Estate of Anthony (Tony) Nitto, 13 T.C. 858 (1949)

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Income derived from illegal activities, such as extortion, is taxable income, and the failure to report such income, especially when coupled with other factors, can support a finding of fraud with intent to evade tax, justifying the imposition of penalties and the extension of the statute of limitations.

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Summary

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The Tax Court addressed deficiencies and fraud penalties assessed against the estate of Anthony (Tony) Nitto, related to unreported income derived from extortion activities in the motion picture industry. The court held that income from illegal sources is taxable and Nitto's failure to report it constituted fraud, thus upholding the fraud penalties and allowing assessment of deficiencies beyond the normal statute of limitations for one of the years in question. The court determined the specific amounts of unreported income based on available evidence and addressed issues concerning the proper year for reporting dividends and the treatment of a partnership interest sale. The court also considered transferee liability issues relating to Nitto's wife and son.

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Facts

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Anthony (Tony) Nitto was involved with Bioff and Browne in a scheme to extract money from members of the motion picture industry. Nitto received substantial sums of money from this scheme during the years 1935-1940. Nitto failed to report any of these amounts on his income tax returns. The Commissioner determined deficiencies in Nitto's income tax and asserted fraud penalties. Other issues involved the year of reporting dividends from Gables Racing Association, Inc., and the treatment of the sale of a partnership interest. The estate challenged these determinations.

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Procedural History

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The Commissioner determined deficiencies and fraud penalties against Nitto’s estate. The estate petitioned the Tax Court for a redetermination. The Tax Court considered evidence presented by both sides, including testimony regarding Nitto’s activities and financial transactions.

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Issue(s)

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1. Whether income derived from illegal activities, specifically extortion, is taxable income.

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2. Whether Nitto’s failure to report income from illegal activities constituted fraud with intent to evade tax, justifying the imposition of penalties and lifting the statute of limitations.

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3. Whether dividends received in the form of notes were properly reported in the year the notes were received or in the subsequent year when they were paid.

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4. Whether the sale of a partnership interest should be treated as the sale of a capital asset.

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5. Whether Annette Caravetta Nitto is liable as a transferee of assets from the estate.

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Holding

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1. Yes, because the funds were knowingly and willingly paid over to Nitto and his

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associates, distinguishing this case from situations involving misappropriated funds without the owner’s knowledge or consent.

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2. Yes, because the consistent failure to report substantial income from illegal sources, coupled with other circumstances, demonstrated an intent to evade tax.

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3. Yes, because the dividends were properly reported in 1939 when the notes were paid, as there was insufficient evidence of the fair market value of the notes in 1938.

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4. Yes, because the sale of a partnership interest is the sale of a capital asset and any gain is reportable as a capital gain.

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5. The issue of transferee liability was contingent on a Rule 50 computation to determine if the estate’s liabilities exceeded the assets remaining after transfers to Annette Caravetta Nitto.

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Court’s Reasoning

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The court reasoned that income from illegal activities is taxable unless it falls under the specific exception of funds misappropriated without the owner’s knowledge or consent, as established in *Commissioner v. Wilcox*. Here, the payors knowingly participated in the scheme, making the income taxable. The court found that Nitto’s consistent failure to report substantial income from these activities, over multiple years, was strong evidence of fraud. The court stated,

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