

Tax Deductions and Public Policy

By Jeffrey A. Galant

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Public policy continues to inform the interpretation of applicable law, including the tax law. The language of a tax provision is obviously key to understanding its meaning and, perforce how it should be applied. Section 162 of the Internal Revenue Code of 1986, as amended (“IRC”), provides for the deductibility of “ordinary and necessary expenses paid or incurred in carrying on a trade or business.” IRC section 165 allows individuals to deduct losses incurred in a trade or business, or in a transaction entered into for profit, as well as certain casualty losses. The principles underlying a particular policy may influence how the language of such provisions should be interpreted, including whether such principles should in effect override the actual language of a provision. This is clearly the challenge when competing policies are at stake.

Tank Truck Rentals

Competing policies concerned *Tank Truck Rentals, Inc., v. Commissioner*, 356 US 30 (1958) (“*Tank Truck Rentals*”). In *Tank Truck Rentals* penalties and fines imposed on the taxpayer for violating state maximum weight laws were held by the Supreme Court to not be deductible as “ordinary and necessary” business expenses because allowing a deduction would frustrate clearly articulated public policy. That is, were such deductions allowed it could reduce if not eliminate the “sting” of the penalties and fines imposed by various states to protect highway safety by discouraging law violations in the first instance. The competing policy here, of course, is that the income tax law is based on taxing net rather than gross income.

Justice Clark explained the balancing of the competing policies as follows: “... Congress intended to tax earnings and profits less expenses and losses ... carrying out a broad basic policy of taxing ‘net, not gross income. Equally well established is the rule that deductibility under [the predecessor to IRC section 162] is limited to expenses that are both ordinary and necessary A finding of “necessity” cannot be made, however, if allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof. *** ... [T]he test of nondeductibility always is the severity and immediacy of the frustration [of sharply defined national or state policies] resulting from allowance of the deduction. The flexibility of such a standard is necessary if we are to accommodate both the congressional intent to tax only net income, and the presumption against congressional intent to encourage violation of declared public policy [Citations omitted].”

The so-called public policy exception to the business deduction rules under the predecessor of IRC section 162 (i.e., 1939 IRC section 23(a)(1)(A)), as articulated in *Tank Truck Rentals*, was codified in IRC section 162(f) by the Tax Reform Act of 1969. Notably there was no complementary provision added to IRC section 165 with respect to otherwise allowable deductions for losses. However, although not codified, the public policy exception has been held to deny an individual a deduction for losses that are otherwise allowable because e.g., incurred in a trade or business or in a transaction entered into for profit.

Hampton v. Commissioner

A recent iteration of the public policy exception is *Hampton v. Commissioner*, T.C. Memo 2025-32. As a result of pleading guilty in 2013 to bribery, fraud and money laundering in the U.S. District Court for the Southern District of Ohio in 2013, Mr. Hampton was sentenced to 45 months of imprisonment and ordered to forfeit approximately \$2.2 million of property as being

derived from the illicit activities. In 2016, the government executed the forfeiture, by seizing certain bank and brokerage/investment accounts held in Mr. Hampton's name as well as two brokerage/investment accounts that were held in the name of Mr. Hampton's wholly owned corporation, Hampton Capital Management ("HCM"). The HCM accounts totaled approximately \$865,000. HCM was not a defendant in the criminal case.

Mr. Hampton, a registered representative, provided asset management, financial planning and college planning services to institutional and retail clients through three separate broker/dealers. Mr. Hampton received all of the commissions from the broker/dealers in his individual name. None of the commissions were paid to HCM by any of the broker/dealers.

Mr. Hampton's illicit activities began in 2008 when he and his high school friend, who was then the deputy treasurer of Ohio, concocted a scheme to share brokerage commissions derived from securities trades to be made on behalf of Ohio. In effect, they agreed that in exchange for directing to Mr. Hampton a substantial number of such trades, Mr. Hampton would share the commissions with his friend (and two associates of his friend). The payments would be disguised as legal fees or business loans. Between October 2009 and August 2010, Mr. Hampton received total commissions from such trades of approximately \$3.2 million and he paid his friend and the two associates approximately \$524,000.

The Gory Details

The tax year in issue was 2016. The question for the Tax Court was whether the loss incurred due to the seizure from HCM of the forfeited accounts, that was reported on HCM's subchapter S tax return (Form 1120S), could be passed through to Mr. Hampton as HCM's sole shareholder, and reported by him on his individual income tax return (Form 1040).

From 2009 to 2013, Mr. Hampton included commissions that he earned on Schedule C to his Form 1040. However, rather than showing any net taxable income on the Schedule C, he “assigned” the commission income to HCM and deducted on his Schedule C, as a purported ordinary and necessary business expense, the amount of such “assigned” commissions. Basically, he moved the commission income from his personal tax return to HCM’s tax return. Of course, since HCM was an S corporation, the commission income ended up on Mr. Hampton’s personal income tax return as his 100% share of HCM’s income based on his 100% ownership of HCM. Although not an issue for the court, interestingly, a portion of the commission income was treated as wage income on Mr. Hampton’s Form 1040, and said amount was deducted by HCM from its taxable income as “compensation of officers.”

Underlying HCM’s 2016 losses was the government’s seizure of the two investment accounts in connection with the court-ordered asset forfeiture. HCM deducted the balances in the seized accounts, subject to certain adjustments not relevant here, as losses, and passed the losses through to Mr. Hampton as the 100% owner of HCM pursuant to IRC section 1366. Thus, the only issue for the court was whether the taxpayer was entitled to a deduction under IRC section 165 for such losses ostensibly passed through to him by HCM pursuant to IRC section 1366.

Regarding the pass-through of items of income and deductions, including losses, when realized or incurred by an S corporation, such items are passed through by being allocated pro rata among the shareholders, based upon share ownership. Additionally, the character of any such items for purpose of a shareholder’s tax reporting “shall be determined as if such items were realized directly from the source from which realized by the corporation or incurred in the same manner as incurred by the corporation.” IRC section 1366(b).

Without getting too far into the weeds, Judge Copeland held that notwithstanding that the public policy exception to deductibility was only codified for purposes of IRC section 162 regarding ordinary and necessary business expenses, the public policy doctrine continued to apply with respect to the deductibility of losses under IRC section 165. “The public policy exception to deductibility under Section 165 was not explicitly affected by the amendments to Section 162. ...[W]e believe that the public policy considerations embodied in Section 162(f) are highly relevant in determining whether [a payment is] deductible under Section 165.” Citing in part *Stephens v. Commissioner*, 905 F.2d 667, 672 (2d Cir. 1990), *rev’g and remanding*, 93 T.C. 108 (1989).

The taxpayer apparently tried to relitigate the legality of the government’s seizure of HCM’s accounts. According to Judge Copeland the Tax Court lacks jurisdiction over the collateral attack on the forfeiture which was imposed by a federal district court.

Mr. Hampton also argued that HCM should have been respected as an entity separate and apart from the taxpayer and therefore since it was not a defendant in the criminal case its loss deduction for the accounts seized was valid, and therefore the passthrough of the deduction to Mr. Hampton was valid. Not so fast, in Judge Copeland’s view. Judge Copeland found that HCM did not deserve to be respected as a taxpayer apart from Mr. Hampton. That is, since HCM was wholly owned and controlled by Mr. Hampton and basically devoid of independent substance. In this regard, HCM’s only income were the commissions actually earned by Mr. Hampton which he then assigned to HCM. Furthermore, there was insufficient evidence presented that HCM honored general corporate formalities.

Basically, Judge Copeland held that the public policy doctrine barred the deduction for the claimed loss. Mr. Hampton was not allowed the deduction, either directly or through the backdoor, i.e., by interposing HCM as an innocent bystander (blocker entity) and attempting to apply the technical pass-through rules

of the S corporation provisions. Judge Copeland wrote “[t]o hold otherwise would be to frustrate the sharply defined public policy against conspiring to commit offenses against the United States (including ... bribery, ... fraud, and money laundering [citations omitted]”.

Denying Mr. Hampton a loss deduction due to the application of the public policy doctrine was sufficient to end the matter. Interestingly, and mentioned in passing by Judge Copeland, there was no need for the court to address the IRS’ other arguments, e.g., (i) Mr. Hampton lacked sufficient basis in his HCM shares to claim the loss deduction, (ii) HCM was a sham entity and should be disregarded, and (iii) the amounts seized from HCM represented either a distribution or compensation paid to Mr. Hampton.

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