## ELIMINATING THE TAX ON EMBEZZLED FUNDS: A CALL FOR REFORM

EMILY FINESTONE\*

#### Abstract

In 1961, the Supreme Court changed the traditional tax treatment of embezzled funds when it held in James v. United States that embezzled money is taxable as income to the embezzler for the year in which the embezzlement took place. This Note calls upon Congress to reform the policy of taxing embezzled money because fairness demands that embezzlement victims receive priority as they seek restitution.

Many policy concerns support eliminating the tax on embezzled money. First, taxing the embezzler on the embezzled money is detrimental to victims and their attempt to seek restitution. Second, if the concern with respect to the embezzler is that he is adequately punished and rendered unable to enjoy the fruits of his illegal behavior, criminal liability is sufficient. By relying on civil punishment, namely targeting the embezzler under the Tax Code, the victims' interests are placed at odds with the government's interests. This position is unfavorable because the government should be assisting the victims of embezzlement, rather than creating another hurdle for them. Third, unlike law-abiding citizens, embezzlers at all times have an unconditional obligation to repay the money that would otherwise constitute a gain. An embezzler actually realizes a gain in only one exceptional circumstance: when the embezzler settles with his victims for less than the full amount embezzled, he has realized a gain similar to the discharge of indebtedness. Accordingly, Congress should recognize that embezzled money generally should not be subject to taxation.

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<sup>\*</sup> Boston University School of Law (J.D. 2015); University of Virginia (B.A. 2012). The author would like to thank the members of the *Review of Banking & Financial Law* who helped make this publication possible, particularly Christopher Mercurio for strongly encouraging the author to submit her note for publication and Thomas Markey for his invaluable feedback. The author would also like to thank Professor Alan Feld for all of his patience and guidance as she attempted to put on the hat of tax scholar and explore an unfamiliar but intriguing area of the law.

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#### Introduction

One could fairly describe embezzlement using terms with a negative connotation such as theft, illegal activity, scam, fraud, or misappropriation. Embezzlers are not likely looked upon with much sympathy, as they profit from taking money that belongs to other people. With respect to an embezzler's treatment for tax purposes, the government has the difficult choice of either (1) taxing profits that technically do not belong to the embezzler, or (2) failing to tax the embezzler, which would allow the embezzler to realize gains from his illegal activity.

Utilizing a common law definition of "income," one might argue that it is logical to tax embezzled profits. In *Eisner v. Macomber*, the Supreme Court defined income as "the gain derived from capital, from labor, or from both combined." Income has also been described

<sup>3</sup> See infra Part II (summarizing the various case law regarding how embezzled money should be treated).

<sup>&</sup>lt;sup>1</sup> See BLACK'S LAW DICTIONARY 635 (10th ed. 2014) (defining "embezzlement").

<sup>&</sup>lt;sup>2</sup> See id.

<sup>&</sup>lt;sup>4</sup> Eisner v. Macomber, 252 U.S. 189, 207 (1920) (internal quotation marks omitted).

as "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Applying these definitions, it would reasonably follow that embezzled money is taxable, as it produces a "gain derived from capital" and is an "accession to wealth, clearly realized." Over time, income has in fact been interpreted to include embezzled funds, although embezzled funds originally were not taxed as income. However, the reason for treating embezzled money as income is not because it fits within the common law definitions of income. Embezzled money is treated as income because it is unfair to allow embezzlers to escape taxation, given that law-abiding citizens do not have the same luxury with respect to their various forms of income.

Seeking to ensure equity in tax treatment balances the interests of the embezzler and the law-abiding taxpayer. However, comparing an embezzler with a law-abiding taxpayer is flawed because the embezzler is legally obligated to return the money that the government seeks to classify as income, whereas the law-abiding taxpayer rightfully has possession of the income. Attended the incomes are embezzler is more suitably compared with a debtor because both hold in their possession money that they must repay, irrespective of the obvious differences between an embezzler and a debtor who obtains a loan. While the debtor has legitimately borrowed the money, the embezzler's requirement to repay

<sup>&</sup>lt;sup>5</sup> James v. United States, 366 U.S. 213, 219 (1961) (internal quotation marks omitted).

<sup>&</sup>lt;sup>6</sup> Eisner, 252 U.S. at 207.

<sup>&</sup>lt;sup>7</sup> James, 366 U.S. at 219.

<sup>&</sup>lt;sup>8</sup> *Id.* (rejecting the argument that embezzlement profits are not taxed as income). <sup>9</sup> Commissioner v. Wilcox, 327 U.S. 404, 407 (1946).

<sup>&</sup>lt;sup>10</sup> See James, 366 U.S. at 221 ("We should not continue to confound confusion, particularly when the result would be to perpetuate the injustice of relieving embezzlers of the duty of paying income taxes on the money they enrich themselves with through theft while honest people pay their taxes on every conceivable type of income.").

<sup>&</sup>lt;sup>11</sup> *Id*.

<sup>&</sup>lt;sup>12</sup> See infra Part V (discussing whether taxing embezzled income is fair).

<sup>&</sup>lt;sup>13</sup> See Jerome B. Libin & George R. Haydon, Jr., Embezzled Funds as Taxable Income: A Study in Judicial Footwork, 61 MICH. L. REV. 425, 440 (1963) ("There can be no doubt, under state law, that an embezzler has no right, title or interest in the funds which he misappropriates—the funds continue to be the property of the victim.").

<sup>&</sup>lt;sup>14</sup> See infra notes 26-29, 92-97 and accompanying text (discussing comparison between embezzlers and debtors).

the money is the functional equivalent of having borrowed the money. The ordinary taxpayer, "[b] orrowing money does not create income to the borrower... since [the borrower] has the same net worth before and after the loan transaction. This Note argues Congress should alter the tax treatment of embezzled money to reflect the presumption that the liability created when the embezzler takes the money will be honored. In the event that the money is not repaid, the embezzler could then be taxed on his discharge of indebtedness in the same manner that a legitimate debtor would be taxed in a situation where the debtor is relieved of his obligation to repay the debt. The same manner that a legitimate debtor would be taxed in a situation where the debtor is relieved of his obligation to repay the debt.

Before continuing, it is important to address one key issue that is raised in evaluating the treatment of embezzlers. The leading cases that this Note discusses are all criminal cases, in which the embezzlers faced criminal liability or jail time. 18 However, this Note is primarily concerned with the civil effects of embezzlement, namely the efforts of the Internal Revenue Service ("IRS") to collect the money. In asserting that public policy requires that preference be afforded to embezzlement victims, this Note presupposes that civil liability—under which the IRS benefits—is not how embezzlers should be forced to pay for their illegal actions, with an exception for situations where the embezzler is unjustly enriched by settling with his victims for less than the amount taken. 19 That is not to say that embezzlers should be able to escape any form of liability; criminal liability in the form of jail time is the better mechanism for punishing embezzlers because justice is served, but not at the expense of the victims. This Note acknowledges that there is a need to balance the fairness to the victims, embezzlers, and IRS, and concludes that the IRS is the party that has to lose because that dynamic places the victims in a better position to receive restitution.

This Note begins in Part II by taking a historical look at the relevant case law that has led to the current rule that embezzled funds

<sup>&</sup>lt;sup>15</sup> See George Blum, Annotation, Measure and Elements of Restitution to Which Victim Is Entitled under State Criminal Statute, 15 A.L.R.5TH 391, § 16[a] (1993) (listing cases in which courts ordered embezzlers to repay victims).

<sup>&</sup>lt;sup>16</sup> MARVIN A. CHIRELSTEIN & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION 48 (12th ed. 2012).

<sup>&</sup>lt;sup>17</sup> See I.R.C. § 61(a)(12) (2012) ("[G]ross income means all income from whatever source derived, including . . . [i]ncome from discharge of indebtedness . . . .").

<sup>&</sup>lt;sup>18</sup> See infra Part II (reviewing cases).

<sup>&</sup>lt;sup>19</sup> See James v. United States, 366 U.S. 213, 221 (1961) (mentioning the "meager settlements" the embezzlement victims made with the embezzler).

are included in income for tax purposes. In Part III this Note explores what happens when the embezzler has money left or does not have any money left, and the implications of his financial status on the victims and on himself for tax purposes. Part IV discusses an exception to this bright-line rule and also draws attention to Ponzi schemes as a model for the government's willingness to alleviate the financial impact of fraudulent schemes on victims. Although acknowledging that there is some merit to the argument for taxing embezzled money, Part V explains the reasons why taxing embezzled funds as income is illogical. Part VI asserts that taxing embezzled money places the government's interests above the victims' interests and is unfair because the government is able to take its full cut of the embezzled funds, whereas the victims may not be able to recover the full amount lost. Part VII proposes tax reform so that embezzled funds are not included in income because the government should only be allowed to tax the gains that an embezzler receives after the victims are first compensated for the embezzlement. This Note concludes that fairness demands the victims be given the primary right to the embezzled funds, with the government taking a secondary position.

# I. An Examination of the Case Law Establishing Embezzled Money Is Income

The current rule that embezzled funds are taxable evolved through mid-twentieth century Supreme Court jurisprudence. The first case of a series of important embezzlement cases, *Commissioner v. Wilcox*, established the traditional standard—no longer followed—that embezzled money does *not* constitute income. Wilcox involved an individual who was a bookkeeper for a warehouse company and was pocketing money that belonged to the company. After being audited, the company realized that Wilcox had embezzled \$12,480.60 for his personal use in 1941, rather than "credit[ing] the customers' accounts or the company's accounts receivable with the funds received. Wilcox then lost most of the embezzled money gambling and was convicted of criminal embezzlement. Despite the fact that he squandered most of the money, he was still obligated to repay the company, and "[t]he company never condoned or forgave the taking of

<sup>&</sup>lt;sup>20</sup> Commissioner v. Wilcox, 327 U.S. 404, 407, 410 (1946).

<sup>&</sup>lt;sup>21</sup> *Id.* at 405-06.

<sup>&</sup>lt;sup>22</sup> *Id.* at 406.

<sup>&</sup>lt;sup>23</sup> *Id*.

the money and still [held Wilcox] liable to restore it."<sup>24</sup> Reasoning 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 or return that which would otherwise constitute a gain,*" the court held that the embezzled money was not taxable as income.<sup>25</sup>

Here, Wilcox did not realize a "taxable gain" because he had a duty to repay the money to his employer. The Court compared Wilcox's duty to repay the warehouse company to a debtor-creditor relationship, stating that "[a]ll right, title and interest in the money rested with the employer." This was unaltered by the fact that Wilcox had already squandered the money gambling, with the Court again comparing the situation to a debtor-creditor relationship, stating "[t]he loss or dissipation of money cannot create taxable income here any more than the insolvency . . . of an ordinary borrower causes the loan[] to be treated as taxable income to the borrower." The Court further added that "[s]anctioning a tax under the[se] circumstances . . . would serve only to give the United States an unjustified preference as to part of the money which rightfully belongs to the taxpayer's employer."

This bright-line rule that embezzled money is not taxable income was complicated when the Supreme Court held in *Rutkin v. United States* that money obtained as a result of extortion constitutes taxable income. <sup>30</sup> In *Rutkin*, the petitioner was indicted for tax evasion after failing to report as income \$250,000 that he received through extortion. <sup>31</sup> The Court opined that "[a]n 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." <sup>32</sup> Here, Rutkin exercised control over the extorted money, and "in the absence of [his victim's] unlikely repudiation of the transaction and demand for the money's return, [Rutkin] could enjoy its use as fully as though his title to it were

<sup>&</sup>lt;sup>24</sup> *Id*.

<sup>&</sup>lt;sup>25</sup> *Id.* at 408 (emphasis added).

<sup>~</sup> Id.

<sup>&</sup>lt;sup>27</sup> *Id*. at 409.

<sup>&</sup>lt;sup>28</sup> *Id*.

<sup>&</sup>lt;sup>2</sup> *Id*. at 410

<sup>&</sup>lt;sup>30</sup> Rutkin v. United States, 343 U.S. 130, 131 (1952).

<sup>&</sup>lt;sup>31</sup> *Id.* at 131-32.

<sup>&</sup>lt;sup>32</sup> *Id.* at 137.

unassailable." Accordingly, the extorted money constituted taxable income. 34

The Court explicitly refused to address the situation that was presented in *Wilcox*, which cast uncertainty on the *Wilcox* holding because it seemed contradictory to tax the gains from extortion but not tax the gains from embezzlement, given the nearly identical result in both situations. Although extortion and embezzlement are two different crimes, both are illegal activities from which the offender profits, but is still legally obligated to return the profits. Both embezzlers and extortionists exercise control over the illegally obtained funds as if they were rightfully entitled to the money. Because gains from extortion were included as income, it would logically follow that gains from embezzlement would be included as income if the *Rutkin* principle of control applied.

In 1961, the Supreme Court resolved this inconsistency regarding the treatment of illegal income when it held that embezzled money is taxable as income to the embezzler for the year in which the embezzling took place.<sup>39</sup> The petitioner in *James v. United States* was a union employee who embezzled \$738,000 from both the union and an insurance company with which the union conducted business.<sup>40</sup> James was sentenced to three years in jail—which the court of appeals affirmed—for willful tax evasion because he failed to report the profits from the embezzlement as income.<sup>41</sup> Recognizing the conflict between

<sup>&</sup>lt;sup>33</sup> *Id.* at 136-37.

 $<sup>^{34}</sup>$  *Id.* at 137.

<sup>&</sup>lt;sup>35</sup> See id. at 138 (limiting Wilcox to its facts).

<sup>&</sup>lt;sup>36</sup> See James v. United States, 366 U.S. 213, 216 (1961) ("Nor was Rutkin's obligation to repay the extorted money to the victim any less than that of Wilcox. The victim of an extortion, like the victim of an embezzlement, has a right to restitution.").

<sup>&</sup>lt;sup>37</sup> See id. at 219; infra note 45 and accompanying text.

<sup>&</sup>lt;sup>38</sup> See Rutkin, 343 U.S. at 137 ("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.").

<sup>&</sup>lt;sup>39</sup> James, 366 U.S. at 222 (overruling *Wilcox*). Even though the Supreme Court abandoned *Wilcox*, the Court reversed James's conviction for "willfully" failing include embezzled funds in his gross income, given the "confusion" that *Wilcox* and *Rutkin* had created. *Id.* at 214, 221-22.

<sup>&</sup>lt;sup>40</sup> *Id.* at 214.

<sup>&</sup>lt;sup>41</sup> *Id.* at 214-15.

*Wilcox* and *Rutkin*, the Supreme Court granted certiorari to resolve the issue of whether embezzled money is taxable income.<sup>42</sup>

In considering what falls within the scope of taxable income, the Court refused to distinguish between embezzlement and other unlawful means of increasing one's wealth, which the Court had already established to be taxable. <sup>43</sup> The Court rejected the assertion that all illegally obtained money should be taxable, except for money obtained as a result of embezzlement. <sup>44</sup> The Court opined that

[w]hen a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, "he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."

Although the embezzler was not a rightful owner of the money, the Court held that the embezzler was still subject to taxation because he had "actual command over the property taxed."

In holding the embezzler subject to taxation for the money over which he exercised control, the Court adopted something similar to a "claim of right" test, under which the embezzler is taxed "when [he] receives earnings under a claim of right without restriction upon their disposition." Under its original formulation, 48 the claim of right doctrine had three elements: "(1) receipt by a taxpayer of money or other property, (2) control by the taxpayer over the utilization or disposition of money or property, and (3) assertion of some claim of right or entitlement by the taxpayer to receipt." Irrespective of the fact

<sup>45</sup> Id. (quoting N. Am. Oil Consol. v. Burnet, 286 U.S. 417, 424 (1932)).

<sup>&</sup>lt;sup>42</sup> *Id.* at 215.

<sup>&</sup>lt;sup>43</sup> *Id.* at 219.

<sup>&</sup>lt;sup>44</sup> *Id*.

<sup>&</sup>lt;sup>46</sup> *Id.* (internal quotation marks omitted)).

<sup>&</sup>lt;sup>47</sup> Milton O. Wordal, Note, Federal Income Taxation: Inclusion of Embezzled Funds in Gross Income, 50 CALIF. L. REV. 149, 154 (1962).

<sup>&</sup>lt;sup>48</sup> See id. (observing that the claim of right doctrine "originated in North American Oil Consol. v. Burnet").

<sup>&</sup>lt;sup>49</sup> Harold Dubroff, *The Claim of Right Doctrine*, 40 TAX L. REV. 729, 733 (1985).

that an embezzler had no legal "claim of right" or "entitlement" to the embezzled funds, the Court still implicitly associated embezzled funds with property held under claim of right<sup>50</sup> because the embezzler exercised control over the embezzled money and used it for his own benefit.<sup>51</sup> Further, all embezzlers received identical treatment because the Court assumed that all embezzlers intended to appropriate the funds, disregarding the fact that some embezzlers may intend to return the funds eventually.<sup>52</sup> The Court, however, stated that in the event that the embezzler repaid the victims, he would be entitled to a reduction in his income.<sup>53</sup>

Whereas the majority in James was willing to consider the public policy argument regarding the moral implications of allowing an embezzler to escape taxation,<sup>54</sup> the dissent divorced its argument from morality and approved the Wilcox Court's focus on whether receipt of embezzled money could actually be considered a taxable gain, finding morality irrelevant for the purposes of interpreting tax liability.<sup>55</sup> The dissent found the majority's discussion of the moral implications of allowing an embezzler to escape taxation misplaced, as embezzled money cannot be considered income "for the obvious reason that the embezzled property still belongs, and is known to belong, to the rightful owner."56 The dissent worried about the detrimental impact that allowing the government to tax embezzled money would have on the

<sup>&</sup>lt;sup>50</sup> Id. at 733 ("Oddly, however, the third element of the formulation, and that from which the doctrine derives its name—may no longer be a necessary condition to its application [because] illegal income received through embezzlement ... is now taxable when received even though the taxpayer cannot assert any claim of right over it.").

<sup>&</sup>lt;sup>51</sup> *James*, 366 U.S. at 219.

<sup>&</sup>lt;sup>52</sup> Wordal, *supra* note 47, at 150 ("The Court in *James* decided to treat all embezzlers like honest wage earners and not like borrowers, regardless of intent. Thus in some cases (when he acts like a borrower) an embezzler may receive less favorable tax treatment under James than his honest counterpart."). <sup>53</sup> James, 366 U.S. at 220.

<sup>&</sup>lt;sup>54</sup> Id. at 221 ("We should not continue to confound confusion, particularly when the result would be to perpetuate the injustice of relieving embezzlers of the duty of paying income taxes on the money they enrich themselves with through theft while honest people pay their taxes on every conceivable type of income.").

<sup>55</sup> Id. at 226 (Black, J., dissenting) (agreeing with Wilcox that "[m]oral turpitude is not a touchstone of taxability"). <sup>56</sup> *Id*.

victims of the crime.<sup>57</sup> Justice Black acknowledged that the victim already had to deal with the burdens of seeking restitution, and allowing the government to tax the money before the victim was repaid would further hinder the victim's attempt to be repaid because it was rare for an embezzler to have "nonstolen assets available for payment of taxes." Thus, the victim's embezzled money would be used to pay taxes.<sup>59</sup> The dissent emphasized the impact of taxing embezzled money by drawing attention to the fact that this case involved embezzlement of \$738,000 and the government was claiming a \$559,000 tax.<sup>60</sup>

The dissent also addressed the conflict between *Rutkin* and *Wilcox*, concluding that the *Rutkin* case, rather than the *Wilcox* case, should be overruled. Although *Rutkin* and *Wilcox* conflicted in some respects, the dissent mentioned "the *Rutkin* opinion expressly purported not to overrule *Wilcox* and specifically said that *Wilcox* was still to govern cases fitting its facts, clearly meaning embezzlement cases." Even if the *Rutkin* case were to stand, the dissent acknowledged that there were significant differences between the *Wilcox* and *Rutkin* cases, given that in *Rutkin* "there was [no evidence] that Rutkin ever had an obligation to repay the funds he took." This is distinguishable from a situation involving embezzlement. The victim of extortion may very likely never demand restitution, given the sensitive nature of the details frequently surrounding extortion, though the victim of embezzlement

<sup>&</sup>lt;sup>57</sup> *Id.* at 229-30 ("[T]o the extent that the Government could be successful in collecting some taxes from embezzlers, it would most likely do so at the expense of the owner whose money had been stolen.").

<sup>&</sup>lt;sup>58</sup> *Id.* at 228 ("The rightful owner who has entrusted his funds to an employee or agent has troubles enough when those funds are embezzled without having the Federal Government step in with its powerful claim that the embezzlement is a taxable event automatically subjecting part of those funds (still belonging to the owner) to the waiting hands of the Government's tax gatherer. We say part of the *owner's* funds because it is on the supposed 'gain' from them that the embezzler is now held to be duty-bound to pay the tax and history probably records few instances of independently wealthy embezzlers who have had nonstolen assets available for payment of taxes.").

<sup>&</sup>lt;sup>59</sup> *Id*.

<sup>&</sup>lt;sup>60</sup> *Id.* at 229.

<sup>&</sup>lt;sup>61</sup> *Id.* at 240 ("Even if we were to join with our Brethren in accepting the Government's present contention that *Wilcox* and *Rutkin* cannot both stand, we would disagree as to which of the two decisions should now be repudiated.").

<sup>&</sup>lt;sup>62</sup> *Id.* at 235-36.

<sup>63</sup> Id. at 236.

will most likely attempt to seek restitution immediately upon discovery of the embezzlement.<sup>64</sup>

Regardless of the potential conflict between Rutkin and Wilcox and irrespective of whether the two cases can both survive, this Note echoes the dissent's concern that allowing the government to tax embezzled money would have a detrimental impact on embezzlement victims and agrees that the Wilcox case was rightfully decided. This Note further argues in the next section that eliminating the tax on embezzled money until after the victims are paid restitution would ameliorate the detrimental impact that taxing embezzled money could have on embezzlement victims.

#### II. Embezzlers: What Happens When There Is No Money?

One issue with not taxing an embezzler is that the embezzler would be permitted to profit from his illegal activity. Why should an embezzler escape taxation when law-abiding citizens are taxed on their gains? The answer lies in the fact that the embezzler is not legally entitled to the money which he has embezzled. As the Wilcox Court recognized, "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."65 At all times in which the embezzler maintains possession of the embezzled money, he has an unconditional obligation to return the money that would otherwise constitute a gain. 66 This is important to recognize because in a situation where the embezzler has squandered the embezzled money, taxing the money would be to the

<sup>64</sup> Id. at 237 ("Although the victim of either embezzlement or extortion ordinarily has a legal right to restitution, the extortion victim, like a blackmail victim, can in a sense be charged with complicity in bringing about the taxable event in that he knowingly surrendered the funds to the extortionist, sometimes in payment of an actual obligation. . . . The longer he acquiesces the less likely it becomes that the extortion victim ever will demand restitution; but once the victim of an embezzlement finds out that his property has been stolen, he most likely will immediately make efforts to get it back." (footnote omitted)).

<sup>65</sup> Commissioner v. Wilcox, 327 U.S. 404, 408 (1946) (emphasis added).

<sup>&</sup>lt;sup>66</sup> See James, 366 U.S. at 226 (Black, J., dissenting) (arguing that embezzled money cannot be considered income "for the obvious reason that the embezzled property still belongs, and is known to belong, to the rightful owner").

detriment of the victims and their attempt to seek restitution.<sup>67</sup> Adopting a policy of not taxing embezzled money would ameliorate a major problem that is presented when the embezzler spends most of the embezzled money.

In Wilcox, the individual taxpayer appropriated funds from a company and then spent most of the embezzled money on a gambling spree, leaving him with almost nothing to compensate his victim. <sup>68</sup> In situations like Wilcox, because the embezzler already has limited funds remaining due to spending most of it, imposing a tax on the embezzled money would likely wipe out all that he has left, if anything remains. As the James dissent recognized, "history probably records few instances of independently wealthy embezzlers who have had nonstolen assets available for payment of taxes."69 Thus, taxing the embezzler would deplete the limited pool of funds from which the victims should be compensated. The Wilcox Court addressed this, concluding that "[s]anctioning a tax under the[se] circumstances ... would serve only to give the United States an unjustified preference as to part of the money which rightfully belongs to the [victim(s)]."70 Adopting this proposal to eliminate the taxation of embezzled money would be good policy because it is protective of victims.

The assertion that an embezzler should not be taxed, however, is not without qualification. An embezzler should be taxed *after* the victims receive compensation from whatever money remains. In the likely event that the victims are not fully compensated for their loss, the embezzler should then be taxed on the difference between the amount he embezzled and the amount he repaid. By not having to repay the victims the full amount of the embezzled money, the embezzler has realized discharge of indebtedness income, which is taxable. While this may seem like a harsh result, given that the embezzler is probably facing criminal charges and probably has no money left after settling with his victims to repay them a lesser amount, it would be inequitable to allow him to escape taxation on the discharge of indebtedness

<sup>&</sup>lt;sup>67</sup> See Wilcox, 327 U.S. at 406 (explaining that taxpayer gambled away embezzled funds).

<sup>&</sup>lt;sup>68</sup> *Id.* at 405-06.

<sup>&</sup>lt;sup>69</sup> James, 366 U.S. at 228 (Black, J., dissenting).

<sup>&</sup>lt;sup>70</sup> Wilcox, 327 U.S. at 410.

<sup>&</sup>lt;sup>71</sup> See I.R.C. § 61(a)(12) (2012) ("[G]ross income means all income from whatever source derived, including . . . [i]ncome from discharge of indebtedness . . . ."); see also infra Part VIII.

<sup>&</sup>lt;sup>72</sup> See I.R.C. § 61(a)(12).

income while an ordinary law-abiding taxpayer is taxed on discharge of indebtedness income.<sup>73</sup> It is unfair to require a law-abiding taxpayer to comply with the Internal Revenue Code ("Tax Code"), but not the law-breaking taxpayer. Admittedly, such a requirement would offer little benefit for the IRS because an embezzler with no money has no money to pay taxes on the discharge of his indebtedness.<sup>74</sup> Yet, this treatment is still preferable because the IRS is in a better position to absorb the loss than an individual in ordinary circumstances.<sup>75</sup>

Nonetheless, under the current system, embezzled money is taxable, regardless of whether the victims have been compensated or whether the embezzler has limited funds remaining.<sup>76</sup> While this is flawed because it is unfair to the victims in that it depletes the money that is rightfully theirs, it is also flawed because it unfair to the embezzler. Under the claim of right doctrine, when a law-abiding taxpayer mistakenly holds money under claim of right and reports it as income but later determines that he did not have an unrestricted right to the money, the taxpaver can either take a deduction in the year in which he discovered that he did not have an unrestricted right to the money or carryback the deduction to a prior year in which he had income. Similar to a law-abiding taxpayer who holds money under claim of right, the embezzler takes possession of money as if he had a legitimate right to it; but unlike the taxpayer who mistakenly holds money under claim of right and later discovers that the right is not unrestricted, the embezzler is not afforded the same carryback deduction when he repays his victims.<sup>78</sup> Thus, the embezzler who repays his victims in a subsequent year after already reporting the embezzled money as

<sup>74</sup> See James, 366 U.S. at 229 (Black, J., dissenting) ("Judging from the meager settlements that those defrauded were apparently compelled to make with the embezzlers in this very case, it is hard to imagine that the Treasury will be able to collect the more than \$500,000 it claims."); McKnight v. Commissioner, 127 F.2d 572, 573-74 (5th Cir. 1942) (discussing how to treat embezzler who spent all embezzled money and became insolvent).

<sup>&</sup>lt;sup>73</sup> See id.

<sup>&</sup>lt;sup>75</sup> In fiscal year 2012, for example, the IRS collected more than \$2.5 trillion in tax revenue. *The Agency, Its Mission, and Statutory Authority*, IRS (Jan. 23, 2015), http://www.irs.gov/uac/The-Agency,-its-Mission-and-Statutory-Authority, *archived at* http://perma.cc/Q4EM-QRXV.

<sup>&</sup>lt;sup>76</sup> See James, 366 U.S. at 219.

<sup>&</sup>lt;sup>77</sup> I.R.C. § 1341(a).

<sup>&</sup>lt;sup>78</sup> See McKnight, 127 F.2d at 574 (rejecting that claim of right doctrine applied to embezzled money, given that leading case involved profits and "a *real dispute as to who was entitled to them*" (emphasis added)).

income will not receive a carryback deduction if he does not have income in the year in which he repaid the money. Failing to give the embezzler a carryback deduction is flawed because, if he has enough of a claim over the money to be required to include it in income, he should have enough of a claim over the money to be afforded a carryback deduction. Doing so would, however, require the court to recognize that the embezzler holds the money under "claim of right" because the Tax Code's carryback remedy only applies where the taxpayer held the money under claim of right. Not allowing the embezzler a carryback deduction further fuels the argument that the tax policy with respect to embezzlers imposes a double punishment. However, by changing the rule so that embezzled money is not subject to taxation, the concern about doubly punishing embezzlers would be ameliorated.

# III. An Exception to the Rule That Embezzled Money Is Taxable Income and a Call to Make the Exception the Norm

As previously mentioned, the bright-line rule that embezzled money is taxable as income is not without qualification. One example of an exception to the bright line rule is *Gilbert v. Commissioner*.<sup>81</sup> Gilbert utilized corporate funds to purchase stock so that he could effectuate a merger.<sup>82</sup> Although he informed the board of directors that he had taken the funds to purchase stock and effectuate a merger, the board would not ratify Gilbert's actions.<sup>83</sup> Before notifying the full board, Gilbert consulted with a law firm about his actions and executed a promissory note that was greater in value than the funds Gilbert appropriated, and the note was secured by the majority of his property and callable on demand.<sup>84</sup> During the meeting when the board refused to ratify Gilbert's actions, the board accepted Gilbert's notes and assignment, but required him to resign.<sup>85</sup> Gilbert was later indicted

<sup>&</sup>lt;sup>79</sup> I.R.C. § 1341(a).

<sup>&</sup>lt;sup>80</sup> See Donald DePass, Note, Reconsidering the Classification of Illegal Income, 66 TAX LAW. 771, 779 (2013) ("The taxation of illegal acquired income raises fairness concerns because it often serves as a double layer of punishment for those already being prosecuted or those already convicted of the crime through which the illegal income was obtained.").

<sup>&</sup>lt;sup>81</sup> 552 F.2d 478, 481 (2d Cir. 1977) (concluding that taxpayer who intended to repay corporate funds did not realize income under *James*).

<sup>&</sup>lt;sup>82</sup> *Id.* at 479.

<sup>83</sup> Id. at 480.

<sup>84</sup> Id. at 479.

<sup>85</sup> *Id.* at 480.

under both federal and state law and he defended his actions on the basis that he believed he was acting in the corporation's best interests and that he always fully intended to repay the amount.<sup>86</sup>

The Second Circuit Court of Appeals elected to treat this case differently than the *James* majority because the plaintiff (1) "recognized his obligation to repay and intended to do so"; (2) used the money in a manner that he thought advantageous for the corporation, rather than just acting for his own benefit; (3) "thought he was serving the best interests of the corporation and he expected his decision to be ratified"; (4) informed his corporation and its law firm about his actions; and (5) manifested that he never intended to keep the money for himself by signing the secured promissory note.<sup>87</sup> The court narrowly held that,

where a taxpayer withdraws funds from a corporation which he fully intends to repay and which he expects with reasonable certainty he will be able to repay, where he believes that his withdrawals will be approved by the corporation, and where he makes a prompt assignment of assets sufficient to secure the amount owed, he does not realize income on the withdrawals under the *James* test.<sup>88</sup>

In *Gilbert*, the court was very careful to ensure that this exception to the rule would be applied narrowly by emphasizing all of the various ways in which the plaintiff manifested his intention to repay the amount that he appropriated. Although the court's decision to effectively treat Gilbert as a borrower accords with this Note's proposal, under this Note's proposed changes in the treatment of embezzled funds, the *Gilbert* situation should not be distinguished as an exception. Whereas the court emphasized Gilbert's intent to repay the money, this Note proposes to ignore Gilbert's intent. Intent is inconsequential in the context of embezzlement because embezzlement always produces the same result: the embezzler unlawfully acquires funds that he is legally obligated to repay. Whether the embezzler

<sup>89</sup> See id.

<sup>86</sup> *Id.* at 479-80.

<sup>&</sup>lt;sup>87</sup> *Id.* at 481.

<sup>&</sup>lt;sup>88</sup> *Id*.

<sup>&</sup>lt;sup>90</sup> See Blum, supra note 15, at § 16[a] (listing cases in which the court ordered the embezzlers to repay their victims).

intended to keep the money forever or intended to return it, he will still be required to return the money. Rather than focusing on exceptions to the general rule that embezzled money is taxable as income, it would be easier to simply eliminate the tax on embezzled funds on the basis that the embezzler does not own them, instead treating the money as a debt. By characterizing the embezzler as a debtor, it logically follows that he realizes no increase in wealth because the money that he attains is cancelled out by a debt obligation.

In McKnight v. Commissioner, the Fifth Circuit Court of Appeals analogized an embezzler to a debtor. 94 The embezzler in McKnight committed suicide after admitting that he had taken some missing funds from his employer, First State Bank of Arlington, Texas, but after he died the bank discovered that the embezzler took an additional \$135,000, for which the administrator of the embezzler's estate admitted liability.95 The IRS assessed additional tax liability for the embezzler based on the \$135,000 that he embezzled, though the embezzler's estate only consisted of assets in an amount of \$6,000, and the bank had only been able to recover \$37,000 and a \$25,000 official bond from the embezzler's administrator. 96 The court rejected the Commissioner's assertion that the embezzled funds were taxable, stating that "when the entrusted fund is used, or even when taken with the purpose of dishonest use, the law immediately and absolutely fixes upon the embezzler the duty to account for and repay the value of what is taken," and even though the embezzler might intend to keep the embezzled money permanently, the "gain . . . realized by borrowing" is still subject to an "offsetting obligation." This Note suggests that the rule that embezzled money is taxable should be eliminated and instead

<sup>&</sup>lt;sup>91</sup> See Commissioner v. Wilcox, 327 U.S. 404, 408 (1946) ("It is obvious that the taxpayer in this instance, in embezzling the \$12,748.60, received the money without any semblance of a bona fide claim of right. And he was at all times under an unqualified duty and obligation to repay the money to his employer.").

<sup>&</sup>lt;sup>92</sup> See McKnight v. Commissioner, 127 F.2d 572, 573 (5th Cir. 1942) ("By the taking the embezzler incurs an equivalent debt as surely as if he had borrowed with the consent of the owner.").

<sup>&</sup>lt;sup>93</sup> *Id.* ("It must be conceded that no gain is realized by borrowing, because of the offsetting obligation.").

<sup>&</sup>lt;sup>94</sup> See id. Note that McKnight predates Wilcox, James, and Rutkin. See supra Part II (discussing Wilcox, James, and Rutkin).

<sup>95</sup> *McKnight*, 127 F.2d at 573.

<sup>&</sup>lt;sup>96</sup> Id.

<sup>&</sup>lt;sup>97</sup> *Id*.

elects to follow the *McKnight* court's logic in recognizing that the embezzler incurs a debt obligation, regardless of his intentions with respect to the embezzled money, and thus should not be taxed on the embezzled money. Changing the rule would not only be logical but also in conformity with public policy, in considering the impact that taxing embezzled money could have on the victims.

One area in which the government has made efforts to protect the victims of fraudulent financial schemes is in its treatment of Ponzi schemes, 98 and this Note proposes extending the favorable treatment of Ponzi scheme victims to embezzlement victims. A Ponzi scheme consists of an illegal investment scheme in which an "apparently legitimate investment entit[y]" solicits money to invest and maintains the façade of legitimacy by "pay[ing] earlier investors a return using the funds of subsequent investors." This makes it appear as if the entity is very successful in generating returns, which attracts new investors, and the scheme is able to survive "until new investors dry up and the scheme disintegrates." When the scheme falls apart, the "[1]ater investors, as well as those who reinvested their earnings over time, often lose not only the return on investment they thought they had made, but [also] their entire principal investment[]." 101

At the outset, it is important to distinguish the government's treatment of Ponzi schemes from this Note's proposal for reform because the regulation of Ponzi schemes centers on the treatment of the misappropriated funds *for the victim*, rather than *for the embezzler*, as this Note argues should change. To lessen the financial loss that Ponzi scheme victims have to endure, the government has provided a tax provision that elects to treat losses from "criminal fraud or embezzlement in a transaction entered into for profit," such as a Ponzi scheme, as a theft loss under I.R.C. § 165. 102 This is favorable for the victims of Ponzi schemes because theft losses are deductible in the amount of the property's adjusted basis, 103 whereas the alternative capital loss treatment only allows the taxpayer to deduct to the extent of capital

<sup>&</sup>lt;sup>98</sup> See Rev. Rul. 2009-9, 2009-14 I.R.B. 735, 735 (explaining how Ponzi scheme victims can deduct losses from criminal fraud).

<sup>&</sup>lt;sup>99</sup> Karen E. Nelson, Note, *Turning Winners into Losers: Ponzi Scheme Avoidance Law and the Inequity of Clawbacks*, 95 MINN. L. REV. 1456, 1464 (2011).

<sup>100</sup> Id.

<sup>&</sup>lt;sup>101</sup> *Id*.

<sup>&</sup>lt;sup>102</sup> Rev. Rul. 2009-9, 2009-14 I.R.B. 735, 735; *see also* I.R.C. § 165 (2012). <sup>103</sup> I.R.C. § 165(e)-(f).

gains or when capital losses exceed capital gains, up to \$3,000 annually. This favorable tax treatment is particularly important for Ponzi scheme victims because after the Ponzi scheme is discovered there are generally very little funds left, if any, and the victims will have little to no chance of recovering the full amount of their investments. The property of t

By allowing the victims to treat their losses as theft losses, the government provides favorable tax treatment for the victims and adopts a policy of assisting the victims of the fraud. The victims of embezzlement face similar challenges to the victims of Ponzi schemes because they will also face an uphill battle in getting back the money that was taken from them. The victims of embezzlement differ from the victims of Ponzi schemes in that Ponzi scheme victims believe they are making an investment; however, the fact that embezzlement victims did not knowingly, and with the intent to engage in an investment, give their money to the party who was defrauding them makes them no less sympathetic than Ponzi scheme victims. While this Note does not propose any changes with respect to the victims' tax treatment, it inherently adopts a pro-victim policy by proposing to eliminate the taxation of embezzled funds, recognizing that taxing the embezzled funds would be to the detriment of the victims. Taxing the embezzler for the embezzled funds depletes the pool of money from which the victims might receive repayment. 106 The government has demonstrated its willingness to provide relief for victims of financial fraud, yet it has left out the victims of embezzlement. The government should take a more progressive stance in protecting victims of embezzlement by ensuring that the embezzled money remains untouched, so that the victims have the greatest chance of receiving restitution. This is important because the victims are already in the vulnerable position of seeking to recover their financial loss, so it is good policy for the government to assist the victims, or at the very least not create more

<sup>105</sup> See Rev. Rul. 2009-9, 2009-14 I.R.B. 735, 735 ("When B's fraud was discovered in Year 8, *B* had only a small fraction of the funds that *B* reported on the account statements that *B* issued to *A* and other investors.").

<sup>&</sup>lt;sup>104</sup> *Id.* § 1211(b).

<sup>&</sup>lt;sup>106</sup> See James v. United States, 366 U.S. 213, 228 (1961) (Black, J., dissenting) ("The rightful owner who has entrusted his funds to an employee or agent has troubles enough when those funds are embezzled without having the Federal Government step in with its powerful claim that the embezzlement is a taxable event automatically subjecting part of those funds (still belonging to the owner) to the waiting hands of the Government's tax gatherer.").

difficulty for the victims, which occurs when the government lays claim to a piece of the embezzled money by taxing it. Furthermore, taxing the embezzler for money that does not rightfully belong to him is illogical, on which this Note elaborates in the following section.

# IV. Taxing a Person for Income That Is Not Rightfully His Is Illogical

A major public policy reason offered by the *James* majority in support of taxing embezzled funds is that the failure to tax embezzled money would produce an inequitable result because it would allow embezzlers to escape taxation while law-abiding citizens are not afforded the same right to escape taxation on their gains. <sup>107</sup> Proponents of taxing embezzled income assert that fairness necessitates that embezzled funds be taxed as income because the embezzlers have realized a gain. 108 They argue that, because the embezzlers are able to reap the full benefits of the embezzled money as if they held legitimate ownership of it, fairness requires that the embezzlers face tax liability, despite the fact that they are not the valid owners of the money. 109 Regardless of whether or not the embezzler is the rightful owner of the embezzled money, those who support taxing embezzled income buy into the logic that "a dollar of profit from unlawful activity will buy just as much as a dollar of lawful profit." Given that the embezzler can use the money for his benefit as if he had rightful ownership of it, supporters of taxing embezzled income do not believe in distinguishing the embezzler in terms of his tax liability. 111

Although it may seem unfair that law-abiding taxpayers are taxed on the gains they realize, and this Note proposes to exempt embezzlers from taxation on the embezzled "gains" they realize, it is

<sup>108</sup> See Wordal, supra note 47, at 150 ("[As] the [James] Court concluded, the embezzler 'has actual command over the property taxed—the actual benefit for which the tax is paid." (quoting James, 366 U.S. at 219)).

<sup>&</sup>lt;sup>107</sup> *Id.* at 221 (majority opinion).

<sup>&</sup>lt;sup>109</sup> Burnet v. Wells, 289 U.S. 670, 678 (1933) ("Liability may rest upon the enjoyment by the taxpayer of privileges and benefits so substantial and important as to make it reasonable and just to deal with him as if he were the owner, and to tax him on that basis.").

<sup>&</sup>lt;sup>110</sup> Boris I. Bittker, *Taxing Income from Unlawful Activities*, 25 CASE W. RES. L. REV. 130, 137 (1974).

<sup>&</sup>lt;sup>111</sup> See id. at 138 ("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.").

important to distinguish embezzlers from law-abiding taxpayers who realize gains because embezzlers do not actually realize "gains"; rather, they incur liabilities. Given that embezzlers do not legally maintain possession of the embezzled money, it is illogical for the government to subject the embezzled money to taxation. Regardless of how fully embezzlers are able to enjoy the "gains" that they realize from embezzlement, embezzlers will be legally obligated to repay the amount stolen, so the appropriated money cannot logically constitute a gain. 112

Some opponents of taxing embezzled income go so far as to suggest that it is unfair to tax the embezzlers on the embezzled money because in doing so the government is able to impose a double punishment on the embezzler, in that the embezzler is already facing criminal liability and the government is adding a layer of punishment in the form of the tax on the embezzled money. 113 By both taxing the embezzler and subjecting the embezzler to criminal liability, opponents of taxing embezzled money who subscribe to this logic assert that the government is imposing a "second punishment for a single mistake or wrong."114 In reaching the conclusion that embezzled money should not be taxed as income, this Note does not adopt this reasoning under which the concern is the embezzler's double punishment. The concept of imposing a civil penalty as well as jail time is neither novel nor limited to embezzlers. 115 Rather, this Note focuses on the potential impact that taxing the embezzled money could have on the victims in their efforts to receive restitution because taxing embezzled money puts the victims' interests at odds with the government's interests.

Opponents of eliminating the tax on embezzled money challenge this concern with the potential impact that taxing embezzled money could have on the victims, arguing that the government cannot harm the victims by taxing embezzled funds because the government

<sup>115</sup> Money laundering, for instance, is a federal crime punishable by "a fine of not more than \$500,000 or twice the value of the property involved in the transaction, whichever is greater, or imprisonment for not more than twenty years, or both." 18 U.S.C. § 1956(a) (2012). Federal law further provides for civil penalties and for civil and criminal forfeiture of property involved in

money laundering transactions. Id. §§ 981, 982, 1956(b).

<sup>&</sup>lt;sup>112</sup> See Blum, supra note 15, § 16[a] (listing numerous cases where the embezzler was ordered to pay restitution for the full amount of the victim's loss).

<sup>&</sup>lt;sup>113</sup> See DePass, supra note 80, at 779.

<sup>&</sup>lt;sup>114</sup> *Id.* at 780.

will be unable to attach a lien to the embezzled money in the event that the embezzler fails to pay his taxes. 116 Yet, the government's inability to attach a lien to the embezzled money highlights that treating embezzled funds like all other forms of illegal income is illogical because "[i]f...a lien cannot attach to embezzled funds, then although an embezzler is subject to tax on the funds he acquires, the very funds which give rise to his tax liability are not within reach of the provisions governing enforcement of that liability." 117 Other forms of illegal income, such as money obtained from an illegal drug transaction, are distinguishable from embezzled money because the government can attach tax liens to the other forms of illegal income, given that the person who receives the illegal income inherits title to it. 118 For example, in an illegal drug transaction, the individual who illegally sells his drugs in exchange for money realizes a cognizable gain and inherits title to the money by virtue of selling the drugs. 119 In contrast, the embezzler does not inherit title to the money that he illegally takes, <sup>120</sup> and accordingly should not be subject to taxation with respect to that illegally obtained money.

Another reason for eliminating the tax on embezzled money is that there are many logistical and administrative challenges that make it illogical. For example, how is tax liability affected when the embezzler repays the money on which he was already taxed? For uniformity's sake, the embezzler should be allowed to decrease the amount of

<sup>&</sup>lt;sup>116</sup> See Note, Embezzlement and Income under the Internal Revenue Code, 30 IND. L.J. 487, 493 (1955) ("[T]he embezzler is immunized against taxation by a clearly inappropriate policy. If the proceeds are traceable, the victim may recover them, for the Government's tax lien will attach only to property of the embezzler; and embezzled funds, identifiable in any form, are not his property.").

<sup>&</sup>lt;sup>117</sup> Libin & Haydon, *supra* note 13, at 440-41. For more discussion of tax liens, see *infra* Part VI.

<sup>&</sup>lt;sup>118</sup> *Id.* at 441.

<sup>&</sup>lt;sup>119</sup> See id. (explaining that title to funds obtained unlawfully, "such as protection payments to racketeers, ransom payments, bribes, grafts, black market gains and bookmaking income," passes to funds' recipient).

<sup>&</sup>lt;sup>120</sup> See James v. United States, 366 U.S. 213, 216 (1961) ("The victim of an extortion, like the victim of an embezzlement, has the right to restitution. Furthermore, it is inconsequential that an embezzler may lack title to the sums he appropriates while an extortionist may gain a voidable title."); Blum, *supra* note 15, at § 16[a] ("Embezzlement defendants could be ordered, according to the courts in the following cases, to make restitution to their victims in the amount of the actual loss caused by their criminal conduct.").

income he reports by the amount that he repays the victims.<sup>121</sup> Not allowing the embezzlers to deduct the amount repaid would subject them to different treatment than law-abiding taxpayers because law-abiding taxpayers are afforded deductions for losses and business expenses; to maintain uniformity embezzlers should therefore be allowed deductions for repaying the money.<sup>122</sup> However, as previously mentioned, the courts have not uniformly allowed a deduction under these circumstances.<sup>123</sup> These complications about whether a deduction should be allowed could be eradicated in a more efficient and logical manner by not taxing the embezzler in the first place. Although other forms of income that face tax liability produce similar complications, embezzled money is unique because there is less of a justification to tax money when the person holding the money has misappropriated it and has a duty to return it.

Finally, while allowing embezzlers deductions for repayment promotes uniformity in the Tax Code, it is not an adequate means for ensuring that victims are repaid. In deciding to tax embezzled money as income, the *James* Court did not consider the embezzler's obligation to repay the money, perhaps because "it [was] disregarded by him and rarely results in a refund to the victim." It seems unlikely that a tax break would compel the embezzlers to return the money that they illegally appropriated. Granting embezzlers a deduction also does not eliminate the major problem associated with taxing embezzled funds: the government is still taking from a pool of money that should be used to make the victims whole. The government should be primarily concerned with the victims, who are the rightful owners of the money, because the government is in a position to lessen the victims' burdens and assisting victims is good policy.

<sup>&</sup>lt;sup>121</sup> See Robert T. Manicke, Note, A Tax Deduction for Restitutionary Payments? Solving the Dilemma of the Thwarted Embezzler, 1992 U. ILL. L. REV. 593, 595 (arguing that "[a] clear rule allowing deductions for restitutionary payments would lend consistency to the tax system").

<sup>&</sup>lt;sup>123</sup> See McKinney v. United States, 574 F.2d 1240, 1243 (5th Cir. 1978) ("Since the language of § 1341 makes its benefits available to a taxpayer only if he 'had an unrestricted right to such item', we agree with the trial court that the plain language of the statute prevents its application in favor of [the embezzler].").

<sup>&</sup>lt;sup>124</sup> Bittker, *supra* note 110, at 137 (footnote omitted).

# V. Allowing the Government to Tax Embezzled Funds Harms the Victims

In holding in James that embezzled funds are taxable to the embezzler as income, the Court justified imposing the tax on the basis that fairness demanded it because law-abiding taxpayers were taxed on their gains. 125 However, focusing on the fairness to law-abiding taxpayers in this context is misplaced and this Note proposes shifting the focus to embezzlement victims, who face the difficulty of attempting to get back their money wrongfully taken. Although it may seem unfair to require law-abiding taxpayers to pay taxes on their gains while providing an exemption for embezzlers, it is even less fair for the government to generate revenue from money that was unlawfully stolen. By allowing the government to tax the embezzled money, the government has an opportunity to take its cut of the money before the victims are even compensated. 126 One definition of the word "tax" is "an enforced exaction that reduces the profits of the taxed enterprise."127 Although this definition is neutral in terms of the government's approval or disapproval of the enterprise which it is taxing, this definition highlights an important point that this Note seeks to emphasize: taxation reduces the taxpaver's profits. By taxing the embezzler. the government is reducing the embezzler's profits and leaving less money that can compensate his victims. This Note asserts that the problem of reducing the funds available to victims from which they will be compensated far outweighs the problem of allowing embezzlers to escape taxation on a potential "gain," especially considering that embezzlers may have spent the majority or all of the money.

When the Court determined in *James* that embezzled money constituted taxable income, it was not without opposition, and the dissent recognized that when then the government took its cut before the victims receive restitution, there was a greater potential for harm to the victims. <sup>128</sup> As Justice Black opined, "to the extent that the government could be successful in collecting some taxes from embezzlers, it would most likely do so at the expense of the owner whose money had

<sup>&</sup>lt;sup>125</sup> James, 366 U.S. at 221.

<sup>&</sup>lt;sup>126</sup> Libin & Haydon, *supra* note 13, at 438 (observing that, under *James*, "the possibility now exists that the Government may get a share of the funds ahead of the victim").

<sup>&</sup>lt;sup>127</sup> Bittker, *supra* note 110, at 145.

<sup>&</sup>lt;sup>128</sup> See James, 366 U.S. at 229-30 (Black, J., dissenting).

been stolen." This mirrored the Wilcox Court's opinion that "[s]anctioning a tax under the[se] circumstances ... would serve only to give the United States an unjustified preference as to part of the money which rightfully and completely belongs to the taxpayer's employer."130 Justice Black recognized that embezzlers generally did not have a lot of money and an attempt to obtain taxes from embezzlers would be futile. 131 He analyzed the situation in James and found it unlikely that the government would be able to collect the large amount for which it taxed the embezzler, especially considering "the meager settlements that those defrauded were apparently compelled to make with the embezzlers." This problem was especially apparent in McKnight, in which the IRS assessed additional tax liability for the embezzler based on the \$135,000 that he embezzled, though the embezzler's estate only consisted of assets in the amount of \$6,000, and the bank had only been able to recover \$37,000 and a \$25,000 official bond from the embezzler's administrator. 133 The embezzlement victim had only been able to collect less than half of the amount that was illegally taken from it, and considering only \$6,000 remained in the embezzler's estate, the victim would unlikely be able to recover the additional \$73,000 that was taken. 134 Yet, the government sought to tax the embezzler for the full amount embezzled, despite the fact that only \$6,000 remained in the embezzler's estate and the victims had not been fully compensated. 135 Assuming even a meager 10% tax bracket, the embezzler's estate would not have enough to cover the full tax liability and the government would take possession of the full \$6,000 remaining, which would be to the victim's detriment as the victim had not already been fully compensated.

Another reason why Justice Black supported exempting embezzled funds from taxation was because "with the strong lien provisions of the federal income tax law an owner of stolen funds would have a very rocky road to travel before he got back, without paying a good slice to the Federal Government, such funds as an embezzler who had not paid the tax might, perchance, not have

<sup>&</sup>lt;sup>130</sup> Commissioner v. Wilcox, 327 U.S. 404, 410 (1946).

<sup>&</sup>lt;sup>131</sup> James, 366 U.S. at 229 (Black, J., dissenting).

<sup>&</sup>lt;sup>133</sup> McKnight v. Commissioner, 127 F.2d 572, 573 (5th Cir. 1942).

<sup>&</sup>lt;sup>135</sup> *Id*.

dissipated." <sup>136</sup> As previously discussed, there are some who take issue with this argument that tax liens could harm the victims and those individuals argue that the government will not be able to take priority over the victims with respect to the embezzled money because the government cannot secure a lien over the embezzled money, as it is not actually the embezzler's property. 137 However, this logic is flawed in that it fails to consider that the government still might secure a lien over the embezzler's legitimate property, which would give the government a secured claim and priority over the victim's unsecured claim against the embezzler. 138 A secured claim is "[a] claim held by a creditor who has a lien or a right of setoff against the debtor's property." 139 This would mean that the government would have priority in collecting before the embezzlement victims were able to collect. 140 Even though the government might not be taking money directly from the pool of embezzled money when it attaches the embezzler's property with a lien, it is still decreasing the available funds that an embezzler has, which makes it harder for the embezzlement victims to receive compensation.

Gilbert provides one example of a situation where the government obtained a tax lien over the embezzler's legitimate property, and doing so was at the expense of the embezzlement victims. <sup>141</sup> In *Gilbert*, the embezzler repaid his employer by providing it with a promissory note that was "secured by an assignment of most of his property," but the employer "failed to file the assignment from Gilbert because of the real estate filing fee involved." When the IRS filed tax liens against the embezzler for reasons unrelated to the embezzlement, the embezzler's employer "found itself subordinate in priority to the

<sup>&</sup>lt;sup>136</sup> James, 366 U.S. at 229 (Black, J., dissenting).

<sup>&</sup>lt;sup>137</sup> See Libin & Haydon, supra note 13, at 439-40.

<sup>&</sup>lt;sup>138</sup> Wordal, *supra* note 47, at 152.

<sup>&</sup>lt;sup>139</sup> BLACK'S LAW DICTIONARY 302 (10th ed. 2014).

<sup>&</sup>lt;sup>140</sup> See Bittker, supra note 110, at 147 ("Even if the [embezzled money] cannot be traced [back to the victims] . . . , 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. 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 . . . .").

<sup>&</sup>lt;sup>141</sup> See Gilbert v. Commissioner, 552 F.2d 478, 480 (2d Cir. 1977).

<sup>&</sup>lt;sup>142</sup> *Id.* at 479-80.

IRS."<sup>143</sup> As a result, the employer was not able to recover the amount that it should have received under the promissory note and the tax court determined that the embezzler had realized income.<sup>144</sup> While this situation is distinguishable in that the government obtained the tax liens for reasons unrelated to the embezzlement, it highlights the power that the government has in enforcing tax liability and the potential impact that it can have on victims of embezzlement. Here, because the employer failed to secure its claim against the embezzler by filing the assignment, the government was able to gain priority over the employer in its claim against the embezzler. Although situations where the government's claims have priority over the victims' claims may be unavoidable under the current taxation model,<sup>145</sup> this Note seeks to eliminate the *Gilbert* situation by affording priority to victims of embezzlement. The following section further analyzes this topic.

# VI. Reforming Current Tax Law: Creating a System That Prioritizes Victims

This Note has stressed that the tax on embezzled funds should be eliminated because taxing embezzled funds harms the victims and is thus against public policy. In addition to the public policy reason why the tax on embezzled income should be eliminated, there is also a reason based on efficiency. Taxing an embezzler in the year in which he realizes a gain poses a problem when the embezzler later repays the amount to the victims because, "[u]nder [a coherent tax] system, an embezzler would be permitted to reduce his taxable income by the amount of money repaid." This creates complications that could be avoided by eliminating taxation of embezzled money, which would be more efficient. Ending the taxation of embezzled money would also eliminate the inefficiencies associated with ensuring compliance with

<sup>&</sup>lt;sup>143</sup> *Id.* at 480.

<sup>&</sup>lt;sup>144</sup> *Id*.

One manner in which the embezzlement victims could ensure that their claims against the embezzler would not be subordinated to a government claim is by "extract[ing] from the embezzler a promise to repay, secured by a mortgage or pledge, or obtain[ing] an outright transfer of property in satisfaction of the embezzler's obligation before notice of the tax lien is filed." Wordal, *supra* note 47, at 152. However, if the embezzlement victims are unable to settle with the embezzler in a manner that provides them a secured claim, "the notice of the tax lien would probably be filed long before a judgment could be obtained, giving the tax lien priority." *Id.*146 Manicke, *supra* note 121, at 595.

the Tax Code. Given that the embezzler has already demonstrated his willingness to break the law, is the threat of an IRS investigation enough to make the embezzler report his illegal embezzled income, as the Tax Code requires? If embezzled money is taxable, the government will have to shoulder the costs of ensuring that the embezzler accurately reports the amount that he illegally took, which will expend government resources in an inefficient manner. 147 It would be inefficient because "the Treasury [would] 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." 148 Some would suggest that, "[t]hough 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." However, does it follow that a taxpaver who is undeterred by the law in committing illegal activity would nonetheless be deterred by a potential run-in with the taxman? The idea that the tax consequences of failing to report one's illegal income would deter a law-breaking taxpayer seems even more ridiculous when considered in light of the fact that reporting illegal income will then subject the taxpayer to criminal liability.

Another reason, briefly mentioned in Part IV, for eliminating the taxation of embezzled funds is that it is unfair to the embezzler to be taxed on money that he is legally required to return. This Note, although not subscribing to this rationale, recognizes that there is support for eliminating the tax on embezzled funds on the basis that, by taxing the embezzled money, the government imposes a double punishment on the embezzler. The embezzler faces a "Catch-22" situation in that he can either (1) report the amount embezzled as income and face criminal liability for his illegal activity or (2) fail to report the amount embezzled and face liability for noncompliance with

<sup>&</sup>lt;sup>147</sup> See Bittker, supra note 110, at 139 ("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.").

<sup>&</sup>lt;sup>148</sup> *Id*.

<sup>&</sup>lt;sup>149</sup> *Id.* at 142.

<sup>&</sup>lt;sup>150</sup> See Blum, supra note 15, at § 16[a] ("Embezzlement defendants could be ordered . . . to make restitution to their victims in the amount of the actual loss caused by their criminal conduct.").

<sup>&</sup>lt;sup>151</sup> DePass, *supra* note 80, at 779.

the Tax Code.<sup>152</sup> As a result, taxing the embezzled income fails to effectuate the fair outcome that the government supposedly seeks to establish, at least with respect to embezzlers.<sup>153</sup> While acknowledging this as a legitimate position, this Note is unsympathetic to the embezzler who has illegally taken money from his victims and does not base its conclusion that embezzled money should not be taxable in any way on the potential punitive effect taxing the embezzled money may have on the embezzler.

In sum, fairness demands that the victims of embezzlement be given priority in their efforts to seek restitution for the money that was illegally taken from them. In order to give the victims priority, the government must stop taxing embezzled funds to the embezzler, with one qualification for embezzlers who have settled for an amount less than the full amount embezzled. While the government has demonstrated a willingness to treat victims of financial fraud favorably at the expense of generating revenue, 154 the government notably excluded from such favorable treatment the victims of embezzlement. The government should take this a step further, extending the favorable treatment to victims of embezzlement in an effort to ensure that the government does not play a role in further harming embezzlement victims. Exempting an embezzler from taxation with respect to the embezzled money is not inequitable because doing so affords the embezzler's victims a greater chance of receiving restitution. Although the government takes a benign approach to the taxation of embezzled money, when taxing the embezzled funds has an adverse effect, or even the possibility of having an adverse effect, on the victims, the government must consider the implications of continuing to tax the embezzled money. Failing to do so puts the government in the position of

<sup>&</sup>lt;sup>152</sup> Suellen M. Wolfe, *Recovery from* Halper: *The Pain from Additions to Tax Is Not the Sting of Punishment*, 25 Hofstra L. Rev. 161, 171 (1996); *see also* Adam Winkler, *Heller's Catch-22*, 56 UCLA L. Rev. 1551, 1552 (2009) (explaining that "[t]he notion of a Catch-22 has since [publication of Joseph Heller's novel by that name] become famous as an idiom representing a nowin situation built on illogic and circular reasoning"). For a discussion of a way to eliminate the embezzler's Catch-22 situation, see Leo P. Martinez, *Federal Tax Amnesty: Crime and Punishment Revisited*, 10 VA. TAX Rev. 535, 561 (1991) ("[A] taxpayer whose income is derived from illegal means may have civil and criminal tax penalties absolved by the tax amnesty but would remain theoretically liable for the substantive crime.").

<sup>&</sup>lt;sup>153</sup> DePass, *supra* note 80, at 781-82.

<sup>&</sup>lt;sup>154</sup> See Rev. Rul. 2009-9, 2009-14 I.R.B. 735, 735; supra Part IV (discussing tax treatment of Ponzi scheme victims).

increasing the difficulties that embezzlement victims have to deal with as a result of the embezzlement, which is against public policy.

#### VII. Conclusion

Under the current tax system, the government is able to tax an embezzler in the year in which he realizes income from the embezzlement, 155 regardless of whether his victims have first received compensation for their losses. Some argue that the current system is inconsequential for the victims, taking issue with Justice Black's suggestion in his James dissent that a tax lien over the embezzler's property would allow the government to impede the embezzlement victims' ability to receive restitution. 156 Such individuals argue that the embezzled money belongs to the victims, rather than the embezzler, so "the embezzler has no interest to which the tax lien may attach, [and] those funds cannot be taken for payment of the embezzler's taxes." Thus, the government does not have the ability to secure a lien over the property that was wrongfully obtained. Summarizing the reasons discussed in Part VI, the government still has the ability to harm the victims in that the government can obtain a secured claim by attaching a tax lien to the embezzler's rightful property. 158 The argument that embezzlement victims are not harmed in a system where the government taxes embezzled funds is flawed because it ignores the fact that the government is still able to obtain a lien, just not over the embezzled money itself, and the victims' ability to receive priority in a situation where the government obtains a lien depends upon the victims' ability to secure priority over the government's claim, which is not guaranteed to occur in every situation. 159 The only way that the victims will be unharmed by the government attaching a lien to the embezzler's property is if the victims first settle with the embezzlers utilizing a settlement that provides them a secured claim. 160 In situations where the victims are

<sup>&</sup>lt;sup>155</sup>James v. United States, 366 U.S. 213, 219-20 (1961).

<sup>&</sup>lt;sup>156</sup> See Wordal, supra note 47, at 152.

<sup>&</sup>lt;sup>157</sup> *Id.* (footnote omitted).

<sup>&</sup>lt;sup>158</sup> See id. ("Where the embezzler has property of his own to which the tax lien may attach, the victim will find his prior unsecured claim for repayment subordinated to the Government's secured tax claim." (footnote omitted)).

<sup>&</sup>lt;sup>160</sup> See id. ("Since the victim is usually the first to learn of the embezzlement he may be able to extract from the embezzler a promise to repay, secured by a

not able to reach a settlement with the embezzler, they will undoubtedly be harmed by the government's prioritized claim, given that embezzlers generally are not rich individuals and the government's claim will likely deplete the pool of funds from which the victims could receive restitution. <sup>161</sup>

The current system should be reformed so that embezzlement victims are able to receive prioritized claims, having a right to restitution before the embezzled funds are subject to taxation. Subjecting unlawful income to taxation is not against public policy in most situations—for example, a drug dealer who realizes gains from his illegal enterprise<sup>162</sup>—but when "the government's tax claim to the lawbreaker's assets [is] preferred over the right of his victims to be reimbursed by him for their losses," as is the situation with embezzled funds, that is against public policy because it places the governments interests both at odds with and above the victims' interests. 163 When there is a case of embezzlement, the victims have suffered financially and face an uphill battle to be compensated for their losses, so while this Note does not contradict the government's right to tax income, it takes issue with the government's ability to tax embezzled income, given that doing so is at the expense of the embezzlement victims. Embezzlement is a situation where the government's taxation rights should be eliminated so that the victims will have the best chance possible to be fully compensated for their loss. 164

This Note does, however, recognize one situation in which the proposed rule that embezzled money is not taxable as income should be qualified. When the embezzler obtains a settlement with his victims that comprises less than the amount he originally stole, the government should be allowed to tax the embezzler on the difference between the amount embezzled and the amount that he repaid to the victims. By settling with the victims in a manner that allows the embezzler to

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mortgage or pledge, or obtain an outright transfer of property in satisfaction of the embezzler's obligation before notice of the tax lien is filed.").

<sup>&</sup>lt;sup>161</sup> See James v. United States, 366 U.S. 213, 228 (1961) (Black, J., dissenting) ("[H]istory probably records few instances of independently wealthy embezzlers who have had nonstolen assets available for payment of taxes.").

<sup>&</sup>lt;sup>162</sup> Unlike the embezzler, the drug dealer does not misappropriate money. Rather, the drug dealer sells drugs in exchange for money. Accordingly, there is no "victim" that needs protection.

<sup>&</sup>lt;sup>163</sup> Bittker, *supra* note 110, at 147.

<sup>&</sup>lt;sup>164</sup> See supra Part VII.

escape the obligation to *fully* repay the victims, <sup>165</sup> the embezzler has realized a gain and should be taxed on that amount, regardless of whether he has already spent the money. Put another way, in settling with the victims for less than the full amount, the embezzler has managed to discharge his indebtedness to the victims, which is cognizable income subject to taxation under the Tax Code. <sup>166</sup> In such a situation, the embezzler should be taxed on the difference between the amount embezzled and the amount repaid to the victims in the year in which he settles with his victims. In any other situation, the embezzler has not realized a gain, and thus does not have income because he has not been relieved of his obligation to repay the victim. As a general rule, therefore, Congress should eliminate taxation of embezzled funds because fairness demands that embezzlement victims receive priority as they seek restitution.

<sup>165</sup> See supra Part III. Frequently the embezzler has already spent a large portion or all of the money by the time the victims discover that their money has been embezzled. By settling with the embezzler for less than was originally taken, they are at least able to ensure that they do not suffer a complete loss. Further, when the discovered embezzler is knowingly facing potential criminal charges and civil action by the IRS, is he likely to agree to repay the full amount if he still has it? The embezzler will still have to fund all of his legal struggles.

<sup>166</sup> I.R.C. § 61(a)(12) (2012) ("[G]ross income means all income from whatever source derived, including . . . [i]ncome from discharge of indebtedness . . . .").