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James v. United States, Wilcox's Fall Completed

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Comment / *James v. United States,* *Wilcox's* Fall Completed

WHEN THE TRUSTED EMPLOYEE SUCCUMBS to temptation, and begins dipping into the till, he is guilty of the crime of embezzlement. Embezzlement can be defined generally as "the fraudulent appropriation to his own use or benefit of property or money intrusted to him by another, by a clerk (etc.). . . ." [1] Once the crime is committed, another problem arises, that of how the funds in the hands of the embezzler are to be treated for income tax purposes.

The many difficulties inherent in this problem are at once apparent. How can the funds be taxable income when the embezzler has to return the money? Does not such a tax create an undue hardship for the victim of the embezzlement in his attempts to recover from the wrong-doer? Is it not true that embezzlers generally will not be able to repay the tax, so that such a tax would be merely a device to get the criminal "coming and going"? And yet, in spite of these objections, does it not seem unfair to allow a criminal to embezzle, use the funds as if they were his own, and then escape taxation?

It is clear, then, that solution of this problem presents many practical difficulties. It is equally clear that a decision must ultimately involve an analysis of the very nature of income.

The Supreme Court and the lower federal courts have wrestled with this question for many years. On May 15, 1961, the Supreme Court handed down a decision which appears to have settled the question at last. In *James v. United States,*[2] the government was prosecuting the defendant for failure to report as income some $700,000 embezzled from a labor union of which defendant was an officer, and from an insurance company with which the union did business. Under the rule of *Wilcox v. United States,*[3] decided fifteen years before, such embezzled funds would not have been taxable income. The Court in *James,* however, ruled that *Rutkin v. United States,*[4] holding extorted funds taxable,

[1] BLACK'S LAW DICTIONARY (3RD ED.) 653 (1933).
[2] 366 U.S. 213, 81 Sup. Ct. 1052, 6 L.Ed. 2d 246 (1961).
[3] 327 U.S. 404, 66 Sup. Ct. 546, 90 L.Ed. 752 (1946).
[4] 343 U.S. 130, 75 Sup. Ct. 751, 96 L.Ed. 833 (1952).

had in effect "vitiated" [5] the *Wilcox* doctrine, and that henceforth the proceeds of embezzlement will be taxable.

A total of six justices so voted to overrule the *Wilcox* doctrine.[6] The individual defendant's conviction was reversed by a combination of those voting to retain *Wilcox,* and those voting to overrule it, but holding that the defendant may have relied on *Wilcox,* and thus lacked the necessary element of wilfullness.[7] Thus, although the *Wilcox* rule served to protect this defendant, it appears that it will not protect future embezzlers.

It has long been well settled that illegal gains in general are subject to taxation.[8] For one reason, exemption of illegal profits would probably promote these activities. But, more basically, the bootlegger's "paycheck" is as much income as is the ordinary legitimate businessman's. When the Supreme Court first dealt with the embezzlement phase of the subject of illegal gains, however, in the *Wilcox* case, an exception was made.

A near-unanimous Court (only Mr. Justice Burton dissenting) held that the embezzler-defendant, who had misappropriated some $12,000 and then sqandered it in Nevada's gambling establishments, had not thereby received taxable income. The Court's rationale was that, "... a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay...." [9] Holding that from the moment of misappropriation there was a debtor-creditor relationship between the embezzler and his victim, the Court ruled that the embezzler no more received taxable income than would a legitimate borrower of funds.[10]

Apparently, there was considerable dissatisfaction with the *Wilcox* rule among the lower courts. This led the courts to go to some lengths to distinguish *Wilcox* from subsequent cases.[11] Indeed, there seems to be good reason for this dissatisfaction. The "claim of right" test, as applied here, does not offer a convincing basis for excepting embezzlements from the treatment generally accorded illegal gains. Simply stated, is not the "take" of the embezzler, treated by him as his own and accepted by others as his own, as much income as the honest man's earnings? This point will be discussed at greater length *infra,* but it does seem that in *Wilcox* the Court chose the superficial approach over the realistic.

[5] 81 Sup. Ct. 1052, 1054 (1961).
[6] Chief Justice Warren, and Justices Brennan, Stewart, Harlan, Clark, and Frankfurter.
[7] 81 Sup. Ct. 1052, 1056-7 (1961).
[8] United States v. Sullivan, 274 U.S. 259, 47 Sup. Ct. 607, 71 L.Ed. 1037, 51 A.L.R. 1020 (1927).
[9] 327 U.S. 404, 408 (1946).
[10] *Id.* at 409.
[11] E.g. United States v. Chapman, 168 F. 2d 997 (7th Cir. 1948), (Proceeds of black-marketing not turned over to employer held taxable); Akers v. Scofield, 167 F. 2d 718 (5th Cir. 1948) (Proceeds of swindling held taxable).

In 1952, the Court was faced with a very similar situation in *Rutkin v. United States.*[12] Here the funds sought to be taxed were the product of defendant's extortion. The Court (this time Mr. Justice Burton significantly writing for the majority), refused to overrule *Wilcox,* contenting itself with limiting that case to its facts,[13] but did hold the money to be taxable income. The majority, in a 5-4 decision, held that regardless of the extortioner's obligation to repay, he had, in fact, derived a substantial economic gain from his activities, having had the use of the money, and should pay taxes thereon.[14]

This approach cannot be reconciled with that of *Wilcox.* In essence, it is a choosing of the realistic test, taxing the wrong-doer because he had the money and used it like a true owner. It ignores the embezzler's duty to repay and concentrates on the fact that for the moment he looks and acts like a person with taxable income.

In spite of the Court's refusal specifically to overrule *Wilcox,* the great bulk of comment and analysis following the *Rutkin* decision looked upon it as having had this effect.[15] Similarly, most of the lower courts treated it this way,[16] with the notable exception of the Second Circuit.[17] Apparently, the clash between the principles enunciated in *Wilcox* and in *Rutkin* was generally looked upon as being too pronounced to allow for reconciling them. The inevitable "show-down" on the true status of the *Wilcox* doctrine occurred in the *James* case. In *James,* the Court held that *Rutkin* had by implication "vitiated" *Wilcox,* and had substituted this test of "use and benefit".[18] Hence, embezzled funds will be taxable in the future.

But there were three dissenters in *James* who opposed the overruling of *Wilcox.*[19] There were four dissenters in *Rutkin.*[20] Why is there such opposition to taxing embezzlers? Can the arguments of the dissenters be effectively answered? The scope of this comment will be to evaluate the *James* doctrine by analyzing and attempting to answer these pro-*Wilcox* arguments of the dissenters.

The objections to *James* and *Rutkin* take two basic forms: (1) It is argued that embezzled funds, both for theoretical and for practical reasons, should not be taxed as income; this argument urges a return to the "claim of right"

[12] 343 U.S. 130 (1952).
[13] *Id.* at 138.
[14] *Id.* at 137.
[15] See 62 Yale L. Rev. 662-72 (1953); 26 Temple L.Q. 211-14 (1952); 7 Rutgers L. Rev. 422-5 (1953); 36 Minn. L. Rev. 988-9 (1952); 7 Miami L.Q. 256-8 (1953); 66 Harv. L. Rev. 173 (1952).
[16] E.g. Berra v. United States, 221 F. 2d 590 (8th Cir. 1955), (Contrived overpayments, fraudulently retained, held taxable); United States v. Merrill, 211 F. 2d 297 (9th Cit. 1954), (Mistaken overpayment to himself by estate's executor held taxable).
[17] J. J. Dix, Inc. v. Commissioner of Internal Revenue, 223 F. 2d 436 (2nd Cir. 1955); United States v. Peele, 159 F. Supp. 45 (E.D. New York 1958).
[18] 343 U.S. 130, 137 (1952).
[19] Justices Black, Douglas and Whittaker.
[20] Justices Black, Douglas, Reed and Frankfurter.

test; (2) It is argued that regardless of the present Court's views on which test should be applied, once the Court has made a statutory interpretation such as *Wilcox*, it should not again entertain suits seeking to overturn the holding, but rather should leave the remedy for possible misinterpretations to Congress.

Under the first objection, greatest stress is placed on the analogy of the loan. In substance, it asks, "Does not an embezzler have the same unconditional obligation to repay that a borrower has? Should he not then receive the same treatment?" It seems that laymen, when presented with this problem, will generally react by saying, "Why should he be taxed? He has to give it back, doesn't he?" [21] There is a great appeal to logic in such an argument. How is the embezzler's economic power increased when the acquisition of the money brings with it an automatic, unconditional obligation to repay?[22]

Though appealing at first glance, this argument is erroneous when viewed against the background of tax treatment of illegal gains generally. It puts the burden on the government to show why an exception should not be made, without advancing any valid reason for making an exception. The Code definition of income is very broad,[23] and has definitely been interpreted to include illegal gains.[24] It would seem, then, that in the absence of a specific statutory exception, a person who has received funds, and has had the relatively unrestricted use thereof, should have the burden of establishing why he should not have to pay taxes thereon.

The argument is made that an embezzler should get the same treatment as a legitimate borrower. But the legitimate borrower *can* carry the burden of justifying an exemption. The reason is that in the majority of cases, the honest man does in fact repay the lender. Thus, in the long run (though not necessarily within the tax-accounting period), the average borrower experiences no economic gain. If the debt is forgiven, in whole or in part, then the borrower to that extent may receive taxable income.[25]

Such an exemption can be justified, then, on the basis of what really occurs, the frequency and/or likelihood of repayment. But this same justification cannot be advanced for embezzlements. Studies indicate that these crimes are largely traceable to a taste for high living of one kind or another.[26] Though in theory the embezzler's obligation to repay makes his situation the same as

[21] An informal survey conducted by this writer in the District of Columbia and Maryland among some fifty persons, all non-lawyers, produced this same loan-analogy answer and rationale thirty-six times.

[22] See opinion of the Court in Wilcox v. United States, 327 U.S. 404, 409 (1946); Mr. Justice Black dissenting in Rutkin v. United States, 343 U.S. 130, 139 (1952), and in James v. United States, 81 Sup. Ct. 1052, 1059 (1961).

[23] "... gross income means all income from whatever source derived...." Sec. 61 (a) of Internal Revenue Code.

[24] United States v. Sullivan, 274 U.S. 259 (1927).

[25] See Commissioner v. Jacobson, 336 U.S. 28, 69 Sup. Ct. 358, 93 L.Ed. 477 (1949).

[26] UNITED STATES FIDELITY AND GUARANTY CO., 1001 EMBEZZLERS 7 (1937).

the borrower's, in practice there is a great difference. Bluntly stated, the difference is that most embezzlers cannot and do not make restitution; the very fact that they are driven to this type of crime indicates that as a class they are very poor "credit risks." An exemption of embezzled funds would be based on a mere theoretical similarity to loans. It is submitted, then, that the *Wilcox* test attempts to extend the special treatment accorded to loans to a situation which lacks the justifying factor of *likelihood* of repayment.

A subsidiary point which militates against lumping loans in with embezzlements is that the law does not oppose loans, *per se.* But it does oppose embezzlement, *per se,* and so a great deal of justification would be needed to permit an interpretation which would promote this kind of crime.

Once this fundamental question of income or no has been dealt with, the additional policy arguments of the *Wilcox* advocates may be discussed. Among these, most weight is put on the problem of unfairness to the victim of the embezzlement. It sees the taxation as prejudicing the rights of the victim seeking to recover from the criminal, since he will have to compete against the powerful tax lien of the government.[27] It is argued that particularly in a case like *James,* where there is a large sum of money involved, the progressivity of the tax rates would make it most unlikely that the embezzler would be able to pay his taxes at a high rate, and still have enough remaining to reimburse the victim.[28]

If the embezzler does have independent sources from which he can manage to pay both, admittedly an unusual situation, there is plainly no unfairness. And if he has nothing, or next to nothing, it is hard to see how the victim has been prejudiced. It is only in those situations in which the embezzler has some money, but not enough to pay both that the problem occurs. It should be noted that the *Wilcox* advocates have come forth with no examples drawn from other fields of illegal gains in which such an injustice to the victim has actually been perpetrated by the government. But, more fundamentally, is not such a theoretical hardship proper subject for remedial legislation?[29] In resorting to judicial protection of wrong-doers to indirectly protect their victims, the cure is plainly worse than the illness. And, of course, it must be asked why such indirect protection should be granted only to embezzlement victims.

Another argument that is made is that *United States v. Sullivan,*[30] holding illegal gains taxable, should not be applied to a situation like this, a kind of "one-shot," rather than steady business crime.[31] The reasoning behind this is

[27] See Mr. Justice Black's dissent in James v. United States, 81 Sup. Ct. 1052, 1060 (1961).

[28] *Ibid.* Mr. Justice Black notes that on a $700,000 embezzlement, some $559,000 of taxes would be levied.

[29] See Mr. Justice Burton's dissent in Wilcox v. United States, 327 U.S. 404, 414 (1946).

[30] 274 U.S. 259 (1927).

[31] See Mr. Justice Black's dissent in Rutkin v. United States, 343 U.S. 130, 140-1 (1952).

that a bootlegger or "numbers man" is engaged in this activity as his regular business, just as is the ordinary butcher or baker. To tax the honest man for his honest earnings, and exempt the criminal's ill-gotten gains would seem unconscionable. But, the argument continues, this should not be extended to include the "sporadic"[32] income of once-in-a-lifetime crimes, since these are not analogous to the butcher's regular profession.

While it is probably true that most embezzlers (the application to extortioners being more questionable) are not engaged in this activity as a regular livelihood,[33] this argument is weak on two points. First, and most obvious, once-in-a-lifetime honest gains are not necessarily tax-free. Second, according to the test offered by this argument, the "professional" criminal would pay taxes, while the "amateur" or "week-end" criminal would not. Thus, a line must be drawn to separate professional and amateur criminals. The thought of applying such a test, of drawing such a line between criminals, conjures up some rather frightening prospects. For instance, allowing persons to earn up to 10% of total income from embezzlement before declaring them to be professionals would make the courts and the government appear ludicrous.

The next argument that must be dealt with is that the taxing of embezzled funds is primarily a device to promote the interference of the federal government in the prosecution of violators of state laws.[34] If the premises upon which this argument is based are granted (that this burdens the federal government, weakens the states, and produces little revenue),[35] it does indeed present considerable difficulties.

Even if these premises are granted, and even if prosecution of state crime is the primary motive, since the embezzlers usually will be unable and unwilling to pay taxes, should these factors of necessity change the outcome? It should be noted that instances of taxes used primarily for non-revenue purposes are not uncommon in the United States. Protective tariffs are an example that can be cited.[36] But, aside from this, all the prior discussion has indicated that a consistent holding would be to tax embezzlers. What the dissenters are arguing is that the *James* adherents only want a consistent holding in order to prosecute state criminals, and so, to prevent this, there should be an inconsistent holding. It seems unwise and unjust to keep the federal government from indirectly prosecuting just this one form of state crime.

These, then are the major arguments of the dissenters on the point of general tax policy. It is apparent that they do offer objections worthy of note, but

[32] *Ibid.*
[33] 1001 EMBEZZLERS, *op. cit., supra,* note 26, at 9.
[34] 81 Sup. Ct. 1052, 1061 (1961).
[35] *Ibid.* See also Rutkin v. United States, 343 U.S. 130, 142-7 (1952).
[36] Protective tariff upheld in Hampton v. United States, 276 U.S. 394, 48 Sup. Ct. 348, 72 L.Ed. 624 (1928).

they can be overcome. It would take stronger arguments than these to support a policy which would make the violator of trust occupy a preferred position in the field of tax law.

The other objection, however, addressing itself to the propriety of re-examining a prior statutory interpretation, presents some thorny problems, too. The *Wilcox* rule, though criticized and distinguished,[37] stood as law for many years. Even after *Rutkin,* the Second Circuit persisted in applying the *Wilcox* rule.[38] The Second Circuit's *Dix*[39] decision was denied *certiorari.*[40] To some extent, then, the *Wilcox* doctrine was still alive, right up to the *James* case.

Yet, this argument continues, Congress has done nothing to overrule *Wilcox.* Two bills that would have reversed it failed to pass.[41] In 1954, the Internal Revenue Code was re-enacted, again without a mention of the *Wilcox* problem.

Against this background of at least some life in the *Wilcox* rule, and complete Congressional inaction in this area of tax law, this jurisprudential argument is then pressed. Admittedly, the Court is not strictly bound by *stare decisis* in the area of constitutional interpretation.[42] If it were so bound, then the only means of change available would be that of constitutional amendment. This is so complex, slow, and cumbersome as to make change very difficult to come by. Therefore, in the interests of the adaptability of the law, the Court can overrule prior constitutional interpretations.[43]

But, it is argued, the matter at hand is one of *statutory* interpretation. As such, it is susceptible of ready remedy, through Congressional action. Instances of such Congressional overruling of unpopular interpretations are cited.[44] Since this is possible, should not the Court abide by its first interpretation and then leave it to Congress to overrule it?

In *Federal Baseball Club v. National League of Professional Baseball Clubs,*[45] the Court ruled that professional baseball was exempt from the anti-trust laws. Later in *Toolson v. New York Yankees,*[46] the Court refused to re-examine this ruling. This is an example of the attitude that the dissenters would recommend in the *James* case too.

[37] See notes 8, 12, and 13 *supra.*
[38] See note 14 *supra.*
[39] 223 F. 2d 436 (2nd Cir. 1955).
[40] 350 U.S. 894, 76 Sup. Ct. 150, 100 L.Ed. 786 (1955).
[41] H.R. 8854, 86th Congress, First Session; H.R. 312, 87th Congress, First Session.
[42] 81 Sup. Ct. 1052, 1063 (1961).
[43] *Ibid.*
[44] Commissioner v. Korell, 339 U.S. 619, 70 Sup. Ct. 905, 94 L.Ed. 1108 (1950), leading to passage of §217 of Revenue Act of 1950, amending §125 (b) (1) of 1939 Code; Commissioner v. Smith, 324 U.S. 177, 69 Sup. Ct. 591, 89 L.Ed. 830 (1945), leading to passage of §218 of Revenue Act of 1950, adding §130 A to 1939 Code.
[45] 259 U.S. 200, 42 Sup. Ct. 465, 66 L.Ed. 898, 26 A.L.R. 357 (1922).
[46] 346 U.S. 356, 74 Sup. Ct. 78, 98 L.Ed. 64 (1953).

Thus, it is argued that by the Court's re-examining of the *Wilcox* doctrine it has put on Congress the burden of actively ratifying or overruling each and every statutory interpretation of the Court, under pain of possible subsequent reversal. Even at the time of *Rutkin,* it was suggested that this amounted to an act of positive judicial legislation.[47]

It can be argued, then, that Congress is busy enough, without having such an added burden heaped upon it. Such a use (or mis-use) of the judicial power might well open up a "Pandora's Box" of uncertainty in the law.

Both the Chief Justice, writing for the Court, and Mr. Justice Whittaker, in his powerful dissent in *James,* cite the case of *Helvering v. Hallock*[48] as controlling this point. In this decision, (significantly a tax statutory interpretation) Mr. Justice Frankfurter said:

> Nor does want of specific Congressional repudiation . . . serve as an implied instruction by Congress to us not to reconsider in the light of new experience, whether those decisions . . . make for dissonance of doctrine. It would require very persuasive circumstances enveloping Congressional silence to debar this Court from re-examining its own doctrines. To explain the cause of non-action by Congress when Congress itself sheds no light is to venture into speculative unrealities. . . . Various considerations of parliamentary tactics and strategy might be suggested as reasons for inaction . . . but they would only be sufficient to indicate that we walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principle.
>
> Our problem then is not that of rejecting a settled statutory construction. The real problem is whether a principle shall prevail over its later misapplications. Surely we are not bound by reason or by the considerations that underlie *stare decisis* to persevere in distinctions taken in the application of a statute which, on further examination, appear consonant neither with the purposes of the statute nor with this Court's own conception of it.[49]

Interestingly, this principle was reiterated by Mr. Justice Frankfurter in the recently decided *Monroe v. Pape,*[50] involving re-examination of an interpretation of the Civil Rights Act.

Mr. Justice Frankfurter in *Hallock* stated that re-examination is permissible when the problem involved was not that of a "settled statutory construction,"[51] but rather "whether a principle shall prevail over its later misapplications."[52] It appears that the bewildering maze of distinctions following *Wilcox,*[53] plus *Rutkin,* which in effect rejected the *Wilcox* test,[54] had left this area of tax law

[47] 7 Miami L.Q. 256-8 (1953).
[48] 309 U.S. 106, 60 Sup. Ct. 444, 84 L.Ed. 604 (1940).
[49] *Id.* at 119-21.
[50] 365 U.S. 222, 81 Sup. Ct. 473, 5 L.Ed. 2d 525 (1961).
[51] Helvering v. Hallock, 309 U.S. 106, 121 (1940).
[52] *Ibid.*
[53] See notes 8 and 13 *supra.*
[54] 343 U.S. 130 (1952).

anything but "settled." And, the reason for the re-examination was to determine whether there was sufficient justification for persisting in this exception to the general treatment of illegal gains. In short, it was re-examination to permit a "principle . . . (to) prevail over its later misapplications", and thus fits squarely under the criteria enunciated in the *Hallock* case.

The argument based upon the failure of the overruling bills to pass[55] is effectively and realistically answered by Mr. Justice Frankfurter's discussion of "parliamentary tactics" and the unreliability of Congressional inaction as a barometer of Congressional intent. Along this same line, it must be noted that no conclusion ought to be drawn pro or con from the denial of certiorari.[56] This is somewhat oversimplified, since such a denial frequently is an indication of the Court's attitude on a question. But in *James* the dissenters' argue that the Court's denial of certiorari in the Second Circuit should have warned Congress that *Wilcox* was very much alive.[57] Such an argument attributes too much meaning to a denial of certiorari, and too much omniscience to Congress to be very persuasive.

It is submitted then, that it is just such a case as this that should be governed by *Hallock*. Here there was a "misapplication" of a "principle" (the taxing of illegal gains), leading to "dissonance of doctrine". The problem was not, it seems, that of a "settled statutory construction", but of an unsettled situation in the field of tax law. In order to clear up the uncertainty, and to restore sanity and consistency to the application of the law, the Court was well-advised to take the *James* case. In overruling *Wilcox,* the Court did in fact restore sanity by choosing a test of taxability which is both realistic in its approach and consistent with the tax law governing other illegal gains.

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[55] 81 Sup. Ct. 1052, 1062 (1961).
[56] See N.L.R.B. v. Lannom Mfg. Co., 243 F. 2d 304, 307 (6th Cir. 1957).
[57] James v. United States, 81 Sup. Ct. 1052, 1063 (1961).