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The Implications of I.R.C. § 280E in Denying Ordinary and Necessary Business Expense Deductions to Drug Traffickers

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THE IMPLICATIONS OF I.R.C. § 280E IN DENYING ORDINARY AND NECESSARY BUSINESS EXPENSE DEDUCTIONS TO DRUG TRAFFICKERS

. . . Bring A Ton of Keys From Puerto Rico
. . .
[T]hese Feds Want Me for Some Tax Evasion[1]

I. INTRODUCTION

Until quite recently, the tax code took a facially neutral view towards the use of deductions and credits by illegal drug traffickers. However, the Tax Equity and Fiscal Responsibility Tax Act of 1982[2] introduced section 280E to the Internal Revenue Code of 1986, as amended ("the Code"). Section 280E denies credits and deductions "for any amount paid or incurred during the taxable year in carrying on any trade or business [that] . . . consists of trafficking in controlled substances . . . ."[3] The language of this provision is applicable only to that portion of the population who choose to earn their livelihood by dealing drugs.

Section 62(a) of the Code defines adjusted gross income as income less certain deductions, including deductions attributable to a taxpayer's trade or business and those permitted under section 162.[4] Section 162 allows deductions for all "ordinary and necessary" expenses incurred in the operation of a taxpayer's business.[5] However, the language of section 280E effectively denies the availability of section 162 business deductions to illegal drug traffickers. Generally, the income tax is not discriminatory as to the nature of income, and the Code imposes a tax on all gross income "from whatever source derived."[6] However, the ultimate effect of section 280E is to impose a

1. LL COOL J, *I Shot Ya (Remix)*, *on* MR. SMITH (Universal/Def Jam 1995). Song on file with author; lyrics *available at* http://www.azlyrics.com/lyrics/llcoolj/ishotyaremix.html (last visited August 25, 2002).

2. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982) (codified in various sections of 26 U.S.C.).

3. I.R.C. § 280E (2000) (indicating that relevant definitions can be found in the Controlled Substances Act or any other Federal or State law).

4. I.R.C. § 62 (2000).

5. I.R.C. § 162 (2000).

6. I.R.C. § 61 (2000).

higher burden of taxation on a drug trafficker's gross income by denying any deductions the drug trafficking taxpayer would otherwise be allowed to take.[7]

Public policy justifications are the basis for the inclusion of section 280E in the Code.[8] However, the section does not conform to the general unbiased functioning of the Code; drug dealers are singled out as a group and are denied access to the normal system of deductions and credits available to "legitimate" business operators. In addition, there is little contemporary evidence to support the alleged public policy justification and the contention that section 280E is effectively deterring the drug problem.[9] This lack of evidence suggests that section 280E is an out-dated provision that should be omitted from the Code.

This Comment will focus on section 280E and the consequences of denying section 162 ordinary and necessary business deductions to illegal drug traffickers. This Comment will begin by examining the historical treatment of illegal income, focusing mainly on the development of the public policy doctrine. Following that will be a discussion of the policy factors underlying the codification of section 280E along with a critical evaluation of the legislation. The ultimate argument will be that section 280E should be omitted from the Code.

II. HISTORICAL ANALYSIS

A. *Prior Legislation and Historical Treatment of Illegal Income*

The drafters of the 1913 Internal Revenue Code, which imposed an income tax similar to that currently in use,[10] specifically avoided stating that the Code would tax only legal income. The Supreme Court has acknowledged that "[d]uring the Senate debate in 1913 on the bill that became the first modern income tax law, amendments were rejected that would have limited deductions for losses to those incurred in a 'legitimate' or 'lawful' trade or business."[11]

7. Since income tax is determined by applying a tax rate to taxable income, denying deductions to gross income will result in a higher net income, which, therefore, will result in a higher tax rate.

8. *See infra* text accompanying note 62.

9. The majority of the statistical analysis dealing with the effectiveness of § 280E was conducted in the mid-to-late 1980s, shortly after the provision was enacted. *See* Jeffery A. Dubin et al., *The Changing Face of Tax Enforcement, 1978-1988*, 43 TAX LAW. 893 (1990); GENERAL ACCOUNTING OFFICE, GENERAL GOVERNMENT DIVISION, TAX ADMINISTRATION: INVESTIGATING ILLEGAL INCOME—SUCCESS UNCERTAIN, IMPROVEMENTS NEEDED (1988).

10. JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 76-77 (1985) (setting forth the general provisions of the former income tax, which is similar to that currently in use, for example, the 1913 tax utilized graduated rates and provided for an initial exemption).

11. Comm'r v. Tellier, 383 U.S. 687, 691 (1966) (citations omitted).

During those debates, Senator Williams (the senator sponsoring the bill) stated that "'[t]he object of the bill is to tax a man's net income . . . . not to reform men's moral characters[;]. . . . [t]he law does not care where he got [his income] from, so far as the tax is concerned . . . .'"[12] Thus, there was an explicit legislative intent that the Code should ignore the underlying source of income for tax purposes.

Subsequent judicial opinions reinforced the idea that the tax code is not concerned with the underlying nature of the income-producing activity when it comes to levying a tax on gross income. For example, in *United States v. Sullivan*, the U.S. Supreme Court held that "the fact that a business is unlawful should [not] exempt it from paying the taxes that if lawful it would have to pay."[13] When dealing specifically with proceeds from illegal drug transactions, courts have found that those proceeds are includable in gross income.[14] In *Wood v. United States*, the Fifth Circuit Court of Appeals recognized "that the gains from illegal activities are just as taxable as gains from legal activities."[15] In recognizing that the income from illegal drug transactions is includable in gross income, courts continue to adhere to the long-standing tradition that the tax code is not concerned with the source of the income.[16] The primary purpose of the Code is still, as originally stated by Senator Williams in the early 1900s, to levy a tax on net income.[17] Also, the Internal Revenue Service (I.R.S.) has continued to acknowledge that all income is taxable, regardless of the legality or illegality of the income-producing activity.[18]

Courts have also recognized that it is important to examine the nature of the tax imposed on illegal income. Although there is no distinction as to the source of taxable receipts[19] and a tax used to raise revenue is valid even if the

12. *Id.* at 691-692 (citation omitted).

13. United States v. Sullivan, 274 U.S. 259, 263 (1927) [hereinafter *Sullivan I*].

14. Wood v. United States, 863 F.2d 417, 418 (5th Cir. 1989); Gambina v. Comm'r, 91 T.C. 826, 829 (1988); Browning v. Comm'r, 61 T.C.M. (CCH) 2053 (1991).

15. *Wood*, 863 F.2d at 419 (applying the actual dominion and control test for determining whether or not proceeds are gain for the purposes of inclusion in gross income).

16. Courts have acknowledged numerous times that income from illegal activities, not just drug trafficking, is includable in gross income, regardless of the legality or illegality of the income-producing activity. *See, e.g.*, *Browning* 61 T.C.M. (CCH) 2053 (holding that § 61 gross income includes gains from illegal activities); Toner v. Comm'r, 60 T.C.M. (CCH) 1016 (1990) (holding that income from massage parlor and prostitution are includable in gross income and the operators or the business are entitled to take business expense deductions); Tech. Adv. Mem. 92-07-004 (Feb. 14, 1992) (advising that "gains acquired by a taxpayer from drug smuggling are includible in the taxpayer's gross income").

17. Comm'r v. Tellier, 383 U.S. 687, 691-92 (1966).

18. I.R.S. Pub. No. 525; Taxable and Nontaxable Income (2001) at 26, *available at* http://www.irs.gov/pub/irs-pdf/p525.pdf (last visited August 24, 2002).

19. Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 429 (1955).

business is conducted in violation of a law,[20] a tax may not impose a higher burden on illegal income and must "be imposed alike on the just and unjust."[21] The Supreme Court has found that one way of imposing a higher tax burden on specific businesses lay in denying business deductions based on the illegality of the business, which, in effect, imposes a tax on the gross receipts while other legitimate businesses are taxed on net income.[22] Yet, section 280E accomplishes just this effect; in denying deductions to drug traffickers, those taxpayers are subjected to a tax on almost all of their net income.[23]

Although the courts, the legislature and the I.R.S. historically have been willing to ignore the nature of the business when levying a tax on income, that blind eye comes into sharp focus when confronting attempts to take business deductions under section 162. Uneasiness in allowing deductions to taxpayers conducting illegal businesses has led to the gradual establishment of the public policy doctrine. The public policy doctrine is a judicially created doctrine, which enables judges to disallow certain expenses arising from illegal activities.[24] One of the first cases to deal with the public policy exception to section 162 involved the question of deductibility of attorney's fees.[25] The court denied the taxpayer's attempt to deduct his attorney's fees resulting from a charge of perjury, by relying on the idea that allowing such a deduction might give the impression that courts condoned this type of activity.[26]

After *Backer*, judicial decisions dealing with the public policy exception to section 162 tended to "focus on the statutory words 'ordinary and necessary' as a means to restrict the deductions available to illegal enterprises."[27] Eventually, the Supreme Court established a two-prong public policy exception to allowing section 162 business deductions. First, even if a business expenditure is ordinary and necessary, it may not be deductible if it sharply frustrates a "defined national or state public polic[y] proscribing particular types of conduct, . . . [but] [t]he policies frustrated must be . . . evidenced by some governmental declaration of them."[28] In addition, a business expense deduction will be denied upon the grounds of the public

20. United States v. Constantine, 296 U.S. 287, 293 (1935).

21. *Id.* (citations omitted).

22. Comm'r v. Sullivan, 356 U.S. 27, 29 (1958) [hereinafter *Sullivan II*]; *Tellier*, 383 U.S. at 692.

23. *See supra* note 7.

24. *See generally* Charles A. Borek, *The Public Policy Doctrine and Tax Logic: The Need for Consistency in Denying Deductions Arising from Illegal Activities*, 22 U. BALT. L. REV. 45, 49-57 (1992) (discussing the development of the public policy doctrine).

25. Backer v. Comm'r, 1 B.T.A. 214, 217 (1924) (referencing the Revenue Act of 1918, where the equivalent of § 162 was § 214(a)(1)); Borek, *supra* note 24, at 49 n.32.

26. *Backer*, 1 B.T.A. at 217; Borek, *supra* note 24, at note 32.

27. Borek, *supra* note 24, at 49-50.

28. Lilly v. Comm'r, 343 U.S. 90, 96-97 (1952) (referencing the Internal Revenue Code of 1939, where the equivalent of § 162 was § 23(a)(1)(A)).

policy exception if "a taxpayer has violated a federal or a state statute and incurred a fine or penalty . . . ."[29] In *Tank Truck Rentals*, the test for nondeductibility was dependent "upon the severity and immediacy of the frustration that would follow from allowing the deduction."[30] In *Commissioner v. Sullivan*, the Court found that business expenses were "nondeductible on the basis of public policy if: (1) the deduction itself is a device to lessen the economic effect of a penalty imposed by statute, or (2) the deduction would contravene a federal policy expressed in a statute or regulation."[31]

Even as the Supreme Court was developing the two-prong test for deductibility, the Court's decisions continued to focus on the nature of the expenditure, not the conduct that gave rise to it. Courts have consistently refused to deny business deductions simply because "an expenditure bears a remote relation to an illegal act . . . ."[32] In *Sullivan II*, a case decided the same day as *Tank Truck Rentals*, the Court specifically allowed the owner and operator of an illegal gambling enterprise to take deductions for rent and wages.[33] The *Sullivan II* Court recognized "'that the fact that an expenditure bears a remote relation to an illegal act' does not make it nondeductible."[34] Therefore, because the rent and wage expenditures were ordinary and necessary expenses in the commonly accepted definitions of the words, the taxpayer was allowed to take a deduction, even though the expenses were associated with an illegal enterprise.[35] In addition, six years later in *Commissioner v. Tellier*, the Supreme Court allowed a taxpayer to take section 162 business expense deductions despite the public policy exception.[36] The Court specifically adopted the *Sullivan II* reasoning, expressly refusing to disallow the deduction solely because of the illegal nature of the underlying business.[37] Therefore, the Supreme Court has established a reluctance to deny business expense deductions simply because the business itself happens to be an illegal enterprise. In fact, courts start with the assumption that the expense is valid and, therefore, deductible, regardless of the nature of the business. Only in certain situations will the public policy doctrine operate to bar deductibility of the expense.[38]

29. Tank Truck Rentals, Inc. v. Comm'r, 356 U.S. 30, 34 (1958) (referencing the Internal Revenue Code of 1939, where the equivalent of § 162 was § 23(a)(1)(A)).

30. Borek, *supra* note 24, at 53 (recognizing two categories of deductions that frustrate public policy: illegal payments and payment of government imposed penalties).

31. *Sullivan II*, 356 U.S. 27, 28-29 (1958); Borek, *supra* note 24, at 53.

32. Comm'r v. Heininger, 320 U.S. 467, 474 (1943). *See also* Comm'r v. Tellier, 383 U.S. 687, 690 (1966); *Sullivan II*, 356 U.S. at 29; Comm'r v. Toner, 60 T.C.M. (CCH) 1016 (1990).

33. *Sullivan II*, 356 U.S. at 29.

34. *Id.* at 29 (quoting Comm'r v. Heininger, 320 U.S. at 474).

35. *Id*.

36. *Tellier*, 383 U.S. at 690-91.

37. *Id*. at 692.

38. Borek, *supra* note 24, at 55.

Eventually, Congress codified the public policy exception by amending parts of section 162. In the Tax Reform Act of 1969, Congress codified the public policy exception by disallowing deductions for payment of penalties and payments that violate the law.[39] Although this amendment would coexist with the recognized, judicially-created public policy exception, Congress also intended "its codified version of the public policy doctrine to completely occupy this area of the tax law."[40] In other words, although the judicial test was still valid, these new amendments to section 162 were intended to be the full and complete statement of the public policy doctrine.

At this point, it is important to note that the Supreme Court recognized that the deduction of section 162 ordinary and necessary business expenses could be "disallowed by specific legislation, since deductions 'are a matter of grace and Congress can, of course, disallow them as it chooses.'"[41] This Comment does not suggest that Congress has neither the right nor the power to make such decisions. Rather, this Comment is intended to demonstrate that section 280E should be omitted from the Code for other reasons. Specifically, section 280E should be omitted because: (1) it is against the original intent of the drafters of the Code; (2) the section does not comply with the general functioning of the Code; (3) other considerations overcome public policy considerations, even though section 280E conforms to the public policy exception; and (4) efforts to use the tax code to deter the drug trade are likely to be ineffective.

Although it may appear incongruous to suggest that section 280E should be omitted from the Code while not taking exception with sections 162(c),[42] 162(e)(1)(A)[43] and 162(f),[44] the differences between the sections becomes apparent upon close examination. Harkening back to the judicial development of the public policy doctrine, those opinions made specific mention of the nature of the payments and refused to focus on the legality or illegality of the business giving rise to the payment.[45] If a payment (not a business) violated a federal or state policy expressly set forth in a statute or tended to lessen the economic effect of a statutory penalty, the payment was not deductible under

39. *Id*. at 55-56.

40. *Id*.

41. *Tellier*, 383 U.S. at 693 (quoting *Sullivan II,* 356 U.S. 27, 28 (1958)).

42. *See* I.R.C. § 162(c) (2000) (preventing a deduction for illegal payments, including bribes and kickbacks).

43. *See* I.R.C. § 162(e)(1)(A) (2000) (preventing a deduction for payments intended to influence legislation).

44. *See* I.R.C. § 162(f) (2000) (preventing a deduction for payment of fines or penalties imposed because of a violation of a law).

45. See *supra* notes 24-40 and accompanying text.

section 162.[46] However, legal payments, such as rent, wages or legal fees, even if made in connection with an illegal business, were deductible.[47]

By analogy, the 1969 amendments to section 162 focused on the nature of the payments and not the nature of the business that would make the payments necessary. For example, section 162(c) denies a deduction for illegal bribes, kickbacks and other illegal payments.[48] Section 162(e)(1) denies a deduction for payments made in an attempt to influence legislation or for lobbying.[49] Section 162(f) denies a deduction for fines or similar penalties incurred because of a violation of the law.[50] None of these sections refers to the nature of the business giving rise to the payment. The language of each section speaks specifically to the illegality of the payment itself, not to the legality or illegality of the underlying business giving rise to the payment.

In contrast, section 280E denies deductions and credits for amounts "paid or incurred during the taxable year in *carrying on any trade or business if such trade or business . . . consists of trafficking in controlled substances. . . .*"[51] The specific language of the statute refers to the nature of the underlying business giving rise to the payment sought to be deducted. This language is a noticeable and blatant departure from the traditional accepted focus on the nature of the payment itself. Section 280E denies a taxpayer who operates a drug business the opportunity to deduct ordinary legal expenses such as rent and wages, while taxpayers operating different types of illegal businesses, such as prostitution[52] or contract killing, will be permitted to take the same deductions. This departure from the traditional focus on the nature of the payment is incongruous and indicates that section 280E should be omitted from the Code.

The suggestion that the Code's treatment of drug traffickers is diametrically opposed to the tax treatment of other illegal businesses is supported by the case law. For example, in *Toner v. Commissioner*, the taxpayer was allowed to take section 162 ordinary and necessary business expense deductions for "office furnishings, telephones, a security system, . . . advertising[,]. . . . rent, heat, some insurance, and some automobile expenses" in connection with his massage parlor and prostitution business.[53] In fact, not only was the petitioner able to take those business expense deductions, the Court held that the taxpayer was allowed to take greater deductions than the

46. Comm'r v. Heininger, 320 U.S. 467, 473-74 (1943).

47. *Sullivan II*, 356 U.S. 27, 29 (1958); *Heininger*, 320 U.S. at 473-474; Comm'r v. Tellier, 383 U.S. 383, 694-695 (1966).

48. I.R.C. § 162(c).

49. I.R.C. § 162(e)(1).

50. I.R.C. § 162(f).

51. I.R.C. § 280E (emphasis added).

52. *See generally* Toner v. Comm'r, 60 T.C.M. (CCH) 1016 (1990).

53. *Id*.

I.R.S. had previously allowed because "petitioners maintained records which would have enabled [the] Court to find more deductions than those allowed by respondent."[54] Obviously, prostitution is an illegal enterprise,[55] and with the high rates of AIDS and sexually transmitted diseases, one could make an argument that there is a public policy in the United States against prostitution. However, none of these considerations has resulted in a similar tax code provision regulating prostitution.

Even though there are equally strong public policy reasons for prohibiting other illegal activities such as prostitution, gambling[56] or contract killing, those activities have not been subject to the same unfavorable tax treatment as drug trafficking. As demonstrated in the *Toner* case, courts are willing to recognize that other types of illegal businesses are entitled to the same tax credits and deductions that are available to taxpayers operating legal businesses.

III. THE ADDITION OF SECTION 280E TO THE CODE

A. Enactment of Section 280E

Section 280E was added to the Code in 1982 as a part of the Tax Equity and Fiscal Responsibility Act of 1982.[57] The amendment was included in Title III, Taxpayer Compliance, of the House Report that accompanied the bill.[58] Title III was further subdivided into subparts and the amendments to section 280E were contained in Part II, Subtitle I, Other Provisions.[59] The House Report lists only the text of the amendment and its effective date, yet gives little indication of Congress' intent behind the enactment of this section.[60]

The Senate Report, however, is much more instructive as to congressional intent. Similar to the House Report, the Senate Report is divided into numerous sections. The amendment to section 280E is included under C, Provisions Designed to Improve Taxpayer Compliance.[61] There, the Senate

54. *Id*.

55. This argument does not ignore the fact that in some areas, such as Nevada, prostitution is a legal activity. In those cases, owners of a prostitution business would be required to follow the tax laws and would be entitled to all ordinary and necessary business expense deductions.

56. *See* Comm'r v. Groetzinger, 480 U.S. 23, 32 (1987) (recognizing that "[f]ederal and state legislation and court decisions . . . have not been noticeably favorable to gambling endeavors and even have been reluctant to treat gambling on a parity with more 'legitimate' means of making a living."). However, the *Groetzinger* decision and I.R.C. § 162(d) limit deductions for operating a gambling business to the gains from gambling.

57. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 640 (1982) (codified as amended at I.R.C. § 280E).

58. H.R. REP. NO. 97-760, at 76 (1982).

59. *Id*. at 7.

60. *Id*. at 598.

61. S. REP NO. 97-494, at 309 (1982) (codified as amended at I.R.C. § 280E).

expressly sets forth the following justification for adding this amendment to the Code:

> To allow drug dealers the benefit of business expense deductions at the same time that the U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other, legal, enterprises. Such deductions must be disallowed on public policy grounds.[62]

This language demonstrates that Congress relied expressly on public policy as its justification for adding section 280E to the Code. However, there is no indication that Congress attempted to satisfy the public policy exception test already set forth by the Supreme Court, and there is no specific mention of the statistical information that Congress relied upon in reaching its conclusion. In fact, the Senate gives little more than a passing acknowledgment that this new amendment will be co-existing with the previous amendments to section 162 that were intended to fully occupy this area of the law.[63]

It is possible that the addition of section 280E had little to do with public policy and everything to do with bureaucratic survival. There has been a suggestion that the enactment of drug legislation has been little more than an attempt by numerous bureaucrats "to 'generate' demand for a bureau's own services through direct lobbying, policy manipulation, and the selective release of information to other interest groups and the media."[64] This is particularly true as it relates to the Treasury Department and its role in the war on drugs, because the nation's program for dealing with the drug problem "is one 'which, to all intents and purposes, was established by the decisions of administrative officials of the Treasury Department.'"[65] The Treasury Department's Federal Bureau of Narcotics was responsible for enforcing both the Harrison Act, passed in 1914 (establishing federal taxes on narcotics), and the Marijuana Tax Act, passed in 1937.[66] However, after 1937, the Federal Bureau of Narcotics began to face stiff competition for attention from both the public and Congress, who began to view the Federal Bureau of Investigation as the proper bureau for crime control; hence, the Federal Bureau of Narcotics needed to create more "demand" for its services in order to survive as an agency.[67] Lobbying for the passage of tax legislation that would require

62. *Id*.

63. *Id*. *See also* Borek, *supra* note 24.

64. Bruce L. Benson & David W. Rasmussen, *Predatory Public Finance and the Origins of the War on Drugs: 1984-1989*, *in* TAXING CHOICE: THE PREDATORY POLITICS OF FISCAL DISCRIMINATION 204 (William F. Shughart II ed., 1997) (using federal and local law enforcement agencies and the Treasury Department's Federal Bureau of Narcotics as examples of agencies likely to use this technique).

65. *Id*.

66. *Id*.

67. *Id*. at 204-205.

enforcement by the Bureau of Narcotics would certainly be one way to ensure survival of the agency.

However, even if one does not agree with this "bureaucratic survival" argument as an explanation for enactment of section 280E, public policy still does not provide a believable justification for amending the Code. As previously mentioned, in the House Report accompanying the bill, the amendment was included under a section entitled "Taxpayer Compliance."[68] Within this section, the Senate stated that there is a sharply defined public policy against drug dealing.[69] However, in the next paragraph, the Senate also stated that, in order "[t]o preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill."[70] The I.R.S. has honored the Senate's finding: "I.R.C. § 280E does not, however, affect the computation of cost of goods sold."[71] Therefore, even though there is a "defined" public policy against drug dealing, and normal business expense deductions are denied to drug traffickers, a drug trafficker may still take into account cost of goods sold.[72]

Two issues arise from the foregoing information. First, how does a provision denying section 162 ordinary and necessary business expense deductions improve taxpayer compliance? Second, if the public policy against drug trafficking is so great, how does allowing adjustments for costs of goods sold not violate this public policy? Denying business expense deductions to a particular group of business owners does little to improve taxpayer compliance, and, in fact, probably operates to the opposite effect. In essence, if a taxpayer is denied a deduction for all of the ordinary and necessary, non-illegal expenses associated with operating a business, that taxpayer has no incentive for reporting his income to the I.R.S., other than avoiding the normal risks and penalties associated with failing to file a federal income tax return.[73]

68. See *supra* text accompanying note 58.

69. S. REP. NO. 97-494, at 309 (1982).

70. *Id*.

71. I.R.M. 31.4.8.6, *available at* http://www.irs.gov/taxpros/display/0,,i1%3D5%26genericId%3D22559,00.html (last visited August 24, 2002).

72. *See e.g.*, Vasta v. Comm'r, 58 T.C.M. (CCH) 263 (1989) (recognizing that, even though the taxpayer did not supply the court with sufficient evidence to allow a deduction for cost of goods sold, such a deduction would be allowed upon a record of expenditures for cost of goods sold).

73. Depending upon the taxpayer's classification as either a delinquent filer or a taxpayer who has not filed a return at all, the penalties that the I.R.S. may assess include the Failure to File Penalty (I.R.C. § 6651(a)(1)(2000)), the Estimated Tax Penalty (I.R.C. §§ 6654-55 (2000)), the Failure to Pay Penalty (I.R.C. § 6651(a)(2)(2000)), the Fraud or Negligence Additions (Pre-1989 I.R.C. § 6653), the Fraudulent Failure to File (Post-1988 I.R.C. § 6651(f)(2000)) and the Accuracy Penalty (I.R.C. § 6662(a)(2000)). In fact, the IRS relies on voluntary compliance. "Compliance is achieved when a taxpayer makes a good faith effort to meet the tax obligations

Therefore, even though a provision denying ordinary and necessary business expense deductions to a drug trafficker may be pertinent to the public policy against drug dealing, the same provision could operate against the defined public policy in favor of paying one's income taxes.[74] The public policy justification also seems overshadowed by the allowance for the cost of goods sold. Although a drug trafficker may be denied a deduction for rent, wages and other necessary legal costs of operating a business, he will be allowed to make adjustments for the cost of goods sold, in this case, drugs, the very item that makes his operation illegal in the first place. This double standard relating to drugs, ostensibly to avoid constitutional challenges, flies in the face of the public policy justification provided as the reason for the amendment.

B. Evaluation of the Components of Section 280E

The section can be divided into three major parts: (a) it bars credits or deductions (b) for the cost of carrying on a business which consists of trafficking in controlled substances (c) either within the meaning of Schedule I and II of the Controlled Substances Act or which is prohibited by any state or federal law.[75] By focusing on one type of business, this section affects only a proportionally small, particularized segment of the taxpaying public.

One effect of this statute is that it bars drug traffickers from taking section 162 ordinary and necessary business expense deductions.[76] However, this statute applies only to those who traffic in particular types of drugs, both those contained in Schedules I and II of the Controlled Substances Act, and those that are made illegal by federal or state laws.[77] The Controlled Substances Act

defined by the Internal Revenue Code. Penalties support voluntary compliance by assuring compliant taxpayers that tax offenders are identified and penalized." I.R.M. 20.1.1.2.1, *available at* http://www.irs.gov/taxpros/display/0,,i1%3D5%26genericId%3D22410,00.html (last visited August 25, 2002).

74. For instance, a business owner operating a massage parlor that provided prostitution services was allowed to take § 162 business expense deductions, and, therefore, reported his income to the I.R.S. and kept the necessary documentation to support his deductions. *See* Toner v. Comm'r, 60 T.C.M. (CCH) 1016 (1990); *Vasta*, 58 T.C.M. (CCH) 263.

75. I.R.C. § 280E (2000).

76. *See id*.

77. *Id*. Each Schedule of the Controlled Substances Act requires specific findings in order for a drug to be classified. The findings required for Schedule I are: "(A) The drug or other substance has a high potential for abuse. (B) The drug or other substance has no currently accepted medical use in treatment in the United States. (C) There is a lack of accepted safety for use of the drug or other substance under medical supervision." ALEXANDER T. SHULGIN, CONTROLLED SUBSTANCES: A CHEMICAL AND LEGAL GUIDE TO FEDERAL DRUG LAWS 11 (2d ed. 1992). The findings required for inclusion under Schedule II are: "(A) The drug or other substance has a high potential for abuse. (B) The drug or other substance has a currently accepted medical use in treatment in the United States or a currently accepted medical use with severe restrictions. (C) Abuse of the drug or other substance may lead to severe psychological or physical dependence." *Id*. The requirements for scheduling under Schedules III-V all include

was originally enacted in 1970, and was intended as an effort to reduce supply of illegal drugs.[78] The Act focuses on a "supply reduction/law enforcement approach" by assigning substances to one of five schedules, and attacking "drug abuse and trafficking at four levels: (1) possession; (2) production; (3) distribution; and (4) laundering of proceeds."[79] The drugs included on Schedules I and II of the Controlled Substances Act are listed by their chemical names, which can make recognition of their street-name equivalents difficult for the layperson.[80] However, amphetamines, cocaine, codeine, heroin, lysergic acid diethylamide (LSD), marijuana, methampehtamines, morphine and opium are some examples of common street drugs found on either Schedule I or II of the Controlled Substances Act.[81]

Therefore, section 280E bars credits or deductions to those whose primary business is trafficking in controlled substances, including marijuana, heroin, amphetamines and cocaine. Although these drugs may include the great majority of inventory that is the illegal drug trade, the preceding paragraphs are intended to show that section 280E does not apply to all drug traffickers.

IV. OMITTING SECTION 280E FROM THE INTERNAL REVENUE CODE

A. Section 280E Contradicts the Intent of the Original Drafters of the Code.

The originally stated purpose of the Code was to tax all income. During the Congressional debates concerning enactment of the 1913 Internal Revenue Code, Senator Williams (the senator in charge of the bill) stated that "'[t]he object of the bill is to tax a man's net income . . . not to reform men's moral characters[;] . . . [t]he law does not care where he got [his income] from, so far as the tax is concerned . . . .'"[82] In addition, the current Code defines gross income as "all income from whatever source derived . . . ."[83] Therefore, the

requirements that the drug have a currently accepted medical use in treatment in the United States; however, beyond that, the requirements for Schedules III-V focus on the drug's potential for abuse and degree of physical or psychological dependence. *Id.*

78. SENATE CAUCUS ON INTERNATIONAL NARCOTICS CONTROL AND THE HOUSE COMMITTEE ON INTERNATIONAL RELATIONS, 105TH CONG., REPORT ON INTERNATIONAL NARCOTICS CONTROL AND UNITED STATES FOREIGN POLICY: A COMPILATION OF LAWS, TREATIES, EXECUTIVE DOCUMENTS, AND RELATED MATERIALS, at xxiii (J. Comm. Print 1997).

79. *Id*.

80. Controlled Substances Act, 21 U.S.C. § 812 (2000).

81. *See generally* SHULGIN, *supra* note 77, at 13-242 (providing an exhaustive list of the original names, synonyms, Chemical Abstracts Service Numbers and Drug Code Numbers of all drugs which are, or ever have been, included under Schedules I-V of the Controlled Substances Act).

82. *See* Comm'r v. Tellier, 383 U.S. 687, 691-92 (1966) (citation omitted).

83. I.R.C. § 61(a) (2000).

Code has never been intended to make a distinction between incomes earned through legal or illegal businesses.

One way a tax system may discriminate between the underlying natures of income-producing activities is through a provision just like section 280E. Courts have been willing to recognize that it is important to examine the nature of the tax imposed on illegal income.[84] Although there is no distinction as to the source of taxable receipts,[85] and a tax used to raise revenue is valid even if the business is conducted in violation of a law,[86] a tax may not impose a higher burden of taxation on illegal income and must "be imposed alike on the just and unjust."[87] The Supreme Court has recognized that one possible way of imposing a higher tax burden on a specific business lay in denying business deductions based on the illegality of the business, which, in effect, imposes a tax on the gross receipts while other legitimate businesses are taxed on net income.[88] Section 280E accomplishes just this effect; in denying deductions to drug traffickers, those taxpayers are subjected to a tax on almost all of their net income.[89]

By denying section 162 deductions to a drug trafficker, that taxpayer cannot deduct ordinary and necessary business expenses, which results in a higher net income. Therefore, the tax will be imposed on a greater amount of the taxpayer's net income if that taxpayer engages in drug trafficking, as opposed to some other legal business, or even some other illegal, but more acceptable, business. This provision impermissibly distinguishes between the natures of taxpayers' incomes. In so discriminating, the tax is not "imposed alike on the just and unjust."[90]

Allowing section 280E to remain in the Code is not only harmful because it impermissibly distinguishes between the legality or illegality of underlying income, it is also harmful to the structure of the Code itself. The Code is a working instrument and no one provision can be taken in isolation from the others. In order to properly and accurately report income tax, a taxpayer must obey all applicable sections of the Code.[91] However, a deadweight provision such as section 280E does little to preserve the vitality of the Code, and, instead, becomes another regulation that taxpayers must follow. Unfortunately, as will be discussed below, section 280E is not effective and no

84. *See Sullivan II*, 356 U.S. 27, 29 (1958); United States v. Constantine, 296 U.S. 287, 293 (1935) (holding that a tax may not impose a higher burden of taxation on illegal income).

85. Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 429 (1955).

86. *Constantine*, 296 U.S. at 293.

87. *Id*. (citations omitted).

88. *Sullivan II*, 356 U.S. at 29; Comm'r v. Tellier, 383 U.S. 687, 692 (1966).

89. *See supra* note 7.

90. *Constantine*, 296 U.S. at 293.

91. For instance, in order to reach the correct taxable income, a taxpayer must compute the correct amount of gross income under I.R.C. § 61 (2000).

longer serves its purpose in light of other powers the I.R.S. has at its disposal for dealing with drug traffickers.[92]

The harm from section 280E is not only demonstrated by its uselessness, but also by the lack of similar provisions anywhere else in the Code. Although there are particular sections, which apply only to certain taxpayers if they chose to engage in a particular type of activity,[93] none of those provisions so radically focuses on the nature of the income producing activities of one particular group of taxpayers to the exclusion of all others. Using section 162(b) as an example, the previous statement is meant to illustrate the fact that, although a provision may deny a charitable gift as a business deduction, that provision denies such deductions to *any* taxpayer making a charitable gift. However, section 280E, on the other hand, focuses specifically on drug dealers to the exclusion of all other business owners and operators. Focusing on a particular group, to the exclusion of all others, is contrary to the general workings of the Code and its supposed uniform applicability to all taxpayers. Even the public policy against drug dealing is not strong enough to override the purpose and function of the Code: "[e]ven if policy outcomes seem to conform to majority will and democratic procedures are followed satisfactorily, they may produce a generally pernicious and possibly self-defeating result."[94] The continued inclusion of section 280E in the Code is harmful and against the original intent of the drafters of the Code.

The tax treatment of other illegal businesses illustrates that section 280E is an anomalous provision. As was discussed above in the prostitution example, using the *Toner* case as a specific example, operators of other types of illegal businesses are allowed to take ordinary and necessary business expense deductions when determining their net income.[95] There is no mention in that case of a potential public policy that would justify treating the income from prostitution similarly to the income of drug traffickers. However, an argument can be made that the social problems associated with prostitution are serious enough to warrant drastic tax treatment in order to discourage people from engaging in that type of business. The absence of any such provision in the Code regulating the income from prostitution businesses is a further indication that section 280E is completely at odds with the general functioning of the Code as it pertains to tax treatment of income from illegal businesses.[96]

92. *See infra* text accompanying notes 114-28.

93. *See, e.g.*, I.R.C. § 162(b) (denying business expense deductions for charitable gifts or contributions).

94. WITTE, *supra* note 10, at 268.

95. *See supra* text accompanying notes 52-54.

96. A somewhat similar provision is section 165(d), which allows the deductibility of losses incurred in a gambling trade or business only to the extent of gains from such transactions. *See* I.R.C. § 165(d). However, Congressional intent behind enacting this provision was "to force

B. Although Section 280E Conforms to the Original Public Policy Exception, Other Considerations Overshadow its Application in this Instance.

The public policy exception, as originally established by the U.S. Supreme Court, prohibits section 162 ordinary and necessary business deductions if: "(1) the deduction itself is a device to lessen the economic effect of a penalty imposed by statute, or (2) the deduction would contravene a federal policy expressed in a statute or regulation."[97] Normal payments in order to sustain the operation of a drug trafficking business clearly do not fall within the scope of the first prong of this test. Rent payments, wages, and other "normal" business deductions are not the type of payment contemplated by the first public policy exception.[98] Therefore, attempting to declare a section 162 business deduction for the cost of carrying on an illegal drug business does not seek to lessen the economic effect of a penalty imposed by statute.[99]

Allowing a section 162 business deduction to an illegal drug trafficker would obviously contravene specific federal and state policies against the drug trade. Other considerations, however, overshadow this contravention. The specific federal policy against drug trafficking is found in the Controlled Substances Act.[100] Also, numerous state policies exist that make drug trafficking an illegal activity. The Office of National Drug Control Policy reports that "[e]very State has laws on its books that enable law enforcement officials to prosecute those who sell drugs."[101] Therefore, every state and the federal government have enacted legislation of some sort making it a punishable crime to traffic drugs.

Although there are defined state and federal policies against drug dealing, other considerations indicate that section 280E is not proper. Therefore, ordinary and necessary business deductions should not be denied to drug traffickers on any grounds, neither through section 280E nor through the public policy exception to section 162. These considerations include: (a) the purpose of the Code is not to enforce social policy; (b) section 280E does not further the general purpose of the Code; and (c) this legislation is out-dated and is no longer effective in the "war on drugs."

taxpayers to report their gambling gains if they desire to deduct their gambling losses." Praytor v. Comm'r, 80 T.C.M. (CCH) 332 n.2 (2000).

97. Borek, *supra* note 24, at 54; *Sullivan II*, 356 U.S. 27, 28-29 (1958).

98. An example of deductions that would seek to lessen the economic effect of a penalty imposed by a statute includes a deduction for a speeding ticket violation or an attempt to deduct a fine paid for running overweight freight trucks. *See, e.g.*, Tank Truck Rentals, Inc. v. Comm'r, 356 U.S. 30, 34 (1958).

99. This argument assumes that a drug trafficker is not attempting to take an ordinary and necessary business expense deduction for a fine incurred in an arrest for possession of drugs.

100. See *supra* text accompanying notes 78-79.

101. OFFICE OF NATIONAL DRUG CONTROL POLICY, WHITE PAPER: STATE DRUG CONTROL STATUS REPORT 7 (1990).

The arguments that the purpose of the Code is not to enforce social policy and that section 280E does not further the general purpose of the Code are inter-related. As previously discussed, the history of the enactment of the Code, in a form that is currently recognizable,[102] suggests that the enactors envisioned the Code as a way to collect revenue, and it was not intended to be a tool used to regulate the manner in which people earned their income nor was it intended to be a way to prohibit certain types of activities.[103] Therefore, if one accepts the contention that the Code should, in some respects, conform to the original intent of the enactors, a provision that seeks to further a social policy against drug dealing that has little or nothing to do with the collection of revenue would not have a proper place in the Code.

In addition, section 280E is an outdated provision that is no longer (if it ever was)[104] effective in the war against drugs. Since the 1960s and 1970s, Unites States' drug policy has been "designed to suppress the production of illicit drugs throughout the hemisphere," thus, affecting the supply of drugs.[105] However, during the first Bush administration, while the focus was still on diminishing the supply of drugs, the national drug policy began to shift its focus towards eliminating the demand for drugs.[106] The importance of focusing on decreasing the demand for illegal drugs has gained momentum and importance in United States' drug policy. For instance, in the Transmittal Letter from the President concerning the 1997 National Drug Control Strategy, President Clinton wrote:

> Our strategy contains programs that will help youth to recognize the terrible risks associated with the use of illegal substances. . . . All Americans must accept responsibility to teach young people that drugs are wrong, drugs are illegal, and drugs are deadly. *We must renew our commitment to the drug*

102. WITTE, *supra* note 10, at 76-77.

103. *See supra* text accompanying note 12.

104. From the very beginning of the "war on drugs," the role of the I.R.S. has been ill-defined. Section 280E was enacted into the Code at a time when the government was first establishing a comprehensive plan to confront the nation's drug problem. However, as has been suggested in this Comment, the enactment of § 280E may have had little to do with drug enforcement and more to do with bureaucratic survival. *See supra* text accompanying notes 64-67. Even if one does not find the bureaucratic survival argument persuasive, as research shows, the I.R.S. no longer uses § 280E as a proactive tool to catch unreported income from drug traffickers or to prevent drug dealers from taking ordinary and necessary business expense deductions. *See infra* text accompanying notes 119-122. Instead, the I.R.S. uses § 280E as a tool to collect revenue from convicted drug dealers in calculating their unreported income, post-conviction. *See infra* text accompanying notes 119-122.

105. Peter H. Smith, *The Political Economy of Drugs: Conceptual Issues and Policy Options*, *in* DRUG POLICY IN THE AMERICAS 6 (Peter H. Smith ed., 1992).

106. *Id.* at 7.

> *prevention strategies that deter first-time drug use* and halt the progression from alcohol and tobacco use to illicit drugs.[107]

Such statements, by former President Clinton in 1997, indicate that the federal government is finding it increasingly important to focus on deterring demand.[108]

Given the increasing importance of decreasing demand in the national drug policy, section 280E, a provision of the Internal Revenue Code, enacted in 1982, when governmental policy focused almost exclusively on eradicating the supply of drugs, no longer has an effective role in the American drug initiative. In fact, the President's 1997 Transmittal Letter sets forth five goals—none of which pertain to the Treasury or to the I.R.S.—including: (1) educating and enabling America's youth to reject illegal drugs, as well as alcohol and tobacco; (2) increasing the safety of America's citizens by substantially reducing drug-related crime and violence; (3) reducing health and social costs to the public of illegal drug use; (4) shielding America's air, land and sea frontiers from the drug threat; and (5) breaking foreign and domestic drug sources of supply.[109] These goals illustrate the increased emphasis on reducing demand, although there is still a substantial concern with decreasing supply. However, these goals seem to suggest a small, if non-existent, role for the I.R.S. in these anti-drug efforts. Certainly, the effect of section 280E, denying ordinary and necessary business deductions, seems out-dated in the current statement of the American drug policy.

Even the National Funding Priorities for Fiscal Years 1998-2002 indicate that the I.R.S. has an increasingly smaller role in the national drug policy.[110] The following list is comprised of areas that the Office of National Drug Control Policy has identified for priority funding and will continue to give priority funding to these areas during the five-year budget: (1) reducing youth drug use; (2) reducing the consequences of chronic drug use; (3) reducing drug-related crime and violence; (4) stopping the flow of drugs at United States' borders; and (5) reducing domestic and foreign sources of supply.[111] These five goals illustrate the two major precepts underlying American drug control policy: decreasing supply and reducing demand. Section 280E does

107. SENATE CAUCUS ON INTERNATIONAL NARCOTICS CONTROL AND THE HOUSE COMMITTEE ON INTERNATIONAL RELATIONS, *supra* note 78, at 395-96 (emphasis added).

108. Although the United States' drug policy is increasingly focused on deterring demand for drugs, attempts at decreasing supply have not been entirely eliminated. In fact, the U.S. government has been involved in a program in which pilots contracted to work for the U.S. government to fly over the Colombian rain forest and spray the chemical weed killer Roundup on exposed coca fields. *See 60 Minutes* (CBS television broadcast, Jan. 13, 2002).

109. SENATE CAUCUS ON INTERNATIONAL CONTROL AND THE HOUSE COMMITTEE ON INTERNATIONAL RELATIONS, *supra* note 78, at 401-07.

110. *Id*. at 421-22.

111. *Id*.

not help to achieve either of these goals. Disallowing a section 162 business deduction has no affect on diminishing supply and certainly does not reach across to the ultimate end-user to affect his or her demand for the drug.

In fact, section 280E may work against these goals by creating a higher demand for small-time dealers with no employees. Because the small-time dealer may still take an adjustment for cost of goods sold, he can make adjustments to his net income for the money he uses to purchase his "product." By allowing such an adjustment, dealers will not receive unfavorable tax treatment for purchasing any amount of product. This could be especially beneficial to smaller dealers who may not have the resources (or tax accountants) that larger dealers are able to afford. Thus, a dealer could make adjustments for all of the inventory he purchases, just as any other businessperson who buys inventory as a part of running his business. Such an anomaly in section 280E seems odd. The dealer may not take business deductions for ordinary, legal payments such as rent and wages, but he can make an adjustment to his net income for his inventory, in this case, drugs, the one illegal aspect of his business!

Also, a revenue argument supports the contention that section 280E should be omitted. Illegal drug production and trafficking is a huge business, "generating global revenues in excess of $400 billion annually."[112] Now, manufacturing and distributing drugs "requires lots of working capital, steady supplies of raw materials, sophisticated manufacturing facilities, reliable shipping contractors and wholesale distributors, the all-important marketing arms and access to retail franchises for maximum market penetration."[113] In other words, although the small-time dealer still has an important place in the drug business, larger, vertically integrated groups that control every aspect from growing the raw materials to the final street distribution, are gradually being developed. By denying the small-time dealer, and the larger, more corporate-structured syndicates, access to the normal business deductions, it becomes less likely that any of these individuals will even report their income. Therefore, the government is not taxing a portion of the available revenue.

In summary, section 280E no longer has a proper place in the Code. Although it does conform to the public policy exception as originally developed by the Supreme Court in that there is an expressly defined federal and state policy against drug dealing, other considerations over-shadow the application of the public policy exception in this instance. Generally, the Code is not intended to enforce social policy, and, therefore, section 280E runs afoul of the intent of the original drafters of the Code. Those drafters intended the Code as a tool to raise revenue without references to the underlying source of

112. Matthew Brzezinski, *Re-engineering the Drug Business*, N.Y. TIMES, June 23, 2002, § 6 (Sunday Magazine), at 26.

113. *Id.*

the income. Section 280E comes into direct confrontation with this proposition by focusing on the nature of the drug trafficking business and denying deductions only to drug traffickers. In addition, section 280E is an outdated provision that no longer serves a purpose in the "war on drugs." It was enacted in 1982, at a time when the national drug control policy focused on diminishing the supply of drugs in the United States. As time has passed and the national strategy has matured, the goal of diminishing supply has come to share at least equal footing with the goal of decreasing demand within the United States. Section 280E does not play a role in diminishing supply nor in decreasing demand. Therefore, this provision should be omitted from the Code.

C. Section 280E Should Be Omitted from the Code Because the I.R.S. Can Use Other tools in the "War on Drugs."

The I.R.S. has played a subtler role in the "war on drugs" than those played by law enforcement agencies and the criminal justice system.[114] In order to carry out its assigned functions, the I.R.S. has been delegated numerous procedural tools to enable them to collect unreported income tax from drug traffickers. These procedures include: (1) jeopardy assessments and termination assessments;[115] (2) civil penalties for "failure to file a return, understatement of income, and fraudulent concealment of illicit income;"[116] and (3) criminal penalties for tax evasion, failure to file a return and fraud.[117] These procedural tools co-exist with specific narcotics programs within the U.S. Treasury Department that focus specifically on criminal investigations. Examples of these programs include the Organized Crime Drug Enforcement Task Force and the High Intensity Drug Area investigations.[118] These specific programs clearly establish the function of the I.R.S. in regards to the "war on drugs," and section 280E has an almost non-existent purpose in this function.

According to the I.R.S., the usefulness of section 280E is primarily found in criminal tax computations.[119] This section is "applied to criminal tax computations to deny deductions and credits."[120] Therefore, section 280E is applied to a drug traffickers' taxes *after* he or she has been charged with

114. Elizabeth M. Rutherford, Note, *Taxation of Drug Traffickers' Income: What the Drug Trafficker Profiteth, the IRS Taketh Away*, 33 ARIZ. L. REV. 701, 702 (1991).

115. *Id*. at 705-06.

116. *Id*. at 707-08 (citations omitted).

117. *Id*. at 712 (citations omitted).

118. I.R.M. 9.5.7, *available at* http://www.irs.gov/taxpros/display/0,,i1=5&genericId=22676,00.html (last visited August 24, 2002).

119. I.R.M. 31.4.8.3, *available at* http://www.irs.gov/taxpros/display/0,,i1%3D5%26genericId%3D22559,00.html (last visited August 24, 2002).

120. *Id*.

earning illegal income through drug trafficking. The use of section 280E is limited to:

> (a) [c]ases in which the proposed defendant is simultaneously being charged with narcotics offenses involving controlled substances listed in [the Controlled Substances Act]; (b) [c]ases in which the proposed defendant has been convicted under [the Controlled Substances Act] for trafficking in such controlled substances during the taxable years involved in the criminal tax prosecution; or, (c) [c]ases in which there is independent admissible evidence sufficient to establish that the source of the proposed defendant's income is illegal trafficking in the controlled substances listed in [the Controlled Substances Act].[121]

This function suggests that the true policy behind section 280E is not a public policy consideration against drug trafficking, but rather a policy to tax a larger amount of a drug trafficker's income. Moreover, a drug trafficker will not use this section when computing his taxes, but rather the government will use this section to impose taxes on a greater amount of a drug dealer's income. However, nowhere in the legislative history is it stated that section 280E should work to impose penalties on drug dealers. Instead, the legislature chose to include the provision in a section entitled "Taxpayer Compliance."[122] In actual practice, this section does not increase taxpayer compliance, but, instead, imposes the revenue tax on a higher proportion of a drug dealer's income than on an income derived from legal activities. Thus, section 280E is not a tool the I.R.S. uses to combat drugs, but is a statute that the I.R.S. uses after-the-fact to raise revenue from the unreported income of a drug trafficker.

The other tools, with which the I.R.S. has the power to regulate and/or investigate narcotics trafficking, are better suited for investigative and regulatory purposes than section 280E. One of the major problems with taxing a drug dealer's income is the cash nature of the business. Because the illegal nature of the business encourages dealers to conceal their identity, most rely on cash transactions and keep little or no financial records.[123] Therefore, the I.R.S. is given the power to calculate a drug dealer's taxable income through the use of income reconstruction in both civil and criminal tax cases, as well as in asset forfeiture proceedings.[124] Income restructuring allows the I.R.S. to reconstruct a taxpayer's income in order to correctly tax previously unreported income.[125] In addition, the civil and criminal penalties that the I.R.S. is

121. *Id*.

122. *See supra* note 61.

123. Rutherford, *supra* note 114, at 704. See *Charga v. Commissioner*, 62 T.C.M. (CCH) 347 (1991), as an example of a drug trafficker's reliance on cash transactions in all aspects of his business and personal life in order to avoid detection.

124. Rutherford, *supra* note 114, at 712-13.

125. *Id*. at 704.

entitled to impose on a taxpayer also reflect the I.R.S.'s power to enforce compliance with the tax laws.

Congress did not intend section 280E as a provision to aid in raising revenue,[126] and section 280E does little to aid compliance with tax laws. Instead, the provision comes into play only after a taxpayer has been accused or convicted of drug trafficking.[127] By using section 280E in such a manner, the I.R.S. and the legislature are ignoring that "the I.R.S.'s main responsibility is to collect revenue."[128] If the main responsibility of the I.R.S. is to collect revenue, section 280E certainly does not help to achieve that goal. The other procedural tools given to the I.R.S., including income reconstruction and asset forfeiture, are better suited to collecting revenue from illegal drug traffickers. Moreover, section 280E has no purpose in collecting revenue, other than imposing taxation on a greater amount of a drug trafficker's income; thus, penalizing a drug trafficker who has in all likelihood already faced criminal charges, as well as being assessed other civil and/or criminal penalties by the I.R.S. Since section 280E has no real purpose in either increasing compliance or raising revenue, but rather imposes a higher burden of taxation, it should be omitted from the Code.

D. Any Efforts to Use the Code to Deter the Drug Trade Are Likely to be Ineffective.

The preceding arguments have touched upon the fact that the true purpose of the Code is to raise revenue. This is accomplished through the I.R.S., which collects taxes and enforces compliance with the tax system. Efforts to deter the drug trade through the Code are likely to be unsuccessful and will only encourage drug dealers not to report their illegal income. The drug trade, to a great extent, is a cash business; therefore, drug dealers keep scant records of their transactions.[129] In addition, dealers attempt to remain anonymous in order to avoid detection and prosecution by the criminal justice system.[130] Obviously, drug dealers and traffickers are reluctant to report their income for fear of being detected. However, provisions such as section 280E, which prevent a drug trafficker from using the normal form of business deductions and credits can only further discourage a drug dealer from correctly reporting his income. If section 280E was omitted from the Code, it could potentially encourage voluntary compliance for some drug dealers who are smart enough

126. *See supra* text accompanying notes 61-63.

127. I.R.M. 31.4.8, *available at* http://www.irs.gov/taxpros/display/0,,i1%3D5%26genericId%3D22559,00.html (last visited August 24, 2002).

128. Rutherford, *supra* note 114, at 712.

129. *See* Rutherford, *supra* note 114, at 704; *see also* Charga v. Comm'r, 62 T.C.M. (CCH) 347 (1991).

130. *See* Rutherford, *supra* note 114, at 704.

to look into the future. Even if drug dealers are unable to avoid prosecution for their illegal activities, some may be willing to report their income currently in order to avoid being stuck with an incredibly large tax bill[131] after they are criminally charged with drug trafficking. Allowing section 280E to remain in the Code will continue to act counter to the purpose of raising revenue. In essence, by deterring drug traffickers from reporting their income, section 280E works against the Congressional intent that the I.R.C. be used to raise revenue and impose a tax "alike on the just and unjust."[132]

V. CONCLUSION

The facial effect of section 280E is to deny section 162 ordinary and necessary business deductions to illegal drug traffickers. The stated legislative purpose behind the enactment of this section was a public and social policy justification. However, this section is not only inappropriate, but is out-dated and ineffective as well. Although it conforms to the traditional public policy exception to section 162, other considerations suggest that it should be omitted from the Code. The section does not conform to the Code's spirit and purpose of raising revenue. In addition, it was enacted in the early 1980s, at a time when our nation's drug strategy focused on decreasing supply. Therefore, in some ways it was probably intended to make drug dealing unprofitable, and, thereby cause drug dealers to withdraw from the trade. No indication exists, however, that section 280E has ever had the desired effect. Instead, this section only encourages drug dealers to continue to not report their income in an effort to avoid detection and taxation on a greater portion of their income.

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131. *Charga*, 62 T.C.M. (CCH) 347.

132. United States v. Constantine, 296 U.S. 287, 293 (1935) (citations omitted).

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