Taxation

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As opposed to the preceding term, the taxpayer fared exceedingly well during this past term of the United States Court of Appeals for the Seventh Circuit. Of particular note were the successes of taxpayers in precluding the enforcement of an Internal Revenue Service summons, discharging in bankruptcy the penalty assessed against a responsible officer for failing to pay over taxes withheld from his employees' salaries, and overturning a determination of the Commissioner to charge as dividend income certain funds arising out of a like-for-like exchange following an involuntary conversion. The government was successful, however, in asserting the priority of federal tax liens over both secured creditors and liabilities owed to state and local governments, in imposing penalties for the late filing of an estate tax return and disallowing intra-department loans at the First National Bank of Chicago for purposes of determining the bank's loan base for computing its reserve for bad debts. The following article will discuss these decisions in detail and analyze their impact upon the development and application of federal tax law in the Seventh Circuit.

**ENFORCEABILITY OF A SUMMONS**

Potentially, the most significant decision of the United States Court of Appeals for the Seventh Circuit during this past term involved the standards to be applied by a federal district court in determining the enforceability of a summons issued by an Internal Revenue Service agent under Internal Revenue Code section 7602. In *United States v. LaSalle National Bank*,

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* Associate, Harris, Burman & Silets; Assistant United States Attorney, Northern District of Illinois, 1970-1975; member of the Illinois and Washington state bars; J.D., University of Washington School of Law.


2. Hereinafter referred to in the text as IRS.


4. Section 7602 of the IRC provides:
   For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary or his delegate is authorized—
   (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;
a special agent from the Intelligence Division of the IRS issued a summons to the LaSalle National Bank calling for testimony and the production of certain books and records in connection with the investigation of one John Gattuso. The bank appeared in response to this summons, but refused to produce the records sought or provide the testimony requested. Thereafter, the IRS sought enforcement of the summonses pursuant to sections 7402(b) and 7604(a). At a district court hearing held subsequent to the issuance of a rule to show cause, the special agent testified repeatedly that the purpose for his investigation was "to determine whether or not there were any criminal violations of the Internal Revenue Code." In an apparent contradiction, however, the special agent stated that he had not formed a firm purpose to recommend criminal prosecution, but that he was attempting to determine "the tax liabilities [of Gattuso] for the years under investigation.

The respondent bank called Gregory J. Perry as a witness, who testified that the special agent had advised him prior to the issuance of the summonses that "the investigation was strictly related to criminal violations" of the IRC, that there was no revenue agent assigned to the case with the

IRC § 7602.


6. The function of the Intelligence Division, as opposed to that of either the Audit or the Collection Division, is to enforce:

the statutory sanctions applicable to income, estate, gift, employment and certain excise taxes through the investigation of cases of possible criminal violations of such laws and the recommendation (when warranted) of prosecution and/or the assertion of the 50% addition to tax in order to create the broadest possible impact on the compliance attitudes of the taxpaying public.

[1977] 4 I.R.S. MANUAL (Handbook for Special Agents) (CCH) ¶ 9141.1 n.27.

7. Section 7402(b) of the IRC provides:

If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, or other data, the district court of the United States for the district in which such person resides or may be found shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

IRC § 7402(b). Section 7604(a) further provides:

If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, records, or other data, the United States district court for the district in which said person resides or is found shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, records, or other data.

IRC § 7604(a).

8. See 554 F.2d at 304 for this discussion of the district court decision.

9. Id.
special agent and that the special agent had stated that his investigation was "strictly a criminal investigation." Citing Donaldson v. United States, the district court judge recognized that a summons may be properly enforced if issued in good faith and prior to a recommendation for criminal prosecution. The lower court, however, chose not to find credible the testimony of the special agent that he was merely investigating the "tax liabilities" of Gattuso, concluding that the summons had been issued solely for criminal purposes and was, therefore, unenforceable.

On appeal, the government asserted that a finding of a "sole criminal purpose" was a conclusion of law, rather than a finding of fact which would be controlled by the "clearly erroneous" standard of rule 52(a) of the Federal Rules of Civil Procedure. The Seventh Circuit disagreed, holding that the "clearly erroneous" standard was applicable to either a finding of "good faith" or "sole criminal purpose." In doing so, the court concluded that there was sufficient evidence produced during the course of the hearing to support the findings of the district court.

The more important issue addressed in the LaSalle National Bank case concerned the legal test to be applied in determining whether a summons is enforceable. To decide this issue, the Seventh Circuit surveyed the decisions of other circuits and found that a variety of standards had been applied. The primary difficulty in determining the proper standard related back to the decision of the Supreme Court in Donaldson v. United States, and a determination as to whether the following language of Justice Blackmun was dictum or holding: "We hold that under Section 7602 an Internal Revenue summons may be issued in aid of an investigation if it is issued in good faith and prior to a recommendation for criminal prosecution."

A conclusion that the phraseology employed by Justice Blackmun was the law of the case results in the application of a two-pronged test determining the enforceability of a summons. First, the summons must have been issued in good faith; that is, not issued solely for criminal purposes. Second, there must not have been a formal recommendation for prosecution.

10. Id.
11. Id. at 305 (citing Donaldson v. United States, 400 U.S. 517 (1971)).
12. Id.
13. FED. R. CIV. P. 52.
14. 554 F.2d at 305.
15. Contra, United States v. Weingarden, 473 F.2d 454, 460 (6th Cir. 1973) ("the finding by the District Court that the sole purpose of the issuance of the summons is for criminal prosecution . . . is subject to appellate review, and the clearly erroneous rule has no application").
17. Id. at 536.
In *United States v. Troupe*, the Eighth Circuit relied upon but misinterpreted the language of Justice Blackmun. In that case, a summons was issued to a partner of an accounting firm for the production of documents concerning the tax liability of a corporate taxpayer. The district court judge granted enforcement of the summons. Upon review, the court of appeals found that a summons could be successfully challenged: “Only when a criminal prosecution has been instituted and is pending at the time of the issuance of the summons or when criminal prosecution has been recommended.”

The Eighth Circuit failed to make the distinction between the two prongs of the *Donaldson* test, and thus would grant enforcement notwithstanding the intentions of the special agent in seeking production of the summoned documents for criminal purposes only. The more logical approach is to allow respondents in summons enforcement proceedings to offer evidence that the summons was issued when the investigating agent had “formed a firm purpose to recommend criminal prosecution,” despite the lack of any pending charges against the respondent or a referral of the investigation to the Department of Justice.

Most federal circuits, other than the Eighth Circuit, have uniformly followed the two-pronged test of *Donaldson*. In *United States v. McCarthy*, although there was no allegation that a recommendation for criminal prosecution had been made, the Third Circuit remanded for a hearing on the allegations of the respondent that the summons was issued for criminal purposes. Citing the District of Columbia case of *United States v. Wall Corporation*, the court held that the district court judge must determine whether the summons was issued “in good faith,” that is, whether the special agent “had formed a firm purpose to recommend criminal prosecution . . . .” The Sixth Circuit, the Ninth Circuit, and the Tenth Circuit have all approved the dual standard which the government must meet in order to obtain the enforcement of an IRS summons. And, in all circuits other than the Eighth Circuit, such a conclusion was reached.

18. 438 F.2d 117 (8th Cir. 1971).
19. *See* 438 F.2d at 118-19 for a discussion of the district court decision.
20. *Id.* at 119.
22. 514 F.2d 368 (3d Cir. 1975).
23. *Id.* at 375.
25. 514 F.2d at 374.
irrespective of the particular court's view of Mr. Justice Blackmun's language as mere dicta or holding.\textsuperscript{29}

Reviewing the melange of opinions from other circuits, the Seventh Circuit, in \textit{LaSalle National Bank}, found particularly appealing the careful analysis of \textit{Donaldson} by the Third Circuit in \textit{United States v. Friedman}.\textsuperscript{30} In \textit{Friedman}, the court authorized enforcement of summonses as long as:

1. the Intelligence Division of the IRS has not yet recommended prosecution,
2. the investigating agent has not already formed a firm purpose to recommend prosecution,
3. the summons is not being used to harass the taxpayer,
4. the material referred to in the summons has not already been inspected by the Government. . . .\textsuperscript{31}

However, the difficulty which the Seventh Circuit found with the \textit{Friedman} articulation of the standards to be applied in determining the enforceability of a summons was a failure of the Third Circuit to include among its standards that of the good faith of the issuing agent. Relying thereafter upon the opinion of the Ninth Circuit in \textit{United States v. Zack},\textsuperscript{32} the Seventh Circuit concluded: "Thus, it is proper for a District Court to grant enforcement of an IRS summons if it is issued in good faith and prior to a recommendation for criminal prosecution. Conversely, if a summons is issued in bad faith or after a recommendation for prosecution, enforcement must be denied."\textsuperscript{33}

Left unresolved by the Seventh Circuit in \textit{LaSalle National Bank} was the issue as to when "a recommendation for criminal prosecution"\textsuperscript{34} occurs during the course of the investigation. In \textit{United States v. Lafko},\textsuperscript{35} the Third Circuit reviewed \textit{Donaldson} and determined that the recommendation from the special agent to the regional counsel of the IRS was "a recommendation for prosecution" sufficient to preclude the enforceability of the summons.\textsuperscript{36} However, the Sixth,\textsuperscript{37} Ninth,\textsuperscript{38} and Tenth\textsuperscript{39} Circuits disagreed with the Third Circuit concluding that a recommendation to the Department of Justice is that crucial stage in the investigation which would preclude the enforceability of the summons.\textsuperscript{40} The author submits that the Supreme Court, in

\begin{itemize}
  \item \textsuperscript{29} See quoted material in the text at note 17 supra.
  \item \textsuperscript{30} United States v. Friedman, 532 F.2d 928 (3d Cir. 1976).
  \item \textsuperscript{31} \textit{Id.} at 932.
  \item \textsuperscript{32} 521 F.2d 1366 (9th Cir. 1975).
  \item \textsuperscript{33} 554 F.2d at 308.
  \item \textsuperscript{34} \textit{Id.}
  \item \textsuperscript{35} 520 F.2d 622 (3d Cir. 1975).
  \item \textsuperscript{36} \textit{Id.} at 625.
  \item \textsuperscript{37} United States v. Weingarden, 473 F.2d 454, 459 (6th Cir. 1973).
  \item \textsuperscript{38} United States v. Hodge & Zweig, 548 F.2d 1347, 1351 (9th Cir. 1977).
  \item \textsuperscript{39} United States v. Hodgson, 492 F.2d 1175, 1177 (10th Cir. 1974).
\end{itemize}
reviewing the decision of the Seventh Circuit in *LaSalle National Bank*, will most likely conclude that the relevant "recommendation" will occur when made to the Department of Justice.

**INVOLUNTARY CONVERSION**

*Broadview Lumber Co., Inc. v. United States*\(^{41}\) involved the "tax consequences of a merger of a parent corporation into its subsidiary, brought about by the subsidiary's purchase of the parent's stock with insurance proceeds received from the involuntary conversion of the subsidiary's assets through fire."\(^{42}\) Allen County Lumber Company\(^{43}\) owned 53% of the Broadview Lumber Co.\(^{44}\) The Fisher family owned approximately 47% of Allen County, with the remaining 53% of Allen County being owned by the Johnston family. Substantially all of Broadview's assets were destroyed by fire, for which Broadview received insurance proceeds, realizing a gain of some $182,000 on the involuntary conversion. In order to avoid recognition of the gain on the receipt of the proceeds, Broadview determined to reinvest the proceeds in property similar to that destroyed by the fire, and as a result sought control of Allen County. Allen County redeemed all of the stock of the Fisher family, and thereafter Broadview purchased all of the stock of the Johnston family, with Broadview becoming the parent company of its former parent, Allen County. Allen County then merged into Broadview, with Broadview taking the assets received from Allen County at Allen County's basis with no reduction for the non-taxable gain realized as a result of the involuntary conversion.\(^{45}\)

The issues to be resolved were whether: (1) the purchase by Broadview of Allen County's stock from its shareholders was a constructive dividend to Allen County; (2) the purchase by Broadview was a transaction which qualified as a tax free replacement; and (3) the acquisition cost rather than the carry-over basis was the proper basis for the assets received by Broadview from Allen. The Seventh Circuit held for the taxpayer on all three issues.

As to the dividend issue, the court relied upon a recent decision of the Tax Court.\(^{46}\) sitting with all sixteen judges, which held that a parent corporation does not realize a constructive dividend under the provisions of section 304\(^{47}\) of the IRC upon the purchase of its stock by a subsidiary. In an

\(^{41}\) 561 F.2d 698 (7th Cir. 1977).
\(^{42}\) Id. at 699.
\(^{43}\) Hereinafter referred to in the text as Allen County.
\(^{44}\) Hereinafter referred to in the text as Broadview.
\(^{45}\) 561 F.2d at 699-700.
\(^{47}\) Section 304 provides in pertinent part: § 304 *Redemption through use of related corporations.*
extended discussion of the legislative history of section 304 and its predecessor statute, the court noted that when a subsidiary buys the stock of its parent corporation from the stockholders of the parent, that purchase may be treated as a dividend to the stockholders from the parent, as if the subsidiary had first distributed the funds to the parent who then paid its stockholders. This does not mean, however, that the parent receives a taxable dividend upon the purchase, for the “as if” language of section 304 is not the equivalent of an actual payment by the subsidiary to the parent, and the purchase therefore from the shareholders involves no tax consequences to the parent corporation.

The second issue concerned the fact that Broadview reinvested the insurance proceeds in the Johnston family stock in Allen County in order to avoid recognition of the gain arising from the involuntary conversion. Section 1033 of the IRC provides for a tax-free replacement of property destroyed in whole or in part, as long as the replacement property is purchased. However, section 304 specifies that where a corporation buys the stock of a related corporation, the acquisition is treated as a contribution to the capital of the acquiring corporation rather than a purchase. The government, therefore, argued that the Broadview acquisition of the Allen County stock was not a purchase, but rather was a contribution to capital, and that the provisions of section 1033, as a consequence, were inapplicable. In analyzing section 304 and its legislative history, the Seventh Circuit concluded that the “contribution to the capital” language of section 304 applied only to transactions between brother-sister corporations, and that because Broadview, a subsidiary, acquired the stock of its parent, rather

(a) Treatment of certain stock purchases.

(2) Acquisition by subsidiary.
For purposes of sections 302 and 303, if—
(A) in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and
(B) the issuing corporation controls the acquiring corporation, then such property shall be treated as a distribution in redemption of the stock of the issuing corporation.

(b) Special rules for application of subsection (a).

(2) Amount constituting dividend.

(B) Where subsection (a)(2) applies.
In the case of any acquisition of stock to which subsection (a)(2) of this section applies, the determination of the amount which is a dividend shall be made as if the property were distributed by the acquiring corporation to the issuing corporation and immediately thereafter distributed by the issuing corporation.

IRC § 304.

48. Section 115(g)(2) of the Internal Revenue Code of 1939 (superseded by IRC § 304).
49. IRC § 304(a)(2), § 304(b)(2)(B).
50. IRC § 1033.
51. 561 F.2d at 705.
than a related corporation, a true "purchase" had been effected. The court specifically found that the constructive ownership rules of section 318(a)(3)(C) were fictions which Congress did not intend to apply to section 304(a).

The final issue in the Broadview case concerned the basis to be attributed to the assets Broadview received from Allen County and the applicability of Kimbell-Diamond Milling Co. v. Commissioner. In Kimbell-Diamond, the Tax Court held that the subjective intention of the acquiring corporation was controlling, and that if the acquiring corporation intended to acquire the assets of the liquidating corporation, the basis to be reflected on the acquiring corporation books would be the cost of the assets.

Subsequent to Kimbell-Diamond, Congress passed the Internal Revenue Code of 1954. In section 334, relating to the liquidation of subsidiaries, Congress set forth two separate standards: section 334(b)(1) provided for a carry-over basis, and section 334(b)(2) for a cost basis. The Seventh Circuit found in Broadview that section 334(b)(2) was "intended to substitute objective, definable standards for the subjective test of Kimbell-Dia-

52. Id. at 709.
53. IRC § 318(a)(3)(C).
55. 14 T.C. at 80.
56. Section 334(b)(1) provides:
   If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), then, except as provided in paragraph (2), the basis of the property in the hands of the distributee shall be the same as it would be in the hands of the transferor. If property is received by a corporation in a transfer to which section 332(c) applies, and if paragraph (2) of this subsection does not apply, then the basis of the property in the hands of the transferee shall be the same as it would be in the hands of the transferor.
IRC § 334(b)(1).
57. Section 334(b)(2) provides, in pertinent part, for the following exception:
   If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), and if—
   (A) the distribution is pursuant to a plan of liquidation adopted . . . not more than 2 years after the date of the transaction described in subparagraph (B) (or, in the case of a series of transactions, the date of the last such transaction); and
   (B) stock of the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), was acquired by the distributee by purchase (as defined in paragraph (3)) during a 12-month period beginning with the earlier of—
      (i) the date of the first acquisition by purchase of such stock, or
      (ii) if any such stock was acquired in an acquisition which is a purchase within the meaning of the second sentence of paragraph (3), the date on which the distributee is first considered under section 318(a) as owning stock owned by the corporation from which such acquisition was made, then the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made. . .
IRC § 334(b)(2).
and that the standards reflected therein were not present in the Broadview acquisition of the Allen County stock. Specifically, the court found that section 334(b)(2) did not apply to the Broadview transaction because the stock acquired was not "purchased" as the term purchase is defined in section 334(b)(3), for purposes of determining the applicability of section 334(b)(2). Thus, the basis for the assets in Broadview's hands "received in liquidation of Allen [was] carried over from the basis of those assets in Allen's hands."

NON-DISCHARGEABLE TAX OR DISCHARGEABLE PENALTY

Section 17 of the Bankruptcy Act provides in essence that a bankrupt shall not be released upon his discharge from withholding taxes which he withheld from the wages of his employees but did not pay over to the United States. In In re Sotelo, the taxpayer, chief executive officer of a corporation, was assessed a 100 percent penalty under IRC section 6672 following the failure of his corporation to account to the government for taxes withheld from the wages of the corporate employees. Sotelo filed for personal bankruptcy, and scheduled the 100 percent penalty as a liability, which the bankruptcy judge allowed.

The sole issue before the Seventh Circuit was the dischargeability of Sotelo's liability, which in turn revolved around a characterization of the liability as either a tax or a penalty. The court found for the taxpayer, concluding that the withholding liability was specifically denominated a "penalty" by section 6672, that section 17 of the Bankruptcy Act provided

58. 561 F.2d at 711.
59. Id. The court specifically declined to follow a contrary holding of the Court of Claims in American Potash & Chemical Corp. v. United States, 399 F.2d 194 (Ct. Cl. 1968).
60. 561 F.2d at 714.
A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as (1) are taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof within three years preceding bankruptcy: Provided, However, That a discharge in bankruptcy shall not release a bankrupt from any taxes . . . (e) which the bankrupt has collected or withheld from others as required by the laws of the United States or any State or political subdivision thereof, but has not paid over . . .
63. Section 6672 is worded as follows:
Any person required to collect, truthfully account for, and pay over tax imposed by this title who willfully fails to collect such tax or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under section 6653 for any offense to which this section is applicable.
IRC § 6672.
64. See 551 F.2d at 1091 for a discussion of the bankruptcy proceedings.
only that withheld "taxes" are non-dischargeable, and that as a policy matter, a contrary holding would "contravene the Bankruptcy Act's basic policy of settling a bankrupt's past debts and providing a fresh economic start." Because the opposite conclusion was reached by the Fifth Circuit in In re Murphy, which the Seventh Circuit specifically declined to follow, the Supreme Court has granted review in Sotelo.

ABATEMENT OF PENALTY FOR FAILURE TO FILE A RETURN

In United States v. Kroll, the government brought suit to reduce to judgment a penalty imposed following the failure to timely file an estate tax return. The return was filed approximately twelve months late. The only issue before the court was whether the taxpayer established reasonable cause and proved that he exercised ordinary business care and prudence as a defense to the imposition of the penalty. Kroll, the executor of the estate, argued that he had relied upon the attorney for the estate, and that that factor alone established reasonable cause as a matter of law. The district court agreed, emphasizing that Kroll was "not an expert in the field of tax or estate reporting," and that he was entitled to and did in fact rely upon the attorney to whom he entrusted the preparation of the estate tax return.

The Seventh Circuit reversed the decision of the lower court, holding that: "[W]hen there is no question that a return must be filed, the taxpayer has a personal, nondelegable duty to file the tax return when due." The court emphasized that the executor of the estate had no responsibilities with respect to the intricacies of the IRC, but rather had only to remember one date, the date on which the estate tax return was due. Had Kroll been advised by the attorney for the estate that the law did not require the filing of an estate tax return, such a legal opinion would have foreclosed the imposition of the late filing penalty. In the circumstances of this case, however, Kroll's only responsibility was "to read a calendar and to jot down on [his] desk or office records a single date." Thus, the penalty will be imposed where there is no question of the duty to file the return, and the taxpayer is aware that such return must be filed.

The opinion of the Seventh Circuit conflicts with that of the Tax Court in the Estate of Bradley. In Bradley, the executor was advised by the

65. 551 F.2d at 1092-93.
66. 533 F.2d 941 (5th Cir. 1976).
67. See note 51 supra.
68. 547 F.2d 393 (7th Cir. 1977).
69. See 547 F.2d at 395 for this discussion of the district court decision.
70. Id. at 396.
71. Id. at 395.
72. Accord, Ferrando v. United States, 245 F.2d 582 (9th Cir. 1957); Logan Lumber Co. v. Commissioner, 365 F.2d 846 (5th Cir. 1966).
73. 33 T.C.M. 70 (1974), aff'd without opinion, 511 F.2d 527 (6th Cir. 1975).
accountant charged with the preparation of the estate tax return that the return was due 18 months from the date of the decedent's death, but, in actuality, the time period was 15 months. The return was filed late, and the Commissioner imposed the late filing penalties against the executor. The Tax Court found for the taxpayer, emphasizing that the executor, Arnold, "had no experience in tax problems relating to probate matters," concluding that "Arnold did not know the due date of the estate tax return." The Seventh Circuit, based on Kroll, would have upheld the imposition of the penalty, because the advice from the accountant related to when the return was due, rather than whether a return was due. The Tax Court finds such argument a distinction without a difference:

To sustain respondent's argument would require a holding that an executor may rely upon the advice of an expert on substantive tax law questions but, as a matter of law, may not do so with respect to the requirements of the law as to the due date of tax returns—that he must research that question for himself. We decline to so hold.75

DEDUCTIBILITY OF PREPAID INTEREST

The Seventh Circuit addressed the deductibility of prepaid interest issue in the case of Resnik v. Commissioner.76 In that case, a limited partnership was formed in Illinois on December 31, 1969, in which the taxpayer, Resnik, contributed $40,000, representing thirty-two percent interest in the partnership. The total capital contributed by Resnik and his partners was $125,000, of which $115,000 was paid to Capital Concepts, a California corporation, as prepaid interest for a fifty-one month period for an interest in certain properties located in Texas. The Resnik partnership had no income in 1969, the capital contribution was made on the last day of the calendar year, and thus the prepaid interest resulted in a $115,000 loss, the only expense reported by the Resnik partnership on its 1969 return.

Resnik claimed a $36,800 deduction as his distributive share of the $115,000 partnership loss in 1969. The Commissioner disallowed the deduction, and was upheld by the Tax Court which found that "the prepaid interest deduction materially distorted the partnership income"77 and that the Commissioner had properly exercised his discretionary authority under IRC section 446(b).78 The Seventh Circuit affirmed, relying upon two recent

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74. Id.
75. Id.
76. Resnik v. Commissioner, 555 F.2d 634 (7th Cir. 1977).
77. Id. at 635.
78. Section 446(b) provides: "If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." IRC § 446.
cases from the Second\textsuperscript{79} and Ninth\textsuperscript{80} Circuits, disallowing deductions for prepaid interest.

The Seventh Circuit viewed the issue as whether "the method of accounting, viewed with reference to the particular item of prepaid interest, clearly reflects or, conversely, materially distorts income."\textsuperscript{81} Because the Resnik partnership had a one day taxable year, the partnership's tax return reflected no income for that year and Resnik individually, in effect, realized a ninety-two percent return on his investment on the very same day the investment was made, the court viewed the intent of the taxpayer with a jaundiced eye.

**PRIORITY OF FEDERAL TAX LIENS**

Two cases were decided by the Seventh Circuit this term involving the priority to be accorded claims by the United States against taxpayers arising out of their failure to pay over taxes withheld from the wages of employees.

In *Dragstrem v. Obermeyer*,\textsuperscript{82} Dragstrem loaned Obermeyer $11,400, taking back as collateral through the vehicle of a security agreement 500 acres of popcorn and the proceeds from their sale. The security interest was never perfected, however, because of Dragstrem's failure to file a financing statement under the provisions of the Uniform Commercial Code.\textsuperscript{83} Dragstrem thereafter brought suit in state court on the obligation,\textsuperscript{84} joining the Weaver Popcorn Company\textsuperscript{85} in order to obtain the proceeds of the sale of the popcorn from Obermeyer to Weaver. Weaver admitted owing Obermeyer some $30,000, but declined to transmit the funds to Dragstrem because of conflicting claims to those proceeds in excess of the $30,000. The United States was joined as a party-claimant to the action, after which Weaver sought an order Authorizing the deposit of the funds with the court. Several days later, but prior to the deposit of the $30,000 by Weaver into the custody of the court, the United States filed a tax lien in the amount of $25,000 against the Weaver monies.\textsuperscript{86} Weaver then deposited the funds into the state court, and the United States obtained a removal of the action to federal district court.

\textsuperscript{79} Burck v. Commissioner, 533 F.2d 768 (2d Cir. 1976).
\textsuperscript{80} Sandor v. Commissioner, 62 T.C. 469 (1974), aff'd, 536 F.2d 874 (9th Cir. 1976).
\textsuperscript{81} 555 F.2d at 636.
\textsuperscript{82} 549 F.2d 20 (7th Cir. 1977).
\textsuperscript{83} IND. CODE ANN. § 26-1-9-401 (Burns 1976) [hereinafter referred to in the text as the UCC].
\textsuperscript{84} See 549 F.2d at 22 for a discussion of the state court decision.
\textsuperscript{85} Hereinafter referred to in the text as Weaver.
\textsuperscript{86} The lien was based upon the assessment of 100 percent penalties against Obermeyer as a responsible officer for his failure to pay over to the United States taxes withheld from the wages of his company's employees. 549 F.2d at 22. See also note 52 supra.
The issue before the Seventh Circuit concerned whether the federal tax lien filed by the United States against the Weaver monies had priority over Dragstrem's unperfected security interest. The court held that it did. Although the Seventh Circuit concluded that "a security interest need not be perfected under the UCC in order to be protected against a subsequent judgment lien under . . . the Federal Tax Lien Act," the court deemed it necessary to determine just what type of protection a security interest need have in order to be protected under local law against the subsequent federal tax lien. Under one set of cases, if the government obtained actual knowledge of the unperfected security interest before filing its tax lien, the tax lien would have been subordinate to the unperfected security interest. Since in Dragstrem, the government was interpleaded in the state court prior to filing its tax lien, this rule would have accorded Dragstrem priority over the government.

The other line of cases apply the so-called "hypothetical judgment lien creditor" test: "Under this test, a security interest primes an unfiled federal tax lien only if the security interest is protected under local law against any hypothetical judgment lien creditor that might arise, whether or not the government has actual knowledge of the security interest." The "hypothetical judgment lien creditor" standard was applied by the district court and approved by the Seventh Circuit in Dragstrem, on the basis that the "government does not rely on any notice, actual or record, in making a determination to become a creditor, or to create and file a tax lien."

The final matter to be resolved in Dragstrem was the finding of the district court, applying the hypothetical judgment lien creditor test, that "no creditor could obtain a judgment lien against property in custodia legis without obtaining knowledge of Dragstrem's security interest." The Seventh Circuit reversed, holding that a hypothetical creditor could in fact obtain a judgment lien against property in the custody of the court, without obtaining actual knowledge of a security interest, by obtaining "an in personam judgment against [the] debtor in another court and delivering a writ of execution based on that judgment to a sheriff." Because the lien attaches to the property at the time the writ of execution is delivered to the

87. See 549 F.2d at 23-26 for the court of appeal's discussion of this issue.
88. 549 F.2d at 25.
90. 549 F.2d at 26.
91. Id.
92. Id.
93. Id. at 27.
sheriff, the creditor could obtain his lien without learning of the action before the court with custody of the property.

In United States v. Burczyk,94 the defendant was appointed receiver in connection with an insolvency proceeding brought by the State of Wisconsin against a manufacturing company. Among the debts of the manufacturer were monies owed to the federal government for income taxes withheld from its employees, as well as unemployment taxes to the state and personal property taxes to the Village of Waterford. Under Title 31, United States Code, section 191,95 the government filed its claim of priority in a timely manner for the amount of the unpaid withholding taxes, notifying Burczyk that he could be held personally liable should he fail to honor the government's priority. Both the State of Wisconsin and the Village of Waterford also filed their tax claims in a timely fashion. Because the report filed by Burczyk did not reflect the priority of the claim of the United States, the state court ordered that the claims of the state and the village be satisfied, with the balance of the assets being insufficient to satisfy the claim of the government.96 Under section 19297 the government sought to hold Burczyk personally liable in federal court for the amount of those sums paid to the state and the village.

Under Wisconsin law, tax claims may be perfected by the docketing of a warrant in the amount of the claims,98 which both the state and the village did. Burczyk argued that the state and the village, having perfected their tax claims, had priority over the claim of priority by the federal government, because of the Wisconsin statute providing for perfection. The Seventh Circuit affirmed the opinion of the district court that "federal, not state law, governs the priority between federal and state or municipal tax liens..."99 The court noted that only in circumstances under which the lien had

94. 556 F.2d 394 (7th Cir. 1977).
95. Title 31, United States Code, section 191 (1970) states:
Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.
96. See 556 F.2d at 395 for a discussion of the state court proceedings.
97. Title 31, United States Code, section 192 (1970) states:
Every executor, administrator, or assignee, or other person, who pays, in whole or in part, any debt due by the person or estate for whom or for which he acts before he satisfies and pays the debts due to the United States from such person or estate, shall become answerable in his own person and estate to the extent of such payments for the debts so due to the United States, or for so much thereof as may remain due and unpaid.
99. 556 F.2d at 396.
been perfected under state law, and the property had been reduced to the possession of the creditor, could the village and the state have prevailed over the general priority accorded claims of the government under section 191.  

THE ANTI-INJUNCTION ACT

Once again the Anti-Injunction Act has precluded a taxpayer from attacking a ruling of the IRS which destroyed the very livelihood of the taxpayer. In Educo, Inc. v. Alexander, the plaintiff corporation designed and managed educational benefit programs for the employees of its clients. Through such plans, the corporate clients would contribute to trust funds administered by Educo, out of which would be paid distributions to children of certain corporate employees for college educations. None of the funds so contributed by the corporate clients would ever be received by the employees themselves. Through the publication of Revenue Ruling 75-448, the IRS advised that the contributions to such plans constituted deferred compensation to employees whose children received benefits thereunder. Furthermore, the contributing corporations could deduct in the year of contribution only such amounts as were included in the gross income of the employees on whose behalf the contributions to the plan had been made. Needless to say, the Revenue Ruling undermined the very nature of the business of Educo. Educo therefore brought suit seeking to enjoin the IRS and the Secretary of the Treasury from implementing the Revenue Ruling. The district court dismissed the suit, finding that it had no jurisdiction to hear the cause because of the Anti-Injunction Act.

In the court of appeals, Educo asserted the argument that because the Anti-Injunction Act precluded suits "for the purpose of restraining the assessment or collection of any tax," the Act was inapplicable to the Educo cause of action because Educo did not seek "to obstruct revenue collecting but instead to maintain Educo's financial viability." Although there was no question that the purpose of the law suit was to maintain Educo's financial viability, the Seventh Circuit concluded that the ultimate effect, should Educo be successful, would be a reduction in the tax liabilities

100. Id. at 397. The court also rejected Burczyk's claim that the state and the village were unjustly enriched, finding Burczyk's own negligence of sufficient magnitude to preclude equitable relief.
101. IRC § 7421(a).
103. 557 F.2d 617 (7th Cir. 1977).
105. See 557 F.2d at 618 for a discussion of the district court decision.
106. IRC § 7421(a).
107. 557 F.2d at 620.
of Educo's corporate client employees. Thus, the court held that the Anti-Injunction Act specifically forbade prosecution of the Educo suit.\textsuperscript{108}

In the "capstone to judicial construction"\textsuperscript{109} of the Anti-Injunction Act, the Supreme Court held in \textit{Enochs v. Williams Packing & Navigation Co.}\textsuperscript{110} that, notwithstanding the Act, an injunction could be entered if the plaintiff could show that "(1) under no circumstances could the government ultimately prevail; and (2) a basis for equity jurisdiction exists."\textsuperscript{111} Educo attempted to avail itself of the \textit{Williams Packing} exception to the Anti-Injunction Act, claiming that there was an insufficient basis for the district court judge to determine whether the government could in fact ultimately prevail. The Seventh Circuit disagreed, noting that the substance of Revenue Ruling 75-448 was approved by the Tax Court less than four months prior to the decision of the Seventh Circuit in \textit{Educo}.\textsuperscript{112} Because the Seventh Circuit similarly dismissed the argument that the government could not prevail on the merits, the court did not consider whether there was a basis for equity jurisdiction, for both prongs of the \textit{Williams Packing} decision "are sine qua nons for the entering of an injunction."\textsuperscript{113}

\textbf{ADDITIONS TO RESERVES FOR BAD DEBTS}

In \textit{First National Bank of Chicago v. Commissioner},\textsuperscript{114} the Trust Department of the bank maintained a separate trust account for each trust it administered. During the course of managing the trusts, disbursements would occasionally exceed cash on hand, causing the Trust Department to authorize overdrafts. To cover the overdrafts, the Commercial Loan Department would advance to the Trust Department the amount by which the particular trust accounts were short, carrying such advances on the books of the Commercial Loan Department as loans to the Trust Department. Because IRC section 166(c)\textsuperscript{115} permits "a reasonable addition to a reserve for bad debts" to be deducted as bad debts, the bank computed its bad debt reserve utilizing the advances as part of its loan base. Upon audit, the Commissioner disallowed that portion of the bad debt reserve reflecting the

\begin{itemize}
  \item \textsuperscript{108} \textit{Id.} The court also rejected Educo's claim that the Anti-Injunction Act precluded suits only by taxpayers, rather than third persons.
  \item \textsuperscript{109} \textit{Bob Jones University v. Simon}, 416 U.S. at 742 (quoting \textit{Enochs v. Williams Packing & Navigation Co.}, 370 U.S. 1 (1962)).
  \item \textsuperscript{110} \textit{Enochs v. Williams Packing & Navigation Co.}, 370 U.S. 1 (1962).
  \item \textsuperscript{111} 557 F.2d at 620-21.
  \item \textsuperscript{112} Richard T. Armantrout, 67 T.C. 996 (1977).
  \item \textsuperscript{113} 557 F.2d at 622.
  \item \textsuperscript{114} 546 F.2d 759 (7th Cir. 1976).
  \item \textsuperscript{115} Section 166(c) provides: "\textit{Reserve for bad debts}—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate [the Commissioner]) a deduction for a reasonable addition to a reserve for bad debts." IRC § 166(c).
\end{itemize}
advances to the Trust Department as not being "representative of the bank's ordinary portfolio of outstanding customer loans," pursuant to section 9 of Revenue Ruling 68-630. The Tax Court reversed the determination of the Commissioner.

Section 166(c) of the IRC provides that, "in the discretion of the Secretary or his delegate," a reasonable addition may be made to a reserve for bad debts. The issue before the Seventh Circuit in First National Bank was therefore "whether the Commissioner's view is reasonable rather than whether the taxpayer's view is reasonable." The court first disposed of the bank's argument that section 9 of the Revenue Ruling was not an independent basis for excluding loans from the loan basis in determining the bad debt reserve. Rather than constituting a catch-all paragraph intending to summarize exclusions set forth in sections 3 through 8 of the Ruling, the court agreed with a recent decision of the Tax Court that "Section 9 constitutes a separate ground for exclusion of loans from a bank's loan base beyond those exclusions set forth in earlier Sections of that Ruling."

In affirming the determination of the Commissioner to exclude the advances to the Trust Department from the loan base, the court placed great emphasis on the facts that the Commercial Loan Department neither received notes nor charged interest, that the bank made no profit on the advances and that there were no losses incurred by the bank for the taxable year in question with respect to the advances. All the foregoing items led the Seventh Circuit to conclude that there was no "element of risk" in the loans from the Commercial Loan Department to the Trust Department, and since no losses could be anticipated with respect to the loans, no additions to the reserve for bad debts could be computed taking such loans into account.

116. 546 F.2d at 761.
117. Section 9 of Revenue Ruling 68-630 provides:
A bank may compute the addition to its reserve for bad debts on the basis of loans outstanding at the close of its taxable year, except that any loan outstanding on such date that is not representative of the bank's ordinary portfolio of outstanding customer loans must be excluded from the loan base. If a loan is entered into or acquired for the purpose (whether or not it is the primary purpose) of enlarging the otherwise available bad debt deduction, it will be presumed that the loan resulting from such transaction is not representative of the bank's ordinary portfolio of outstanding customer loans.
119. See IRC § 166(c).
120. 546 F.2d at 761.
122. 546 F.2d at 762.
123. Id. at 762-63.
WHEN IS A RETURN “FILED”

In Hotel Equities Corp. v. Commissioner, \(^{124}\) the corporate taxpayer’s return was due on July 15, 1970. On July 14, 1970, the return was mailed, being received by the IRS on July 17, 1970. Exactly three years from the date of receipt of the return, the IRS mailed to the taxpayer a statutory notice of deficiency for the year 1970. The sole issue before the Seventh Circuit was whether section 7502\(^ {125}\) defined the time when a tax return was “filed” for purposes of section 6501(a).\(^ {126}\)

Inasmuch as section 6501(a) proscribes the imposition of an assessment unless made within three years after the filing of the return, the assessment was untimely if the return was filed on the date of mailing, rather than the date of receipt. The Seventh Circuit read the language of section 7502(a)(1)\(^ {127}\) literally, finding that: “[W]hen a document required to be filed by a prescribed date (such as the tax return in the instant case) is properly mailed, it will be deemed delivered (i.e. filed) on the date of its mailing.”\(^ {128}\)

The Commissioner conceded that section 7502 controlled in determining whether a timely return was filed to avoid an addition to a tax\(^ {129}\) or to determine whether a deadline prescribed by law for filing a claim for refund was timely. The Commissioner’s argument, that section 7502 did not apply when determining whether a return was filed for purposes of triggering the running of the statute of limitations, was a distinction the court found not to be borne out by either logic or congressional intent.\(^ {130}\)

“MARRIAGE PENALTY” UPHELD

In Barter v. United States,\(^ {131}\) the Seventh Circuit rejected an attack by married taxpayers on those provisions of the IRC which impose higher tax

\(^{124}\) 546 F.2d 725 (7th Cir. 1976).
\(^{125}\) IRC § 7502.
\(^{126}\) IRC § 6501(a).
\(^{127}\) Section 7502(a)(1) of the IRC provides:
If any return, claim, statement, or other document required to be filed, or any payment required to be made, within a prescribed period or on or before a prescribed date under authority of any provision of the internal revenue laws is, after such period or such date, delivered by United States mail to the agency, officer, or office with which such return, claim, statement or other document is required to be filed, or to which such payment is required to be made, the date of the United States postmark stamped on the cover in which such return, claim, statement, or other document, or payment, is mailed shall be deemed to be the date of delivery or the date of payment, as the case may be.
IRC § 7502(a)(1).
\(^{128}\) 546 F.2d at 728.
\(^{129}\) Id. at 726-727.
\(^{130}\) Id. at 729.
\(^{131}\) 550 F.2d 1239 (7th Cir. 1977), cert. denied, 46 U.S.L.W. 3436 (U.S. Jan. 9, 1978) (No. 77-490).
rates ""on the taxable income of a married person whose spouse has significant income than on the same taxable income of an unmarried person.""\textsuperscript{132} The taxpayers claimed a constitutional infringement of their rights under the due process clause of the Fifth Amendment, the free exercise clause of the First Amendment and the rights of association in marriage under the First, Fourth, Fifth, Ninth and Tenth Amendments.\textsuperscript{133} The Seventh Circuit found no constitutional proscription against such disparity in treatment, and specifically noted that: ""[P]erfect equality or absolute logical consistency between persons subject to the Internal Revenue Code has been, at least since the adoption of the Sixteenth Amendment, a constitutional sine qua non.""\textsuperscript{134}

**VALUATION OF ARGENTINE PESOS**

In a published opinion without any apparent precedential value, the Seventh Circuit in *Durovic v. Commissioner*,\textsuperscript{135} affirmed a decision of the Tax Court,\textsuperscript{136} calculating the exchange rate for Argentine pesos on January 26, 1950. The first issue in the case involved the need for a determination as to the rate of exchange was a result of Durovic's importation of the drug Krebiozen from Argentina in 1950 and its subsequent contribution to a partnership with his brother. Income tax deficiencies had been assessed against Durovic and the accuracy of the assessments rested upon his basis in the partnership. In the second issue before the court, Durovic claimed that his distribution free of cost of some 60,000 ampules of the drug was deductible as either an advertising expense or an amortizable capital expenditure. The Seventh Circuit again agreed with the Tax Court, disallowing the deduction, and found that neither characterization applied to the distribution of the ampules.

**INTERNAL REVENUE SERVICE MANUAL**

**NO SOLACE TO TAXPAYER**

In *United States v. Mapp*,\textsuperscript{137} the taxpayer was indicted and convicted for tax evasion.\textsuperscript{138} A substantial portion of the government's case relied upon statements taken from Mapp by both revenue agents from the Audit Division and special agents from the Intelligence Division of the IRS. The district court judge initially granted the defendant's motion to suppress his

\begin{itemize}
  \item \textsuperscript{132} *Id.* at 1240.
  \item \textsuperscript{133} U.S. Const. amend. I, IV, V, IX & X.
  \item \textsuperscript{134} 550 F.2d at 1240.
  \item \textsuperscript{135} 542 F.2d 1328 (7th Cir. 1976).
  \item \textsuperscript{136} 65 T.C. 480 (1976).
  \item \textsuperscript{137} 561 F.2d 685 (7th Cir. 1977).
  \item \textsuperscript{138} IRC § 7201.
\end{itemize}
statements, based on prior decisions of the Seventh Circuit in *United States v. Dickerson*,139 and *United States v. Oliver*.140 While the government's appeal of the suppression order was pending, the United States Supreme Court decided *Beckwith v. United States*,141 causing a remand of the case from the court of appeals back to the district court, which reversed the suppression order.142 In *Beckwith*, the Supreme Court held that *Miranda*143 warnings need not be provided to a taxpayer under investigation by the IRS for potential criminal violations unless the taxpayer is in a custodial situation. Because the interviews of Mapp were conducted at his tavern, and not in inherently coercive surroundings, the court found that Mapp had not been deprived "of his freedom of action in a significant way"144 and that no warnings were required.

Of primary importance in *Mapp* was the holding of the Seventh Circuit that the rules and regulations contained in the IRS Agents handbook were "adopted for the internal administration of the service and not for the protection of the taxpayer, and they, therefore, conferred no rights on the taxpayer."145 Mapp had argued that the IRS regulations required special agents to advise taxpayers under investigation for potential criminal violations of their *Miranda* warnings.146 The decision of the Seventh Circuit that Mapp could not avail himself of administrative rules imposed upon IRS employees was consistent with the findings of the Tenth Circuit.147

**Conclusion**

Whether the taxpayers will ultimately prevail in two of the most important cases decided by the Seventh Circuit this past term should be determined this year by the United States Supreme Court. In both *LaSalle National Bank* and *In re Sotelo*, the Supreme Court granted writs of certiorari, the cases have been argued and are awaiting decision. With thirteen written opinions rendered, the 1976-1977 term was certainly one of the most prolific of the Seventh Circuit in the area of taxation.

139. 413 F.2d 1111 (7th Cir. 1969).
140. 505 F.2d 301 (7th Cir. 1974).
142. See 561 F.2d at 687 for a discussion of the district court decision.
144. 561 F.2d at 688.
145. Id. at 690.
146. [1968] 7 STAND. FED. TAX REP. (CCH) ¶ 6946; [1967] 8 STAND. FED. TAX REP. (CCH) ¶ 5709.
147. United States v. Lockyer, 448 F.2d 417 (10th Cir. 1971).
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