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DEDUCTING THE EXPENSES OF AN ILLEGAL BUSINESS

The decision of the United States Supreme Court in *Commissioner v. Sullivan*,¹ rendered March 17, 1958 once again brings to prominence the controversy over deductibility of the expenses of an illegal business, in particular those of the popular and litigious business of bookmaking. In the *Sullivan* case, Mr. Justice Douglas, speaking for a unanimous court, allowed the deduction of wages and rent as "ordinary and necessary" business expenses within the meaning of section 23(a)(1)(A), Internal Revenue Code of 1939.² In so holding, the Court was in line with the greater number of existing cases. Nevertheless there have been conflicts between the Tax Court and the United States Courts of Appeals. Further, the Congressional policy as enunciated in the Internal Revenue Code has not always agreed with the policy of the Internal Revenue Service announced in its Regulations, and neither of the latter two has been in complete accord with the avowed policy of the Attorney General's department. Therefore it would not be altogether surprising if the *Sullivan* case were not a final settlement of the question.

In reviewing the history of the controversy to date, a preliminary inquiry into the taxability of illegal income is first necessary. The problem could never have arisen under the original Revenue Act of 1913. That act purported to tax only "gains, profits, and income . . . from . . . the transaction of any lawful business."³ Since income from an unlawful business was expressly outside the scope of that act, no question could exist about the deductibility of the expenses of such an enterprise. In 1916, however, to provide for an increase in revenue the word "lawful" was deleted,⁴ clearly indicating that Congress intended thereby to include unlawful income in the classification of "gains or profits and income derived from any source whatever." The early case of *United States v. Sullivan*⁵ (not to be confused with *Commissioner v. Sullivan, supra*) noted the deletion of the word "lawful" and found that income earned in violation of the National Prohibition Act was taxable. Following this case all manner of illegal income, specifically, that derived from swindling,⁶ fraud,⁷ extortion,⁸ smuggling,⁹ gambling,¹⁰ bookmaking,¹¹ and kidnaping¹² has been held taxable. Thus it is possible to state as a general rule that income, whether legally or illegally earned, is taxable. Indeed, the Internal Revenue Code itself, besides taxing income from "any source whatever," subjects wagers of certain types to a 10 per cent excise tax,¹³ and imposes an occupational tax of

¹78 Sup. Ct. 512 (1958).

²Now INT. REV. CODE OF 1954, § 162(a).

³Revenue Act of 1913, § II B, 38 STAT. 167.

⁴Revenue Act of 1916, § 2(a), 39 STAT. 756.

⁵274 U.S. 259 (1927).

⁶*Akers v. Scofield*, 167 F.2d 718 (5th Cir. 1948).

⁷*United States v. Wampler*, 5 F. Supp. 796 (D. Md. 1933).

⁸*Rutkin v. United States*, 343 U.S. 952 (1952).

⁹*Steinberg v. United States*, 14 F.2d 564 (2d Cir. 1926).

¹⁰*L. Weiner*, 10 B.T.A. 905 (1928).

¹¹*James P. McKenna*, 1 B.T.A. 326 (1925).

¹²*Murray Humphreys*, 42 B.T.A. 857 (1940), *aff'd*, 125 F.2d 340 (7th Cir. 1942).

¹³INT. REV. CODE OF 1954, §§ 4401, 4421.

\$50 per year on any person engaged in receiving wagers for a bookmaker.¹⁴

The one notable exception to the taxation of illegal income is embezzlement. *Commissioner v. Wilcox*¹⁵ held that funds embezzled by an employee were not taxable income because there was a duty on his part to repay his employer, and that therefore the money was never his. This holding has not been applied beyond its facts, however. An extortioner, seemingly in an identical legal position as an embezzler insofar as duty to repay and ownership of the money are concerned, was held subject to income tax on his gain in *Rutkin v. United States*.¹⁶ The Court in the *Rutkin* case laid great stress on the fact that an extortioner has control over the money, and distinguished the case on its facts from the *Wilcox* decision. In *Alice v. Prokop*¹⁷ the secretary of a labor union kept union funds paid to her. The Tax Court held the money taxable even though clearly the funds in question were embezzled, stating that (1) the taxpayer was not convicted of embezzlement and (2) there was no showing that the taking had not been forgiven. Finally, in *United States v. Wyss*¹⁸ it was held that the doctrine of the *Wilcox* case could not be applied unless the lower court found the defendant to be an embezzler—that money received under any other circumstances was received under a “claim of right” and was therefore taxable. In view of the cases, it is then safe to say that the freedom from tax of embezzled monies is more apparent than real, and that the original reasoning has been qualified almost out of existence.

Having examined the question of taxability of illegal income, we concern ourselves with the deductibility of expenses of an illegal business. Section 162 of the Internal Revenue Code of 1954 allows as a deduction “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”

One of the contentions of the taxpayer in *United States v. Sullivan*, *supra*, in his attempt to show his illegal income to be free of taxation, was that if his liquor traffic were taxable then he would be entitled to deduct such an illegal expense as bribery paid to continue the business. Justice Holmes replied, “This by no means follows, but it will be time enough to consider the question when a taxpayer has the temerity to raise it.”¹⁹ It has since been established that bribes and fines are not deductible, as the bribes are themselves illegal, and the fines are penalty for an illegal act.²⁰

Expenses of lobbying are not deductible. Treasury Regulations provide that “sums of money expended for lobbying purposes . . . are . . . not deductible from gross income.”²¹ It is, however, arguable that they are as valid an expense as legal fees, and there is proposed legislation to allow deduction for “lawful resistance to legislation.”

¹⁴INT. REV. CODE OF 1954, § 4412. See also §§ 4401-23.

¹⁵327 U.S. 404 (1946).

¹⁶343 U.S. 130 (1952).

¹⁷P-H 1957 T.C. Mem. Dec. ¶67075.

¹⁸239 F.2d 658 (7th Cir. 1957).

¹⁹274 U.S. at 264.

²⁰Anthony Cornero Stralla, 9 T.C. 801 (1947); Harry Wiedetz, 2 T.C. 1262 (1943).

²¹U.S. Treas. Reg. 118, §§ 39.23(o)-1, (q)-1; 111 §§ 29.23(o)-1, (q)-1; 103 §§ 19.23(o)-1, (q)-1. See also *Textile Mills Security Corp. v. Commissioner*, 314 U.S. 323 (1941).

In *Lilly v. Commissioner*²² the claimed deduction was for the expenditure of "kickbacks" paid by the taxpayers, opticians, to general practitioners who had referred them business. It was shown that kickbacks were the custom in the community, that in fact business by referral from the general practitioners in the community was dependent on the payment of kickbacks. The Court of Appeals for the Seventh Circuit held that Lilly's expenses were ordinary, necessary, and deductible because (1) they were regular and unavoidable (thus conforming to the general qualifications of ordinary and necessary expenses), (2) there was no existing law making the expenditures illegal, and (3) the allowance did not "frustrate sharply defined national or state policies proscribing particular types of conduct."

A distinction exists between the above named illegal or quasi-illegal expenses and those expenses, whether legal or illegal in themselves, of an illegal business. The latter expenses are the primary concern of this Note, and the balance of the discussion will be confined to this subject. Regarding this problem, Attorney General Brownell in his address at the 1953 annual meeting of the American Bar Association stated:

[It is] anomalous that a person engaged in a business which is admittedly illegal may take a deduction for "ordinary and necessary expenses" incurred in the business. . . . [A]s either a legal or practical matter, I can see nothing ordinary or necessary in expenses incurred in long distance telephone calls made to place bets, or make lay-offs; automobile expenses for collecting numbers or delivering dope, rent for houses used for gambling or other vice. But even if they are "ordinary" expenses, there is certainly nothing "necessary" about them. Our policy in the Department will henceforth be to disallow all deductions for expenses incurred in illegal enterprise, and the Treasury Department has promised us its fullest cooperation. While there is some judicial confusion among the lower courts as to the right under existing law to disallow such expenses, the Supreme Court has never passed on the question.²³

In *Heininger v. Commissioner*,²⁴ the Seventh Circuit held that the fact that an expense is remotely related to an illegal act does not bar deduction. There the claimed deduction was attorney's fees expended to enjoin a fraud order of the Postmaster General against the taxpayer's business of mail-order false teeth. The litigation was ultimately unsuccessful but the injunction temporarily obtained permitted the continuation of the taxpayer's business for two years, during which time the income against which the deduction was sought was earned. The court held the expense deductible, saying "without the expense, there would have been no business. Without the business there would have been no income. Without the income there would have

²²343 U.S. 90 (1952).

²³78 A.B.A. REP. 338 (1953). In full agreement with the view expressed by the Attorney General is Baker, *Federal Taxing Power and Organized Crime*, 1953 WASH. U.L.Q. 121, wherein the author abhors equal treatment of legal and illegal incomes and suggests amendment of the Internal Revenue Code to provide for taxation of gross income where the income is illegal. The question presented here, however, is deductibility of expenses under the Internal Revenue Code as it now exists.

²⁴133 F.2d 567 (7th Cir.), *aff'd*, 320 U.S. 467 (1943).

been no tax. To say that this expense is not ordinary and necessary is to say that that which gives life is not ordinary and necessary."²⁶ Regarding the Commissioner's position, the court noted that an illegal business is treated the same as a legal business by the Internal Revenue Code—they are both taxed on net income, and to disallow the expense here would be to tax on gross income. "We are asked in the guise of construing the words 'ordinary and necessary' to amend the statute. In other words to engage in a little judicial legislation. We decline the invitation."²⁷ This holding was affirmed in the Supreme Court.

The specific problem of income of a bookmaker was first litigated in 1925 in *James P. McKenna*.²⁷ That case arose when the Commissioner disallowed a diminution of McKenna's taxable income by the amount which he paid to winning bettors. The Board of Tax Appeals held that the statute contemplated a tax on *actual* income, and that to impose a tax on the entire intake without consideration of the outgo was to ignore the purpose of the tax. The question of the deduction of expenses of the illegal business was not involved in the *McKenna* case; the Board stated that while it was the intent of the statute to tax net income, the tax in this case would be in effect one on gross income because no statutory deductions, from which net income is ascertained, were claimed.²⁸ The case is significant to a consideration of deduction of expenses, however, because of the events which followed. Up to the time of the *McKenna* decision the Commissioner had refused to allow either expenses or losses of an illegal business to be deducted.²⁹ But he acquiesced in the *McKenna* decision and immediately revoked his prior rulings.³⁰

The petitioner in *Silberman v. Commissioner*³¹ maintained a legal business from which he received income. He also operated on the side as a bookmaker and in the year in question suffered a loss from his illegal operation. The litigation arose over his attempt to deduct fees for betting booths and salaries to assistants in his bookie business from his legal income. The deduction was denied, both as an expense and as a loss, the Board finding that gambling, renting premises to gamblers, and assisting gamblers were all illegal in New York and therefore public policy dictated disallowance of such expenditures. The Board, citing the *McKenna* case, distinguished this from an attempt to pare taxable income to that amount which was net income (by deducting from gross receipts amounts paid to winning bettors). Silberman's activity was held to be an attempt to deduct *losses* of an illegal business from the taxable income of a legal business. Here it should be noted that denial of a deduction for expenses of an illegal business on the ground of public policy, where a statute makes such expense illegal, is borne out by later cases on the subject. At the time of the Board's

²⁶*Id.* at 570.

²⁷*Ibid.*

²⁸1 B.T.A. 326 (1925).

²⁹The Board held McKenna's gross income consisted of his winnings less the amount of his losses. He made no claim for deduction of expenses.

³⁰I.T. 1983, III-17 CUM. BULL. 1514 (1924); I.T. 2127, IV-1 CUM. BULL. 138 (1925).

³¹I.T. 2175, IV-1 CUM. BULL. 141 (1925).

³²44 B.T.A. 600 (1941).

decision, however, it was without precedent. Not one case cited to sustain the proposition that ordinary and necessary expenses of an illegal business are not deductible involved what is generally accepted as "ordinary and necessary expense" (light, heat, wages, rent, etc.). Without exception, the cases cited involved either deduction of *losses* of persons employing the services of a bookie, or deduction of fines, penalties, or amounts paid to influence public officials (all clearly outside any concept of an ordinary and necessary expense). Notwithstanding the error, little harm was done, as later cases have noted the distinction between the various types of expenses, and the *Silberman* case is usually cited for the proposition that expenses of an illegal business are not deductible from the income of a legal business.

*G. A. Comeaux*⁸² litigated the question of deductibility of expenses of an illegal business from the income of that same business. In that case the Commissioner had disallowed deduction for (1) protection payments⁸³ and (2) salaries and miscellaneous expenses. The Tax Court affirmed the disallowance of protection payments (the opinion states that the disallowance was conceded by the taxpayer, so no reasoning is given, but such payments are patently not ordinary and necessary). But the court termed the salaries and miscellaneous expenses as "legitimate expenses of an illegitimate business." It allowed their deduction, stating that "the income tax law is not a tax on gross income, even if the income be earned in an illegal business. . . . The deduction of such expenses depends on the innate character of the item itself. Thus the protection expenses have been disallowed as being contrary to sound public policy or proscribed types of conduct. But items not so to be characterized may be deductible."⁸⁴ This decision was affirmed, *sub nom. Cohen v. Commissioner*, by the Court of Appeals for the Tenth Circuit.⁸⁵

Again, six years later, in *Charles V. Doyle*⁸⁶ the Tax Court considered the deductibility of expenses of an illegal business, this time a claimed deduction for wages and rent paid by a Chicago bookmaker. In a memorandum decision⁸⁷ the court again held these to be ordinary and necessary expenses, and deductible as such. Quoting the *Comeaux* case, which it approved, the court termed them "legitimate expenses of an illegitimate business," and the deduction was allowed in spite of the Commissioner's argument that the allowance of these deductions would frustrate the laws of Illinois which prohibit bookmaking. The Tax Court decision was appealed and affirmed. The appeal will be discussed, but inasmuch as shortly thereafter there are seven decisions in the Tax Court during a period of seventeen months which hold both ways on the same question, the various decisions and appeals will be considered in chronological order.⁸⁸

⁸²10 T.C. 201 (1948).

⁸³Taxpayer had advanced a novel argument that he and the parties to whom the protection money had been paid were partners, and the payments represented partnership income to them, but not to him.

⁸⁴10 T.C. 201, 207 (1948).

⁸⁵176 F.2d 394 (10th Cir. 1949).

⁸⁶P-H 1954 T.C. Mem. Dec. ¶54340.

⁸⁷The court thereby indicated that the subject was of no more than routine interest, and by implication that it considered the question settled.

⁸⁸After the *Comeaux* case, in 1948, the following decisions appeared: *Charles V.*

The same argument the Commissioner made in the *Doyle* case was again made to the Tax Court in *Sam Mesi*.³⁹ This time the Commissioner's position was upheld. The court denied Mesi, a Chicago bookmaker, a deduction for wages paid, holding the expenditure to be contrary to public policy. The court noted the similarity in the situations of Comeaux and Mesi (though Doyle, who, like Mesi and unlike Comeaux, operated in Chicago and under the same statutes and public policy that Mesi did, was not mentioned) but found reason for a different result in the Illinois Criminal Code, which makes bookmaking illegal and makes employees and lessors of bookmakers guilty as principals. The court stated that inasmuch as the hiring here was itself the perpetration of an illegal act, the expense thereof was not deductible. It is submitted that the court argued in a circle. Illinois has the customary accessory statute common in most if not all jurisdictions (among them Kansas, where Comeaux operated). The other provision relied upon merely makes anyone who engages in any part of the bookmaking business a "bookmaker" himself to aid in the administration of the criminal law of Illinois. The court, while not purporting to administer criminal law, used the Criminal Code to deny a deduction for wages paid though the Criminal Code itself says *nothing* about the payment of wages. In effect it said, "The taxable income of an illegal business cannot be diminished by a deduction of expenses because the business is illegal." This position is not only unsupported by the Internal Revenue Code, which makes no distinction between expenses of legal and illegal businesses, but in addition flies in the face of the *Doyle* and *Comeaux* cases. As to the public policy argument, cases which deny the deduction on this ground have done so because some local law was being violated (bribes, kickbacks *where provided for by statute*, and fines) and the cases cited in the *Mesi* opinion for this argument were of that nature. As has been stated, there was no Illinois statute which prohibited the payment of the wages in question.⁴⁰

The dissenting opinion, representing four of the Tax Court judges, noted that this was the first case in the knowledge of the judge writing the dissent to deny a deduction for wages of regular employees of an illegal business. The dissent went on to argue that the majority was denying the salaries of employees who kept the records which show income while admitting their statement of income, and using it in determining the tax and thus "the expense of keeping the very records which are essential to a correct reflection of income [was] denied as an ordinary and necessary expense of the business."⁴¹ It distinguished between this expense and bribes

Doyle, 12/27/54, Tax Court; Sam Mesi, 12/16/55, Tax Court; James Ross, 1/3/56, Tax Court; Commissioner v. Doyle, 4/11/56, Court of Appeals; Albert D. McGrath, 10/29/56, Tax Court; Charles English, 11/16/56, Tax Court; Sullivan v. Commissioner, 2/13/57, Court of Appeals; Mesi v. Commissioner, 4/5/57, Court of Appeals; Commissioner v. Sullivan, 3/17/58, Supreme Court.

³⁹25 T.C. 513 (1955).

⁴⁰Following the court's reasoning to its logical conclusion, in view of statutes common to most jurisdictions, *any* expenditure of a bookmaker would be "the perpetration of an illegal act." Even the payments to winning bettors, as in the *McKenna* case, would thus have to be disapproved, and the tax would be on gross receipts.

⁴¹25 T.C. 513, 523 (1955).

by pointing out that whereas the giving of a bribe was a separate offense from the conduct of an illegal business, here the employees were engaged in the same crime as the employer, and their salaries were inherent in and indispensable to the earning of the income in question. Finally the dissent urged that the deduction for wages should be the same in every state and not subject to fluctuation dependent on the law of each state.

Less than a month later the Tax Court again decided the question in favor of the Commissioner in *James Ross*.⁴² Ross, another Chicago bookmaker, sought to deduct wages and rent. The court held that the *Mesi* case was controlling on the question of wages, and that rent presented a similar problem also covered by the Illinois Criminal Code.

The next decision on the subject was *Commissioner v. Doyle*,⁴³ rendered on April 11, 1956. This was the Commissioner's appeal from the Tax Court decision *Charles V. Doyle, supra*. The Commissioner had allowed expenses for light, heat, phone, forms and scratch sheets while he had disallowed expenses for salaries and rent. The Court of Appeals for the Seventh Circuit affirmed the Tax Court's holding that all the named expenses were deductible, saying "the business whose income the government seeks to tax is a unit. Its income is as unlawful as any of its ordinary and necessary expenses. They are all integral parts of a whole tree whose fruit the commissioner would tax. He is inconsistent" when he allows one and disallows the other. In this decision the court imposes a test of integrality for an expense to qualify as ordinary and necessary. Under this test bribes, fines, penalties, lobbying — all illegal expenses in themselves — are non-deductible because they are not "integral." Though perhaps necessary to maintaining the business, they are merely a "concomitant" of the business, as contrasted with expenses of wages and rent which are an "integral" expense of any business, legal or illegal. Here, although the court's wording is cumbersome and perhaps reads into the words it uses meanings and shading which they do not ordinarily have, the court clearly has a definite concept in mind which is not too difficult to apply. Finally, the court notes, as did the dissent in the *Mesi* case, that the Commissioner's view would impose a tax on gross income where the business is unlawful, and upon net income where the business is lawful, an inequitable result not intended by Congress and not justified by the Illinois Criminal Code. The dissent in this case adverted to the Illinois Criminal Code, and would have denied the deduction as contrary to public policy.

Notwithstanding this decision of the appellate court allowing the deduction in a case where the illegality of the payments and public policy argument had been raised in the first instance, the Tax Court, seven months later, adhered to its former position in *Albert D. McGrath*.⁴⁴ On the basis of the *Mesi* decision and the Criminal Code of Illinois, the Tax Court denied McGrath, still another Chicago bookmaker, a deduction for wages and rent. The court admitted "due respect" to the Court of Appeals and its decision in *Commissioner v. Doyle* but again maintained that allowance of these

⁴²P-H 1956 T.C. Mem. Dec. ¶56005.

⁴³231 F.2d 635 (7th Cir. 1956).

⁴⁴27 T.C. 117 (1956).

Montana Law Review, Vol. 19 [1957], Iss. 2, Art. 5

expenses would "frustrate sharply defined . . . policies" of the state. The *McGrath* case was decided in October; in December *Charles English*⁴⁵ denied the same deduction on the authority of the *Mesi* and *McGrath* decisions.

Meanwhile, Ross had petitioned for review by the Court of Appeals. That court reversed the Tax Court's holding, *sub nom. Sullivan v. Commissioner*,⁴⁶ on February 13, 1957, stating that *Commissioner v. Doyle* controlled, and that if the Commissioner were dissatisfied with that decision he should have applied to the Supreme Court for certiorari. The opinion went on to say: "Lacking such a decision by the highest court a decision by one judge of the Tax Court which in effect overrules a decision of the Court of Appeals in the circuit in which both cases arose is not consonant with the responsibilities of the respective tribunals."⁴⁷

Mesi also had petitioned for review. On April 5, 1957, the Seventh Circuit reversed the Tax Court's decision in this case, too, stating that under the authority of the *Doyle* case wages and rent were a deductible expense.⁴⁸

On the last two cases (*Sullivan v. Commissioner*, and *Mesi v. Commissioner*) the Commissioner applied for certiorari to the Supreme Court of the United States. It was granted.⁴⁹ The decision, the first by the Supreme Court on the question, was rendered on March 17, 1958, and affirmed the decisions of the Court of Appeals allowing the deduction as ordinary and necessary business expenses of payments made for wages and rent to an illegal business.⁵⁰ The Court noted that wages and rent are "ordinary and necessary" expenses in the accepted meaning of the words. This it found sufficient to allow the deduction unless the allowance (1) is a device to avoid the consequence of violation of a law or (2) is contrary to federal policy as expressed in a statute or regulation. In its decision the Supreme Court also pointed out a new approach: "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 wages deductible as ordinary and necessary business expense."⁵¹ From this the court argued recognition of a gambling enterprise as a business for federal tax purposes, stating, "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."⁵² The Supreme Court also recognized that the Commissioner's position would result in a discrimination not

⁴⁵P-H 1956 T.C. Mem. Dec. ¶56254.

⁴⁶241 F.2d 46 (7th Cir. 1957).

⁴⁷*Id.* at 48. Incidentally, while as much could be said of the Tax Court's decisions in the *McGrath* and *English* cases, which were decided after *Commissioner v. Doyle* (*Doyle* was the first decision of the question by the Court of Appeals), it is difficult to justify the Court's vehemence in regard to the Ross decision. How a decision of the Tax Court rendered on January 13, 1956 could "in effect overrule" a decision of the Court of Appeals rendered April 11, 1956, is hard to understand.

⁴⁸*Mesi v. Commissioner*, 242 F.2d 558 (7th Cir. 1957).

⁴⁹354 U.S. 920 (1957).

⁵⁰*Commissioner v. Sullivan*, 78 Sup. Ct. 512 (1958).

⁵¹*Id.* at 514.

⁵²*Ibid.*

provided for in the Code in taxing illegal businesses on gross receipts while taxing all others on net income. The Court left such an option to Congress.

The effect of the decision *may* be to settle the question. But in light of the history of this question, a stronger statement would not be safe. The cases stand thus: the Tax Court allowed the deduction in *G. A. Comeaux* and *Charles V. Doyle*. Both cases were affirmed in the Court of Appeals. The Tax Court disallowed the deduction in *Sam Mesi*, *James Ross*, *Albert D. McGrath*, and *Charles English*. The *Mesi* and *Ross* cases were reversed in the Court of Appeals, and the Supreme Court affirmed the appellate court's allowance of the deduction in both cases. The *English* and *McGrath* decisions remain the two cases not finally disposed of which disallow the deduction, but both relied on the *Mesi* case, which has been overruled. An appeal is pending in the Seventh Circuit in the *English* case, and there are cogent reasons, besides the overruling of the *Mesi* case, for predicting a reversal: (1) the Supreme Court has ruled in favor of the allowance, and (2) the Seventh Circuit has allowed the deduction whenever presented with the opportunity. Finally, the strongest words against allowance of the deduction were those of the former Attorney General, and he stated that "the Supreme Court has never passed on the question." Although the attitude of his department may remain the same, the support of that particular argument is now lost.

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