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Income Tax—Extorted Funds Held Taxable Income

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subject matter submitted was not made. Under this section arbitrators were required to complete the award by naming the amount each reinstated employee should receive, for without this the award is not considered final. In re *E. A. Laboratories Inc.*, 50 N. Y. S. 2d 222 (Sup. Ct. 1944). In *Matter of Pfeiffo,* 222 App. Div. 62, 225 N. Y. Supp. 294 (1st Dep't 1922), the award was vacated and remitted to the arbitrator for a final determination of the quality of the product before the award would be enforced.

As this case exemplifies, the conflict between labor arbitration awards and enforcement by strict judicial review constitutes a bar to successful arbitration of labor disputes. If the advantages of labor arbitration are to be enjoyed to the fullest extent, it is important that the courts ungrudgingly acknowledge the authority of labor arbitration boards within their delineated area.

Myron Siegel

INCOME TAX—EXTORTED FUNDS HELD TAXABLE INCOME

Taxpayer was convicted of willfully attempting to evade federal income tax by failing to report cash obtained by extortion. *Held* (5-4): Extorted funds are taxable income under Int. Rev. Code § 22(a). *Rutkin v. United States,* 343 U. S. 130 (1952).

United States v. Sullivan, 274 U. S. 259 (1927), established the basic principle that the unlawful character of a transaction is no reason to exempt it from a tax which would be imposed if it were lawful. Later cases also establish this conclusion by the use of one or more of the following bases for *generally* holding disputed gains to be taxable income:

(1) Tax liability has been based on the enjoyment of the economic benefits of, or on the actual control over, the property, regardless of where title technically lay. *Corliss v. Bowers,* 281 U. S. 376 at 378 (1930); *Burnet v. Wells,* 289 U. S. 670 at 678 (1933); *Flato v. Commissioner,* 195 F. 2d 580 at 582 (5th Cir. 1952).

(2) Taxability has rested on the receipt of earnings under a claim of right and without restriction as to their disposition. *North American Oil v. Burnet,* 286 U. S. 417 at 424 (1932); *United States v. Lewis,* 340 U. S. 590 at 591 (1951); *National City Bank of New York v. Helvering,* 98 F. 2d 93 at 96 (2d Cir. 1938).

(3) Some gains have been held taxable through the interpretation of the legislative history of Int. Rev. Code § 22(a). The Act of Oct. 3, 1913, c. 16, § II B, 38 STAT. 167 (1913), provided,

"(I)ncome of a taxable person shall include gains, profits, and income . . . from . . . the transaction of any *lawful* business carried on for gain or profit, or gains or profits and income derived from any source whatever . . ." (Ital. added). The Revenue Act of 1916, § 2a, 39 STAT. 757 (1916), was a reenactment of this provision, omitting only the word *lawful*. This latter section is in all material respects identical with § 22(a) of the present Internal Revenue Code. The single omission is a strong indication of a legislative intent to tax the gains, profits, and income from any unlawful activity as well as from any lawful one. *United States v. Sullivan, supra.* It has also been stated that "the broad sweep of this language indicates the purpose of Congress to use the full measure of its taxing power within those definable categories." *Helvering v. Clifford,* 309 U. S. 331 at 334 (1940).

(4) Gains have been held taxable by the use of analogies to other unlawful, but taxable, activities, including: illegal sale of liquor, *United States v. Sullivan, supra;* ransom payments to a kidnapper and protection payments, *Humphreys v. Commissioner,* 42 B. T. A. 857 (1940), *aff'd,* 125 F. 2d 340 (7th Cir. 1942), *cert. denied,* 317 U. S. 637 (1942); graft, *Chadick v. United States,* 77 F. 2d 961 (5th Cir. 1935), *cert. denied,* 296 U. S. 609 (1935); bribes, *United States v. Commerford,* 64 F. 2d 28 (2d Cir. 1933), *cert. denied,* 289 U. S. 759 (1933); kickbacks, *Caldwell v. Commissioner,* 135 F. 2d 488 (5th Cir. 1943); lotteries, *Christian H. Droge,* 35 B. T. A. 829 (1937); illegal prize fight pictures, *George L. Rickard,* 15 B. T. A. 316 (1929); race track bookmaking, *James P. McKenna,* 1 B. T. A. 326 (1925); and various other illegal enterprises, *Robert L. Carnahan,* 9 T. C. 1206 (1947), *aff'd sub nom. Cohen v. Commissioner,* 176 F. 2d 394 (10th Cir. 1949).

Prior to the principal case, the leading case was *Commissioner v. Wilcox,* 327 U. S. 404 (1946), holding that embezzled funds do not constitute taxable income. The Court stated, at 408:

> (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 or return that which would otherwise constitute a gain. Without some bona fide legal or equitable claim, even though it be contingent or contested in nature, the taxpayer cannot be said to have received any gain or profit within the reach of § 22(a).

The conclusion of non-taxability followed on the ground that, in the opinion of the Court, neither of these conditions is present in embezzlement.

Even before the principal case, however, the courts showed dissatisfaction with the *Wilcox* case and resorted to technical distinctions in order to hold unlawful gains taxable. Swindled money was held taxable on the ground that a state law gave the swindler title, although only a voidable one, to the unlawful gain. *Akers v. Scofield,* 167 F. 2d 718 (5th Cir. 1948), *cert. denied,* 335 U. S. 823 (1948). It has been stated that extorted funds are properly taxable, even though the payors might later be able to recover the funds extorted from them. *Estate of Joseph Nitto,* 13 T. C. 858 at 867 (1949). Even fact situations bordering on embezzlement have given rise to tax liability. *United States v. Currier Lumber Co.,* 70 F. Supp. 219 (D. Mass. 1947), *aff'd,* 166 F. 2d 346 (1st Cir. 1948); *United States v. Iozia,* 104 F. Supp. 846 (S. D. N. Y. 1952).

Finally, in the principal case, Mr. Justice Burton, speaking for the majority, avoided the *Wilcox* case by narrowly limiting it to its facts, without discussing the criteria it set up to determine taxable gains. He rested his decision on several grounds: (1) the extortioner's complete dominion over the cash, in the absence of his victim's unlikely demand for its return, gives him the free use and economic benefit of it, and (2) the legislative history of Int. Rev. Code § 22(a) demonstrates an intent to tax unlawful as well as lawful gains.

Since the *Rutkin* case, the trend has been toward its reasoning and away from the test set up by the *Wilcox* decision. This may be illustrated by two recent Tax Court cases. In *Henry C. Boucher,* 18 T. C. No. 85 (June 30, 1952), profits were held taxable which were obtained through a manipulation of the employer's books, causing him to make overpayments which were appropriated by employees. *W. L. Kann,* 18 T. C. No. 131 (Sept. 18, 1952), held taxable, funds misappropriated from a corporation of which petitioners were in complete control. Although both cases were clearly embezzlement-type situations, the courts again limited the *Wilcox* case "to its facts" and proceeded to hold the unlawful gains taxable on the authority of the instant case.

Admittedly, it seems inequitable to petitioner to change the law in the midst of a criminal proceeding. Perhaps that fact accounts for the Court's reluctance expressly to overrule the *Wilcox* case. However, an analysis of the instant case leads to the probable conclusion that, in effect, it does overrule the *Wilcox* decision. This is for the best, since the *Wilcox* test does not lend itself easily to a practical administration of taxation, being dependent upon refinements of title. The question of title might be affected by varying state laws, thus leading to inconsistent tax results in similar fact situations. The *Wilcox* test also puts the wrongdoer in a position to profit by his own wrong by using his crime as a bar to taxation. A better test, applicable to unlawful as well as lawful gains, appears to be that of the principal case, which taxes the gain in the hands of the person who has the freedom to dispose of it and who derives a "readily realizable economic value from it."

Jerome D. Adner

INCOME TAX—COSTS IN VIOLATION OF CEILING PRICES HELD DEDUCTIBLE

In their income tax returns, taxpayers included amounts paid in excess of World War II ceiling prices in computing their deductions for cost of goods sold. These over-ceiling payments were disallowed by the Commissioner of Internal Revenue. In the first appellate rulings on the question three Circuit Courts held that in the absence of legislation to the contrary, such payments are deductible from gross receipts as a part of the cost of goods sold, in determining gross income. *Commissioner v. Weisman,* 197 F. 2d 221 (1st Cir. 1952); *Hofferbert v. Anderson Oldsmobile, Inc.,* 197 F. 2d 504 (4th Cir. 1952); *Commissioner v. Guminski,* 198 F. 2d 265 (5th Cir. 1952).

An income tax, levied by Congress under the Sixteenth Amendment to the Constitution, in order to be valid, must be based only upon income, and if other than income is used as the basis for such a tax it is a direct tax requiring apportionment under Art. I § 9 of the Constitution. *Eisner v. Macomber,* 252 U. S. 189 (1920). No income from business operations can be realized until the cost of goods sold has been recovered, and therefore an income tax cannot reach receipts from which that cost has not been subtracted. *Doyle v. Mitchell Bros. Co.,* 247 U. S. 179 (1918); *Sullenger,* 11 T. C. 1076 (1948). Accordingly, the Internal Revenue Code § 22 (a), and U. S. Treas. Reg. 111, § 29.22 (a)-5 (1943), provided that the cost of goods sold should be offset against gross receipts in determining gross income from business for income tax purposes.

Considering the constitutional limitations of the Sixteenth Amendment alone, it is clear that Congress could not pass an *income tax* disallowing the deduction from gross receipts of any part of the cost of goods sold. However, such an otherwise unconstitutional exercise of the taxing power may be found valid when applied as incident to some other power of Congress. Thus, if the tax is an expedient regulation of commerce by Congress, and the end to be attained is one falling within the commerce power, then the tax is not void, although within a loose and more extended sense than was used in the Constitution it was called a