***Faulk v. Commissioner*, 26 T.C. 948 (1956)**

Payments made as a result of knowingly submitting fraudulent claims against the government, including double damages and associated legal expenses, are not deductible as ordinary and necessary business expenses under the Internal Revenue Code.

Summary

The case of *Faulk v. Commissioner* involved a taxpayer, David Faulk, who was found to have submitted false claims to the U.S. Government. The government sued Faulk under the False Claims Act and was awarded double damages and other penalties. Faulk sought to deduct the damages, attorneys' fees, and other expenses related to the litigation as ordinary and necessary business expenses. The Tax Court ruled against the taxpayer, holding that such deductions would be against public policy because they stemmed from the taxpayer's deliberate fraudulent actions against the government. The court distinguished this case from others where deductions were allowed, emphasizing the taxpayer's knowing and deliberate fraud as the key factor in denying the deduction.

Facts

David Faulk owned and operated Faulk Creamery, which had a contract to supply fresh milk to Lackland Air Base. Faulk knowingly submitted false claims to the government for reconditioned or recombined milk, mislabeling the bottles to appear as "Grade A" milk. A civil action was brought against Faulk under the False Claims Act (31 U.S.C. § 231), resulting in a judgment for double damages ($28,638.72) and a forfeiture. Faulk also incurred $3,442.52 in attorneys' fees and other expenses related to the litigation. Faulk sought to deduct these amounts as ordinary and necessary business expenses on his income tax return.

Procedural History

A criminal action was initially filed against David Faulk for the same fraudulent activities, but he was acquitted. The civil action followed, resulting in a judgment against Faulk in the U.S. District Court for the Western District of Texas. Faulk appealed the judgment to the Fifth Circuit Court of Appeals, which affirmed the lower court's decision. Faulk then brought the case to the U.S. Tax Court, seeking to deduct the payments related to the judgment.

Issue(s)

1. Whether the $28,638.72 paid by petitioners to the United States as double damages on a judgment arising out of a civil action brought by the Government for knowingly presenting false claims to the Government is deductible as ordinary and necessary business expenses.

© 2025 SCOTUSreports.com. All rights reserved.

2. Whether the $3,442.52 paid by petitioners for attorneys' fees and other expenses incurred in said litigation is deductible as ordinary and necessary business expenses.

Holding

1. No, because allowing the deduction would frustrate sharply defined national policy against knowingly presenting false claims to the government, and the expenses were not ordinary or necessary.

2. No, because the attorneys' fees and expenses were directly related to the fraudulent activities that led to the judgment and are therefore also not deductible.

Court's Reasoning

The Tax Court reasoned that deducting the payments would be against public policy. The court emphasized that Faulk's actions were deliberate and fraudulent, which is a key distinction from cases where deductions were allowed for unintentional violations. The court stated, "Sound public policy would forbid such a deduction. The allowance of the instant deduction would frustrate the sharply defined national policy proscribing the conduct of knowingly presenting false claims to the Government." The court also found that the expenses were neither ordinary nor necessary, as fraud is not an ordinary or necessary part of conducting business. The court cited *Standard Oil Co. v. Commissioner* in noting that no case permits a deduction based on a sum paid to the Government for damages arising from fraud perpetrated upon the Government.

Practical Implications

This case is crucial for understanding the limitations on business expense deductions when the expenses arise from fraudulent or illegal activities. Lawyers should advise clients that expenses related to knowingly submitting false claims to the government, including damages and litigation costs, are unlikely to be deductible. The court specifically distinguished Faulk's situation from cases involving innocent or unintentional violations, highlighting the importance of the taxpayer's intent. This ruling reinforces that taxpayers cannot use tax deductions to indirectly benefit from their own fraudulent conduct and that "the law will not recognize the necessity of engaging in illegal courses in the conduct of a business."

© 2025 SCOTUSreports.com. All rights reserved.