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Federal Taxation

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FEDERAL TAXATION

MARTIN S. ALLEN*

During the past term the United States Court of Appeals for the Seventh Circuit decided twenty-six cases relating to federal taxes. Twenty-one of these were on appeal from the district courts and five from the Tax Court. Thirteen of the cases involved appeals from criminal convictions, ten involved civil income tax controversies, and two involved the federal estate tax. One case related to the enforcement of the federal excise tax on diesel fuel. Of course, many of the decisions are of limited significance since they concern such things as the sufficiency of evidence in areas where the law is settled. This article discusses only those cases which are of more general interest to the tax bar.

INCOME TAX

Sale of Patent Rights Limited to A Geographic Area: Ordinary Income or Capital Gain

In *Klein v. Commissioner*¹ the Seventh Circuit, reversing the Tax Court, lined up with the Sixth² and Ninth Circuits³ in sustaining the validity of regulations under section 1235 of the Internal Revenue Code of 1954.⁴

Briefly, section 1235 accords long-term capital gain treatment to gain recognized on a transfer by certain individuals of "all substantial rights to a patent."⁵ The section applies irrespective of whether the amount of the consideration is contingent upon the use or productivity of the patent or whether it is paid in a lump sum or over the life of the patent. The holding period is also immaterial for long-term capital gain treatment to apply.⁶ In order to qualify for the special treatment accorded by section 1235, the transferor must be a "holder" of the patent rights.⁷ A "holder" is defined as either an individual whose efforts created the patented invention or an individual who purchased his interest in the patent before the invention was

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1. 507 F.2d 617 (7th Cir. 1974), *rev'g* 61 T.C. 332 (1973), *cert. denied*, 421 U.S. 991 (1975).

2. *Fawick v. Commissioner*, 436 F.2d 655 (6th Cir. 1971), *rev'g* 52 T.C. 104 (1969).

3. *Mros v. Commissioner*, 493 F.2d 813 (9th Cir. 1974), *rev'g* 30 T.C.M. 519 (1971).

4. Hereinafter referred to in the text as the Code.

5. INT. REV. CODE OF 1954, § 1235; Treas. Reg. § 1.1235-1 (1965).

6. *Id.*

7. *Id.*

reduced to practice, that is before it was tested and operated successfully under operating conditions.⁸

Section 1235 was first enacted with the 1954 Code. Prior to its enactment, there was no special provision applicable to transfers of patent rights. Whether a transfer resulted in a capital gain depended first upon whether sufficient rights were transferred to constitute a sale of a capital asset under section 117 of the 1939 Code (the predecessor of section 1221 of the 1954 Code), as distinguished from the transfer of a lesser interest such as a license, and second upon whether the taxpayer held the asset primarily for sale to customers, that is, whether he was a professional inventor as opposed to an amateur.⁹ Such considerations continue to apply to transfers of patent rights which do not come within section 1235, for example, because the transferor is not a "holder" as defined in that section.¹⁰

In defining the term "all substantial rights to a patent," the regulations state that the term does not include a grant of rights which is limited "geographically within the country of issuance."¹¹ It was the validity of this regulation which was at issue before the Seventh Circuit in *Klein v. Commissioner*.¹² The taxpayer held a patent covering a process for the conversion of organic waste into fertilizer. In 1960 he entered into an agreement under which he assigned his patent rights as to certain eastern states to a Pennsylvania company, retaining his rights as to all other areas. In his tax returns for 1966 through 1968, he treated the resulting royalties as long-term capital gain. Based upon the regulation, the Service treated the royalties as ordinary income.

The Tax Court, relying on its earlier decision in *Vincent B. Rogers*,¹³ held that "all substantial rights" were transferred despite the geographical limitation.¹⁴ In *Rogers* the Tax Court had held that the regulation was invalid since, in the Tax Court's view, the restriction in the regulation on geographically limited transfers is contrary to the intent of Congress in enacting section 1235. The court stated:

8. INT. REV. CODE OF 1954, § 1235(b); Treas. Reg. §§ 1.1235-2(d), 1.1235-2(c) (1965). See also *Flanders v. United States*, 172 F. Supp. 935 (N.D. Cal. 1959).

9. See, e.g., *Edward C. Myers*, 6 T.C. 258 (1946).

10. Treas. Reg. § 1.1235-1(b) (1965).

11. Treas. Reg. § 1.1235-2(b)(1)(i) (1965). The regulations also provide that grants which are limited to a period less than the remaining life of the patent, cover less than all fields or uses covered by the patent, or cover less than all of the claims or inventions covered by the patent do not constitute a grant of "all substantial rights." Treas. Reg. §§ 1.1235-2(b)(1)(ii)-(iv) (1965). *Fawick v. Commissioner*, 436 F.2d 655 (6th Cir. 1971), *rev'g* 52 T.C. 104 (1969), and *Mros v. Commissioner*, 493 F.2d 813 (9th Cir. 1974), *rev'g* 30 T.C.M. 519 (1971), the Sixth and Ninth Circuit decisions cited in notes 2 and 3 *supra*, involved the validity of the regulation prohibiting section 1235 treatment to transfers which are limited by field of use. The circuit courts in both cases reversed the Tax Court and sustained the validity of the regulation.

12. 507 F.2d 617 (7th Cir. 1974).

13. 51 T.C. 927 (1969), *acquiesced in result only* 1973-2 CUM. BULL. 3.

14. 61 T.C. 332 (1973).

By "rights to a patent" we think Congress was referring to the rights to "make, use and sell" the patented invention We think section 1235 requires merely the transfer of "property" and that the rights in such property to make, use, and sell the patented invention be conveyed to the transferee. We read therein no prohibition on the division of a patent into different fields of application or into different geographical areas so long as all substantial rights to the patent so divided are granted.¹⁵

In reversing the Tax Court in *Klein*, the Seventh Circuit reasoned that the plain meaning of the phrase "all substantial rights" precludes separating the rights inherent in the patent geographically.¹⁶ By "substantial," the court concluded that Congress meant that the retention of "minor" rights by the transferor, such as a security interest, would not preclude capital gain treatment.¹⁷ The court found support for its conclusion that geographically limited transfers are outside the intended purview of the statute in the Senate Finance Committee report on the bill which became section 1235.¹⁸ Section 1235 applies to a transfer "of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights."¹⁹ The Seventh Circuit quoted the section of the Senate report defining the term "undivided" interest:

By "undivided interest" a part of each property right represented by the patent (constituting a fractional share of the whole patent) is meant (and not, for example, a lesser interest such as a right to income, or a license limited geographically, or a license which conveys some, but not all, of the claims or uses covered by the patent).²⁰

The Senate report, however, appears to be ambiguous in regard to whether geographically limited transfers are within the contemplation of the statute and seems, in fact, to support an interpretation contrary to that given it by the Seventh Circuit. While the quoted language may be read, as the Seventh Circuit read it, to imply that Congress intended to exclude licenses

15. 51 T.C. 927, 930 (1969) (citation omitted).

16. 507 F.2d 617, 621 (7th Cir. 1974).

17. *Id.* The court cited two cases, *Allen v. Werner*, 190 F.2d 840 (5th Cir. 1951), and *Allied Chemical Corp. v. United States*, 370 F.2d 697 (2d Cir. 1967), both of which applied the accepted rule that in determining whether a transfer constitutes a sale or a license the form of the transaction does not govern, but instead actual circumstances will be examined. In *Allen v. Werner*, *supra*, the Fifth Circuit held that the reservation by the seller of a right to prevent unlimited reassignment by the assignor and a right to terminate the assignment in the event that the assignor fails to perform his obligations under the agreement do not evidence a license as opposed to an assignment. In *Allied Chemical Corp.*, *supra*, the Second Circuit held that the facts demonstrated that a license was intended. The facts showed, among other things, that the alleged assignment was non-exclusive, that is, that the assignor did not obtain an exclusive right to use the patented invention in any geographic location or in any industry. *Id.* at 699.

18. 507 F.2d 617, 621 (7th Cir. 1974).

19. INT. REV. CODE OF 1954, § 1256(a).

20. 507 F.2d 617, 621 (7th Cir. 1974), quoting S. REP. NO. 1622, 83d Cong., 2d Sess. (1954), 1954 U.S. CODE CONG. & AD. NEWS at 5082.

limited geographically, it may also be read to indicate merely that such licenses do not constitute an "undivided interest" in a patent, without any implication concerning whether or not they are contemplated within the phrase "all substantial rights." It is revealing that at another point the Senate report indicates that the phrase "all substantial rights" was intended to pick up the existing case law concerning the requirements of a sale or exchange and was not intended to alter the requirements as then recognized, with one exception which will be discussed. The Senate report states:

The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent (other than the right to such periodic or contingent payments) should be transferred to the transferee for consideration. *This requirement recognizes the basic criteria of a "sale or exchange" under existing law, with the exception noted relating to contingent payments, which exception is justified in the patent area for "holders" as herein defined.*²¹

Because of the difficulty of valuing a patent before it is exploited, patents are often sold on a royalty basis. The exception to which the Senate report refers related to a controversy concerning whether amounts received from the assignment of a patent were entitled to capital gain treatment if the purchase price was conditioned on the use or productivity of the invention. The Service frequently litigated this question and lost consistently.²² In 1946 it acquiesced in the result of a Tax Court decision allowing capital gain treatment.²³ In 1950, however, it reversed its position and in Mimeograph 6490 announced that amounts payable over the remaining life of a patent or measured by the production, sale, or use of the patent would be taxable as ordinary income.²⁴ The Senate report states:

To obviate the uncertainty caused by this mimeograph and to provide an incentive to inventors to contribute to the welfare of the Nation, your committee intends, in subsection (a), to give statutory assurance to certain patent holders that the sale of a patent (whether as an "assignment" or "exclusive license") shall not be deemed not to constitute a "sale or exchange" for tax purposes solely on account of the mode of payment.²⁵

Thus, the Senate report indicates that section 1235 was enacted to legislatively overrule Mimeograph 6490 and the phrase "all substantial rights

21. S. REP. NO. 1622, 83d Cong. 2d Sess. (1954), *supra* note 20 (emphasis supplied).

22. *See, e.g., Kronner v. United States*, 110 F. Supp. 730 (Ct. Cl. 1954); *Edward C. Meyers*, 6 T.C. 258 (1946); *Commissioner v. Celanese Corp.* 140 F.2d 339 (D.C. Cir. 1944); *Commissioner v. Hopkinson*, 127 F.2d 406 (2d Cir. 1942).

23. 1946-1 CUM. BULL. 3, *acquiescing in result of Edward C. Myers*, 6 T.C. 258 (1946).

24. 1950-1 CUM. BULL. 9; The Service also withdrew its acquiescence in *Edward C. Myers* and substituted non-acquiescence. 1950-1 CUM. BULL. 7.

25. S. REP. NO. 1622, 83d Cong. 2d Sess. (1954), *supra* note 20.

to a patent" was included to incorporate existing case law on the requirements for a sale or exchange. It remains only to be considered whether a transfer of patent rights prior to 1954 which was limited geographically would have qualified as a sale or exchange under pre-1954 Code law.²⁶

*Vincent A. Marco*²⁷ was the first case expressly holding that such a transfer constituted a sale or exchange under section 117 of the 1939 Code. It was decided in 1955, after the enactment of section 1235, but it seems reasonably clear that the same result would have applied under authority existing before the enactment of the 1954 Code. For example, the leading case setting forth the distinction between an assignment of a patent and a license is the Supreme Court's decision in *Waterman v. Mackenzie*.²⁸ Though not a tax case, *Waterman v. MacKenzie* was cited and quoted in numerous tax cases before 1954 for the requirements of a sale or exchange.²⁹ It held that for a transfer to constitute an assignment the transferor must convey the three basic rights: the right to make, use, and sell the patented invention. In addition, the decision expressly recognized that such a transfer would constitute an assignment irrespective of whether it transferred such rights for all or any specified part of the United States. Thus, the Supreme Court said:

Whether a transfer of a particular right or interest under a patent is an assignment or a license does not depend upon the name by which it calls itself, but upon the legal effect of its provisions. For instance, a grant of an exclusive right to make, use and vend two patented machines within a certain district is an assignment, and gives the grantee the right to sue in his own name for an infringement within the district, because the right, although limited to making, using and vending two machines, excludes all other persons, even the patentee, from making, using or vending like machines within the district. On the other hand, the grant of an exclusive right under the patent within a certain district, which does not include the right to make, and the right to use, and the right to sell, is not a grant of a title in the whole patent-right within the district, and is therefore only a license.³⁰

Again, in *United States v. General Electric Co.*,³¹ another decision frequently cited in pre-1954 (and post-1954) tax cases, the Supreme Court restated the rule as follows:

26. The Tax Court in *Vincent B. Rodgers*, discussed in the text at note 13 *supra*, concluded that such a transfer would have constituted a sale or exchange. 51 T.C. 927, 929 (1969). The cases cited by the court, however, were decided after the enactment of the 1954 Code, though under prior law. *Id.*

27. 25 T.C. 544 (1955).

28. 138 U.S. 252 (1891).

29. See, e.g., *Broderick v. Neale*, 201 F.2d 621, 623-24 (10th Cir. 1953); *Cleveland Graphite Bronze Co.*, 10 T.C. 974, 987-89 (1948); *Kimble Glass Co.*, 9 T.C. 183, 189-90 (1947); *Edward C. Myers*, 6 T.C. 258, 262-63 (1946), *result acquiesced in* 1946-1 CUM. BULL. 3, *non. acq.* 1950-1 CUM. BULL. 7.

30. 138 U.S. 252, 256 (1891) (citation omitted).

31. 272 U.S. 476 (1926).

The owner of a patent may assign it to another and convey (1) the exclusive right to make, use and vend the invention throughout the United States or (2) an undivided part or share of that exclusive right or (3) *the exclusive right under the patent within and through a specific part of the United States*. But any assignment or transfer short of one of these is a license giving the licensee no title in the patent and no right to sue at law in his own name for an infringement.³²

Thus, the Seventh Circuit's decision in *Klein v. Commissioner*³³ appears to be incorrect. While the phrase "all substantial rights to a patent" could reasonably be understood in common parlance to exclude from section 1235 transfers of geographically limited patent rights, the legislative history, rather than supporting such a construction, indicates that the phrase was intended to have a technical meaning. It was intended to adopt by reference existing case law on the requirements of a sale or exchange, and under existing law a transfer of the right to make, use, and sell the patented invention apparently would have been treated as a sale or exchange for tax purposes even though the transfer was limited to a specific geographic region within the United States.

Inclusion in Gross Income of the Value of Unsolicited Merchandise

In an unusual case, *Haverly v. United States*,³⁴ the Seventh Circuit held that the value of unsolicited merchandise must be included in gross income if the taxpayer donates the merchandise to a charity and takes a charitable deduction for the gift. The taxpayer in *Haverly* was an elementary school principal. He regularly received unsolicited textbooks from publishers seeking consideration of the books for use in the school's curriculum. During the tax year in question he donated the books to the school library and took a charitable deduction.

The parties stipulated that the taxpayer's receipt of the textbooks did not constitute a gift within the meaning of section 102 because the transfer "did not proceed from a detached and disinterested generosity nor out of affection, respect, admiration, charity or like impulses."³⁵ They also stipulated that the taxpayer was entitled to a deduction under section 170 for the gift to the school library.³⁶ The government contended, however, that the value of the books constituted gross income under section 61. It argued that "once a person 'manifests an intent . . . to accept such property' it is properly

32. *Id.* at 489 (emphasis supplied).

33. 507 F.2d 617 (7th Cir. 1974).

34. 513 F.2d 224 (7th Cir. 1975), *rev'g* 374 F. Supp. 1041 (N.D. Ill. 1974), *cert. denied*, 96 S. Ct. 216 (1975).

35. 513 F.2d 224, 225 (7th Cir. 1974).

36. *Id.*

classified as taxable income" and "the claiming of the charitable deduction . . . evidences the requisite intent."³⁷

The district court rejected this contention.³⁸ The court distinguished cases which have considered the definition of gross income under section 61,³⁹ including the Supreme Court's landmark decisions in the *Glenshaw Glass*⁴⁰ and *Duberstein*⁴¹ cases. It noted that the receipt of unsolicited merchandise does not fit within the examples of gross income enumerated in section 61, which it considered to be "instructive of the types of things that are . . . considered [to be included in gross income]." Essentially, the court reasoned "that income cannot be foisted upon an individual involuntarily."⁴² It rejected the government's contention that the taxpayer's taking of the deduction indicated his "voluntary" acceptance of the unsolicited merchandise on the ground that the taking of the deduction does not differ from the acceptance of such merchandise in other situations which are not deemed to result in gross income. Thus the court said:

The problem is that such an intent [to accept the merchandise] is equally as clearly evidenced when the housewife uses the detergent sample for the family wash, or when the book reviewer takes the book for his own personal library, or when the store customer swallows the new brand of cracker being promoted, or when the school principal donates his sample text to the school library *without* claiming any deduction, or when a judge receives books from a publisher and puts them on the shelves in his chambers for possible future reference.⁴³

In reversing the district court, the Seventh Circuit expressly sidestepped the hypothetical situations posed in the district court opinion. It emphasized that the phrase "all income from whatever source derived" in section 61 reflects a Congressional intention "to use the full measure of its taxing power" and "to tax all gains except those specifically exempted."⁴⁴ The court also referred to the Supreme Court's decision in the *Glenshaw Glass Co.* case,⁴⁵ which it said "held that the language of Section 61(a) encompasses all 'accessions to wealth, clearly realized, and over which the taxpayers have complete dominion'.⁴⁶ Thus, the court concluded as follows:

In view of the comprehensive conception of income embodied in the statutory language and the Supreme Court's interpretation of

37. 374 F. Supp. 1041, 1043 (N.D.Ill. 1974).

38. 374 F. Supp. 1041 (N.D.Ill. 1974).

39. *Id.* at 1044.

40. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

41. *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

42. 374 F. Supp. 1041, 1045 (N.D.Ill. 1974).

43. *Id.* (emphasis by the court).

44. 513 F.2d 224, 226 (7th Cir. 1975), *quoting* *James v. United States*, 366 U.S. 213, 218-19 (1961).

45. 348 U.S. 426 (1955).

46. 513 F.2d 224, 226 (7th Cir. 1975).

that language, we conclude that when the intent to exercise complete dominion over unsolicited samples is demonstrated by donating those samples to a charitable institution and taking a tax deduction therefor, the value of the samples received constitutes gross income.⁴⁷

Although the Seventh Circuit's decision in *Haverly* will undoubtedly provoke discussion, the decision appears to be correct. The result is in accordance with the broad scope of the definition of gross income consistently recognized by the Supreme Court. It is also consistent with the rule that found money, or treasure trove, must be included in gross income.⁴⁸ That the receipt and use of unsolicited merchandise in cases such as those described in the district court's opinion is not treated as gross income under section 61 probably results from considerations that do not apply with equal force to the situation presented in *Haverly*. The value of such merchandise is ordinarily minimal. And, the burden on the taxpayer in valuing and reporting the receipt of such merchandise, and on the Internal Revenue Service in administering the tax laws, would be excessive if all such items were required to be included in gross income.

Liability of Third Parties for the 100 Percent Penalty for Failure to Pay Over Withholding Taxes

In two cases decided during the past term, *Adams v. United States*⁴⁹ and *Haffa v. United States*,⁵⁰ the Seventh Circuit considered the question of the liability of third parties for the 100 percent penalty imposed by section 6672⁵¹ for failure to collect and pay over withholding taxes on employee wages. The two decisions illustrate the penalty to which creditors and other third parties are exposed when they become actively involved in the day-to-day financial affairs of distressed companies.

Section 6672 imposes a penalty upon "[a]ny person required to collect, truthfully account for, and pay over any tax imposed [by the Internal Revenue Code] who willfully fails to collect . . . or truthfully account for and pay over such tax".⁵² The penalty so imposed is equal to the total amount of the tax not collected or paid over. Ordinarily, when withholding taxes are not paid, the 100 percent penalty is imposed upon the company's officers or employees who are responsible for the payment of its obligations.⁵³ However, it is well established that the penalty may be assessed

47. *Id.*

48. *Cesarini v. United States*, 296 F. Supp. 3 (N.D. Ohio 1969), *aff'd*, 428 F.2d 812 (6th Cir. 1970); Treas. Reg. § 1.61-14(a) (1965); Rev. Rul. 61, 1953-1 CUM. BULL. 17.

49. 504 F.2d 73 (7th Cir. 1974), *rev'g* 353 F. Supp. 333 (E.D. Wis. 1973).

50. 516 F.2d 931 (7th Cir. 1975).

51. INT. REV. CODE OF 1954, § 6672.

52. *Id.*

53. *See, e.g., Bernardi v. United States*, 507 F.2d 682 (7th Cir. 1974) (a Seventh Circuit decision during the past term), *aff'g* 74-1 U.S. Tax Cas. ¶ 9170 (N.D. Ill. 1973).

against persons who are not officers, directors, employees, or shareholders if it is they who are actually responsible for the company's failure to withhold or pay over the taxes due.⁵⁴

The issue in *Adams v. United States*⁵⁵ was whether the district court was correct in granting summary judgment in favor of a finance company which had entered into a revolving loan arrangement with the defaulting employer, the Skobis Company. The Service assessed the penalty against both an officer of Skobis, William Adams, and against the finance company, Lakeshore Commercial Finance Corporation.

Pursuant to the loan agreement, Lakeshore made 61 advances over a six-month period to the Skobis Company, secured by the company's inventory and accounts receivable. Lakeshore collected the accounts receivable and determined the amount of each advance depending upon the amount of then available collateral.⁵⁶ The details of the arrangement are sketchy. According to an affidavit filed in the district court in support of Lakeshore's motion for summary judgment, the advances were generally made by check payable to Skobis or by deposit directly into its bank account. In one instance a check was made payable to one of Skobis' creditors, and in some other instances checks were made payable jointly to Skobis and certain taxing authorities. Lakeshore's affidavit asserted that it had no control over the funds once they were transferred to Skobis.⁵⁷ However, an affidavit filed by Adams in opposition of the motion for summary judgment asserted that Lakeshore did have "final authority" over the application of the earnings of Skobis" and that it exercised such authority on a day-to-day basis.⁵⁸ The Adams affidavit also asserted that "Lakeshore, at one point, actually determined to discontinue the payment of withholding taxes to the government on behalf of Skobis".⁵⁹

The district court granted Lakeshore's motion for summary judgment, holding that the affidavits disclosed no issue of material fact and that Lakeshore was not a "person" obligated to collect or pay over withholding taxes within the meaning of section 6672.⁶⁰ In the latter regard, the district court relied on *United States v. Hill*,⁶¹ a Fifth Circuit decision which implies that the 100 percent penalty may be assessed against a creditor only if it manages the internal affairs of the defaulting corporation, even if the

54. See, e.g., *Regan & Co. v. United States*, 290 F. Supp. 470 (E.D.N.Y. 1968); *Pacific Nat'l Ins. v. United States*, 422 F.2d 26 (9th Cir. 1970), cert. denied, 398 U.S. 937 (1970); *Melillo v. United States*, 244 F. Supp. 323 (E.D.N.Y. 1965).

55. 504 F.2d 73 (7th Cir. 1974).

56. *Id.* at 74.

57. *Id.* at 75.

58. *Id.* at 76.

59. *Id.*

60. 353 F. Supp. 333, 335 (E.D. Wis. 1973).

61. 368 F.2d 617 (5th Cir. 1966).

creditor is able to, and does, prevent the defaulting company from paying withholding taxes to the government.⁶²

The Seventh Circuit reversed. With respect to the district court's reliance on *Hill*, the court noted a possible factual distinction relating to the degree of the lender's control over its debtor's financial affairs.⁶³ More significantly, however, it observed "that the more recent trend seems to favor an expanding view of 'persons' liable or responsible for the nonpayment of withholding taxes."⁶⁴ The court noted that summary judgment has been held to be inappropriate where the issue is "whether a lending institution has assumed such control over its debtor's business as to become a liable 'person' and whether the particular institution has acted willfully in preferring other creditors over the government within the meaning of §6672, since such questions present material and substantial issues of fact."⁶⁵ In view of the conflicting affidavits of Adams and Lakeshore, the court concluded that summary judgment was improper and remanded the case for trial.⁶⁶

Haffa v. United States,⁶⁷ the second case decided by the Seventh

62. In *Hill* the evidence showed that pursuant to a loan agreement which the defendant bank made with a financially distressed customer, the bank's approval was required for a time on all checks over \$500 written by the corporation. Since the corporation had no balance in its checking account, all such checks were, in effect, loans from the bank. In exercising its power to approve checks, the bank refused to honor some checks, allowing payment only of those bills which it determined to be essential to the company's continued operations, and it expressly refused to authorize checks to the government in payment of withholding taxes. 368 F.2d at 620, 623. In affirming the setting aside of a jury verdict against the bank, the Fifth Circuit concluded in *Hill* as follows:

That the Bank allowed the company to retain and use some of the funds belonging to it cannot be transposed into an assumption of tax liability by the Bank. . . . That the Bank exercised a veto power over corporate checks, funded by this method to insure their use to keep the company alive nowhere brings the Bank within the penal provisions of the statute.

Id. at 623.

63. 504 F.2d 73, 76-77 (7th Cir. 1974).

64. *Id.* at 76. The court cited *Pacific National Insurance Co. v. United States*, 422 F.2d 26 (9th Cir.), *cert. denied*, 398 U.S. 937 (1970). The defendant in that case was an insurance company which had written performance bonds for a company which became unable to meet its obligations in connection with certain government contracts. The evidence showed that the insurance company paid the employees' wages and other operating expenses as they came due but expressly refused to advance the additional amounts needed to pay the withholding taxes. In holding the insurance company liable for the penalty, the Ninth Circuit observed that "the language of [section 6672] is broad enough to reach an entity which assumes the function of determining whether or not an employer will pay over taxes withheld from its employees." 422 F.2d at 30.

65. 504 F.2d 73, 77 (7th Cir. 1974).

66. *Id.* Judge Campbell (Senior District Judge of the Northern District of Illinois sitting by designation) dissented. In his view, the affidavits disclosed that Lakeshore controlled the disposition of the Skobis Company's "earnings and income" only in the sense that under the revolving loan agreement its "earnings and income" constituted liquidated collateral, and, hence, the basis for future loans. Because he perceived no genuine issue concerning Lakeshore's control over the expenditure of the funds which it loaned to Skobis, he believed summary judgment was proper. 504 F.2d 73, 77-80 (7th Cir. 1974).

67. 516 F.2d 931 (7th Cir. 1975).

Circuit during the past term on the question of the liability of third parties for the 100 percent penalty, involved a more novel factual situation. The company whose failure to pay the withholding taxes caused the controversy was G.T.O. Steel Erectors, a firm which had been hired to do construction work in connection with the renovation of certain facilities at the Aurora Downs racetrack. The issue in the case concerned the liability for the penalty of Thomas Cooper, an employee and financial adviser to the partnership which owned the track.

The facts are as follows. During the course of construction, the bank with which G.T.O. maintained its checking account contacted the racetrack indicating that G.T.O. was frequently overdrawing its account. The bank stated that it would close the account unless Cooper, with whom the bank was familiar, co-signed all future G.T.O. checks in order to assure the bank that sufficient funds were on deposit. Cooper was directed by his employer to do so and for a period thereafter spent a small amount of time each week at G.T.O.'s offices, signing checks and verifying that expenditures claimed by G.T.O. in connection with its construction work at the racetrack were actually being made.⁶⁸ The opinion indicates that Cooper did not supervise the accounting and bookkeeping of G.T.O., other than in relation to the one checking account, and that he "never exercised any control over preferences of one creditor to another".⁶⁹

Early in 1967, however, after Cooper's co-signing authority had ended, certain creditors of G.T.O. contacted Aurora Downs and indicated that amounts owed them by the construction company were not being paid.⁷⁰ The opinion indicates that Cooper paid these creditors on behalf of the partnership believing that, if not paid, the creditors would be entitled to mechanic's liens against the racetrack property, and that such liens "would constitute a breach of the partnership's mortgage on the property and grounds for revocation of [its] racing license as well".⁷¹

Based upon all of these actions, the Service contended that Cooper was responsible for G.T.O.'s failure to pay withholding taxes on the wages paid to its employees. However, the district court held that the government had failed to prove that Cooper was a person " 'required' to collect or pay over

68. *Id.* at 933-34.

69. *Id.* at 934. In this regard, it is also noteworthy that in paying G.T.O. on behalf of the racetrack, the amounts Cooper paid reflected gross wages. Thus, the court concluded "that G.T.O. always had an available source of revenue specifically intended for the withholding fund." *Id.* at 937. The opinion also states that when Cooper was informed by one of the principals of G.T.O. that the company was not going to file a tax return covering withholding taxes because its accountant had died, he stressed the importance of filing the return and paying the tax if funds were available, and "was led to believe that another bookkeeper was retained to remedy the problem." *Id.* at 934.

70. *Id.*

71. *Id.*

taxes for [G.T.O]."⁷² The government appealed, contending among other things, that, as a factual matter, Cooper had sufficient control over G.T.O.'s financial affairs to make him responsible for the payment of its withholding taxes.⁷³

The Seventh Circuit affirmed. In its opinion, the court referred to its earlier decision in *Adams v. United States*,⁷⁴ which, it stated, "held that the critical question was whether the [party upon whom the government sought to impose the penalty] had assumed significant control of the disbursal of funds by the debtor corporation."⁷⁵ The court concluded that the facts showed that Cooper did not have sufficient control over G.T.O.'s finances to be liable for the penalty.⁷⁶ It noted that Cooper's connection with G.T.O. was for the limited purpose of preventing further overdrafts on G.T.O.'s checking account and verifying that certain claimed expenditures were actually made, and also concluded that the payment of certain of G.T.O.'s creditors on behalf of the partnership in order to avoid possible mechanics' liens was irrelevant to the question of whether Cooper was liable for payment of G.T.O.'s withholding taxes.⁷⁷

ESTATE TAX

Special 10-Year Estate Tax Lien Not Extended by the Filing of an Action

In *United States v. Cleavenger*,⁷⁸ the Seventh Circuit held that the special estate tax lien provided by section 6324(a)(1) expires ten years from the date of the decedent's death and is not extended by the filing of an action to recover the tax within the ten-year period.

Two types of tax liens are available for the enforcement of the estate tax. The first is the general tax lien under section 6321, which provides as follows:

[I]f any person liable to pay any tax neglects or refuses to pay the same after demand, the amount . . . shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.⁷⁹

72. *Id.* at 935. The district court's opinion is unpublished but is reproduced in the Seventh Circuit opinion.

73. The government also contended that the district court had based its decision on the erroneous premises that only officers and employees of the debtor company could be liable for the penalty. *Id.* The Seventh Circuit found no such premise in the district court's opinion.

74. 504 F.2d 73 (7th Cir. 1974), discussed *supra* at note 55 and accompanying text.

75. 516 F.2d 931, 936 (7th Cir. 1975).

76. *Id.* at 936-37.

77. *Id.*

78. 517 F.2d 230 (7th Cir. 1975), *aff'g* 325 F. Supp. 871 (N.D. Ind. 1971).

79. INT. REV. CODE OF 1954, § 6321.

Section 6322 provides that the general tax lien arises at the time the tax is assessed and continues "until the liability for the amount assessed (or a judgment against the taxpayer arising out of such liability) is satisfied or becomes unenforceable by reason of lapse of time".⁸⁰

The second type of lien available for the enforcement of the estate tax is the special estate tax lien provided by section 6324. It arises on the date of the decedent's death and attaches to all property which is includable in the gross estate. Specifically, the statute provides as follows:

Unless the estate tax imposed by Chapter 11 is sooner paid in full, or becomes unenforceable by reason of lapse of time, it shall be a lien upon the gross estate of the decedent for 10 years from the date of death⁸¹

The section also provides that the lien is divested from property which is used to pay charges against the estate and administration expenses which are allowed by court order.⁸²

In *Cleavenger* the government sought to enforce the special lien against property in which the decedent had been a joint tenant, and which, therefore, passed by operation of law to the other joint tenant upon her death. The decedent died on July 14, 1958. Although a federal estate tax return was filed, the tax was never paid, and in 1964 the state probate court entered judgment against the estate for the taxes which had been assessed.⁸³ In 1965, the government filed suit in the federal district court to foreclose the tax liens. In June of 1970, five years later, the government moved for summary judgment against all parties.⁸⁴ With respect to the property at issue before the Seventh Circuit, the district court held that the lien expired on July 14, 1968, ten years after the date of the decedent's death.⁸⁵ In rejecting the government's argument that the ten-year period mentioned in section 6324(a) is merely a period of limitation, which therefore would be extended by the filing of the government's suit, the district court held that the plain meaning of the statute was that ten years was the duration of the lien, rather than the period during which the government could commence an action. The court noted that it is unlikely that the ten-year period in section 6324 was intended as a period of limitation since the section expressly makes applicable the general periods of limitation provided by sections 6501 and 6502.⁸⁶

80. *Id.* § 6322.

81. *Id.* § 6324(a).

82. *Id.*

83. 517 F.2d 230, 231 (7th Cir. 1975).

84. Neither the district court nor the Seventh Circuit decision indicates why the case remained dormant for so long. The district court decision indicates only that certain procedural matters were resolved in late 1969 and in 1970. 325 F. Supp. 871, 873 (N.D. Ind. 1971).

85. 325 F. Supp. 871 (N.D. Ind. 1971). Liens against other property were also involved in the district court proceedings.

86. *Id.* at 871-76. Sections 6501 and 6502 contain the general limitation periods

The Seventh Circuit affirmed.⁸⁷ It noted that although there are five federal cases in which the special estate tax lien has been foreclosed more than ten years after the date of the decedent's death, no issue was raised in any of these cases concerning the expiration of the lien.⁸⁸ Thus, the case was one of first impression in the federal courts. The court agreed with the district court's reasoning that the plain meaning of the statutory language indicates that the ten-year period was intended to denote the duration of the lien. The opinion indicates that, in reaching its decision, the Seventh Circuit was concerned with the impact of the special estate tax lien on the transferability of assets held by a decedent at the time of his death. A cloud on the title to such property results from the fact that the special estate tax lien attaches as of the decedent's death and, unlike the general tax lien, the special estate tax lien requires no filing. The court said:

Under the Government's position, there would be no assurance whatsoever from the passage of time. Suit could be filed for foreclosure within the ninth year after the decedent's death and if the proceedings took the normal leisurely course which tax litigation reaching this court seems sometimes to have as an attribute, the foreclosure, and the life of the now latent lien, could be extended well into the next decade. We have been furnished no persuasive reason for determining that the Government does not have available more than adequately effective means of estate tax collection by utilization of assessment line procedures buttressed by the freezing act of the special tax lien, assuming, of course, that the business of collecting the tax is followed with any type of vigor whatsoever.⁸⁹

Thus, the Seventh Circuit concluded that the special estate tax lien expires 10 years from the date of the decedent's death and is not extended by the government's filing of an action to collect the tax within the 10-year period.

CRIMINAL TAX PROCEDURE

Dickerson Rule on Miranda Warnings Reaffirmed

In *United States v. Oliver*,⁹⁰ the Seventh Circuit reaffirmed the rule it announced in 1969 in *United States v. Dickerson*,⁹¹ that *Miranda*⁹² warn-

applicable to the assessment and collection of taxes imposed by the Internal Revenue Code.

87. 517 F.2d 230 (7th Cir. 1975).

88. *Id.* at 233; *Detroit Bank v. United States*, 317 U.S. 329 (1943); *United States v. Cruikshank*, 48 F.2d 352 (S.D.N.Y. 1931); *Rosenberg v. McLaughlin*, 66 F.2d 271 (9th Cir. 1933), *cert. denied*, 290 U.S. 696 (1933); *United States v. Cury*, 61-1 U.S. Tax Cas. ¶ 12,003 (W.D. Va. 1961); *United States v. Novack*, 74-2 U.S. Tax Cas. ¶ 13,013 (S.D.N.Y. 1974). See also *Kaufman v. Herter*, 194 N.Y.S.2d 848, 851, 24 Misc. 2d 187 (Sup. Ct. 1959) (a state court decision which expressly deals with the issue and concludes that the lien expires 10 years from the date of the decedent's death).

89. 517 F.2d 230, 234 (7th Cir. 1975).

90. 505 F.2d 301 (7th Cir. 1974).

91. 413 F.2d 1111 (7th Cir. 1969).

92. *Miranda v. Arizona*, 384 U.S. 436 (1966).

ings must be given to a taxpayer who is under criminal investigation "at the inception of the first contact . . . after the case has been transferred to the Intelligence Division" and that the exclusionary rule of *Miranda* will apply to any evidence obtained from the taxpayer if the required warning is not given.⁹³

The taxpayer in *Oliver* was convicted of failing to report substantial earnings, apparently resulting from sales of narcotics. Certain information concerning the defendant's net worth was crucial to his conviction. This information was obtained from him during an interview with two special agents at the office of the Intelligence Division.⁹⁴ Although the agents read a *Miranda*-like warning to the defendant at the beginning of the interview, the warning failed to advise him of his right to remain silent and contained an ambiguity concerning his right to have counsel present during the interview.⁹⁵

The government did not contend that the warning which was given was adequate if *Miranda* applied.⁹⁶ Instead it argued that *Miranda* was inapplicable, since the defendant was not in custody,⁹⁷ and that the Seventh Circuit should reexamine the *Dickerson* rule in light of its more recent decision in *United States v. Sicilia*.⁹⁸

The court, however, while noting that the *Dickerson* rule has not been followed in other circuits,⁹⁹ distinguished *Sicilia*¹⁰⁰ and reaffirmed *Dickerson*, holding that taking the defendant into custody is not the crucial point in the case of an Internal Revenue Service investigation. Essentially, the court reasoned that in the usual non-tax criminal case the warnings must be given

93. 413 F.2d 1111, 1117 (7th Cir. 1969).

94. The decision notes that the interview occurred after the special agents, having learned that the defendant would be in the Federal Building, located him "in the vicinity of the grand jury room." 505 F.2d at 303. This was apparently their first interview with the taxpayer, though the investigation was begun by the Intelligence Division several months earlier. The opinion also notes that though the taxpayer was technically free to go at any time during the meeting, the special agents intercepted and refused to transmit to the taxpayer a message purportedly from his attorney. Accordingly, the court characterized the situation "for the purpose of applying the *Miranda* test . . . as one in which [the] defendant's liberty was significantly restrained." 505 F.2d at 306. It does not appear, however, that that fact is material to the holding of the case since the *Dickerson* rule applies irrespective of the degree of restraint.

95. 505 F.2d at 304. The warning which was given is the warning which IRS News Release IR-949 (Nov. 26, 1968) states is required to be given by the agents at such meeting.

96. *Id.*

97. *Id.*

98. 475 F.2d 308 (7th Cir. 1973).

99. 505 F.2d at 304 n.9 and associated text. See note 105 *infra*.

100. The court noted that in *Scilia* it refused to extend *Dickerson* to require F.B.I. agents to give a *Miranda* warning when they were merely seeking permission to search the premises of the defendant's company for a stolen fork lift which a tip indicated might be present. The court noted that unlike the situation in a tax investigation, there was no ambiguity in the role of the F.B.I. agents. Moreover, the defendant was not a real suspect until after the stolen fork lift was discovered. 505 F.2d at 306.

when the defendant is taken into custody because “[i]t is at [that] point that our adversary system of criminal proceedings commences.”¹⁰¹ The court stressed the “dual criminal-civil nature of an I.R.S. interrogation.”¹⁰² The Internal Revenue Service commences the preparation of its criminal case when it assigns the case to the Intelligence Division. When the taxpayer is interrogated by the special agents after that point without a clear explanation of their mission, “three key misapprehensions for the taxpayer” are created, namely “*the nature of the inquiry, his obligation to respond, and the possible consequences of doing so.*”¹⁰³ The court concluded that:

[T]he practical effect of these misapprehensions during questioning of a taxpayer was to compel him to provide information that could be used to obtain his conviction in a criminal tax fraud proceeding, in much the same way that placing a suspect under physical restraint leads to psychological compulsion. Thus, the misapprehensions are tantamount to the deprivation of the suspect’s freedom of action in any significant way, repeatedly referred to in *Miranda*.¹⁰⁴

It should be noted that the Seventh Circuit is alone among the circuits in requiring *Miranda* warnings when a tax investigation is transferred to the Intelligence Division. All other circuits have considered the issue and have held that “the test is whether the suspect ‘has been taken into custody or otherwise deprived of his freedom in any significant way.’”¹⁰⁵ While there is language in the Seventh Circuit’s opinion in *Oliver* to the effect that the court characterized the interrogation involved there as constituting a significant deprivation of the defendant’s liberty, it is clear that such a finding was not material to the result since the *Dickerson* rule requires that *Miranda* warnings be given at the first interview with the taxpayer after the case is transferred to the Intelligence Division, irrespective of the circumstances of that meeting.¹⁰⁶

CONCLUSION

Of the twenty-six cases involving federal tax controversies decided by the Seventh Circuit during the past term, none is likely to become a

101. 505 F.2d at 305 n.12, quoting *Miranda v. Arizona*, 384 U.S. 436, 477 (1966).

102. 505 F.2d at 305.

103. *Id.*

104. *Id.*

105. *United States v. Beckwith*, 510 F.2d 741, 742 (D.C. Cir. 1975), quoting *Miranda v. Arizona*, 384 U.S. 436, 477 (1966). See also *Taglianetti v. United States*, 398 F.2d 558 (1st Cir. 1969); *United States v. White*, 417 F.2d 89 (2d Cir. 1969); *United States v. Jaskiewicz*, 433 F.2d 415 (3d Cir. 1970); *United States v. Bagdasian*, 398 F.2d 971 (4th Cir. 1968); *United States v. Prudden*, 424 F.2d 1021 (5th Cir. 1970); *United States v. Maius*, 378 F.2d 716 (6th Cir. 1967); *Muse v. United States*, 405 F.2d 40 (8th Cir. 1968); *United States v. Chikata*, 427 F.2d 385 (9th Cir. 1970); *Hensley v. United States*, 406 F.2d 481 (10th Cir. 1969); 10 MERTONS, LAW OF FEDERAL TAXATION at 55 & nn.13.28-13.37 (Cum. Supp. 1975); and 10 MERTONS, *supra*, at 6 (Supp. July 1975.).

106. 505 F.2d 301, 305-06 (7th Cir. 1974); *United States v. Dickerson*, 413 F.2d 1111, 1117 (7th Cir. 1969).

landmark in federal tax law. As one would expect, most of the cases applied established principles to ordinary factual circumstances. Of the few cases where the law was unsettled, *Klein v. Commissioner*,¹⁰⁷ the patent case, and *United States v. Cleavenger*,¹⁰⁸ the estate tax lien case, stand out. In *Klein*, the rationale advanced by the court, namely its reference to legislative history, does not appear to support the result which the court reached. The result in *Cleavenger*, however, a case of first impression, appears to be fully justified by the inferences which the court drew from the statute and by the policy which the court sought to further.

107. 507 F.2d 617 (7th Cir. 1974), discussed *supra* in the text at notes 1 through 33.

108. 517 F.2d 230 (7th Cir. 1975), discussed *supra* in the text at notes 78 through 89.

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