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TAXATION

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During the past term, the United States Court of Appeals for the Seventh Circuit decided six cases under the Internal Revenue Code,[1] including three income tax cases, one estate tax case and two cases dealing generally with questions of tax procedure. The income and estate tax cases were on appeal from the Tax Court and the two procedure cases were on appeal from federal district courts. In finding for the federal government, the Seventh Circuit affirmed all six of the decisions below.

THE INCOME TAX DECISIONS

In *Don E. Williams Co. v. Commissioner*,[2] the Seventh Circuit held that an accrual basis taxpayer's delivery of its secured, interest-bearing, demand promissory note to a qualified employees' profit sharing trust did not constitute "payment" within the meaning of section 404(a)(6) of the Code.[3] During the taxable year in question, Williams accrued a liability to contribute to a qualified profit sharing plan and delivered its note in payment of the contribution after the end of the taxable year but before its return for that year was due. The note was guaranteed by Williams' officers and was secured by adequate collateral. Williams viewed delivery of the secured, demand note as payment of the liability and deducted the profit sharing contribution in the taxable year of accrual under section 404(a)(6) of the Code.

Section 404 of the Code generally provides that profit sharing contributions are deductible in the taxable year when paid.[4] However, at the time this

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

2. 527 F.2d 649 (7th Cir. 1975), *aff'g* 62 T.C. 166 (1974), *cert. granted*, 96 S. Ct. 2622 (1976) (No. 75-1312).

3. Int. Rev. Code of 1954, § 404(a)(6) (amended 1974) reads as follows:

> (6)Taxpayers on accrual basis.—For purposes of paragraphs (1), (2), and (3), a taxpayer on the accrual basis shall be deemed to have made a payment on the last day of the year of accrual if the payment is made on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).

4. Treas. Reg. § 1.404(a)-1(c), T.D. 6203, 1956-2 C.B. 257.

case arose,[5] under section 404(a)(6) of the Code, if an accrual basis taxpayer accrued such a liability in a given taxable year, payment of such contributions was deemed to have been made on the last day of such year if payment was made after year-end but before the return for the year was due.[6] In deciding that delivery of a note was not payment for purposes of section 404(a)(6) of the Code and hence, that Williams was not entitled to the claimed deduction, the Seventh Circuit relied principally on the applicable Treasury Regulations, the legislative history relating to section 404 of the Code, and a series of cases dealing with the meaning of the term "payment" for cash basis taxpayers.

Section 1.404(a)-1 (c) of the Treasury Regulations provides, in pertinent part, that "[section 404(a)(6) of the Code]is intended to permit a taxpayer on the accrual method to deduct such contribution or compensation in the year of accrual, *provided payment is actually made* not later than [when the return is due] . . . ."[7] Similarly, Senate Finance Commitee Report Number 1622 on the Internal Revenue Code of 1954 stated that: "[u]nder present law a taxpayer on the accrual basis is deemed to have made a contribution to an employee plan in the year of accrual provided he *actually makes payment* within 60 days after the close of that year."[8] In light of these authorities, the Seventh Circuit interpreted "the emphasis on 'actually paid' to connote a liquid form of payment and not a promissory note which is in substance only another form of an obligation to pay."[9]

The Seventh Circuit, in holding that actual payment means payment in cash, stated that it saw "no difference in the way the statute and regulation treat the accrual . . . and cash basis taxpayers for purposes of what constitutes 'payment' except that the accrual taxpayer may make 'payment' during the grace period"[10] provided in section 404(a)(6) of the Code. Consequently, the court was "unable to justify accepting payment in the form

5. As a result of the Employees Retirement Income Security Act of 1974, 29 U.S.C. § 1082(c)(10)(1974), section 404(a)(6) of the Code now gives both cash and accrual taxpayers the same grace period in which to make "payment" of their contributions to employee plans. I.R.C. § 404(a)(6) reads as follows:

> (6) Time when contributions deemed made.—For purposes of paragraphs (1), (2), and (3), a taxpayer shall be deemed to have made a payment on the last day of the preceding taxable year if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).

6. Int. Rev. Code of 1954, § 404(a)(6) (amended 1974) also provided that the time when the return for such taxable year is due also includes any extensions granted. See note 3 *supra*.

7. Treas. Reg. § 1.404(a)-1(c), T.D. 6203, 1956-2 C.B. 257 (emphasis added).

8. SENATE FINANCE COMMITTEE REPORT NO. 1622 ON THE INTERNAL REVENUE CODE OF 1954, S. REP. NO. 1622, 83d Cong., 2d Sess. 55 (1954) (emphasis added).

9. 527 F.2d at 651. This interpretation is in accordance with the Tax Court's decision in Logan Eng'r. Co. v. Commissioner, 12 T.C. 860 (1949), which interpreted "payment" under a predecessor of section 404 of the Code as meaning "to liquidate a liability in cash." 12 T.C. at 868.

10. 527 F.2d at 650.

of a promissory note for an accrual taxpayer when it . . . would not be considered payment for the cash basis taxpayer."[11]

In support of the proposition that delivery of a note is not payment for a cash basis taxpayer, the Seventh Circuit relied on the United States Supreme Court's decisions in *Eckert v. Burnet*[12] and *Helvering v. Price*[13] and on its own decision in *Cleaver v. Commissioner.*[14] In *Eckert*, the Court held that a cash basis taxpayer did not incur a loss where he issued his own note in respect of a corporation's obligation on which he was secondarily liable.[15] Similarly, in *Price* the Court held that a cash basis taxpayer did not recognize a loss by substituting a new note for an earlier one in discharge of a guaranty obligation.[16] The Court stated, in part, that:

> We think . . . [*Eckert*] is controlling in the instant case. As the return was on the cash basis, there could be no deduction in the year 1932, unless the substitution of [taxpayer's] note in that year constituted a payment in cash or its equivalent. There was no cash payment and under the doctrine of the Eckert case the *giving of the taxpayer's own note was not the equivalent of cash to entitle the taxpayer to the deduction.*[17]

In response to the taxpayer's argument that the substituted note represented payment because it was secured, the Court stated that:

> [Taxpayer] urges that his note was secured, but the collateral was not payment. It was given to secure [taxpayer's] promise to pay, and if that promise to pay was not sufficient to warrant the deduction until the promise was made good by actual payment, the giving of security for performance did not transform the promise into the payment required to constitute a deductible loss in the taxable year.[18]

In *Cleaver* the Seventh Circuit adopted the *Price* analysis and held that a cash basis taxpayer was not entitled to a deduction for interest the payment of which was evidenced by a promissory note.[19]

Despite the contrary position of other circuits,[20] the Seventh Circuit's decision in *Williams* is correct for three reasons. First, the legislative history and Treasury Regulations under section 404 of the Code speak in terms of

11. *Id.* at 651.
12. 283 U.S. 140 (1931).
13. 309 U.S. 409 (1940).
14. 158 F.2d 342 (7th Cir. 1946), *cert. denied*, 330 U.S. 849 (1947).
15. 283 U.S. at 141-42.
16. 309 U.S. at 413.
17. *Id.* at 413 (emphasis added).
18. *Id.* at 413-14.
19. 158 F.2d at 343-44.
20. *See* Wasatch Chemical Co. v. Commissioner, 313 F.2d 843 (10th Cir. 1963), *vac'g and rem'g* 37 T.C. 817 (1962); Time Oil Co. v. Commissioner, 258 F.2d 237 (9th Cir. 1958), *rem'g* 26 T.C. 1081 (1956); and Sachs v. Commissioner, 208 F.2d 313 (3d Cir. 1953), *rev'g* 11 T.C.M. (CCH) 882 (1952), all holding that delivery of a note to a qualified employees' retirement plan constituted "payment" for purposes of section 404(a)(6) of the Code.

"contributions actually paid" and "payment . . . actually made" respectively.[21] This suggests that payment must be in cash or its equivalent and that the mere delivery of a note to evidence the taxpayer's obligation does not suffice. Second, numerous cases hold that a cash basis taxpayer's delivery of a note does not constitute payment.[22] This also buttresses the court's view that actual payment means payment in cash or its equivalent. Third, section 404(a)(6) of the Code would serve no purpose if, as Williams contended, delivery of a note were sufficient.

Generally, an accrual basis taxpayer may accrue and deduct an expense in the taxable year in which all events have occurred to establish the fact of liability and the amount thereof can be determined with reasonable accuracy.[23] Since the Tax Court found that Williams did, indeed, accrue a liability to make the profit sharing contribution in the taxable year in question,[24] Williams clearly would have been entitled to the claimed deduction if section 404 were not in the Code. Under section 404 of the Code, on the other hand, an accrual basis taxpayer must *both* accrue *and* pay such a liability in order to obtain a deduction. If, however, section 404(a)(6) of the Code is construed to permit payment by note, then as applied to accrual basis taxpayers, section 404 of the Code seems wholly superfluous. This is because the presence of a note adds nothing to the accrual basis taxpayer's fixed liability or obligation to pay, which must exist in the first place in order to accrue and deduct an expense. If delivering a note would suffice, why would an accrual basis taxpayer be required to make payment and be given a grace period in which payment could be made?

In the Seventh Circuit's view, the purpose of section 404(a)(6) of the Code was to place cash and accrual basis taxpayers on an equal footing when deducting employee plan contributions. It is difficult to imagine that section 404(a)(6) of the Code could have any other purpose.

The second income tax case which the Seventh Circuit decided this term was *Quinn v. Commissioner*.[25] In *Quinn* the most interesting of the several issues involved was whether Howard Quinn was taxable on $553,166 received as advanced rent.[26] Howard and Charlotte Quinn were directors of

21. See notes 7 and 8 and accompanying text *supra*.

22. *E.g.*, Helvering v. Price, 309 U.S. 409 (1940); Baltimore Dairy Lunch, Inc. v. United States, 231 F.2d 870 (8th Cir. 1956); Quinn v. Commissioner, 111 F.2d 372 (5th Cir. 1940).

23. Treas. Reg. § 1.461-1(a)(2), T.D. 6282, 1958-1 C.B. 228.

24. 62 T.C. at 167.

25. 524 F.2d 617 (7th Cir. 1975), *aff'g* 62 T.C. 223 (1974).

26. The only other issue of importance in the case was whether the Commissioner was estopped from asserting the claim of right doctrine because of his prior acquiescence in other decided cases, such as Clark v. Commissioner, 11 T.C. 672 (1948), and Gaddy v. Commissioner, 38 T.C. 943 (1962), *rem'g* 344 F.2d 460 (5th Cir. 1965), upholding the contention of the taxpayer in *Quinn*. The Seventh Circuit held that the Commissioner was not estopped and relied on the

the Beverly Savings and Loan Association and Howard, through a trust, owned Beverly's office building. On April 3, 1963, Howard caused Beverly to prepay $553,166 of rent. Two days later Beverly's Board of Directors, at a special meeting, adopted a resolution requiring return of the funds and Howard actually repaid $53,166 on April 22, 1963. In July 1963 he gave Beverly his secured note for $500,000 but never made any further payments.[27] In his 1963 federal income tax return, Howard did not report any taxable income from this transaction and took the position on his return that his $500,000 net proceeds in 1963 were a loan from Beverly. The Commissioner contended that it was taxable income received under a claim of right.

The United States Supreme Court established the claim of right doctrine in *North American Oil v. Burnet*[28] when it held that:

> 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 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.[29]

Approximately thirty years later, in *James v. United States*,[30] the Court expanded its doctrine to include embezzled funds when it stated that the essence of the doctrine was the receipt of "earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition."[31]

Under these decisions, the critical fact in *Quinn* was that Howard did not recognize an obligation to repay at the time that he received the money. Instead, he apparently recognized for the first time his obligation to repay at the directors' special meeting two days *after* he received the money. Consequently, the Seventh Circuit held that Howard had taxable income when he received the $553,166 "without consensual recognition . . . of an obligation to repay."[32] The court also held that Howard, a cash basis taxpayer, would be

United States Supreme Court's decision in Dixon v. United States, 381 U.S. 68 (1965), that an erroneous decision of the Commissioner cannot in and of itself bar the United States from collecting a tax that is lawfully due. 381 U.S. at 73. The Seventh Circuit noted there was no showing that the taxpayer had actually relied on the Commissioner's acquiescences. 524 F.2d at 623. An unresolved issue is whether the Commissioner would have been estopped if there had been reliance. *Id. Cf.* International Business Machines Corp. v. United States, 343 F.2d 914 (Ct. Cl. 1965), *cert. denied*, 382 U.S. 1028 (1966) (Internal Revenue Service's refusal to limit prospectively its ruling was under the circumstances an abuse of discretion).

27. Howard was later indicted and convicted of fraud under 18 U.S.C. § 657 (1970) as a result of these transactions. United States v. Quinn, 398 F.2d 298 (7th Cir.), *cert. denied*, 393 U.S. 983 (1968).

28. 286 U.S. 417 (1932).

29. 286 U.S. at 424.

30. 366 U.S. 213 (1961).

31. 366 U.S. at 219.

32. 524 F.2d at 623.

entitled to an offsetting deduction when he actually made repayment.[33] As the court stated:

> A cash basis taxpayer's giving of his own note is not sufficient to support a deduction in the year given; it will only support a deduction in the year in which the note is paid . . . . Thus, recognition of the obligation to repay funds received under a claim of right has no tax consequences regardless of whether it occurs in the year the funds were received or a later year.[34]

Accordingly, Howard was given an offsetting deduction for the $53,166 actually repaid but not for the $500,000 note.

In deciding *Quinn*, the Seventh Circuit created another conflict in the circuits by rejecting the Ninth Circuit's decision in *United States v. Merrill*.[35] There, a taxpayer received executor's fees to which he was not entitled amounting to $2,500 in 1939 and $7,500 in 1940. Before December 31, 1940, he discovered the error and entered on his books an obligation to repay the $10,000. He actually repaid this sum in 1943. The Ninth Circuit held: (1) that the $2,500 was received under a claim of right and was taxable in 1939; and (2) that the $7,500 received in 1940 was not taxable because the taxpayer recognized the obligation to repay it before the end of the taxable year in which it was received.[36] In the Seventh Circuit's view, "*Merrill* was incorrectly decided. We therefore hold that the *Merrill* exception to the claim of right doctrine should not be applied in this circuit."[37] Thus, the *Quinn* decision creates a conflict between the Seventh Circuit, on the one hand, and the Ninth Circuit, on the other.[38]

In light of the Seventh Circuit's decision in *Williams* that under section 404 of the Code cash and accrual basis taxpayers are to be treated identically, it is appropriate to indicate here that the claim of right doctrine discriminates in favor of accrual basis taxpayers. As previously indicated,[39] Howard was given a deduction for the $53,166 actually repaid and would be able to deduct the remaining $500,000 when paid. However, an accrual basis taxpayer in Howard's position could have accrued and deducted the entire $553,166 in 1963, regardless of when actually paid, because all events would have occurred to establish the fact of liability and the amount thereof could have been determined with reasonable accuracy.[40] Whether the Seventh Circuit

33. *Id.* at 624.
34. *Id.* at 625.
35. 211 F.2d 297 (9th Cir. 1954).
36. 211 F.2d at 303-4.
37. 524 F.2d at 624.
38. In a footnote to the *Quinn* decision the court acknowledged the conflict and stated that the decision had been circulated among all judges of the Seventh Circuit and that none voted for a rehearing en banc. *Id.* at 624 n.2. The Second Circuit had previously distinguished *Merrill* in Buff v. Commissioner, 496 F.2d 847 (2d Cir. 1974).
39. See text at notes 26-27 *supra*.
40. Treas. Reg. § 1.461-1(a)(2), T.D. 6282, 1958-1 C.B. 228.

fully considered how the claim of right doctrine discriminates between cash and accrual basis taxpayers is open to question. However, it is interesting to note that the court, in deciding *Quinn*, dismissed its earlier opinion in *Bates Motor Transport Lines v. Commissioner*[41] as "not relevant precedent because it involved an accrual basis taxpayer, and there is no question that the rules for such a taxpayer are different."[42]

Blair v. Commissioner[43] is the third income tax case which the Seventh Circuit decided this past term. There the court disallowed a charitable contribution for the fair market value of real estate purportedly deeded to the University of Illinois because the court concluded that under Illinois law the taxpayer never owned the real estate.[44] Blair purchased the lot in question at a tax sale for approximately $600. At the time of his purchase, the lot was subject to a pending condemnation proceeding by the University of Illinois. Blair was to receive a deed to the property if there was no redemption by the original owner during the statutory period. However, the property was condemned before the redemption period expired and therefore Blair deeded the property to the University of Illinois. The court found that under Illinois law a purchaser at a tax sale does not receive merchantable title to real estate when that real estate is condemned before the redemption period expires.[45] Since Blair only had a lien against the condemnation proceeds for approximately $600, he could deduct only that amount as a charitable contribution.[46]

THE ESTATE TAX CASE

Estate of Steffke v. Commissioner[47] concerned the meaning of the term "surviving spouse" as used in section 2056(a) of the Code.[48] This section sets forth the marital deduction for federal estate tax purposes. *Steffke* involved a rather bizarre set of circumstances. After twenty-two years of marriage Priscilla obtained a Mexican divorce on grounds not recognized in Wisconsin and married Wesley Steffke. Wesley died the following year and left the bulk of his estate to Priscilla. Following his death, the Wisconsin Supreme Court held that for state inheritance tax purposes, Priscilla was not the decedent's

41. 200 F.2d 20 (7th Cir. 1952).
42. 524 F.2d at 624.
43. 538 F.2d 155 (7th Cir. 1976).
44. *Id.* at 159.
45. *Id.* at 158.
46. *Id.* at 159.
47. 538 F.2d 730 (7th Cir. 1976).
48. I.R.C. § 2056(a) reads as follows:

(a) Allowance of marital deduction.—For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsections (b), (c), and (d), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

wife under Wisconsin law. Therefore, the property she received was taxable at rates applicable to strangers rather than widows. The decedent's estate also claimed on the federal estate tax return the marital deduction under section 2056 of the Code, but the Commissioner disallowed this deduction on the ground that Priscilla was not the decedent's surviving spouse.

Since the Seventh Circuit's principal task in *Steffke* was to define how the term "surviving spouse" was used in section 2056 of the Code, it held that:

> When there are conflicting judicial decisions regarding the validity of a divorce, the decision should be followed for federal estate taxation purposes that would be followed by the state which has primary jurisdiction over the administration of a decedent's estate, i.e., the jurisdiction in which the decedent was domiciled at the time of his death.[49]

This decision is generally consistent with the Commissioner's rather long-standing policy of challenging only those divorce decrees which are declared invalid by a court with jurisdiction over the parties.[50] Even though two recent estate tax cases are in accord with *Steffke*,[51] the law in this area is not wholly consistent. The Second Circuit[52] has held, and the Third Circuit[53] has agreed, that for federal *income tax* purposes "[t]he subsequent declaration of invalidity [of a divorce] by a jurisdiction other than the one that decreed the divorce is of no consequence under these provisions of the tax law."[54] Since the Second and Third Circuits' decisions are generally accepted,[55] Priscilla and the decedent probably were married for federal *income tax* purposes and hence, could have filed (and possibly did file) a joint federal income tax return.

Although the wisdom of having different rules for income and estate tax purposes might be open to question, it is difficult to fault the court's decision for estate tax purposes. As the court noted, the operation of section 2056 of the Code is almost totally dependent on state law.

> Section 2056(e) defines when an interest in property will be considered to have passed within the meaning of the section. Each of the ways listed is dependent on state law, e.g., by will, by intestacy, by dower, or by joint tenancy with the right of survivorship. State

49. 538 F.2d at 735.

50. Rev. Rul. 67-442, 1967-2 C.B. 65.

51. See Estate of Goldwater v. Commissioner, 64 T.C. 540 (1975), and Estate of Spaulding v. Commissioner, 34 T.C.M. (CCH) 1074 (1975). The Second Circuit affirmed the Tax Court's decision in Estate of Goldwater v. Commissioner, 539 F.2d 878 (2d Cir. 1976), thereby agreeing with the Seventh Circuit's decision in *Steffke*.

52. See Borax v. Commissioner, 349 F.2d 666 (2d Cir. 1965), and Wondsel v. Commissioner, 350 F.2d 339 (2d Cir. 1965). In Goldwater v. Commissioner, 64 T.C. 540 (1975), the Second Circuit refused to apply *Borax* in an estate tax situation.

53. Feinberg v. Commissioner, 198 F.2d 260 (3d Cir. 1952).

54. *See* Borax v. Commissioner, 349 F.2d at 670.

55. 538 F.2d at 734.

> law also determines the nature of the property interest passing for purposes of the terminable interest rule of section 2056(b).[56]

Thus, there is logic to the Seventh Circuit's holding that the courts of the state whose law determines the succession of the decedent's property shall also determine his marital status. Therefore, it is curious that the court commented near the end of the decision that "[t]he application of principles of logic, however, has had no conspicuous place in the construction of taxation statutes."[57]

THE TAX PROCEDURE DECISIONS[58]

In *United States v. Scornavacco's Restaurant, Inc.*,[59] the Seventh Circuit upheld a summons by the Internal Revenue Service for the books and records of a restaurant business because the business was conducted by a corporation and not by the defendant, Anthony Scornavacco, individually. In asserting his privilege against self-incrimination, Anthony argued that the business was not a corporation because a corporate income tax return was not filed for the restaurant business, because restaurant income and expenses were shown on his individual return, and because his reporting practices governed the determination of whether the restaurant business was conducted in corporate form or as a sole proprietorship.

Anthony relied principally upon *United States v. Theodore*,[60] where an Internal Revenue Service summons was enforced because a corporate return was filed, even though no articles of incorporation had been filed as required by applicable state law. The Seventh Circuit's short answer was that *Theodore* was a "one-way street" for the government because:

> A sole proprietorship actually doing business through a corporation and also holding itself out as a corporation cannot avoid corporate tax liability by failing to file corporate tax returns. If such a result were possible, the tax liability of any corporate entity could be terminated by failure to file returns.[61]

CONCLUSION

The Seventh Circuit's most important federal tax decisions during the past term were *Williams* and *Quinn*. Each of these decisions created a conflict in the circuits and each bears importantly on the relative positions of cash and accrual basis taxpayers. *Williams* placed cash and accrual basis taxpayers on

56. 538 F.2d at 735.
57. *Id.* at 737.
58. This article will not discuss United States v. Interstate Tool & Eng'r Corp., 526 F.2d 59 (7th Cir. 1976), because it dealt generally with the enforceability of an Internal Revenue Service summons and reached predictable decisions amply supported by the record.
59. 528 F.2d 19 (7th Cir. 1976).
60. 479 F.2d 749 (4th Cir. 1973).
61. 528 F.2d at 24.

an equal footing for purposes of deducting employee plan contributions, whereas *Quinn* preserved the different treatment accorded cash and accrual basis taxpayers under the claim of right doctrine. Given these seemingly illogical results, it is ironic that in *Steffke* the court admonished that logic holds "no conspicuous place in the construction of taxation statutes."

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