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ILLEGAL INCOME AS A DEFENSE IN CRIMINAL TAX PROSECUTION

In a recent report to Attorney General Brownell the Justice Department's tax division said that during 1954 the division had brought to a close more than 4,150 civil and criminal cases, about 25% more than in any previous year.1 This stepped up activity, particularly in criminal cases, has been evident for some time. There is an increasing effort to convict not only the more notorious criminals, but also the businessman who has been evading his taxes. The division is no longer prosecuting only the "sure" cases, but is also bringing to trial many of the cases where the certainty of conviction is considerably less than those cases brought to trial in past years.2

The increased activity in criminal tax prosecution causes many practitioners to query as to what defenses are available to the taxpayer, and which of those available will in all probability prove to be the most effective. This comment will concern itself with the availability of the defense that unreported income was obtained illegally and thus is not includible in gross income.

DECISIONS PRIOR TO 1946

During the days of prohibition the courts on a number of occasions had to determine if illegal income was taxable, although these were not the first decisions in the area. An aid in determining that this type of income was taxable was a change that had been made in the definition of taxable income in 1916. The Income Tax Act of 1913 originally defined income as including "gains, profits and income ... from . . . the transactions of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever ...."3 In 1916 this was amended by omitting the one word "lawful."4 In United States v. Sullivan5 the Supreme Court noted this change, and approved the Circuit Court's interpretation of the meaning of the omission.6

"... it is significant that the word 'lawful' has been omitted from the corresponding sections of subsequent revenue acts, ...")(p. 811)

The Supreme Court could not discover any interpretation of the Revenue Act which indicated an intention on the part of Congress to exempt from taxes the gain obtained from the sale of liquor contrary

2 Murphy, Increased Tempo for Criminal Tax Prosecutions, 59:5 Case and Comment 28.
3 38 Stat. 167 (1913).
5 274 U.S. 259, 47 S.Ct. 607, 71 L.Ed. 1037 (1926).
6 United States v. Sullivan, 15 F.2d 809 (4th Cir. 1926).
to law. Further, they could find no reason why a business prohibited by law should not pay taxes when, if it were lawful, it would have to pay them.

Prior to the Sullivan case\(^7\) the Supreme Court had found in two other cases\(^8\) that gains obtained from engaging in business in violation of the Volstead Act was taxable. A comment from one\(^9\) was quoted in many later cases in this area.

"Of course, Congress may tax what it forbids." (p. 480)

At the same time the Board of Tax Appeals held that income obtained from race track bookmaking in violation of the law was also includible in gross income.\(^10\) The court said,

"... the words, 'from any source whatever' are as broad and comprehensive as it is possible for language to be. There is no limitation that the gain, profits, and income must be legally received." (p. 328)

During the period to 1946 the courts also found gain from illegal prize fight pictures,\(^11\) bribes,\(^12\) misapplied funds of a client by an attorney,\(^13\) lotteries,\(^14\) unlawful insurance policies,\(^15\) protection payments,\(^16\) and ransom money\(^17\) taxable to the receiver.

The only indication that there might be some types of illegal income that were not taxable had come in early dicta in the Second Circuit.\(^18\) This court then stated that proceeds of embezzlement, robbery, and burglary were not taxable.\(^19\)

Prior to any decisions squarely in point, the Treasury was asked if the proceeds of an embezzlement constituted taxable income.\(^20\) The reply was in the affirmative.

\(^7\) Supra note 5.
\(^9\) United States v. Stafoff, ibid.
\(^10\) McKenna v. Commissioner, 1 B.T.A. 326 (1925).
\(^12\) United States v. Commerford, 64 F.2d 28 (2nd Cir. 1933) ; Chadick v. United States, 77 F.2d 961 (5th Cir. 1935) cert. den.
\(^16\) Humphreys v. Commissioner, 125 F.2d 340 (7th Cir. 1942).
\(^18\) Rau v. United States, 260 F. 131 (2nd Cir. 1919) ; Steinberg v. United States, 14 F.2d 564 (2nd Cir. 1919).
\(^19\) In the Rau case the court said, "... if the moneys were merely to be passed on to the insurance company, to be paid as premium by the defendant, as agent, and if he embezzled them, he committed a larceny, and the money so received would not be subject to taxation under the income tax law." (p.136)

In the Steinberg case the court stated, "It is true that a distinction may be drawn between the profits of an embezzlement, a robbery, or a burglary ... and those of sales of liquor, or plumes from birds of paradise, both of which are at present restricted rather similar bans; but there remains a long list of unlawful and profitable occupations in which the proprietor has the legal title to his illegal gains, which the thief has not." (p.566)

\(^20\) C.B. XV-1, G.C.M. 16572, p. 82 (1936).
"Furthermore, the definitions of taxable income and all analogies indicate that such proceeds were not excepted by Congress from those gains which do not constitute taxable income."

(p. 83)

"There is nothing in the definition [of gross income as set out by the Internal Revenue Code of 1916] to suggest that Congress intended to draw a distinction between gains enjoyed by the taxpayer to which he had legal title and those possessed by him and inuring to his benefit but to which he does not have legal title." (p. 82)

The first time that the question was directly in issue arose in 1938.21 The Second Circuit was faced with a fact situation in which one O'Neil, as president and general manager of a corporation, mingled bonds representing profits on the corporation's contracts with his own bonds. He had cashed the coupons therefrom and deposited them in his own account. When a Senate Committee began an investigation, he left for France, delivering the bonds to his son with instructions to deliver them to the corporation on his order, or at his death. He never had reported the bonds as income in his returns. The Circuit Court upheld the lower court's determination that the funds were taxable.

"They were of course the property of the Prairie company in the sense that it could have reclaimed them: they were not therefore like the earnings of an illicit liquor seller, which belongs to him however acquired.22 . . . But there are several cases in which persons have been taxed upon property which could be recovered from them." (p. 95)

In 1932 the Supreme Court had held that when a taxpayer has a claim of right to money he has received, although he may have to repay the money later, on receipt of it he is in receipt of taxable income.23 The decision was in a case where the money had been obtained legally, but nonetheless the Second Circuit appropriated it to the field of illegal income.

22 The courts do not explain what they mean when they make statements that the person in receipt of certain types of illegal income have complete title to them. Actually, what the courts must mean is that, in the absence of a statute, a party to an illegal contract cannot invoke the aid of the courts in order to recover any money paid in connection with the illegal contract. In the McKenna case, supra note 10, the court did state this. "It is an elementary principle of law that courts refuse to assist either party to an illegal contract—either to enforce or abrogate it." In regard to the statutes providing that the courts may enforce restitution it states, "Until the loser moves thereunder the parties are just where they would be if no such statute existed. Without that statute no enforceable status of debtor and creditor would exist. The statute, then, does not provide for the enforcement of a preexisting status, but provides a new right in the loser. . . . If then, the loser does not pursue his remedy under the law, there is no obligation to return property won by wager and unless and until the loser does so act the property is unqualifiedly that of the winner; . . ." (pp. 328 and 329).
"If he holds with a claim of right, he should be taxable as owner, regardless of any infirmity of his title." (p. 96)

Some years later the Eighth Circuit was faced with the same question as to whether or not the proceeds of an embezzlement was includible in taxable income. One Kurrle, admitting he had embezzled funds from his employer, attempted to defeat the imposition of a tax on the grounds that he had no title to the money thus acquired. The lower court's decision that the money was taxable was affirmed by the Circuit Court. In the opinion the court cites the National City Bank case with approval, and points out that in many cases where illegally acquired funds were held to be taxable income, the funds could have been recovered by the rightful owners. The Burnet case is again cited and used as authority for the proposition that if a person has a claim of right to the money he is in receipt of taxable income, even though he may later have to repay it.

In the same year another embezzlement case came up in another circuit. In this case the court held to the contrary.

"[He] got no title, void or voidable, to what he took. He was in possession as he was before, but with a changed purpose. He still had no right or color of right." (p. 573)

The court equates an embezzler with a debtor, and as a debtor is not held to be in receipt of taxable income it follows, according to the court, that neither should an embezzler. The court does not explain what it means when it states that the embezzler received no title, void or voidable, and in making an analogy to the creditor-debtor relation overlooks the possibility of adverse possession. If the property embezzled by Spruance, the embezzler in this case, were sold by him to an innocent purchaser for value, and that third person held the property openly and adversely for the statutory period, the employer could not recover it. If Spruance received no title whatsoever, this would hardly be true.

In this case Spruance was insolvent. A supporting reason for holding that there was no income to be taxed was the inability of the taxpayer to pay back the money to his employer.

"Moreover, the direct result of such a doctrine would be that the United States would assert a preferential claim for part of the dishonest gain, to the direct loss and detriment of those to whom it ought to be restored." (p. 574)

24 Kurrle v. Helvering, 126 F.2d 723 (8th Cir. 1942).
25 Supra note 21.
26 Supra note 23.
27 McKnight v. Commissioner, 127 F.2d 572 (5th Cir. 1942).
28 Ibid. at p. 573.
29 Chapin v. Freeland, 142 Mass. 383, 8 N.E. 128 (1886); Shelby v. Shaner, 28 Okla. 605, 115 P. 785, 34 L.R.A.(N.S.) 621 (1911); Title by Adverse Possession, 32 Harv. L. Rev. 135 (1918).
THE WILCOX CASE

Faced with two opposing views in the lower courts, the Supreme Court passed on the issue in Commissioner v. Wilcox. Wilcox had embezzled funds from his employer and then lost the money gambling. He had been convicted of embezzlement by the state of Nevada prior to the income tax evasion case coming before the Supreme Court. In the opinion of the court "no single, conclusive criterion" had up to that time been found which determined in all situations what was a sufficient gain to support the imposition of an income tax. All relevant facts and circumstances were, in the opinion of the court, to be taken into consideration. A standard for what was taxable income was enunciated.

"For present purposes, however, it is enough to note 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 gain. Without some bona fide legal or equitable claim, even though it be contingent or contested in nature, the taxpayer cannot be said to have received any gain or profit with the reach of Section 22(a)."

Citing the McKnight case, the analogy to a debtor is again used. It was pointed out that under Nevada law the crime of embezzlement was complete whenever an appropriation was made, and the employer was entitled to replevy the money as soon as it was appropriated.

The inability of the taxpayer to repay the funds was also used to support the decision. The grounds for this being the same as the Fifth Circuit's: by asserting a lien, the government would have a right superior to the employer for the money, and the employer is the one who ought to be the first to recover.

The standard set down by the Supreme Court, however, left a great deal to be desired. They first stated that all relevant facts and circumstances had to be taken into consideration. This is so general as to be meaningless. Then, instead of setting down a clear-cut definition of when illegal income was taxable, they gave a very loose criterion of what was necessary to have taxable gain generally. The court used the term "unconditional obligation to repay," but did not state in any detail what it meant by that term. If it meant that the complete absence of title would make acquired funds nontaxable, only the gain of an embezzler or thief would be tax exempt. Persons having voidable title to property, such as an extortioner or swindler, would

31 Ibid. at p. 407.
32 1954 INTERNAL REVENUE CODE, §61 (a).
33 Supra note 27.
be required to pay a tax on their illegal income. On the other hand, if it meant that any obligation to repay voided the supposition of a taxable gain, then also those with voidable title to funds would be tax exempt. Also, they stated that the first requirement to be met in order to have taxable gain was that there be a claim of right. If this is taken in a strict sense of the term, any illegal income would be tax exempt, yet the court did not indicate that it meant that it was overruling all the prior cases where the taxpayer had voidable title and was held to be in receipt of taxable income. By leaving the matter in a vacuum, the Supreme Court left the lower courts to fend for themselves, so to speak.34

DECISIONS SUBSEQUENT TO WILCOX AND PRIOR TO RUTKIN

After the Wilcox decision the lower courts held black market operations35,36,37,38 graft,36,37,38 and gambling37 gains to be taxable income. The apparent result was making the line between void and voidable title the dividing line between nontaxable and taxable income. In the Steinberg, Himmelfarb, Potson, Schuermann, and Reichert38 cases the courts did not discuss Wilcox. In the Chapman case39 the defendant was convicted of selling meat for overceiling prices, over his contention that the meat and money belonged to the corporation. The court said,

"However, even if it were shown that appellant collected as agent for the corporation, it would not necessarily follow that there would be no liability on his part for attempted evasion of the taxes due on such collections . . . . Hence, we find the Wilcox case no authority for holding appellant not liable for the tax evasion here charged." (p. 1002)

In the Nitto case40 the court was called upon to decide whether graft money obtained by union leaders through threats against the employers of increases in the number of employees, increases in wages, and strikes was taxable income. In holding that it was, the court stated,

"The Wilcox case does not stand for the proposition that all funds ‘fraudulently or illegally obtained’ are nontaxable." (p. 865)

While making the dividing line the line between void and voidable

35 Petit v. Commissioner, 10 T.C. 1253 (1948) ; Steinberg v. United States, 162 F.2d 120 (5th Cir. 1947), cert. den.; United States v. Chapman, 168 F.2d 997 (7th Cir. 1948) ; Himmelfarb v. United States, 175 F.2d 924 (9th Cir. 1949).
37 United States v. Potson, 171 F.2d 495 (7th Cir. 1948) ; United States v. Schuermann, 174 F.2d 397 (8th Cir. 1949) ; Showell v. Commissioner, 23 T.C. 60 (1955).
38 Supra notes 36 and 37.
39 Supra note 35.
40 Supra note 36.
title, the courts did something else. They found no cases of void title. An analysis of the cases during the six year period shows that the courts went out of their way to find that there was not an embezzlement in the case then before them. While acknowledging the existence of the *Wilcox* decision, they made no apparent effort to apply it to any fact situation. In some of the cases there is even an indirect criticism of the *Wilcox* case.

In *United States v. Currier Lumber Company*[^41] a corporate officer had transferred checks received by the corporation for sales of lumber to his own personal account. He made no entry of either the original receipt or the transfer to himself in the books of the corporation. The District Court overruled his contention that he did not act under a claim of right, and thus came within the *Wilcox* case, by holding that as he had acted as a corporate officer he had transferred not only possession and custody of the checks, but also legal title. The court also relied on the fact that under Massachusetts law he was not an embezzler because they could find no intent to steal or embezzle at the time he took the checks, a requisite of the state statute. After finding that the money was taxable, the court stated that it would have been appropriate to rule that Currier both had a claim of right to the gain, and was under no obligation to repay, thus having taxable income under the *Wilcox* test,

"[But] with due deference to the Supreme Court, it seems better to point out . . . that the second prerequisite required in the *Wilcox* case is not a universal *sina qua non* in determining whether unlawful acquisition is a taxable gain." (p. 221)

A case in which the court definitely stated that they were drawing the dividing line at voidable title was *Akers v. Scofield*.[^42] Akers obtained substantial amounts of money from a Mrs. Roberts by representing to her that he could get maps showing where there was buried gold on her ranch. The maps he produced he had drawn himself, and the gold uncovered was brass bars that he had buried. In affirming the holding that the funds so obtained were taxable income, the court said:

"The distinction between theft and embezzlement on the one hand and swindling on the other is that in the former case title to the property acquired never passes, while in the latter case title does pass." (p. 720)

This definition was obtained from the Texas statutes. The court also said that Akers was estopped from denying his title to avoid taxation.

[^41]: 70 F.Supp. 219 (1947), aff'd. 166 F.2d 346 (1st Cir. 1948).
[^42]: 73 F.Supp. 553 (1947), aff'd. 167 F.2d 718 (5th Cir. 1948).
THE RUTKIN DECISION

This is the way matters stood in 1952 when the Supreme Court had an opportunity to clarify the matter, but did not. In Rutkin v. United States\(^{43}\) the court had before it a case in which the petitioner had obtained $250,000 by threats against the life and family of another. A new test for determining taxable income was announced by the majority of the court.

"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 recognizable economic value from it." (p. 137)

The Wilcox case was limited to its facts. Taking the standard on its face, it appears that all wrongful appropriations are taxable, including embezzlements and thefts, since at least temporary control is obtained by the criminal. But, as the majority refused to overrule Wilcox, the court opened the way for more confusion. It distinguished between an embezzler and an extortioner, and stated that an extortioner, unlike an embezzler, obtains funds "from a victim with his consent." There was no explanation of the significance of the consent of the victim. Yet its only legal consequence is to pass voidable title to the criminal.\(^{44}\) Thus, Rutkin did not decide the issue of whether control or voidable title was to be the measure of taxability.\(^{45}\)

POST RUTKIN DECISIONS

The lower courts, having no more to go on than prior to Rutkin, continued to make the distinction between void and voidable title, holding that in the voidable title area there was taxable gain. The seeming policy of not finding an embezzlement, with its inevitable inconsistencies, also continued.

One of the first cases to arise after Rutkin was Rollinger v. United States.\(^{46}\) Rollinger was hired as an agent by a Mrs. Mieras to purchase diamonds for her. Instead he purchased zircons, sold them to her as diamonds, and pocketed the excess, which he never reported as income. On other occasions he did buy diamonds, but sold them to her for more than he had paid. He also received a large sum when he told her that the diamonds had been stolen, there was a police investigation being conducted, and he needed money for pay-offs. None of this was ever reported as income either. The court refused to agree with him that he was an embezzler and held that he was either an extortioner or an agent who made a profit on his agency. The court stated

\(^{43}\) 343 U.S. 130, 72 S.Ct. 571, 96 L.Ed. 833 (1952).
\(^{44}\) BROWN, LAW OF PERSONAL PROPERTY, §70 (1936); 2 BURDKIN, THE LAW OF CRIME, §§535, 835 (1946); 3 WILLISTON, SALES OF GOODS, §§625(a), 635 (1948).
\(^{45}\) 62 YALE L. J. 667, supra note 34.
\(^{46}\) 208 F.2d 109 (8th Cir. 1953).
that the difference being that an embezzler appropriates funds he has been intrusted with, whereas a swindler acquires property in the first instance by means of false pretenses. While the law is correct, it appears that in some instances Mrs. Mieras may have given the money to Rollinger in order that he might buy the diamonds. If such was the case, by the definition of the court, he was an embezzler. The court only vaguely mentions the matter in the facts, and passes over any mention of it in the opinion.

Another case that came up for decision shortly after Rutkin was Kann v. Commissioner.47 The Kann brothers, who owned or controlled 90% of the stock of two corporations, caused payments to be made to them by deliberate false and fictitious entries in the corporations' books. In distinguishing Wilcox the court took cognizance of a number of facts. They stated that there was no external evidence of an embezzlement, as neither had ever been indicted or convicted, nor had any corporate officer ever urged a prosecution. It appeared that the corporation forgave the "unauthorized withdrawal."48 And in this case the brothers were well set financially and could make restitution, unlike the Wilcox case.49 The court also concluded that this could not be an embezzlement because in reality it was merely a taking of their own money. The fact that the state law made diverting corporate money to their own pockets without the declaration of a dividend an embezzlement, was held not to control in a tax case.

The court did not stop at a distinction from Wilcox, but also intimated that the Supreme Court made an error in that case.

"Although the North American Oil case did not purport to hold that there must be a claim of right before there can be taxable income, the Wilcox case, citing North American Oil, did so state." (p. 249)

Within the last year the Eighth and Fourth Circuits have had to pass upon the question,50 and they also found ways to distinguish the Wilcox case.

The court could find little similarity between the case of a bookkeeper who lost his employer's money gambling and that of the defendant in the Briggs case51 who realized a secret profit on the sale of his employer's land. Clark was authorized by his employer to pro-

47 210 F.2d 247 (3rd Cir. 1953), cert. den.
48 This is the phrase the Circuit Court used to characterize the transaction in this case.
49 "We agree with respondent [Commissioner] that if Wilcox is to be limited to its facts this aspect of the case assumes considerable stature." Kann v. Commissioner, supra note 47 at p. 251.
51 Briggs v. United States, supra note 50.
cure bids on surplus land which the company desired to sell. He and Briggs agreed that Briggs was to secure purchasers for prices in excess of those that Clark would report to the company, with the excess being divided. The firm discovered the arrangements when Clark and Briggs were indicted for tax evasion, at which time they repaid the company the money they had made. The court decided the case as being controlled by Rutkin.

"We need not go into the question as to whether they were guilty of embezzlement under the North Carolina statutes; for we think it perfectly clear that through the fraudulent transactions in which they engaged they received moneys over which they had complete control, which they treated as part of their estates, which resulted in economic value to them and for which they probably never would have been required to account, had it not been for the discovery of the fraud . . . ." (p. 700)

The Eighth Circuit\textsuperscript{52} admits that they could find only a frail distinction in their case. Marienfeld had a contract with Stokely-Van Camp Company to bone meat which Stokely delivered to him. He was authorized to sell the by-products in Stokely's name, and periodically make a report of the sales and return the proceeds therefrom. Marienfeld sold some of the by-products in his own name, rendered false reports, and pocketed the excess. The law of Missouri termed this an embezzlement.

"But the present question is not whether appellant was guilty of embezzlement under the law of Missouri, but whether the funds he received were his income under the Act of Congress defining taxable income. State law will not be decisive in that determination." (p. 636)

The court admitted difficulty in reconciling the Wilcox case with the later opinion in the Rutkin case, but made an attempt at distinguishing Marienfeld's situation from Wilcox's anyway. The best that could be done was to find that Wilcox was under an immediate and instantaneous obligation to pay his employer the money collected for him, whereas Marienfeld had no obligation to pay the money collected to Stokely until there had been an accounting rendered. On the second requisite to taxable gain announced in Wilcox, the court had more difficulty.

"But we see no possible distinction between this case and the Wilcox case with reference to the bona fide legal or equitable claim to the money. Appellant, like Wilcox, had no bona fide claim. And the obligation of appellant to repay differed from that of Wilcox only in point of time." (p. 637)

The court finally comes to the conclusion that the Rutkin test is

\textsuperscript{52}Marienfeld v. United States, \textit{supra} note 50.
the more appropriate one in this situation, and under it Marienfeld had taxable income. The concurring opinion flatly states that control, economic gain, value and enjoyment ought to be the tests, and fails to see that the distinction between Rutkin and Wilcox is the matter of void and voidable title.

Practical Results of the Decisions

As a practical matter it can be stated that all illegal income is taxable, and that any defense on that ground is doomed to failure, unless the situation is exactly identical with that in the Wilcox case. Even then it appears to be, in the opinion of some writers, a good possibility that the Supreme Court will reverse itself to conform to what is now "existing law."

To attempt to plead that the crime was embezzlement under the state law appears to be futile. In the Kann, Briggs, and Marienfeld cases the courts refused to apply local law, saying that it was not determinative in tax cases. And this in view of the fact that embezzlement is purely a statutory offense, not known at common law.

To plead that the transaction was not embezzlement under local law, but should be ruled an embezzlement for the tax case, is equally futile. Akers v. Scofield and Wilcox v. Commissioner applied local law either to find no embezzlement or to find there was an embezzlement. Hence, it appears the courts will use the statutes, or not use them depending on the result they desire to obtain.

If intent is an essential under the state law, the Currier case indicates that the court may find no intent, even though it would appear that could be no other intent than to steal or embezzle.

The Akers case also indicates that the taxpayer may be estopped from denying his title in order to avoid taxation.

Rollinger, Briggs, and Marienfeld illustrate that the facts are not necessarily in the taxpayer's favor regardless of how clear they may seem to be. In Rollinger and Briggs the courts overlook relevant

53 The identity would have to be at least as complete as the taxpayer being insolvent as Kann v. Commissioner, supra note 49 states this, and might very well have to have the taxpayer at least under indictment for embezzlement.

The Kann case also indicates this in the discussion of the facts.

54 62 Yale L. J. 667, supra note 34; 96 L.Ed. 845 annotation to Rutkin case; Surrey & Warren, Federal Taxation, CCH §1139, p. 57.

55 Supra note 47.
56 Supra note 50.
57 Supra note 50.
58 29 C.J.S., Embezzlement, §2, p. 671.
59 Supra note 42.
60 Supra note 30.
61 Supra note 41.
62 Supra note 42.
63 Supra note 46.
64 Supra note 50.
65 Supra note 50.
facts to come to their conclusion, and in *Marienfeld* they admit the fragile nature of their distinction, but make it nonetheless.

The end conclusion can only be that in the field of taxation the old maxim that crime does not pay is still much alive and true.

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