10 T.C. 201 (1948)

Payments made to protect an illegal business from law enforcement are not deductible for income tax purposes, as such deductions would be contrary to public policy; however, ordinary and necessary expenses directly related to generating income in an illegal business are deductible.

Summary

G.A. Comeaux operated an illegal horse-book business. He sought to deduct payments made to Cohen and Carnahan for protection from law enforcement and also the ordinary expenses of running the business. The Tax Court held that the protection payments were not deductible because they violated public policy. However, it found that salaries and other operational expenses directly related to generating income were deductible, distinguishing them from expenses that facilitate illegal activity itself. The court also upheld fraud penalties against Comeaux for filing false returns.

Facts

Comeaux owned and operated a horse-book business (accepting illegal bets on horse races) named Lawrence Commission Company. Cohen and Carnahan offered "protection" to illegal businesses in the county against raids and arrests. Comeaux paid Cohen a portion of his profits for this protection, who in turn shared some with Carnahan. Comeaux's tax returns, prepared by an accounting firm that also served Cohen and Carnahan, did not accurately reflect the payments made or the nature of the business. The Commissioner of Internal Revenue determined deficiencies and penalties against Comeaux.

Procedural History

The Commissioner of Internal Revenue assessed income tax deficiencies and fraud penalties against Comeaux. Comeaux appealed to the Tax Court, contesting the disallowance of deductions for protection payments and business expenses, as well as the fraud penalties. The Tax Court consolidated the case with similar cases involving Cohen and Carnahan.

Issue(s)

1. Whether payments made by Comeaux to Cohen and Carnahan for protection against law enforcement actions are deductible for income tax purposes.
2. Whether salaries and expenses of operating an illegal business are deductible for income tax purposes.
3. Whether Comeaux filed false and fraudulent income tax returns with the intent to evade tax, thus justifying the imposition of fraud penalties.

Holding

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1. No, because payments for protection against law enforcement in the operation of an illegal business are contrary to public policy and therefore not deductible.
2. Yes, because the expenses directly related to earning income in an illegal business are deductible, as the income tax law taxes net income, not gross income, even if earned illegally.
3. Yes, because Comeaux failed to report large items of income and claimed deductions without legal basis, intending to mislead the respondent.

Court's Reasoning

The court reasoned that the payments to Cohen and Carnahan were clearly for protection from law enforcement, which facilitates the illegal operation itself. Such payments are "contrary to public policy" and cannot be deducted. The court distinguished these payments from the ordinary and necessary expenses of running the business (salaries, etc.), which are directly related to generating income. While the business was illegal, the income tax law taxes net income, not gross income, regardless of the income source. "The income tax law is not a tax on gross income, even if the income be earned in an illegal business. 320 U.S. 467." The court also found clear evidence of fraud, noting that Comeaux failed to report large amounts of income and claimed improper deductions, showing an intent to deceive the respondent. The court stated,

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