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**THE FEDERAL TAXING POWER AND ORGANIZED  
CRIME**

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The problem of organized crime presents one of the greatest threats to the stability of our manner of living and to our form of government. In a dictatorship, organized crime, along with all manner of wholesome individual and group activities, is ruthlessly suppressed. Can a free society such as ours protect itself from those of its members who consciously select crime as a business and make a life outside the law and, at the same time, preserve the constitutional guarantees which we value and cherish? These are serious questions. The answers must be supplied very largely by the Bar and the judiciary. This paper is by no means a final attempt to answer them. The effort in producing it will be justified if it serves to emphasize resources within the law and the Constitution which could be useful in meeting the problem.

**THE NATURE OF THE PROBLEM AND POSSIBLE SOLUTIONS**

Law enforcement in terms of meeting the challenge of organized crime is often over-simplified by the claim that it is a local problem. This statement is by no means reliable as a general proposition, even where related to individual crimes. It is fatally erroneous in the face of organized crime, which is a very large and powerful business having national distribution and whose central motive is profit. The phenomenon of syndicate crime is a threat to all government, and the resources of government at all

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levels must be mobilized to meet it. The present power and affluence of the organized criminal is an indication of the degree to which the popular myth "law enforcement is a local problem" has been accepted.<sup>1</sup>

Taking the constitution of the State of Illinois as more or less typical of the other state constitutions, we find that the governor is the chief law enforcement officer, "who shall take care that the laws be faithfully executed."<sup>2</sup> Where, as often happens in Illinois, local law enforcement is paralyzed by the strangling grip of the syndicate applied to a whole community,<sup>3</sup> the governor is called upon by the constitution to act. He has the state police at his command and, of course, the militia if required.

A very serious defect in our executive machinery in Illinois is the fact that each one of the more than 100 state's attorneys operate independently and without any supervisory or coordinating authority over them. This haphazard result was not contemplated by your constitution. The attorney general has the same authority as pertained to that office at common law, and consequently he does have authority superior to the state's attorney within each county and could, if he desired, effect the necessary supervision and coordination.<sup>4</sup> This is particularly necessary in the face of the complicated pattern of syndicate crime, which operates not on a county but on a state-wide and national basis.

It is a fair conclusion to draw that the resources of the state constitution have not been fully used and certainly not exhausted in the mobilization of weapons with which to fight organized crime.

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1. See former Governor Adlai Stevenson's article entitled, *Organized Crime and Law Enforcement: A Problem for the People*, 38 A.B.A.J. 26 (1952), in which Mr. Stevenson contends that law enforcement is a local problem and should not be taken over or aided by the state or Federal Government unless and until local authorities have proved useless or ineffective.

2. ILL. CONST. Art. V, § 6.

3. Headlines from Chicago papers: "Saloon Vice Grips Cal City Again," Chicago Daily News, Jan. 26, 1953; "Four Shot in Cal City Bar," Chicago Daily News, Nov. 22, 1952; "Cal City Defies Vice Cleanup," Chicago Herald American, Sept. 8, 1952; "Boozy, Sordid Cal City Still Oasis of Sin," Chicago Daily News, Aug. 25, 1952.

4. See the following Illinois cases for authority that the attorney general may, if he wishes, act against organized crime and supervise the state's attorneys: *People v. Barrett*, 382 Ill. 321, 46 N.E.2d 951 (1943); *Rowan v. Shawneetown*, 378 Ill. 289, 38 N.E.2d 2 (1941); *Saxby v. Sonnemann*, 318 Ill. 600, 145 N.E. 526 (1925); *People v. Looney*, 314 Ill. 150, 145 N.E. 365 (1924); *Ferguson v. Russel*, 270 Ill. 304, 110 N.E. 130 (1915).

The central government, by virtue of the Federal Constitution, has assumed full control of whole areas of our collective activities, such as customs, coinage, interstate commerce, immigration and naturalization, and income tax. These delegations of authority certainly carry with them the duty of exercising the power granted for the well-being of all the people who live by the law. Therefore, when the income tax law is so written and administered as to create a recurring crop of gangster millionaires, just cause for complaint exists. Crime as a business is one of the largest industries in this country today. Consequently, taxation of income produced by such business is a particularly sensitive point in the whole machinery of control and suppression. It is difficult to justify a scheme of income taxation which taxes income from honest business at the same rate as gains taken in an illegal enterprise. Still more difficult is it to justify a system of income tax law which, in the treatment of deductions and losses of an illegal business, grants preference to the latter over legitimate business.

The ultimate objective of this paper is to demonstrate the legal basis for taxing illegal gains at a rate much higher than that applied to income from legal sources and to show as well that the current practice of allowing a deduction of losses and "legitimate" expenses of an illegal business is based on premises wholly untenable.

#### THE REGULATORY ASPECT OF TAXATION

The claim is made that the income tax law should have as its sole function the raising of revenue for the Federal Government, and that the Federal Government does not possess authority, under the Constitution, to regulate, control, or suppress rackets and organized crime pursued as a business, through income taxation. These claims lack constitutional support and are not justified by the history of taxation in this country and elsewhere.

Taxes played a significant part in the founding of the Republic. Under the Articles of Confederation, the central government had no right to raise revenue by taxation. It was forced to depend upon the several states for voluntary contributions, which were slow in arriving and often were never made. This, of course, was a very unworkable and unsatisfactory state of things, and no nation could operate under any such regimen. Consequently, the

necessity of having in the central government the right to levy and collect taxes led directly to the adoption of the present Federal Constitution and, therefore, to the permanent founding of our nation.

Taxation has always been associated with the raising of revenue by the state, and no doubt the raising of revenue will always remain its chief function. That fact, however, does not imply that taxation does not have, or that it should not have, other important functions to perform in the modern state.

No longer is it correct to think of taxation in terms of production of revenue alone. We know that the whole theory and practice of taxation has undergone a radical change in this country, and, indeed, throughout the whole world, in the past 150 years. During that time this country passed through several distinct phases of taxation:

1. From 1789 to the Civil War, customs receipts were the principal source of revenue.<sup>5</sup>
2. During the Civil War, income and inheritance taxes made their appearance.<sup>6</sup>
3. From 1868 until 1913, excise taxes on liquor and tobacco accounted for ninety per cent of the revenue collected by our government.<sup>7</sup> During that same period, a second attempt at a graduated income tax was made.<sup>8</sup>
4. Beginning in 1913, a new and, as it turns out, the present era of federal taxation began. This new period is distinguished by the graduated income tax.<sup>9</sup>

Not only have the forms of taxation changed from one period to the next, but the theories which support those forms have varied as well. Both the form and the theory change as the economic and social bases of society change. Fiscal forms and patterns are always the outcome of these basic underlying but dynamic factors.

As pointed out, customs duties, also known as tariffs, were once the principal source of revenue of our government. At the same time, the tariff was, and perhaps still is, an instrument of national political and economic policy. Certainly the tariff is an

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5. SURREY AND WARREN, *FEDERAL INCOME TAXATION* 2 (Temp. ed. 1950).

6. *Id.* at 3.  
7. *Id.* at 4.  
8. *Id.* at 5.  
9. *Id.* at 10.

example of a tax measure which has serious regulatory consequences. Today its prime function is not the raising of revenue. It is highly regulatory in effect. It has a serious influence in the cold war in that it prevents countries of the free world from selling in the United States market and may very well force them to trade with Russia and the Iron Curtain countries.<sup>10</sup>

To what extent may the federal taxing power be used in dealing with the problem of organized, commercial, syndicated crime? The question really is: how far may Congress go under the Constitution in the use of taxation as an instrument of regulation and suppression of activities and enterprises that are dangerous and undesirable, judged by the ethical, moral, and legal standards of the community?

All taxation has a regulatory effect, whether so intended or not, a fact easily illustrated in the provisions of the federal tax laws presently in force. As a consequence of tax laws presently extant, the growth of some businesses is stifled. Out of tax motives, some enterprises are operated as sole proprietorships, others as partnerships rather than corporations. A business is organized and operated as a cooperative or as a trust rather than as a corporation because of a tax advantage enjoyed by the particular form selected. Financial papers frequently carry advertisements of the offer of sale of business with long loss records and accumulated deficits. A market for such companies exists solely because of the nature and effect of the tax law. Tax-free state and municipal securities with a low interest yield are purchased and held instead of stocks and bonds. The family partnership presents the phenomenon of infants as partners in business enterprises. These are but a few of the many examples of the effects of our tax laws and their regulatory effect on economic activity.

The very first law which Congress passed was the Tariff Act of 1789.<sup>11</sup> Duties were imposed by that law for the raising of revenue. It was frankly stated in that legislation that it had for its purpose "the encouragement and protection of manufactures."<sup>12</sup>

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10. See the excellent article by Sumner Slichter, *More Imports Needed*, 191 *ATL. MONTHLY* 37 (Jan. 1953).

11. 1 *STAT.* 24 (1789).

12. *Id.* § 1.

In 1866, an annual tax of ten per cent was imposed on state bank notes.<sup>13</sup> The purpose of this tax was not to raise revenue but to give the notes of the newly established National Bank a monopoly of bank note circulation in the nation. The law was upheld by the Supreme Court in *Veazie Bank v. Fenno*<sup>14</sup> not only on the ground that Congress had authority to provide currency for the nation and, hence, could prohibit all circulation except its own obligations but on the additional ground that it had the power to tax the state bank notes as property. This law has never been repealed. It has produced no revenue.

The dairy industry of this country was articulate, in the pressure group sense, as early as 1886, and in that year induced Congress to impose heavy license taxes on oleomargine manufacturers and dealers. A special tax of fifteen cents a pound was imposed on imported oleomargarine.<sup>15</sup> In 1902, the general rate of tax on oleomargarine was fixed at ten cents a pound, while oleo free from artificial coloring was set at a quarter of a cent a pound. In 1902 the Supreme Court upheld this law in *McCray v. United States*.<sup>17</sup> It was not until 1950 that this legislation was repealed.<sup>18</sup>

The manufacture of white phosphorus matches causes an occupational disease in which the jaw of the victim is eaten away. After an unsuccessful effort by American manufacturers themselves to eliminate the use of white phosphorus matches, Congress imposed a tax of two cents per 100 matches.<sup>19</sup> The law successfully eliminated white phosphorus matches, which was its purpose. It produced no revenue.

In 1914 an internal revenue tax of \$300 per pound was imposed on the manufacturers of opium for smoking purposes.<sup>20</sup> It was believed by the proponents of this law that the only way in which Congress could constitutionally stop the manufacture of narcotic drugs was by the imposition of a prohibitive tax. Later in that same year, a statute was passed which levied a stamp tax of one cent an ounce on narcotic drugs. It also provided for an occupa-

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13. 14 STAT. 146 (1866), 18 U.S.C. § 250 (1946).

14. 8 Wall. 533 (U.S. 1869).

15. 24 STAT. 209, 211 (1886), 26 U.S.C. § 2308 (1946).

16. 32 STAT. 193, 194 (1902), 21 U.S.C. § 25 (1946).

17. 195 U.S. 27 (1904).

18. 64 STAT. 20 (1950).

19. 37 STAT. 81 (1912), 26 U.S.C. § 2651 (1946).

20. 38 STAT. 277 (1914).

tional tax on dealers and a detailed set of regulations.<sup>21</sup> These occupational taxes were intended to be the constitutional basis for a regulatory system that might otherwise have been held unconstitutional. The Supreme Court, by a five to four decision, upheld the act as constitutional.<sup>22</sup> The majority opinion stated: "The act may not be declared unconstitutional because its effect may be to accomplish another purpose as well as the raising of revenue. . . ." <sup>23</sup> The dissenting opinion stated that the "statute was a mere attempt by Congress to exert a power not delegated" to it by the Constitution.<sup>24</sup>

The Cotton Futures Act of 1914 imposed a tax of two cents a pound upon all sales of cotton futures.<sup>25</sup> Spot sales are exempt from the tax. This law has produced no revenue. It was, however, successful in forcing the use of the specified types of contract. This statute was not challenged in the courts and is still operative.

The National Firearms Act of June 6, 1934, imposed a \$200 annual license tax on dealers in firearms.<sup>26</sup> This law was upheld in *Sonzinsky v. United States*.<sup>27</sup> It produces very little revenue.

In 1937 Congress passed a law regulating the coal industry and imposed an excise tax of nineteen and one-half per cent of the sale price of coal at the mine, with the provision that this tax should not apply to any producer who had membership in the Bituminous Coal Code set up under the statute.<sup>28</sup> The Supreme Court upheld the constitutionality of this act,<sup>29</sup> despite its similarity to the Bituminous Coal Conservation Act of 1935,<sup>30</sup> which was struck down.<sup>31</sup> This decision is no doubt the result of the broadening of the Supreme Court's interpretation of the interstate commerce clause of the Constitution.

Under the Social Security Act of 1935 an excise tax at the rate of three per cent of the wages paid has been imposed, since Janu-

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21. 38 STAT. 785 (1914), 26 U.S.C. § 2550 (1946).

22. *United States v. Doremus*, 249 U.S. 86 (1919).

23. *Id.* at 94.

24. *Id.* at 95.

25. 38 STAT. 693 (1914).

26. 48 STAT. 1236 (1934).

27. 300 U.S. 506 (1937).

28. 50 STAT. 75 (1937), 26 (U.S.C. § 3520 (1946)).

29. *Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381 (1940).

30. 49 STAT. 991 (1935).

31. *Carter v. Carter Coal Co.*, 298 U.S. 238 (1935).

ary 1, 1938, on employers of eight or more employees.<sup>32</sup> A credit is allowed against this tax for amounts paid by the taxpayer into the unemployment funds set up under state law and approved by the Social Security Board. The total credit may not exceed ninety per cent of the federal tax. Thus ten per cent of the tax is imposed for revenue, while the remaining ninety per cent is intended to encourage states to adopt unemployment compensation systems. The plan has been successful, and such systems have been set up in every state.

We know, of course, that the wartime excise taxes contained in the Revenue Act of 1941<sup>33</sup> were enacted to discourage the purchase of taxed articles and thereby to encourage the manufacturer to shift resources to the production of articles required for the defense program. The desirability of such excise taxes was pressed upon the Treasury Department by Mr. Leon Henderson, Administrator of the Office of Price Administration and Civilian Supply.<sup>34</sup>

It should be noted that the various features of the federal income tax embody obvious regulatory objectives. The granting of exemption to certain businesses and non-profit organizations to encourage their activities is one form.<sup>35</sup> Special tax encouragement is given to religious, charitable, and educational institutions.<sup>36</sup> The income of such organizations are exempt. Contributions to them may be deducted from the giver's income up to a maximum of twenty per cent of the gross.<sup>37</sup> In addition, the allowance of a percentage depletion in oil, gas, and certain mining industries satisfies a regulatory objective.<sup>38</sup> A purpose is disclosed to stimulate exploration and development in the natural resources industries.

The excise taxes on alcoholic liquors and on persons manufacturing and distributing them have regulatory aspects. The rates would not be as high as they are if discouraging consumption of such beverages were not believed to be desirable. The taxation of this activity permits the Federal Government to regulate the

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32. 49 STAT. 620 (1935), 42 U.S.C. § 301 *et seq.* (1946).

33. 55 STAT. 687 (1941), 26 U.S.C. § 12 *et seq.* (1946).

34. BLOUGH, THE FEDERAL TAXING POWER 414 (1952).

35. INT. REV. CODE § 101.

36. *Ibid.*

37. 66 STAT. 443 (1952).

38. INT. REV. CODE §§ 23(m), 23 (n), 114(b).



alcoholic beverage industry.<sup>39</sup> Chapter 27 of the Internal Revenue Code not only imposes taxes but prescribes as well accounting methods to be followed, the types of physical construction of distilleries, and an elaborate system of reporting sales of alcoholic beverages and distilled spirits.

The foregoing is a rather extensive but by no means exhaustive list of federal taxes every one of which has a very strong regulatory purpose and effect. We see that the very first act of Congress after the adoption of the Constitution was the adoption of the tariff law, the regulatory characteristics of which certainly claim equal, if not greater, importance than its revenue raising function. We see that, from 1789 down through the intervening years, tax laws, the regulatory character of which cannot be denied, have been enacted by Congress and sustained by the Supreme Court. Therefore, is there any profit, as a practical matter, in further contention that the taxing power of Congress does not include at least the incidental right at the same time to regulate the activity taxed?

Regulation by taxation is, as of now, a permanent and fixed feature of taxing practice and philosophy. We should accept that fact and apply it to our purpose of taxing all of the profit out of crime.

The legal question is really this: does Congress have power under the Constitution to regulate an activity by taxation which it does not have power to control or regulate under some specific delegation of that instrument? The question is fully answered in *United States v. Sánchez*.<sup>40</sup>

In enacting the Marihuana Tax Act, the Congress had two objectives: "First, the development of a plan of taxation which will raise revenue and at the same time render extremely difficult the acquisition of marihuana by persons who desire it for illicit uses and, second, the development of an adequate means of publicizing dealings in marihuana in order to tax and control the traffic effectively."<sup>41</sup>

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*First.* It is beyond serious question that a tax does not cease to be valid merely because it regulates, discourages, or even definitely deters the activities taxed. . . . The principle

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39. BLOUGH, *op. cit. supra* note 34, at 416.

40. 340 U.S. 42 (1950).

41. SEN. REP. No. 900, 75th Cong., 1st Sess. 3 (1937); H. R. REP. No. 792, 75th Cong., 1st Sess. 2 (1937).

applies even though the revenue obtained is obviously negligible, . . . or the revenue purpose of the tax may be secondary, *Hampton & Co. v. United States*. . . .<sup>[42]</sup> Nor does a tax statute necessarily fall because it touches on activities which Congress might not otherwise regulate. As was pointed out in *Magnano Co. v. Hamilton*, . . . :<sup>[43]</sup>

"From the beginning of our government, the courts have sustained taxes although imposed with the collateral intent of effecting ulterior ends which, considered apart, were beyond the constitutional power of the law makers to realize by legislation directly addressed to their accomplishment."<sup>[44]</sup>

These principles are controlling here. The tax in question is a legitimate exercise of the taxing power despite its collateral regulatory purpose and effect.<sup>45</sup>

We must conclude from the decisions that:

1. Congress may regulate through taxation, even though the revenue produced is negligible and the activity taxed is hampered or even destroyed.
2. Congress has power to do this even in those cases where it lacks constitutional power to regulate directly.
3. The constitutional limits to which Congress may go in the use of the income tax law as a means of taking the profit out of organized crime have not been approached. Congress has a duty to use its power in this behalf.

#### LIMITS ON THE POWER OF CONGRESS TO REGULATE THROUGH TAXATION

The case of *McCray v. United States*<sup>46</sup> represents the high-water mark of congressional power, sanctioned by the Supreme Court, regulate through taxation. Congress had no power to regulate or prohibit the manufacture of oleomargarine under the commerce, or any other, clause of the Constitution. The tax which Congress imposed was so heavy that it seriously limited the business possibilities of the oleo manufacturers. This was the frank design of the statute. The measure, consequently, produced only a very small amount of revenue. Nevertheless, the Supreme Court upheld the law in a decision which has never been overruled.

42. 276 U.S. 394 (1928).

43. 292 U.S. 40 (1934).

44. *Id.* at 47.

45. *United States v. Sanchez*, 340 U.S. 42, 43, 44 (1950).

46. 195 U.S. 27 (1904).

Congress has the power to classify taxpayers according to the activities from which the income results. The *McCray* case is such an example. It may also classify income as to origin or geographical source. Sections 109 and 454 (f)<sup>47</sup> are clear examples of such classifications. Income of eleemosynary corporations is treated differently from that of a business enterprise. This is a classification based on the use to which the taxpayer puts the income.

Consequently, no objection could be raised to a classification of income on the basis of the legality or illegality of its source. No valid reason exists for not taxing illegal gains at much higher rates than honest income.

In *Barclay & Co. v. Edwards*,<sup>48</sup> the Supreme Court held that the "power of Congress in levying taxes is very wide, and where a classification is made of taxpayers that is reasonable, and not merely arbitrary and capricious, the Fifth Amendment cannot apply." In the earlier case of *Evans v. Gore*,<sup>49</sup> the Court had noted that the taxing power of Congress could be applied "to every object within its range 'in such measure as Congress may determine'"<sup>50</sup> and "enables that body 'to select one calling and omit another, to tax one class of property and to forbear to tax another,'"<sup>51</sup> and that the tax might be applied "in different ways to different objects so long as there is 'geographical uniformity' in the duties, imposts, and excises imposed."<sup>52</sup> There could, then, hardly be room for complaint of arbitrary or capricious action if Congress should decide to divide taxpayers into distinct categories on the basis of the legality or illegality of their activities and to apply one rate to legitimate income and another and much higher rate to illegal gains.

It costs the government much more in time and expense to collect a tax on income produced by an illegal business than it does to collect from honest enterprise. On that basis alone, a large differential in rates is absolutely necessary to defray the extra cost. The fact that the high rate of tax would put the organized criminal out of business is a matter of which no one,

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47. INT. REV. CODE §§ 109, 454 (f).

48. 267 U.S. 442, 450 (1924).

49. 253 U.S. 245 (1920).

50. *Id.* at 256.

51. *Ibid.*

52. *Ibid.*

not even the criminal, can complain. He is simply seeing democracy at work at the necessary task of preserving itself from those who would destroy its basic foundations.

There is an obvious inconsistency in the tacit condonement which the Federal Government extends to the criminal when it taxes the income which he has taken from the community, often by force, but always in defiance of its laws, at the same rate as that which it applies to wholesome, honest income. The situation is even more grotesque when it is realized that the racketeer receives preferential treatment under the current application and enforcement of the Internal Revenue Code.

#### PRESENT METHODS OF TREATING THE EXPENSES AND LOSSES OF ILLEGAL ENTERPRISES

The Commissioner of Internal Revenue and the Tax Court hold that "legitimate expenses" of an illegal business are deductible.<sup>53</sup> They hold that items like rent, light, salaries, gasoline, depreciation, and similar items can be deducted by an illegal enterprise as "the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ."<sup>54</sup>

This result is possible only on the basis of gross favoritism of the racketeers. A vast loophole has been created in the administration of the income tax law which could be closed immediately if the desire to do so were present at the administrative level in the enforcement machinery. The Commissioner and the Tax Court are simply not following the law in the treatment that they are affording expenses and losses of illegal enterprises.

The income tax law as originally enacted in 1913 made no pretense of taxing illegal gains. It imposed a tax upon the gains and profits from "any lawful business."<sup>55</sup>

The Revenue Act of 1916 re-enacted section 166 of the previous act, verbatim, except that the word "lawful" was omitted, so that the tax was, by the 1916 Act, imposed on "interest, rents, dividends, securities, or the transaction of any business carried on

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53. *Comeaux v. Commissioner*, 10 T.C. 201, 207 (1948), *aff'd* in *Cohen v. Commissioner*, 176 F.2d (10th Cir. 1949).

54. INT. REV. CODE § 23 (a) (1) (A).

55. 38 STAT. 167 (1913).

for gains or profits and income derived from any source whatsoever."<sup>56</sup>

The sections of the various revenue acts which deal with deductions from gross income have varied very little through the years, so that what is said about the current law<sup>57</sup> applies with equal force to the preceding years.

From 1913 to 1925, the Commissioner of Internal Revenue refused to allow the expenses of an illegal business to be deducted from gross income. He also refused to allow losses suffered in an illegal business to be subtracted or deducted from gross income, regardless of whether the gross income was from an illegal or a legal activity. These opinions he clearly set forth in the bulletins which he issued during that period.<sup>58</sup>

56. 39 STAT. 756 (1916).

57. INT. REV. CODE § 23 (a) (1) (A):

Sec. 23. DEDUCTIONS FROM GROSS INCOME

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or business expenses.—

(A) In general.—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; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; 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. . . .

Section 23(e) relates to losses and provides as follows:

(e) Losses by Individuals.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; . . . .

58. I.T. 1983, III-17 CUM. BULL. 1514 (1924) stated that the expenses of an illegal business were not deductible:

The taxpayer accepts bets outside of licensed race tracks and under the statutes of the State of Kentucky his business is illegal.

Held, the taxpayer is not entitled to claim deductions on account of expenses incurred in carrying on an illegal trade or business under section 214(a) 1 of the Acts and he should file returns of income for all years even though in some of them his losses and expenses exceeded his winnings.

The same opinion was expressed in I.T. 2127, IV-1 CUM. BULL. 138 (1925):

Inasmuch as the operation of baseball pools is illegal in the State of Wisconsin, the amount paid out in prizes and the expenses of operating the pools are not allowable deductions as expenses incurred in carrying on a trade or business as contemplated by section 214(a) 1

In 1925 the Board of Tax Appeals was called upon to decide in *James P. McKenna*<sup>59</sup> whether a bookmaker in the State of Kentucky, where his activities were illegal, should be allowed to deduct from his gross receipts the amounts he paid out to winners. The bookmaker operated on a modified parimutual system. He treated his bookmaking en bloc and deducted from his year's receipts the payments made to winning bettors, as well as amounts returned to bettors in cases where bets were called off.

The Commissioner disallowed the deductions of the amounts paid to winners or returned to bettors and restored them to income. The Board stated the issue on the case to be "whether the winnings realized from gaming operations are taxable as income and if so, what portion of said winnings constitutes taxable income."<sup>60</sup>

The bookmaker contended that his winnings on handbook operations should not be taxed at all because: (1) they did not constitute income within the view of the Sixteenth Amendment to the Constitution or within the Revenue Act of 1918; (2) under the laws of the State of Kentucky, such winnings were gifts and not income; and (3) even if construed to be income, they were not such until after the statutory period of limitations had tolled the loser's right to recover his losses.

The bookmaker contended that his winnings were gifts and not income. The Board's opinion did not set out specifically what the contentions of the Commissioner were. It must be assumed, however, that his restoration to income of the amounts paid out to winners corresponded to the requirements of his published

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of the Revenue Act of 1921, and the taxpayer should file returns reflecting as his net income from the operation of the baseball pool the entire receipts therefrom, without credit for any deductions.

With regard to losses of an illegal business, I.T. 1854, II-2 CUM. BULL. 125 (1923) was to the effect that "losses in an illegal transaction are not deductible under the Revenue Act of 1921." SOLICITER'S MEMORANDUM 2680, III-2 CUM. BULL. 110 (1924) was to the same effect:

Under Article 141 of Regulations 45, it is the rule of the Bureau that losses sustained in illegal transactions were not deductible in the determination of net income. This rule is also applied to the year 1917. It is necessary, therefore . . . to determine the status of losses incurred in betting on horse races to determine the legality of such transactions in the various States in which the taxpayer operated during the period in question.

59. 1 B.T.A. 326 (1925).

60. *Id.* at 328.

rulings to the effect that losses sustained in illegal transactions could not be deducted in determining net income.<sup>61</sup>

The holding in this case was that the winnings of the bookmaker, less his losses, constituted taxable income. The basic fallacy of this position is apparent. The Board completely ignored the fact that the bookmaker was engaged in an illegal and unlawful enterprise. It treated him as though he were a legitimate merchant selling goods or services in wholesome commerce and allowed gross income to be determined by subtracting from gross receipts the cost of goods or services sold. The inescapable fact is that the bets paid did not represent expenses "incurred," since the winners had no legal right to enforce payment. This is true whether the gambler operated one hour, one day, or one year, and whether he made one bet or a thousand bets. These basic elements were ignored by the Board.

The view was expressed by the Board that "[t]he income tax law is strictly a revenue measure enacted for the purpose of raising the necessary revenues for the Federal Government."<sup>62</sup> That premise is unsound. It is based on a philosophy that corresponds to neither the facts nor the law. There are many provisions of the Code whose purpose and effect go far beyond the raising of revenue. The depletion allowance available to the oil and other natural resources industries<sup>63</sup> can be added to the examples already mentioned to show that the Board's basic concept of the income tax law as expressed in this opinion is completely out of harmony with reality.

The Commissioner acquiesced in the *McKenna* case and immediately revoked his prior rulings limiting deductibility of losses in illegal operations.<sup>64</sup> His haste in this respect contrasts strangely with the persistence and tenacity with which he is known to pursue revenue where legitimate business is the quarry.<sup>65</sup>

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61. See note 58 *supra*.

62. James P. McKenna, 1 B.T.A. 326, 330 (1925).

63. See note 38 *supra*.

64. I.T. 2175, IV-1 CUM. BULL. 141 (1925).

65. Commissioner v. East Coast Oil Co., 85 F.2d 322 (5th Cir. 1936), *cert. denied*, 299 U.S. 608 (1936), was decided in 1936, overruling G.C.M. 8594, IX-2 CUM. BULL. 354 (1930). The Commissioner did not acquiesce until 1947 in G.C.M. 25131, 1947-2 CUM. BULL. 85. Dexter v. Commissioner, 37 B.T.A. 1331 (1938), *aff'd*, 99 F.2d 769 (1st Cir. 1938), and Commissioner v. Nell, P-H 1942 TC MEM. DEC. ¶ 42,586 (1942), *petition to review denied*, 139 F.2d 865 (4th Cir. 1944), were decided in 1938 and 1942, overruling

Three days after the *McKenna* case was decided by the Board of Tax Appeals, the opinion in *Mitchell M. Frey*<sup>66</sup> was filed. The decedent was a successful businessman. He indulged in betting and gaming as an incident to his leisure hours, and these operations extended generally throughout the year. During 1919, he won \$900 and lost \$26,105 in betting on races, poker, and roulette. In 1920 he won \$26,588 and lost \$64,996. These amounts were won or lost in illegal operations. The estate claimed that the transactions were entered into for a profit. The amounts won were included as income and the losses claimed as a deduction from total income. The Commissioner argued that each venture was a separate item, that those in which winnings were made stood apart from those in which money was lost, and that total winnings had to be returned and taxed, while totals of the losses could not be deducted.

The opinion in this case recognized the voluntary nature of the payment of gambling losses and concluded that such losses were not "incurred" within the meaning of section 214 (a) of the Revenue Act of 1918.<sup>67</sup> The Board held also that the word "transaction" as used in the statute meant a legal transaction. On the basis of the decision in the *McKenna* case, however, the Board held that the decedent's tax liability should be computed on a yearly basis and if, as was the fact in this case, his losses exceeded his gains, he would in reality have had no gain, hence no income, from gaming.

This refusal by the Board to test each expenditure separately as to its deductibility in arriving at net taxable income constituted a clear departure from the law as announced in the same opinion. It represents as well gross favoritism of illegal business over honest enterprise. If an expenditure is not deductible because it is not "incurred" in a "legal" transaction, there is no reason to permit its deduction in an illegal activity. The fact that the taxpayer won some money in an illegal transaction during the year means simply that he had taxable income. Money lost in illegal gambling is not made deductible as "incurred" simply because more was lost than was won. The case was

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rulings of the Commissioner. He is still trying to enforce his views with regard to section 131 of the Internal Revenue Code. See *Brace v. Commissioner*, P-H 1952 TC MEM. DEC. ¶ 52,265 (1952).

66. 1 B.T.A. 338 (1925).

67. *Ibid.*



wrongly decided. It should have been appealed. Instead it was acquiesced in.

These two cases, *McKenna* and *Frey*, constitute the opening wedge through the operation of which a glaring loophole has been worked for the benefit of syndicate gamblers and racketeers.

Within a few days after the opinions in the *McKenna* and *Frey* cases, the Commissioner issued a bulletin incorporating the holdings in those cases.<sup>68</sup>

#### THE LEGAL POSITION OF EXPENSES AND LOSSES OF AN ILLEGAL BUSINESS UNDER THE INTERNAL REVENUE CODE

There are at least three good, sound, unassailable reasons why expenses and losses of an illegal enterprise are not deductible: (1) an expense or a loss is not "incurred" under section 23 of the Code unless it represents a legally fixed and binding obligation; (2) the words "trade or business," as used in section 23 of the Code, mean a *legal* trade or business; and (3) expenses and losses of an illegal enterprise are not deductible where to allow their deduction would frustrate sharply defined policy.

1. *An expense or a loss is not "incurred" under section 23 of the Code unless it represents a legally fixed and binding obligation.*

Voluntary disbursements, such as gratuities, "debts of honor," "moral obligations" cannot be deducted as losses by a legitimate

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68. I.T. 2175, IV-1 CUM. BULL. 141 (1925) provides as follows:

In the appeal of James P. McKenna (decision No. 127, docket No. 121, 1 B.T.A. 326), acquiesced in by the Commissioner, the Board of Tax Appeals held that the net gains of the taxpayer arising out of his illegal business of operating a handbook constituted taxable income under the Revenue Act of 1918, but that the gross income of the taxpayer derived from such bookmaking operations should be determined by applying against the total receipts therefrom the sum of the amounts paid to bettors on his handbook plus amounts returned to bettors by reason of scratches, called-off bets, and lay-off bets.

In the appeal of Mitchell M. Frey, et al., executors William B. Scaife Estate (decision No. 128, docket No. 391, 1 B.T.A. 338), acquiesced in by the Commissioner, the Board of Tax Appeals held that losses sustained in illegal gambling operations are not deductible under Section 214 (a) of the Revenue Act of 1918. The Board held, however, that the taxpayer was entitled to offset his gains from illegal transactions against his losses from such transactions and, therefore, the amounts won by the taxpayer during the years in question, being less than the losses sustained by him, did not constitute taxable income.

In view of these decisions, I.T. 1983 (C.B. III-1, 124) and I.T. 2127 (see page 138) are modified to conform thereto.

business. The word "incurred" means that a legal obligation had become firmly fixed before the disbursement was made. Abundant case law, including the cases of *Lucas v. Ox Fibre Brush Co.*,<sup>69</sup> and *Bauer Bros. v. Commissioner*,<sup>70</sup> establishes this interpretation of the word "incurred" as used in section 23 of the Code. All of the cases, it is admitted, deal with legitimate business. If a legitimate business, in order to deduct an expense or a loss, is held to the rule that the sum sought to be deducted must represent a legal obligation, does it not produce a grotesque result to say that if the enterprise is illegal, if it is a racket, then disbursements which do not represent legal and binding obligations may be deducted as expenses and losses?

Applying the principle of law of the *Bauer* and *Lucas* cases to the subject matter before us, it seems very evident that where the owner of real estate leases it to a gangster or to a vice, narcotics, or gambling syndicate, and the property is used for illegal purposes, the lease is not enforceable and the landlord cannot collect the rent. The landlord is under a duty to see that his property is not used for illegal purposes. He is presumed in law to know what uses are being made of his premises.<sup>71</sup> The payment of the rent by the operator of such an establishment is purely voluntary.<sup>72</sup> The rent is not an enforceable obligation and should not, therefore, be permitted as a deductible expense.

The salaries which a racketeer pays to his assistants arise

69. 281 U.S. 115 (1930).

70. 46 F.2d 874, 875 (6th Cir. 1931):

. . . Our first concern is with the sense in which the term "incurred" is used in section 234. It seems not to be disputed here that expenses are incurred only when there is an agreement or a legal obligation to pay them. . . . Indeed, that seems to be the view taken of the very language of this section by the Supreme Court of the United States in *Lucas, Commissioner of Internal Revenue v. Ox Fibre Brush Co.*, 281 U.S. 115. . . .

. . . It will therefore be observed that, whether the term "incurred" as used in the Revenue Act of 1918 is used in a technical legal sense or in an economic or bookkeeping sense, the expenses are not incurred unless there has arisen a legal obligation to pay them, and they do not accrue within a given taxable year unless all the events which fix the amount and determine the liability of the taxpayer to pay occur within that year.

71. *People v. Brickley*, 332 Ill. App. 370, 75 N.E.2d 534 (1947); *People v. Viskniskki*, 155 Ill. App. 292 (1910); *People v. Leach*, 143 Ill. App. 442 (1908); *People v. Brewer*, 142 Ill. App. 610 (1908).

72. *Harris v. McDonald*, 194 Ill. 75, 62 N.E. 310 (1901); *Heidenreich v. Raggio*, 83 Ill. App. 521 (1899); *McDonald v. Tree*, 69 Ill. App. 134 (1897). Also see ILL. REV. STAT. c. 38, § 333 (1951).

through a void employment contract. If such an employee sues the gangster for his wages for helping him (the gangster) commit a murder, an extortion, a rape, it is perfectly obvious that nothing can be collected on such a contract. It is equally true that the cashiers, the shills, the steerers, the chauffeurs, the waitresses, the bartenders, employed in the gambling joint cannot enforce those wage contracts, and the payment of their salaries for the purposes of section 23 is purely voluntary.<sup>73</sup> The duties thus performed represent integral parts of the illegal venture. They are not "just a little bit illegal"; they are entirely illegal. This view is well expressed in *Silberman v. Commissioner*,<sup>74</sup> where the Board said:

Petitioner's gambling operations were illegal and the amounts he expended for fees and salaries were expenditures made to obtain occupancy and services which were illegal. Petitioner contends that the gambling activities were not "illegal" because they were not "criminally punishable," or that they were "illegal" only in the sense that they were "*ultra vires*." The argument is without merit and is confused in many respects. It is wholly immaterial here that the statutory offense involved is *malum prohibitum* rather than *malum in se*. Petitioner's argument in essence is that his gambling operations were only "a little bit" illegal because the penalty of forfeiture of a bet received if a civil action is brought to recover the bet is only a slight penalty. The only merit of the argument is its humor. We must proceed here with recognition that without any doubt betting, receiving, and recording bets, letting a booth be used for the same, and assisting anyone in doing the same, all were illegal under New York statutes.<sup>75</sup>

In the *Silberman* case the operating expenses were those of a race track gambler. He rented booths at various tracks. He employed persons to register bets and to assist him. He paid salaries for their services. These items aggregated \$12,633 for the taxable year. *Silberman* claimed he was entitled to deduct the items as ordinary and necessary business expenses or as losses under section 23. Under state law it was illegal to rent a booth to be used for receiving or recording bets, and it was also illegal to

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73. ILL. REV. STAT. c. 38, § 325 (1951), makes it a crime to rent places for gambling purposes. Also see ILL. REV. STAT. c. 38, § 329 (1951), making all contracts based on gambling void.

74. 44 B.T.A. 600 (1941).

75. *Id.* at 603.

assist in receiving or recording bets. The lease was unenforceable, as were the employment contracts.

The considerations which require expenses of an illegal enterprise to be unavailable as a deduction would also make illegal gambling unavailable as deductions, except for the distortion created by the case of *Humphrey v. Commissioner*,<sup>76</sup> to be noted hereafter.

The foregoing view is supported by the holding in *Wagner v. Commissioner*.<sup>77</sup> Taxpayer in that case invested \$15,000 in a small loan business in violation of the laws of Michigan. The district attorney raided his office, tore the place apart, and confiscated the records. The total investment was lost. In denying a deduction as either a loss or an expense, the Board took the view that the enterprise was illegal and that neither a loss deduction nor an expense deduction can be had if they are incurred or sustained in the commission of acts forbidden by statute or in the omission of acts made mandatory by statute, subjecting those guilty to either a fine or imprisonment or both. The reasoning which leads to such a result as to an expense applies with equal force to a loss.<sup>78</sup>

2. The words "trade or business," as used in section 23 of the Code, mean a legal trade or business.

The case of *Humphreys v. Commissioner*<sup>79</sup> (not to be confused

76. 162 F.2d 853 (5th Cir. 1947).

77. 30 B.T.A. 1099 (1934).

78. In the *Wagner* case, *supra* note 78, the court said:

The petitioner engaged in a business prohibited by the "Small Loans Act" of Michigan. He made loans under contracts which he knew or should have known were void and unenforceable under such act. In our opinion the instant proceeding is governed by the principle enunciated in the above cited cases and is a loss arising from the operation of a business prohibited by state statutes, subjecting those violating them, upon conviction, to fine or imprisonment, or both, and is not deductible under section 214 (a) (4) and (5) of the Revenue Act of 1926.

*Id.* at 1106, 1107.

79. 125 F.2d 340 (7th Cir. 1942):

The further controlling facts adduced at the hearing before the Board showed that during the tax years in question the petitioner was not engaged in any legitimate business. He was regarded as a gangster and racketeer. . . .

*Id.* at 341.

The final point raised concerns the disallowance of \$2,526 as a business expense, made up as follows: \$500 for gasoline and oil; \$451 for garage and service; and \$1,575 on account of depreciation on an automobile. Expenses of this nature are deductible only if they are incurred "in carrying on any trade or business" § 23(a). . . . The Board sustained the action of the respondent in disallowing these de-

with *Humphrey v. Commissioner*) illustrates this principle of statutory construction. The court stated that Humphreys' profession was regarded as that of a gangster and a racketeer. He claimed as deductible expense the cost of the gasoline for the automobile used in transportation about the city of Chicago to and from his illegal business. Another item was for garage storage, service, and depreciation. The case reached the Circuit Court of Appeals in the Seventh Circuit. The Board of Tax Appeals,<sup>80</sup> as well as the Circuit Court, found that Humphreys was not engaged in any "business" within the meaning of the statute, because his activities were illegal. He was not engaged in any legal business. On a parity of reasoning, it follows that a gambling, narcotics, or vice joint is not a "business," with the consequent result that operating expenses are not deductible.

Humphreys' activities which produced his income were illegal and illegitimate. So are the activities of the proprietor of a house of prostitution. So are the activities of the proprietor of a gambling house or a horse parlor, or those of the owner or operator of slot machines, in all except one or two of our states.

It is a crime in Illinois, and in most other states, to employ a man to work in a gaming house.<sup>81</sup> It is a crime to lease property for that purpose.<sup>82</sup> In the face of the *Humphreys* decision, how can it be claimed that the expenses and losses of such businesses are deductible under section 23? The expenses for light, heat, and salaries are items which are integral parts of the legal enterprise. There are no such things in law as "legitimate expenses of an illegitimate business."

The words "trade or business" in section 23 can only mean legal trade or business. A strong authority for this proposition and the principle involved is *Walsch v. Call*,<sup>83</sup> which had to do with the interpretation of an exemption statute which exempted from execution the goods of a person used in his trade or business. The plaintiff was operating a saloon and selling liquor

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ductions on the ground that the petitioner was not engaged in any business within the meaning of the statute. We agree and in view of what we have already said in this opinion relative to petitioner's activities, it will not be necessary to discuss the matter further.

*Id.*, at 343.

80. *Humphreys v. Commissioner*, 42 B.T.A. 857 (1940).

81. ILL. REV. STAT. c. 38, § 325 (1951).

82. *Ibid.*

83. 32 Wis. 159 (1873).

illegally. An execution was levied on the liquor, and the owner claimed the benefit of the statute. The court stated:

. . . [W]e are of the opinion, and so hold, that the term "trade or business," as used in the statute . . . must be construed to mean some *lawful* trade or business, and that no person who is engaged in any business which is prohibited by law, is entitled to any exemption of his tools, implements or stock in trade used and kept for the purpose of carrying on the same, unless such property be exempted by some provision of law other than the statute under consideration.<sup>84</sup>

The widening breach of the loophole is observed in the opinion of the Tax Court in *Ellery v. Commissioner*.<sup>85</sup> In that case, the taxpayer, a big-scale slot machine operator, had been convicted for fraud under the income tax law and was about to leave town to serve his sentence. To preserve better his illegal business, he formed a partnership with his wife and left her in charge. The case holds that under Ohio law a partnership may be formed for a legal purpose only. Therefore, no partnership resulted. All of the income was charged to the husband.

It further appears from this opinion that Ellery operated slot machines illegally. He claimed a deduction of \$500 allegedly spent to defray the cost of a banquet to entertain his best customers, but he failed to prove the amount spent. It was disallowed on that ground. Nevertheless, the opinion contains unnecessary, as well as wholly inaccurate, reference to the case of *Commissioner v. Heininger*,<sup>86</sup> to be discussed presently, and says that that case casts doubt on the holding of the Board of Tax Appeals in the *Silberman* case. The *Heininger* case involved a lawful business. Neither the *Silberman* nor the *Ellery* cases related to a lawful enterprise. There is nothing in the *Heininger* case that has any bearing on a case where the items sought to be deducted relate to expenses or losses of an illegal business. The language in the *Ellery* case was not only gratuitous but grossly erroneous.

The Tax Court in *Stralla v. Commissioner*<sup>87</sup> was concerned with expenses of a gambling ship which was anchored within the headlands of the Santa Monica, California, harbor. The courts had held that the ship was within the jurisdiction of the State

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84. *Id.* at 161, 162.

85. 4 T.C. 407 (1944).

86. 320 U.S. 467 (1943).

87. 9 T.C. 801 (1947).

of California and that its operation was illegal. Certain expenses for which deduction was claimed consisted of fines, penalties, attorneys' fees spent in defense of criminal charges and lobbying. These were denied deduction:

. . . The allowance of the deductions here claimed would be in our opinion "to frustrate sharply defined . . . policies" of the State of California "proscribing" gambling operations. The expenditures here in issue [*i.e.*, fines, penalties, attorneys' fees, etc.] were not made in the actual production of income; deduction of expenses of that character [*i.e.*, expenses related to the actual production of income] has been allowed. The expenditures here were made to perpetuate or to assure the continuance of an illegal business, and their deduction, in our opinion, would be contrary to public policy and not within the meaning, purpose, and intent of the statute.<sup>88</sup>

The *Stralla* case is long and involved on its facts, and it is not exactly simple to understand the language of the court as quoted above in terms of the precise issues. It appears, however, that the operators of the gambling ship in their tax returns deducted from gross income expenses such as salaries, repairs, light and power. The Commissioner had allowed the deduction. They were not, therefore, at issue in the case. Consequently, the court in saying that "deductions of expenses of that character has been allowed"<sup>89</sup> was simply referring to what had already happened in the case and was not attempting to say that there was any judicial or statutory authority to justify such treatment. This point is important in view of what happened in *Comeaux v. Commissioner*,<sup>90</sup> to be noticed presently.

There is, of course, no basis in law, common sense, or reason, for saying that money spent for salaries, rent, light, heat, are not "expenditures . . . made to perpetuate or to assure the continuance of an illegal business,"<sup>91</sup> for without these disbursements, the illegal business could not be perpetuated for a single day. Nor is there any basis for the view that the money spent in the payment of a fine, or for attorneys' fees in defending a criminal charge brought against a gambling operator, is not an expenditure "made in the actual production of income."<sup>92</sup> With

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88. *Id.* at 821.

89. *Ibid.*

90. 10 T.C. 201 (1948).

91. *Stralla v. Commissioner*, 9 T.C. 801, 821 (1947).

92. *Ibid.*

the operator in jail, income would dry up quickly. There is no validity in the fine distinctions drawn by the court in this case in support of the deductibility of salaries and like expenses. It is significant as well that no authority is cited in support of the position taken by the Commissioner and the gratuitous statement of the court in describing said position.

In *Comeaux v. Commissioner*<sup>93</sup> for the first time the Tax court used the language, "legitimate expenses of an illegitimate business," and cited the *Stralla* case as authority for their being allowable as deductible expenses. Of course, the *Stralla* case is no authority for that proposition at all. It could not be by reason of the simple fact that that issue was not before the court. Nevertheless, the Tax Court in the *Comeaux* case said:

The second issue relates to the deduction of salaries and miscellaneous expenses, the "legitimate expenses of an illegitimate business." The amount of such items is not in dispute. These expenses were incurred in earning the income reported by petitioner or attributed to him by respondent. In *Anthony Cornero Stralla*, 9 T. C. 801, at 821, this Court recognized that such expenses are deductible, in contradistinction to those expenses which are not deductible because contrary to public policy. We said: "The expenditures here in issue were not made in the actual production of the income; deduction of expenses of that character has been allowed."<sup>94</sup>

The *Comeaux* case reached the Circuit Court of Appeals, and there it appears that the Commissioner "agreed that . . . legitimate expenses incurred in an illegitimate business are deductible . . ."<sup>95</sup> The claim is justified that the Commissioner has been soft with the gamblers and racketeers. He has no authority whatsoever for agreeing to allow and allowing the so-called "legitimate expenses" of illegal businesses. All expenses related to a gambling joint are incurred in carrying on an illegal business and are an integral part of the same.

In the *Comeaux* case, the statement was made that "[T]he income tax law is not a tax on gross income, even if the income be earned in an illegal business."<sup>96</sup> Issue must be taken with that statement. The question of whether the Internal Revenue Code operates in a given case as a tax on gross income depends

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93. 10 T.C. 201 (1948).

94. *Id.* at 207.

95. *Comeaux v. Commissioner*, 176 F.2d 394, 400 (10th Cir. 1949).

96. *Comeaux v. Commissioner*, 10 T.C. 201, 207 (1948).



upon whether the taxpayer has any legal deductions or exemptions as defined in the law. If the claimed deductions cannot be brought within the legal limits of the law, it is purely incidental that the tax rate applies to gross receipts.<sup>97</sup>

It is plainly evident that no case authority exists in support of the present practice of allowing a deduction of the expenses of operating a business which is condemned by statute as illegal.

As to the deduction of gambling losses, a statutory development must be noted. It has been pointed out that the case law does not justify the deduction of gambling losses from gross income where, by state law, gaming is illegal. It has always been the case, however, that where the taxpayer engaged in gaming in a state where that occupation was legal, his losses in respect to that activity were treated exactly as were losses suffered in any other legal business.<sup>98</sup>

The Treasury was not quite satisfied with this state of affairs and in 1942 proposed to Congress an amendment to section 23 which assumes the present form of section 23(h).<sup>99</sup> The Treasury desired by the proposed amendment to limit the deduction of legal gambling losses to the amount of legal gambling winnings. The intention was to prevent a resident of Illinois, for example, who might go to Monte Carlo or Reno and who might (and usually did) lose sizeable sums, from deducting said losses from his gross income produced by his regular legal occupation. This intention is clearly shown in the statement made by Professor Magill on behalf of the Treasury favoring the Amendment.<sup>100</sup>

97. *Kjar v. Commissioner*, P-H 1941 B.T.A. MEM. DEC. ¶ 41,446 (1941) at page 978:

. . . But while we are required to compute gross income in the same manner whether the taxpayer's business be legal or illegal, we do not allow the same deductions in computing taxable net income. As we have already indicated, *supra*, this is because of well founded policy reasons aimed toward giving rewards (deductions, in this case) to only those who conduct their everyday lives and business within the confines of the law. Accordingly, we disallow any deductions for amounts paid for storage of liquor or for loading.

98. *Beaumont v. Commissioner*, 25 B.T.A. 474 (1932).

99. INT. REV. CODE § 23(h): "Wagering Losses. Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions."

100. *Hearings before the Committee on Finance on H.R. 7835*, 73d Cong. 2d Sess. 32-33 (1934), where Dr. Magill testified as follows:

Dr. Magill. The next paragraph (g), is a new provision which is

In spite of the unmistakable purpose of section 23(h) as shown by the Senate Finance Committee Report, the gamblers received a big assist from the Circuit Court of Appeals in the case of *Humphrey v. Commissioner*.<sup>101</sup> The court there held that section 23 (h) applied to all gambling losses, whether carried on legally or not and whether carried on for a profit or not. There is a strong dissenting opinion. In view of the unmistakable congressional purpose in enacting section 23(h), the case was wrongly decided. Congress should by all means make a further amendment to 23(h) for the purpose of removing the distortion resulting from the *Humphrey* opinion.

3. *Expenses and losses of an illegal enterprise are not deductible where to allow their deduction would frustrate sharply defined public policy.*

This premise is the strongest of the three and is the most compelling in denying the deductibility of any expense of an illegal enterprise or any of its losses.

Our point of departure should be a definition of the term "public policy." What is it? The term "public policy" has been subject to a multitude of definitions. For our purposes here let us resort to the "limited rule" which is as follows:

. . . The public policy of a state or a nation must be determined by its constitution, laws, and judicial decisions; not by the varying opinions of laymen, lawyers, or judges as to the demands of the interests of the public.<sup>102</sup>

Reference to the statutes of Illinois discloses that it is made a crime to rent or occupy a room or enclosure for the purpose of

self-explanatory, that losses from wagering transactions are to be allowed only to the extent of gains from such transactions.

. . . The Chairman. Explain that paragraph.

. . . Dr. Magill. The line which the Treasury draws, is, I believe, whether or not the particular gambling transaction was legal in the State in which it occurred; and they have gone into a good deal of dissertation as to whether it is legal gambling.

. . . Senator Reed. Also, haven't they discussed the question of whether that is the taxpayer's regular business?

Dr. Magill. You wouldn't need to in this connection, because he could get the deduction as a loss if the transaction was entered into for a profit, in the event that the transaction was legal.

This quotation also appears in *Humphrey v. Commissioner*, 162 F.2d 853, 855 n. 1 (5th Cir. 1947).

101. 162 F.2d 853 (5th Cir. 1947).

102. *Hartford Fire Ins. Co. v. Chicago M. & St. P. Ry.* 70 Fed. 201, 202 (8th Cir. 1895), *aff'd*, 175 U.S. 91 (1899).

commercial gambling<sup>103</sup> or prostitution,<sup>104</sup> or to possess or use any device for the purpose of recording or registering bets or wages.<sup>105</sup> It is illegal for any person to register or record bets or wagers whether he does it on his own account or as agent for another.<sup>106</sup> These various components of an illegal enterprise are all "integral parts" of the illegal venture.

Practically every phase of gambling activity, if it is practiced on a commercial basis, is condemned by the laws of the State of Illinois and most other states. It is safe to say that the public policy in that respect is sharply defined, even within the terms of the limited rule.

To advance our thesis a little further, under this point, reference must be made to the *Heininger*<sup>107</sup> case. Heininger was a Chicago dentist who used the United States mails in the conduct of his business. He made false teeth for people without ever having seen them. He advertised extensively. Some of his representations concerning his goods were found by the Postmaster General to be fraudulent. It is important to notice at the outset that Heininger was in a lawful business. He was engaged in a legitimate profession, recognized by the state from whom he held a license to practice.

Pursuant to sections 259 and 732 of Title 39 of the United States Code, hearings were held before the solicitor of the Post Office Department, which hearings resulted in a fraud order being issued against Heininger denying him the use of the mail. Heininger fought the fraud order all the way up to the Supreme Court and lost. On his income tax return he claimed legal expenses incurred in defending himself against the fraud order, in the amount of \$36,600, as deductible under section 23(a) (1) (A). The Commissioner of Internal Revenue disallowed the item because allowance would frustrate the sharply defined policies of the above mentioned Code sections, which authorized the Postmaster General to issue fraud orders.

The Supreme Court upheld Heininger saying:

. . . The single policy of these sections is to protect the public from fraudulent practices committed through the use of the mails. It is not their policy to impose personal

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103. ILL. REV. STAT. c. 38, § 325 (1951).

104. *Id.* § 162.

105. *Id.* §§ 341, 342, 343.

106. *Id.* §§ 336, 338.

107. *Commissioner v. Heininger*, 320 U.S. 467 (1943).

punishment on violators; such punishment is provided by separate statute, and can be imposed only in a judicial proceeding in which the accused has the benefit of constitutional and statutory safeguards appropriate to trial for a crime. Nor is it their policy to deter persons accused of violating their terms from employing counsel to assist in presenting a bona fide defense to a proposed fraud order. It follows that to allow the deduction of respondent's litigation expenses would not frustrate the policy of these statutes; and to deny the deduction would attach a serious punitive consequence to the Postmaster General's finding which Congress has not expressly or impliedly indicated should result from such a finding. We hold therefore that the Board of Tax Appeals was not required to regard the administrative finding of guilt under 39 U.S.C. §§ 259 and 732 as a rigid criterion of the deductibility of respondent's litigation expenses.<sup>108</sup>

It appears from the reasoning exhibited in this opinion that if Heininger had been charged with the crime of using the mails to defraud and had been convicted, his legal expense would not have been deductible because to have permitted deductibility would have frustrated the sharply defined public policy of the mail fraud sections of the law.

Applying this reasoning to the illegal businesses of gambling, prostitution, extortion and racketeering in general, we can say that any expense arising out of an activity which is prohibited and punished by law must be denied deductibility, because it frustrates the public policy which is sharply defined by the statute.

The case of *Lilly v. Commissioner*<sup>109</sup> is significant. The issue was whether the "kickbacks" by optical houses could be deducted by them (the optical houses) as ordinary expenses under section 23(a)(1)(A). There was no statute, either state or federal, condemning the rebate practice. As a result of that state of fact, the Supreme Court said:

. . . The policies frustrated must be national or state policies evidenced by some governmental declaration of them. In 1943 and 1944 there were no such declared public policies proscribing the payments which were made by petitioners to the doctors.<sup>110</sup>

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108. *Id.* at 474.

109. 343 U.S. 90 (1952), *reversing* 14 T.C. 1066 (1950), 138 F.2d 269 (4th Cir. 1951).

110. *Lilly v. Commissioner*, 343 U.S. 90, 97 (1952).

Of course, in the case of commercial gambling we do have a declared public policy in statute form, condemning the enterprise and making it entirely illegal.<sup>111</sup>

The *Lilly* case also points out the fact that the issue to be resolved in this respect is quite different where the enterprise is an illegal one:

We do not have before us the issue that would be presented by expenditures which themselves violated a federal or state law or were incidental to such violations. In such a case it could be argued that the outlawed expenditures, by virtue of their illegality, were not "ordinary and necessary" business expenses within the meaning of § 23(a)(1)(A).<sup>112</sup>

The operation of a gambling house is illegal by state law.<sup>113</sup> Any expenditure made in its operation would certainly be "incidental to such violation."

The conclusion is reached that Congress has not only the power, but the duty as well, if it is preoccupied at all with the general welfare of the people, to classify illegal gains separately from honest income and to tax the former at a much higher rate. Section 23(h) should be amended and made to express clearly and unmistakably the purpose for which it was enacted. The Bureau should restore the former rulings which denied deduction of expenses and losses of illegal business.

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111. See notes 103, 105, 106 *supra*. For other state statutes to the same effect, see, for example, MO. REV. STAT. §563.370 (1949) and N.Y. PENAL LAW § 971 *et seq.*

112. *Lilly v. Commissioner*, 343 U.S. 90, 94 (1952).

113. See note 103 *supra*.