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Boris I. Bittker
Yale Law School

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Taxing Income From Unlawful Activities*

Boris I. Bittker†

In a series of cases dating back to the 1920's, the Supreme Court has considered whether earnings derived from unlawful activities constitute taxable income. After tracing the development of this case law, Professor Bittker asserts that the federal income tax statutes have contained no clear congressional mandate on this issue and that therefore the question may appropriately be resolved from a policy standpoint. Professor Bittker admits that some of the arguments against taxability, such as the potential for discriminatory enforcement and the possibility of prejudice to the defendant at trial, have merit, but he contends that these problems can be solved short of immunizing from tax all illegal profits and concludes that the optimal rule is to tax the net income from any unlawful activity.

I. INTRODUCTION

IN 1931, Al Capone, the most publicized racketeer of the 1920's, was prosecuted, convicted, and sentenced to 11 years in prison for federal income tax evasion.¹ The average citizen was probably satisfied with this termination of Capone's career, even if tax evasion seemed to be a minor offense when compared with the other crimes attributed to him by the press. But the disparity troubled many other observers. To them the tax charge was only a pretext used by government officials who could not prove that Capone had committed the murders and other gangland crimes imputed to him, but who were either too incompetent to gather the necessary evidence or too supine to defy public opinion by clearing his reputation. Some of these critics were also bothered by the use of *federal* law to prosecute a man whose "real" crimes violated state and local law. These criticisms were weakened by the undeniable fact that a person can be guilty of federal tax evasion even though he is also guilty, suspected, or innocent of state and local offenses. But this response did not entirely satisfy the critics who sensed that

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† Sterling Professor of Law, Yale University. B.A., Cornell University, 1938; LL.B., Yale University, 1941.

1. J. KOBLER, *CAPONE: THE LIFE AND WORLD OF AL CAPONE* (1971); K. ALLSOP, *THE BOOTLEGGERS AND THEIR ERA* (1961).

Capone's reputation—rather than any provable wrongdoing—had led the Treasury to launch its implacable search for evidence of tax evasion, and who also realized that the same suspicions might have prejudiced the jury against him. Thus, latent in the prosecution of Al Capone was an issue that became the subject of intense examination by the United States Supreme Court in later years: Do the fruits of unlawful activity constitute taxable "income," as that term was used by Congress when it enacted the federal income tax statutes?

II. IS INCOME FROM UNLAWFUL ACTIVITY TAXABLE?

The sixteenth amendment authorizes Congress to tax "incomes, from whatever source derived." In 1913, when Congress first exercised its authority under the sixteenth amendment, it imposed a tax on net income from a variety of sources, including "any *lawful* business carried on for gain or profit."² Three years later, Congress eliminated the qualifying word "lawful" from the statute without saying why the change was made.³

With the advent of Prohibition, the Treasury relied on this unexplained change in the law when prosecuting bootleggers for failing to report their income from the unlawful sale of liquor. In several litigated cases, the courts acknowledged that taxing an activity seemed inconsistent with prohibiting it,⁴ and that it might be thought degrading for the government to become a "silent partner" in an unlawful business by taxing its profits.⁵ Even so, the courts were not willing to conclude that Congress intended to exempt income from unlawful activities. As one appellate court, in *Sullivan v. United States*,⁶ put the point:

It does not satisfy one's sense of justice to tax persons in legitimate enterprises, and allow those who thrive by violation of the law to escape. It does not seem likely that Congress intended to allow an individual to set up his own wrong in order to avoid taxation, and thereby increase the

2. Revenue Act of 1913, ch. 16, § 2B, 38 Stat. 167 (emphasis added).

3. Revenue Act of 1916, ch. 463, § 2(a), 39 Stat. 757 (now INT. REV. CODE OF 1954, § 61).

4. *See, e.g., Steinberg v. United States*, 14 F.2d 564, 566 (2d Cir. 1926). *But see United States v. Stafoff*, 260 U.S. 477, 480 (1922), imposing an excise tax on liquor prohibited by the National Prohibition Act: "Of course Congress may tax what it also forbids."

5. *See, e.g., Steinberg v. United States*, 14 F.2d 564, 569 (2d Cir. 1926) (Manton, J., concurring), *quoted at* text accompanying note 33 *infra*.

6. 15 F.2d 809 (4th Cir. 1926), *rev'd*, 274 U.S. 259 (1927).

burdens of others lawfully employed. The problem which Congress had to consider was not so simple as that presented by the case of one whose entire income is earned in a business which offends against a national law of uniform application. Activities lawful in one state of the Union may be unlawful in another. The operations of individual men in the prosecution of their business enterprises are sometimes within and sometimes without the pale of the law. Great aggregations of capital, which have a place in the popular mind, far above the sordid level of the illicit distiller, and the common criminal, sometimes find it profitable to ignore the laws of the state or of the nation. The complexities of the situation are without number. Can it be said that in all such cases Congress intended to tax the law-abiding, and let the criminal go free?⁷

The court's answer to its own question was a surprising compromise. It held that the bootlegger's income was taxable, but that the privilege against self-incrimination, granted by the fifth amendment, protected him against prosecution for failing to file a tax return that required disclosure of his illegal activities. As a practical matter, this decision evidently meant that the government could collect taxes from a bootlegger if it could prove, without aid from him, how much income he received, but that no criminal penalties could be imposed unless he filed a demonstrably false return instead of none at all.

When the Treasury appealed this decision to the Supreme Court, however, it got a more palatable result. Expressing no embarrassment about letting the government share in the profits of an unlawful business, the Court said curtly: "We see no reason . . . why the fact that a business is unlawful should exempt it from paying the taxes that if lawful it would have to pay."⁸ The opinion (by Mr. Justice Holmes) used only a few more words to dispose of the defendant's claim that the fifth amendment exempted him from filing a return:

Most of the items [called for by the return] warranted no complaint. It would be an extreme if not an extravagant application of the Fifth Amendment to say that it authorized a man to refuse to state the amount of his income because it had been made in crime. But if the defendant desired to test that or any other point he should have tested it in the return so that it could be passed

7. 15 F.2d at 811. See also *Steinberg v. United States*, 14 F.2d 564 (2d Cir. 1926).

8. *United States v. Sullivan*, 274 U.S. 259, 263 (1927).

upon. He could not draw a conjurer's circle around the whole matter by his own declaration that to write any word upon the government blank would bring him into danger of the law.⁹

Although the *Sullivan* case was decided by the Supreme Court in 1927, the scope of the privilege against self-incrimination, so far as tax returns are concerned, remains unclear to this day. When income from unlawful activities is reported, the taxpayer often supplies his name, address, and net income (usually in round figures, with such laconic labels as "miscellaneous income" or "income from various sources") and leaves the rest of the return blank. Returns that are this terse invite intensive scrutiny by the Internal Revenue Service, but taxpayers are rarely prosecuted for failing to supply more information, either because the fifth amendment is thought to protect them against making further disclosures or because juries are not likely to convict for mere silence. Instead, revenue agents endeavor to verify the amounts listed on the tax return by reconstructing the taxpayer's financial history—his purchases, investments, loans, and so on.

The scope of the *Sullivan* opinion was cloudy in another respect. It may be that the customers of the defendant in that case, having purchased bootleg liquor from him voluntarily, were not entitled under state law to get their money back. Thus, the Supreme Court did not speak explicitly to the taxability of an unlawful activity in which the wrongdoer can be compelled by his victims to disgorge the fruits of his crime (*e.g.*, embezzlement or burglary). Can he be said to realize "income," in view of his obligation to pay back whatever he has taken? Should he be treated like a person who borrows from a bank, and is not taxed on the borrowed funds because he has a duty to repay the loan?

When the Supreme Court first addressed this issue, in *Commissioner v. Wilcox*¹⁰ it accepted the "borrower" analogy and held (with one Justice dissenting) that embezzled funds are not taxable:

[T]axable income [does not] accrue from the mere receipt of property or money which one is obliged to return or repay to the rightful owner, as in the case of a loan or credit

. . . Moral turpitude is not a touchstone of taxability. The question, rather, is whether the taxpayer in fact received a statutory gain, profit or benefit. That the tax-

9. *Id.* at 263-64.

10. 327 U.S. 404 (1946).

payer's motive may have been reprehensible or the mode of receipt illegal has no bearing on the application of [the taxing statute].¹¹

In support of this holding, the Court asserted that the victim's chance of recovering from the wrongdoer would be jeopardized if the wrongdoer were required to pay part of the embezzled funds to satisfy his tax liability. In point of fact, the defendant in *Wilcox* had dissipated the embezzled funds in gambling, and hence could probably not reimburse his victim's losses. But the Court held that this fact was irrelevant: "[T]axability is determined from the circumstances surrounding the receipt and holding of the money rather than by the disastrous use to which it is put."¹² The Court left open the possibility that the embezzler would become taxable if he retained the funds until his obligation to repay was terminated by the statute of limitations or by an act of forgiveness on the part of the victim.

Six years later, the Supreme Court had to decide whether the defendant in *Rutkin v. United States*¹³ was taxable on \$250,000 extorted by him from an ex-partner in a "high seas venture" (*i.e.*, bootlegging) by threats to kill the victim and his family. In theory, extortion resembles embezzlement in imposing an obligation on the wrongdoer to reimburse his victim on demand. But in practice an extortioner is less likely to be asked for repayment; if the victim's fear of exposure or violence keeps him from complaining to the police when he is first approached, he will probably remain silent thereafter. For this reason, the Supreme Court held in the *Rutkin* case that extorted funds are taxable:

An unlawful gain, as well as a lawful one, constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it. . . . That occurs when cash, as here, is delivered by its owner to the taxpayer in a manner which allows the recipient freedom to dispose of it at will, even though it may have been obtained by fraud and his freedom to use it may be assailable by someone with a better title to it.¹⁴

This decision evoked a vigorous dissent by four of the nine Justices, who could see no valid distinction between embezzled and extorted funds:

11. *Id.* at 408.

12. *Id.* at 409.

13. 343 U.S. 130 (1952).

14. *Id.* at 137.

We . . . pointed out [in the *Wilcox* case] that the embezzler had no bona fide legal or equitable claim to the money, was under a definite legal obligation to return it to its rightful owner, and consequently had no more received the kind of "gain" or "income" which Congress has taxed than if he had merely borrowed money. One who extorts money not owed him stands in this precise situation. He has neither legal nor equitable claim to the extorted money and is under a continuing obligation to return it to its owner.¹⁵

The dissenters were not prepared, however, to extend the "borrower" analogy to criminal activity that was sufficiently sustained and regular to constitute a "business." Acknowledging that "some states have laws which under special circumstances permit some particular groups to assert a legal claim for recovery of gambling losses or money paid for bootleg liquor,"¹⁶ they asserted that "bootleggers and gamblers are engaged in going businesses and make regular business profits which should be taxed in the same manner as profits made through more legitimate endeavors."¹⁷ If such a taxpayer actually makes a refund to a customer, the dissenting Justices would allow him to deduct the amount when paid (just as an ordinary businessman can deduct refunds to customers victimized by false advertising or other improper business practices); all other receipts of an unlawful "business" would be taxable despite the theoretical obligation to make restitution. Thus, it was only the "sporadic loot of an embezzler, an extortioner or a robber"¹⁸ that these Justices would have exempted from tax.

It is not clear whether the line between "business profits" and "sporadic loot" was to be based on the type of unlawful activity engaged in by the taxpayer, or the number of transactions. If an amateur bootlegger was obligated by state law to make refunds to his infrequent customers, would they tax his profits as "business income" or exempt them as "sporadic loot"? Conversely, if the defendant in the *Rutkin* case had decided to make a career of extortion, would the dissenting Justices have classified his profits as taxable "business income" rather than tax-exempt "sporadic loot"?

Though they left these questions unanswered, the dissenters' prediction that the majority's distinction in the *Rutkin* case between embezzlement and extortion was not viable proved to be correct.

15. *Id.* at 139-40.

16. *Id.* at 140.

17. *Id.* at 140-41.

18. *Id.* at 141.

Less than 10 years later, in *James v. United States*¹⁹ (involving a union official who had embezzled more than \$700,000 from his union and a related insurance company), the Court announced that income from illegal activity is taxable despite the recipient's legal obligation to make restitution. The offsetting liability should be disregarded, according to Mr. Chief Justice Warren, because the taxpayer himself does not intend to honor this obligation and because "as a practical matter" he has enough control over the funds to derive economic value from them.²⁰ The majority in *James* went on to say that if the taxpayer actually made restitution to his victim, he would be entitled to a deduction in the year of repayment. Save for ambiguous cases in which the wrongdoer succeeds in persuading the Internal Revenue Service or the courts that he "borrowed" the disputed funds and intended to repay them, the *James* case evidently embraces all illegal receipts. Three Justices dissented on the ground that the *Wilcox* case correctly interpreted the Internal Revenue Code in holding that no "income" is realized by an embezzler, and two of the three implied that the same principle should be applied to funds obtained by extortion.²¹

Throughout this tortuous judicial history, the Justices have agreed in principle that Congress did not intend to differentiate between honest and dishonest taxpayers, and that "income" is taxable whether generated by legal or illegal activities. Once accepted, this principle could be easily applied if the wrongdoer had no obligation to repay his profits (*e.g.*, gambling profits realized by a professional gambler in a game with other professionals). But no case actually came before the Court with an explicit finding that the taxpayer was free of any offsetting liability, and ordinarily the wrongdoer is obligated to make restitution to the victim (or, in some circumstances, to the state). Much can be said, however, for the approach of the *James* case, which disregards the wrongdoer's theoretical duty

19. 366 U.S. 213 (1961).

20. *Burnet v. Wells*, 289 U.S. 670, 678 (1933), established that, in the case of the honest taxpayer, tax liability can rest on the enjoyment of substantial benefit from the funds.

21. Six of the Justices on the *James* Court dissented from at least part of the plurality's decision to overrule *Wilcox* but to apply the new rule to criminal prosecutions only if arising thereafter. Dissenting from the plurality's decision to overrule were Justices Black, Douglas, and Whittaker, 366 U.S. at 225-41, 248-58. Justices Black and Douglas added that if *Wilcox* could not be reconciled with *Rutkin*, where the Court had held that an extortioner's income was taxable, it was the latter case that should be overruled. *Id.* at 240.

to make repayment because it is disregarded by him²² and rarely results in a refund to the victim. Even the dissenters accept this approach in the case of criminal activity that can be classified as a regular business.²³ The *James* rationale equates illegal and legal income in the sense that the taxpayer must report both types of income on receipt, but can then deduct any amounts that are actually refunded.

III. SHOULD ILLEGAL INCOME BE TAXED?

All of these Supreme Court decisions, culminating in the *James* case, purport to interpret the word "income" as used by Congress in enacting the federal income tax statutes; the issue to be decided was what Congress intended to do about the receipts of unlawful activity, not what would be wise public policy. But explicit clues to the legislative intent were lacking, and the opinions are suffused with a concern with broader issues, a concern that reflects a clash of opinion about how the profits of illegal activity *ought* to be treated. In approaching this ultimate question, it may be helpful to start with two simple points.

The first is that a dollar of profit from unlawful activity will buy just as much as a dollar of lawful profit. The comparison is obvious enough when the lawbreaker has no obligation to surrender his profit; but even if there is such a duty, he is at least as well off as a businessman who sells his merchandise on a money-back-if-not-satisfied guarantee, knowing from experience that few if any customers will demand a refund. When the receipts of a lawful business are subject to offsetting obligations of this type, the company is taxed on the aggregate amount received. It is not allowed to exclude the receipts from income on the theory that the full amount may have to be repaid to its customers (in the way borrowed funds are excluded because of the offsetting liability to make repayment), because this contingency is too unlikely to occur.²⁴ Instead, any amounts that are actually repaid are deductible when the payments are made.

22. Occasionally a wrongdoer, such as an embezzler who is caught *in flagrante*, agrees to make repayment, usually to forestall prosecution or to mitigate the penalty. When this occurs in the same year as the wrongful act, the receipts have been held to be nontaxable. *Wilbur Buff*, 58 T.C. 224 (1972).

23. *Id.* at 254-55.

24. Even if experience provides the basis for a reliable estimate of the amount that will have to be refunded, the taxpayer cannot establish a tax-deductible reserve against such future expenses, but must instead deduct them

The second point is that the term "income from illegal activity" is not self-defining. Income can be derived from a much wider range of unlawful activities than the bootlegging, embezzlement, and extortion that came before the Supreme Court in the cases summarized in the preceding section. The taxpayer may derive economic benefit from peripheral misconduct in a business that is entirely lawful (such as a corporate officer's illegal use of inside information in purchasing his company's stock), from an unlawful enterprise that could be conducted (though perhaps less profitably) in conformity to law (such as a mail-order business that persistently engages in false advertising), or from behavior that is wholly unrelated to any legitimate enterprise (such as murder-for-hire). The unlawful activity may be confined to a single act of misconduct, which the taxpayer does not intend to repeat; it may consist of behavior that would have been repeated if it had not been detected by the police; or it may constitute a continuous business. The profits may, or may not, be refundable to the victim; if neither party to an unlawful act is a victim (*e.g.*, bribery of a public official), the government may have a right to recover the fruits of the crime, and there may be other cases in which the status of the unlawful profit is not defined by law. The behavior may be punishable by fine and imprisonment, or it may be unlawful only in the sense that the courts will order restitution or impose civil penalties. Whether the penalties are criminal or civil, the misconduct may be abhorrent to society and energetically prosecuted by the police, or it may be tolerated or even patronized by "respectable" segments of society.

The dissenting Justices in the *Rutkin* and *James* cases proposed to distinguish between the "regular business profits" of a bootlegger or professional gambler, which they regarded as taxable, and the "sporadic loot" of embezzlers, extortioners, and robbers, which they would not include in "income." But it is difficult to justify such a differentiation, and even more difficult to see how it could be effectively administered. Unlawful receipts are of equal economic value to the recipient whether they are sporadic or regular, and they are equally likely to be retained or spent by him. In any event, the full range of the taxpayer's unlawful activities, which would determine whether he is engaged in a "regular business" or only in "sporadic" criminal activities, will ordinarily not be known. Unless he has been convicted in a separate criminal case, the only evidence

when, as, and if they are paid. See B. BITTKER & L. STONE, *FEDERAL INCOME, ESTATE AND GIFT TAXATION* 837-41 (4th ed. 1972).

in the tax case may be that his expenditures substantially exceeded the income reported on his tax returns, and that he was reputed to be a gambler, thief, corrupt public official, or loan shark. For these reasons, it would be very difficult to administer a distinction between one type of illegal income and another, whether it is based on the regularity of the receipts, the morality of the behavior, the existence of a legal duty to make restitution, or the severity of the penalties. On the other hand, a blanket exemption for all unlawful income would embrace not only the neighborhood thief and bootlegger, but also a much broader range of taxpayers, including businessmen whose profits are attributable to violations of antitrust and price control laws, health, safety, environmental, labor, and racial standards, and other governmental regulations.

A major theme in the debate over taxing income from unlawful activity is that it will not be accurately reported by its recipients, no matter what the Internal Revenue Code provides, and that they will conceal or destroy all records of their income and assets and invoke the fifth amendment when asked for information. As a result, the Treasury will have to engage in costly investigations in an effort to enforce the law, with no assurance that the taxes actually collected will exceed its expenses. Since, it is argued, such an enforcement program is more likely to lose than to make money, it will be employed mainly or solely as a device to harass or prosecute persons suspected, perhaps on the basis of mere rumor or hearsay, of committing other crimes.

In one of the early bootlegger cases, the Court of Appeals for the Second Circuit accepted this explanation of the income tax prosecution before it:

It hardly needs mention that the record before us, common knowledge of prosecuting methods, and the comment of the court in sentencing [the defendant] clearly show that [he] was indicted, not to enforce a revenue law, nor penalize him for failing to comply with one, but to punish severely for dealing *largely* in liquor. . . . [T]he prohibition statute makes no difference between the sale, possession, or transportation of a bottle of liquor, and the same acts in relation to a shipload; wherefore, as Congress has furnished weapons appropriate for frontal attack only against small fry, endeavor is made to net the larger fish in the meshes of revenue, customs, and tax laws, with the ever-useful conspiracy statute in reserve for a plurality of wrongdoers. The question is not whether this is wise or politic, fair or in good taste, but whether it can legally

be done. We think it can under the language of the statutes, and know that similar things have been done for generations.²⁵

While these sentiments were evidently put forth in a spirit of resignation if not serenity, often there is an attitude of queasiness about what might be called the "Al Capone syndrome."

It would be fatuous to deny that taxpayers with income from unlawful activities are sometimes selected for intensive tax audit because they are suspected by officials of the Treasury or Justice Departments of violating nontax laws,²⁶ but it would be equally fatuous to overlook the many taxpayers with the same type of income whose returns come to the surface in the course of routine tax investigations. A blanket tax exemption for income from unlawful activities would apply to both groups, including, as pointed out above, numerous taxpayers with income from violations of anti-trust, usury, fair advertising, health, and price control laws, whose tax returns are often selected for examination for reasons unrelated to their misconduct, under standards uniformly applied to all taxpayers. Exempting income that flows from an unlawful source in order to discourage discriminatory law enforcement is a needlessly blunt instrument. To use a term that is currently popular among constitutional lawyers, it is "overinclusive."

But it is simultaneously underinclusive. The disease that produces the "Al Capone syndrome" is discriminatory enforcement of the law, whose victims can include political enemies as well as persons suspected of engaging in criminal misconduct. Exempting the income of the latter group will do nothing for their fellow victims. A remedy is required that will discourage discriminatory law enforcement, without regard to sources from which its victims derive their income. The most drastic remedy would be a grant of tax immunity to anyone whose return was selected for audit in an irregular fashion; slightly less draconic would be a forbidden-fruit doctrine, under which the Treasury could assess a deficiency against a person whose return was improperly selected for examination only upon proof that the same deficiency would have been assessed if the return had been processed in a routine manner.

25. *Steinberg v. United States*, 14 F.2d 564, 566-67 (2d Cir. 1926).

26. For a discussion of the organized crime drive during President Kennedy's administration, see V. NAVASKY, *KENNEDY JUSTICE* 42-95 (1971). Navasky states that one of the prosecutors was described by a colleague as willing "to indict a man for spitting on the sidewalk if he thought that was the best [charge] he could get [against him]." *Id.* at 53.

Still another point needs to be made about the "Al Capone syndrome." While it is easy and proper to condemn use of the tax laws to punish someone whose "real" crime is embezzlement or black marketeering, it is difficult to decide when this has happened. Enough pillars of society are tried and convicted for tax evasion to rebut the notion that the offense is comparable to "spitting on the sidewalk,"²⁷ or that it is condoned or overlooked unless committed by one of society's outlaws. Gamblers and racketeers account for only about 10 percent of tax prosecutions; as defendants, they are outnumbered by doctors, lawyers, and accountants.²⁸ These statistics, of course, do not prove that gamblers and racketeers have not been singled out for disproportionate attention by revenue agents; perhaps they would be even less numerous if their returns were examined in a completely routine fashion. Even so, it is altogether too glib to assert that a charge of tax evasion is no more than a pretext for prosecuting persons whose "real" offense is gambling, embezzlement, or other illegal activity, or who are reputed to engage in such misconduct. With greater accuracy, it could be said that to refrain from taxing unlawful receipts would amount to exempting persons from one law because they have violated another.

It is also too glib to assert that taxing the income of unlawful activities is a losing enterprise for the Treasury, a premise that is often used to buttress the conclusion that punishment, rather than revenue, is the "true" reason for taxing illegal income. It is obvious that much business income is routinely reported on tax returns even though derived from activities that violate a host of regulatory statutes, and there is no evidence that auditing these returns costs more than the tax attributable to the unlawful activities. Lawyers and accountants who are familiar with the folkways of professional gamblers report that their clients, imbued with a healthy respect for the Internal Revenue Service, often report substantial amounts of income in order to avoid scrutiny by an agency that is less complaisant than their local police departments. It is, no doubt, far less common for embezzlers, corrupt public officials, and burglars to report their "sporadic loot" or even their steady profits, though a few may be foresighted enough to do so; and the circle may grow as knowledge of the tax danger spreads from one recidivist to another.

27. See note 26 *supra*.

28. PRESIDENT'S COMMISSION ON LAW ENFORCEMENT AND ADMINISTRATION OF JUSTICE, TASK FORCE REPORT: CRIME AND ITS IMPACT—AN ASSESSMENT 113 (1967).

Recipients of unlawful income have an aversion to written records. This is, of course, an obstacle to the revenue agent who is investigating a suspected individual's failure to file or auditing a return that is deficient in details. But lawbreakers often leave a trail of conspicuous consumption that permits the probable amount of their income to be estimated by such indirect methods as an analysis of bank deposits or net worth changes, and once a deficiency is assessed, the taxpayer has the burden of disproving the agent's computation. At *this* point, the taxpayer's lack of records hampers him more than the revenue agent.²⁹ Though the investigation of a particular taxpayer receiving unlawful income may cost the Treasury more than it produces, taxpayers who have lived through one such proceeding are ordinarily more circumspect in filing returns in future years, and every publicized investigation induces a wave of "voluntary" filings and amended returns by other taxpayers in the same occupational class and geographical location.

In the *Rutkin* case, Mr. Justice Black ventured the "guess that this one trial has cost United States taxpayers more money than the Government will collect in taxes from extortioners in the next twenty-five years."³⁰ This colorful speculation may be correct so far as extortioners are concerned, but it does not support the conclusion that a tax on unlawful income will produce less revenue, measured on a nationwide basis, than the cost of enforcement. Once the range of unlawful activities that may give rise to income is taken into account, a more plausible conclusion is that taxing unlawful income is a profitable enterprise for the Treasury. The cost per dollar of taxes collected is no doubt much greater than the cost of collecting taxes from employees subject to the wage withholding system, but so is the cost of enforcing the income tax in many other areas (e.g., tips, cash earnings of persons performing household services and odd jobs, etc.).

But if income from unlawful activities is taxed, will disclosure of the facts make it impossible for the taxpayer to get a fair trial? Dissenting in *Rutkin*, Mr. Justice Black argued that the tax evasion charge in that case was obscured by evidence of the defendant's criminal history and associations and that "[T]he fantastic story of supposed extortion . . . would probably never have been accepted

29. For a suggestive illustration of the problem, see James Clifford Rogers, P-H TAX CT. REP. & MEM. DEC. (43 P-H Tax Ct. Mem.) ¶ 74,004 (Jan. 14, 1974).

30. *Rutkin v. United States*, 343 U.S. 130, 141 (1952).

by a jury if presented in a trial uncolored by the manifold other inflammatory matters which took up 887 of the 900 pages in this 'tax evasion' case."³¹

Though real enough, the danger to the defendant's right to a fair trial does not justify a tax exemption for all income from unlawful activity. To begin with, a tax evasion trial may require only a minimal reference to the defendant's illegal behavior, or even none at all. If the government's case consists of evidence that the taxpayer spent more money than his reported income made available to him and that he had a "likely source" of unreported income from which the unaccounted-for funds may have come, for example, there is rarely a need for extensive details about the source, and the judge can reduce the possibility of prejudice by firm instructions to the jury. If a public official is charged with deducting the cost of his daughter's wedding as a business expense, to take another example, proof that he financed the party with funds received as bribes might well be excluded as irrelevant. Sometimes, however, more extensive or lurid evidence of the defendant's misconduct is properly offered by the government or must be introduced by the defendant himself, and he must rely on the judge, acting under the principles established by the appellate courts, to exert his authority over the jury in an effort to insure a fair trial. While the residual risk of prejudice to the defendant is not trivial, neither is it demonstrably so substantial that prosecuting persons with income from unlawful activities on federal tax evasion charges is inconsistent with the fair administration of justice. Mr. Justice Black himself was prepared to tolerate the risk of unfairness in the case of bootleggers, professional gamblers, and other "businessmen," whose income he regarded as subject to tax. And he suggested no reservations about taxing persons whose income derives from false advertising, black marketeering, usurious loans, over-ceiling rental charges, and violations of other regulatory laws, even though juries—especially in urban centers—may well find these white collar crimes as abhorrent as extortion and robbery.³²

31. *Id.* at 147.

32. It should also be noted that a disallowance of deductions may entail proof by the government that the defendant was engaged in activities that a jury will disapprove. For example, in *United States v. Lillehei*, 357 F. Supp. 718 (D. Minn. 1973), deductions for "additional professional secretarial and maid help" were shown by the government to reflect payments to three women "whose testimony indicated . . . a rather personal relationship with the defendant." *Id.* at 724. See also *United States v. Windham*, 489 F.2d 1389 (5th Cir. 1974) (tax evasion prosecution of physician; held, reference to abortions not prejudicial).

I do not suggest that Mr. Justice Black was crying "wolf." The danger of unfairness is real, and it is more widespread than his remedy—tax exemption for income derived from sporadic unlawful activities—implies. If prejudice to the defendant cannot be adequately checked by a searching voir dire before the jury is impanelled and by the judge's control of the courtroom, however, it does not necessarily follow that exempting all illegal income from tax is the most appropriate remedy. A more limited corrective would be to abandon the use of criminal sanctions in such cases, leaving the defendant subject to the normal civil remedies of liability for the tax itself, interest, and penalties for negligence or deliberate disregard of the regulations. There would be, of course, a residue of unavoidable prejudice even in civil proceedings, but a regime of blanket immunity from the rules of government for everyone who *might* be treated unfairly by a jury would be intolerable.

Assuming that it is both fair and profitable to tax the profits of unlawful activities, is it degrading for the government to do so? Judge Manton, concurring in one of the early bootlegging income cases, argued that it was:

It is hard to conceive of Congress ever having had in mind that the government be paid a part of the income, gains, or profits derived from successfully carrying on this crime, or entering into a combination with the person engaged in this unlawful business to ascertain how and to what extent he shall be taxed. The Criminal Code provides punishment for those who violate the [National Prohibition Act] . . . and, if severer punishment should be inflicted, it is a matter for Congress to legislate. It is incredible to believe that it was intended that a bootlegger be dignified as a taxpayer for his illegal profit, so that the government may accept his money for governmental purposes, as it accepts the money of the honest merchant taxpayer.³³

Though Judge Manton's argument is not necessarily weakened by his subsequent personal history, an ironic footnote to these remarks is that he was later convicted of conspiracy to obstruct justice by accepting bribes to influence his decisions³⁴ and that the Internal Revenue Service was successful in taxing these receipts to him.³⁵ It is not known whether the government's willingness to accept money from both Judge Manton and "the honest merchant tax-

33. *Steinberg v. United States*, 14 F.2d 564, 569 (2d Cir. 1926).

34. *United States v. Manton*, 107 F.2d 834 (2d Cir. 1938), *cert. denied*, 309 U.S. 664 (1940).

35. *Martin T. Manton*, 17 P-H Tax Ct. Mem. 833 (1948).

payer" served to "dignify" the former or to insult the latter.

Opinions will differ, but I find the Manton theory farfetched to the point of absurdity. The notion that the government is a "silent partner" in all profitable activities because it taxes their income is a familiar and sometimes useful figure of speech, but the relationship entails no moral responsibility for the behavior of the private member of this fictional partnership. A tax is an enforced exaction that reduces the profits of the taxed enterprise, and this no more implies approval than does the confiscation and sale of a drug peddler's automobile and merchandise by the police. Moreover, as suggested earlier, unlawful income arises not only from wholly unlawful activities, like bootlegging and embezzlement, but also from a wide range of activities that could be, but are not conducted in a wholly lawful manner. If taxing income implies moral responsibility for the activities from which it flows, the government could preserve its soul only by exempting not only the income of bootleggers, but also the profits derived from violating the antitrust laws, charging over-ceiling prices, manufacturing unsafe products, and misrepresenting the quality of the taxpayer's merchandise. Finally, Judge Manton's advice turns tax exemption—often a device to encourage the exempted activity—on its head. It suggests that spiritual purity is to be obtained only by exempting, and hence encouraging, the very activity which the government should despise.

To buttress the theory that taxing an unlawful enterprise is degrading to the government, Judge Manton asserted that the mere act of computing a criminal's income is a dirty business.³⁶ If this income is taxed, he argued, it might be necessary to allow a bootlegger to deduct any bribes paid by him, in order to comply with the Congressional intent to tax "net" rather than gross income. When this issue was raised before the Supreme Court in the *Sullivan* case, Mr. Justice Holmes said:

It is urged that if a return were made the defendant [who had been convicted of failure to file] would be entitled to deduct illegal expenses such as bribery. This by no means follows, but it will be time enough to consider the question when a taxpayer has the temerity to raise it.³⁷

The Yankee from Olympus may have thought that no mortal taxpayer would dare to claim that bribes and other illegal payments were deductible business expenses. The issue was in fact raised in numerous later cases, however, and the courts gradually developed

36. *Steinberg v. United States*, 14 F.2d 564, 569 (2d Cir. 1926).

37. *United States v. Sullivan*, 274 U.S. 259, 264 (1927).

a distinction between the "legal" expenses of an illegal business (*e.g.*, salaries and rent) which the taxpayer was allowed to deduct, and its "illegal" expenses (*e.g.*, bribes and "protection" payments) which were disallowed.³⁸

In administering this distinction, close cases were often encountered (*e.g.*, salaries paid to persons who were accessories to the crime,³⁹ loss of merchandise confiscated by the police,⁴⁰ and depreciation on instrumentalities of crime) which required the government to concern itself with the details of unlawful activities, as predicted by Judge Manton. But he used a misleading label in describing the audit process, which is adversary rather than cooperative, as a "combination" between the government and the criminal. There is, at most, a bit of irony in a revenue agent's bureaucratic audit of a tax return embracing unlawful income, in the course of which he must ask for documentation of its receipts and expenditures, separate "legitimate" business expenses from unlawful payments, determine whether salaries paid to accessories were in keeping with the reasonable value of their services, and so on.

There is, in fact, another irony in this area, which might have scandalized Judge Manton and titillated Mr. Justice Holmes. Because the Social Security Act's definition of "income" is taken from the Internal Revenue Code, a criminal whose activity constitutes a "trade or business" (*e.g.*, a professional gambler or bootlegger) is covered by the self-employment tax and evidently becomes entitled, on retirement, to social security benefits geared to his earnings during the last few years of work preceding his retirement.⁴¹ If there

38. See Comment, *Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code*, 72 YALE L.J. 108 (1962). See also *James v. United States*, 366 U.S. 313 (1961) (dictum to effect that repayment of embezzled funds gives rise to deduction); *Raymond Mazzei*, 61 T.C. No. 55 (Jan. 23, 1974) (taxpayer who invested in a bogus counterfeiting scheme cannot deduct his outlay on discovering that he was duped); *Herbert E. Tharp*, 41 P-H Tax Ct. Mem. 21 (1972) (taxpayer engaged in usurious loan business allowed to deduct uncollectible loans).

For discussion of the subsequent statutory amendments which now dominate, if not preempt, this area, see Taggart, *Fines, Penalties, Bribes, and Damage Payments and Recoveries*, 25 TAX L. REV. 611 (1970).

39. *Commissioner v. Sullivan*, 356 U.S. 27 (1958).

40. *Fuller v. Commissioner*, 213 F.2d 102 (10th Cir. 1954).

41. Rev. Rul. 60-77, 1960-1 CUM. BULL. 386. In response to an inquiry to the Social Security Administration regarding the number of persons whose illegal activities served as a base for social security benefits, I was advised:

The Social Security Administration keeps no records concerning whether remuneration covered for social security purposes is derived from legal or illegal activities, nor have any studies in this area been made. However, our general position in this matter would be the

is anything to the argument that the government is tainted by taxing unlawful income, perhaps the payment of these benefits serves as a purgative.

A final comment on this issue: While I perceive nothing unseemly in taxing unlawful income, one might properly object if the government's tax claim to the lawbreaker's assets was preferred over the right of his victims to be reimbursed by him for their losses. In general, however, if the victim can trace and identify his property, as in the case of a stolen work of art, he can get it back, even if the thief has nothing left to pay his taxes. Even if the property cannot be traced (*e.g.*, cash whose serial numbers are not known), the victim will ordinarily be familiar with the facts sooner than the government, and this prior knowledge will usually enable him to establish an enforceable claim against any assets that can be discovered in the criminal's possession before the government's tax lien takes hold.⁴² Situations can be imagined in which the victim's right to reimbursement will be subordinated to the government's right to collect taxes on the unlawful income, but they are unusual, and a corrective for this injustice could be provided by Congress without going so far as to confer a blanket exemption on unlawful income.⁴³

same as that of the Internal Revenue Service: all remuneration from employment or self-employment is covered under social security unless specifically excepted under Section 209 and 211 respectively of the Social Security Act (42 U.S.C. 409 and 411). The legality or illegality of the activities involved is immaterial.

Letter from Hugh F. McKenna, Director, Bureau of Retirement and Survivors Insurance, to Boris I. Bittker, July 17, 1973.

42. If the victim has not stimulated an investigation of the wrongdoer by the Internal Revenue Service, he will ordinarily be interviewed by the revenue agents, and in either event will have an opportunity to file suit against the wrongdoer before the government can obtain a tax lien. If the government is unusually swift in making a jeopardy assessment, or if the victim is not interviewed by the government because his name is unknown to the investigating agents, however, his claim may be so belated that it will rank after the government's.

43. See B. BITTKER & L. STONE, *supra* note 24, at 124. Congress could protect the victim, for example, by adding his claim against the wrongdoer to the list of favored claims in INT. REV. CODE OF 1954, § 6323.

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