McGee v. Commissioner, 61 T. C. 249 (1973)

Income obtained through fraudulent schemes, including those resembling embezzlement or swindling, is taxable and must be reported on tax returns, with failure to do so potentially constituting fraud with intent to evade taxes.

Summary

George C. McGee, a port engineer for Gulf Oil Corp. , engaged in a fraudulent scheme with a marine contractor, Port Arthur Marine Engineering Works (PAMEW), to inflate invoices for Gulf's ship repairs. McGee approved these invoices, receiving kickbacks from PAMEW which he failed to report on his tax returns from 1957 to 1963. The U. S. Tax Court held that these unreported kickbacks constituted taxable income and that McGee's omission was fraudulent with intent to evade taxes, thus not barred by the statute of limitations. The court's reasoning hinged on distinguishing McGee's actions as swindling rather than embezzlement, applying the *James v. United States* ruling retrospectively to uphold the taxability of the income, and finding clear evidence of fraudulent intent.

Facts

George C. McGee was employed by Gulf Oil Corp. as a port engineer in Port Arthur, Texas, from 1957 to 1963. His duties included overseeing maintenance and repairs on Gulf's marine vessels. McGee arranged for PAMEW to inflate invoices for repairs, which he approved and Gulf paid. PAMEW then remitted portions of the excess charges to McGee, who did not report these payments on his tax returns. McGee received similar payments from Gulf Copper & Manufacturing Co. (GCMC), which he reported on his returns. McGee denied receiving any unreported funds from PAMEW during an audit in 1965.

Procedural History

The Commissioner of Internal Revenue determined deficiencies and additions to McGee's federal income tax for the years 1957 to 1963. McGee petitioned the U. S. Tax Court, arguing that the unreported income from PAMEW before 1961 was not taxable due to the *Wilcox v. Commissioner* ruling, and that the statute of limitations barred assessment for years before 1963. The Tax Court ruled in favor of the Commissioner, finding the income taxable and McGee's underreporting fraudulent.

Issue(s)

1. Whether the unreported income received by McGee from PAMEW from 1957 to 1960 was taxable income.
2. Whether McGee's failure to report income received from PAMEW from 1957 to 1963 was due to fraud with intent to evade tax.
3. Whether the statute of limitations barred the assessment of deficiencies for the years 1957 to 1962.

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Holding

1. Yes, because the income from PAMEW was taxable under the principles established in *James v. United States*, which overruled *Wilcox v. Commissioner*.
2. Yes, because McGee's actions constituted swindling rather than embezzlement, and the court found clear and convincing evidence of fraudulent intent to evade taxes.
3. No, because the fraudulent nature of McGee's returns for the years 1957 to 1962 lifted the bar of the statute of limitations under section 6501(c)(1).

Court's Reasoning

The court distinguished McGee's actions as swindling rather than embezzlement, based on Texas law and federal principles. It applied *James v. United States* retrospectively to find the income taxable, noting that *James* only prohibited criminal penalties for pre-1961 embezzlement, not civil fraud findings. The court found clear evidence of McGee's fraudulent intent, citing his scheme to defraud Gulf, his denial of unreported income during an audit, and his consistent pattern of not reporting PAMEW income even after *James*. The court emphasized that civil fraud requires only the intent to evade taxes the taxpayer believes are owed, not necessarily those known to be owed. It rejected McGee's reliance on *Wilcox*, given the uncertainty about whether his actions constituted embezzlement and the impact of *Rutkin v. United States* in limiting *Wilcox*. The court upheld the 50% additions to tax under section 6653(b) as appropriate to protect the revenue and indemnify the government for extra expenses incurred in uncovering McGee's fraud.

Practical Implications

This decision underscores that income from any fraudulent scheme must be reported as taxable income, even if it resembles embezzlement. It clarifies that *James v. United States* applies retroactively to civil fraud cases, allowing the IRS to assess deficiencies and additions to tax for unreported income from pre-1961 schemes. Practitioners should advise clients that failure to report such income can lead to fraud findings, lifting the statute of limitations. This case also highlights the importance of distinguishing between different types of fraudulent schemes when applying tax law, as the court's reasoning hinged on characterizing McGee's actions as swindling rather than embezzlement. Subsequent cases have followed this precedent in assessing tax liabilities for unreported income from fraudulent activities.

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