

# Moral Arguments & Moral Hazards

## Sindustry of THEIRS

Sin Taxes:  
Size, Growth, and Creation  
of the Sindustry



Profit, Non-Profit and illegal industries involved in or create Moral Arguments & Moral Hazards

“The Congress shall have power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States” Article 1, Section 8, Clause 1.

This used power was never granted to Congress: to pay our personal or business Debts or provide for the personal or common earmarked or corporate Welfare or health, wealth, and happiness of any one group, special class, or any individual who has the power to buy tax law or make it so. The Moral Arguments & Moral Hazards created by IRS exemptions- exclusions- credits- deductions- adjustments- abatements from income tax are endless. Each moral or wrong decision made by any Profit, Non-Profit and illegal industries creates and supports the Sindustry of THEIRS.

# Moral Arguments & Moral Hazards

The **Taxing and Spending Clause** (which contains provisions known as the **General Welfare Clause** and the **Uniformity Clause**), Article I, Section 8, Clause 1 of the United States Constitution, grants the federal government of the United States its power of taxation. While authorizing Congress to levy taxes, this clause permits the levying of taxes for two purposes only: to pay the debts of the United States, and to provide for the common defense and general welfare of the United States. Taken together, these purposes have traditionally been held to imply and to constitute the federal government's taxing and spending power.

**Uniformity Clause** refers to the clause in the U.S. constitution, requiring the uniform collection of federal taxes. Article I, Clause 1 of the U.S. constitution gives the federal government of the U.S. its power of taxation. The uniformity clause was intended to prevent the legislature and local officials from granting preferential tax treatment to influential property owners and to protect the citizen against unequal and consequently unjust taxation

## U.S. Supreme Court

### **Commissioner v. Sullivan, 356 U.S. 27 (1958)**

**Commissioner of Internal Revenue v. Sullivan**

**No. 119**

**Argued January 30, 1958**

**Decided March 17, 1958**

**356 U.S. 27**

*CERTIORARI TO THE UNITED STATES COURT OF APPEALS*

*FOR THE SEVENTH CIRCUIT*

*Syllabus*

Amounts expended to lease premises and hire employees for the conduct of gambling enterprises, illegal under state law, are deductible as ordinary and necessary business expenses within the meaning of § 23(a)(1)(A) of the Internal Revenue Code of 1939. Pp. 356 U. S. 27-29.

241 F.2d 46, 242 F.2d 558, affirmed.

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

The question is whether amounts expended to lease premises and hire employees for the conduct of alleged illegal gambling enterprises are deductible as ordinary and necessary business expenses within the meaning of § 23(a)(1)(A) of the Internal Revenue Code of 1939. [Footnote 1]

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The taxpayers received income from bookmaking establishments in Chicago, Ill. The Tax Court found that these enterprises were illegal under Illinois law, [Footnote 2] that the acts performed by the employees constituted violations of that law, and that the payment of rent for the use of the premises for the purpose of bookmaking was also illegal under that law. The Tax Court accordingly held that the amount paid for wages and for rent could not be deducted from gross income, since those deductions were for expenditures made in connection with illegal acts. 15 CCH TC Mem. Dec. 23, 25 T.C. 513. The Court of Appeals reversed, 241 F.2d 46, 242 F.2d 558, on the basis of its prior decision in *Commissioner v. Doyle*, 231 F.2d 635. The case is here on a petition for certiorari, 354 U.S. 920, for consideration in connection with the companion cases *Hoover Motor Express Co. v. United States*, post, p. 356 U. S. 38, and *Tank Truck Rentals, Inc. v. Commissioner*, post, p. 356 U. S. 30.

Deductions are a matter of grace, and Congress can, of course, disallow them as it chooses. At times, the policy to disallow expenses in connection with certain condemned activities is clear. It was made so by the Regulations in *Textile Mills Securities Corp. v. Commissioner*, 314 U. S. 326. Any inference of disapproval of these expenses as deductions is absent here. The Regulations, indeed, point the other way, for they make the federal excise tax on wagers deductible as an ordinary and necessary business expense. [Footnote 3] This seems to us to be recognition of a

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gambling enterprise as a business for federal tax purposes. The policy that allows as a deduction the tax paid to conduct the business seems sufficiently hospitable to allow the normal deductions of the rent and wages necessary to operate it. We said in *Commissioner v. Heininger*, 320 U. S. 467, 320 U. S. 474, that the "fact that an expenditure bears a remote relation to an illegal act" does not make it nondeductible. And see *Lilly v. Commissioner*, 343 U. S. 90. If we enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts, while all other business would be taxable on the basis of net income. If that choice is to be made, Congress should do it. The amounts paid as wages to employees and to the landlord as rent are "ordinary and necessary expenses" in the accepted meaning of the words. That is enough to permit the deduction, unless it is clear that the allowance is a device to avoid the consequence of violations of a law, as in *Hoover Motor Express Co. v. United States*, supra, and *Tank Truck Rentals, Inc. v. Commissioner*, supra, or otherwise contravenes the federal policy expressed in a statute or regulation, as in *Textile Mills Securities Corp. v. Commissioner*, supra.

*Affirmed.*

[Footnote 1]

Section 23(a)(1)(A) provides:

"In computing net income there shall be allowed as deductions:"

"\* \* \* \*"

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"All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; . . . and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

53 Stat. 12, as amended 56 Stat. 819, 26 U.S.C. §23(a)(1)(A).

[Footnote 2]

Ill.Rev.Stat.1945, c. 38, § 336.

[Footnote 3]

Treas.Reg. 118, § 39.23(a)-1, Rev.Rul. 54-219, 1954-1 Cum.Bull. 51:

"The Federal excise tax on wagers under section 3285(d) of the Internal Revenue Code and the special tax under section 3290 of the Code paid by persons engaged in receiving wagers are deductible, for Federal income tax purposes, as ordinary and necessary business expenses under section 23(a) of the Internal Revenue Code, provided the taxpayer is engaged in the business of accepting wagers or conducting wagering pools or lotteries, or is engaged in receiving wagers for or on behalf of any person liable for the tax under section 3285(d) of the Code."

[<< Previous](#) [TITLE 26 / Subtitle D / CHAPTER 35 / Subchapter A](#)

## 26 USC 4405: Cross references

### From Title 26-INTERNAL REVENUE CODE

Subtitle D-Miscellaneous Excise Taxes

CHAPTER 35-TAXES ON WAGERING

Subchapter A-Tax on Wagers

## §4405. Cross references

**For penalties and other administrative provisions applicable to this subchapter, see sections 4421 to 4423, inclusive; and subtitle F.**

(Aug. 16, 1954, ch. 736, 68A Stat. 526.)

Where the word "see" is used in the cross reference of **26 U.S. Code § 4405 – Cross References** are made only for convenience, and in so doing **26 U.S. Code § 4421 - Definitions (Wager / Lottery)**; shall be given no legal effect pursuant to 26 U.S. Code § 7806(a).

Where the word "see" is used in the cross reference of **26 U.S. Code § 4405 – Cross References** are made only for convenience, and in so doing **26 U.S. Code §4423. Inspection of books**; shall be given no legal effect pursuant to 26 U.S. Code § 7806(a).

Where the word "see" is used in the cross reference of **26 U.S. Code § 4405 – Cross References** are made only for convenience, and in so doing **subtitle F**; shall be given no legal effect pursuant to 26 U.S. Code § 7806(a).

*The Moral Arguments & Moral Hazards are advanced by law that "shall be given no legal effect"*

# Moral Arguments & Moral Hazards

## Don't ignore the powerful moral arguments against high taxation

Eamonn Butler is director of the Adam Smith Institute.

by [Eamonn Butler](#)

23 May 2012 12:14am

WE ALL know the moral arguments for taxation: it pays for police, roads, hospitals and other vital services. But there is a moral case against taxation too – and a surprisingly strong one.

First, while most of us would happily make some voluntary contribution to essential services, it is only the threat of prison that makes us stump up taxes at today's eye-watering levels. Tax is extracted by force – and the use of force is an evil we want to minimize. That puts an awesome responsibility on governments to ensure that every penny they extract through coercion is spent wisely. Waste and bureaucracy are not just a drain on the economy – they are a moral outrage.

But not only is taxation a form of confiscation by coercion. It is confiscation by groups who believe their values and priorities are superior to other people – a breathtaking moral claim. It forces families to pay for things they fundamentally disagree with. People with deep moral objections to abortion or foreign wars or mixed-sex schools have to live with the dismal thought that they, unwillingly, help pay for those things. That should give politicians the utmost discomfort, though I doubt it does.

Tax reduces people's ability to act morally. They might prefer to spend their money on helping their children become good citizens, caring for their elderly relatives, or supporting good causes. Instead they see it taken and going on bank bailouts or expensive prestige projects. Though we wish to see individuals, families and local groups taking more responsibility for their own lives and welfare, high taxes leave them less able to do so.

And when the authorities usurp our choices, we cease to be morally sovereign and responsible individuals, and become mere agents of the state. A society cannot be considered "generous" or "caring" when its care and generosity is funded on money forced out of people, rather than freely given. Giving that comes voluntarily, through the public spirit of private donors, is far more laudable morally than support that is extracted by coercion.

Americans give almost twice as large a proportion of their earnings (1.67 per cent of GDP) to charity as does the UK (0.73 per cent). In large part, that is because the US government absorbs a much smaller part of its citizens' income, leaving them space to make their own giving decisions. Within that space, Americans have become the largest philanthropic givers in the world, with libraries, orchestras, hospitals, schools and medical research all funded by private donations.

By contrast, we in the UK pay so much in tax that many of us convince ourselves that we have no outstanding social obligations at all. We are told that our taxes do wonderful work paying for education, welfare and policing. So we see it as teachers' jobs, not ours, to ensure our children are literate and well behaved. We see the duty to help others as a matter for the welfare state

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rather than accepting that duty on ourselves. We even walk blindly past crime, vandalism or neglect, reassuring ourselves that these are things for officials to deal with.

And when people believe the state will provide, they see less reason to contribute to philanthropic causes. Why support good causes when the state already supports them? A classic example was the Royal National Lifeboat Institution (RNLI), which was created independently in 1924, but later fell on hard times. In 1854 it started accepting government grants. But for every pound the government put in, the RNLI lost thirty shillings (£1.50) in voluntary donations. So in 1869 it cut loose again – and has flourished ever since.

Remember too that our politicians and officials have their own interests, which inevitably colour how they spend our money. Ruling politicians steer tax revenues to their own supporters and pet causes. Interest groups vie against each other for grants and subsidies. The only group not represented in this carve-up of taxpayer funds is, unfortunately, taxpayers themselves.

Taxation, then, rests on force. It undermines morality, crowds out charity, rewards power, undermines personal responsibility, promotes group conflict and turns governments and the public into cheats. Taxation may be a necessary evil – but it is still an evil.

Eamonn Butler is director of the Adam Smith Institute and a contributor to the 2020 Tax Commission

<http://www.cityam.com/article/don-t-ignore-powerful-moral-arguments-against-high-taxation>

## **Taxation of illegal income in the United States**

In the United States, the Internal Revenue Code (IRC) was enacted by the U.S. Congress in part for the purpose of taxing net income. A person's taxable income will generally be subject to the same Federal income tax rules, regardless of whether the income was obtained legally or illegally.

### **Notable cases**

Al Capone was successfully prosecuted for tax evasion. Additionally, Soviet spy Aldrich Ames, who had earned more than \$2 million cash for his espionage, was also charged with tax evasion as none of the Soviet money was reported on his tax returns. Ames attempted to have the tax evasion charge dismissed on the grounds his espionage profits were illegal, but the charges stood.

### **5th Amendment**

The United States Supreme Court has ruled that requiring a person to declare income on a federal income tax return does not violate an individual's right to remain silent, although the privilege may apply to allow the person to refrain from revealing the source of the income.

### **Income**

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In *James v. United States*,<sup>[4]</sup> the Supreme Court held that an embezzler was required to include his ill-gotten gains in his "gross income" for Federal income tax purposes. In reaching this decision, the Court looked to the seminal case setting forth the tax code's definition of gross income, *Commissioner of Internal Revenue v. Glenshaw Glass Co.*,<sup>[5]</sup> in which the Supreme Court held that a taxpayer has gross income when he has "an accession to wealth, clearly realized, and over which the taxpayers have complete dominion".<sup>[6]</sup> At the time the embezzler acquired the funds, he did not have a consensual obligation to repay, or any restriction as to his disposition of the funds.<sup>[7]</sup> If he had acquired the funds under the same circumstances legally, there would have been no question as to whether he should have gross income. Therefore, the embezzler had gross income under the tax code, even though the application of another body of law would later force him to return the money.

## Deductible expenses in illegal activity – the general rule

While embezzlers, thieves, and the like are forced to report their ill-gotten gains as income for tax purposes, they may also take deductions for costs relating to criminal activity. For example, in *Commissioner v. Tellier*, a taxpayer was found guilty of engaging in business activities that violated the *Securities Act of 1933*.<sup>[8]</sup> The taxpayer subsequently tried to deduct from his gross income the legal fees he spent while defending himself.<sup>[9]</sup> The U.S. Supreme Court held that the taxpayer was allowed to deduct the legal fees from his gross income because they meet the requirements of §162(a),<sup>[10]</sup> which allows the taxpayer to deduct all the "ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business."<sup>[11]</sup> The Court reasoned (and the Internal Revenue Service did not contest the point) that it was ordinary and necessary for a person engaged in a business to expect to have legal fees associated with that business, even though such things may only happen once in a lifetime.<sup>[12]</sup> Therefore, the taxpayer in *Tellier* was allowed to deduct his legal fees from his gross income, even though he incurred the fees because of his crime. The U.S. Supreme Court in *Tellier* reiterated that the purpose of the tax code was to tax net income, not punish unlawful behavior.<sup>[13]</sup> The Court suggested that if this was not the case, Congress would change the tax code to include special tax rules for illegal conduct.<sup>[14]</sup>

## Expenses that are not deductible

Deductions relating to unlawful conduct may be disallowed when to allow them would sharply frustrate a national or state policy prohibiting such conduct.<sup>[15]</sup>

Congress may impose specific provisions that prohibit deductions in connection with illegal activity or other violations of law. No deduction is allowed for fines or similar penalties paid to a government for the violation of any law.<sup>[16]</sup>

Internal Revenue Code section 280E specifically denies a deduction or credit for any expense in a business consisting of trafficking in illegal drugs "prohibited by Federal law or the law of any State in which such trade or business is conducted."<sup>[17]</sup>

Similarly, no business deduction is allowed "for any payment made, directly or indirectly, to an official or employee of any government [ . . . ] if the payment constitutes an illegal bribe or

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kickback or, if the payment is to an official or employee of a foreign government, the payment is unlawful under the Foreign Corrupt Practices Act of 1977."<sup>[18]</sup> Similarly, tax deductions and credits are denied where for illegal bribes, illegal [kickbacks](#), or other illegal payments under any Federal law, or under a State if such State law is generally enforced, if the law "subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business."<sup>[19]</sup> No deduction is allowed for kickbacks, rebates, or bribes made by those who furnish items or services for which payment may be made under the Social Security Act.<sup>[20]</sup>

## **Medical marijuana: Treatment of deductions for expenses in business legalized under state laws**

Recently, the provisions of Internal Revenue Code section 280E are being applied by the [Internal Revenue Service](#) (IRS) to businesses operating in the [medical marijuana](#) industry. Section 280E provides:

No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.

Even though 18 states have medical marijuana laws (and two of those states now allow marijuana to be consumed without a doctor recommendation), the IRS is applying section 280E to deny business deductions. Businesses operating legally under state law argue that section 280E should not be applied because Congress did not intend the law to apply to businesses that are legal under state law. The IRS asserts that it was the intent of Congress to apply the provision to anyone "trafficking" in a controlled substance, as defined under federal law (as stated in the text of the statute). Thus, section 280E is at the center of the conflict between federal and state laws with respect to medical marijuana.<sup>[21][22]</sup>

Such is so even when the marijuana is medical marijuana recommended by a physician as appropriate to benefit the health of the user, as explained by the United States Tax Court in *Californians Helping to Alleviate Med. Problems, Inc. v. Commissioner* ("CHAMP").<sup>[23]</sup>

## **References**

1. [^](#) *Commissioner v. Tellier*, 383 U.S. 687, 691, 86 S. Ct. 1118, 66-1 U.S. Tax Cas. (CCH) paragr. 9319 (1966) (hereinafter *Tellier*).
2. [^](#) 274 [U.S. 259](#) (1927)
3. [^](#) *Garner v. United States*, 424 [U.S. 648](#) (1976)
4. [^](#) *James v. United States*, [366 U.S. 213](#) (1961), *overruling* *Commissioner v. Wilcox*, [327 U.S. 404](#) (1946).
5. [^](#) *Commissioner of Internal Revenue v. Glenshaw Glass Co.*, [348 U.S. 426](#) (1955).
6. [^](#) *James v. United States*, 366 U.S. at 219 (quoting *Commissioner v. Glenshaw Glass*, 348 U.S. 426, 431).



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7. <sup>^</sup> [366 U.S. at 219.](#)
8. <sup>^</sup> [Tellier, 383 U.S. at 688.](#)
9. <sup>^</sup> [Id.](#)
10. <sup>^</sup> [Tellier, 383 U.S. at 690.](#)
11. <sup>^</sup> [See 26 U.S.C. § 162\(a\).](#)
12. <sup>^</sup> [Tellier, 383 U.S. at 690](#)
13. <sup>^</sup> [Tellier, 383 U.S. at 691.](#)
14. <sup>^</sup> [Tellier, 383 U.S. at 692.](#)
15. <sup>^</sup> [Tellier, 383 U.S. at 694.](#)
16. <sup>^</sup> [See 26 U.S.C. § 162\(f\).](#)
17. <sup>^</sup> [See 26 U.S.C. § 280E.](#)
18. <sup>^</sup> [See 26 U.S.C. § 162\(c\)\(1\).](#)
19. <sup>^</sup> [See 26 U.S.C. § 162\(c\)\(2\).](#)
20. <sup>^</sup> [See 26 U.S.C. § 162\(c\)\(3\).](#)
21. <sup>^</sup> [See, e.g., John Ingold, "IRS opens audit of Denver medical-marijuana dispensary," April 26, 2011, \*Denver Post\*, at \[\\[1\\]\]\(#\).](#)
22. <sup>^</sup> [See, generally, Ariel Shearer, "IRS Targets Medical Marijuana Businesses In Government's Ongoing War On Pot," May 29, 2013, \*Huffington Post\*, at \[\\[2\\]\]\(#\), and Steve Hargreaves, "Marijuana dealers get slammed by taxes," Feb. 25, 2013, CNN News, at \[\\[3\\]\]\(#\).](#)

## Moral Hazard

By **Tejvan Pettinger** on February 20, 2013 in **economics**

Moral Hazard is the idea that, under certain circumstances, individuals will alter their behavior and take more risks. Moral hazard can occur if

1. **There is information asymmetry.** Where one party holds more information than another. For example, a firm selling sub-prime loans may know that the people taking out the loan are liable to default. But, the bank purchasing the mortgage bundle has less information and assumes that the mortgage will be good.
2. **A contract affects the behaviour of two different agents.** In some cases, two parties face different incentives. If you are insured then you may have less incentive to take care against risks. For example, if a country knows it will receive a bailout from the IMF, then it may feel less incentive to reduce debt. Moral hazard is particularly a problem in the insurance market because when insured, people may be more liable to lose things.

### Definition of Moral Hazard:

The risk that a person has the incentive to take greater risks before the completion of the contract.

“any situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly.” [1]

– Paul Krugman

### Examples of Moral Hazard

#### 1. Insurance and consumer behavior

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If your bike is not insured you will take great care to avoid it getting stolen. You will lock it carefully. However, if it becomes insured for its full value then if it gets stolen you do not really lose out. Therefore, you have less incentive to protect against theft. This becomes a situation of asymmetric information. The insurance company may assume you will look after your bike, but you may know that you won't.

In these cases an insurance firm faces a dilemma.

- When your bike is uninsured, it has say a 10% chance of getting stolen. Therefore, if the bike is worth £1,000. The cost of insurance would be based around £100.
- However, once insured, the bike may now have a 30% chance of getting stolen. Therefore, if the insurance firm charges £100 based on the 10% risk, it will lose out.
- This could lead to a missing market. The insurance firm doesn't want to insure bicycles because people change their behavior.

## 2. Moral hazard and Sub Prime Mortgages

In the case of the sub-prime mortgage market. Lenders faced a situation of moral hazard. They were able to sell on any mortgage they lent to other financial institutions. Because there was strong demand from other people, and because other banks were taking on all the risk, the mortgage companies had less incentive to check the mortgages could be repaid. Therefore, there was a big growth in sub-prime mortgage lending with inadequate checks made.

## 3. Bank Bailouts and Moral Hazard

If a manufacturing company goes bankrupt, the government will not intervene. Therefore, they have an incentive to avoid taking unnecessary risks. However, generally governments feel they have to bailout banks to prevent a collapse in confidence in the banking industry. Therefore, banks may change their behavior and take more risks. Sometimes people argue we shouldn't bailout banks because this creates future moral hazard. If we always bail them out, they will repeat the risky mistakes later.

## 4. Fiscal and Monetary Union

It is argued that membership of the Euro can cause a type of moral hazard. A country in the Euro may assume that if it gets into difficulties, other countries will bail it out. Therefore, they may allow debt to grow. For example, when Greece joined the Euro, it benefited from low interest rates because it was in the Euro. This encouraged them to keep borrowing, until markets realised too late, that they actually had high debts.

## Overcoming Moral Hazard

**1. Build in incentives.** The insurance firms needs to provide incentives so that you still want to insure your bike. This is why they will not insure for the full amount. Usually you have to pay the first £50 of an insurance claim. Insurance firms also make the process of getting money difficult. This means that you become more reluctant to make claims and so will try to avoid having your bike stolen in the first place.

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**2. Penalize bad behavior.** The government could bailout banks, but penalize those responsible for making the reckless decisions. In the case of Greece, bailout funds are being given very reluctantly and with conditions to reform and pursue austerity.

Two parties may have good information, but the presence of a contract changes people's behavior, e.g. in the case of insurance. In that sense the information isn't really complete because the insurer isn't aware the contract will change people's behavior. Exaggerated or asymmetric information can all lead to moral hazard.

Worth being aware of **adverse selection**. Adverse selection occurs when there may be a bad choice of products due to asymmetric information.

[1] Krugman, Paul (2009). *The Return of Depression Economics and the Crisis of 2008*. W.W. Norton Company Limited. ISBN 978-0-393-07101-6.

<http://www.economicshelp.org/blog/105/economics/what-is-moral-hazard/>