Of Time and Up the River: Criminal Restitution and the Annual Accounting System

By JOEL S. NEWMAN *

The author addresses the legal issues of whether, as a matter of law, Sections 172 and 1341 are applicable to deductions for criminal restitution payments, with or without the public policy doctrine. He sees no reason to treat the payments any differently where the original income was illegally earned.

Transactions that give rise to taxable income have no more than a random relationship to the calendar. Such transactions may commence at any time and may come to fruition at any time, irrespective of the boundaries of months, calendar years, and fiscal periods. Yet, the Supreme Court has stated:

...it is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practicable operation.¹

Thus, the “annual accounting system” has imposed a rigid tax year grid upon the timing happenstance of income-producing transactions. Income or loss must be reported at the end of each tax year, whether or not the given transaction has come to fruition.² In a transaction that spans more than one tax year, for example, an excess of in-

*As we go to press, the Fifth Circuit Court of Appeals has affirmed the District Court’s opinion in McKinney (mentioned throughout this article) as to Section 1341, Docket No. 76-4260, filed June 13, 1978. The taxpayer abandoned his Sec. 172 argument before the Fifth Circuit.

²See 1954 IRC Sec. 441 (hereinafter all references to Code sections will be to the Internal Revenue Code of 1954).

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come over deductions at the end of the first tax year will give rise to taxable income, even if it later appears that the entire transaction is a net loss. The result, given the progressive rate structure, can be a distortion in the timing and in the practical effect of income and deductions in multi-year transactions.

The distortion of the annual accounting system is mitigated for most taxpayers by statutory provisions, such as the net operating loss carryback, income-averaging, and the “claim of right” adjustment. Clearly, a legislative or judicial refusal to apply the benefits of these mitigating provisions across the board can give rise to significant distortion and injustice to those taxpayers who are left out. Such discrimination should not be countenanced without a strong showing that it has a rational basis. It is submitted that no such rational basis has been shown by recent decisions denying the benefits of these statutory sections to criminal restitution payments.

**Facts in McKinney**

A review of the facts and reported testimony of *McKinney v. United States* will delineate the nature of the problem. According to the reports, Herman McKinney embezzled between $1,000 and $2,000 from a high school concession operation while he was a high school student; embezzled $58,000 from his employer in 1956, and, after ten years of planning, embezzled an additional $91,702.06 from the same employer in 1966. Upon the authority of *James v. United States*, McKinney reported the $91,000 embezzlement upon his 1966 tax return and paid taxes thereon. In 1969, an IRS audit of McKinney’s 1966 return produced confessions of the embezzlement both to the IRS and to McKinney’s employer. As a result, McKinney was fired and convicted of embezzlement. Furthermore, in 1969, when his adjusted gross income was $12,964, he made full restitution of $91,000 of embezzled funds to his employer. As a result, McKinney paid taxes in 1966 on $91,702.06 of embezzlement income and had a deductible criminal restitution expense of the same amount in 1969. However, because his 1969 income was only $12,964, over $78,000 of his original restitution deduction was wasted in 1969.

McKinney claimed a refund of his 1966 taxes, arguing that his embezzlement activities constituted a trade or business so that a Section 172 net operating loss carryback would be applicable, or, in the alternative, that his 1966 income was subject to a Section 1341 adjustment. As to Section 172, the court held on the facts that, in spite of the alleged years of work and planning culminating in the three embezzlements, McKinney’s reported embezzlement activities were more than an “occasional lark,” not sufficient to constitute the required “trade or business.” Furthermore, the court held as a matter of law: “embezzlement is not a trade or business for § 172 purposes” and “an embezzler is not entitled to the benefits of § 172 when embezzled funds are repaid.” As to Section 1341, the court held it inapplicable because the embezzled funds had not been held under a claim of right.

If McKinney’s case is at all atypical, it is probably so only in that McKinney had the wherewithall to make full restitution as soon as he was caught. Otherwise, his predicament is probably quite common. Embezzlers normally do not make restitution until they are caught. Being caught probably usually leads to being fired, and being fired leads to a low-income year. Therefore, the year in which criminal restitution is made is probably usually a low-income year, in which the restitution deduction exceeds the otherwise taxable income. Accordingly, the nature and extent of the tax distortion suffered by McKinney is probably the norm among those making criminal restitution payments. It is submitted that this distortion is justified neither by Sections 172 and 1341, nor by the public policy doctrine.

**Section 172**

Should criminal restitution payments be deductible losses for the purposes of Section 172, or must the holdings of *McKinney* and *Hankins v.*
United States 18 be accepted that Section 172 is not applicable to criminal restitution payments?

The threshold question is the general deductible of such losses. The losses are clearly deductible pursuant to Section 165(c)(2), which allows the deduction of losses incurred in any transaction entered into for profit, though not connected with a trade or business. However, one might ask if the treatment of such restitution payments as a “deductible expense” is not a misnomer. Conceptually, a deductible expense of producing income ought to be an expense that was intended to generate income. Repayments can fit into this category. For example, when a retail store makes refunds to dissatisfied customers, it does so with the hope that its refund policy will generate more sales volume to other customers. However, it is a quantum leap from a retail refund policy to a compulsory restitution of all of the income earned from a for-profit transaction. Such criminal restitution is perhaps too drastic to be termed an “expense” of producing income; in fact, it is a virtual cancellation of the income realized from the activity. The contrast is more striking when it is realized that the very nature of the restitution makes it highly improbable that the same activity will ever be repeated by that taxpayer.

If criminal restitution is something more than an expense, then perhaps it deserves more than a deduction. If business expenses were non-deductible, then the tax would be computed on gross income, as opposed to net income. That is bad enough. 19 If restitution were non-deductible, then the tax would be computed on nonincome. That is worse. One might assume, therefore, that if the annual accounting system were ever to be disregarded in order to save a deduction, it would be disregarded in the area of criminal restitution. In fact, restitution is not a meanimgful category in terms of the net operating loss carryback. The crucial distinction is that between expenses attributable to a trade or business, which are eligible for the net operating loss carryback and others, which, essentially, are not. 20 The issue here is whether, as a matter of law, criminal activity can ever constitute a trade or business. Are McKinney and Hankins correct in that, as a matter of law, criminal activity can never be a trade or business? 21

The guidelines set forth in the Mertens treatises as quoted by the McKinney decision furnish a good general definition of “a trade or a business”:

Important considerations are (1) the continuity of the business (whether it is engaged in regularly or merely from time to time), (2) the amount of time and energy devoted thereto by the taxpayer, and (3) whether the taxpayer is engaged in earning a livelihood, in investment activities, in pursuit of pleasure, or an avocation. An isolated or occasional activity or transaction is not sufficient. 22 It should be noted that none of these considerations would eliminate criminal activity as a trade or business.

Another significant definition of “trade or business” is that which “involves holding one’s self out to others as engaged in the selling of goods or services.” 23 Under this definition, many criminals, including embezzlers and thieves, would be held not to be engaged in a trade or business. However, dope peddlers, usurious lenders, murderers for hire, prostitutes, and employees of organized crime syndicates clearly would be engaged in a trade or business. Therefore, neither

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18 Brief for the Appellee, footnote 9, at App. 6.
20 Id.
21 Id.
22 Id.
24 For an argument against the right and propriety of taxing gross income, see Griswold, “An Argument Against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace,” 56 Harvard Law Review 1142 (1943). See also, Herbert E. Thrall, CCH Dec. 31,211 (M), 31 TCM 22 (1972). In rejecting the government’s request to deny a Sec. 165(c)(1) deduction on public policy grounds for losses on uncollectible, usurious loans, the court noted: To deny a deduction in this case would come close to making this business taxable on the basis of gross receipts, while all other businesses would be taxable on the basis of net income.
25 Sec. 172(d)(4); Reg. Sec. 1.172-3(a)(3).
27 S. J. Mertens Law of Federal Income Taxation (1975) Sec. 29.06. The only weakness of the Mertens considerations is the reference to “earning a livelihood.”

This reference probably relies upon Flint v. Stone Tracy Co., 220 U. S. 107, 171 (1909), which mentioned this phrase, citing Bowter’s Law Dictionary. Reference to the definition of “business” in this dictionary (W. Baldwin, ed., Bowter’s Law Dictionary (student’s Ed. 1946) 143) reveals that the term was indeed defined as “that which occupies the time, attention and labor of men for the purpose of livelihood or profit…” However, the only citation in the dictionary for this definition is Harris v. State, 50 Ala. 127 (Sup. Ct. 1873), a case involving the prohibition of carrying on the “business” of retailing liquor without a license. Accordingly, there is no tax justification for the “livelihood” factor in Flint, and neither Flint nor the tax cases that followed it (Caroline T. Kissel, CCH Dec. 4921, 15 BTA 2370 (1929); Albert M. Briggs, CCH Dec. 2557, 7 BTA 409 (1927)) turned upon the presence or absence of a livelihood for their finding of the presence or lack of a trade or business. See, generally, Saunders, “Trade or Business; Its Meaning Under the Internal Revenue Code,” University of Southern California 12th Tax Institute 693
this definition nor the Mertens considerations would eliminate illegal activity across the board from the trade or business category.

The issue has not arisen often in the cases and rulings, apart from McKinney and Hanks.\textsuperscript{24} However, when it has arisen, there has been support for the concept of criminal activity as a business. In Herbert E. Tharp,\textsuperscript{25} the court held that losses on usurious loans were losses incurred in a trade or business pursuant to Section 165(c)(1) and noted, "There is nothing in section 165 requiring the taxpayer to be engaged in a 'legal' business to qualify for the statutory deduction."\textsuperscript{26} Dictum in Commissioner v. Sullivan\textsuperscript{27} recognized that gambling, whether legal or illegal, can be a business. The dissenting justices in Rutkin v. United States\textsuperscript{28} essentially urged that criminal activities should be scrutinized under the same guidelines as other activity; criminal activities regularly carried on are probably a trade or business, while those generating only "sporadic loot" are not. Moreover, the revenue rulings have specifically recognized that criminal activity can constitute a trade or business for the purposes of the Social Security Act.\textsuperscript{29}

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Therefore, the holdings of McKinney and Hanks that criminal activity is not a trade or business as a matter of law cannot be supported by the cases and rulings, either in terms of their specific holdings and dicta or their general definitional guidelines, nor can they be supported by logic. What support they can muster must come from the public policy doctrine, which will be considered below.

\section*{Section 1341}

Pursuant to Section 1341(a)(1), the benefits of Section 1341 apply only if "an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item." Reg. Sec. 1.1341-1(a)(2) clearly equates the statutory phrase "appeared that the taxpayer had an unrestricted right to such item" to the case-law concept of "claim of right". It is unclear whether or not this equation of the two phrases is sound.\textsuperscript{30} However, there is authority both for the proposition that Section 1341 is not applicable to criminal restitutions because the criminal income is not "claim of right" income, and for the proposition that Section 1341 is not applicable to criminal restitution because the income did not appear to be subject to the "unrestricted right" of the criminal recipient. It is submitted that both propositions are questionable.

\textbf{Claim of Right.}—The phrase "claim of right" first arose in North American Oil Consol. v. Burnet.\textsuperscript{31} The issue was the year in which disputed income should have been taxable to the company. Justice Brandeis commented, "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it still may be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.\textsuperscript{32}

The phrase was applied to illegal income in Commissioner v. Wilcox,\textsuperscript{33} a case involving embezzlement income. There, it was held that, since embezzled income is not received with any semblance of (1960); Groh "Trade or Business: what it means, what it is and what it is not," 26 Journal of Taxation 78 (1967).\textsuperscript{34} Deputy v. duPont, 401 U.S. 9161, 308 U.S. 488, 499 (Frankfurter, J., concurring).\textsuperscript{35} McKinney, cited at footnote 6; Hanks, cited at footnote 18.\textsuperscript{36} Case cited at footnote 19.\textsuperscript{37} 1d.\textsuperscript{38} 58-1 ustc \$ 9368, 356 U.S. 27.\textsuperscript{39} 52-1 ustc \$ 9200, 343 U.S. 130, 140-141.\textsuperscript{40} Rev. Rul. 60-77, 1960-1 CB 386. See, Alfred A. Gentile, CCH Dec. 33,446, 65 TC 1 (1975), appeal dismissed (4/9/76), criminal gambling activities were held not to be a trade or business for Social Security Act purposes. However, it was the passive, investment nature of the activity, and not the criminal nature, upon which the holding was based.\textsuperscript{41} But see Webster, "The Claim of Right Doctrine: 1954 Version," 10 Tax Lawyer Review 381, 387 (1955).\textsuperscript{42} 3 usct 943, 286 U.S. 417 (1932). The confusion surrounding "claim of right" is perhaps best expressed in the McKinney transcript:

McKinney: I now know in retrospect that the phrase "claim of right" was all fouled up in my mind and I didn't then know. I think I now know what "claim of right" means, but at that time I certainly did not know what the phrase "claim of right" means.

The Court: Would you mind telling us what it is?

McKinney: Claim of right—no, sir, Judge, please, sir.

Mr. Hearne: (attorney for McKinney): Wait a minute. Did you ask him?

The Court: Sure.

Hearne: He asked you.

The Court: He can tell us if he wants to. I haven't been able to find out what it is yet.

blance of a bona fide claim of right, it is not taxable. Then came Rutkin v. United States,44 which limited Wilcox to its facts, and held, without explicit mention of "claim of right," that income from extortion is taxable income.

The resulting confusion was only somewhat alleviated by James v. United States,45 an embezzlement case, which specifically repudiated Wilcox, and restated the North American Oil rule as follows:

When 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."46

Did James replace "claim of right" with "consensual recognition"? If so, then what used to be "claim of right" income now includes illegal income, which income should have the benefits of Section 1341. Perhaps, alternatively, James held that "claim of right" as defined in North American Oil, Wilcox and Rutkin is not relevant to the definition of gross income, but may be applied in other contexts. Therefore, illegal income is "claim of right" income in spite of Wilcox for the purpose of the definition of gross income, but is not "claim of right" income for the purpose of Section 1341. Such an interpretation, hardly a victory for consistency, is essentially the rationale of McKinney and Bernard A. Yerke.47 However, even these authorities are assuming that the case-law phrase "claim of right" applies to a statutory section that mentions the phrase in its title but never in its body. The argument based upon the statutory language is quite different.

The Statutory Language.—The statutory language itself never mentions "claim of right"; instead, it must "appear" that the taxpayer had an "unrestricted right" to the income. The argument against the applicability of this language to illegal income focuses on the word "appeared".

The term "appeared" as used in section 1341(a)(1) of the Code and in section 1.1341-1(a)(2) of the regulations refers to a semblance of an unrestricted right in the year received as distinguished from an unchallengeable right (which is more than an "apparent" right) and from absolutely no right at all (which is less than an "apparent" right) . . . .

Thus, for example, although the proceeds of embezzlement constitute gross income in the year of embezzlement, they are held without any semblance of entitlement whatsoever, and therefore a restoration of embezzled amounts does not come within the general rule of section 1341(a) of the Code.48

However, an equally plausible argument focuses upon the phrase "unrestricted right."49 It has been suggested that the word "right" is a partial misnomer, having been placed in the statute only to expand the statutory language to cover accrual basis as well as cash basis taxpayers. A reading of the legislative history strongly implies that, but for problems of accrual, the word should have been "use." The real requirement, therefore, should be that only those who appear to have an unrestricted "use" and enjoyment of the income can get the benefits of Section 1341. The recipients of illegal income might not have a right to it, but they certainly have the use of it. Under this interpretation, then, Section 1341 would apply to the recipients of illegal income.

Therefore, no matter what "claim of right" means, and no matter whether or not the judicial doctrine was intended to be applied to Section 1341, there are strong arguments that the benefits of Section 1341 should apply to the recipients of illegal income, along with everyone else.50 If not, then there must be a rational basis for the discrimination against criminals. It will be shown in the discussion of the public policy doctrine, below, that such a basis does not exist.

Public Policy

The public policy doctrine would serve to disallow deductions for expenses "if allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some govern-

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44 Id. at 424.
45 46-1 usst § 9188, 327 U. S. 404.
46 Case cited at footnote 28.
47 Case cited at footnote 11.
51 This argument was first and best stated in Emanuel, "The Scope of Section 1341," 53 Taxes—The Tax Magazine 644, November 1975.
52 For a cryptic reference to the possibility of a Sec. 1341 deduction for embezzlement repayments, see Geiger's Est. v. Commissioner, 65-2 ustcc § 9697, 352 F. 2d 221, 231 (CA-8), cert. denied 382 U. S. 1012 (1965).

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mental declaration thereof.\textsuperscript{41} For the doctrine to apply, the conduct giving rise to the deduction must be proscribed. Clearly, it is the nature of the conduct, and not the nature of the deduction, that is paramount; if the conduct giving rise to deductions is proscribed, then the public policy doctrine must be applied to all such deductions, not some.

How can McKinney, Hankins and Yerkie agree with prior case law\textsuperscript{42} that losses from illegal activity are deductible pursuant to Section 165, and then hold that losses from the very same conduct are nondeductible on public policy grounds pursuant to Section 1341 or 172? Conduct either is proscribed or it is not.

To determine whether or not the conduct in criminal restitution cases is proscribed, we must know precisely what conduct is to be examined. We know that the “fact that an expenditure bears a remote relation to an illegal act does not make it nondeductible.”\textsuperscript{43} Therefore, the conduct to be examined must bear a more than remote relation to the expense. But where is the line drawn? Given a series of connected acts leading up to an expenditure, which acts are related directly enough to the expense to be examined in light of the public policy doctrine? Perhaps a but/for test will suffice. Under this theory, in cases of criminal restitution, the restitution expense would not have been incurred but for the criminal act. Therefore, it is the criminal act that must be examined in light of the public policy doctrine. However, this theory fails in light of Commissioner v. Tellier.\textsuperscript{44} In Tellier, a convicted criminal sought to deduct the cost of the legal fees incurred in his unsuccessful defense. Clearly, the expense would not have been incurred but for the crime. Therefore, the government argued against the deductibility of the legal fees since they were an expense caused by proscribed conduct. However, the Court rejected the argument.

No public policy is offended when a man faced with serious criminal charges employs a lawyer to help in his defense. That is not “proscribed conduct.” It is his constitutional right.\textsuperscript{45}

In light of Tellier, the conduct to be examined must be more closely related to the expense than that conduct suggested by a but/for test. In the criminal restitution cases, then, the crime itself, the conduct suggested by the but/for test, is not close enough. It is submitted that the only conduct left is the restitution itself. Is criminal restitution proscribed conduct? Certainly not.


\textsuperscript{42}James, cited at footnote 11; Spitz v. United States, 77-2 usrc § 9501, 432 F. Supp. 148 (DC Wis.); Rapaport v. United States, 76-2 usrc § 9702, 419 F. Supp. 1236 (DC III.); Bluff v. Commissioner, 74-1 usrc § 9353, 496 F. 2d 847 (CA-2) (Oakes, J., concurring).

\textsuperscript{43}Commissioner v. Sullivan, cited at footnote 27, at 29, quoting Commissioner v. Heininger, 44-1 usrc § 9109, 320 U. S. 467, 474.

\textsuperscript{44}60-1 usrc § 9319, 383 U. S. 687.

\textsuperscript{45}Id. at 694.

\textsuperscript{46}Sec. 6323.
in what way a restitution of stolen funds frustrates the state policy." 47

**Conclusion**

Arguments against the application of Section 172 to criminal restitution fall of their own weight when viewed in the light of any sensible definition of "trade or business." Criminal activities should be given the same chance at being a trade or business as any other activity. Arguments against the application of Section 1341 to criminal restitution become quickly mired in the unresolved confusion of the claim of right doctrine. This doctrine should not be allowed to get in the way of a just, usable deduction for such restitution. Both arguments ultimately rely upon the public policy doctrine, which logically, should be of no help to them.

The deductibility of the repayment of income in a tax year subsequent to that of its receipt is generally saved from the ravages of the annual accounting system by mitigating statutes. There is no reason to treat the repayments any differently when the original income was illegally earned.

47 *Shube, cited at footnote 42.*

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**California Voters Approve Proposition 13**

More than two centuries later and more than 3,000 miles away, voters in California turned their polling places into a modern-day Lexington by approving a revolutionary initiative proposal amending the California Constitution to limit real property taxes. The Jarvis-Gann Initiative, Proposition 13 on the primary ballot, limits real property taxes to 1% of value except to pay indebtedness previously approved by the voters. Assessed values from 1975-1976 are established as the base value of property for tax purposes. The fair market value base may reflect an inflationary rate not to exceed 2% for any given year. The amendment provides for tax reassessment only after the sale, transfer or construction of property. The limitation on property taxes is effective for the tax year beginning on July 1, 1978.

Effective immediately, the amendment requires that any changes in state taxes enacted for the purpose of increasing revenue, either by increased rates or changes in the method of computation, must be imposed by an act passed by not less than two-thirds of all members elected to the legislature. No new ad valorem taxes on real property, or sales or transaction taxes on sales of real property, may be imposed. Cities, counties, and special districts may, by a two-thirds vote of their qualified electors, impose special taxes other than ad valorem taxes on real property or transaction or sales taxes on the sale of real property, effective for the tax year beginning on July 1, 1978.

**Oregon Voters Reject Gasoline Tax Hike**

Voters in Oregon rejected a measure that would have increased the excise tax imposed on the use of fuel in a motor vehicle from 7¢ to 9¢ per gallon, according to unofficial results of the May 23 state-wide primary election. The measure would also have increased from 7¢ to 9¢ per gallon the license tax paid by dealers and subdealers on motor fuel and aircraft fuel sold, used, or distributed in Oregon.

**U. S.-U. K. Treaty**

The Senate Foreign Relations Committee reported favorably on the Tax Treaty with the United Kingdom. If the treaty receives the consent of the Senate it will, among other things, limit the right of states to tax the income of British multinational corporations.