting standards were totally irrelevant in criminal cases involving accountants.[120] In *Simon* there was no explicit authoritative accounting principle that specifically applied to Continental's situation. The court, however, refused to condone the statement's presentation just because it was otherwise in compliance with GAAP. Hence, because GAAP were not specific, the auditor's appropriate responsibility was to honestly evaluate the financial statement's impact on anyone who might use the figures. In making this evaluation the auditor must consider his complete knowledge about the client.

The *Simon* court did leave an opening for the application of professional standards. If the financials were not presented "fairly," the inquiry would be whether the auditors acted in good faith. Compliance with GAAP was relevant to this issue. What happened in *Simon* was that GAAP were silent on Continental's problem so compliance with GAAP had little probative weight. Had there been an express accounting principle that sanctioned the auditors' actions, compliance with that principle might have reflected the defendants' good faith and led to a different result. Furthermore, had the defendants really conducted a vigorous audit, properly applying GAAS, such facts would have been quite important in resolving the good faith issue.

Natelli does not really buttress the contention that professional accounting standards are inapplicable when determining criminal responsibility. Part of the criminal charge was based upon the auditors' "association" with the unaudited interim statement. In analyzing the appropriate action which the accountants ought to have undertaken, the court expressly resorted to a professional guideline delineating responsibility when an auditor is "associated" with a misleading financial statement.[121] This appears to be the first time a court has evaluated an accountant's alleged criminal conduct solely with reference to professional standards.

Simon and *Natelli* do not establish a definite rule about the relevancy of using proof of compliance with professional standards in evaluating criminal conduct. The fundamental issue in these cases is whether the financials fairly and honestly present the underlying economic results. Compliance with professional standards is a useful measure in resolving this issue, but cannot be considered apart from an assessment of whether the financial statements honestly and meaningfully convey relevant financial facts. This approach takes on added significance when one realizes that the complexity and diversity of modern business transactions make it impossible to develop explicit accounting principles for each and every conceivable situation.

Practical Implications

Although these criminal cases have evoked strong negative reactions from the accounting profession, they have stimulated changes in auditing procedure as well. Accountants are now realizing that certain facts often may be the danger signals that fraudulent

94,200, *appeal docketed sub nom.* United States v. Weiner, No. 75-2973, 9th Cir., July 16, 1975, resulted in the conviction of three accountants. Wall St. J., May 21, 1975, at 14, col. 3. An indictment was returned against a CPA for preparing false and misleading statements for American Funds Corporation, United States v. Riebold, SEC Litigation Rel. No. 6674 (D. N. M., Jan. 10, 1975). There is also an indictment pending against accountants involved in the Home-Stake Production Co. scandal. Wall St. J., July 9, 1975, at 1, col. 1.

[119] Olson, *A Look at the Responsibility Gap,* 139 J. Accountancy 52, 57 (Jan. 1975) [hereinafter cited as Olson].

[120] Without some basic approach for an auditor to use in determining the "fairness of financial statements," an accountant's opinion would be less credible; each auditor would have only a personal feeling as to what fairness is instead of some agreed upon, formalized guidelines. Carmichael, *What Does the Independent Auditor's Opinion Really Mean?,* 138 J. Accountancy 83, 84 (Nov. 1974).

[121] *See* note 114 *supra.*

activity is being carried on, and that some business arrangements are particularly susceptible to fraud and thus require more extensive auditing. Additionally, there is some feeling in the financial community calling for an investigation into the responsibilities of executives who design and implement fraudulent schemes.

Several symptoms that are easy for an auditor to recognize ought to arouse his curiosity. Litigation against accountants "occurs in conjunction with business failures or companies that have encountered severe setbacks."[122] Almost without exception the companies engaging in fraud are either extremely short of cash and working capital or have an urgent need for a continued flow of favorable earnings to support stock prices, or both.[123] Solid operating results are noticeably absent in these companies. This message is finally being translated into audit practice;[124] observers of financial statements noted that 1974 annual reports contained more auditing reservations and qualifications of opinion than in prior years.[125]

Additionally, the accounting profession has taken some key steps to improve audit procedures. First, a commission to examine the modern audit function and its responsibilities has been established.[126] Second, recently pronounced *Statement on Auditing Standards No. 6—Related Party Transactions,*[127] stresses the vital importance for an auditor to discern substance over form when reviewing transactions between "related parties" and provides guidelines for audit procedures and appropriate disclosure. Although several specific illustrations of related parties are provided,[128] the basic definition is

> any other party with which the reporting entity may deal when one party has the ability to significantly influence the management or operating policies of the other, to the extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.[129]

This is an important expansion of audit procedure because such related-party transactions can easily hide fraudulent activities. The guidelines are no doubt partially in response to increasing securities fraud.[130]

Even though these criminal cases underscore the need for auditors to be alert to fraudulent schemes, they do not burden only the public accountant with greater responsibility for financial statements. It is still agreed that financial statements are primarily management representations,[131] even though the accountants play an important role in designing footnotes and recommending journal entries. SEC Commissioner A. A. Sommer, Jr. has pointed out the neglected attention that financial executives who have masterminded the fraud scheme receive:

> First, I would suggest that the totality of the inside professional's responsibilities to the investing public is as broad as and even broader than that of the outside independent accountant. . . . [I]t is the obligation of the inside financial officer, as it is of the auditor, at least since the *Simon* case, to determine whether the financial statements present fairly the financial position and results of operations of the enterprise.[132]

Recently a federal grand jury indicted two former officers of King Resources, Inc. for assorted securities fraud violations.[133] A large part of the charge against them is that they knowingly and intentionally sought to deceive King's auditors to prevent them from learning the truth. Thus, the increased wave of cases against accountants may have even greater implication for financial executives engaging in fraudulent schemes.

Conclusion

Perhaps the most definite caveat that an accountant should keep in mind when auditing is that his best defense to potential criminal charges is simply to

[122] Olson, *supra* note 119, at 53.

[123] Address by Douglas R. Carmichael before the New Mexico Society of Certified Public Accountants, May 6, 1975, *noted in* BNA Sec. L. Rep. D-2 (May 14, 1975).

[124] *See, e.g.,* Chazen & Solomon, *The Art of Defensive Auditing,* 140 J. Accountancy 66 (Oct. 1975). This article points out a number of circumstances that an auditor ought to closely scrutinize. *Id.* at 68–69.

[125] Wall St. J., Apr. 17, 1975, at 1, col. 8.

[126] The wave of litigation has influenced audit practice within accounting firms. The Commission on Auditor's Responsibilities, Statement of Issues: Scope and Organization of the Study of Auditors' Responsibilities (1975). *See also* Bedingfield, *The Effect of Recent Litigation on Audit Practice,* 137 J. Accountancy 55 (May 1974). In particular, one large firm has recently hired another accounting firm to review its audit practices and quality control, a rather unprecedented step. Wall St. J., May 22, 1975, at 9, col. 1.

[127] American Institute of Certified Public Accountants, Statement on Auditing Standards No. 6 (1975).

[128] For example, related parties specifically include the reporting entity's affiliates, principal owners, management, and members of their immediate families. *Id.* § 2.

[129] *Id.*

[130] Wall St. J., March 31, 1975, at 14, col. 2.

[131] *See* note 47 *supra.*

[132] Address by A.A. Sommer, Jr. before the Cleveland Treasurers Club, November 14, 1973, in 137 J. Accountancy 71, 72 (Apr. 1974).

[133] United States v. King, Grand Jury Crim. No. 75-70 (S.D.N.Y. 1975).

have performed a thorough audit. Affirmative application of GAAS will uncover many kinds of fraud and provide a solid basis upon which to base a good faith defense. Yet, while applying GAAS, the auditor must be aware of the resulting impact that a certain manner of presentation will have on the financial statement user.

This approach is consistent with the conclusion reached by a special committee of the American Institute of Certified Public Accountants convened to review the massive fraud of the Equity Funding debacle. The committee concluded that a full application of GAAS and "customary audit procedures properly applied would have provided a reasonable degree of assurance that the existence of fraud at Equity Funding would be detected."[134]

This is not to suggest that auditors should be obstinate and make unyielding demands about every item presented in financial statements. Rather, in making decisions about whether the financials really present economic realities, the auditor must insist upon presentation that is complete, fair to the user, and, above all, honest, for this will provide the auditor with his strongest defense to federal criminal charges.

[134] AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, REPORT OF THE SPECIAL COMMITTEE ON EQUITY FUNDING 27 (1975).

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EQUAL TREATMENT FOR CRIMINAL DEFENDANTS IN THE ALLOWANCE OF A TAX DEDUCTION FOR LEGAL EXPENSES

INTRODUCTION

A criminal defendant's "right to the assistance of counsel" under the sixth amendment to the Constitution[1] gained considerable vitality in 1963 with the Supreme Court's decision in *Gideon v. Wainwright.*[2] In *Gideon,* the Court held that a criminal defendant charged with a state felony prosecution is entitled to the services of an attorney even if he cannot afford one. *Gideon* marked the beginning of a liberal interpretation by the Court of the "right to counsel" portion of the sixth amendment.[3]

The repercussions of *Gideon* were also felt in the sphere of federal income tax law. In the 1966 landmark decision of *Commissioner v. Tellier,*[4] the Supreme Court held that a taxpayer, a securities dealer convicted of violating both the Securities Act of 1933 and the Mail Fraud Act, could deduct the cost of his criminal defense from his gross income as an ordinary and necessary business expense. The decision in *Tellier* overturned the traditional rule, based on public policy, of prohibiting a deduction if the taxpayer had been convicted. The dubious justification for the rule was that the taxpayer-defendant would otherwise receive an "indirect subsidy" for his unlawful activities, thereby frustrating the authorities' efforts to halt such activity. Recognizing the harshness of this rule and its inconsistency with a criminal defendant's right to counsel under the sixth amendment, the Court emphasized that it could never be against public policy to permit a taxpayer to defend himself in a criminal prosecution. Further, the Court held that no public policy would be frustrated by permitting a deduction for the defendant's legal expenses on his tax return. While its potential application to all criminal defendants is apparent, the *Tellier* doctrine is limited by the Supreme Court's earlier decision in *United States v. Gilmore*[5] to a claim which *"arises in connection with* the taxpayer's [trade or business or] profit-seeking activities."[6]

The interrelationship between tax and criminal law presented by these two cases will be analyzed in this comment. It is surprising to note the myopic treatment which this interrelationship has received by the courts and legal commentators. The thrust of the analyses in the writings by legal scholars has often been confined to a simple expository of the latest significant tax decision, which is then accepted virtually without consideration as to its possible impact on the criminal law.[7] The purpose of this comment is to closely examine this area of the law, largely untouched by previous writings.

The survey will begin with a summary of the present state of the law concerning tax deductions for legal expenses. Then, the applicable tax law will be analyzed and criticized for its internal inconsistencies and deficiencies. First, it will be shown that the courts, in resolving the issues of statutory interpretation presented in cases following *Gilmore* and *Tellier,* have articulated a highly artificial distinction which is discriminatory in its application to the criminal defendant in the tax arena: "business misconduct" versus "personal misconduct." Second, it will be shown that the scope of *Gilmore's* "origins" test, when judged on its own terms, tends to be too inclusive at times, and too exclusive at other times. Third, it will be shown that the "origins" test

[1] "In all criminal prosecutions, the accused shall enjoy the right to . . . have the Assistance of Counsel for his defense." U.S. CONST. amend. VI.

[2] 372 U.S. 335 (1963).

[3] *See generally* Faretta v. California, 422 U.S. 806 (1975) (the "right to counsel" includes the right to defend oneself); Argersinger v. Hamlin, 407 U.S. 25 (1971) (counsel must be provided for an indigent defendant faced with possible incarceration).

[4] 383 U.S. 687 (1966).

[5] 372 U.S. 39 (1963).

[6] *Id.* at 48. This is the "origins" test which will be criticized later in this comment.

[7] For a general discussion of the deductibility of legal expenses see Brookes, *Litigation Expenses and the Income Tax,* 12 TAX. L. REV. 241, 274-75 (1957); Schlenker, *Tax Deductibility of Legal Expenses,* 54 A.B.A.J. 199 (1968); Snyder, *Legal Fees: Their Deductibility,* 57 ILL. BAR J. 488 (1969); Troiano, *Deduction of Legal Fees as Ordinary and Necessary Business Expenses—The Unsuccessful Defense of Criminal Prosecutions,* 33 BROOKLYN L. REV. 280 (1967); Comment, *Income Tax Deductibility of Attorneys' Fees Incurred in Unsuccessful Criminal Defense,* 114 U. PA. L. REV. 274 (1965).

One commentator has touched upon the problems presented in this comment. *See* Note, *A General Practitioner's Guide to the Deductibility of Attorneys' Fees,* 5 GA. L. REV. 751 (1971).

is inadequate to effectively classify, for the purpose of a deduction for legal expenses, the myriad of crimes in existence. In the next section of the comment the "integral" test, a more useful mechanism consistent with the principles enunciated by the courts, will be proposed.

The focus of the comment will then shift its emphasis to the criminal defendant in the tax arena. A possible judicial response to *Gilmore,* rejecting the rigidity of the "origins" test, will be explored. A modified "consequences" test, abandoned in *Gilmore,* will be proposed. This test, although retaining vestiges of the business-versus-personal distinction drawn by the Internal Revenue Code, contains a conclusive presumption of a business motivation in defending against a criminal charge, and thus allows a deduction to all criminal defendant-taxpayers for the cost of defense expenses.

Continuing this theme, the next major section of the comment will offer a theoretical income tax discussion supporting an amendment of the Code itself to allow an across-the-board deduction for all legal expenses incurred in defense of a criminal prosecution. To illustrate this argument, legal expenses will be analogized to medical expenses, already accorded a personal deduction in the Code on a theory consistent with tax policy.

Finally, possible alternatives to a tax deduction, such as prepaid legal service programs and expanded public defender programs, will be discussed and criticized with a view toward providing effective assistance of counsel for the majority of society. The ultimate position to be taken is that an amendment to the Code providing for a tax credit for criminal defense expenses, a proposal consistent with sixth amendment considerations, offers the most acceptable solution to the severe problem of financing a criminal defense.[8]

A Brief Summary of the Law Concerning the Tax Treatment of Legal Expenses

The Code contains several provisions relating to various aspects of the criminal law,[9] but there is no single provision in the Code explicitly covering the deductibility of legal expenses. Generally, legal expenses incurred by individuals in the prosecution or defense of any litigation are deemed to be personal in nature and hence non-deductible under section 262.[10] However, the courts have engrafted a deduction for certain legal expenses into several existing broadly-worded provisions of the Code.[11]

At present, a deduction for legal expenses is permitted when the expenditure qualifies as an ordinary and necessary trade or business expense

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[8]"Legal expenses" (herein defined as attorney's fees and court costs) incurred in the prosecution or defense of civil actions are not within the scope of this comment. Significant distinctions between civil and criminal litigation suggest a different treatment for each under the tax deduction laws. First, there is the constitutional difference. The sixth amendment does not guarantee the right to counsel in civil cases. While an enlightened public policy should certainly demand the benefit of counsel in civil cases, constitutional support exists only with respect to criminal cases. Derivatively, tax treatment of civil legal expenses is unaffected by the commands of the sixth amendment.

Second, the tax treatment of criminal legal expenses needs closer scrutinization because of the absence of genuine alternatives to financing the litigation as found in civil cases. Statutes exist which allow recovery of attorney's fees by the plantiff or by the winning party in certain kinds of civil litigation. *See, e.g.,* Fair Labor Standards Act, 29 U.S.C. § 216(b) (1970); Ship Mortgage Act, 46 U.S.C. § 941 (1970); Truth-in-Lending Act, 15 U.S.C. § 1640(a)(2) (1970). Granting attorney's fees is within the court's discretion in the Securities Act, 15 U.S.C. § 77k(e) (1970). Recoverable attorney's fees reduces the financial obstacle to bringing or defending a civil suit. However, no equivalent mechanism exists for criminal litigation.

Third, there are indirect ways to recover litigation expenses in civil cases. Where a suit for money damages is brought, the jury award will often include the plaintiff's legal expenses even though the plaintiff's recovery is not intended to reflect such costs. Under the Code, if the dispute is over capital property, the costs of the litigation can be added to the basis of the property under Int. Rev. Code of 1954, § 263. Woodward v. Commissioner, 397 U.S. 572 (1970). This amounts to a delayed deduction if the capital item is depreciable. *See* Int. Rev. Code of 1954, § 167. No comparable means of indirectly recouping legal expenses is present in criminal litigation.

Fourth, in some types of personal injury litigation, insurance will cover the cost of legal assistance. Except to the limited extent that insurance or quasi-insurance is available to defendants in criminal litigation, as discussed at text accompanying notes 107–28 *infra,* this alternative is also unavailable to criminal defendants.

[9]Section 162(c) disallows a trade or business expense deduction for the payment of illegal bribes or kickbacks to governmental employees, or any other unlawful bribe or kickback. Section 162(f) disallows a trade or business expense deduction for the payment of any fine or similar penalty for a violation of any law. Section 162(g) disallows a trade or business deduction for two-thirds of the treble damages paid as a result of a criminal violation of the antitrust laws. Section 165(d) permits losses from wagering transactions only to the extent of the gains from such transactions. Int. Rev. Code of 1954, §§ 162(c),(f),(g), 165(d).

[10]Section 262 provides: "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses." Int. Rev. Code of 1954, § 262.

[11]*See* Welch v. Helvering, 290 U.S. 111 (1933).

under section 162(a).[12] A "trade or business" has been defined as "extensive activity over a substantial period of time during which the taxpayer holds himself out as selling goods or services."[13] Thus, if the expenses are incurred in the defense of a criminal charge, then the criminal charge itself must at least relate somehow to the taxpayer's trade or business. In *Tellier,* for instance, the defendant had been found guilty of violating the Securities Act of 1933,[14] the Mail Fraud Act,[15] and of conspiring to violate those statutes.[16] The Commissioner conceded that the charges undoubtedly *arose*[17] from the defendant's business as a securities dealer, so the relation of the criminal charge to the trade or business went uncontested. The same result would follow if an officer of a corporation were charged with a violation of the antitrust laws, and the legal expenses would be deductible by the corporation itself if it had an indemnification plan for wrongful acts by its agents done in the course of their employment.[18]

Another requirement for section 162(a) is that the trade or business expense be "ordinary and necessary." For many types of expenses, the "ordinary and necessary" restriction can be a difficult hurdle to overcome. But, with respect to legal expenses incurred as a defense to a criminal prosecution (regardless of the outcome), the Supreme Court has reduced the requirement to a determination of whether the ordinary reaction of a businessman to the particular situation would be to incur the expense and has concluded that in all cases it would be.[19] One should also be able to draw the inference that the reasonableness of the expenditure is not relevant. In other

[12]Section 162(a) provides: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . . " INT. REV. CODE OF 1954, § 162(a). This section applies to both individuals and corporations.

[13]McDowell v. Ribicoff, 292 F.2d 174, 178 (3d Cir. 1961). *See* Rev. Rul. 58-5, 1958-1 CUM. BULL. 322. *See also* Folker v. Johnson, 230 F.2d 906, 907 (2d Cir. 1956) (for IRS purposes, the phrase "'trade or business' has a common and well-understood connotation as referring to activity or activities in which a person engages for purposes of earning a livelihood"); Wooten v. United States, 41 F. Supp. 496, 497 (N.D. Tex. 1941) ("trade or business" refers to a "regular occupation or calling of the taxpayer, for the purpose of livelihood or profit"). None of these definitions is particularly helpful in determining what criminal activities may be considered to have "arisen in connection with" the "trade or business." The definitions also provide few clues as to when a criminal activity itself will be considered a "trade or business."

[14]15 U.S.C. § 77q(a)(3) (1970), which the defendant in *Tellier* was charged with violating, provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly
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> . . . .
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> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

[15]18 U.S.C. § 1341 (1970) provides:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined not more than $1,000 or imprisoned not more than five years, or both.

[16]18 U.S.C. § 371 (1970) provides:

> If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than $10,000 or imprisoned not more than five years, or both.

[17]*See* the discussion of the "origins" test at notes 27-30 and accompanying text *infra.*

[18]In Central Coat, Apron & Linen Service, Inc. v. United States, 298 F. Supp. 1201 (S.D.N.Y. 1969), the corporate taxpayer was allowed to deduct payments of all legal expenses, except fines paid, incurred by the corporation and its president in defense of a prosecution for violating the Sherman Antitrust Act. In permitting a corporate deduction for its president's attorney's fees, the court relied on the indemnification plan that protected corporate officers in situations such as this one.

[19]This definition of "ordinary and necessary" was established in the oft-cited case of Welch v. Helvering, 290 U.S. 111 (1933), wherein Justice Cardozo stated:

> Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.

290 U.S. at 114 (citation omitted). This quote, of course, presumes that the crime was of a business origin. For Justice Cardozo's "lawsuit affecting the safety of a business," the thrust of the inquiry is with the businessman's motiva-

words, since a reasonable businessman would be expected to litigate his case to the hilt, even astronomical expenditures should come within the purview of the rule.

Although the conditions for deductibility under section 162(a) are relatively straightforward, application of the "trade or business" requirement has created several peculiar holdings in the case law. For example, in *Peckham v. Commissioner,*[20] a doctor convicted of performing an illegal abortion was denied a deduction for his legal defense expenses on the ground that he failed to show that the abortion was related to the business of practicing medicine. This curious holding cannot logically be explained simply by asserting that only lawful medical practices are contemplated to be within a doctor's business because the law draws no distinction between "lawful" and "unlawful" businesses.[21] Two possible explanations for the decision are either that the defendant failed to prove that abortions were a continuous or extensive part of his practice (which in 1964 he surely would not have admitted),[22] or that he was not compensated for performing it and therefore it was a voluntary and personal undertaking.[23] If, in fact, either of those two possibilities existed, then the criminal charge probably did not arise out of the defendent-taxpayer's trade or business.

A second provision which has been interpreted to allow deductions for legal expenses is section 212,[24] which was enacted in 1942 to equalize treatment between taxpayers engaged in a trade or business with those simply engaged in a profit-seeking, but non-business, activity.[25] Section 212 allows a tax

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tion in defending the suit: to avoid the adverse business consequences.

The "ordinary and necessary" restriction was clarified by the Court in *Tellier*:

> Our decisions have consistently construed the term "necessary" as imposing only the minimal requirement that the expense be "appropriate and helpful" for "the development of the [taxpayer's] business." (citations omitted). The principal function of the term "ordinary" in § 162 (a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset. (citation omitted)

383 U.S. at 689–90. In making this sweeping determination, the Court also disposed of two other conditions which normally confront a taxpayer who seeks to make a trade or business deduction: (1) the capital expenditure limitation and (2) the public policy limitation.

If the legal expenses are incurred in connection with a capital asset, section 263 requires that the expenses be added to the cost basis of the asset instead of being deducted during the taxable year incurred. *See, e.g.,* United States v. Wheeler, 311 F.2d 60 (5th Cir. 1962), *cert. denied,* 375 U.S. 818 (1963) (suit for specific performance of a contract to sell the taxpayers stock); Laemmle v. Eisner, 275 F. 504 (S.D.N.Y. 1920) (suit initiated to acquire control of a corporation's stock). Since the Court held that the expenses were incurred in a defense against a charge of past criminal misconduct, and not in the acquisition of a capital asset, this restriction does not apply to criminal defense fees. 383 U.S. at 690.

The public policy limitation, eliminated by the Court in *Tellier,* will be discussed at text accompanying notes 87–106 *infra.*

[20] 327 F.2d 855 (4th Cir. 1964).

[21] In Commissioner v. Sullivan, 356 U.S. 27 (1958), the Supreme Court held that amounts expended to lease premises and hire employees for the operation of gambling enterprises, illegal under Illinois state law, were deductible as ordinary and necessary business expenses under the predecessor to section 162(a)(3). The Court feared that a decision to the contrary would have meant that Sullivan's illegal business would have been taxed on the basis of gross receipts, while other businesses would have been taxed on the basis of net income. The Court could find no rational justification for this distinction in the Code.

Admittedly, Congress has subsequently chosen to prohibit trade or business deductions for certain business expenses (note 9 *supra*), but it has never disallowed deductions on the basis of the type of business involved.

[22] This is a rather stringent test for a "trade or business." The defendant might have been more successful had he relied upon section 212 of the Code. *See* notes 27–30 and accompanying text *infra.*

[23] There was no evidence presented on this point. But, that a voluntary undertaking in the course of one's business activities is not considered a part of his business activities is an important concept. In Friedman v. Delaney, 171 F.2d 269 (1st Cir. 1948), a voluntary payment of a bankruptcy deposit by the lawyer-taxpayer on behalf of his client was held to be nondeductible because it was not an "ordinary" or "necessary" expense of being a lawyer. The taxpayer argued that the deposit was paid by him because he gave his word that it would be paid, and that the ethics of his profession compelled him to honor his word. The court rejected his argument, terming his moral obligation an "extra-professional liability." *Id.* at 271.

This limitation becomes especially crucial in discussing the "difficult cases" at notes 41–68 and accompanying text *infra.*

[24] Section 212 provides:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> (1) for the production or collection of income;
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> (2) for the management, conservation, or maintenance of property held for the production of income; or
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> (3) in connection with the determination, collection, or refund of any tax.

INT. REV. CODE OF 1954, § 212.

[25] *See* United States v. Gilmore, 372 U.S. 39, 44–46 (1963). In Higgins v. Commissioner, 312 U.S. 212 (1941),

deduction for expenses incurred for the production or collection of income, for the management, conservation, or maintenance of property held for the production of income, or in connection with the payment of any tax. This section attempts to distinguish those activities carried on primarily as a hobby or sport from those engaged in for profit. According to one court, to qualify for a section 212 deduction, the taxpayer must "initiate or conduct the enterprise in good faith with an intention of making a profit or of producing income."[26] Typical examples of personal profit-seeking activities are investments in stock or securities, mineral interests, or real estate.

In order for legal expenses incurred in defense of a criminal prosecution to qualify for a deduction under section 212, the criminal charge must directly relate to the profit-seeking activity. Or, as stated more specifically in *Gilmore v. United States*,[27] the expense item involved must be one that has a business origin.[28] In *Gilmore*, the taxpayer had successfully resisted an attempt by his former wife to appropriate his income-producing stock during a property settlement proceeding subsequent to the divorce. The taxpayer then sought to use section 212 to deduct his litigation expenses, arguing that they were incurred in the preservation of property held for the production of income. Since the claim had arisen out of the exacerbated marital relationship, it was held to be of a personal origin, and the taxpayer's attempted deduction was frustrated.

Though formulated in the context of a civil action, the principle enunciated in *Gilmore* was applied with equal force by *Tellier* to criminal actions: it is the "origin" of the dispute leading to the legal expenses, rather than the potential consequences of losing the dispute, which determines whether such expense is business-related or personal.[29] Put another way, the characterization of the expense as "business" or "personal" depends on whether or not the claim arises in connection with the taxpayer's trade or business or profit-seeking activities.[30]

Another interpretation of what deductions would be allowed by sections 162(a) and 212 was rejected by *Gilmore*. This test, called the "consequences" test, permitted a deduction for the cost of legal expenses if the *consequence* of the claim which prompted the taxpayer to incur the expense involved potential damage to his business or its assets.[31] Beginning with *Kornhauser v. United States*,[32] where the somewhat ambiguous standard was whether the legal expenses were incurred "directly connected with, or . . . proximately resulted from [the] business,"[33] the courts had vacillated between the "origins" test and the "consequences" test.[34]

the Supreme Court narrowly construed the phrase in section 162 allowing deductions only for expenses incurred "in carrying on any trade or business" by holding that the activities of an individual in managing his securities investments did not constitute the "carrying on of a trade or business."

[26] International Trading Co. v. Commissioner, 275 F.2d 578, 584 (7th Cir. 1960). The "good faith" standard attempts to distinguish business-like activities from personal activities where there is no real intent to yield a profit. The "good faith" standard does not require that the taxpayer actually show a profit, or even have a reasonable expectation of one, but there must be a showing of an intent to earn one. In *International Trading*, the corporate taxpayer was not permitted to deduct certain upkeep expenses incurred in maintaining land and buildings used for stockholder residences and for business entertainment. The court held that the homes were maintained primarily for the personal benefit of the stockholders, even though the stockholders paid rent. *Id.* at 580. This "primary purpose" test finds its way into tax analysis with respect to other sections as well. *See, e.g.*, Woodward v. Commissioner, 397 U.S. 572, 576 (1970) (capital expenditures, § 263).

[27] 372 U.S. 39 (1963).

[28] *Id.* at 45.

[29] *Id.* at 49.

[30] *Id.* at 48. Precisely when a crime "arises in connection with" the taxpayer's trade or business or profit-seeking activities has never been fully determined. The text accompanying notes 38–75 is intended to shed some light on this issue.

[31] Draper, 26 T.C. 201 (1956), *acquiesced in*, 1956-2 CUM. BULL. 5 (prosecution of a libel action to protect taxpayer's business); Salt, 18 T.C. 182 (1952) (expenses incurred for advisement of legal rights where witness' testimony before a Congressional committee could have threatened witness-taxpayer's future business); Howard, 16 T.C. 157 (1951) (defense against a court martial).

[32] 276 U.S. 145 (1928). In *Kornhauser*, the taxpayer sought a deduction for legal expenses incurred in successfully defending an accounting suit brought by his former law partner for shares of stock received for professional services performed by the taxpayer during the existence of the partnership, as claimed by the law partner, or after its termination, as claimed by the taxpayer. Applying its test, the Court granted the deduction.

[33] *Id.* at 153. Although the Court in *Gilmore* relied upon *Kornhauser* as support for its "origins" test, the *Kornhauser* test seems to leave more avenues open for the taxpayer. Since it does not speak strictly of "business origins," legal expenses incurred simply to defend a business would arguably fall within its ambit. This was certainly suggested by Justice Cardozo in Welch v. Helvering, 290 U.S. 111 (1933). *See* note 19 *supra*.

[34] *See* Gibbs, *Post-Gilmore—Recent Trends in the Deductibility of Professional Fees*, 23 Sw. L.J. 644, 646 (1969). *Compare* Commissioner v. Heininger, 320 U.S. 467 (1943) *with* Lykes v. United States, 343 U.S. 118 (1952). *See also* Lewis v. Commissioner, 253 F.2d 821 (2d Cir. 1958); Baer v. Commissioner, 196 F.2d 646 (8th Cir. 1952).

Gilmore effectively eliminated the "consequences" test and the *Kornhauser* standard by construing the latter to coincide with its "origins" test.

The primary concern of the Court in *Gilmore* was with the logical extension of a "consequences" test as applied to section 212. Most civil litigation involves a plaintiff seeking property from a defendant, often income-producing money. If either the plaintiff or the defendant were given a choice as to whether or not income-producing property was to be used to satisfy the judgment, most would decide in the affirmative, and thus the literal language of sections 212(1) and (2) referring to the "production" or "maintenance" of income-producing property would permit deductions for virtually all civil legal expenses.[35] Unwilling to allow the tax base to be eroded so capriciously, the Court restricted the legal expense deduction to claims arising out of profit-seeking activities. By contrast, this concern has only partial relevance to the potential consequences stemming from a criminal action because the element of choice of sanctions, including those not imposed by the court, cannot be made by the defendant. His choice, if any, is limited to the type of asset used to pay a fine. Thus, based on its underlying rationale, *Gilmore* arguably could have been limited to civil actions.

However, the language of *Gilmore* was broad enough to engulf the legal expenses of criminal defendants and courts subsequent to *Gilmore* seized upon it. *Nadiak v. Commissioner*[36] provides an edifying illustration of this ramification. In *Nadiak*, the taxpayer-defendant was an airline pilot. Legal expenses incurred in a successful defense against criminal charges of assault and battery and grand larceny were held to be nondeductible because the origin of the claim generating such expenses arose out of his strained marital relationship.[37] The court deemed it irrelevant to the issue of deductibility that the taxpayer-defendant would have lost his pilot's license if he had been convicted. That would have been only an unfortunate "consequence." The court reiterated that the claim or criminal charge must have arisen in connection with the taxpayer's trade or business or profit-seeking activity rather than with any personal conduct.

An Evaluation of the Present State of the Law

The net result of this development of judicially-authorized deductions for legal expenses has been the creation of a rigidly-applied "origins" test for deductibility. The courts, relying upon the venerable judicial declaration that all deductions are a "matter of legislative grace,"[38] have grudgingly introduced only a modicum of liberality into the Code with respect to most criminal defendants. Predicated upon

[35]The Court tempered its dissatisfaction with the "consequences" test by offering the following hypothetical:

> If two taxpayers are each sued for an automobile accident while driving for pleasure, deductibility of their litigation costs would turn on the mere circumstance of the character of the assets each happened to possess, that is, whether the judgments against them stood to be satisfied out of income—or nonincome—producing property. We should be slow to attribute to Congress a purpose producing such unequal treatment among taxpayers, resting on no rational foundation.

372 U.S. at 48. Even a situation such as the one described in the Court's hypothetical could lead to a deduction for the payments made if satisfied out of the cash assets of the defendant. Cash itself is an income-producing asset because it earns taxable interest. The Court spoke of "rational foundations" for its distinction, but the fact that the taxpayer-defendant could choose what type of asset with which to satisfy the judgment also must have influenced the Court.

[36]356 F.2d 911 (2d Cir. 1966).

[37]The "personal" nature of Nadiak's actions was not questioned. The assault and battery charges were brought by a friend of his former wife, and the larceny charges stemmed from an allegation that he had taken property belonging to his former wife. 356 F.2d at 911–12.

[38]The power to tax income like that of a new corporation is plain and extends to the gross income. Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.

New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). *See also* Deputy v. DuPont, 308 U.S. 488, 493 (1940).

The theory that all deductions are a matter of legislative grace is subject to question. The sixteenth amendment reads:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.

U.S. Const. amend. XVI. If "income" means "net income," then some deductions must be permitted. In Griswold, *An Argument Against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace*, 56 Harv. L. Rev. 1142 (1943), the author argues that the issue is one of statutory interpretation only, uninfluenced by the aspect of whether an income item or a deduction item is involved. Griswold thought that the structure and history of the income tax made it plain that Congress intended to allow deductions as well as to tax income. *Id.* at 1144. Also, Griswold points out that the predecessors to section 162 were meant to be broad—to cover "all the legitimate expenses attending the business." 26 Cong. Rec. 6887 (1894) (remarks of Senator Vest).

the legislative policy of granting a deduction for the cost of generating gross income, the "origins" test excludes a defense expense deduction for all those taxpayers who cannot show that their crime had a business origin even though there may have been valid business motivations for incurring the expense itself. On the other hand, there is arguably a portion of the criminal element that benefits unjustifiably from its use: corporations and "white-collar" criminals who are able to fit their crime into the category of business origin without a showing that the commission of the crime was intended to generate additional gross income.

The question posed by the "origins" test is whether the crime arises in connection with the taxpayer's business or profit-seeking activities. Or, put another way, is the crime "business" or "personal" in nature? The phrase "arise in connection with" is not self-explanatory: nevertheless, courts generally have not undertaken to define it in the context of criminal activity. In a 1968 Revenue Ruling, the IRS added little content in suggesting the following factors to be employed to determine deductibility on a case-by-case method:

> The determination of the character of the conduct from which a given criminal charge arises or the source of such a criminal charge is dependent upon a consideration of all the facts and circumstances concerning the taxpayer involved. In this connection, consideration is given to, among other things, the acts committed or alleged to have been committed, their relationship to the taxpayer's business activities, how the taxpayer conducts those activities (for example, what acts, associations, relationships, and endeavors are involved in the conduct of the taxpayer's business activities), and whether being subject to the criminal offense charged was an inherent risk of engaging in the taxpayer's business activities.[39]

Except for the last clause, the IRS factors are hardly more than reformulations of the general "origins" test itself. Something more concrete is needed if taxpayers are to be able to anticipate the IRS reaction to a claim for a deduction for criminal defense expenses and courts are expected to rationally decide who is correct.

In *Tellier,* the Supreme Court was not confronted with the issue because the Commissioner conceded that the securities violations "arose in connection with" the defendant's securities business. Implicit in the Commissioner's position may have been a recognition of the close relationship that securities laws bear to the securities business. The Securities Act of 1933 by its very nature is a form of "business regulation"—its purpose is to monitor and control the ways of generating gross income within the securities business. With few exceptions, only those who are in the securities business doing securities work could violate the securities law.[40] "But for" the defendant's securities business he could not have committed the crime. Thus, if the deductibility of criminal defense expenses turns on crimes of "business regulation," then the Supreme Court's application of *Gilmore* to the taxpayer *Tellier* was correct.

If the Commissioner's concession in *Tellier* is read narrowly, then arguably a crime arising in connection with business activities has a business origin only if it is some type of "business regulation." If that is the teaching of *Tellier,* then some vexatious problems arise, especially with respect to corporations. A corporation, although a business entity, is criminally responsible for the acts of its agents if the agent was acting within the scope of his employment and if the violation was perpetrated in furtherance of the corporation's ends.[41] A corporation, by having the culpability of its agents imputed to it, can be held criminally liable for many types of misconduct

[39] Rev. Rul. 68-662. The IRS dealt with two hypothetical taxpayers. The first, a corporation's secretary-treasurer, had diverted corporate funds to his personal use. Both the corporation, the second taxpayer, and the secretary-treasurer were convicted of income tax evasion. Each attempted to deduct the cost of legal expenses incurred in defense of the prosecution for tax evasion. The IRS held that the secretary-treasurer could deduct his legal expenses under section 212(3) since that provision provided for a deduction for expenses incurred in any proceeding for the determination of a tax. This is a very broad interpretation of section 212(3) because it does not require the taxpayer to show he was engaging in a profit-seeking activity.

The IRS also held that the corporation could deduct its legal expenses under section 162(a) (section 212(3) not being applicable to corporations). The IRS reasoned that the income tax evasion charge was of "business origins" because it was the duty of the secretary-treasurer to fill out the tax return.

Unfortunately, the IRS did not comment on whether a charge of embezzlement against the corporation's secretary-treasurer would also be a crime with "business origins." He did commit the crime under the color of his office. *See* notes 55-62 and accompanying text *infra* for further discussion on this subject.

[40] This is a narrow reading of *Tellier,* but it is consistent with the Court's reasoning. If one looks to the type of business involved in using the "origins" test, then it would seem that only criminal laws designed to control the activities traditionally associated with the operation of that particular business would qualify under the "origins" test. 383 U.S. at 689.

[41] United States v. Wise, 370 U.S. 405, 406-16 (1962).

traditionally thought to be "personal" in nature.[42] For instance, corporations can be subject to the laws against involuntary manslaughter,[43] larceny,[44] and malicious destruction of property.[45] For the corporation to be held criminally responsible in each of these situations of "personal misconduct," the agents must be acting in the regular course of their duties and in furtherance of the corporate ends.[46] It could be argued that these crimes, like crimes of "business regulation," occur regularly and simply constitute an inherent risk entailed in doing business. They may be considered inevitable to a certain extent. This is probably what the IRS meant in its Revenue Ruling when it said: "[C]onsideration is given to... whether being subject to the criminal offense charged was an inherent risk of engaging in the taxpayer's business activities."[47] If they are an inherent risk, they present a compelling case under traditional tax theory for allowing a deduction for legal expenses incurred in a defense of a criminal prosecution for them.

However, if in order to show that a crime "arises in connection with" business activities one only has to show that the agent was acting within the scope of his employment and in furtherance of the corporate ends, the "origins" test becomes meaningless in this situation. Although a corporation is presumed to be engaged in a trade or business,[48] it does not necessarily follow that everything it does is ipso facto business related. It does not follow that every crime that a corporation may be liable for has a truly "business origin." First, a corporation may be criminally liable even though the acts of its officers, acting within the outer perimeters of their expected duties, are ultra vires as to the corporation.[49] If the corporate charter itself has expressly limited the corporation's business activities, then its misconduct arguably falls outside the "origins" test for purposes of a tax deduction sought by the corporation for its legal expenses incurred in defense of the criminal prosecution brought against it. Second, corporations may also be held criminally liable for certain types of misconduct which, although not necessarily ultra vires, are nevertheless speciously business-related. For instance, a corporation is subject to criminal penalties for violations of the political contributions law[50] and the campaign disclosure laws.[51] These criminal laws relate neither to "business regulations" nor "inherent risks of doing business" even though the corporate agents may have had the authority to do them. It is hard to see how these forms of misconduct bear a sufficiently close connection to the corporation's ultimate activity of generating gross income in order to assert that the crime itself has a "business" origin.[52] The best conclusion is to say that certain

[42] Jurisdictions used to limit corporate criminal liability by holding that a corporation was incapable of committing "specific intent" crimes. This position has been eroded by modern decisions. *See generally* Comment, *Corporate Criminal Liability in Oregon: State v. Pacific Powder and the New Oregon Criminal Code,* 51 ORE. L. REV. 587 (1972). Of course, the corporation must be a "person" capable of committing the crime. *See* United States v. Hougland Barge Line, Inc., 387 F. Supp. 1110 (W.D. Pa. 1974). And finally, if the penalty for the crime mandates imprisonment, then the corporation cannot be held criminally liable even if it is a "person."

[43] State v. Lehigh Valley R.R., 90 N.J.L. 372, 103 A. 685 (1917).

[44] People v. Canadian Fur Trapper's Corp., 248 N.Y. 159, 161 N.E. 455 (1928).

[45] *Cf.* State v. Rowland Lumber Co., 153 N.C. 610, 69 S.E. 58 (1910).

[46] The apparent contradiction between the dual intents held by a corporate official who commits a "specific intent" crime of personal violence while having the intent to benefit the corporation has been a troublesome area. Only New Jersey has extended corporate criminal responsibility to crimes involving personal violence, specifically, homicide or manslaughter. State v. Lehigh Valley R.R., 90 N.J.L. 372, 103 A. 685 (1917). *See* State v. Pacific Powder Co., 226 Ore. 502, 505, 360 P.2d 530, 531 (1961). However, People v. Rochester Ry. & L. Co., 195 N.Y. 102, 107, 88 N.E. 22, 24 (1909) suggested that it would be within the legislative power to enact specific legislation which would create corporate criminal responsibility for crimes of personal violence.

[47] Rev. Rul. 68-662, 1968-2 CUM. BULL. 69.

[48] International Trading Co. v. Commissioner, 275 F.2d 578, 584 (7th Cir. 1960).

[49] United States v. Mirror Lake Golf & Country Club, Inc., 232 F. Supp. 167, 172 (W.D. Mo. 1964).

[50] 18 U.S.C. § 610 (1972). This section applies only to banks and corporations chartered by Congress.

[51] Federal Election Campaign Act, 2 U.S.C. §§ 431(h), 441 (Supp. II, 1972).

[52] If the corporate donor's political candidate is elected, he may seek to introduce favorable legislation, which, if passed, might ultimately enhance the corporate donor's profits. On the other hand, the political contribution might also be intended simply as a form of political expression by the board of directors. Or, it might be calculated to gain a political advantage for a member of the board of directors or other corporate officer. But, it is very clear that few, if any, corporations are in the business of making campaign contributions.

The notion of using some sort of economic calculator, *i.e.,* a simple test of whether the criminal activity is intended to yield a profit, to bring every criminal activity within the "business origins" parameters has its drawbacks. Suppose that a corporation wishes to dispose of one of its neighborhood competitors. Instead of attempting to drive it out of business by employing illegal antitrust tactics, the corporate

crimes fall within a corporation's "personal" undertakings and hence a deduction for legal expenses incurred in defense of a criminal prosecution should be disallowed.

The courts apparently have not adopted this position, but case law on this issue has been surprisingly sparce. In *Union Investment Co.*,[53] decided long before *Gilmore,* the corporate taxpayer sought to deduct attorney's fees paid out by the taxpayer for the defense of a corporate officer in a criminal suit for conspiracy to corrupt legislators in connection with legislation introduced. The court, in allowing the deduction, reasoned that the misconduct involved was proximately and directly connected with the taxpayer's business since the legislation sought would have been favorable to its business. However, since there were three vigorous dissents, the continuing validity of the decision is questionable.[54]

These intellectual stumbling blocks are not confined to corporate activities. "White-collar" criminals, especially those in an employer-employee relationship, are also suspect under the foregoing analysis relating to "business-versus-personal" misconduct. The expression "white-collar," although originally used by Professor Edwin Sutherland to designate a class of criminal offenders,[55] has also evolved to denote a variety of business-like crimes:

> White-collar criminality in business is expressed most frequently in the form of misrepresentation on financial statements of corporations, manipulation in the stock exchange, commercial bribery, bribery of public officials directly or indirectly in order to secure favorable contracts and legislation, misrepresentation in advertising and salesmanship, embezzlement and misapplication of funds, short weights and measures and dishonest grading of commodities, tax frauds, and misapplication of funds in receiverships and bankruptcies.[56]

These are specific intent crimes where "cheating, dishonesty or corruption are the central elements,"[57] but they certainly do not exhaust the list of crimes capable of being committed by individuals ostensibly acting in a business capacity. One commentator has distinguished "white-collar crime" from "street crime,"[58] although he offers no criteria to differentiate one kind from the other. Admittedly, corporate or "white-collar crimes" usually are not regarded in the same manner as traditional crimes.[59] For tax purposes, the natural inclination is to draw the line between "white-collar crime" and "street crime" in the same place as between "business misconduct" and "personal misconduct." Consequently, "white-collar crime" is equated with crimes of business origins. This makes a minimal amount of sense because most "white-collar crimes" imply a breach of trust by the businessman often at the monetary loss of another, and hence "income" for tax purposes of the tax laws.

However, "white-collar crime" may also be viewed as a form of theft, a notorious "street crime," or "personal misconduct."[60] A careful examination of the examples listed above reveals at least one "white-collar crime" which is tantamount to theft: embezzlement. Embezzlement is a dishonest activity which produces income,[61] but the crime itself, from the embezzler's standpoint as an employee performing services for his employer, attempts to control non-business endeavors. It is personal misconduct which occurs in a business setting; it is an unauthorized, intentional taking from the business in contravention of the employee's duties. That embezzlement is included in the list of "white-collar crimes" suggests that there is an element of "personal misconduct" involved in the commission of many, if not all, of the "white-collar crimes," especially those that are not engaged in for a profit. This element of personal misconduct, although perhaps in some instances resulting in financial gain, should

executives decide that arson would be the most effective means. A secret resolution is passed and then implemented. The competitor goes out of business. Whether antitrust tactics or arson is used, the intention is to increase profits. Assuming that the corporation would be held liable for arson, can it be said that the arson in this hypothetical case stands on the same legal footing as a campaign contribution with respect to its "origin"?

[53]21 T.C. 659 (1954).

[54]There are no recent reported cases on this point.

[55]E. SUTHERLAND, WHITE COLLAR CRIME (1949).

[56]E. SUTHERLAND, *White-Collar Criminality—1940,* in THE SUTHERLAND PAPERS 48 (1956) [hereinafter cited as E. SUTHERLAND].

[57]Ogren, *The Ineffectiveness of the Criminal Sanction in Fraud and Corruption Cases: Losing the Battle Against White-Collar Crime,* 11 AM. CRIM. L. REV. 959 n.1 (1973).

[58]*Id.* at 960.

[59]Geis, *Criminal Penalties for Corporate Criminals,* 8 CRIM. L. BULL. 377, 384 (1972). For instance, Geis points to the lenient treatment accorded white-collar criminals in sentencing.

[60]A convicted larcenist probably would not impress a tax court with the argument that he should be allowed to deduct his legal fees because they were incurred in defense against a prosecution for a crime arising out of a profit-seeking activity. *But see* notes 69–75 and accompanying text *infra.*

[61]*See* note 70 and accompanying text *infra.*

not be ignored when adjudging whether the crime has truly "arisen in connection with business activities."[62]

Adding Content to the "Origins" Test

In the previous section, an attempt was made to suggest guidelines for limiting the application of the "origins" test to crimes which truly have a business origin. In the course of the discussion, several existing distinctions of questionable validity were mentioned, and a few new ones were raised. In drawing these subtle distinctions and in failing to draw real ones, the courts have yet to formulate a satisfactory test for determining when a crime "arises in connection with business or profit-seeking activities." This society tends to rely on criminal sanctions when other methods of social control fail.[63] As more and more forms of misconduct are criminalized and prosecuted, each one will have to be fit into the "origins" test if the taxpayer-defendant claims a deduction for litigation expenses. Therefore, it is important for the administration of the tax laws to develop a test for deductions which can handle the problems in a fair and equitable manner.

A common thread running through many of the crimes discussed above, such as the Sherman Antitrust Act and involuntary manslaughter, is that they could be expected to arise substantially as a matter of course during the life of the business. Although the enforcement of each may vindicate a vastly different public interest, from the tax point of view they represent a "cost of doing business." In other words, certain conduct which leads to criminal liability is "integral" to carrying on the trade or business.[64] A crime is not "integral" in the sense that one would expect the business to commit it, but that when the crime does occur, it was committed in the regular course of the business. As a result, a violation of the antitrust laws has a business origin because its commission is "integral" to the competitor's business activities. The same could probably be said for the white-collar criminal who runs a crooked business. On the other hand, a corporation's illegal campaign contribution or an illegal attempt to influence the vote of its employees at a public election[65] are hardly integral to the operation of any trade or business. Also, when a politician illegally trades a lucrative state construction contract for a few votes or campaign dollars, one is very reluctant to concede that that activity is integral to the business of public service.[66] Nevertheless, the "origins" test

[62]This argument can be extended to the more puzzling situation in which the "white-collar" taxpayer, without an intent to yield a profit of any kind, commits a crime while ostensibly in the performance of his delegated duties. Consider the fate of a taxpayer, a "white-collar" employee of a union or other not-for-profit organization, whose principal duties include the gathering of information of interest to his employer, and whose authority is clothed with a certain amount of discretion. The taxpayer decides to exercise his discretionary powers by instructing an agent to commit a burglary to retrieve information valuable to his employer. Can the taxpayer deduct the cost of his legal assistance in a prosecution for burglary as an ordinary and necessary business expense? The taxpayer's business is that of rendering services to his employer, and therefore his business expenses are deductible by him. Folker v. Johnson, 230 F.2d 906 (2d Cir. 1956); Central Coat, Apron & Linen Service, Inc. v. United States, 298 F. Supp. 1201 (S.D.N.Y. 1969). The crime, although not sanctioned by the employer, was committed by the taxpayer solely in furtherance of his duties of providing information to his employer. It might also be argued that the crime was committed in return for compensation. Thus, it seems that regardless of the approach, the "origins" test would grant a deduction to this "white-collar" criminal for a type of personal misconduct.

[63]*See, e.g.*, Mix, *The Misdemeanor Approach to Pollution Control*, 10 Ariz. L. Rev. 90 (1968); Comment, *The Criminal Responsibility of Corporate Officials for Pollution of the Environment*, 37 Albany L. Rev. 61 (1972). Both authors generally favor the use of the criminal sanction to control air and water pollution.

[64]An "integral" test for use with respect to section 162(a) was suggested by the Seventh Circuit in Allen v. Commissioner, 283 F.2d 785 (7th Cir. 1960). Since the case arose before *Gilmore* and the test appeared in an entirely different factual context, it is mentioned here only to support the terminology employed.

The "integral" test is not meant to supplant the "origins" test, but only to supplement it where deductions are sought for legal expenses incurred in defense of a criminal prosecution.

[65]*See* Vulcan Last Co. v. State, 194 Wis. 636, 217 N.W. 412 (1928). The defendant corporation in Vulcan was convicted of attempting to influence the votes of its employees by threatening to discharge them if they voted contrary to the interests of the company at a referendum election.

[66]Of course, from the construction company's point of view, it may very well be integral to its business, but that does seem to be a cynical position.

The problem of the public official is similar to that of the union employee who commits a crime in furtherance of his duties. *See* note 62 *supra*. Both are committing "non-business regulation" crimes; both seem to be going out of their way to risk prosecution. In light of these facts, arguably their misconduct falls outside the "integral" test for purposes of a tax deduction. Although the union employee may have been acting within the scope of his authority and in furtherance of the employer's ends, it does seem that in *choosing* to violate the law against burglary to perform his duties, the union employee acted in a personal capacity and therefore would not be entitled to a deduction for his legal expenses. The condemnation of "choosing to violate the law" occurs here, and not with respect to corporate officials who conspire to violate the antitrust laws, because of the nature of the crime involved in the latter situation—direct business regulation expected to conflict with the business

alone, which seems to beg the question of "business misconduct," would probably allow a deduction for the legal expenses incurred in defense of a charge for any of these crimes. The "integral" test, to be used as a standard for determining when a crime "arises in connection with trade or business or profit-seeking activities," adds a rational criterion to the "origins" test.

The superiority of the "integral" test over the unadorned *Gilmore* test is illustrated in several other situations. In *Sproul v. State Tax Commission*[67] the taxpayer sought a deduction on his state income tax return for legal expenses incurred in his successful defense against a murder charge. The taxpayer owned a farm which had only one outlet to the road. That outlet consisted of an easement across Williams' property. When it came time to harvest his crop and take it to the market, Sproul discovered that Williams had blocked the right-of-way. Legal threats failed to remove the blockade, so Sproul, fearing the loss of his crop if immediate action was not taken, confronted Williams at the blockade. There was an altercation, and Sproul killed Williams in self-defense.

Before the tax commission, Sproul asserted that the crime charged arose in connection with his business, and therefore he was entitled to claim the deduction. The court rejected his argument and disallowed the deduction but did not rely explicitly on *Gilmore*.[68] The court reasoned that although the crime may technically have arisen in connection with Sproul's business, his action was so extravagant as to lose its nexus with his business. A more straightforward approach would have been to hold that the homicide was not an "integral" part of his business of farming. In this unusual case, the "integral" test would have provided a more satisfying base upon which the court could have rested its decision than the "origins" test.

It is also not clear how the "origins" test would resolve a claim for a deduction for legal expenses incurred in defense of a criminal presecution for perjury or jury bribery. Suppose that the defendant in *Tellier* had given perjurious testimony before a grand jury investigating his securities activities. Under the reasoning in *Gilmore*, Tellier could argue that the perjury charge had a business origin because it was derivable from the securities violation. However, a possible response is that the perjury charge did not arise from the defendant's business activities, but rather from his false testimony. The interest to be vindicated by the second prosecution relates to a sphere of conduct unrelated to business activities: appearance before a grand jury. Moreover, the defendant probably testified falsely not pursuant to any business purpose, but to avoid conviction of the substantive crime. Under the "integral" test, perjury or jury bribery would surely be ancillary to the operation of any business or profit-seeking activity and hence would not qualify for a deduction. *Gilmore*, which does not contain an "ancillary" exception, offers no easy solution to this problem.

One of the most troublesome applications of *Gilmore* occurs with respect to traditionally personal crimes which generate "gross income." It is quite clear that the Code does not differentiate between lawful activities and unlawful activities for "gross income" purposes.[69] In *James v. United States*,[70] a prosecution for income tax evasion, embezzled funds were held includible in gross income. As the Court stated: "A gain 'constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it.'"[71] So, if all unlawful gains are comprehended within the term "gross income," as was

decisions intermittently. This example illustrates the importance of the concept of "business regulation" crimes under the "integral" test.

[67] 234 Ore. 567, 382 P.2d 99 (1963).

[68] The state tax law pertaining to trade or business deductions was worded identically to section 162(a). One reason that can be offered for the majority's failure to rest its holding on *Gilmore* is that *Gilmore*, dealing with property settlement proceedings, had just been decided, and the majority may have been uncertain as to its applicability in the criminal context. Another reason is that since the decision involved an interpretation of state law, the court probably did not feel constrained to consider *Gilmore* as precedent. The concurring opinion, however, did mention *Gilmore*. 234 Ore. at 578, 382 P.2d at 104 (Sloan, J., concurring).

[69] *See* notes 70–73 and accompanying text *infra*. Neither section 162(a) nor its analogue, section 212, were intended to be used for moral reform. Senator Williams, in charge of the income tax sections of the 1913 bill, said of section 162(a)'s predecessor:

> 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 characters; 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. . . .

50 CONG. REC. 3849 (1913) (remarks of Senator Williams).

[70] 366 U.S. 213 (1961).

[71] *Id.* at 219, *quoting* Rutkin v. United States, 343 U.S. 130, 137 (1952). Thus, even if the defendant is required to make restitution of the money, it is still income.

suggested by *James*, then any activity generating those gains must necessarily be characterized as a form of income-producing activity. Whether the activity falls within section 162(a)'s "trade or business" rubric or section 212's "profit-seeking activity" rubric simply depends on the amount of time and energy that the taxpayer-defendant devotes to the activity.[72] It makes no difference that these are "prohibited activities" because, except for the specific exceptions listed in sections 162(c), (f), and (g) (also read into section 212), these "prohibited activities" are entitled to otherwise proper deductions for ordinary and necessary business expenses on par with legitimate activities.[73] Hence, those activities generally labelled as elements of "organized crime," *e.g.*, gambling, prostitution, racketeering, drug-trafficking, and extortion, logically fall within sections 162 or 212 for deduction purposes.

With regard to a prosecution for the criminal activity itself, the purpose is apparently to deter the income-producing activity. This amounts to a very direct form of business regulation. The crime cannot be distinguished from the income-producing activity itself. Therefore, commission of the crime is clearly "integral" to the carrying on of the illegal business or profit-seeking activity. Since these activities are entitled to deductions on par with legitimate enterprises, the taxpayer-defendant should be allowed to take a deduction for criminal legal expenses incurred in defense of a prosecution for "organized crime."

The court in *Glimco v. Commissioner*[74] recognized this possibility. However, its apparent reluctance to condone such a practice through a literal reading of the Code inspired it to conclude that the taxpayer, a union official in the morning, who extracted money from poultry merchants in the afternoon, had failed to prove that his afternoon activities were part of his employment or were done for the production of income. The court, therefore, denied the taxpayer a deduction for his legal expenses in defense of the extortion charge. The "origins" test theoretically cannot escape the opposite conclusion except upon a failure of proof as in *Glimco*. Of course, defendants charged with profiteering through criminal methods will not readily admit to the receipt of such income, but once convicted, there should no longer be a bar to the deduction of their legal expenses.[75] If the taxpayer-defendant admits the activity, then income from that

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[72] It is always a matter of degree and will vary from case to case. *See* Fischer v. United States, 336 F. Supp. 428 (E.D. Wis. 1971), *aff'd*, 490 F.2d 218 (7th Cir. 1973). If the activity is extensive and amounts to the taxpayer's livelihood, then it is a trade or business. *See* note 13 and accompanying text *supra*.

[73] *See* note 21 *supra*.

[74] 397 F.2d 537 (7th Cir. 1968). Another case with facts resembling those of *Glimco* is United States v. Moore, 96 S. Ct. 335 (1975). In *Moore*, the defendant, a doctor registered under the Controlled Substances Act, 21 U.S.C. § 801 *et seq.* (1970), was convicted of unlawfully distributing methadone in violation of 21 U.S.C. § 841 (1970). The doctor unsuccessfully argued that since he was registered he could not be charged for unlawful distribution under section 841. The Supreme Court reasoned that a registered physician could be prosecuted for violation of the Controlled Substances Act when his or her activities fell outside the usual course of professional practice.

The defendant's tax return was not involved. However, the distinction drawn by the Court between approved and unapproved professional practice might be carried over to the tax arena if the defendant were to claim a deduction for his attorney's fees. It is suggested here that such an analogy would be inappropriate under *Gilmore*. The doctor was making money regardless of which law he was violating. Of course, until the case arises, this is all pure speculation. Nevertheless, *Moore* does sit at the crossroads between criminal law and tax law.

[75] It would be a curious situation if, for instance, the defendant were acquitted on state charges of embezzlement and then sought to deduct the litigation expenses on his federal tax return. Since the state presumably failed to prove the existence of the income-producing activity, at least on that occasion, then perhaps the defendant as taxpayer could not claim to the contrary on his tax return. Except for those situations where the state may have lost on a procedural ground and there would still be evidence of embezzlement, the result seems paradoxical: the taxpayer can win only if he loses as a defendant. The problem revolves around the defendant's proof before the tax court. Although he need not show that his illegal activity realized a profit (*see* note 26 and accompanying text *supra*) the taxpayer must show that he entered the transaction with the good faith intention of doing so. In the context of criminal activity as profit-seeking activity, the only acceptable proof of the requisite intent may be an admission of income. A possible counterargument is that the criminal charge itself asserted that the defendant was engaged in a profit-seeking activity. Since at the time of the expense the outcome was uncertain, the defendant could treat the expense as one allegedly arising out of a profit-seeking activity just as the defendant did in *Tellier*.

If the income is admitted in the tax court, must it also be admitted on the federal tax return? Defendants who fear a federal tax evasion charge more than a state embezzlement charge may as a consequence run the risk of subjecting themselves to a state criminal charge by reporting illegal income and taking valid deductions. *But cf.* Marchetti v. United States, 390 U.S. 39 (1968). On the other hand, if the income is not admitted on the federal tax return and the defendant-taxpayer is charged with criminal income tax evasion, section 212(3) allows him to deduct his legal expenses for that defense regardless of the outcome in any of the other possible suits. Rev. Rul. 68-662, 1968-2 CUM. BULL. 69.

activity subject to tax could easily be reduced via the deduction on the tax return. Nevertheless, it is a peculiar anomaly in the law that theoretically allows a professional criminal filing a tax return to deduct legal expenses and denies the same to a jealous husband who kills his wife's paramour. The enlightened solution, based on sixth amendment considerations, would be to allow a deduction to both.

A Possible Judicial Response

Thus far the analysis has been concerned with developing a rationale, consistent with present tax theory, for handling the deductions of criminal defense expenses. The focus will now shift momentarily to an examination of the *Gilmore* test from a criminal defendant's perspective. Even a moment's reflection on the judicial treatment of legal expenses incurred in defense of a criminal prosecution reveals some significant inequities.

As *Gilmore* is presently applied, it results in disparate treatment for essentially like defendants in the tax arena. If the taxpayer-defendant has been charged with a crime arising in a business setting, the "origins" test assumes that it has arisen out of his business or profit-seeking activity and all legal expenses incurred are deductible. No attempt is made by the courts to establish a nexus between the commission of the crime and the actual production of income. On the other hand, for the taxpayer-defendant charged with a crime allegedly arising solely out of personal misconduct (as opposed to business misconduct), the legal expenses are not deductible. But, absent a showing that there is a nexus between the crime charged and the taxpayer-defendant's endeavors to produce gross income, all misconduct is equally "personal." This inequity is most visible when it arises with respect to the same crime. Consider the respective fates of two taxpayer-defendants in the same income tax bracket, each faced with a criminal prosecution for violating the Rivers and Harbors Act.[76] Taxpayer *A*, while taking a pleasure cruise, is charged with dumping refuse matter into a navigable waterway in violation of section 407. Taxpayer *B*, while entertaining business guests on his yacht, is charged with the same violation.

In the eyes of the tax court, *B*'s conduct neatly comforms to the requirements of the Code, so *B* gets a tax deduction for his legal expenses. *A* is deprived of any tax benefit whatsoever. Viewed comparatively, taxpayer *A* is saddled with a sanction in addition to the one imposed by the violation itself: increased financial burden. However, at the criminal trial, proof of a violation of Rivers and Harbors Act does not entail a showing of "business misconduct." From the standpoint of the pollution law's non-business objective of maintaining the purity of the nation's water, *A* and *B* are treated similarly as due process and equal protection dictate that they must. It is only when the criminal activity is placed in the tax law context of "business" that due process and equal protection requirements cease to have any meaning for criminal defendant *A*. The crucial question is whether the constitutional protections afforded the defendant in the criminal law arena can be extended to the defendant in another legal context.

It is highly unlikely that a tax court would look favorably upon such an argument on behalf of taxpayer *A*. Due process and equal protection attacks on the Code by taxpayers have generally met with little success in tax cases.[77] Criminal defendant-taxpayers have done no better. In *Messina v. United States*[78] the taxpayer-defendant had been found guilty of several sex perversion charges. In appealing

[76] 33 U.S.C. § 411 (1970) makes violation of 33 U.S.C. § 407 (1970) a misdemeanor. Section 407 provides:

> It shall not be lawful to throw, discharge, or deposit, or cause, suffer, or procure to be thrown, discharged, or deposited either from or out of any ship, barge, or other floating craft of any kind ... any refuse matter ... into any navigable water of the United States ....

Sections 407 and 411 also apply to corporations. Although it has been assumed, *arguendo*, that a businessman or corporation would be allowed a deduction for legal expenses incurred in defense of a prosecution for a violation of section 407, the resolution of that issue is by no means clear. 33 U.S.C. § 1151 (1970) expresses the intent of the pollution laws which is to enhance the quality of the nation's water resources. The water pollution laws, then, basically seek to punish wrongful conduct that bears no intrinsic relationship to business activities in some circumstances. It has not been argued thus far that the legislative intent of the criminal law in question should *control* the determination of whether the crime has a business origin. But, if the purpose of the law is essentially non-business regulation, and applies to individuals and corporations alike, then perhaps the legislative intent should be a relevant factor to be considered under the "integral" test.

[77] The typical response to a constitutional attack is that income tax laws are not unconstitutional under the due process clause of the fifth amendment, nor are they unconstitutionally defective because of discriminatory progressive tax rates. Brushaber v. Union Pacific R.R., 240 U.S. 1, 24-25 (1916). *See* H. Black, Income and Other Federal Taxes 13 (4th ed. 1919); J. Henderson, Introduction To Income Taxation 47 (2d ed. 1949). Technically, the equal protection clause applies only to state action. Detroit Bank v. United States, 317 U.S. 329, 337 (1943). However, the equal protection principles are subsumed in the fifth amendment's due process clause, applicable to the federal government. Schneider v. Rusk, 377 U.S. 163, 168 (1964).

[78] 202 Ct. Cl. 155 (1973).

the disallowance of his tax deduction for legal expenses, Messina offered two constitutional arguments to the court: (1) Since he was not an indigent, he had to pay his attorney out of after-tax dollars, thus producing a "gross inequality"; and (2) the "business-versus-personal" distinction drawn by the courts and the Code also produced a "gross inequality." The court rejected both arguments, the first by saying that a system of taxation which discriminates on the basis of income is not so wanting a basis for classification as to produce a gross inequality.[79] The court rejected Messina's second argument by holding that the business-versus-personal distinction confronting the taxpayer does not produce a "gross and patent inequality" because Congress has chosen to grant only business deductions and deductions are a matter of legislative grace.[80] But the court's rejection of the taxpayer's second constitutional argument ignores a crucial fact: since Congress has never mentioned legal fees explicitly, deductions for them in reality amount to an exercise of "judicial grace." The degree of "judicial grace" dispensed is solely a function of the interpretative test employed by the court in ascertaining deductibility. The court's reply also overlooks the previously mentioned possibility that like criminals can be treated unequally depending upon the economic circumstances surrounding the commission of the crime, even though those economic circumstances may in fact bear no close relationship to the actual motivation underlying the commission of the crime. In such a case, the "business-versus-personal" distinction would collapse.

Although it may not be feasible to make constitutional attacks on the policies underlying the Code, criminal defendants might be more successful by emphasizing that the problems occur because of the courts' insistence on employing the "origins" test under sections 162 and 212 for criminal defense expenses. In justification of the present approach, the court in *Nadiak v. Commissioner*[81] commented: "A test which makes consequences determinative would be unwise because it would 'carry us too far' and result in unequal treatment of like taxpayers."[82] Presumably, the court meant that if a "consequences" test were employed, a taxpayer who is charged with "personal misconduct," a conviction for which would damage his trade or business or profit seeking activity, is placed in a more favorable tax position than is a taxpayer who is charged with the identical crime but for whom there would be no adverse business consequences. So, to avoid what it perceived to be an irrational distinction, the *Gilmore* Court with its "origins" test shifted the emphasis to the other end of the sequence of events. The setting of the crime became the sine qua non of deductibility and adverse business consequences became irrelevant. Does the "origins" test actually eliminate the unequal treatment? Assume that a taxpayer-defendant is confronted with a relatively minor criminal offense arising out of personal misconduct, which nevertheless could seriously damage his business if it resulted in a conviction (as in *Nadiak*). Isn't it more likely than not that a vigorous and expensive defense can be best explained by grounding it in a genuine fear of adverse business consequences rather than a personal concern for the outcome? Yet, the "origins" test does not recognize this reasoning and would deny the deduction. On the other hand, the "origins" test would allow a deduction for legal expenses incurred in defense of a criminal prosecution for "personal misconduct" masquerading as "business misconduct," such as illegal campaign contributions.[83]

Moreover, it is arguable that any criminal defense to a charge of personal misconduct is maintained to protect a certain kind of property held for the production of income, namely, one's own person. The legal consequences of a criminal conviction often entail the possibility of a prison term. In many cases, such incarceration is an absolute bar to the production or collection of income. Even the conviction (or in some cases the trial) itself generates enough social opprobrium to stigmatize the taxpayer in the conduct of his business. Hence, there certainly are enough dire business consequences accompanying a criminal conviction to support the proposition that any criminal defense for personal misconduct can be dominated by business motives. Theoretically, a crime with business origins is induced by business motives and defended for business reasons although no attempt is ever made in the cases to ascertain the validity of this proposition.[84] If business motives are sufficient to make the defense to a business-related crime an ordinary and necessary business expense, even those crimes that have been characterized as non-integral, then why are business motives not enough for a defense to a "street crime"?[85] If there

[79] *Id.* at 160–61. No attempt will be made here to question the constitutionality of progressive tax rates in the Code.

[80] *See* note 38 *supra.*

[81] 356 F.2d 911 (2d Cir. 1966).

[82] *Id.* at 912.

[83] *See* note 66 *supra.*

[84] *See* notes 48–61 and accompanying text *supra.*

[85] *See* note 19 *supra.*

are inherent business aspects to any criminal defense, then the solution benefiting all criminal defendants is to devise a test for deductibility that takes this into account.

The shortcomings of the "origins" test argue persuasively for the adoption of a more equitable and liberal "consequences" test for use in the criminal sphere. While the "origins" test attempts to categorize crime and therefore has no direct relation to the actual expense incurred, the "consequences" test looks to the reason for the expense itself. The latter seems to be more congruous with tax analysis. However, the "consequences" test as presently formulated requires a determination that the trial or the conviction would have actual adverse consequences on the defendant's trade or business or profit-seeking activity. Because of the inherent difficulties in proving such an impact, especially where the crime arises out of allegedly personal misconduct, it is suggested that the new rule contain a conclusive presumption of adverse business consequences to circumvent these evidentiary problems.[86] The practical result is, of course, a deduction in every instance.

Theoretical and Policy Considerations Supporting a Change in the Code

If the courts refuse to alter the standard currently utilized to determine the deductibility of legal expenses for criminal defenses by broadening its scope to include all criminal defendants, the next alternative is a revision of the Code. Since the Code forbids the utilization of the tax laws to frustrate sharply-defined national or state policies proscribing particular types of conduct,[87] the deductibility of legal expenses incurred in the defense of a criminal prosecution must not be against public policy. Allowing deductions for legal expenses incurred in defense of a criminal prosecution, even an unsuccessful one, can never be against public policy. As the Court said in *Tellier*:

> No public policy is offended when a man faced with serious criminal charges employs a lawyer to help in his defense. That is not "proscribed conduct." It is his constitutional right . . . In an adversary system of criminal justice, it is a basic [sic] of our public policy that a defendant in a criminal case have counsel to represent him.[88]

This reasoning was essentially a refutation of the non-deductibility position of the Internal Revenue Service in cases where the defendant had been convicted. Before *Tellier*, the IRS's position was as follows:

> When the business or the activity out of which the expense grew is illegal or against public policy, the expense is not ordinary and necessary since it is not ordinary and certainly not necessary to conduct illegal activity or to act against public policy; therefore it is not ordinary and necessary to defend such activity and therefore legal fees incurred in this defense are unnecessary.[89]

To maintain it is not ordinary or necessary to defend against illegal activities puts the cart before the horse. A criminal defendant enters the criminal adversary system with a presumption of innocence.[90] That presumption legitimizes any defense and negates any detrimental effect on public policy. And, this public policy rationale provides support for any broadening that might be suggested for deducting legal expenses. In the absence of judicial reformation, the next problem is finding evidence in the existing Code to support a general deduction for legal expenses.

In the past legal expenses have been analogized to medical expenses.[91] The provision in the Code authorizing a personal deduction for medical expenses,[92] enacted in 1942, has generally been

[86] There is no compelling reason why the "origins" test should not be retained for civil litigation. There the connection between the claim asserted and the business consequences anticipated may be much more tenuous or even non-existent.

[87] *See* Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958). In *Tank Truck Rentals*, deductions for fines paid for violations of state law were disallowed on the basis of public policy. Allowance of the fines would have meant that the taxpayer could have avoided the sanction imposed by the law violated. Paying the fine and then deducting it as a business expense would have become a way of doing business. The Court refused to authorize such a practice. This rationale was incorporated into section 162 (f) of the Code. *See* note 9 *supra*.

[88] 383 U.S. at 694-95.

[89] Comment, *Deductibility of Attorney's Fees Incurred in Defense of a Criminal Prosecution*, 13 Stan. L. Rev. 92, 98 (1960).

[90] Deutch v. United States, 367 U.S. 456, 471 (1961); *cf.* Morissette v. United States, 342 U.S. 246 (1952).

[91] Note, *A General Practitioner's Guide to the Deductibility of Attorney's Fees*, 5 Ga. L. Rev. 751, 782 (1971); Note, *The Deductibility of Attorney's Fees*, 74 Harv. L. Rev. 1409, 1428 (1961).

[92] Section 213 (a) provides:

> There shall be allowed as a deduction the following amounts, not compensated for by insurance or otherwise—
>
> (1) the amount by which the amount of the expense paid during the taxable year (reduced by any amount deductible under graph (2)) for medical care of the taxpayer, his spouse, and dependents (as de-

well-received.[93] The emphasis on good health and society's confidence in medical services has led to the position that no one should forego medical treatment because of inadequate financial resources. The purpose of the medical expense deduction is to provide relief for those medical expenditures thought to be abnormally large in relation to the taxpayer's income.[94] It is thought that these expenses are often unpredictable, involuntary, and, on occasion, disastrously large.

Legal expenses incurred in defense of a criminal prosecution can, to a certain extent, be similarly characterized. For an innocent person wrongfully accused, the expenses are clearly both unpredictable and involuntary. For an individual ultimately convicted, the presumption of innocence creates an involuntary aspect to the ordeal, and the amount expended for legal expenses depends on the length of the trial and the complexity of the case. Depending on the nature of the charge, a matter within the discretion of the prosecutor in many instances, legal fees can reach an astronomical level and become as much of a hardship to the taxpayer as any medical expense. Even for a defendant who merely pleads guilty to a felony, legal fees still range from $500 to $1500.[95] Because of the many alternatives available to civil litigants,[96] the factors of unpredictability, involuntariness, and amount can often be minimized and consequently justify a difference of treatment for civil litigation expenses. But, the distinctions between health and liberty do not seem to be sufficient to justify the difference in treatment accorded these two types of expenditures.

Analogizing legal expenses to medical expenses does expose the former to certain policy objections levelled at the latter. The medical expense deduction is sometimes viewed as a hardship provision designed to relieve the burden on the ill.[97] A "hardship" provision of this sort does not further any *tax* policy and must be contrasted with "tax hardship" provisions for business activities.[98] A common criticism of tax deductions in general is that the Code is an inferior device for implementing extraneous *social* objectives such as "personal hardship" provisions primarily because of the progressive nature of the tax rates.[99] Whereas the typical social objective is de-

fined in section 152) exceeds 3 percent of the adjusted gross income, and

(2) an amount (not in excess of $150) equal to one-half of the expenses paid during the taxable year for insurance which constitutes medical care for the taxpayer, his spouse, and dependents.

INT. REV. CODE OF 1954, § 213 (a).

[93] *See, e.g.*, R. GOODE, THE INDIVIDUAL INCOME TAX 166 (1964).

[94] *Id.* at 165.

[95] Blumberg, *Lawyers With Convictions,* in THE SCALES OF JUSTICE 57 (A. Blumberg ed. 1970).

[96] *See* note 8 *supra.*

[97] *See* 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 247 (1972) [hereinafter cited as SURREY].

[98] *Id.* at 247. "Personal hardship" tax provisions are generally related to involuntary activities or conditions of taxpayers such as the extra exemption granted to the aged or the blind. INT. REV. CODE OF 1954, §§ 151(c), (d). On the other hand, "tax hardship" provisions, pertaining primarily to business activities, include the intangible drilling expenses deduction for oil and the research and development expense deduction. *See, e.g.*, INT. REV. CODE OF 1954, § 174.

[99] In SURREY, *supra* note 97, a "tax incentive" is defined as a tax provision which induces certain activities or behavior in response to the monetary benefit available. SURREY, *supra* note 97, at 246. The investment credit for certain depreciable property is an example. INT. REV. CODE OF 1954, § 38.

Surrey *et al.* offer an elaborate criticism of the "tax expenditure" budget concept in the federal income tax system. *See* SURREY, *supra* note 97, 240–73. According to the authors, "tax expenditures" include not only exclusions from income, but also deductions, credits, exemptions, deferrals, and preferential rates. *Id.* at 240. They argue that these special provisions amount to indirect government subsidies having no relation to the tax structure itself.

Surrey *et al.* begin their criticism of the "tax expenditure" budget concept by exposing some of the mistaken notions about it. First, while it cannot be denied that there is little government supervision under such an arrangement, direct governmental programs could be designed with the same feature. Second, private decision-making would be no more advanced by an indirect subsidy than a direct one because the government could release its monies with no questions asked.

It is also pointed out that tax incentives permit windfalls for taxpayers who would have undertaken the activity anyway. *Id.* at 261. However, this claim is directed more at the provisions encouraging certain types of behavior rather than those designed to relieve personal hardships. It is also mentioned that the upside-down benefits result from the use of graduated tax rates.

In comparing the relative advantages between "tax incentives" and direct assistance programs, the authors find much is lost by employing the "tax incentive" method. The executive agencies that ordinarily would be responsible for the accomplishment of the social goal involved are deprived of any control over the administration or budgeting of the program because it is supervised by the tax committees in Congress. Tax committees lack the expertise and insight to deal effectively with the substantive matters contained in the social program. The result of this is an unfortunate decrease in the government's power to control the management of its priorities. *Id.* at 266-69.

Surrey *et al.* further lament that Congressmen seem to vote irrationally for programs structured as tax provisions

signed to aid individuals on the basis of some previously-defined need, an income tax deduction often benefits the rich at the expense of the not-so-rich without reference to need. Thus, a deduction of $100 to an individual in the 50 per cent tax bracket in effect results in a government subsidy of $50 for whatever activity is being encouraged (or hardship relieved), while an individual in the 25 per cent tax bracket in the same circumstances receives a subsidy of only $25. If the expense is fairly constant from bracket to bracket, the deduction aids those least who need it most. This is especially true if the expenditure is occasionally very large, as it can be with respect to medical or legal expenses.

However, the fallacy of the above argument lies in its assumption that allowing deductions for either medical or legal expenses would be implementing a public policy extraneous to the objectives of the Code. One legal commentator, Professor William Andrews,[100] has offered a theoretical formulation of an ideal income tax which argues that the medical expense deduction is consistent with present income tax goals. Under Andrews' system tax burdens are apportioned to the taxpayer's personal consumption and accumulation of real goods and services. Andrews begins his discussion by defining "income" in terms of how receipts (salary and other forms of compensation, interest, rents, etc.) are used by the taxpayer instead of in terms of their source as is presently done.[101] The notions of "consumption" and "accumulation," qualified substitutes for "spending" and "saving," imply a certain measure of advancement of material well-being in Andrews' model. Although the concept of "material well-being" is somewhat nebulous, it connotes a combination of "high standard of living" and "financial security" obtained through expenditures for ultimate goods and services. In any event, the result after tabulating the "consumptions" and "accumulations" provides an index of relative material well-being from which tax burdens are to be distributed. The higher the total, the higher the taxes.

Under Andrews' theoretical construct, however, a deduction would be allowed for any expenditure other than for consumption or accumulation.[102] Andrews asserts that a medical expense can be characterized as an involuntary expenditure, and not as a type of consumption, because it puts the taxpayer back to where he should have been. It can be analogized to a loss of earnings, a setback from which there is no recovery. Andrews concludes, then, that above a certain normal level, medical expenses should be regarded as a reduction of an individual's freely disposable income (for consumption and accumulation) and hence a reduction in his ability to pay taxes relative to others with the same initial potential.[103]

The close analogy between medical expenses and legal expenses incurred in defense of a criminal prosecution strongly suggests that from Andrews' theoretical point of view the latter should be treated like the former in the Code. If the goal is to apportion tax burdens fairly, *i.e.*, on an ability to pay, then the granting of a deduction for legal expenses within the present structure of graduated rates is consistent with tax policy. Of course, particular legal or medical expenses are, to a certain extent, a function of voluntary personal gratification. Consequently, for taxpayers able to pay regardless of cost, a deduction for legal expenses would, on occasion, financially reward personal choice by subsidizing an unnecessary expense. If the objective is to grant the deduction on the basis of need, the question then becomes whether or not to penalize a taxpayer simply because he elects to pay more than is required to conduct an

which they would reject as direct expenditures. *Id.* at 271. Moreover, businessmen allegedly respond to tax credits but not to other forms of government assistance. *Id.* But, regardless of the truth of the assertion, the authors believe that properly publicized direct government assistance programs could eliminate business suspicion.

From all of this, it is concluded that the best approach to a new situation is to first explore the various direct expenditure alternatives.

For a lively debate of Surrey's criticism of the tax expenditure budget concept see Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget, 22* NAT'L TAX J. 244 (1969); Surrey & Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker,* 22 NAT'L TAX J. 528 (1969); Bittker, *The Tax Expenditure Budget—A Reply to Professors Surrey & Hellmuth,* 22 NAT'L TAX J. 538 (1969).

[100] Andrews, *Personal Deductions in an Ideal Income Tax,* 86 HARV. L. REV. 309, 313 (1972) [hereinafter cited as Andrews].

[101] *Id.* at 313. Under the Code, "gross income" means all income from whatever source derived. INT. REV. CODE OF 1954, § 61(a). Andrews' definition is an elaboration of the one suggested by Henry Simons in H. SIMONS, PERSONAL INCOME TAXATION 50 (1938). Andrews contends that his approach is consistent with the intended effect of of the income tax: to reduce consumption to free money for public use. Andrews, *supra* note 100, at 313.

[102] Andrews, *supra* note 100, at 325.

[103] *Id.* at 336. The taxpayer who misses work due to illness suffers a loss of earnings. The loss of earnings results in a reduction of income subject to tax. Similarly, an individual who incurs medical expenses loses a certain amount of disposable income, so his taxes are reduced as well. *See also* R. GOODE, THE INDIVIDUAL INCOME TAX 166 (1964).

adequate criminal defense. But, even if there is a correlation between the defendant's income tax bracket and the amount he can and will spend on a criminal defense, his tax-paying ability will be reduced. And, it seems that as long as the taxpayer has a free choice of legal services, the problem of controlling personal expenditures for legal services will persist regardless of what general solution is pursued. Moreover, especially in light of the difficulties in determining the cost of an "adequate defense," differences in expenditures could also imply differences in need. And finally, with respect to legal expenses, it does seem reasonable to proceed upon the assumption that a criminal trial is a burden where heavy costs make every victory a Pyrrhic one, and, consequently, any difference in result caused by large expenditure is counterbalanced by the psychological and financial losses.

A more pragmatic objection to deduction for legal expenses must be considered. Allowing a deduction for the cost of defending a criminal prosecution under the present tax structure might prompt high-income taxpayers to engage in illegal activities or to prolong hopeless defenses because the cost of defense would be negligible. Of course, such strategies may already be undertaken with respect to crimes qualifying under *Gilmore*. But, what possible benefit could there be to the taxpayer in a situation where one's liberty or property must be jeopardized in order to claim a tax deduction? Likewise, indigents who commit crimes are probably no more inclined to do so because legal representation subsequent to the arrest will be free.[104]

However, even to the extent that this is a realistic assumption, the separate issue remains whether to permit the additional sanction of non-deductibility of legal fees regardless of the tax bracket of the individual or the nature of the crime. The imperfections in the administration of the criminal justice system should not influence an attitude toward tax law reform to comport with the goals of the system. Since statistical evidence is unavailable, one can only speculate as to the number of taxpayer-defendants of modest means who have been discouraged or prevented from effectively defending against prosecutions arising out of personal misconduct because of the anticipated prohibitive costs.[105] To allow an extraneous factor such as cost to influence the functioning of the administration of the criminal justice system prevents the accomplishment of the goals of the system. The prosecution, defendant, and society may lose the benefit of a complete trial, so a full disclosure of the truth is never made.[106]

A New Proposal

It has been seen that an across-the-board tax deduction for legal expenses incurred in the defense of a criminal prosecution would be consistent with both public policy and tax policy.[107] While this conclusion follows from the premises advanced above, it overlooks the fact that still not everyone similarly situated would be treated equally under a liberal expansion of the present tax deduction structure. This comment was originally concerned with the disparate treatment accorded like criminal defendants in any tax bracket when they are in the role of a taxpayer.[108] The focus then shifted to the plight of criminal defendants in a like tax bracket with non-criminal taxpayers.[109] Now, if equality among all criminal defendants with respect to criminal defense expenses, regardless of the defendant-taxpayer's income tax bracket, is the goal, then a simple provision for a uniform flat-rate deduction would be inadequate to achieve that goal. If "equality among criminal defendants" is tantamount to the ultimate social objective of providing effective counsel for all criminal defendants, it could only be attained if free and unlimited access to the most competent legal counsel were made available to each criminal defendant. This ideal is unattainable unless a "socialized bar" is preferred, because so long as the market forces control supply and demand of legal services the wealthy will be able to capture the market and

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[104] *But cf.* Oaks & Lehman, *The Criminal Process of Cook County and the Indigent Defendant*, 1966 U. Ill. L. F. 584, 714–15. Free legal services may increase the number of appeals which are filed.

[105] Other prohibitive costs may also interfere with the proper functioning of the criminal process. In former Vice-President Agnew's television and radio address to the nation, he declared that one of the reasons he declined to "fight for the integrity of his office whatever the cost" following his indictment for federal income tax evasion was to "spare [his] family a great anguish." N.Y. Times, Oct. 16, 1973, § 1, at 34, col. 1 (city ed.). Psychological and financial barriers present serious impediments to an effective defense to a criminal prosecution and should be assuaged.

[106] Several Supreme Court decisions have recognized that the "pursuit of truth" is one of the primary goals of a criminal trial. *See, e.g.*, Michigan v. Tucker, 417 U.S. 433, 454 (1974) (Brennan, J., concurring); Tehan v. United States *ex rel.* Shott, 382 U.S. 406, 416 (1966).

[107] *See* notes 87–106 and accompanying text *supra*.

[108] *See* text accompanying notes 38–86 *supra*.

[109] *See* text accompanying notes 87–106 *supra*.

monopolize the private criminal legal services.[110] Less ambitious proposals will be considered.

One alternative is to have the federal or state governments provide direct funding for defenses of criminal prosecutions.[111] If incorporated into the present structure of public defender programs,[112] a substantial increase in the number and salaries of public defenders, coupled with giving more individuals access to them, would greatly ease the financial burden on many criminal defendants. But, the coveted element of choice of private counsel would be lost. So, the government could also provide a direct subsidy to privately retained counsel. However, both of these suggestions necessitate a more visibly expansive role by the government in private affairs, a political strategem in disfavor in contemporary times.

A second alternative is the pre-paid legal service program.[113] Experiments with pre-paid legal service programs have suggested that there is a substantial unfulfilled need among individuals of moderate means for general legal services,[114] but there is also criticism that there is no empirical data to support this conclusion.[115] While utilization of legal services has increased somewhat under experimental programs, it is thought that participants may be reluctant to pay for legal services that they have not been induced to use or feel they do not need.[116] Typical pre-paid legal services plans reflect this reluctance because they generally do not provide for coverage in case of catastrophic expenses like the legal fees expended in defense of a serious felony charge.[117] In fact, very few pre-paid legal service programs provide for comprehensive coverage.[118] The last, and perhaps the most crippling criticism of pre-paid legal services programs as they are presently designed, is that they are fraught with legal problems.[119]

This reluctance on the part of an individual to pay for something that he does not think he needs or would not use hampers the development of commercially-sponsored legal insurance also. Most people probably would not insure themselves against the risk of a serious criminal charge because of the slight possibility of one ever being brought against them.[120] It is this refusal to hedge against legal expenses generally, and criminal legal expenses specifically, that have impeded insurance companies—there simply are not enough major legal expenses to make a legal insurance package marketable.[121] The point is that if the public is relatively indifferent toward using legal services or for paying for something that it thinks happens (and probably does happen most of the time) only to someone else, then it does not seem to be economically or politically feasible to ask the general public to share the burden of paying for someone else's legal fees beyond what is constitutionally required.

Although a tax expenditure program may be an inferior and piecemeal way of attempting to equalize and ease the financial burden on criminal defendants, it may be the only feasible method available at the present.[122] In drafting a new provision for the Code, care must be exercised to avoid the pitfalls that have plagued other deduction sections of the Code and subjected them to much criticism.[123] The structure must reflect and satisfy the needs of every taxpayer regardless of his income level. Admittedly, individuals without income tax liability will not benefit from

[110] As one commentator has mentioned, there is a major obstacle: the legal profession has never really directed its attentions to the working man and his criminal problems—it caters to business and property interests. Greene, *Prepaid Legal Services: More Than an Open and Closed Case*, 22 CLEV. ST. L. REV. 425, 431 (1973).

[111] This approach would be favored by Surrey. *See* note 99 *supra*.

[112] The federal defender program was established by the Criminal Justice Act of 1964, *now* 18 U.S.C. § 3006A (1970). For comparable state programs see, *e.g.*, CAL. GOV'T CODE § § 27700 *et seq.* (West 1968); ILL. REV. STAT. ch. 34, § § 5601 *et seq.* (1975); N.Y. COUNTY LAW § § 716 *et seq.* (McKinney 1972).

[113] A "pre-paid legal service" is one in which payments are made in advance for the use of legal services in the future. They are generally administered by an organization and operated for the benefit of its members.

[114] *See* F. MARKS, THE SHREVEPORT PLAN 36 (1974) [hereinafter cited as F. MARKS]. The experiment showed that only 54 per cent of the participants had ever been to a lawyer before.

[115] Greene, *supra* note 110, at 430.

[116] B. CHRISTENSEN, LAWYERS FOR PEOPLE OF MODERATE MEANS 67-69 (1970) [hereinafter cited as B. CHRISTENSEN].

[117] The Shreveport Plan provided for a total of $1665 per year in coverage for each member. The plan paid 80 per cent on the next one thousand dollars. Beyond that the participant shouldered the entire load. F. MARKS, *supra* note 114, at 8.

[118] *See* Murphy, *Buy Now—Receive Later: A Vision of the Future*, 11 TRIAL 12, 13 (1975) [hereinafter cited as Murphy]. Of the several thousand group plans presently in operation, only fifteen offer substantial legal benefits paid for in full.

[119] There are significant ethical considerations, antitrust laws, insurance regulations, and income tax laws blocking the pathway to experimentation. *Id.* at 15-17.

[120] B. CHRISTENSEN, *supra* note 116, at 67.

[121] In a similar vein, another commentator states: "No plans [for pre-paid legal services] are now offered to individuals in the general public." Murphy, *supra* note 118, at 13.

[122] One must depend on Congress to enact something indirectly that they probably would not enact directly. *See* note 99 *supra*.

[123] *See* note 99 and accompanying text *supra*.

any personal deduction provision. But, for the bottom 20 per cent of the income scale, there are the various federal and state defender programs.[124] Since the most affluent 10 per cent of the citizens of this country have never had any difficulty in supplying themselves with legal services, the primary concern must lie with the middle 70 per cent.

The most enlightened amendment to the Code would entail a tax credit, such as the existing investment tax credit, instead of the more indirect deduction.[125] A tax credit provides for a dollar for dollar reduction from tax liability, while a deduction is tied to the income level. The credit must be large enough to make it valuable regardless of the level of the expenditure. Alternatively, a personal deduction provision could be designed with a diminishing rate structure, probably best conceptualized as an inverted pyramid. However, since the goal is to provide protection for all taxpayers, the taxpayers in the higher income levels must be given a deduction equal to what they would have gotten under the present calculations. It is admitted that neither proposal would cure all the defects in the present system, but either would significantly reduce some of the existing inequities.

One broad objection to this proposal would be that the inequities being combatted are more theoretical than real. It is true that any change will have only a minimal effect on corporations because *Gilmore* has been giving them a tax deduction all along, even when perhaps unjustified. But, society has been conditioned to believe that individuals in the middle income brackets, usually Sutherland's white-collar workers, commit little crime.[126] When they do commit crime, the mythology claims that the crimes are "white-collar crime" of a "business origin" anyway, so the allegedly forsaken middle-income taxpayer-defendants have been getting a tax deduction for legal expenses all along. This contention is vigorously disputed, but it is admitted that there is also no evidence to support the contrary position.[127] It does seem that individuals in the middle and upper income brackets commit "street crimes," or are at least accused of them—"street crimes" are not reserved for the bottom 20 per cent. If they commit them in significant proportions, then consideration of their plight is warranted. But, even if it happens rarely, the sixth amendment suggests that some mechanism should be developed to assure that there is an effective right to counsel for every criminal defendant.[128]

CONCLUSION

This comment has presented a broad survey of the law pertaining to tax deductions for legal expenses incurred in defense of a criminal prosecution. It was

[124] *See* note 112 *supra*. Public defender programs have not escaped criticism. *See, e.g.*, Oaks & Lehman, *The Criminal Process of Cook County and the Indigent Defendant*, 1966 U. ILL. L. F. 584.

[125] *See, e.g.*, INT. REV. CODE OF 1954, § 38. This section provides for a tax credit of 7 per cent on certain depreciable property used in a trade or business.

[126] Sutherland designated the persons of high socioeconomic status, those who were "respected" or "socially accepted and approved," as "white-collar" workers. *See* E. SUTHERLAND, *supra* note 56, at 51 n.1. There is little empirical data on the proclivity of white-collar individuals toward crime, or the system's response to the white-collar criminal. One study revealed the following information:

> It is interesting that "white-collar" criminals do not appear to have the extensive immunity to prosecution that sociologists have believed. During 1964 the probation division [of the group of courts studied] investigated 3,643 persons; of these approximately 8 per cent, by virtue of their education, occupation, income, and nature of their offense, would qualify as "white-collar" criminals. While these offenders might ultimately have fared better by plea or sentence, they could not by virtue of a more favorable social position overcome the organizational mechanism of the court entirely—contrary to a rather shopworn notion among criminologists. In addition, the probation division collected more than $250,000 in restitution money during that year, a substantial amount of that sum being amounts returned to their victims by "white-collar" offenders.

A. BLUMBERG, CRIMINAL JUSTICE 40–41 (1967). Of course, this excerpt reflects a mixing of white-collar criminals who committed some form of business misconduct with those who committed some form of personal misconduct. Hence, it is impossible to determine what portion of the 8 per cent could have taken a deduction for their legal expenses. But, the study does show that individuals who must pay for the services of a lawyer out of after-tax dollars are being prosecuted.

[127] Inquiries to the American Judicature Society, American Bar Foundation, Law Enforcement Assistance Administration, and National District Attorney's Association received the same response: nobody collects demographic information pertaining to socioeconomic status of criminal offenders.

Approaching the problem from another angle does produce some results. In an empirical study of the effectiveness of privately-retained counsel versus public defenders, Dallin Oaks and Warren Lehman examined the type of representation employed by criminal defendants in all felony cases in Cook County, Illinois, in 1964. Oaks & Lehman, *Lawyers for the Poor*, in THE SCALES OF JUSTICE 92 (A. Blumberg ed. 1970). Of the 5,579 indictments, 3,140 or 56 per cent were defended by privately-retained attorneys. Of this group 95 per cent were paid by their clients. *Id.* Although it is impossible to determine what portion of this 56 per cent would benefit from a tax credit, further investigation does seem to be in order.

[128] A person accused of a crime, regardless of his financial station in society, is entitled to effective counsel at trial. Santellan v. Beto, 371 F. Supp. 194, 197–98 (S. D. Tex. 1974).

seen that a taxpayer is entitled to a deduction for his legal expenses paid out in defense against a criminal charge only if the crime arose in connection with taxpayer's trade or business or profit-seeking activity. However, the vagueness of the "origins" test in the criminal context makes its application uncertain to many types of crimes. And, because the application occurs on a tax return, rarely reviewed by anyone beyond the Internal Revenue Service, its uncertainty is even more pronounced. But, it does seem implicit from the few cases available for study that there is a tendency by the courts to be generous with corporations and white-collar taxpayers. It was argued that this generosity is unjustified in those instances where corporations or white-collar businessmen engage in illegal personal undertakings under the guise of business conduct. It was also suggested that perhaps the courts and the IRS are too demanding of taxpayers charged with crimes arising from profit-seeking activities. To remedy this uneven treatment, an "integral" test for determining the "origin" of a crime was proposed. The "integral" test looks to the purpose of the crime and the inherent risk it creates for the taxpayer in the operation of his trade or business or profit-seeking activity: Under it, a corporation's deduction for legal expenses incurred in defense of a criminal charge for an illegal political contribution would be disallowed; that of a taxpayer tried for extortion would be allowed.

The focus of the comment then shifted to an external examination of the tax deduction policy from the criminal defendant's perspective, particularly that of the individual charged with a so-called "crime of personal misconduct." In furtherance of equitable treatment of criminal defendants, a judicial revamping of the existing rules for tax deductions for criminal legal expenses was called for. It was noted that criminal defendants, facing identical criminal charges, would face dissimilar tax consequences depending on the economic setting of the crime. Finding that somewhat disturbing, it was then demonstrated that the "business-versus-personal" distinction is highly artificial in the criminal context; there are personal aspects to a business-related crime, but business aspects to probably all criminal defenses. Recognizing the inherent business aspects to a criminal defense, *i.e.*, avoidance of adverse business consequences if convicted, a "consequences" test ultimately allowing an across-the-board deduction was proposed.

Conceding that adoption of a new judicial test is unlikely, a solution for the plight of the criminal defendant saddled with heavy legal expenses was sought in an amendment to the Code itself. Two suggestions were advanced. The first, consistent with present tax policy and public policy, argued for the passage of a legal expenses deduction analogous to the existing medical expenses deduction. The second, extension of the first adding sixth amendment policy considerations, argued for a tax credit or similar provision for criminal legal expenses. The latter is preferred as a better implementation of the basic goal of relieving the financial burden confronting every criminal defendant. However, not until criminal defendants are treated in a uniform manner can it truly be said that due process is applied in practice, and that the right to effective counsel is within everyone's grasp.