Taxation

George A. Luscombe II
TAXATION

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The Court of Appeals for the Seventh Circuit in the past year has decided tax cases covering a broad spectrum of federal income taxation law, substantive and procedural, civil and criminal. This article will discuss those decisions which are most significant or interesting from the viewpoint of the attorney practicing federal tax law. The discussion does not purport to be an exhaustive analysis of the issues discussed, but hopefully presents the issues in a manner useful to the attorney desiring a review of the tax decisions of the Seventh Circuit.

Receipt of an Interest in Partnership Profits for Services

Under section 721 of the Internal Revenue Code of 1954,1 the receipt of a partnership interest in exchange for the contribution of property is a nontaxable event. However, the Treasury Regulations provide, in part, as follows:

To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.2

Thus, if an interest in partnership capital is received for the performance of services, the fair market value of the capital interest is taxable to the recipient-partner as compensation.3

Based, in part, on the parenthetical in the above-quoted material from the Treasury Regulations, it has been assumed by tax practitioners and scholars that the receipt of an interest in partnership profits,

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rather than an interest in capital, in exchange for the performance of services would not give rise to taxable income to the recipient-partner. The recipient-partner would have a zero tax basis in his partnership interest and would be taxed on his allocable share of the partnership profits as earned by the partnership.\footnote{Id. § 722.}

\begin{quote}
In \textit{Sol Diamond v. Commissioner of Internal Revenue},\footnote{Id. §§ 702, 704.} the Seventh Circuit, affirming the Tax Court,\footnote{492 F.2d 286 (7th Cir. 1974).} held that the receipt of an interest in partnership profits was taxable as compensation in an amount equal to the fair market value of the partnership interest at the time received. In \textit{Diamond}, one Kargman asked Diamond, a mortgage broker, to obtain a mortgage loan for the $1,100,000 purchase price of an office building which Kargman had acquired the right to purchase. Diamond and Kargman agreed that if Diamond succeeded in obtaining financing he would receive a 60 percent share of profit or loss on the venture. Diamond obtained the necessary financing, and on December 15, 1961, the two entered into an agreement providing that:

(1) They were associated as joint venturors for 24 years (the life of the mortgage) unless earlier terminated;

(2) Kargman was to advance all cash needed for the purchase in addition to the loan proceeds;

(3) Diamond and Kargman would share profits and losses 60\% to 40\%;

(4) In the event of the sale of the building, the net proceeds would be used to repay Kargman amounts supplied by him and the remainder divided in a 60:40 ratio between Diamond and Kargman. Closing occurred on February 18, 1962, with Kargman putting up $78,195.13. Shortly after closing, it was proposed that Diamond would sell his interest. Diamond sold his interest to one Liederman on March 8, 1962, for $40,000.

Diamond argued that the receipt of the interest in partnership profits was tax free under section 721 and the above-quoted provision of the regulations, even though received for the performance of services. He argued further that the receipt of the $40,000 was taxable\footnote{Sol Diamond, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974).}
as short-term capital gain as proceeds on the sale of a partnership interest.\textsuperscript{8}

The court found that the provision of the regulations was not intended to be all inclusive, but only dealt with the tax consequences of the receipt of an interest in partnership capital in exchange for the performance of services. The court reviewed the commentators, the very limited judicial authority,\textsuperscript{9} the legislative history, and the lack of prior administrative interpretations. The court then concluded that where an interest in partnership profits which had a determinable market value is received for services, that value should be taxable as compensation.

This decision has resulted in a great deal of consternation in the tax bar. Until the decisions of the Tax Court and Seventh Circuit in the \textit{Sol Diamond} case, it had uniformly been assumed that the receipt of an interest in partnership profits would be tax free. This decision is particularly troublesome in light of section 83,\textsuperscript{10} added by the Tax Reform Act of 1969.\textsuperscript{11} Section 83 provides, in general, that if property is transferred in connection with the performance of services, the fair market value is taxable at the time of transfer if the property is either transferable or not subject to a substantial risk of forfeiture. The proposed regulations under section 83 define the term "property" to include "both realty and personalty other than money and other than an unfunded and unsecured promise to pay deferred compensation."\textsuperscript{12} Thus, it appears that an interest in partnership profits is viewed by the IRS as "property" for purposes of section 83.

If a partner holding only an interest in partnership profits is taxed when he receives that interest, the transaction would be viewed as the receipt of cash equal to the market value of the partnership interest and the contribution of that cash in exchange for the partnership interest. Thus, the partner would acquire a tax basis in his partnership in-

\textsuperscript{8} \textsc{Int. Rev. Code of 1954, § 741.}
\textsuperscript{9} In Herman M. Hale, 24 T.C.M. 1497, 1502 (1965), the Tax Court stated: "Under the regulations, the mere receipt of a partnership interest in future profits does not create any tax liability. Sec. 1.721-1(b), Income Tax Regs." There was no explanation by the Tax Court as to how it derived this conclusion from the cited provision of the regulations, quoted note 2, \textit{supra} and accompanying text.
\textsuperscript{10} \textsc{Int. Rev. Code of 1954, § 83.}
\textsuperscript{11} \textsc{Pub. L. No. 91-172, § 321, 83 Stat. 487, 588 (1969).}
\textsuperscript{12} Proposed Treas. Reg. § 1.83-3(c), 36 Fed. Reg. 10787 (1971). In the same notice of proposed rule making, the Treasury proposed an amendment to § 1.721-1(b)(1) to provide that a transfer of an interest in partnership capital is subject to the rules of \textsc{Int. Rev. Code of 1954, § 83.}
interest equal to the value of that partnership interest. The partner would be taxed on his allocable share of the partnership income when earned by the partnership. Thus, he would be taxed on the partnership profits twice to the extent of the value when he receives the interest—once when he receives the partnership interest, and again when the partnership earns the income. When the partnership terminates, presumably the partner would be entitled to a loss deduction for the basis in his partnership interest. This deduction, however, would only occur after the double taxation has occurred, thereby compounding the effect of the double taxation.

If, as Diamond did here, a partner sells his partnership interest immediately after acquiring it, he would realize no gain because his tax basis would be equal to the amount received on the sale. The purchaser would be taxed on his allocable share of partnership profits and at the termination of the partnership presumably would be allowed a deduction for his cost of the partnership interest.

Further, it may be impossible to value the future profits which the partnership may generate. Any value placed on the interest in future profits may be purely speculative. In Sol Diamond, however, the partnership was formed after Diamond had obtained financing. Thus, the income-earning ability of the partnership could be determined with reasonable accuracy. Also, Diamond sold his profits interest within a month after the purchase of the office building. Using these facts, the court could value the interest and include it as taxable compensation. The result in this case may have been different if the partnership were formed before Diamond commenced efforts to obtain financing, or if Diamond had not sold his interest (at least not immediately following the purchase of the office building). In these situations, it may have been impossible to establish a fair market value.

With regard to the above practical problems, the court of appeals noted that the Treasury should provide regulations in order to achieve certainty in the area. It remains to be seen what position the IRS will take and whether Sol Diamond will be extended beyond its facts to any

14. Id. § 702.
receipt of an interest in partnership profits whether for the performance of past, present, or future services.\textsuperscript{17}

**BUSINESS EXPENSES**

In *Fischer v. United States*,\textsuperscript{18} the taxpayer was an officer-shareholder of a corporation. Pursuant to settlement of a dispute between the corporation and holders of its convertible debentures, and in order to induce the debenture holders to enter into the settlement, the taxpayer sold a portion of his shares in the company to the debenture holders for $4.20 per share at a time when the shares had a market value of $16.625. The taxpayer was aware that his resignation from the board of directors would be demanded if the dispute were not settled. He also thought that the resulting publicity would adversely affect his business reputation and jeopardize his future as a corporate executive, as well as adversely affect the value of the taxpayer's stock in the company. If the debenture holders had prevailed in the dispute the value of the stock would have been adversely affected.

The taxpayer argued that the difference between the market value of the stock and what he sold it for should be deductible as a business expense.\textsuperscript{19} The government conceded that for tax purposes a salaried corporate officer is engaged in a trade or business separate and distinct from that of his corporation—the business of rendering services for compensation. Following the reasoning of a decision of the United States Court of Appeals for the Fourth Circuit,\textsuperscript{20} the Seventh Circuit held that the difference between the selling price and market value of the stock was not a deductible business expense because it was the corporation's, not the taxpayer's, obligation that was being discharged. This was the case even though the taxpayer, in his own mind, might have felt compelled to participate in the settlement agreement.

The taxpayer also argued that the amounts were deductible to protect his investment in the stock.\textsuperscript{21} The court held that the origin


\textsuperscript{18} 490 F.2d 218 (7th Cir. 1973).

\textsuperscript{19} INT. REV. CODE OF 1954, § 162.

\textsuperscript{20} Noland v. Comm'r, 269 F.2d 108, 111 (4th Cir. 1959), where the court stated, in part, that "[t]hough the individual stockholder-executive, in his own mind, may identify his interests and business with those of the corporation, they legally are distinct, and, ordinarily, if he voluntarily pays or guarantees the corporation's obligations, his expense may not be deducted on his personal return."

\textsuperscript{21} INT. REV. CODE OF 1954, § 212(2) allows a deduction for the ordinary and
of the claim in settlement of which the taxpayer sold the stock was a threatened lawsuit arising out of the corporation's financing operation and not out of the taxpayer's personal stock dealing. The court stated that section 212\textsuperscript{22} does not turn upon the possible consequences of a claim to the fortunes of the taxpayer.\textsuperscript{23}

**Reasonable Compensation**

Amounts paid or incurred for compensation are deductible only if the amounts are reasonable.\textsuperscript{24} The Seventh Circuit, in *Edwin's Inc. v. United States*,\textsuperscript{25} held that as a matter of law contributions to a pension fund constitute compensation which must be included with salaries and bonuses (as well as other forms of compensation) in determining whether compensation paid an employee is reasonable.\textsuperscript{26}

The court also stated that there are situations where owner-employees could reasonably be paid more as deductible compensation than an employee who is not an owner but in a similar job. The court stated that:

The owners of a business, particularly one which they have built up from scratch, will have the personal incentive not necessarily shared by hired help, and will devote those extra ounces of energy, thought, and devotion that will spell not merely the difference between success and failure but the difference between success and extraordinary success.\textsuperscript{27}

In the case of an owner-employee of a closely-held corporation, excessive compensation is generally treated as a dividend taxable as ordinary income to the extent of earnings and profits.\textsuperscript{28}

necessary expenses for the management, conservation, or maintenance of property held for the production of income.

22. *Id.*

23. In his dissenting opinion, 490 F.2d at 223, (Cummings, J., dissenting), Judge Cummings raised the prospect (not raised by the government) that, if the taxpayer were entitled to the deduction, he may have a capital gain in the amount of the excess of the market value of the stock over the selling price which the government contended was the taxpayer's basis. See, United States v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960), cert. denied, 365 U.S. 843 (1961); International Freighting Corp., Inc. v. Comm'r, 135 F.2d 310 (2d Cir. 1943).


25. 501 F.2d 675 (7th Cir. 1974).

26. INT. REV. CODE OF 1954, § 404(a) provides, in part, that contributions to a pension plan are not deductible under section 404, unless they satisfy the conditions of either section 162 or section 212.

27. 501 F.2d at 678 (7th Cir. 1974).


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**DATE OF SALE**

*Herbert J. Investment Corp. v. United States*\(^{29}\) involved the sale of a trucking business which required the approval of the Interstate Commerce Commission.\(^{30}\) On February 26, 1968, taxpayer agreed to the sale of all its assets to CW Corporation for stock of CW. As part of the agreement, taxpayer and CW agreed to seek permission from the ICC for CW to assume temporary control pending final approval. Such permission was granted on March 26, 1968, and management control was assumed by CW on April 1, 1968. The April 1, 1968, date was the valuation date used by the parties. Final approval by the ICC with formal exchange of assets and CW stock occurred on August 30, 1968. The value of the CW stock increased substantially between April 1 and August 30.

The court, affirming the district court,\(^{31}\) held that the April 1 date was the date of sale and consequently the date on which the proceeds of the sale—the CW stock—were to be valued. The court found that the parties intended the April 1 date to govern, as the benefits and the risk of ownership were transferred to CW on that date. The district court found that the condition of final approval contained in the sale agreement was merely a condition subsequent to the sale contract which would in all likelihood be granted, and that the increase in value of the CW stock between April 1 and August 30 was probably attributable to the acquisition of taxpayer's trucking business.

**BANKRUPTCY**

As a general rule, bankruptcy courts have summary jurisdiction to adjudicate controversies with respect to property in their actual or constructive possession, but do not have such jurisdiction as to property not in their possession.\(^{32}\)

In *United States v. Phelps*,\(^{33}\) the court held that the United States had possession of intangible property under a tax lien even where it did not yet have actual possession. On August 25, 1971, the IRS filed a notice of tax lien with the Cook County Recorder of Deeds and

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29. 500 F.2d 44 (7th Cir. 1974).
31. 360 F. Supp. 825 (E.D. Wis. 1973), aff'd, 500 F.2d 44 (7th Cir. 1974).
33. 495 F.2d 1283 (7th Cir. 1974). The case arose under the Bankruptcy Court's jurisdiction to collect the estates of bankrupts under section 2a(7) of the Bankruptcy Act, 11 U.S.C. § 11a(7) (1970).
served a notice of levy on the taxpayer's assignee for the benefit of creditors. On September 14, 1971, an involuntary petition for bankruptcy was filed and a receiver appointed ten days thereafter; the taxpayer was then adjudged bankrupt on September 28, 1971. The government resisted the receiver's application for an order requiring the assignee to turn over all the taxpayer's assets.

The court determined that actual possession of intangible property is not necessary to upgrade the government's tax liens from the subordinate priority accorded under section 67(c)(3) of the Bankruptcy Act, and found for the government. Service of notice on the assignee, stating that the taxpayer's properties "are hereby levied upon and seized for satisfaction" of the taxes, is instead sufficient. The court relied upon section 6331(b) which provides that the term "levy" includes the power of distraint and seizure by any means. The Treasury Regulations provide in part as follows:

Levy may be made by serving a notice of levy on any person in possession of, or obligated with respect to, property or rights to property subject to levy including receivables, bank accounts, evidences of debt, securities, and accrued salaries, wages, commissions, and other compensation.

The court also relied upon decisions of the First and Fourth Circuits involving plenary suits, both of which involved debts owing the bankrupt. The Seventh Circuit here declined to follow a contrary 1973 holding of the United States Court of Appeals for the Ninth Circuit in which the government served a notice of levy on the person with whom the taxpayer-bankrupt had factored its accounts receivable.

34. 11 U.S.C. § 67(c)(3) (1970), provides:

"(3) Every tax lien on personal property not accompanied by possession shall be postponed in payment to the debts specified in clauses (1) and (2) of subdivision (a) of section 104 of this title. Where such a tax lien is prior in right to liens indefeasible in bankruptcy, the court shall order payment from the proceeds derived from the sale of the personal property to which the tax lien attaches, less the actual cost of that sale, of an amount not in excess of the tax lien, to the debts specified in clauses (1) and (2) of subdivision (a) of section 104 of this title. If the amount realized from the sale exceeds the total of such debts, after allowing for prior indefeasible liens and the cost of the sale, the excess up to the amount of the difference between the total paid to the debts specified in clauses (1) and (2) of subdivision (a) of section 104 of this title and the amount of the tax lien, is to be paid to the holder of the tax lien." 11 U.S.C.A. § 107(c)(3) (1974 Supp.).

Section 104(a)(1) and (2) provides, generally, for priority treatment for certain enumerated debts of administration, etc., of the bankruptcy estate, and for wages and commissions, not in excess of $600 per claimant, earned within three months of the commencement of the bankruptcy petition. 11 U.S.C.A. § 104(a)(1) and (2) (1974 Supp.).

35. INT. REV. CODE OF 1954, § 6331(b).
37. Rosenblum v. United States, 300 F.2d 843 (1st Cir. 1962); United States v. Eiland, 223 F.2d 118 (4th Cir. 1955).
38. In re United General Wood Products Corp., 483 F.2d 975 (9th Cir. 1973).
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DEFINITION OF "WILLFUL"

The Internal Revenue Code provides criminal penalties for willfully attempting to evade or defeat any tax imposed by the Internal Revenue Code, and for willfully failing to perform certain acts, including the filing of income tax returns. The former is a felony while the latter is a misdemeanor. After a great deal of controversy concerning whether a different test of scienter was intended between sections 7201 and 7203, the United States Supreme Court decided in 1973 that the term "willfully" has the same meaning in both provisions. In United States v. Bishop, the Supreme Court held that willfully contemplates "a voluntary, intentional violation of a known legal duty", and that proof of willfullness required a demonstration of "bad faith or evil intent" or "evil motive and want of justification in view of all the financial circumstances of the taxpayer."

In United States v. McCorkle, the Seventh Circuit reversed the conviction of the taxpayer for willfully failing to file tax returns, in part, because the trial judge's charge to the jury was not consistent with the decision of the Supreme Court in United States v. Bishop. The trial judge had instructed the jury that all the government was required to prove was that the defendant intended not to file tax returns, explicitly instructing the jury that it need not consider whether the defendant intended to defraud the Government. The court also found the instructions deficient because they eliminated justifiable excuse as a consideration in determining whether the defendant willfully failed to file returns. The court rejected a government contention that the jury instructions were proper when taken as a whole because certain of the instructions correctly described the element of willfullness.

ABUSE OF DISCRETION

The Treasury Regulations provide that the amount of discount on a bond issued by a corporation on or before May 27, 1969, should

40. Id. § 7203.
42. Id. at 360.
43. 74-1 U.S. Tax Cas. ¶ 9347 (7th Cir. 1974).
44. It should be noted that the Supreme Court issued its opinion in Bishop after the conviction of the defendant in McCorkle.
be amortized over the life of the bond. The regulations also allow an amortization deduction for discount on bonds issued after December 31, 1954, and before December 24, 1968, as part of investment units consisting of obligations and options, but only beginning with the first taxable year ending on or after December 24, 1968. The amortization period is the remaining life of the bonds. Thus, the discount on such a bond issued as part of investment units consisting of obligations and options may be deducted in full in the form of amortization over the remaining life of the bonds, if the bonds were still outstanding in the issuer-corporation's first taxable year ending on or after December 24, 1968. However, if the bonds had been called or retired before the first taxable year ending on or after December 24, 1968, no deduction would be allowed for discount on such bonds.

The taxpayer in Danly Machine Corp. v. United States argued that the Secretary of the Treasury abused his statutory authority by not allowing a comparable deduction to corporations which had issued similar obligations, but which at the time the regulation was adopted no longer had the obligations outstanding. The court stated that, if it found that the regulation was arbitrary and a misapplication of statutory authority, the only power it had would be to nullify the regulation. Thus, the court could not allow a deduction to the taxpayer, but could only deny deductions to corporations covered by the regulation. The court then proceeded to find the regulation to be a valid exercise of the Secretary's authority under section 7805. The court stated that it will take a generous view of the discretion allowed to the Secretary, and it is less willing to see an abuse of discretion where the Secretary exercises the ample powers available under section 7805. Thus, it would seem to be extremely difficult in the Seventh Circuit to overturn a regulation because of the failure of the Treasury to give a regulation

48. 492 F.2d 30 (7th Cir. 1974).
49. Under Int. Rev. Code of 1954, § 7805(b), the Secretary is authorized to prescribe the extent, if any, to which any regulation shall be applied without retroactive effect.
50. Id.
51. The United States Court of Appeals for the Fourth Circuit recently overturned a Treasury Regulation in an unrelated area because the discretion granted under Section 7805(b) was abused. Farmers' and Merchants' Bank v. United States, 476 F.2d 406 (4th Cir. 1973). The Seventh Circuit noted in Danly Machine that it could distinguish the Fourth Circuit case since the regulation there involved drew a line which "seems to have been nearly if not quite irrational from any point of principle, policy, or pragmatism" but did not do so since it took a "more generous view" than the Fourth Circuit of the discretion granted under section 7805(b). 492 F.2d at 34.
retroactive effect.

**Failure to Deposit Withholding Taxes**

In affirming the conviction of the defendant for failing, after no-notice, to deposit taxes withheld from employees in a special bank account in trust for the Government, the court rejected the defendant’s argument that he was being imprisoned for debt because he was unable to pay the taxes. The court followed a recent decision of the United States Court of Appeals for the Ninth Circuit which stated:

The argument that he is being imprisoned for debt is specious. Patterson’s misdemeanor was using as his own the tax money he was required by law to withhold from his workmen’s wages and to pay over to the government. Congress had adequate power to punish such conduct.

The Seventh Circuit in *Gorden* then stated that to avoid criminal penalties the defendant could have gone out of business, or could have borrowed the money to pay the employee’s wages and to deposit the withholding taxes, or could have paid the withholding taxes instead of other creditors.

The court also held that it is immaterial that section 7215 does not require willfullness to sustain a conviction because the statute provides adequate safeguards which must be met before a defendant can be convicted under that provision.

**EstoppeL**

The Internal Revenue Code provides two statutory provisions for the administrative settlement of tax liability. Under section 7121, the Secretary or his delegate is authorized to enter into a written agreement which shall be final and conclusive in any suit or proceeding, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact. Section 7122 authorizes the Secretary or his delegate

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52. INT. REV. CODE OF 1954, §§ 7215, 7512.
55. Under section 7512(a)(2), notice must be hand-delivered. Under section 7215(b), guilt does not attach if the defendant can show there was reasonable doubt whether the law required collection of the tax or who was required by law to collect the tax, or if the defendant can show that failure to comply was due to circumstances beyond his control.
56. INT. REV. CODE OF 1954, § 7121.
57. *Id.* § 7122.
to compromise any civil or criminal case arising under the internal
revenue laws prior to referral of the case to the Department of Justice
for prosecution or defense. The Treasury Regulations provide that a
case can be compromised only if there is doubt as to liability and/or
collectibility.\footnote{58}

These statutory provisions, however, are not always used to settle
cases because, among other reasons, the number of cases do not make
it possible to have the designated officers approve every proposed
agreement, due to the delay between the receipt of an offer and ultimate
action by the IRS.\footnote{59} Instead, nonstatutory methods have been
used by the IRS to settle cases. Form 870-AD (Offer of Waiver of
Restrictions on Assessment and Collection of Deficiency in Tax and
of Acceptance of Overassessment) is used by the Apellate Division to
effect a settlement without using a statutory closing agreement. That
form recites the taxpayer's offer to waive the statutory restrictions on
assessment and collection,\footnote{60} the taxpayer's consent to the assessment
and collection of the deficiencies specified, and acceptance of the over-
assessments as correct, so that after acceptance by or on behalf of the
Commissioner the case cannot be reopened absent fraud or serious
mistake in mathematical calculation. Further, the Form provides that
no claim for refund or credit may be filed for the years stated. The
form itself also provides that execution of the form is not a final closing
agreement under section 7121, and does not extend the statute of limita-
tions for refund, assessment, or collection of the tax.

There has been much litigation over the question of whether the
execution of a nonstatutory agreement, such as Form 870-AD, bars
a taxpayer from bringing a subsequent suit for a refund of the taxes
paid pursuant to the agreement. In the leading case (which involved
a nonstatutory settlement agreement not on Form 870-AD) on the
question,\footnote{61} the Supreme Court held that the statute prescribing meth-
ods by which cases could be settled must be strictly complied with.
Under the statute involved in that case only the Commissioner, with
the advice and consent of the Secretary of the Treasury, could compro-
mise tax suits.\footnote{62} The government argued that the taxpayer entered
into an agreement and was enjoying the benefits of concessions granted by the government as a part of that agreement. It was not stated whether or not the government could assess a deficiency or whether the statute of limitations had run. The Court stated:

[W]ithout determining whether such an agreement, though not binding in itself, may when executed become, under some circumstances, binding on the parties by estoppel, it suffices to say that here the findings disclose no adequate ground for any claim of estoppel by the United States.

Since the Supreme Court's decision, the cases have not been consistent regarding the question of under what circumstances, if any, a settlement agreement not executed in accordance with the statutory provisions would be binding on the taxpayer and the government by estoppel.

The Seventh Circuit had occasion to address this question in Bennett v. United States. In that case the agreement recited that it was subject to acceptance by, or on behalf of, the Commissioner and if not accepted the agreement would have no effect. It also stated that the taxpayer agreed to execute at any time, upon request of the Commissioner, a final agreement under the provisions of section 3760 of the Internal Revenue Code of 1939. There was no showing by the government that the officer who entered into the agreement had the authority to close out the matters described in the waiver of restrictions. The court held that the taxpayer was not estopped because under the agreement the ability to comply with the closing agreement statutory provisions was solely within the government, and that the government therefore knew that the statute of limitations applicable to assessment of deficiencies might expire. The court held that, since the applicable statutory provision under the Internal Revenue Code of 1939 required action by the Commissioner or by some officer or employee expressly authorized by the Commissioner, nothing short of action by the Commissioner would satisfy the exclusive statutory method for formalizing a settlement agreement.

The Seventh Circuit recently had occasion to examine the question

63. The court in General Split Corp. v. United States, 500 F.2d 998 (7th Cir. 1974), pointed out that it appears that the statute of limitations for assessment of deficiencies had expired.
64. 278 U.S. at 289.
65. For a collection of cases on this question see Uinta Livestock Corp. v. United States, 355 F.2d 761 (10th Cir. 1966); 9 MERTENS, LAW OF FEDERAL INCOME TAXATION § 52.07 (1971); Gutkin, supra note 59.
66. 231 F.2d 465 (7th Cir. 1956).
67. INT. REV. CODE OF 1939, § 3760, 53 Stat. 462,
The taxpayer and the IRS executed a settlement agreement on Form 870-AD. The taxpayer then filed suit in the district court for refund of taxes paid. The IRS had disallowed interest deductions on certain loans on the ground that the advances were not true loans but equity capital. While the subsequent Tax Court case was pending, the taxpayer and the IRS negotiated a settlement of the asserted deficiencies. The settlement agreement was evidenced by a stipulated Tax Court decision, which became final,9 effecting a 20 percent disallowance of the claimed interest deductions for taxable years 1962, 1963, and 1964; a "collateral agreement" providing for a 20 percent disallowance of the claimed interest deductions for 1965 and 1966 and providing that, as additional consideration for the acceptance of this agreement, the taxpayer agreed not to claim interest deductions on the loan in future years; and the execution of a Form 870-AD for the latter years which effected a 20 percent disallowance of the interest deductions with respect to one loan and a 100 percent disallowance of the interest deductions on others. The court affirmed the granting of summary judgment by the district court on the theory that the taxpayer was estopped from bringing the action because of the settlement agreement on which the government relied to its detriment.70

In this case however, the Seventh Circuit distinguished Bennett71 and held that the taxpayer was estopped from bringing a suit for refund. In the present case, the settlement package contained a stipulated Tax Court decision which had become final and could not be set aside or reviewed. At that point, there was no equitable way to undo the portion of the settlement reflected in the Form 870-AD. The Form 870-AD and the stipulated Tax Court decision were related parts of the settlement agreement.

Thus, the Seventh Circuit will bar a suit for refund on estoppel grounds in an appropriate situation where the Government is itself barred by a finalized stipulated court decision from assessing further deficiencies. It would appear that, based on the Bennett decision, the court would not bar a refund suit in a situation where the Government, in reliance on the settlement agreement, allowed the statute of limitations for assessment of deficiencies to expire, because the Government could have protected itself by causing a formal closing agreement to

68. General Split Corp. v. United States, 500 F.2d 998 (7th Cir. 1974).
70. 363 F. Supp. 313 (E.D. Wis. 1973), aff'd, 500 F.2d 998 (7th Cir. 1974).
71. 231 F.2d 465 (7th Cir. 1956).
be executed. But, in General Split Corp. the Government, it would seem, could also have protected itself by means of a formal closing agreement under section 7121. It is interesting to note that the Government, in the district court, conceded that Form 870-AD does not in itself preclude a subsequent suit for refund.

In Howard v. United States, taxpayers claimed a theft loss on their 1965 federal income tax return. The return was audited by the IRS and the theft loss was not disallowed. Taxpayers then sought to carry the theft loss back to secure refunds for taxes paid for the years 1962 and 1963 on the ground that the 1965 theft loss created a net operating loss carryback. Upon audit, the IRS denied the refund on the grounds that the 1965 loss was not a theft loss but rather a non-business bad debt which cannot constitute a net operating loss. Taxpayer argued that the Government was estopped to deny the refund because it had not disallowed the loss as a result of the audit of the 1965 tax return. The court held, citing numerous authorities, that even if the IRS review of the 1965 return constituted an approval of the claimed theft loss, the doctrine of collateral estoppel is not applicable because, under that doctrine, only judicial decisions are given conclusive effect in subsequent proceedings. A determination by the IRS is not judicial in nature, but only administrative.

ENFORCEMENT OF SUMMONS

In United States v. Awerkamp, a revenue officer in the Collection Division of the IRS issued a summons to Awerkamp, directing him to appear before the revenue officer and give testimony relating to his tax liability or the collection of his tax liability and to bring with him all documents and records in his possession or control which are necessary to enable the IRS to complete a federal income tax return for taxable years 1970 and 1971. Upon Awerkamp's failure to testify or submit records, the revenue officer petitioned the district court for enforcement of the summons. Over Awerkamp's assertions that sections 7402(a), 7602, and 7604(a) violated the fourth, fifth, and thirteenth amendments to the Constitution, the court ordered Awerkamp

72. 497 F.2d 1270 (7th Cir. 1974).
73. INT. REV. CODE OF 1954, § 165.
74. Id. § 172.
75. Id. § 166.
76. Id. § 172(d).
77. 497 F.2d 832 (7th Cir. 1974).
78. INT. REV. CODE OF 1954, §§ 7402(b), 7604(a).
to appear and give testimony concerning his federal income tax returns.

In affirming the unreported decision of the district court which enforced the summons, the Seventh Circuit stated that the information sought by the summons was to be used for the completion of tax returns for 1970 and 1971. The agent was not a special agent with the Intelligence Division, but was in the Collection Division. There was nothing to indicate that a recommendation for prosecution had been made.79 The court stated further than the mere possibility of criminal prosecution does not make the summons unenforceable.

Citing its earlier decision in *United States v. Dickerson,*80 the court held that the *Miranda*81 warning need not be given a taxpayer until the first contact with the taxpayer after the case has been transferred to the Intelligence Division.82 The Seventh Circuit is a maverick among the courts of appeal on the application of *Miranda* in tax investigations. The prevailing view is that *Miranda* warnings are not constitutionally required in tax investigations where the taxpayer is not deprived of his freedom and is not actually compelled or coerced to furnish statements or documents.83

The IRS has required special agents to give a *Miranda*-type warning to taxpayers at the first interview.84 The United States Court of Appeals for the Fourth Circuit has held that the IRC is required to comply with its own rule in tax investigations occurring after the inception of its requirement for special agents.85

The court stated that the proper manner in which the taxpayer should raise his Constitutional objections is to appear before the agent

80. 413 F.2d 1111 (7th Cir. 1969).
82. This is generally indicated by the presence of an IRS Special Agent.
83. United States v. Prudden, 424 F.2d 1021 (5th Cir. 1970); cert. denied, 400 U.S. 831 (1970); Taglianelli v. United States, 398 F.2d 558 (1st Cir. 1969); aff’d, 394 U.S. 316 (1969) (the Court did not discuss this question); United States v. White, 417 F.2d 89 (2nd Cir. 1969), cert. denied, 397 U.S. 912 (1970); United States v. Jaskiewicz, 433 F.2d 415 (3rd Cir. 1970), cert. denied, 400 U.S. 1021 (1971); United States v. Bagdasian, 398 F.2d 971 (4th Cir. 1968); United States v. Maus, 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).
85. United States v. Heffner, 420 F.2d 809 (4th Cir. 1969). The Fifth Circuit has held that substantial compliance with the IRS procedure is all that is required, United States v. Dawson, 486 F.2d 1327 (1973).
and raise objections as specific questions are asked. 86

In United States v. Joyce, 87 another case involving a summons, the court reversed the judgment of the district court holding the defendant in contempt for failing to produce certain records and documents relating to the federal tax liability of a foreign corporation. The district court ordered the defendant to use his "best offices" to obtain the requested records. The Seventh Circuit held that this order was not clear and specific and did not give the defendant sufficient direction as to how he was to proceed to try to obtain the records, which he had stated under oath that he did not have in his possession. The court found that the defendant had done everything in his power to try to obtain the records. Citing the Supreme Court decision in United States v. Brepan, 88 the court stated that a witness could not be held in contempt for failure to produce documents not in his possession, unless he is responsible for them or he is impeding justice by not explaining what happened to them.

Citing its earlier opinion in United States v. Hayes, 89 the court also held that a claim that the foreign corporation is exempt from federal income tax will not defeat a proper inquiry or the use of summonses by the IRS to seek information that is relevant to the determination of tax liability.

CLOSING ARGUMENT

In Epperson v. United States, 90 the taxpayer argued on appeal that the finding of a district court jury that he owed deficiencies should be reversed. One of the arguments the taxpayer raised on appeal was that the jury was inflamed by the closing argument of counsel for the Government in which counsel said:

We see no reason why a man who has as much money as Dr. Epperson, who has more money than he can probably ever spend, is entitled to ignore all the rules that everybody else has to live by . . . . We say he is not entitled to a refund of taxes because he hasn't paid his fair share . . . . Let's make this doctor pay the kind of income taxes he ought to pay. . . . I am sick and tired and I know you are at having to pay taxes at a rate when these

86. See Sullivan v. United States, 274 U.S. 259 (1927), where the Supreme Court held that the fifth amendment protection does not excuse a failure to file an income tax return. The taxpayer can raise objections to specific questions asked on the return.
87. 498 F.2d 592 (7th Cir. 1974).
89. 408 F.2d 932 (7th Cir. 1969).
90. 490 F.2d 98 (7th Cir. 1973).
rich people like to construe and set up all these transactions to save taxes so they don't have to pay any.\textsuperscript{91}

Counsel for the Government also made reference to the taxpayer paying only eight percent taxes and stated: "I guarantee you, every one of you, pay taxes far in excess of eight percent"; and "if he doesn't [pay his fair share] somebody else is going to have to do it for him."\textsuperscript{92}

The court held that, although the above statements of counsel were in bad taste if not reprehensible, the verdict should not be reversed because taxpayer's counsel did not request an admonition of the jury and did not move for a mistrial, and because in the context of the entire argument the taxpayer was not denied a fair trial in view of the record as a whole.

Judge Pell, in a strong dissent,\textsuperscript{93} stated that the verdict should be reversed because an official representative of the Government was in effect saying that tax avoidance was egregious conduct which should be penalized for its own sake. The statements, in Judge Pell's opinion, could not help but influence the jury.

It appears that the Government counsel was not drawing a line between tax evasion, which is not permissible, and tax avoidance, which is. The Government counsel was indeed, it would seem, telling the jury that the taxpayer should be held liable to pay more taxes because he, if nothing more, had arranged his affairs in such a way as to minimize his taxes under the law.

**CONCLUSION**

In conclusion, perhaps the most significant decisions of the Court of Appeals for the Seventh Circuit dealt with partnerships and whether a settlement agreement on Form 870-AD prevents a suit for refund. It will be interesting to see the effect of these decisions in future cases.

\textsuperscript{91} Id. at 100.
\textsuperscript{92} Id. at 101, 102.
\textsuperscript{93} Id. at 101 (Pell, J., dissenting).
CHICAGO-KENT LAW REVIEW

ILLINOIS INSTITUTE OF TECHNOLOGY
CHICAGO-KENT COLLEGE OF THE LAW

The Seventh Circuit Review is published annually by the students of the Illinois Institute of Technology/Chicago-Kent College of Law
10 N. Franklin Street, Chicago, Illinois 60606

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