25 T.C. 513 (1955)

Wages paid in an illegal business that directly facilitate the illegal activity are not deductible as ordinary and necessary business expenses because allowing the deduction would violate public policy.

Summary

Sam Mesi operated an illegal bookmaking business and claimed deductions for wages paid to his employees. The IRS disallowed these deductions, arguing that they violated public policy. The Tax Court agreed, ruling that the wages were directly tied to the illegal activity and therefore not deductible. The court distinguished this situation from the deductibility of legitimate business expenses in an illegal enterprise, emphasizing that the wages were integral to the illegal activity itself. The court also found that Mesi had overstated the amounts paid to winning bettors. This case underscores the principle that expenses that are inherently illegal and facilitate an illegal business are not deductible.

Facts

Sam Mesi was engaged in the business of accepting wagers on horse races (bookmaking) in Illinois in 1946. He employed several people, including a cashier and sheet writers, and paid them gross wages of $14,563.84. These employees assisted in the illegal operation by recording bets, entering data, and paying winners. Mesi’s bookmaking business was illegal under Illinois law. Mesi’s records showed total wagers of $793,287.50 and a gross profit of 5.45%. The IRS accepted the accuracy of gross receipts and operating expenses but found that Mesi overstated the amount paid to winning bettors and disallowed a portion of the claimed losses. The IRS also sought to disallow the deduction of wages on public policy grounds.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Mesi’s income tax for 1946. The case was brought before the United States Tax Court, which ruled on the deductibility of wages and the accuracy of reported payouts to bettors. The Tax Court sided with the Commissioner on both issues, leading to the current ruling.

Issue(s)

1. Whether Mesi overstated the amounts paid to winning bettors.

2. Whether the wages paid by Mesi in the conduct of his illegal bookmaking business are deductible as ordinary and necessary business expenses.

Holding

1. Yes, because Mesi's records contained discrepancies that he could not adequately explain.

2. No, because such payments violated the clearly defined public policy of the State of Illinois.

Court's Reasoning

The court first addressed the issue of overstatement of amounts paid to winning bettors. The court found discrepancies in Mesi's records and upheld the Commissioner's determination. The court reasoned that because Mesi's records were susceptible of easy manipulation, and because there was no method of verifying the accuracy, the court could adjust the claimed losses. The court applied the rule in *Cohan v. Commissioner*, which permits estimating expenses when records are imperfect but does not absolve the taxpayer of the burden to maintain them accurately.

The court then considered whether wages paid to employees were deductible. The court cited the well-established principle that deductions may be disallowed for reasons of public policy. It noted that "wages paid to procure the direct aid of others in the perpetration of an illegal act, namely, the operation of a bookmaking establishment" violated public policy. The court quoted Illinois law, which made it illegal to operate a bookmaking establishment and criminalized assistance in the operation of such a business. The court stated, "Certainly, it would be a clear violation of public policy to permit the deduction of an expenditure, the making of which constitutes an illegal act." The court also distinguished this case from instances where legitimate expenses are incurred in an illegal business, pointing out that the wages were integral to the illegal activity itself.

Practical Implications

This case has important practical implications for tax law. It clarifies that expenses directly related to an illegal activity, and essential to its execution, are not deductible, even if the activity generates income. Attorneys should advise clients engaged in potentially illegal activities that they may face disallowance of related expenses, especially those directly facilitating the illegal acts. This case has been frequently cited regarding the deductibility of expenses related to illegal businesses and the impact of public policy considerations. Subsequent cases have followed *Mesi* in denying deductions for expenses related to criminal activity.

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