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Taxability of Illegally Acquired Funds

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principles of trust law the courts will continue to remain divided as to acceptance of the Totten Trust theory.

TAXABILITY OF ILLEGALLY ACQUIRED FUNDS

Does illegally obtained money or property constitute taxable income to the person so obtaining it? This area of the income tax law has been a source of great discomfort to the federal courts and has been the subject of considerable judicial divergence.

The initial consideration is, simply stated, whether or not illegally received funds meet the requirements of "gross income," according to the Internal Revenue Acts—as that term is interpreted by the federal courts. The decisions further raise a question at times at to the motivation of the government; that is, does the federal government seek to tax a given type of receipt as a matter of policy, to punish those who participate in illegal activities? This discussion, however, will center mainly on the question first presented, that is, are illegal gains taxable?

EARLY DECISIONS (1919–27)

In a 1919 case, *Rau v. United States*,[1] the defendant insurance agent embezzled moneys which were delivered to him to be paid as insurance premiums, and the court held that defendant had committed a larceny, and therefore, the money so received was not subject to taxation under the Revenue Act.[2]

In 1926, there were two cases in which the decision in the *Rau* case was attacked. *Steinberg v. United States*[3] held that profits from the sale of liquor in violation of the law were taxable income. The court, in discussing the applicable provision of the Internal Revenue Act,[4] said that since the phrase, "gains and profits from any source whatever," was used in the statute, as contradistinguished from the term 'income," there was no doubt that Congress meant to include all species of gain, no matter how immoral or vicious the method of acquiring the same might be.

The case of *United States v. Sullivan*,[5] in opposing the *Rau* case, presents a concise and persuasive argument, by showing the trend in the history of national income tax legislation. The court quoted from the first income tax law to be passed under the Sixteenth Amendment of the federal Consituation,[6] where it was provided that the net income of a taxable person

[1] 260 Fed. 131 (C.A. 2d, 1919).

[2] Revenue Act referred to here was the Act of 1916.

[3] 14 F. 2d 564 (C.A. 2d, 1926).

[4] Internal Revenue Act, 1921, at § a, 42 Stat. 238 (1921).

[5] 274 U.S. 259 (1927). [6] Internal Revenue Act, 1913, at § b, 38 Stat. 167 (1913).

should include income from "the transaction of any *lawful* business. . . ." The court went on to explain that the word "lawful" has been omitted from the corresponding sections of all subsequent revenue acts,[7] thus clearly showing the legislative intent to make illegally obtained funds taxable income.

The argument is often advanced that Congress is being totally inconsistent by prohibiting an activity, then proceeding to collect taxes on the gains made from the same activity. The court in the *Steinberg* case, in answering this objection, quoted Justice Holmes' opinion in *United States v. Stafoff*,[8] where he said, "Of course Congress can tax what it also forbids," and went on to say that such was the regular procedure, and properly so, in regard to prohibited liquor. The *Steinberg* court then concluded that if the Legislature could tax the liquor which it forbids, then it can also tax the gains made by dealing in that which is prohibited.[9]

INTERMEDIATE DECISIONS (1932–42)

The decisions from this period lean quite heavily toward the proposition that money illegally obtained constitutes taxable income. However, some diversity of authority was still in evidence.

A 1932 case, *North-American Oil v. Burnet*,[10] took the position that 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 the income tax law.[11] This contention received support in the case of *McKnight v. Commissioner of Internal Revenue*,[12] where the defendant had embezzled the funds in question. The court in this case conceded that profits made from the use of embezzled funds are income, and taxable as such. However, the court went on to declare that no taxable gain arose from the embezzlement itself under Section 22(a) of the 1936 Revenue Act.

The *North-American Oil* and *McKnight* cases must be considered the minority in deference to the great number of cases taking a contrary view during this period. In a prosecution for the failure to pay income tax or to file a return, it was held, in 1933, that bribes accepted by the defendant from unions seeking admission to the association of which defendant was vice-president, constituted taxable income.[13] In a 1935 prosecution against

[7] E.g., Internal Revenue Act, 1928, at § 22, 45 Stat. 797 (1928).

[8] 260 U.S. 477 (1923).

[9] Steinberg v. United States, 14 F. 2d 564 (C.A. 2d, 1926).

[10] 286 U.S. 417 (1932).

[11] Internal Revenue Act, 1928, at § 22, 45 Stat. 797 (1928).

[12] 127 F. 2d 572 (C.A. 5th, 1942).

[13] United States v. Commerford, 64 F. 2d 28 (C.A. 2d, 1933).

a county commissioner for attempting to evade income tax, it was stated that, "because the part of the net income omitted from the income tax report was income derived from unlawful transactions was no defense to the charge of attempting to evade income tax."[14] A 1942 case held that the receipt of $50,000.00 as a ransom payment for a kidnapping constituted taxable income.[15]

In specific refutation of the argument, as advanced in the *North-American Oil* and the *McKnight* cases that illegally received money is not taxable because the taxpayer does not have good title to it, it must be stated that there are several cases, besides those already cited, in which persons have been taxed upon property which could have been recovered from them. For example, if a lender takes usurious interest (on an accrual basis), he must include his apparent profit on his return.[16] When a railroad collects too-large fares, the excess is income, although the passengers have a theoretical right of restitution.[17] An unlawful bonus acquired by a director at his company's expense was held to be income.[18]

Justice Learned Hand, in *National City Bank of New York v. Helvering*, said of the *Rau* case:

> We are disposed to overrule it, because, although the decisions are not, as we have shown, entirely harmonious, the weight of authority is against it, and it seems to us wrong in principle. Although taxes are public duties attached to the ownership of property, the state should be able to exact their performance without being compelled to take sides in private controversies. . . . Collection of the revenue cannot be delayed, nor should the Treasury be compelled to decide when a possessor's claims are without legal warrant. If he holds with claim of right, he should be taxable as an owner, regardless of any infirmity of his title; no other doctrine is practically possible, and no injustice can result.[19]

RECENT DECISIONS (1946–55)

In a 1946 case, *Commissioner v. Wilcox*, wherein the defendant embezzled money and dissipated it in gambling houses, the Supreme Court of the United States held that the proceeds of the embezzlement did not constitute taxable income. In the language of the court, "Not every benefit received by a taxpayer from his labor or investment necessarily renders him taxable. Nor is mere dominion over money or property decisive in all cases.[20] The court went on to say that the reason that embezzled money

[14] Chadick v. United States, 77 F. 2d 961 (C.A. 5th, 1935).

[15] Humphreys v. Commissioner, 125 F. 2d 340 (C.A. 7th, 1942).

[16] Magruder v. Barker, 95 F. 2d 122 (C.A. D.C., 1938).

[17] Chicago R.I. & P.R. Co. v. Commissioner, 47 F. 2d 990 (C.A. 7th, 1931).

[18] Board v. Commissioner, 51 F. 2d 73 (C.A. 6th, 1931).

[19] 98 F. 2d 93 (C.A. 2d, 1938).

[20] Commissioner v. Wilcox, 327 U.S. 404, 407 (1946).

does not come under the definition of taxable income in the Internal Revenue Code is obvious upon the face of the statute, which says, "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."[21]

North-American Oil v. Burnet[22] was cited in support of this contention that money cannot constitute income to an individual unless he holds it under some bona fide legal or equitable claim. The court in the *Wilcox* case felt that the situation was analogous to that of a lender-borrower relationship, when they said: ". . . nor can taxable income accrue from the mere receipt of money or property which one is obliged to return or repay to the rightful owner. . . ."[23] In commenting on the commissioner's contention that the defendant's dissipation of the money in gambling houses rendered the money taxable, the court held that such dissipation could no more create taxable income to the embezzler-dissipater than the insolvency or bankruptcy of an ordinary borrower causes the loans to be treated as taxable income to the borrower.

In *Rutkin v. United States*,[24] the United States Supreme Court was faced with the decision of whether or not $250,000.00, extorted by Rutkin, should be deemed taxable. A five to four decision ruled that the extorted funds were subject to the income tax.

The majority of the court first pointed out, as has already been discussed herein, that the first Revenue Act[25] contained the phrase ". . . from the transaction of any *lawful* business"; while the revised Act of 1916 excluded the word *lawful*.[26] This, they said, demonstrated the congressional intent to tax illegally gained funds. Secondly, the majority opinion declared that the administrative and judicial recognition of the taxability of unlawful gains of many kinds is widespread and settled, citing many of the cases already discussed herein.[27] Concluding, the five concurring justices said:

> We think the power of Congress to tax those receipts as income under the Sixteenth Amendment is unquestionable. The broad language of section 61(a) supports the declarations of this court that Congress in enacting that section exercised its full power to tax income.[28] We therefore conclude that section 61(a) reaches these receipts.[29]

21 Ibid., at 408.

22 286 U.S. 417 (1932).

23 327 U.S. 404, 408 (1946).

24 343 U.S. 130 (1952).

25 Internal Revenue Act, 1913, at § b, 38 Stat. 167 (1913).

26 Internal Revenue Act, 1916, at § 2(a), 39 Stat. 757 (1916).

27 E.g., Humphreys v. Commissioner, 125 F. 2d 340 (C.A. 7th, 1942).

28 Internal Revenue Act, 1954, at 61(a), 26 U.S.C. Supp. III 678, says: "Except as otherwise provided in this subtitle, gross income means all income, from whatever source derived. . . ."

29 United States v. Rutkin, 343 U.S. 130, 138 (1952).

The dissent of the *Rutkin* case was based on two lines of reasoning. The first is substantially the same rationale underlying most of the previous decisions of this nature, that is, one who extorts money not owed him has neither legal nor equitable claim to the extorted money and is under a continuing obligation to return it to its rightful owner. The *Wilcox* case is cited for support. The other basis for dissent is different from any judicial approach yet taken, and one which is extremely interesting. It can best be conveyed by quoting from the dissenting opinion, written by Justice Black:

> To all intents and purposes, gamblers and bootleggers are engaged in going businesses and make regular business profits which should be taxed in the same manner as profits made through more legitimate endeavor. However in my judgment, it stretches previous tax interpretations too far to classify the sporadic loot of an embezzler, an extortioner, or a robber as taxable earnings derived from a business, trade or profession. I just do not think Congress intended to treat the plunder of such criminals as theirs.[30]

Now that the line has been drawn between the *Wilcox* case (along with the dissent in the *Rutkin* case) on one side, and the majority opinion of the *Rutkin* case on the other, a few 1955 decisions will be examined to see which line of reasoning they chose to follow. Where the business manager of a labor welfare organization arranged with a painting contractor to overstate his bills to the organization, then approved and paid the bills, and finally received the amount of the overpayment from the contractor, such receipts constituted taxable income.[31] Where defendants, in the course of their employment as traffic managers and solicitors of bids for subsidiaries of steel company, used their position to extract personal gains in the form of kickbacks from companies interested in doing business with their employers, the kickbacks constituted income to the defendants—despite the fact that the kickbacks constituted the proceeds from embezzlement required to be restored to the employer.[32] In a case where a corporation president embezzled money from corporate bank accounts, it was declared that *Commissioner of Internal Revenue v. Wilcox* governs and that *Rutkin v. United States* does not apply. The court here was of the opinion that *Rutkin* did not completely obliterate *Wilcox*.[33] The court then cited *Marienfield v. United States*, where it was said:

> Since the court in the Wilcox case flatly held that embezzled funds were not taxable income to the embezzler and in the Rutkin case has unequivocally held that extorted funds were taxable income to the extortionist, the line of demar-

[30] Ibid., at 140.

[31] Berra v. United States, 221 F. 2d 590 (C.A. 8th, 1955).

[32] United States v. Bruswitz, 219 F. 2d 59 (C.A. 2d, 1955).

[33] Dix v. Commissioner, 223 F. 2d 436 (C.A. 2d, 1955).

cation lies between those rather closely related factual situations and must be determined by the facts in the individual case.[34]

The conclusion was then drawn that the facts in the instant case were closer to those of *Wilcox*, so that case was followed.

A casual inspection of the above-mentioned recent decisions will reveal the considerable amount of judicial "fencing" which has been carried on in this area. For example, Justice Black, in the *Rutkin* case, drew a conclusion which meant, in effect, that the determining factor of taxability is the incidence of occurrence of the activity from which the illegal funds are derived. Thus, a distinction is made between the steadier, more efficient crimes, such as bookmaking and bootlegging, and the sporadic-type crimes, such as embezzlement and extortion—for the purpose of determining which criminals should have their receipts taxed. The court in the *Marienfield* case then proceeded to "split the hair" a bit finer by making a distinction between embezzlement and extortion, so far as taxability is concerned; and it ruled that while money derived from the latter is taxable, one deriving funds by the former method has no income tax liability.

There remains one aspect for consideration. That is, is the federal government using its taxing power to punish those who participate in illegal activities? In other words, there are those who feel that some courts are first deciding that criminals should have their monetary intake taxed, and then, in seeking legal justification for such decision, proclaiming that such intake represents income under the Revenue Act. To lend support to the fact that this problem exists, we quote from Justice Black's dissent in the *Rutkin* case, wherein he was joined by three of the other justices:

> Since it seems pretty clear that the government can never collect substantial amounts of money from extortioners, there must be another reason for applying the tax law to money they extract from others . . . the only other reason that occurs to me is to give Washington more and more power to punish purely local crimes such as embezzlement and extortion.[35]

Numerous legal as well as ethical considerations arise in connection with this theory of federal "encroachment" on state jurisdiction. It is not to be argued whether or not this theory is correct, nor to deal with these collateral considerations. Suffice to say, that in considering the state of the law in this area, one should be cognizant of the possibility that some of the decisions declaring illegal gains to be taxable may have been motivated by these "extraneous" factors. In other words, the court may be trying to prevent a wrongdoer from accomplishing something which an honest man, in most instances, cannot, that is: acquiring money and not surrendering a portion of it to the government.

[34] 214 F. 2d 632, 637 (C.A. 8th, 1954).

[35] E.g., Internal Revenue Act, 1936, at § 22, 49 Stat. 1657 (1936).

CONCLUSION

In summary, it can be seen that the split of authority which developed shortly after the passage of the 1916 Revenue Act is in existence, even at the present time; but it can be safely concluded that the weight of authority is made up of the cases holding illegally obtained money to be taxable income. The rationale usually relied upon is that since Congress saw fit to revise the 1913 Revenue Act to omit the word "lawful" from the definition of gross income, it manifested an obvious intent to tax the profits of crime. The primary legal contention of the minority is that since the taxpayer does not have good legal or equitable title to the unlawfully-acquired funds (in other words, he is under a continuing obligation to return them to their rightful owner), they should not be considered taxable to him.[36]

Aside from the legal issues involved, there are strong policy aspects to consider. The arguments for both sides are presented in *United States v. Sullivan*, where it was explained, in essence, as follows.[37] The minority felt that Congress could not have intended to include the gains from crime within the meaning of the income tax code, because the effect would be to place legitimate and illegitimate transactions on the same footing. It is argued that strong reasons of public policy require that the gains of commercial dealings, which are also criminal, be regarded as beneath the contempt of the law for purposes of taxation. The inconsistency of the government in prohibiting an act, and at the same time subjecting it to taxation for purposes of revenue is obvious. On the other hand, argues the majority, it certainly does not satisfy the standard concept of justice to tax those who are engaged in legal enterprise, and allow those who thrive by violation of the law to escape. It seems doubtful that Congress should intend that an individual set up his own wrong to avoid taxation, and thereby increase the burden on those who are lawfully employed.

It becomes apparent that either a future revision of the Internal Revenue Code, or a broad, yet well-defined judicial interpretation of the present code is necessary to clarify this area of the tax law where confusion and inconsistency have reigned for four decades. Whether or not one of these reform measures is forthcoming is a matter for conjecture; but it would certainly be most welcome.

[36] Commissioner v. Wilcox, 327 U.S. 404 (1946).
[37] 274 U.S. 259 (1927).