

Loss Deduction Denied Under Public Policy Doctrine: *Hampton v. Commissioner*

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The Supreme Court held in 1958 that an amount otherwise satisfying all statutory hurdles to allowance of a deduction for Federal income tax purposes will nevertheless not be allowed if it would “frustrate sharply defined national or state policies proscribing particular kinds of conduct, evidenced by some governmental declaration thereof” (*Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958)). This “public policy doctrine” was codified in 1969 with respect to amounts otherwise deductible as ordinary and necessary business expenses by section 162(f) as then added to the Internal Revenue Code (see T.D. 7345 (Feb. 19, 1975) (preamble to regulations promulgated under section 162(f))).

Under section 162(f), fines, penalties, and other amounts paid to or at the direction of a governmental entity by reason of the violation of any law are generally nondeductible as business expenses under section 162 or as expenses incurred in connection with the production of income under Code section 212. With respect to amounts otherwise deductible as losses under IRC section 165, rather than as business expenses under section 162, the area continues to be governed by judge-made law, the continued vitality of which was recently confirmed by *Hampton v. Commissioner* (TC Memo 2025-32).

Facts in *Hampton*

Douglas Hampton was a registered representative of various broker-dealer firms and provided asset management and financial planning advice. His earnings consisted mostly of commissions remitted by the broker-dealers to him personally.

Hampton registered the trade name “Hampton Capital Management” and then created Hampton Capital Management, Inc. (HCM), as an S corporation for Federal tax purposes. HCM employed Hampton and an administrative assistant. Hampton took the position on his Forms 1040 that the commissions he received had been assigned to HCM, of which he was the sole shareholder. HCM reported the commissions on its corporate returns, and a portion of the commission income was then reported on Hampton’s Forms 1040 as wages paid by HCM to Hampton.

In 2013, the U.S. Government filed a criminal information against Hampton in U.S. District Court, charging him with conspiracy to commit bribery, wire fraud, and money laundering in connection with payments directed by Hampton to a government official to obtain trading commissions from trades on behalf of a state government. Hampton pleaded guilty to the conspiracy charge and was sentenced to imprisonment and forfeiture of approximately \$2.2 million. Hampton and the United States signed a “Consent Order of Forfeiture” providing for the forfeiture by Hampton of any proceeds of the violations described in the criminal information, up to the \$2.2 million amount.

While Hampton was incarcerated, the district court issued warrants under which the U.S. Marshals Service seized \$865,230 in 2016 from two accounts in the name of HCM (as well as other amounts from accounts in the name of Hampton). On the basis of the seizure from HCM accounts, its 2016 Form 1120S reported a loss under section 165 of \$855,882. The loss was described in a statement attached to the return as having been incurred by reason of a forfeiture, enforced by the U.S. Marshals Service, of HCM account balances that had been generated by its business of financial advising and sale of financial products.

A footnote in the Tax Court opinion notes that the amount seized from HCM accounts exceeded the amount it claimed as a loss, but does not explain the differential.

HCM had gross income of \$6,547 for 2016 and reported a net loss of \$849,335. That loss was, in turn, reflected by Hampton, as sole shareholder of the S corporation, on Schedule E of his 2016 Form 1040. In a notice of deficiency, the IRS disallowed HCM's deduction of \$855,582 and increased Hampton's income reported on his Schedule E by the same amount. Although the opinion does not describe any rationale asserted by the IRS in the notice of deficiency or related documents for the adjustment of Schedule E income, the Commissioner argued before the Tax Court that the loss was not allowable under the public policy doctrine.

Discussion

The court agreed with the Commissioner that, in light of the criminal information, Hampton's guilty plea, and evidence that the account balances of HCM were property derived from the criminal conduct of Hampton, the allowance of the loss as a deduction would frustrate the government's policy against conspiracy to commit the offenses that were described in the information. The circumstance that HCM itself was not charged with wrongdoing was found by the court to be irrelevant, based on a prior Tax Court decision (*Holmes Enterprises, Inc. v. Commissioner*, 69 T.C. 114 (1977)). In that case, a loss was disallowed where a car owned by a corporation was forfeited by reason of use of the car by the corporation's sole shareholder and president in committing a crime of which the sole shareholder had been convicted.

Hampton's argument that the court should consider whether applicability of the public policy doctrine was affected by illegal or over-zealous conduct by the United States in effectuating the seizure was also dismissed by the court, which concluded that the seizure was authorized under relevant statutes. The opinion further observed (citing prior case law) that the proper remedy, if Hampton believed the seizure to have been invalid, would have been for Hampton to sue the government to seek return of the funds.

Taking into account the court's conclusion that deduction of the loss was appropriately disallowed under the public policy doctrine, the court declined to address other arguments apparently made by the Commissioner in support of disallowance of the deduction. Those included that (i) HCM was a sham entity that should be disregarded for tax purposes and (ii) the seizures "effectively constituted" a distribution or compensation payment from HCM to Hampton.

Observations

In *Holmes Enterprises*, the Tax Court had upheld a deficiency asserted against a corporation that had claimed a deduction by reason of the forfeiture of property. By contrast, in *Hampton*, HCM was not a party to the Tax Court proceedings, and the opinion stated: "Even if we assume that HCM was entitled to claim a deduction for the asset seizures (a question we need not decide here), Mr. Hampton is barred by the public policy doctrine" from claiming his pass-through share (100%) of the resulting corporate loss.

Treasury Reg. section 1.1366-1(b)(1) states that, with exceptions that do not appear relevant here, "the character of any item of income, loss, deduction, or credit described in section 1366(a)(1)(A) or (B) and paragraph (a) of this section [which include a shareholder's pro rata share of so-called "nonseparately computed income or loss" of an S corporation] is determined for the S corporation and retains that character in the hands of the shareholder."

On the basis of the court's stated assumption that HCM was entitled to claim the deduction and this language from the regulation, a technical argument could perhaps be made that, if a deduction is allowable to a corporation, circumstances specific to a shareholder cannot then cause denial to that shareholder of a deduction for the resulting overall business loss of the corporation. After all, the regulations under IRC section 1366 that determine how S corporation items are taken into account in computing a shareholder's tax liability seem to look solely to circumstances at the corporate level.

Although the opinion briefly discussed the application of section 1366, it is not clear whether Hampton made this specific argument or, if he did, that the court properly addressed the issue. Even if Hampton had convinced the court on the section 1366 point, however, it is entirely possible that the court could have reached the same result under a different rationale – for example, by finding that HCM was not truly engaged in a business at all, but acted simply as a holder of record for property beneficially belonging to Hampton.

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