1979

Cost of Goods Sold--An Unwarranted Exception to the Public Policy Doctrine

Minn. L. Rev. Editorial Board

Follow this and additional works at: https://scholarship.law.umn.edu/mlr
Part of the Law Commons

Recommended Citation
https://scholarship.law.umn.edu/mlr/3121

This Article is brought to you for free and open access by the University of Minnesota Law School. It has been accepted for inclusion in Minnesota Law Review collection by an authorized administrator of the Scholarship Repository. For more information, please contact lenzx009@umn.edu.
I. INTRODUCTION

Any calculation of federal income tax liability must begin with an identification of a taxpayer's gross income. For some income-producing activities, arriving at gross income is simply a matter of totalling the gross receipts the activity generates during a given period. Personal services yielding wages, fees, and commissions are common examples of income-producing activities in which gross receipts and gross income are synonymous.\(^1\) For other income-producing activities, however, the two concepts diverge, necessitating a subtraction from gross receipts in order to arrive at gross income. One example is “gross income derived from business.”\(^2\) Treasury regulations interpret these ambiguous statutory words to require taxpayers engaged in manufacturing, merchandising, or mining to calculate gross income by subtracting the “cost of goods sold” from their total sales.\(^3\)

Defining gross income does not end the matter, however, for the tax rates apply to taxable income, not to gross income.\(^4\) To arrive at taxable income, the Internal Revenue Code permits certain deductions from the taxpayer's gross income.\(^5\) For taxpayers engaged in a trade or business, the most important deduction is for “ordinary and necessary” expenses of carrying on the taxpayer's trade or business.\(^6\) Yet, because the Internal Revenue Code and the Treasury regulations define gross income as gross receipts for some activities but as gross receipts minus the cost of goods sold for others, taxpayers engaged in the latter activities are permitted subtractions to arrive at gross income, while others are permitted only deductions from gross income.

The level at which a taxpayer is permitted to make the subtraction can, under present law, lead to markedly differing tax treatment for taxpayers who make illegal bribes, kickbacks, or rebates. If the illegal transaction is considered to be a part of the “cost of goods sold,” it can be subtracted in full to reduce the base for application

---

4. See I.R.C. §§ 1, 63(a).
5. See, e.g., I.R.C. §§ 143-250. Included are trade or business expenses (§ 162), interest (§ 163), taxes (§ 164), losses (§ 165), and depreciation (§ 167).
7. See I.R.C. § 162 (a).
of the tax rate. If, on the other hand, it is taken into account as a “deduction,” it can not be subtracted. The difference, reaffirmed by two recent Tax Court decisions,8 is that the frequently criticized but firmly entrenched public policy doctrine applies only to deductions.10 The result is that a seller of services is precluded from deducting illegal bribes, kickbacks, and rebates, while a seller of goods may be permitted to subtract them as a part of the cost of goods sold.11

While the Code originally defined a deductible business expense only as one both “ordinary and necessary,”12 courts added the proviso that payments made in violation of a public policy13 could not be deducted in arriving at taxable income.14 A deduction was denied


13. The term “public policy” is difficult to define. “Generally, however, the concept of violation of public policy is connected with that which is illegal, immoral, or tends to the injury of the public welfare.” Annot., 27 A.L.R.2d 498, 508 (1953).

14. See, e.g., Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958); United Draperies, Inc. v. Commissioner, 340 F.2d 936 (7th Cir. 1964), cert. denied, 382 U.S. 813 (1965); Dixie Machine Welding & Metal Works, Inc. v. United States, 315 F.2d 439 (5th Cir. 1963). Some courts reached this result by holding that illegal payments are not “necessary.” See, e.g., Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30, 33 (1958) (“A finding of 'necessity' cannot be made . . . if allowance of the deduction would frustrate sharply defined national or state policies . . . .”); Finley v. Commissioner, 255 F.2d 128, 134 (10th Cir. 1958). See also S. REP. No. 552, 91st Cong., 1st Sess. 273 (1969), 1969-3 C.B. 423, 596; 27 A.L.R.2d 498, 508 (1953); Annot., 16 L.Ed. 2d 1117, 1123 (1967). This approach, however, is inconsistent with the generally accepted rule that the “necessary” requirement means only that the expense need be “appropriate and helpful.” See Welch v. Helvering, 290 U.S. 111, 113 (1933). Thus, the analysis of the public policy doctrine as an exception to the “ordinary and necessary” requirement rather than as a limitation seems preferable. See Heininger v. Commissioner, 133 F.2d 567, 570 (7th Cir.), aff'd, 320 U.S. 467 (1943).
when the payment violated a "sharply defined" legislative policy, with the courts focusing on the "severity and immediacy of the frustration resulting from allowance of the deduction." Since distinguishing "sharply defined" policies from "less defined" policies was no easy task, decisions reached under this standard lacked consistency, and taxpayers were unable to predict whether a given payment would violate what the courts might later label a "sharply defined legislative policy."

Reacting to criticism of the imprecise public policy doctrine, Congress added section 162(c)(2) to the Code with the Tax Reform Act of 1969. This new section was intended to articulate a more

---

15. This standard was first announced in Commissioner v. Heininger, 320 U.S. 467, 474 (1943).
17. See cases cited in Note, Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code, 72 Yale L.J. 108, 109 n.4 (1962). See also Commissioner v. Sullivan, 356 U.S. 27, 28-29 (1958) (although payment of rent for the use of premises for bookmaking was illegal under Illinois law, deduction was allowed since the "amounts paid . . . to the landlord as rent are 'ordinary and necessary expenses' in the accepted meaning of the words").
18. See cases cited in Note, supra note 17, at 110 nn.5-13. Taxpayers had to determine not only whether an expenditure was in contravention of a sharply defined policy but also the directness of the relationship between the expenditure and the illegal act itself. See Commissioner v. Heininger, 320 U.S. 467, 474 (1943) (deduction not barred by "the mere fact that an expenditure bears a remote relation to an illegal act . . ."). The issue was yet further complicated by the fact that "[e]ven if a public policy is evidenced by a criminal or civil statute, administrative regulation, or court decision, there may be evidence of a conflicting public policy." Annot., 16 L.Ed.2d 1117, 1125 (1967); see Note, supra note 17, at 116.

No deduction shall be allowed . . . for any payment made, directly or indirectly, to any person if the payment constitutes an illegal bribe, illegal kick-
objective standard of which public policies were sufficiently important to justify denying a tax deduction. Under section 162(c)(2), to warrant denial of a deduction, the payment must violate a public policy expressed in a federal statute or in a generally enforced state statute.

II. DEVELOPMENT OF THE PUBLIC POLICY RATIONALE FOR DENYING BUSINESS DEDUCTIONS

The public policy doctrine has long been invoked to bar deduction of illegal business payments. Thus, for example, taxpayers have been denied deductions for fines and penalties, expenses involving back, or other illegal payment under any law of the United States, or under any law of a State (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer.


22. Originally, § 162(c) stated that the deduction would be disallowed only in cases in which the taxpayer pleaded guilty or nolo contendere to a charge of having violated such a statute. Congress determined, however, that this requirement could “unduly restrict the denial of deductions.” S. Rep. No. 437, 92nd Cong., 1st Sess. 72 (1971), 1972-1 C.B. 599. The Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 525, retroactively removed the requirement that the taxpayer plead either guilty or nolo contendere, amending I.R.C. § 162(c)(2) to provide that the IRS was to decide whether the statute had been violated. In order to protect the taxpayer, the burden of proof in such a case is explicitly placed on the IRS, and the standard is that which is required to establish fraud as specified in § 7454.

23. Treas. Reg. § 1.162-18(b)(3), T.D. 7345, 1975-1 C.B. 52, defines the term “generally enforced” as follows:

For purposes of this paragraph, a State law shall be considered to be generally enforced unless it is never enforced or the only persons normally charged with violations thereof in the State (or the District of Columbia) enacting the law are infamous or those whose violations are extraordinarily flagrant. For example, a criminal statute of a State shall be considered to be generally enforced unless violations of the statute which are brought to the attention of appropriate enforcement authorities do not result in any enforcement action in the absence of unusual circumstances.

illegal liquor transactions,25 kickbacks,26 "immoral expenditures,"27 and bribes.28 Taxpayers in such cases paid taxes on an amount exceeding their net income in an accounting sense. Thus, if a taxpayer's gross receipts are defined as his gross income under section 61 and all his expenses are barred from deductibility by the public policy doctrine, his taxable income would be equivalent to his gross receipts. This can lead to dire tax consequences for some taxpayers, especially those in businesses that have a high volume of activity, yet only a modest net income.

A. APPLYING THE TRADITIONAL DOCTRINE TO INSURANCE COMMISSIONS

An excellent illustration of the public policy bar to deductibility can be found in cases involving insurance commission kickbacks and rebates.

In Boyle, Flagg & Seaman, Inc. v. Commissioner,29 the taxpayer was an insurance agency that had returned a portion of its commissions on the sale of automobile insurance to automobile dealers who referred their customers to the taxpayer. The payments violated a state statute allowing rebates to be given only to licensed insurance agents.30 Although the taxpayer argued that the rebates should reduce its gross income, the Tax Court disagreed, finding that the taxpayer's gross premiums constituted its gross income. Once that had been concluded, the result followed inexorably: no deduction was allowed for the illegal payment because of the public policy doctrine.

In a closely related case, Schiffman v. Commissioner,31 the Tax Court adopted a different perspective, determining that it had before it an issue of the definition of gross income rather than deductibility.

---

25. See United States v. Winters, 261 F.2d 675 (10th Cir. 1958), cert. denied, 359 U.S. 343 (1959); Finley v. Commissioner, 255 F.2d 128 (10th Cir. 1958); Smith v. Commissioner, 33 T.C. 861 (1960); Lorraine Corp. v. Commissioner, 33 B.T.A. 1158 (1936).


27. See Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178 (2d Cir. 1931).


30. Id. at 45-46. Although the taxpayer maintained that it should be allowed to exclude the rebates from gross income on the ground that it had engaged in a series of joint ventures with the automobile dealers, this argument was rejected because the dealers "acquired no proprietary interest in the business" and because there was no "convincing evidence that the dealers and the petitioner ever intended that the relationship between them should be that of a joint venture." Id. at 48.

31. 47 T.C. 537 (1967).
The taxpayer, again an insurance agent, returned a portion of his commission directly to his customers as an inducement for them to purchase life insurance from him. Distinguishing Boyle on the ground that it dealt with payments to third parties whereas the case before it dealt with payments to the customer, the Schiffman court held that the payments were properly excludable from gross income when paid to the purchaser of the insurance. Relying on Pittsburgh Milk Co. v. Commissioner, the court concluded that the entire transaction should be viewed as a single event yielding net commissions; therefore, only net commissions should be considered gross income.

In Alex v. Commissioner the Tax Court repudiated its Schiffman analysis, returning to the view that illegal insurance commission rebates are prohibited deductions, not adjustments to gross income. In Alex, the taxpayer/life insurance agent, as in Schiffman, violated state law by returning portions of his commissions to his clients as an incentive for them to purchase insurance. On his income tax returns, he reported these illegal payments as "cost of goods sold and/or operations," labelling them as "discounted premiums." He, like Schiffman, subtracted them from gross commissions to arrive at his gross income.

Unlike the approach in Schiffman, however, the Tax Court resorted to a literal statutory analysis. Section 61 lists commissions as an item of gross income. The Tax Court concluded, therefore, as it had in Boyle, that the insurance agent had gross income in the full amount of commissions received from the insurance company. The proper rule, the court said, was that "any claim of exclusion from gross income, based upon an adjustment to the purchase price resulting from a discount or rebate, should at most be available only to the buyer or the seller." Since the insurance company, not the agent, was the seller of the insurance, there was "no selling price to which any adjustment as to him might be applied." The Tax Court justified its action by observing that any other result would "open the door to wholesale evasion of the purposes of section 162(c)."

32. Id. at 541-42.
33. Id. at 542.
35. 47 T.C. at 542.
36. 70 T.C. 322 (1978), appeal docketed, No. 78-3032 (9th Cir. Sept. 11, 1978).
37. CAL. INS. CODE § 750 (West 1972).
38. 70 T.C. at 324.
40. 70 T.C. at 326.
41. Id. But see Winkler v. United States, 230 F.2d 766 (1st Cir. 1956).
42. 70 T.C. at 326. This obviously represents a shift in the approach the Tax Court had taken earlier; in Schiffman the court had noted that "concepts of taxation
B. APPLICATION OF THE PUBLIC POLICY DOCTRINE TO SELLERS OF GOODS

Sellers of goods are consistently accorded the treatment briefly given to insurance agents in Schiffman and subsequently withdrawn in Alex. No matter how egregious the statutory violation, so long as a taxpayer's illegal payment is characterized as part of the cost of goods sold, it is fully subtracted before arriving at gross income. An early leading case espousing this approach is Sullenger v. Commissioner. The taxpayer had purchased meat from wholesalers, paying amounts in excess of the prices set by the Office of Price Administration. The taxpayer treated as income only the excess of the purchase price over the amounts actually paid for the meat. When the Commissioner attempted to disallow the deduction for the amounts paid in excess of the OPA prices the Tax Court rebuffed his efforts, asserting that "the cost of goods sold must be deducted from gross receipts in order to arrive at gross income. No more than gross income can be subjected to income tax upon any theory." Although the Tax Court offered neither authority nor its own analysis in support of this sweeping proposition, the language quoted has often since been cited by other courts to justify reducing gross receipts by the cost of goods sold, including illegal payments, to arrive at gross income.

In 1956, the Tax Court reached the same result in Pittsburgh Milk Co. v. Commissioner. In that case, the taxpayer corporation was engaged in selling milk at wholesale. Despite its awareness that minimum prices had been established by the state, the corporation entered into agreements with many of its customers to sell milk below the legal minimum prices. To preserve the appearance of legitimacy, the taxpayer first billed customers at the minimum prices and later...
offered them separate refunds to reduce the price to the previously agreed upon sum.\textsuperscript{49} Although the Commissioner disallowed the deduction on the ground that it frustrated the pricing policy expressed in the state statute,\textsuperscript{50} the Tax Court refused to consider the public policy issue at all, instead making the crucial finding that the milk had not actually been sold for the prices established by the state but at the net effective prices. The rebates, it said, were not deductions from gross income, but were price adjustments reducing gross receipts.\textsuperscript{51} Although expressly refusing to condone such business practices,\textsuperscript{52} the court relied on language from Supreme Court decisions to conclude that "[m]oral turpitude is not a touchstone of taxability"\textsuperscript{53} and, therefore, the amount of the illegal rebates was not included in the taxable income of the corporation.

In succeeding years, the Commissioner presented the Tax Court\textsuperscript{54} with a series of cases raising issues substantially identical to those raised in \textit{Pittsburgh Milk}.\textsuperscript{55} But in each case the Tax Court refused to alter its position that illegal payments, so long as they took the form of price adjustments, could be subtracted from gross sales in calculating gross income. Finally, in 1962, the Commissioner announced his acquiescence to the \textit{Pittsburgh Milk} result,\textsuperscript{56} and litigation in this area temporarily ceased.

After Congress enacted section 162(c)(2) of the Internal Revenue Code,\textsuperscript{57} however, the Commissioner renewed the fight to extend the public policy doctrine into the cost-of-goods-sold arena. In 1976, the Commissioner withdrew his acquiescence in the \textit{Pittsburgh Milk} result,\textsuperscript{58} and, in 1977, issued Revenue Ruling 77-244\textsuperscript{59} to clarify his position. In the ruling, which dealt with a fact situation similar to that in \textit{Pittsburgh Milk}, the IRS asserted that illegal price rebates could not be subtracted from gross sales in arriving at gross income.\textsuperscript{60}

\begin{thebibliography}{99}
\item 49. 26 T.C. at 711.
\item 50. \textit{Id.} at 715.
\item 51. \textit{Id.} at 714.
\item 52. \textit{Id.} at 716.
\item 53. \textit{Id.} (quoting Commissioner v. Wilcox, 327 U.S. 404, 408 (1946)).
\item 54. The Commissioner initially refused to acquiesce in the \textit{Pittsburgh Milk} result. 1959-1 C.B. 6.
\item 55. Atzingen-Whitehouse Dairy, Inc. v. Commissioner, 36 T.C. 173 (1961); Bloomingdale Dairy Co. v. Commissioner, 20 T.C.M. (CCH) 575 (1961); Harmony Dairy Co. v. Commissioner, 19 T.C.M. (CCH) 582 (1960); Rosedale Dairy Co. v. Commissioner, 16 T.C.M. (CCH) 1121 (1957).
\item 56. \textit{See} 1962-2 C.B. 5.
\item 57. The text of I.R.C. § 162(c)(2) is reproduced in note 20 supra.
\item 58. 1976-2 C.B. 3.
\item 60. \textit{Id.}
\end{thebibliography}
In *Max Sobel Wholesale Liquors v. Commissioner*, the IRS presented the Tax Court with the first case in which it sought to apply section 162(c)(2) directly to illegal price adjustments. The taxpayer in *Sobel* was a wholesale liquor dealer required by state law to file monthly price lists with the state and to refrain from selling below those announced prices. The statute’s aim was to prevent wholesale liquor dealers from giving individual retailers preferential treatment. In violation of the law, Sobel established a system for favored retailers under which customer credits could be utilized to obtain free liquor after the customer had purchased a given quantity at the legal minimum price. Because the illegal rebates were made in goods rather than cash, they were automatically reflected in lower closing inventories, thus increasing the cost of goods sold that Sobel subtracted from its gross sales in calculating gross income for tax purposes.

The Tax Court concluded that this subtraction of the price rebates from gross sales to reach gross income was proper. The substance of the agreement that Sobel had entered into, the court said, was to provide a given quantity of liquor for a net price below that required by the regulatory statute. Having reached this conclusion, it was a simple step to determine that section 162(c)(2) did not apply to Sobel’s acts, since that section merely denies the deduction of its cost of goods sold.

61. 69 T.C. 477 (1977), *appeal docketed*, No. 78-2833 (9th Cir. Aug. 17, 1978). Still pending before the Tax Court is Haas Brothers, Inc. and D & D Wholesale Liquors, Inc., No. 5219-76 (filed June 11, 1976), which presents a tax problem similar to that of *Sobel*.

62. *Cal. Bus. & Prof. Code* §§ 24756, 24862 (West 1964) (amended 1968, 1970), provided that wholesale liquor and wine dealers were required to file price lists with the Department of Alcoholic Beverage Control of the State of California, with sales of liquor and wine to be made only at the prices specified in such lists. As a practical matter, the price lists were established by the distributors, since wholesalers who refused to file the lists as provided by the distributors faced having their supply of liquor cut off by the distributors. Brief for Petitioner at 6, *Max Sobel Wholesale Liquors v. Commissioner*, 69 T.C. 477 (1977). The validity of this state regulatory scheme was brought into question by *Rice v. Alcoholic Beverage Control Appeals Bd.*, 21 Cal. 3d 431, 579 P.2d 476, 146 Cal. Rptr. 585 (1978), which declared *Cal. Bus. & Prof. Code* § 24755 (West 1964) (dealing with minimum retail prices for distilled spirits) to be an illegal restraint of trade under the Sherman Antitrust Act. The fact remains, however, that at the time of the violations in *Sobel*, §§ 24756 and 24862 were generally enforced. *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30, 36 (1958), suggests that a legislative amendment to the substantive state law does not preclude application of the public policy doctrine. It is not clear whether this would also be true when the statute is invalidated judicially.


64. 69 T.C. at 485.

65. *Id.* at 485.
illegal payments from gross income. In support of its holding, the court relied on *Pittsburgh Milk*.\textsuperscript{66}

The IRS had argued, however, that section 162(c)(2) was meant to overrule the *Pittsburgh Milk* line of cases.\textsuperscript{67} To dispose of that argument, the Tax Court focused on the limited scope of the statute, noting that the *Pittsburgh Milk* series of cases had been decided on the basis of calculating gross income rather than under the public policy doctrine relating to deductions from which section 162(c)(2) evolved. If Congress had meant to overrule *Pittsburgh Milk*, it would, according to the Tax Court, have done so explicitly.\textsuperscript{68} Finding no such intent in either the statute or the committee reports, the court concluded that the precedent established was still good law.\textsuperscript{69}

The IRS had also sought to forestall public policy violators' use of the cost of goods sold subtraction by promulgating an amendment to Treasury Regulation section 1.61-3(a).\textsuperscript{70} That section states that the cost of goods sold is to be determined "without subtraction of . . . amounts which are of a type for which a deduction would be disallowed under section 162(c), (f), or (g) in the case of a business expense."\textsuperscript{71} The stated purpose of similar changes to the regulations under sections 212 and 471 was to "prevent the Congressional intent from being circumvented by the allowance under [other] sections of deductions which Congress explicitly denied by its amendments to section 162."\textsuperscript{72} But the Tax Court blocked this extension of the public policy doctrine by construing section 1.61-3(a) "to preclude the deductibility of an illegal payment charged to overhead in the cost of sales of the type which might otherwise be deductible as administrative or sales expenses."\textsuperscript{73}

This restrictive interpretation seems consistent with the legislative intent behind section 162(c)(2). Before that section was enacted, a number of cases substantive statute indicated an intent to exclude

\textsuperscript{66} Id. at 482.
\textsuperscript{68} 69 T.C. at 484.
\textsuperscript{69} Id. at 486 (citing S. REP. No. 552, 91st Cong., 1st Sess. 273 (1969), 1969-3 C.B. 423, 597).
\textsuperscript{70} Treas. Reg. § 1.61-3(a), T.D. 7285, 1973-2 C.B. 163, 164. Unfortunately, the modification to the Treasury Regulation was incorporated into a set of changes designed to implement the use of the full absorption method of inventory costing and thus direct attention may not have been focused on the implication of the modification relating to illegal payments.
\textsuperscript{71} Id.
\textsuperscript{72} T.D. 7345, 1975-1 C.B. 51.
\textsuperscript{73} 69 T.C. at 485 (emphasis in original).
illegal payments from the cost of goods sold. Almost uniformly, the courts had determined that they should not be so excluded. Given this history, it is unlikely that Congress, without explicitly addressing the matter, intended that the distinctions that had been drawn up to that time were no longer to be of any consequence. It is more probable that Congress did not intend to alter the treatment given to a cost of goods sold item when it enacted a statute dealing only with business deductions. Thus, Treasury Regulation section 1.61-3(a), if interpreted as the IRS had intended, would exceed its congressional authorization and consequently be invalid. To avoid this problem, the Tax Court selected a restrictive but defensible interpretation that made the regulation nearly meaningless.

III. MODIFYING THE SCOPE OF SECTION 162(c)(2)

By looking to the language of section 162(c)(2) in light of the cases interpreting that statute, The Tax Court found support for its determination that although the fact situation in Alex fell within the confines of the public policy doctrine as codified in the section, Sobel could not rightly be governed by that section. Accordingly, Sobel was allowed to give effect to its illegal transfer of liquor in computing its ultimate tax liability. Because the disparate treatment of Sobel and Alex seems mandated by the Code, it is necessary for Congress to modify the statutory structure within which these cases have been decided if a change in result is desired.

A number of arguments may be raised against extending 162(c)(2). One argument that is likely to be made is that a statute excluding items from the cost of goods sold would run afoul of the sixteenth amendment by imposing a tax on something that in some metaphysical sense is not income. Such an argument would be

74. See, e.g., Jones v. Herber, 198 F.2d 544, 545 (10th Cir. 1952); Commissioner v. Guminski, 198 F.2d 265, 266 (5th Cir. 1952); Hofferbert v. Anderson Oldsmobile, Inc., 197 F.2d 504, 506 (4th Cir. 1952); Commissioner v. Weisman, 197 F.2d 221, 221-22 (1st Cir. 1952). Even if the congressional intent is clear, however, the issue whether cost-of-goods-sold items are constitutionally protected remains. See notes 76-84 infra and accompanying text. See Note, Disallowance of Over-Ceiling Costs of Goods Sold: The Defense Production Act of 1950, 4 Syracuse L. Rev. 323, 324 (1953).


76. U.S. Const. amend. XVI provides: "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." Because of the breadth of this constitutional language, uncertainty as to the limits of congressional power to tax remains. See 4 H. MERTENS, LAW OF FEDERAL INCOME TAXATION § 5.01 (1974) [hereinafter cited as MERTENS]. For a useful discussion of the bounds of the sixteenth amendment, see S. Rep. No. 2140, 76th Cong., 3d Sess., part 2, at 33-43 (1940).
premised on the conventional wisdom that gross income for tax purposes is precisely what is intended by the term “income” in the sixteenth amendment. Therefore, any extension of the definition of gross income in the Code must first pass muster under the sixteenth amendment. Consideration of the merit of such an argument requires closer scrutiny of the distinction between items subtracted as part of the “cost of goods sold” and those deducted as “expenses.” Although expenses are more or less universally acknowledged to be deductible only as a matter of legislative grace, it has been argued that the non-taxability of items included in the cost of goods sold has a constitutional underpinning. Early tax cases defined income in terms of gains, the best-known example being the Eisner v. Macomber statement that income is “‘gain derived from capital, from labor, or from both combined,’ provided it be understood to include profit gained through a sale or conversion of capital assets.” It is apparent that a taxpayer gains nothing until he has recovered his costs of acquiring the income upon which the tax is to be imposed. Viewed from this perspective, however, expenses stand on an equal footing with cost-of-goods-sold items. In either case, the taxpayer expends funds in anticipation of realizing receipts in excess of those expenditures. Following this analysis to its logical conclusion, it would seem that Congress could never tax anything more than a taxpayer’s net income. Yet, Congress has, with the approval of the Supreme Court, never strictly limited itself to taxing only net income. One need look no further than the well-established perception of expense deductions as being discretionary. This hardly coincides with the notion that Congress is constitutionally required to allow other “expenses”—those labelled as part of “cost of goods sold”—to be subtracted in arriving

77. This doctrine that deductions are allowed only as a matter of legislative grace originated in Helvering v. Independent Life Ins. Co., 292 U.S. 371, 381 (1934) (“Unquestionably Congress has power to condition, limit or deny deductions from gross income in order to arrive at the net that it chooses to tax.”); accord, Burnet v. Thompson Oil & Gas Co., 283 U.S. 301, 304 (1931).
80. 252 U.S. at 207 (quoting Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918)).
81. The subtraction of the cost of goods sold is often accepted by courts without analysis of the reasons for the subtraction. See 4 Mertens, supra note 76, at § 5.06; May, Accounting and the Accountant in the Administration of Income Taxation, 47 Colum. L. Rev. 377, 382 (1947); Note, Taxability of Gross Income Under the Sixteenth Amendment, 36 Colum. L. Rev. 274, 280 (1936).
82. See note 77 supra.
at the base for the income tax.

There is, then, an inherent illogic in drawing a constitutional distinction between the cost of goods sold and other business expenses. Allowing taxpayers engaged in the production or sale of goods to rely on the sixteenth amendment to claim subtractions from gross receipts while forcing taxpayers engaged in the provision of services to claim subtractions from gross receipts only to the extent of legislative grace is a distinction that lacks a rational basis. Since the cost-of-goods-sold subtraction for goods sold in the ordinary course of business is authorized solely by regulation and custom, statutory modification of the cost-of-goods-sold doctrine is proper when competing considerations dictate. Thus, Congress should not feel constrained by constitutional limitations from extending the section 162(c)(2) prohibition to encompass items in the cost-of-goods-sold category as well.

Another reason for not extending the public policy doctrine to cost-of-goods-sold items might be that it departs from the established policy, recognized by the courts, of imposing a tax on only net income. For example, in *Tank Truck Rentals, Inc. v. Commissioner*, the Supreme Court discussed the applicability of the public policy doctrine in terms of weighing the competing tax goals of (1) taxing only net income and (2) denying deductions for public policy reasons. When Congress subsequently codified the public policy doctrine in section 162(c)(2), however, it implicitly struck the balance in favor of implementing the public policy doctrine even if sacrificing the objective of taxing only net income was the inevitable corollary.

Because the purposes behind the public policy doctrine are often poorly articulated, it is difficult to determine whether this congres-
sional policy favoring the doctrine is proper. There seem to be two basic purposes behind the public policy doctrine. The first of these is consistent with a general view that tax deductions are a type of reward for certain types of activity or are a specific congressional statement that such activities are to be sanctioned by allowing deductions for engaging in that activity. Thus, it is perceived that those who have violated a statute should not be able to achieve the tax savings that flow from the deductibility of an expense item. Instead, the deduction should be disallowed so that taxpayers can obtain tax advantages only from engaging in legal activities. 87 This purpose of the policy doctrine seems to merely reflect a general sense of equity which may not be defensible on a more specific level.

The second purpose of the public policy doctrine, however, can be expressed in more concrete terms: the doctrine operates to reinforce substantive statutory mandates. 88 If taxpayers were allowed tax deductions for activities that violate the law, their incentive to comply with the laws that regulate their business activities would be lessened. Accordingly, the public policy doctrine denies a deduction for these illegal expenses in order to avoid frustrating other legislative objectives.

Whatever the merit of these purposes of the public policy doctrine, Congress has, by enacting section 162(c)(2), made the determination that these purposes outweigh competing considerations such as the policy of taxing only net income. 89 The real question, then, is not whether the purposes of the public policy doctrine outweigh these other considerations, but rather whether payments made as part of the cost of goods sold should be treated differently from payments falling within the deduction category. In nearly all respects, a taxpayer who makes an illegal payment and subtracts it as part of the cost of goods sold is in the same position as one who makes an illegal payment and deducts it as an expense. 90 From a "moral" standpoint,

87. See generally Gordon, supra note 19, at 410-12.
88. See generally Annot., 27 A.L.R.2d 498, 503-04 (1953). Without this reinforcing influence, the tax statutes could operate at cross purposes with other statutes. For example, the taxpayer in Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958), intentionally violated weight restrictions and chose to pay the fines imposed as a cost of doing business. Denial of a tax deduction in such a case increases the cost of violating a regulatory statute and, accordingly, encourages taxpayers to comply with it. Id. at 35. But see Gordon, supra note 19, at 411-12. In reaching its result, the Supreme Court also noted that "judicial deference to state action requires, whenever possible, that a state not be thwarted in its policy." 356 U.S. at 35.
89. See notes 85-86 supra and accompanying text.
90. See Tyler, Disallowance of Deductions on Public Policy Grounds, 20 Tax. L. Rev. 665, 679 (1965). To the extent that one accepts an "accessions-to-wealth" concept of income, the taxpayers are identically situated and should be accorded identical tax
the two cases are indistinguishable. In each case the taxpayer's activity contravenes a sharply defined legislative policy. From a net income standpoint, whether the illegal payment is characterized as an exclusion from income or as a deduction is irrelevant. Each taxpayer has an equal amount of net disposable income remaining at the conclusion of the overall transaction. Thus, simply as a matter of equity, the two should be treated similarly under the Code. Yet, because under current law one taxpayer's payment is labelled as an exclusion from gross income rather than as a deduction, a tax difference results. These taxpayers are similarly situated not only in economic terms, but also in relation to the purposes of the public policy doctrine. Allowing the illegal payment to result in a tax savings in either case would have a detrimental effect on the substantive regulatory laws involved. If the public policy doctrine is an effective means of reinforcing other statutes when applied to deductions, it is equally appropriate to apply it to the cost of goods sold.

Moreover, by altering the mechanics of a transaction only slightly, different tax consequences can result, again suggesting that the distinction between taxpayers subtracting payments as part of the cost of goods sold and those taking deductions is not material from a public policy perspective. For example, if the taxpayer in Sobel, had made payments to the purchasing agent rather than to the buyer, the deduction would have been denied. Since the payment would not have been given to the buyer of the goods, the result would be controlled by Alex. Conversely, if in Alex the insurance company itself, at the request of its agent, had agreed with the buyer of the insurance to reduce the premiums on the policy by decreasing the commission to its agent, the result arguably would have been controlled by Sobel and the agent would have paid income taxes on only the commission actually retained by him. Under present law, therefore, illegal transactions can often be structured to receive favorable

---

treatment. The Supreme Court relied on the accessions-to-wealth definition of income in Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (Items are taxable as income when there have been "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."). See generally R. Goode, The Individual Income Tax 13-17 (rev. ed. 1976); H. Simons, Personal Income Taxation 41-58, 103-09 (1938).


92. See H. Simons, supra note 90, at 106.

93. See Note, supra note 17, at 130 ("[T]he apparent distinction between cost of goods sold and business expenses . . . is a distinction which is without significance or relevance to the enforcement objectives of the federal or state regulatory legislation . . . ."). See also Comment, supra note 48, at 820.
tax treatment by careful planning.

If any change is to occur in the tax treatment of those who currently escape the public policy limitation on deductions because their payments are labelled as cost-of-goods-sold subtractions, it must originate with Congress rather than with the Treasury or the courts. Because of the complex nature of the modification needed, however, a detailed statutory change risks being either overinclusive or underinclusive. Thus, the amendment to the Code itself should simply be a direct and explicit authorization in section 61 for the Secretary of the Treasury to promulgate regulations designed to exclude illegal payments from the cost of goods sold. Such an approach would clearly announce congressional intent to overrule Pittsburgh Milk, Sobel, and other cases of that type.

Once the authority has explicitly been given by Congress, the Treasury could enact regulations to eliminate the "loophole" that currently exists for illegal payments structured so that they are characterized as exclusions from income rather than deductions. Such a provision, which would amend the regulations to section 61 of the Code, could be drafted as follows:

Amounts paid (directly or indirectly), including trade discounts and sales allowances, that, if they were deductions, would be disallowed under section 162(c), (f), or (g), shall not be utilized to (1) reduce gross sales or (2) increase the cost of goods sold.

94. This statute would eliminate the objection raised to the present Treas. Reg. § 1.61-3(a). See notes 71-75 supra and accompanying text.

95. An alternative solution to the problem presented in Sobel and Alex is statutory abolition of the distinction between the cost of goods sold and other "ordinary and necessary" business expenses. Such a statute would not only simplify the tax law, but would eliminate the practical problem of inequality of treatment between two classes of taxpayers who make illegal business payments. The statute would probably meet significant opposition, however, because the cost-of-goods-sold concept is so deeply ingrained in tax practice. Eliminating the distinction between cost of goods sold and other business expenses could, theoretically, also be accomplished by constitutional amendment eliminating the distinction between direct and indirect taxes. The sixteenth amendment itself does not authorize a tax on income; it merely removes the requirement that such a tax be apportioned. William E. Peck & Co., Inc. v. Lowe, 247 U.S. 165, 172-73 (1918); Stanton v. Baltic Mining Co., 240 U.S. 103, 112-13 (1916). The need for that amendment stemmed from the distinction between direct and indirect taxes drawn in Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 557 (1895). See 4 MERTENS, supra note 76, at § 4.08. Particularly since a tax on corporate income can be characterized as an excise tax not subject to the apportionment requirement of U.S. CONST. art. 1, § 8, cl. 1, see Flint v. Stone Tracy Co., 220 U.S. 107, 151-52 (1911); Sierk, The Cost of Goods Sold Concept in Federal Income Taxation, 31 U. KAN. CITY L. Rev. 327, 334 (1963), there is a legitimate question whether the distinction between direct and indirect taxes is itself of continuing validity. But the process of constitutional amendment should be reserved for pressing matters incapable of resolution except by resort to extraordinary measures.
To further assist in the interpretation of this provision, an example could be included in the regulation as follows:

The taxpayer is engaged in the wholesale milk business for which minimum prices are established by generally enforced state statutes. These statutes require that milk be sold at no less than $10 per unit. In violation of these statutes, the taxpayer sells milk for $9 per unit. Since the $1 discount per unit has the effect of reducing the taxpayer's gross sales, such discount will not be recognized, since it would not be deductible under section 162(c)(2) if it were a business expense. Accordingly, the taxpayer must report gross sales of $10 per unit from this transaction.

Alternatively, if the taxpayer transfers an additional quantity of milk to reduce the net effective price to the buyer below the $10 per unit statutory minimum, the cost of such additional milk is not includable in the cost of goods sold, because such inclusion would have the effect of increasing the cost of goods sold by an amount for which a deduction would have been denied under section 162(c)(2).

The proposed regulation departs from a policy of taxing only net income, but this departure extends no further than does the deductions treatment of similar illegal payments under current law. Furthermore, the proposed modification would have a number of advantages over current law. First, refusing to allow illegal payments to result in tax benefits would increase the public policy doctrine's reinforcement effect on state and federal statutes. Second, the new scheme would operate to incrementally increase public acceptance of the tax law itself, because similarly situated taxpayers would be afforded uniform treatment. Moreover, by removing the loophole available to those taxpayers who can characterize their payments as exclusions rather than deductions, the proposed modification would eliminate the incentive to attempt to characterize a transaction as falling within that loophole. The result would be a decrease in litigation on this issue. Finally, the overall revenues generated by the tax law would increase.

Although the distinction between illegal payments subtracted from the cost of goods sold and those treated as deductions may have its origin in constitutional history, it currently lacks validity. By expressly extending the public policy doctrine to apply to items traditionally considered as part of the cost of goods sold, Congress could complete the codification process, begun with the enactment of I.R.C. section 162(c)(2), in a manner that is equitable, certain, and consistent with substantive statutory goals.
Commercial Paper: Taking a Bank Money Order "For Value" Under U.C.C. Section 3-303

As partial payment for an irrigation system, Bonanza Valley Sales and Irrigation, Inc. (Bonanza) received a $10,000 personal check from Steve Radloff drawn on his account with American National Bank (American).1 Bonanza presented the check to American for payment and received, as it requested, a bank money order for $10,000 payable to State Bank of Brooten (State Bank).2 Bonanza delivered the bank money order to State Bank, where it was applied to a loan made by State Bank to Bonanza. After making the appropriate credit entries on the loan ledger, State Bank placed the money order into the usual collection channels. American refused to pay the money order, however, when it discovered that Radloff had stopped payment on his check to Bonanza.3 Upon learning of American's refusal to honor the money order, State Bank obtained Bonanza's permission to reverse the loan credit originally given Bonanza and brought suit against American for wrongful stopping of payment.4 The trial court ordered judgment in favor of State Bank. On appeal, the Minnesota Supreme Court reversed, holding that a payee who conditionally accepts a bank money order in payment of an antecedent debt is not a holder in due course and the issuer of the bank money order is therefore entitled to stop payment of the money order and assert the defense of failure of consideration against the payee. State Bank v. American National Bank, 266 N.W.2d 496 (Minn. 1978).

1. The check was made payable to Bonanza and Welte Enterprises. State Bank v. American Nat'l Bank, 266 N.W.2d 496, 497 (Minn. 1978).
2. The bank money order was issued designating Bonanza's chief officer as remitter (purchaser) and State Bank as payee. The instrument was signed by American's assistant vice-president and cashier. Id.
3. Radloff stopped payment on his check at nine a.m., August 5. Bonanza presented the check to American at three p.m. the same day. Due to a computer malfunction, the American bank officer that signed the bank money order did not learn of the stop payment order until August 7, when he stopped payment on the money order. American notified State Bank of the stop order, and upon receipt of the money order, returned it to State Bank with "payment stopped" stamped on it. State Bank v. American Nat'l Bank, 266 N.W.2d 496, 497-98 (Minn. 1978).
4. After acquiescing to the reversal of the credit entries, Bonanza brought a separate action against Radloff demanding payment of the full amount for the irrigation system, including the amount of the bank money order. Brief for Appellant at 19, State Bank v. American Nat'l Bank, 266 N.W.2d 496 (Minn. 1978). This suit was compromised and settled prior to trial. There is some dispute, however, about whether the amount of the money order was included in the settlement agreement. Compare id. with Brief for Respondent at 15, State Bank v. American Nat'l Bank, 266 N.W.2d 496 (Minn. 1978).
A bank money order is a negotiable instrument issued by an authorized officer of a bank to a named payee that operates as an unconditional promise to pay the holder upon demand. It is thus a primary obligation of the bank, which acts as both the drawer and the drawee of the money order. Since a bank's obligation is the same

5. A holder is defined as "a person who is in possession of a document of title or an instrument . . . drawn, issued or indorsed to him or to his order or to bearer or in blank." U.C.C. § 1-201(20). For a holder to become a holder in due course, additional requirements must be satisfied. See note 45 infra and accompanying text.

6. A remitter, the purchaser of a bank money order or cashier's check, is not a party to the instrument. Therefore, he "is not a holder because the instrument is usually not 'issued or indorsed to him or his order or to bearer in blank.'" Comment, Adverse Claims & the Consumer: Is Stop Payment Protection Available?, 67 Nw. U.L. Rev. 915, 916 & n.9 (1973) (quoting U.C.C. § 1-201(20)).


whether it issues a bank money order or a cashier's check, courts and commentators universally treat a bank money order as a cashier's check.\(^9\)

Most courts adopt the general rule that a cashier's check is not subject to countermand by the remitter\(^{10}\) or the issuing bank.\(^{11}\) This is true whether a cashier's check is viewed as a draft or a promissory note.\(^{12}\) Courts characterizing a cashier's check as a draft rely primar-
ily on two Uniform Commercial Code (Code) sections to support this conclusion. The first is section 4-303, which provides that once a drawee bank accepts a check, the drawer of the check cannot stop payment. Since the drawer of a cashier's check is the drawee bank, the cashier's check is accepted by the very act of issuance. Courts have held, therefore, that payment cannot be stopped on such an instrument. The second provision relied on is section 3-413, which states that the "acceptor engages that he will pay the instrument according to its tenor at the time of his engagement . . . . " Under this section, courts have reasoned, the bank, having accepted the cashier's check, is prevented from refusing payment. Similarly, courts that view a cashier's check as a promissory note rely on section 3-413, which provides that the engagement to pay an instrument according to its original tenor is made by a maker as well as an acceptor.

In addition to arguments based on specific provisions of the Code, many courts have invoked general policy considerations in sup-

"[w]here there is doubt whether the instrument is a draft or a note the holder may treat it as either," it also states that "[a] draft drawn on the drawer is effective as a note." U.C.C. § 3-118(a). Nevertheless, most courts continue to follow the pre-Code view that a cashier's check drawn by the bank upon itself is a draft accepted by the bank by the very act of issuance. See, e.g., Swiss Credit Bank v. Virginia Nat'l Bank, 538 F.2d 587, 588 (4th Cir. 1976); Munson v. American Nat'l Bank & Trust Co., 484 F.2d 620, 623-24 (7th Cir. 1973); Pennsylvania v. Curtiss Nat'l Bank, 427 F.2d 395, 398 (5th Cir. 1970); Ross v. Peck Iron & Metal Co., 264 F.2d 262, 269 (4th Cir. 1959). A minority view, however, characterizes cashier's checks and bank money orders as promissory notes representing the bank's promise to pay the holder. See, e.g., TPO Inc. v. FDIC, 487 F.2d 131, 136 (3d Cir. 1973); Banco Ganadero y Agricola v. Society Nat'l Bank, 418 F. Supp. 520, 524 (N.D. Ohio 1976); Thompson Poultry, Inc. v. First Nat'l Bank, 199 Neb. 8, 9, 255 N.W.2d 856, 858 (1977).

13. U.C.C. § 4-303(1)(a)-(b) provides in part that "[a]ny . . . stop-order received by . . . a payor bank . . . comes too late to so terminate, suspend or modify such right or duty [to pay an item or to charge its customer's account for the item] if the . . . stop-order . . . is received . . . after the bank has . . . (a) accepted . . . the item . . . [or] (b) paid the item in cash."


15. U.C.C. § 3-413(1).


18. U.C.C. § 3-413(1).
port of the position that cashier's checks cannot be countermanded.\textsuperscript{19} In the commercial setting, cashier's checks and bank money orders are generally viewed as the equivalent of cash.\textsuperscript{20} Creditors are ordinarily willing to take cashier's checks in lieu of cash since these instruments are bank obligations rather than personal obligations of the remitter.\textsuperscript{21} Since it is frequently impractical and unsafe to transfer large amounts of cash, a cashier's check or money order serves an important commercial function.\textsuperscript{22} If banks were allowed to countermand cashier's checks, the utility of such instruments might be undermined.\textsuperscript{23}

The principle that cashier's checks are not subject to countermand, however, is not applied literally by the majority of courts because of the harsh effect of the rule in cases in which a bank has issued a cashier's check by mistake or for insufficient consideration. While many courts continue to assert that payment cannot be stopped on a cashier's check,\textsuperscript{24} most courts allow a bank to decline payment and assert its own defense of fraud,\textsuperscript{25} mistake,\textsuperscript{26} or failure of

\begin{itemize}
  \item \textsuperscript{22} Benson, \textit{supra} note 6, at 460-61; \textit{see} Johnson v. First State Bank, 144 Minn. 363, 366, 175 N.W. 612, 613 (1920).
  \item \textsuperscript{24} See notes 10-11 supra.
  \item \textsuperscript{25} See, e.g., Bank of Coffee Springs v. McGilvray & Co., 167 Ala. 408, 409-11, 52 So. 473, 473-74 (1910); Thompson Poultry, Inc. v. First Nat'l Bank, 199 Neb. 8, 9, 255 N.W.2d 858, 859 (1977); Benson, \textit{supra} note 6, at 447.
\end{itemize}
consideration\textsuperscript{27} against one who is not a holder in due course.\textsuperscript{28}

In State Bank, the Minnesota Supreme Court initially considered whether to strictly apply the rule that cashier’s checks cannot be countermanded. It noted that cases decided under the Code\textsuperscript{29} had reached conflicting results with respect to this issue,\textsuperscript{30} and then, citing TPO Inc. \textit{v.} FDIC,\textsuperscript{31} concluded that “a bank may stop payment on its own obligation if the obligation is in the hands of one who is not a holder in due course.”\textsuperscript{32}

The State Bank opinion perpetuates a misconception that has arisen in cases in which a bank has refused to pay a cashier’s check because it issued the check by mistake or without consideration. The court framed the issue as whether American was entitled to stop payment on the money order because of a failure of consideration.\textsuperscript{33} Whether the court viewed the bank money order as a promissory note or a draft,\textsuperscript{34} this “stop payment” characterization is incorrect. According to the only Code section concerning stopping payment, a “customer may by order to his bank stop payment of any item payable for his account . . . .”\textsuperscript{35} Since the Code makes it clear that a bank cannot be its own customer,\textsuperscript{36} section 4-403 does not apply to


\textsuperscript{28.} The bank cannot invoke the defenses of the remitter, however. See U.C.C. § 3-306(d); Benson, \textit{supra} note 6, at 450.

\textsuperscript{29.} The Uniform Commercial Code was adopted in Minnesota by Act of May 26, 1965, ch. 811, 1965 Minn. Laws 1290, from the 1962 official draft. The official numbering system was retained with the addition of the chapter prefix, 336. Except as otherwise noted, the statutory provisions cited herein are substantively unchanged from the 1962 official draft. 21A \textit{MINN. STAT. ANN.}, Preface at III (West 1966). In this Comment, textual references to provisions of the U.C.C. will be presented without repeated reference to the 1962 version or the Minnesota Statutes chapter prefix.

\textsuperscript{30.} 266 N.W.2d at 498-99.

\textsuperscript{31.} 487 F.2d 131, 136 (3d Cir. 1973).

\textsuperscript{32.} 266 N.W.2d at 499 (emphasis in original).

\textsuperscript{33.} \textit{Id.} at 499.

\textsuperscript{34.} See note 12 \textit{supra}.

\textsuperscript{35.} U.C.C. § 4-403 (emphasis added).

\textsuperscript{36.} The Code defines a customer as “any person having an account with a bank
drafts that are the bank’s primary obligation. As one commentator has noted,

it would be well for the courts to eschew the phraseology of “stopping payment” when considering the question of a bank’s right to decline to pay [a cashier’s check]. The phrase, rooted in the concept that a customer has an absolute right to order his bank not to pay, serves mainly to confuse the issue.

Despite the court’s misuse of stop payment terminology, it properly identified the primary issue in the case: whether American’s defense of failure of consideration was applicable in an action by State Bank to enforce the instrument. Notes and drafts are both negotiable instruments; under the Code, transferees and holders of negotiable instruments take them subject to personal and real defenses. Holders in due course, on the other hand, take instruments free from personal defenses and are subject only to real defenses. Failure of consideration is a personal defense and therefore is effective only against one who is not a holder in due course. Thus, as the court recognized, the critical issue in State Bank was whether State Bank was a holder in due course.

Section 3-302 of the Code defines a holder in due course as a holder who takes an instrument for value, in good faith, and without notice of any claim to or defenses against it. Since there was no question that State Bank was a holder that had taken the bank money order in good faith and without notice of any claims or defenses, State Bank’s status as a holder in due course depended on whether it had taken the American bank money order for value. Section 3-303(b) of the Code provides that a holder who takes an instrument as payment for an antecedent debt takes it for value. In

or from whom a bank has agreed to collect items and includes a bank carrying an account with another bank.” U.C.C. § 4-104(1)(e). An issuing bank having an account with itself does not qualify as a customer under this definition. See Benson, supra note 6, at 448; Fox, supra note 7, at 685-86.

37. See Fox, supra note 7, at 685.
38. Id. at 697 (footnote omitted).
39. Id. at 689; see U.C.C. § 3-104.
40. See U.C.C. §§ 3-305, -306, -408; Fox, supra note 7, at 687, 690.
42. See U.C.C. § 3-306(c).
43. Id. §§ 3-305, -306(c), -408.
44. 266 N.W.2d at 493.
45. U.C.C. § 3-302.
46. See 266 N.W.2d at 499.
47. U.C.C. § 3-303(b) (“A holder takes the instrument for value... (b) when he takes the instrument in payment of or as security for an antecedent claim against any person whether or not the claim is due.”).
Leininger v. Anderson, the court relied on this section to hold that the application of cashier's checks to a preexisting debt constituted taking for value. Since State Bank had applied the bank money order to Bonanza's debt with the bank, it would seem that the bank took the money order for value under Leininger. The court distinguished Leininger from State Bank, however, holding that State Bank had not taken for value because the credit entries made on the loan ledger were "conditional or provisional." This reading of the Code is untenable, however. Since section 3-303 refers to "taking" for value, the appropriate time for determining whether value has been received is when the instrument is taken. In State Bank, there is no indication that either Bonanza or State Bank viewed the payment as conditional at the time State Bank received the bank money order and credited the amount against Bonanza's loan. Although Bonanza later allowed the credit reversal to be made, under the most logical reading of section 3-303, value was given when the bank money order was originally received by State Bank in part payment for the loan.

The court also relied on section 3-802(1)(a) of the Code to support its holding that State Bank did not take the money order for value. That section provides that "[u]nless otherwise agreed where an instrument is taken for an underlying obligation . . . the obligation is pro tanto discharged if a bank is drawer, maker or acceptor of the instrument and there is no recourse on the instrument against the underlying obligor." The court held that since Bonanza allowed State Bank to reverse the credit entries on its loan, Bonanza and
State Bank "otherwise agreed"; thus, payment was conditional. Consequently, the court concluded that State Bank did not take the bank money order for value.

This conclusion is inconsistent with the language and apparent purpose of section 3-802(1)(a). Under the most reasonable construction of that section, the agreement that the taking of a bank obligation will not constitute final payment must be made by the parties at the time the instrument is received. Once the payee takes the instrument without reserving the right to sue the debtor on the underlying obligation, section 3-802(1)(a) recognizes that payment should be considered final, since recourse may be had by the payee against the bank as a drawer, maker, or acceptor. If, as the court's opinion suggests, payment is always conditional until the bank obligation is actually paid, section 3-802(1)(a) would be rendered superfluous.

Even if the court was correct in its finding that payment was conditional, the Minnesota Code Comment to section 3-303 indicates that conditional payment by delivery of an instrument ordinarily constitutes the giving of value. The Comment states that "section 3-303 does not make clear whether the ordinary conditional payment by indorsement [and] delivery of an instrument is a transfer 'for value' . . . . Presumably it is . . . ." In addition, the Comment states that the section "establishes" that the taking of an instrument in payment of an antecedent claim is value and "cannot be held to be otherwise."

Whether State Bank gave value because conditional payment constitutes value or because the payment was final rather than provisional, the court should have found that, having taken the money order for value, State Bank was a holder in due course. Since personal defenses are ineffective against a holder in due course, traditional doctrine would have required the court to hold that American's defense of no consideration failed.

Although it was incorrect to conclude that State Bank was not a holder in due course, the reason the court thought that to be a desirable result is clear. Since State Bank had reversed the credit entries on Bonanza's loan account, it had sustained no loss as a result of the

54. 266 N.W.2d at 500.
55. Id. at 501.
56. See U.C.C. § 3-802, Official Comment 2; E. Peters, supra note 41, at 45.
58. Id.
59. Id.
60. See notes 51-59 supra and accompanying text.
61. See notes 39-43 supra and accompanying text.
unpaid money order. There was, therefore, no reason to require American to pay State Bank. The court thus reached an equitable result; neither State Bank nor American sustained a loss, and any remaining dispute was left to be resolved between the original parties to the transaction, Radloff and Bonanza.\(^2\)

The court could have reached the same result without straining the Code's definition of "value," however, had it invoked the "election" theory. This theory is based on the principle that a holder in due course should not be allowed to exercise its rights on an instrument once it has taken actions evidencing an "election" to hold other parties liable. State Bank acted inconsistently with the exercise of its rights as a holder in due course when it reversed the loan credit entries it had made in favor of Bonanza, since the reversal of the credit entries restored Bonanza's full liability to repay its loan from State Bank. State Bank thus made an "election" to hold Bonanza accountable for the loan and refrain from exercising its rights as a holder in due course of the bank money order against American.

Although no court has invoked an "election" theory to deny an action by a holder in due course against the drawer or maker of a negotiable instrument, one court indicated that it would have applied such a theory had it not decided the case on alternative grounds.\(^3\) In Massachusetts Bank & Trust Co. v. McGillicuddy,\(^4\) the bank reversed a credit entry it had made to a customer's overdrawn checking account after a third party's check deposited by the customer was dishonored. The bank then sued the drawer of the check. In dictum, the court noted:

Counsel for the defendant . . . contends . . . that the bank, by charging [the check] back, has elected to hold [its customer] responsible and that it cannot therefore sue the maker of the check. This contention would seem to have a lot of merit, and the position of the bank, is to say the least, inconsistent, if not irreconcilable.\(^5\)

In State Bank, the court could have invoked this election theory and held that State Bank did have a cause of action against American. The principle advantage of this theory is that it does not defeat the expectations of the parties. Because an election is a voluntary act, both the bank and its customer can decide, in advance, whether they wish to treat the instrument as valid payment. If the parties choose

---

\(^2\) The court thus reached an equitable result; neither State Bank nor American sustained a loss, and any remaining dispute was left to be resolved between the original parties to the transaction, Radloff and Bonanza.

\(^3\) Although no court has invoked an "election" theory to deny an action by a holder in due course against the drawer or maker of a negotiable instrument, one court indicated that it would have applied such a theory had it not decided the case on alternative grounds.

\(^4\) In Massachusetts Bank & Trust Co. v. McGillicuddy, the bank reversed a credit entry it had made to a customer's overdrawn checking account after a third party's check deposited by the customer was dishonored. The bank then sued the drawer of the check. In dictum, the court noted:

Counsel for the defendant . . . contends . . . that the bank, by charging [the check] back, has elected to hold [its customer] responsible and that it cannot therefore sue the maker of the check. This contention would seem to have a lot of merit, and the position of the bank, is to say the least, inconsistent, if not irreconcilable.

\(^5\) In State Bank, the court could have invoked this election theory and held that State Bank did have a cause of action against American. The principle advantage of this theory is that it does not defeat the expectations of the parties. Because an election is a voluntary act, both the bank and its customer can decide, in advance, whether they wish to treat the instrument as valid payment. If the parties choose
to consider the instrument invalid, they can expect a court to refuse to hear their claim on the instrument; there is no uncertainty. In contrast, the State Bank court's tampering with the requisites of holder in due course status can only lead to uncertainty about the value of bank money orders and other instruments. As a result, the commercial utility of such instruments will be greatly decreased.

The court's determination that State Bank was not entitled to recover from American appears to be equitable in this case, but the court failed to present a convincing rationale for this result. Had the court held that State Bank was a holder in due course that had made a binding election not to exercise its rights on the bank money order, it could have avoided using strained interpretations of the Code's "value" provisions. This would have allowed the court to reach an equitable result while fulfilling a primary goal of the Code: preserving the commercial utility of negotiable instruments.