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COMMENTS

CONGRESS OR THE COURTS AS FINAL ARBITER IN TAX DISPUTES?

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During the last two years the Supreme Court of the United States has handed down only five income tax opinions. The box score stands four for the Government, one for the taxpayer. None of the cases involved modifications in fundamental concepts of tax law or resulted in major policy changes in the administration of the fiscal system. The record for the taxpayer is far more impressive in the Congress than it is in the courts. As will be pointed out later Congress rather than the Supreme Court is tending to become the final arbiter in tax disputes. Problems that were traditionally solved by the judiciary are more and more being solved by Congress and this shift has not hurt the taxpayer.

The Concept of Taxable Income

There has never been a precise, all-inclusive definition of taxable income. Section 22 of the Code defines income as "gains, profits or income." Thus the definition contains the very word to be defined. An early Supreme Court case, *Eisner v. Macomber*,[1] gave us what has become a working concept. It defined income as "Gain derived from capital, from labor or from both combined."[2] This statement has been incorporated in the regulations[3] and continues to be the closest approach to a definition that we have. While winnings on radio contests have long been regarded as taxable income, the Tax Court refused to tax an award made on the Pot O' Gold program.[4] There the taxpayer received $1,000 simply because he happened to be at home when his telephone rang. He employed no capital, he rendered no service. This, thought the court, was different from making a fool of oneself for a contingent fee on Groucho Marks' program.

Borrowed money is not income. There is no gain. It may later become income if the debtor compromises the claim for less than the full amount,[5] or the statute of limitations bars a recovery.[6] Similarly the finding of money or property does not result in taxable income since the finder is a bailee. On the same reasoning the Supreme Court held

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1. 252 U.S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521 (1920).
2. *Ibid.*
3. U.S. Treas. Reg. 111, § 29.22(a) (1) (1943).
4. Pauline C. Washburn v. Comm'r, 5 T.C. 1333 (1945).
5. Comm'r v. Jacobson, 336 U.S. 28, 69 Sup. Ct. 358, 93 L. Ed. 477 (1949).
6. Securities Co. v. United States, 85 F. Supp. 532 (S.D.N.Y. 1948).

that stolen money was not subject to the tax.[7] The thief gets no title. He is like the borrower and the finder. On the other hand the fact that money or property has been illegally obtained does not prevent its being income. Thus the proceeds from gambling, from the operation of a bucket shop, and other unlawful occupations have always been subject to tax.[8]

The Tax on Ill-Gotten Gains

It is well settled that if I steal a diamond ring I have no income. What if I obtain it by fraud? What if I trick a widow into exchanging a diamond ring for some worthless oil stock? In *Rutkin v. United States,*[9] the taxpayer, an underworld trigger-man, became associated with a group of bootleggers in 1929 in an operation known as "High Seas Venture." He contributed no capital but received a share in the profits because his associates were fearful that otherwise they would have "trouble and interference." In 1933, with the end of prohibition, his associates turned honest and formed a company to carry on a legitimate liquor business. They attempted to exclude Rutkin but he claimed a vested right to the same proportionate share in the new venture that he had in the old. His associates finally paid him $60,000 for his alleged claim, taking a formal assignment of his interest, if any. But hoodlums are not thus easily bought out. Through the years with a nice disregard for the document of assignment he insisted he was still "in." His insistence took the form of threats that he would kill members of the family of the principal stockholder if his claims were ignored. Over the years he was paid more than $750,000. Were these receipts taxable income or were they, as the taxpayer contended, tax exempt like stolen money? The Supreme Court reaffirming the traditional distinction between void and voidable transactions held that money obtained through extortion was income. It is true that an action could have been brought to recover these sums. But meanwhile he had the funds under a claim of right. He was not indebted like the borrower, the finder or the thief. The money was his until a court of equity should avoid the transaction.

The Requirement of an Annual Accounting Period

One wonders why the Supreme Court agreed to hear the *Rutkin* case. Less than a year earlier it had affirmed the claim of right doctrine in a more conventional controversy. In *Lewis v. United States,*[10] the taxpayer had reported and paid tax on an employee-bonus of

7. Comm'r v. Wilcox, 327 U.S. 404, 66 Sup. Ct. 35, 90 L. Ed. 413 (1946).
8. United States v. Sullivan, 274 U.S. 259, 47 Sup. Ct. 607, 71 L. Ed. 1037 (1927).
9. 343 U.S. 130, 72 Sup. Ct. 571 (1952). For a detailed discussion of this case, see *infra,* at XXX.
10. 340 U.S. 590, 71 Sup. Ct. 522, 95 L. Ed. 560 (1931).

$22,000. As a result of subsequent litigation in a state court, it was found some two years later that the bonus had been improperly computed and he was required to repay $11,000 to his employer. Lewis' claim for a refund was denied. The Court held that the full amount of the bonus received was income in the year received, suggesting that he was entitled to a deduction in the year of repayment. But in the later year his income may have been less, tax rates may have been reduced and, if the year of repayment had happened to be after 1948, the split income tax provisions[11] would have greatly curtailed the value of the deduction.

It is not, however, practical to wait until a man dies and then cast up his life's income and assess the tax thereon. Considerations of a sound fiscal policy dictate that income taxes be collected on a yearly basis. The unfairness resulting from the requirement of an annual accounting period has to some extent been corrected by remedial legislation. Section 107 of the Code permits prorating earnings received in one year for services rendered over a period of 36 or more months. It takes care of lawyers, authors, composers, and others whose income is likely to be "bunched" in a single year. The capital loss carry-over,[12] the business loss carry-back and carry-forward,[13] the instalment sale provision[14] and the completed contract method of accounting,[15] are illustrations of legislative compromises to avoid the rigors of the yearly accounting requirement. Perhaps there should be a carry-back and carry-forward rule for individual as well as business losses.

Contest Winnings

In *United States v. Robertson*,[16] the Court had an opportunity to clarify the confused area between gifts and taxable income — an area in which the lower courts, Commissioner and taxpayers alike had long floundered. But the opinion, as is not uncommon with recent Supreme Court opinions, unsettled much more than it settled. A Detroit philantropist, president of the Detroit Orchestra, Inc., offered $25,000 for the best musical composition submitted by an American composer. The winner was required to grant to the Detroit Orchestra Inc. all synchronization rights for motion pictures and mechanical rights for phonographic recordings, electrical transcriptions and music rolls. Robertson submitted a composition and was awarded $25,000.

Tips, bonuses, pensions, radio and newspaper contest prizes have always been considered as taxable income.[17] Even though characterized

11. INT. REV. CODE § 51 (b).
12. *Id.* § 117 (e) (1).
13. *Id.* § 44.
14. *Ibid.*
15. U.S. Treas. Reg. 111, § 29.42-4 (1943).
16. 343 U.S. 711, 72 Sup. Ct. 994 (1952).
17. Cesanelli v. Comm'r, 8 T.C. 776 (1947); *cf.* McDermott v. Comm'r, 150 F.2d 585 (C.A.D.C. 1945).

as gifts they are given in recognition of services rendered and so are taxable. On the other hand the pure gift is exempt. Nobel prize winners, Rhodes Scholars and recipients of college scholarships have in the past enjoyed tax exemption.[18] In *McDermott v. Commissioner*,[19] the Ross prize, a $3,000 award by the American Bar Association, was given in 1939 to a Duke law professor in recognition of an outstanding paper on Administrative Law which he had submitted to the committee. The Court of Appeals held the award exempt as a gift. On the taxable side of the line was a payment of $25,000 by the Pabst Brewing Company for the best essay on Post War Employment.[20] The Supreme Court could have decided the *Robertson* case on the theory that the donor was buying something, Robertson was selling something. This was the recognized distinction between the Ross prize and the Pabst Brewing award. McDermott did not sell anything to the Bar Association. The Bar Association did not buy anything from McDermott. Pure scholarship was being fostered. The Pabst payment, on the other hand, was tainted with commercialism. The tax bar had generally understood the distinction to be whether the award resulted from a philanthropic or commercial transaction. But the Supreme Court in a very unsatisfactory opinion taxed Robertson on the ground that a binding contract resulted from an offer and acceptance. Therefore, argued the Court, the payment could not have been a gift. To what extent this will affect scholarships to students and stipends to scholars and scientists, where the recipients are selected on a competitive basis, must await further clarification by the Court. It seems clear, however, that the rationale of this opinion has materially curtailed the area of tax exempt awards.

Deductions

Income tax deductions fall into three classifications — business, nonbusiness and personal. Reasonable and necessary business expenses as contrasted with capital expenditures are deductible.[21] So are nonbusiness expenses if incurred in the production of income or in the management, conservation or maintenance of income producing property.[22] In addition a few arbitrary expenses and losses are allowed even though unrelated to business or to the production of taxable income such as interest payments, taxes, charitable gifts, extraordinary medical expenses, alimony and losses through theft, storm, fire or casualty.[23] All other personal, living and family expenses are specifically excluded.[24]

18. *Cf.* GCM 5881, VIII-I CUM. BULL. 68 (1929).
19. 150 F.2d 585 (D.C. Cir. 1945).
20. Herbert Stein v. Comm'r, 14 T.C. 494 (1950).
21. INT. REV. CODE § 23(a) (1).
22. *Id.* § 23(a) (2).
23. *Id.* § 23.
24. *Id.* § 24(a).

Certain illegal expenses have long been disallowed by regulations and court decisions. Bribes to Congressmen,[25] payments to stay the hand of law enforcement officers[26] and payments to labor racketeers[27] are disallowed in computing net income on the theory that such expenses are contrary to public policy. Where to draw the line had long troubled the courts. It is clear that income from illegal operations is taxable. Bootleggers, gamblers and others operating outside the law have been careful not to run afoul of the Treasury. A gambler may gross $100,000 but only net $50,000. He will have rent, office and travel expense as well as "protection" costs. To disallow all his expenses would frequently, at our present high rates, impose a tax considerably in excess of his net. To avoid this dilemma a practical line has been drawn which is best expressed by saying that the legitimate expenses of an illegitimate business are deductible.[28]

Opticians' Kickbacks

In *Lilly v. Comm'r*,[29] the Court held that payments by an optician to doctors of one-third of the retail sales price received by the optician from patients sent by doctors were properly deductible. This result seems sound, even though from time immemorial such practices have been regarded as against public policy and therefore illegal. The Court frowned upon the Commissioner's setting himself up as a guardian of the public morals. In view of recent developments within the Treasury Department, the Court would appear to have exhibited rare and unusual foresight.

Legal Fees not Always Deductible

On the same day the Court rendered the *Lilly* decision, it decided a case involving the deductibility of legal fees adversely to the taxpayer.[30] One Lykes had reported taxable gifts of stock at what the Commissioner determined to be a substantial under-valuation. Lykes employed counsel to contest the Commissioner's action in increasing the amount of the gifts and consequently the amount of the tax. The issue was compromised at a very material saving to the taxpayer. He then claimed the right under section 23 (a) (2) to deduct the attorneys fees incurred in settling this dispute. This provision permits the deduction of nonbusiness expenses incurred in the production of income or in the management, conservation or maintenance of income producing property. It is clear that legal fees in the defense of a personal injury suit are not deductible. They are personal expenses, disallowed

25. Alexandria Gravel Co. v. Comm'r, 95 F.2d 615 (5th Cir. 1938).
26. Maddas v. Comm'r, 40 B.T.A. 572 (1939).
27. Excelsior Baking Co. v. United States, 82 F. Supp. 423 (D. Minn. 1949).
28. SURREY AND WARREN, FEDERAL INCOME TAXATION 173 (1950).
29. 343 U.S. 90, 72 Sup. Ct. 497 (1952).
30. Lykes v. United States, 343 U.S. 118, 72 Sup. Ct. 585 (1952).

under section 24(a). On the other hand legal fees paid for income tax advice or for advice concerning mortgage investments are deductible.[31] These fees are incurred in relation to the management of income producing property. Lykes' difficulty was that he no longer owned the property over which the dispute arose and the argument that any reduction in tax would result in the conservation of his property seems untenable. The defense against liability for gift tax no more relates to the conservation of income producing property than does the defense of any personal tort action.

Conclusion

In the last two years we have had only five opinions in income tax cases — none of them touching on basic issues of national importance. The extortion and excessive compensation opinions followed well-settled principles. While the prize case dealt with a small area of the law in which there was considerable uncertainty it unsettled much more than it settled. Again the deduction cases followed expected lines. The selection of cases leaves much to be desired. But the fault may be with our system and not with the Court. We expect it to have expertness in too many complex and unrelated fields of law — Admiralty, Patents, Bankruptcy, Labor, Anti-trusts and Corporate Reorganization, to mention but a few. The members of the Court cannot conceivably keep abreast with the developments in all these fields. They cannot hope to have an awareness of the policy considerations that should enter into the granting or denying of certiorari. What we need, at least in some of these highly technical areas of the law, is a series of appellate courts, each of which could develop expertness in a particular field. The only refreshing aspect of this problem is that, as always, the ingenuity of lawyers has found at least a temporary solution. Major interpretative problems and the clarification of existing law, a function traditionally performed by courts of last resort, is, in tax law, fast becoming a legislative function. More and more tax lawyers are seeking to persuade Congress to clarify the law, to finally determine the rule where the circuit courts are in conflict or to overrule unrealistic Supreme Court decisions.

When the Supreme Court startled the business world with its decision in *Commissioner v. Smith*,[32] holding that the entire profit on the exercise of a stock option by a corporate executive was taxable as ordinary income in the year the option was exercised rather than as a capital gain when and if the stock were sold, hundreds of executives holding options rushed to their Congressmen. Rather than argue in the courts for a narrow intepretation of the *Smith* doctrine, their

31. T.D. 5513, 1946-1 CUM. BULL. 61.
32. 324 U.S. 177, 65 Sup. Ct. 591, 89 L. Ed. 830 (1945).

lawyers drafted a workable rule and persuaded the Congress to make it law.[33] After the Supreme Court, first in the *Tower* case[34] and then in the *Culbertson* case,[35] unsettled the family partnership tax status to the bewilderment of Tax Court, Treasury lawyers and the tax bar, alike, it was Congress which gave us a workable rule fashioned after the principles applicable to the family corporation.[36] For years lawyers were afraid of partial stock redemptions to pay death taxes. The lower court cases gave no comfort. Rather than assume the delays and risks involved in appealing to the Supreme Court, tax lawyers sought and obtained adequate relief from Congress.[37] One of the vexing problems over the years has been the distinction between ordinary income and capital gain, the most recent version of this long dispute being the sale of land with growing crops. Here again the taxpayers' lawyers found it easier and more advantageous to seek Congressional rather than judicial relief.[38] The tax on a gain from involuntary conversion — destruction, theft or condemnation — has long been postponed if the taxpayer invested the funds received on the conversion in other property related in service or use.[39] Court decisions held that the taxpayer in order to get the benefit of this provision of the Code had to use the very money received on account of the involuntary conversion. For example, in the case of a fire, he had to use the very proceeds received from his insurer. If he borrowed money in advance of settling with his insurer and used these funds for the replacement the section was held not to apply.[40] This was a literal but absurd interpretation. Again, instead of going to the Supreme Court for a sensible interpretation, Congress was persuaded to amend the Code to remove these absurd judicial and administrative restrictions.[41] These are but a few illustrations of the fact that more cases are being won by taxpayers in the Congress than in the Court.

33. INT. REV. CODE § 130(a).
34. Comm'r v. Tower, 327 U.S. 289, 66 Sup. Ct. 532, 90 L. Ed. 670 (1946).
35. Comm'r v. Culbertson, 337 U.S. 733, 69 Sup. Ct. 1247, 93 L. Ed. 1686 (1949).
36. INT. REV. CODE § 191.
37. *Id.* § 115(g).
38. *Id.* § 117(j).
39. *Id.* § 112(f).
40. Kennebec Box and Lumber Co. v. Comm'r, 68 F.2d 646 (1st Cir. 1948).
41. INT. REV. CODE § 112 (4).