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COMMENTS

TAX ASPECTS OF EMBEZZLEMENT

For persons looking for a so-called loophole in our tax law enforcement one of the last remaining frontiers appears to be embezzlement within the jurisdiction of the second judicial circuit of the federal court system.¹ The second circuit has continued to follow a 1946 Supreme Court decision in *Commissioner v. Wilcox*² which recites the interesting doctrine that proceeds of embezzlement are not taxable income to the embezzler. In spite of respectable authority that the doctrine is no longer the law of the land the second circuit continues to hold out an invitation to the would be embezzler.

History

A 1919 court of appeals decision held "Money so received [embezzled] would not be subject to income taxation."³ This principle, however, has never been regarded as extending an exemption to illegal gains generally and the courts have upheld the taxation of illegally derived funds involving bootlegging profits,⁴ bribes,⁵ extortion money,⁶ illegal commissions,⁷ illegal contract profits,⁸ illicit bonuses,⁹ kickbacks,¹⁰ ransom,¹¹ ultra vires stock issues¹² and usurious interest.¹³ Thus the right of taxation of unlawful or illegally derived funds has seldom if ever been questioned.¹⁴ As Mr.

1. New York, Vermont and Connecticut.

2. *Commissioner v. Wilcox*, 327 U.S. 404 (1946).

3. *Rau v. United States*, 260 F. 131 (2d Cir. 1919).

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

5. *Chadick v. United States*, 77 F. 2d 961 (5th Cir. 1935).

6. *Estate of Joseph Nitto*, 13 T.C. 858 (1949).

7. *Moore v. Thomas*, 131 F.2d 611 (5th Cir. 1942).

8. *Commonwealth Investment Co.*, 44 B.T.A. 445 (1941).

9. *National City Bank v. Helvering*, 98 F.2d 93 (2d Cir. 1938); *Griffin v. Smith*, 101 F.2d 348 (7th Cir. 1938).

10. *Caldwell v. Commissioner*, 135 F.2d 488 (5th Cir. 1943); *Estate of Helene Simmons*, 26 T.C. 409 (1956).

11. *Humphreys v. Commissioner*, 125 F.2d 340 (7th Cir. 1942) *cert. den.* 317 U.S. (1942).

12. *Penn v. Robertson*, 29 F. Supp. 386 (M.D. N.C. 1939).

13. *Barker v. Magruder*, 95 F.2d (D.C. Cir. 1938); *Barker v. United States*, 26 F. Supp. 1004 (Ct. Cl. 1939). *Barker* is the same party in each case. In *Barker v. Magruder* he was seeking a refund for the years 1926 and 1927, in *Barker v. United States* he is fighting assessment of a deficiency for 1928 and 1929. See also *Edgar B. Terrell*, 7 B.T.A. 773 (1927).

14. See Annot. 43 A.L.R. 799 (1926) and supplementary Annot. 51 A.L.R. 1026 (1927). See also IREY & SLOCUM, *THE TAX DODGERS* (1948), an interesting and colorful story of taxing and convicting the top bracket illegal income group, including Al Capone and Moses Annenberg. There is no indication that these parties ever questioned the *right* to tax their illegal income.

Justice Holmes casually commented in 1923, "of course congress may tax what it also forbids."¹⁵

The Wilcox Loophole

In 1946 the Supreme Court adopted the early treatment of embezzled funds on the ground that the embezzler did not hold under claim of right:

To be taxable, a gain must be conditioned on the presence of a "bona fide legal or equitable" claim of right to the alleged gain, and the absence of an unconditional obligation to repay.¹⁶

The impact of the decision upon legal scholars was considerable;¹⁷ however non-legal periodicals gave little attention to the holding.¹⁸ The claim of right theory advanced by the court in *Wilcox* was not new. In some earlier cases the courts had held that the recipient of illegally derived funds had a claim of right,¹⁹ hence taxable income. Nevertheless, in other cases where the wrongdoer was held to have no *claim of right* and a clear legal obligation to repay his victim the courts held the funds to be taxable income.²⁰ Mr. Justice Burton in his dissenting opinion in *Wilcox* emphasized the artificial distinction upon which the majority opinion was based:

The embezzlers complete possession of the embezzled funds is exercise of dominion over them to the extent of disposing of every cent of them, amounts to such an ample enjoyment of them . . . as to make them and his transfer of possession of them to others in such a manner as to give the recipients title to them . . . as to make them of obvious economic value to the embezzler. Such a readily realizable value presents no reasonable basis for exempting these funds from taxation that would be applied to them if earned in a lawful manner.²¹

15. *U.S. v. Stafford*, 260 U.S. 477 (1923) (Involving taxation of bootlegging profits).

16. *Commissioner v. Wilcox*, 327 U.S. 404 (1946).

17. Geller & Rogers, *Embezzlement Has Its Tax Problems Too*, 26 TAXES 1097 (1948); *Taxing Unsettled Income: The "Claim of Right" Test*, 58 YALE L.J. 955 at 961 (1949); Notes, 62 L.J. 662 (1953), 46 COLUM. L. REV. 677 (1947), 25 TEX. L. REV. 693 (1947), 26 B.U.L. REV. 404 (1946); See also Annot. 166 A.L.R. 884 (1947).

18. WALL STREET JOURNAL, Feb. 26, 1946, p. 9, Cols. 5 & 6, The Journal carried portions of the majority and dissenting opinions without editorial comment; N. Y. TIMES, Feb. 26, 1946, p. 45 Col. 4, The Times carried the item on the next to the last page in extra fine print listing only the style of the case, the decision and the justices filing opinions. Perhaps the decision was not entirely overlooked on Madison Avenue. The following day the Times carried on its last page an advertisement for an article by Wesley Price on "How to Rob a Bank." The item opened with a statement in large type "There Are 210 Ways to Embezzle." N.Y. TIMES, Feb. 27, 1946 p. 44 Cols. 4, 5, 6, & 7.

19. *Caldwell v. Commissioner*, 135 F.2d 488 (5th Cir. 1943) (Kickback); *Moore v. Thomas*, 131 F.2d 611 (5th Cir. 1942) (Illegal commission); *National City Bank v. Helvering*, 98 F.2d 93 (2d Cir. 1938) (Illicit bonus); *Penn v. Robertson*, 29 F. Supp. 386 (M.D. N.C. 1939) (Ultra vires stock issue); *Barker v. United States*, 26 F. Supp. 1004 (Ct. Cl. 1938) (Usury).

20. *Humphreys v. Commissioner*, 125 F.2d 340 (7th Cir. 1942) (Ransom); *Griffin v. Smith*, 101 F.2d 348 (7th Cir. 1938) (Illicit bonus); *Barker v. Magruder*, 95 F.2d 122 (D.C. Cir. 1938) (Usury); *Chadick v. United States*, 77 F.2d 961 (5th Cir. 1935) (Bribe).

21. *Commissioner v. Wilcox*, 327 U.S. 404 (1946) (Dissenting opinion).

Immediately following the court's decision in *Wilcox* the country was overrun with would be embezzlers who upon assessment of tax deficiencies temerarily advised the Commissioner of Internal Revenue that no tax was due on their "embezzled" gains.²² A speedy lady "embezzler" successfully raised the embezzlement defense within a week of the *Wilcox* decision,²³ but generally the courts *refused to hear such a defense* and have held the ill gotten gains taxable.²⁴ In cases nearer genuine embezzlement the courts found the taxpayer to be a swindler²⁵ or a converter²⁶ rather than an embezzler thereby avoiding the so-called *Wilcox* defense.

The Rutkin Decision

In 1952 the Court decided that money obtained by extortion is income taxable to the extortioner.²⁷ The majority opinion was written by Mr. Justice Burton, the lone dissenter in *Wilcox*. A strong dissent by Mr. Justice Black²⁸ referred to the claim of right theory set forth in *Wilcox* and declared, "I just do not think Congress intended to treat the plunder of such criminals as theirs."²⁹ The intent of Congress is stated perhaps, more clearly and less emotionally in Mr. Justice Burton's dissent in *Wilcox*.³⁰ As pointed out by Geller and Rogers:

. . . Mr. Justice Burton calls attention to an important change made by the Revenue Act of 1916. The Act of 1913 originally provided that "the net income of a taxable person shall include gains, profits, and income from . . . the transaction of any *lawful* business carried on for gain or profit. [emphasis added] The 1916 Act omitted the word "lawful."³¹

The *Rutkin* decision³² was hailed by a few judges and writers as overruling *Wilcox*;³³ however some diehard embezzlers continued to fight for their

22. *Schira v. Commissioner*, 240 F.2d 672 (6th Cir. 1957); *United States v. Wyss*, 239 F.2d 658 (7th Cir. 1957); *Drybough v. Commissioner*, 238 F.2d 735 (6th Cir. 1956); *Davis v. United States*, 226 F.2d 331 (6th Cir. 1955); *United States v. Bruswitz*, 219 F.2d 59 (2d Cir. 1955); *United States v. Currier Lumber Co.* 70 F. Supp. 219 (D. Mass. 1947); *Estate of Helene Simmons*, 26 T.C. 409 (1956); *Henry C. Boucher*, 18 T.C. 710 (1952); *Wallace H. Petit*, 10 T.C. 1253 (1948); *Agnes McCue*, P-H 1956 T.C. Mem. Dec. ¶ 46,059; 12 CCH Tax Ct. Mem. 349 (1953).

23. *Agnes McCue*, P-H 1946 T.C. Mem. Dec. ¶ 46,059; 12 CCH Tax Ct. Mem. 349 (1953). Decided March 4, 1946. The *Wilcox* decision was handed down on Feb. 25, 1946.

24. See note 21 *supra*.

25. *Rollinger v. United States*, 208 F.2d 109 (8th Cir. 1953); *Akers v. Scofield*, 167 F.2d 718 (5th Cir. 1948), *cert. den.*, 335 U.S. 823 (1948).

26. *Mariensfeld v. United States*, 214 F.2d 632 (8th Cir. 1954), *rehearing den., cert. den.*, 348 U.S. 865 (1954).

27. *Rutkin v. United States*, 343 U.S. 130 (1952).

28. Joined by Mr. Justice Reed, Mr. Justice Frankfurter and Mr. Justice Douglas.

29. See note 26, *supra*, dissenting opinion.

30. *Commissioner v. Wilcox*, 327 U.S. 404 (1946).

31. Geller & Rogers, *Embezzlement Has Its Tax Problems Too*, 26 TAXES 1097 (1948).

32. See note 26 *supra*.

33. "It is difficult to perceive what, if anything is left of the *Wilcox* holding after *Rutkin* . . ." *United States v. Bruswitz*, 219 F.2d 59 (2d Cir. 1955) at 61; *Notes*, 7 MIAMI L. Q. 256 (1953); 62 YALE L. J. 662 (1953).

Wilcox rights. The majority of cases since *Rutkin* involve apparently genuine embezzlements by taxpayers who wholly own or control close corporations.³⁴ Generally the courts have refused the *Wilcox* defense here as they did in other illegal income cases.³⁵ A conflict of decisions between the sixth and second circuits³⁶ gave the Supreme Court an opportunity to clarify the issue but the Court declined.³⁷ The factual situation of the embezzlement in the second circuit case was well within the fact pattern of similar cases decided against embezzlers and would be embezzlers subsequent to the *Rutkin* case.³⁸

The Supreme Court's denial of certiorari in the face of the conflicting contemporaneous decisions of the sixth and second circuits leaves the tax consequences of embezzled funds more muddled than ever. The Court's action suggests that it will leave to Congress a specific affirmation of the views set forth in either the *Wilcox* or *Rutkin* cases.

Proposed Solution

It is suggested that embezzlement is like other crimes and should not receive preferential treatment for tax purposes on the basis of such technical niceties as the legal concept of when title passes. "[T]axation is not so much concerned with the refinements of title, as it is with the actual command over the property taxed"³⁹

Further:

Tax liability is an economic not a moral question. No prostitute, narcotics peddler, or anyone else can escape the payment of income tax on moral grounds. No more should an embezzler, a thief, a robber, a burglar, or any other criminal be permitted to go tax free . . . upon the moral or legal basis that the money which he acquired was not technically his own but his victims as against

34. *Dawkins v. Commissioner*, 238 F.2d 174 (8th Cir. 1956) (Husband held 3%, wife 95%, two children, each 1%); *Drybough v. Commissioner*, 238 F.2d 735 (6th Cir. 1956) (Two persons owned or controlled 100%); *Davis v. United States*, 226 F.2d 331 (6th Cir. 1955), *cert. den.* 350 U.S. 965, *rehearing den.*, 351 U.S. 915 (1956) (wholly owned); *Dix v. Commissioner* 223 F.2d 436 (2d Cir. 1955), *cert. den.*, 350 U.S. 894 (1955) (wholly owned); *Kann v. Commissioner*, 210 F.2d 247 (3rd Cir. 1954) (Kann family owned or controlled 90%), *cert. den.*, 347 U.S. (1954); *United States v. Currier Lumber Co. Inc.*, 70 F. Supp. 219 (D. Mass 1947) (husband held 75%, wife 25%).

35. See note 21 *supra*.

36. *Dix v. Commissioner*, 223 F.2d 436 (2d Cir. 1955) and *Davis v. United States*, 226 F.2d 331 (6th Cir. 1955).

37. *Commissioner v. Dix*, 350 U.S. 894 (1955) *cert. den.* and *Davis v. United States*, 350 U.S. 965 (1956), *cert. den.*, 351 U.S. 951, *rehearing den.*

38. *Dix v. Commissioner*, 223 F.2d 436 (2d Cir. 1955) (Dissenting opinion of Judge Hincks, ". . . I think the facts here are stronger than in *Wilcox* and come within the rationale of the *Rutkin* case. Cf. *Kann v. Commissioner* . . . *Mariefeld v. United States* . . .")

39. Mr. Justice Holmes in *Corliss v. Bowers*, 281 U.S. 376 (1930).

the economic reality of funds having been taken by him with intent to appropriate and enjoy them as his own . . .⁴⁰

It is offered that the collection of taxes should be a purely administrative function. It is not for the Commissioner of Internal Revenue to sit as a summary court for the determination of innocence or guilt of taxpayers in collateral matters. Rather it should be his job to assess taxes on the basis of money coming into the hands of taxpayers from *whatever source derived* and to allow subsequent adjustments in such tax liabilities as allowed by law. Finally it is deemed outrageous that a criminal or would-be criminal should be accorded an advantage in tax consequences over an honest taxpayer simply because he may be guilty of a crime and the honest taxpayer is not. A legislative directive, drafted to include embezzlement proceeds, is in order.⁴¹

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40. *Marienfeld v. United States*, 214 F.2d 632 (8th Cir. 1954), *rehearing den.*, *cert. den.*, 348 U.S. 865 (1954). Quoted from the excellent special concurring opinion of Judge Johnson. It appears to this writer that the district court found as a matter of fact that the defendant was a converter rather than an embezzler. *United States v. Marienfeld*, 116 F. Supp. 634 (E. D. Mo. 1953). As a result the defense of embezzlement was not maintainable. Mr. Justice Black was of the opinion that certiorari should have been granted. 348 U.S. 865 (1954). See also *Briggs v. U.S.*, 77 F.2d 699 (4th Cir. 1954), *cert. den.*, 348 U.S. 864 (1954).

41. It is suggested that the INT. REV. CODE of 1954 be amended in the following fashion.

To § 61 Gross Income Defined.

(a) General Definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items . . . Add the following.

(16) Any funds or benefits exclusive of gifts which are received or taken with intent to appropriate or enjoy such funds or benefits in the manner of an owner and upon which there is no actual or express promise or obligation to the owner or possessor of repayment.

To § 1341 Computation of tax where taxpayer restores substantial amount held under claim of right.

(a) General Rule. -1-

(1) An item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item; (2) . . . Add the following

(c) Special Presumption.

(1) Any item which was included in gross income under (a) (1) of this section shall be treated as if held under claim of right in regard to the allowance of computations and adjustments provided by this section.