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Case Comments

Criminal Law: *Miranda* Warning
Required in Tax Investigation

Defendant was subjected to a tax audit while serving a prison sentence for an unconnected offense. During two interviews with a revenue agent, he identified his tax returns for the years in question and signed voluntary extensions of the statute of limitations for deficiency claims.\(^1\) The revenue agent later found indications of fraud and referred the case to the Intelligence Division, which handles criminal matters arising in the course of such investigations. A special agent interviewed the defendant and apprised him of the criminal aspects of the pending investigation and of his constitutional rights.\(^2\) Defendant refused to cooperate further. At the trial, evidence given to the revenue agent was admitted over objection, and the defendant was convicted of willfully filing false claims for tax refunds. The Fifth Circuit upheld the conviction\(^3\) but the Supreme Court reversed, holding, that a taxpayer in custody is entitled to *Miranda* warnings prior to questioning by an Internal Revenue agent regarding an audit of his tax return. *Mathis v. United States*, 391 U.S. 1 (1968).

An audit or "routine tax investigation" is conducted by a revenue agent and is designed to determine whether the taxpayer has correctly computed his tax liability. If the audit reveals indications of fraud, the revenue agent refers the case to the Intelligence Division, whose agents, known as "special agents," are law enforcement officers concerned only with the criminal potential of the case. If the special agent's investigation convinces the Intelligence Division of the taxpayer's guilt, he will be formally charged and prosecuted under federal criminal statutes.

The *Mathis* case raises the problem of the applicability of the fifth amendment privilege against self-incrimination and the

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1. Form 872, known as "Consent fixing period of limitation upon assessment of income and profits tax." 6 CCH 1969 STAND. FED. TAX REP. ¶ 6044.

2. The majority opinion does not refer to the special agent, but Justice White, in his dissent, indicates that the special agent gave Mathis a "full set of 'Miranda warnings.'" 391 U.S. 1, 6 n.2. Note, however, that this interview occurred on June 9, 1965, more than a year before *Miranda* was handed down.

3. 376 F.2d 595 (5th Cir. 1967).
sixth amendment right to counsel in tax investigations. Its solution depends on an interpretation of the principles enunciated in the landmark cases of Escobedo v. Illinois and Miranda v. Arizona. Most pre-Escobedo cases that dealt with taxpayers' rights were concerned with the constitutional significance of deceit or misrepresentation on the part of investigating agents. Generally, the courts held that the fourth and fifth amendments require special agents to refrain from the type of conduct that would be affirmatively misleading, but that mere failure to inform the taxpayer of the criminal nature of the investigation did not amount to a constitutional violation. Escobedo and Miranda attempted to define the nature and scope of an accused person's constitutional rights, the point at which they attach, and the procedure which must be followed in order to insure their protection. Thus Escobedo says that police must issue warnings to a person being questioned when he has become the "focus" of an "inquiry into an unsolved crime." Miranda set out a specific four point warning which must precede the interrogation of any person who is under custody or otherwise deprived of his freedom in any significant way. Since these two cases were concerned with the preservation of an accused's constitutional right to refrain from self-incrimination, they do not apply to non-criminal investigations.


7. The language of the opinion is as follows:
We hold, therefore, that where, as here, the investigation is no longer a general inquiry into an unsolved crime but has begun to focus on a particular suspect, the suspect has been taken into police custody, the police carry out a process of interrogations that lends itself to eliciting incriminating statements, the suspect has requested and been denied an opportunity to consult with his lawyer, and the police have not effectively warned him of his absolute constitutional right to remain silent, the accused has been denied "the Assistance of Counsel" in violation of the Sixth Amendment of the Constitution....
378 U.S. at 490-91.
8. He must be warned prior to any questioning that he has the right to remain silent, that anything he says can be used against him in a court of law, that he has the right to the presence of an attorney, and that if he cannot afford an attorney one will be appointed for him prior to any questioning if he so desires.
384 U.S. at 479.
9. [W]e hold that when an individual is taken into custody or otherwise deprived of his freedom by the authorities in any significant way and is subjected to questioning, the privilege against self-incrimination is jeopardized.
Id. at 478.
10. The Escobedo ruling is actually based upon the sixth amend-
The applicability of *Miranda* and *Escobedo* in the tax context is troublesome because of the difficulty in distinguishing between the civil and criminal aspects of tax investigations. The audit itself has always been regarded as a civil investigation, which may or may not lead to a civil action for collection of a tax deficiency.\(^1\) The fraud investigation, which frequently begins as a civil audit, looks toward criminal prosecution of the taxpayer.\(^2\) Most courts, however, have shown reluctance to apply the *Escobedo* and *Miranda* principles to investigations of tax crimes.\(^3\) In *Kohatsu v. United States*,\(^4\) the court said that the *Escobedo* principles did not require even special agents to issue warnings to the taxpayer, reasoning that their investigation could not properly be termed an "inquiry into an unsolved crime," but was actually an attempt to discover whether a crime had in fact been committed.\(^5\) This distinction was criticized by writers and some courts,\(^6\) on the ground that it raised a meaningless difference to constitutional significance, and that it ignored the fact that the taxpayer in a fraud investigation is actually a criminal suspect.\(^7\) Nonetheless, the *Kohatsu* reasoning prevailed in most courts.\(^8\)

\(^1\) See 378 U.S. at 485, 487, 488-90.


\(^3\) See *Hewitt*, supra note 6, at 662, 683. The author asserts that the functions of a special agent compare in all essential respects to those of an FBI agent or any other law enforcement officer.

\(^4\) See cases cited note 11 supra.

\(^5\) 351 F.2d 893 (9th Cir. 1965).

\(^6\) Id. at 901.

\(^7\) See cases cited note 37 infra.

\(^8\) See *Hewitt*, supra note 6. Attacking the constitutional significance of the distinction, he notes that to accord a taxpayer constitutional protection only after the existence of the crime has been proven is to accord him no protection whatever, since at that point his guilt is also conclusively proven. Id. at 694. The distinction is also criticized as baseless since in many ordinary criminal cases the existence of the criminal act itself is determined by the trier of fact. Comment, *The Constitutional Right to Counsel in a Tax Investigation*, 33 U. Cin. L. Rev. 134, 140 (1965). See also Lay, *The Right to Counsel in a Criminal Tax Investigation*, 43 Ind. L.J. 69 (1967); Comment, *Constitutional Rights of the Taxpayer in a Tax Fraud Investigation*, 42 Tul. L. Rev. 882 (1968).

\(^11\) *Kohatsu* was a case of first impression in the appellate courts; other circuits have since concurred. See, e.g., Taglianetti v. United States,
By rejecting the Kohatsu holding, the Supreme Court viewed Mathis as a man in custody giving incriminating evidence to officers.\textsuperscript{19} He was therefore entitled to be warned of his right to remain silent and of his right to counsel.\textsuperscript{20} The Court noted that although tax investigations may differ from other criminal investigations in that they usually lead only to civil actions, there is always the possibility that a criminal prosecution will result from the audit.\textsuperscript{21} The Court also held that Miranda does not require that a defendant's custody be directly related to the matter under investigation.\textsuperscript{22} Thus, the fact that Mathis' custody was unrelated to the tax matter was immaterial.

The Mathis holding apparently broadens the concept of "custodial interrogation." The Miranda opinion emphasized the repugnancy of using stationhouse interrogation techniques to coerce confessions.\textsuperscript{23} Stationhouse interrogation, therefore, had to be preceded by a warning sufficient to apprise the suspect of his rights. In Mathis, the majority found that the facts warranted application of the Miranda rule despite seemingly material differences in the custodial settings of the two cases. Unlike Miranda, Mathis was interviewed in familiar surroundings, was not held captive by his interrogators, and was questioned by a tax auditor rather than a number of police officers. It seems reasonable to say that a man in Mathis' position would

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398 F.2d 558 (1st Cir. 1968); United States v. Squeri, 398 F.2d 795 (2d Cir. 1968); Frohmann v. United States, 380 F.2d 832 (8th Cir.), cert. denied, 389 U.S. 976 (1967); United States v. Mancuso, 378 F.2d 612 (4th Cir. 1967), cert. denied, 390 U.S. 955 (1967); Mathis v. United States, 376 F.2d 595 (5th Cir. 1967).
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The Ninth Circuit has repeatedly reaffirmed its Kohatsu ruling. Freichtmeir v. United States, 389 F.2d 498 (9th Cir. 1968). In Whitfield v. United States, 376 F.2d 5 (8th Cir. 1967), when faced with a direct and open challenge to the Kohatsu reasoning, the court disposed of the case on the ground that defendant's trial had begun prior to the Miranda ruling and the warnings given him were sufficient at that time. See Rickey v. United States, 360 F.2d 32 (9th Cir.), cert. denied, 385 U.S. 835 (1966).
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19. 391 U.S. at 3.
20. Id. at 5.
21. Id. at 4.
22. Id. at 5.
23. Hewitt, supra note 6, also draws a number of parallels between the police procedures reviewed in Miranda and the practices employed by the special agents. In both cases, it is said, the officers strive to get their suspect alone, wear him down through constant questioning, "harassing," or "haranguing," cultivate the suspect's impression that his guilt has been confirmed and that he has no choice but to cooperate, and finally, to stifle any desire he may have to exercise the privilege to remain silent. Hewitt, supra note 6, at 683.
be far less psychologically vulnerable than Miranda's hypothetical suspect, who is suddenly apprehended by the police and taken from familiar surroundings to police headquarters for questioning. The Mathis Court rejected this line of reasoning by cautioning that the justification behind the Miranda decision should not be confused with the holding of the case. The Court apparently saw no need to discuss the presence or absence of a "coercive influence" in Mathis' surroundings but instead quoted a broad statement of the Miranda rule which refers not to coercion but only to custody.25

The Court also abruptly rejected the Government's argument that Miranda only applies to the questioning of a suspect who is in custody in connection with the matter under investigation.26 The Court may have feared that this position would allow police to escape the Miranda rule by manipulating the charges brought against arrested persons, either by misstating the real reason for the arrest or by obtaining custody on any available grounds in order to question the person on another matter. On balance, however, it seems more likely that the Supreme Court simply did not desire to limit its Miranda rule. The important language in Miranda, it would then seem, is that which indicates that custody must be considered as inherently and presumptively coercive.27

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24. This is the position taken by the dissent, in which Justices White, Harlan and Stewart joined. 391 U.S. at 7.
25. See note 9 supra.
26. The Government also seeks to narrow the scope of the Miranda holding by making it applicable only to questioning one who is "in custody" in connection with the very case under investigation. There is no substance to such a distinction, and in effect it goes against the whole purpose of the Miranda decision which was designed to give meaningful protection to Fifth Amendment rights. We find nothing in the Miranda opinion which calls for a curtailment of the warnings to be given persons under interrogation by officers based on the reason why the person is in custody. 391 U.S. at 4-5.

This same interpretation had previously been reached in United States v. Harrison, 265 F. Supp. 660 (S.D.N.Y. 1967) (facts directly on point with Mathis) and again in People v. McFall, 66 Cal. Rptr. 277 (Ct. App. 1968) (defendant arrested for forgery and subsequently interrogated about a car theft). See also People v. Chavez, 68 Cal. Rptr. 759 (Ct. App. 1968) (stating that "custodial interrogation" rather than the "focusing" of an investigation is the crucial element in Miranda).
27. Several parts of the Miranda opinion itself strongly suggested that this emphasis would be forthcoming:
Even without employing brutality, the "third degree" or the specific stratagems described above, the very fact of custodial interrogation exacts a heavy toll on individual liberty and trades on the weakness of individuals.
This view of Miranda is consistent with a number of lower court interpretations. Thus, Miranda has been read as stating that custody may result when a person reasonably believes that his freedom of action has been significantly restricted. Some courts have broadened the "custodial interrogation" concept by finding that custody may result when a person is interrogated in the office of the investigator or even in his own home. In these situations the psychological pressures employed by the interrogator may determine custody either by inducing a person to believe that his freedom has been curtailed or by coercing incriminating evidence from him. Such cases emphasize the effect of the interrogation situation on the accused person's own conception of his freedom of action, rather than any demonstrable physical restraint. Between these cases and the in-custody cases like Miranda and Mathis there runs a strong common thread: Custody results from the operation of factors which tend to render self-incriminating testimony less than purely voluntary.

The most significant effects of Mathis will probably be felt outside the prison or stationhouse walls since it affirms the applicability of the Miranda precepts to the area of tax investigations. The Supreme Court apparently assumed that as a

384 U.S. at 455 (emphasis added).

Unless adequate protective devices are employed to dispel the compulsion inherent in custodial surroundings, no statement obtained from the defendant can truly be the product of his free choice.

384 U.S. at 458 (emphasis added). See also note 26 supra; People v. Ellingsson, 65 Cal. Rptr. 744 (Ct. App. 1968) (the court, dealing with a police interrogation, said there is no distinction between the accusatory and investigatory stages of an in-custody interrogation).


30. See Commonwealth v. Sites, 427 Pa. 486, 235 A.2d 387 (1967) (defendant, suspected of murder, was found to be in the custody of police when escorted from a relative's home to his own home for interrogation).

31. See cases cited notes 28 & 29 supra.

32. In White v. United States, 395 F.2d 170 (8th Cir. 1968) the court, referring to Mathis, said:

This decision extends the Miranda precepts to the area of civil tax investigations and holds that under appropriate circumstances the warnings must be given prior to interrogation by the investigating agents.

395 U.S. at 173. In distinguishing Mathis, the court noted that the revenue agent had interviewed the taxpayer at his place of business.
practical matter the civil and criminal aspects of tax investigations are inseparable. It appears that the auditor actually functions as a preliminary investigator in a fraud case. He evaluates any incriminating evidence he discovers and decides whether to call in special agents. Evidence given to the auditor is admitted in criminal trials and all audits carry the possibility that a criminal prosecution may result. Seemingly, to the extent that a tax investigation is a criminal matter, the taxpayer deserves meaningful protection of his constitutional rights, including his privilege against involuntary self-incrimination.

In recognizing that a tax investigation incorporates some criminal features from the very outset, Mathis devitalizes the widely accepted Kohatsu distinction that a tax investigation differs for constitutional purposes from the investigation of an unsolved crime. This distinction had blocked a number of courts from applying the Miranda principles to tax fraud investigations, although a growing number of writers and judges were unable to see why a tax fraud investigation should be regarded as anything but a purely criminal matter. Also, by treating the auditor as a quasi-criminal investigator, the Mathis Court refused to allow the Internal Revenue Service to determine for itself the criminal or civil status of its investigations. The significance of this point lies in the fact that a taxpayer suspected of fraud is unlikely to flee to avoid prosecution, constitutes no immediate danger to society, and is readily available to the investigating agents. Moreover, the Internal Revenue Service is free to conduct its investigations in its own manner and at its own pace. To allow tax agents to determine the civil or criminal status of their investigations would permit them to decide for their own convenience the point at which a taxpayer's constitutional rights should attach.

and had made a constant and conscientious effort to inform him of the relevant provisions of the law, and that the taxpayer appeared to understand fully the nature of the proceeding and to cooperate willingly. The pains the court took to distinguish Mathis may be an indication of how broad that holding is.

Nothing in the Mathis reasoning suggests that it need apply only to tax investigations. Mathis should apply to any civil investigation which by its nature might lead to a criminal prosecution. See People v. Accavallo, 57 Misc. 2d 264, 291 N.Y.S.2d 972 (Nassau County Ct. 1968) (holding Mathis applicable to an investigation by state labor officials).

33. See cases cited note 18 supra.
34. See articles cited note 17 supra, and cases cited note 37 infra.
35. Hewitt includes a well-developed discussion of these points in his article. Hewitt, supra note 6, at 660.
It seems clear, however, that treating the taxpayer as a criminal suspect will not in itself assure that he will be adequately warned of his constitutional rights. *Mathis* only applies when the taxpayer is in some form of custody. But the peculiar nature of the tax investigation indicates that he should be entitled to constitutional warnings at the point in the investigation when the danger arises that he may be coerced into making self-incriminating statements. According to *Miranda*, this danger arises in the ordinary criminal case when the suspect is taken into custody and interrogated. But a tax investigation differs in that it is often conducted in the home or business office by men not easily recognized as police. As previously noted, custody in this context does not play the same significant role that it does in other criminal investigations. Indeed, a taxpayer will not ordinarily be taken into custody unless his guilt is firmly established, probably on the basis of his own evidence. Custody should not, therefore, be regarded as an appropriate prerequisite to the attachment of a taxpayer's constitutional rights. Some other point should be selected, but the *Mathis* case does not address this issue.

If one accepts the principles of *Miranda*, it seems clear that the taxpayer should be made aware of the true character and possible consequences of the investigation, and of the availability of constitutional safeguards well in advance of the custodial stage. A few courts have taken this approach. In *United States v. Turzynski*[^36] the court reasoned that custody is not in itself constitutionally significant, but rather is evidence of the beginning of the accusatorial process, the point at which constitutional safeguards must come into play.[^37] The court observed


[^37]: The court first discarded the *Kohatsu* distinction, then noted that tax fraud investigations, though criminal in nature, are usually devoid of actual “custody.” But the court found a strong parallel between taking a person into custody, in the ordinary criminal case, and referring the taxpayer's case to the special agents. In the respective cases the event marks the beginning of the adversary process, the point at which the suspect needs to know his constitutional rights. *Id.* at 853. This reasoning has persuaded a few courts to reject the *Kohatsu* rule. See *United States v. Wainwright*, 284 F. Supp. 129 (D. Colo. 1968); *United States v. Gower*, 271 F. Supp. 655 (M.D. Pa. 1967). See also *Whitfield v. United States*, 376 F.2d 5 (8th Cir. 1967); *United States v. Kingry*, 67-1 U.S. Tax Cas. ¶ 9262, 19 A.F.T.R. 2d 762 (N.D. Fla. 1967); *United States v. Schoenburg*, 19 A.F.T.R. 2d 348 (D. Ariz. 1966).

However, the Second Circuit has specifically rejected the *Turzynski* approach. In *United States v. Mackiewicz*, 401 F.2d 219, cert. denied, 39 S. Ct. 253 (1968), the court rejected the argument that an investigation shifts to the accusatory stage when referred to a special agent,
that in a tax case the beginning of the accusatorial process is marked clearly by the referral of the case to special agents, and held that a taxpayer should at that point be entitled to *Miranda* warnings. 38 *United States v. Gower*, 39 using a more conventional approach, held that a taxpayer was in "custody" for *Miranda* purposes while answering questions in a special agent's office. 40 Since *Mathis* does not refer to any of the leading cases in the tax area, it is not clear which position the Supreme Court would find persuasive.

Merely by recognizing the criminal nature of a tax investigation, *Mathis* may force some revision of Internal Revenue Service procedure. Until recently the Service maintained that the *Escobedo* and *Miranda* principles did not apply to its investigations. 41 A 1967 ruling now requires special agents to identify themselves immediately as criminal investigators and to issue further warnings as their investigations proceed. 42 With a

and cited *Mathis* to illustrate that no formalistic reliance may be placed on the official title of the investigator. This is a questionable treatment of the policy behind *Mathis*, however, and the characterization of the *Turzynski* holding seems somewhat unfair. See also Frohmann v. United States, 380 F.2d 832 (8th Cir.), cert. denied, 389 U.S. 976 (1967).

38. By tying the attachment of constitutional rights to the referral of the case to the Intelligence Division, rather than to the appearance of the special agent in the investigation, the court in *Turzynski* departs somewhat from one of the main precepts of *Miranda*—that the warnings are to precede the *questioning* of the suspect. *Miranda* does not require warnings at the moment a man becomes a suspect. This departure may be warranted by the fact that in a tax case the initial determination to institute the shift to a criminal investigation is usually based on evidence previously supplied, at the government's demand, by the taxpayer. The taxpayer should be entitled to know of the shift in purpose as soon as it occurs. 39. 271 F. Supp. 655 (M.D. Pa. 1967).

40. Deprivation of freedom of action cannot be treated separately and in isolation, but must be evaluated in the light of what influence the atmosphere and surroundings of governmental oriented facilities had on the free choice of the person being interrogated. 


41. See 33 U. Ctr. L. Rev. 134, 136 n.7 (1965).

42. The text of that regulation reads:

(A) On initial contact with the taxpayer the special agent is to produce his credentials and state, "As a special agent I have the function of investigating the possibility of criminal tax fraud."

(B) If the potential criminal aspects of the matter are not resolved by preliminary inquiries and further investigation becomes necessary, the special agent is required to advise the taxpayer of his constitutional rights to remain silent and to retain counsel.
tax investigation now clearly categorized as a criminal matter, the new ruling should probably be considered constitutionally inadequate, especially if the Turzynski analysis is followed. An adequate solution requires a candid disclosure of the nature of the investigation, both at its inception and as it passes from one phase to the next. As a practical matter, a letter should be sent in advance of the audit informing the taxpayer of the nature of the investigation, the theoretical possibility of a subsequent criminal investigation, the functions of the different agents, and the taxpayer's constitutional rights. Such a procedure would minimize misunderstanding, protect the rights of the taxpayer and impose a minimal economic burden on the Internal Revenue Service. The law should also require a revenue agent, when he finds that he has sufficient grounds to refer the case to the Intelligence Division, to explain the significance of that move, and to issue the Miranda warnings himself if he intends to question the taxpayer further. The taxpayer should be informed again by letter that his case has been referred for investigation of its criminal potential, that a special agent will be in contact with him, and that he has a right to remain silent and to have a lawyer. The special agent should then identify himself as the criminal investigator and satisfy himself that the taxpayer has received the Miranda warnings before proceeding with his questioning. This whole procedure is simple and straightforward, designed only to insure that the Internal Revenue Service disclose the true character of its investigation and how it relates to the taxpayer's rights.

Several conclusions emerge from this analysis of the Mathis opinion. The Supreme Court shows no intent to restrict the

(C) If it becomes necessary to take the person into custody, special agents must give a comprehensive statement of rights before an interrogation. This statement warns a person in custody that he may remain silent and that anything he says may be used against him. He is also told that he has the right to counsel before making a statement or answering any questions, and that if he cannot afford counsel he can have one appointed. United States v. Wainwright, 284 F. Supp. 128, 133 (D. Colo. 1968).


44. The primary function of this requirement is to assure a prompt disclosure to the taxpayer that a formal and structural shift in the character of the investigation has occurred. A secondary function is to prevent the auditor from pursuing a criminal investigation, without disclosure of the fact, in a case where a referral is clearly warranted.
Miranda ruling, but has instead extended its reach to certain types of civil investigations. The most significant impact of the case will probably be in the area of tax investigations, where it rejected the previous view that a tax investigation is not a criminal matter subject to the principles announced in Escobedo and Miranda. The Court also confirmed the Miranda language which indicates that physical custody need not arise in connection with the very matter under investigation. Finally, while the Mathis case overtly extends the Miranda principles to tax investigations, it does not decide the point at which the constitutional rights of the taxpayer should attach in an ordinary tax investigation. An adequate solution to the special problems presented by tax crime investigations probably requires a revision of the investigating procedures, and it is recommended that legislative or administrative action be taken along the lines indicated.

Federal Estate Taxation: Loan Secured by Third Party’s Insurance Policy on Decedent’s Life Constitutes “Economic Benefit” to Decedent Under Section 2042(2)

Decedent’s wife-executrix claimed that the proceeds from an insurance policy on the decedent’s life, solely owned and irrevocably assigned by her as collateral security for a debt of the marital community,1 were not includable in decedent’s gross

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1. In community property states, such as Texas, a debt incurred by one of the spouses during the marriage becomes a debt of the community property (marital community), “except in such cases as are specially excepted by law.” Lovejoy v. Cockrell, 63 S.W.2d 1009 (Tex. Civ. App. 1933); Tex. Rev. Civ. Stat. Ann. art. 4620 (1948). But a wife is not personally liable for the community debts contracted by her husband; Vinson v. Whitfield, 133 S.W. 1095 (Tex. Civ. App. 1911), nor are her separate funds legally subject to a community debt. Lush v. Farmer, 114 S.W.2d 677 (Tex. Civ. App. 1938). Upon the death of one spouse, the surviving spouse takes an undivided one-half interest in the entire estate, not as an heir, but as an owner, Kreis v. Kreis, 36 S.W.2d 821 (Tex. Civ. App. 1931), and, by qualifying as community survivor, acquires the right to manage, control and dispose of both her half and the other half of the community property. Patterson v. Twaddell, 301 S.W.2d 680 (Tex. Civ. App. 1957).

In Prichard v. United States, 397 F.2d 60 (5th Cir. 1968), therefore, the Commissioner allowed the wife-executrix to claim one-half the community debt as a debt of decedent’s estate and included one-half the proceeds of the insurance policy in decedent’s gross estate. Inclusion of only one-half the policy proceeds was apparently based on the theory that since possession of incidents of ownership by the husband arose from the economic benefits of the policy—secured a com-
estate. The district court disagreed, holding the proceeds includable in decedent’s estate under section 2042(1), since they were to pay a debt owed by his estate, and includable under section 2042 (2) since decedent “possessed incidents of ownership” thereunder. Affirming on other grounds, the Fifth Circuit held that although decedent’s wife was the sole owner of the insurance policy, decedent’s involvement in its purchase and assignment, and his continued enjoyment of the economic benefits of the loan secured thereby, up to the time of his death, required inclusion of one-half the proceeds in his estate under section 2042 (2). *Prichard v. United States*, 397 F.2d 60 (5th Cir. 1968).

Whereas the federal estate tax law directs that when the proceeds of life insurance policies are “receivable by the executor,” such amounts are to be included in the gross estate of the decedent under section 2042 (1), the sole criterion for inclusion of those proceeds not “receivable by the executor” is whether “the decedent possessed at his death any of the incidents of ownership.” Whether the proceeds are “receivable by the executor,” or the decedent had “incidents of ownership” at death, is determined on the basis of local law. Thus, the question of whether an insurance policy is the separate property


3. In assigning the policy involved herein as security for a loan made contingent on the application for the policy and its assignment, [decedent] possessed incidents of ownership in the policy making the proceeds includable in his estate under the provisions of section 2042. . . .

Id. at 554.

4. The court, finding one-half the proceeds includable in the gross estate of the decedent under section 2042 (2), refused to consider whether section 2042 (1) was applicable despite its being the main ground upon which the district court relied.

5. See note 1 supra.


7. Id. § 2042:
The value of the gross estate shall include the value of all property— . . . (2) Receivable by other beneficiaries.— To the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person.

As an additional step in determining whether or not a decedent possessed any incidents of ownership in a policy or any part of a policy, regard must be given to the effect of the State or other applicable law upon the terms of the policy.
of a spouse in a community property state is determined by state law, as is the question of a spouse's control over insurance policies he or she "owns."9

The test of "receivable by the executor" under section 2042 (1) is whether the proceeds are receivable for administration and distribution as an asset of the estate.10 Even where life insurance proceeds are payable to the executor, courts hold them not includable in decedent's estate if the executor is bound either by the terms of the policy or by state law to pass the proceeds directly to named beneficiaries.11 However, where the insurance proceeds are payable to a trustee who is required to apply them in payment of debts or obligations of the insured's estate, they are deemed, to the extent so expended, to be "receivable by the executor" under section 2042 (1).12

Although the "incidents of ownership" test was judicially applied as early as 1929,13 and promulgated in the Treasury Regulations in 1934,14 it was not incorporated into the statutory scheme until 1942.15 The predecessor of section 2042 (2) then contained a two-pronged criterion for including life insurance proceeds in a decedent's estate: the payment of premiums by

9. Whereas the general rule in Texas was that the husband was deemed to be the agent and manager of all community property, Texas law now grants joint management rights to the spouses in community property. Tex. Rev. Civ. Stat. Ann. art. 4621 (Supp. 1968).
11. Flick's Estate v. Commissioner, 166 F.2d 733 (5th Cir. 1948); Commissioner v. Jones, 62 F.2d 496 (6th Cir. 1932).
12. See, e.g., Hooper v. Commissioner, 41 B.T.A. 114 (A & NA) (1940); Rohnert v. Commissioner, 49 B.T.A. 1319 (1939). In Old Colony Trust Co. v. Commissioner, 39 B.T.A. 871 (A & NA) (1939), the court held that insurance policy proceeds payable to a trustee who was authorized, but not legally bound, to pay debts and charges against the insured's estate were not "receivable by the executor" on the grounds that the obligation to pay the estate's debts must be legally binding on the other beneficiaries. Id. at 876. Recognizing either explicitly or by implication that life insurance proceeds which are required to be applied toward the satisfaction of debts of decedents' estates are to be dealt with as though "receivable by the executor" under section 2042 (1), many courts have held that whereas the proceeds of the policies in question were payable to beneficiaries other than the executor, they nonetheless were to be included in the decedent's gross estate. See, e.g., Matthews v. Commissioner, 3 T.C. 525 (A) (1944); Hofferbert v. Commissioner, 46 B.T.A. 1101 (1942); Mason v. Commissioner, 43 B.T.A. 813 (NA) (1941).
the decedent; or his possession at death of "incidents of ownership." The former criterion, however, was dropped in the enactment of section 2042. Other than the five per cent reversionary interest provision of the 1954 Code, Congress has never defined such "incidents of ownership," and this task has therefore rested with the courts. The regulations, since 1934, have listed the rights and powers exercisable by the decedent "either alone or in conjunction with any other person" that courts have found to be sufficient incidents to warrant inclusion in a decedent's estate. These incidents are not restricted to ownership in the technical proprietary sense, but are based on the right of the insured or his estate to the policy's economic benefits.

In Prichard, decedent, a Texas resident doing business as a general contractor, was required by his lender to purchase a $250,000 life insurance policy as collateral security for permanent mortgage financing on a planned shopping center. At the lender's insistence the decedent placed the policy in his wife's name. At the closing, both decedent and his wife assigned absolutely the policy proceeds to the lender. Despite

16. The Revenue Act of 1942 included in decedent's gross estate
(2) RECEIVABLE BY OTHER BENEFICIARIES.— . . .
(A) purchased with premiums, or other consideration, paid directly or indirectly by the decedent . . . or (B) with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person.
18. E.g., Commissioner v. Noel, 380 U.S. 678, 683 (1965) (the right to change the beneficiary); Commissioner v. Treganowan, 183 F.2d 288 (2d Cir.), cert. denied, 340 U.S. 853 (1950) (power to surrender or cancel the policy); Liebmann v. Hassett, 148 F.2d 247 (1st Cir. 1945) (power to assign the policy); Bowers v. Commissioner, 23 T.C. 911 (A) (1955) (right to receive policy dividends held not a significant incident of ownership); Int. Rev. Code of 1954, § 2042(2) (right to a possible reversion).
20. Prichard v. United States, 397 F.2d 60, 61 (5th Cir. 1968).
21. Id. In his initial application decedent designated the lender as owner and beneficiary.
22. At the time this loan was made, July 7, 1958, the Texas law of coverture "provided that a married woman could not bind her separate property unless she had first obtained a court decree removing her disability to contract." United States v. Yazell, 382 U.S. 341, 343 (1966) (emphasis added and footnotes omitted). There is no evidence in Prichard to suggest that such incapacity to contract was removed by Mrs. Smith. Great Southern may have sought to overcome this disability in the wife's assignment by requiring that her husband, the decedent, also assign the policy as manager of her separate assets.
a finding that as a matter of Texas law decedent's wife was complete and sole owner of the policy, the court concluded that until decedent's death, "the insurance policy and the loan were indispensable parts of an integrated transaction." Reticent on the applicability of section 2042(1), the court reasoned that the legal incidents possessed by the wife were not controlling since the substance of the transaction was for the decedent's continuing enjoyment of the policy's economic benefits until his death, and therefore he possessed incidents of ownership as to one-half the proceeds.

Although payment of premiums was dropped as a determinative incident of ownership in the 1954 Code, it has remained a critical factor in determining whether an insurance policy is separate or community property in a community property state. Property purchased by a spouse takes its status at the time of acquisition, and when purchased with community funds it "is presumed to be community property even though taken in the name of only the husband or the wife." As recently as 1967, the Fifth Circuit held in Freedman v. United States that where community funds are used to pay the policy premiums on insurance purchased during the marriage, such insurance will be characterized as community property. The court noted

Great Southern may also have felt the insurance policy, despite language to the contrary, might be found to be community property, thus necessitating the husband's assignment.  
23. 397 F.2d at 63.  
24. Id.  
25. The Fifth Circuit may have acknowledged sub silentio the correctness of one commentator's attack on the district court's inclusion of the policy proceeds in decedent's estate under § 2042(1). Thies, Prichard Decision Confuses Estate Taxation of Life Insurance Receivable by the Executor, 25 J. Tax. 291 (1966). Thies persuasively argues that since there was no evidence that the widow had waived her right of reimbursement as to her separately held collateral, she would have a § 2053(a)(3) "enforceable 'claim against the estate' for the $250,000 running to the lender" when the lender took that amount of the loaned assets. Therefore, Thies reasons, decedent's estate had not benefited from his wife's loan of collateral.  
26. The court cited Commissioner v. Court Holding Co., 324 U.S. 331 (1945), for the proposition that they were "bound to give effect to substance over form." 397 F.2d at 63-64.  
28. Comment, 20 BAYLOR L. REV. 247, 252 (1968). See also Hemmingway v. Matthews, 10 Tex. 207 (1853); Huston v. Curl, 8 Tex. 239 (1852).  
29. Freedman v. United States, 382 F.2d 742 (5th Cir. 1967).  
30. Appellant in Freedman argued that since the "payment of premiums" test was dropped in 1954, it should not be determinative in any case. The court brushed the argument aside, stating that, [w]hile this reasoning seems forceful at first blush, it wilts
that under such circumstances a gift will not be found merely because the insured wife designated her husband as “owner,” for such designation is assumed to be merely for the purpose of acting as the agent of the community.31

Thus, before the court in Prichard could determine as a matter of Texas law that appellant was the sole owner of the disputed policy, it would have been necessary to find either that the insurance policy was not purchased with community funds, or that despite the use of community funds decedent had made a bona fide gift of the policy to his wife with the subsequent premiums being paid from her separate assets. The court, however, failed to address itself to these questions,32 noting only that all negotiations leading up to the policy’s purchase were conducted by decedent.33 Had there been a finding that the insurance policy was community property, the decedent would have been deemed to have enjoyed incidents of ownership in one-half the proceeds at death, rendering unnecessary the court’s strained economic benefits analysis.34

The circuits appear split on what constitutes “incidents of ownership” under section 2042. The critical issue in section 2042(2) cases is whether decedent possessed, at his death, any power to affect the proceeds’ disposition. In the recent case of Commissioner v. Noel,35 the United States Supreme Court stated that the issue was not whether decedent was in a position to or ever did exercise a power with respect to the policy, but rather whether he possessed any legal power to affect the disposition of the policy.36 The decedent in Noel purchased, in his wife’s presence, $125,000 of life insurance immediately prior to boarding an airplane, the policies being given to his wife at his di-

in the face of the proposition that payment with community funds is important where it results in community ownership. Section 2042 prescribes ownership as the test; and, according to the Treasury regulations and court decisions, state law must be considered in determining ownership.

Id. at 748.
31. Id. at 746-47.
32. Prichard v. United States, 397 F.2d 60, 63 (5th Cir. 1968).
33. Id.
34. In Freedman the court discussed the presumption that property purchased during the marriage is community property. Freedman v. United States, 382 F.2d 742, 746-47 (5th Cir. 1967). See also Commissioner v. Fleming, 155 F.2d 204 (5th Cir. 1946); Brick & Tile Inc. v. Parker, 143 Tex. 383, 186 S.W.2d 66 (1945); Carter v. Barnes, 25 S.W.2d 606 (Tex. Com. App. 1920) (presumption may be rebutted by showing gift from husband to wife).
36. Id. at 684.
rection and remaining in her possession. Decedent was killed when his airplane crashed, and his wife disputed inclusion of the policies’ proceeds in his gross estate on the grounds that the policies were purchased with her money, given to her, and the decedent never exercised any rights with respect to them. The Court held that since the decedent possessed general, legal power to exercise ownership over the policy, section 2042(2) required inclusion of the policies’ proceeds in decedent’s gross estate.

Recently faced with the question of what constituted incidents of ownership, the First Circuit, in United States v. Rhode Island Hospital Trust Company, declared the crucial issue to be the nature of the decedent’s power. Stressing the significance of Noel, the court stated that “[i]n . . . the predecessor of section 2042, [Congress] was not trying to tax the extent of the interest of the decedent,” but rather “was attempting to reach . . . the power to dispose . . . .” Noting the powers enumerated in Treasury Regulations, section 20.2042-1(c)(2), the court stated that “it is clear that the reference to ownership in the ‘technical legal sense’ is not abandoned and supplanted by reference to ‘economic benefits,’” and that the powers referred to by Congress in its reports “are powers which may or may not enrich decedent’s estate, but which can affect the transfer of the policy proceeds.” The inquiry then becomes a matter of determining whether the decedent, at the time of his death, had “a capacity to do something to affect the disposition of the policy if he had wanted to.”

The court in Prichard did not frame its inquiry in the manner suggested in Noel and enunciated in Rhode Island Hos-

37. Id. at 679-80.
38. Id. at 683-84.
39. 355 F.2d 7 (1st Cir. 1966). The court here goes into the rationale of section 2042(2) in greater detail than any recent case, attempting to place Noel in proper perspective in the process. Id. at 10-11.
40. Id. at 11.
42. United States v. Rhode Island Hospital Trust Co., 355 F.2d 7, 10 (1st Cir. 1966).
43. Id.
44. For purposes of this paragraph [§ 20.2042-1(c) Receivable by other beneficiaries], the term “incidents of ownership” is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy.
45. United States v. Rhode Island Hospital Trust Co., 355 F.2d 7, 11 (1st Cir. 1966).
pital Trust. Rather the court found, in accordance with the
Commissioner’s argument, that the life insurance policy was an
essential part of an integrated transaction and that the decedent
continued to enjoy the fruits of that transaction until his death
two years later. Therefore, the “economic benefit” found in Prich-
ard was twofold: first, that the policy was part of an inte-
grated transaction controlled by the decedent, and the wife’s
ownership of the policy was merely a result of that transaction;
and second, that the decedent was enjoying, at the time of his
death, the economic benefits of that earlier transaction.

The holding in Prichard is distinguished, therefore, in find-
ing incidents of ownership possessed by a decedent absent any
finding by the court of a legal power possessed by the decedent
to influence disposition of the policy proceeds. The Fifth Cir-
cuit appears to have supplanted ownership in the “technical
legal sense” with “economic benefits.” The court’s holding
may, however, be narrower than it first appears. The court
states that it is not deciding the case where “a wife who has
become the absolute owner of an insurance policy on her hus-
band’s life, her husband no longer having any incidents of owner-
ship therein,” assigns “it as collateral for a community debt,”
the husband then commencing to enjoy the economic benefits
of the assignment. Query whether there is any distinction be-
tween that and the instant case other than the nature of the
transaction giving rise to the policy’s assignment. But the
court may be saying that in the absence of an integrated trans-
action giving rise to the creation and subsequent assignment of
an insurance policy, mere economic benefits will not give rise
to incidents of ownership, absent a showing of some legal power
in the decedent to affect the disposition of the policy proceeds.

While the facts as presented and analyzed by the court pro-
vide little support for the court’s conclusions, a different analysis
of the facts in Prichard may provide some justification for the
final result. In Commissioner v. Karagheusian, the court held
that a husband’s ability to change the ultimate disposition of in-
surance policy proceeds partially funding an inter vivos trust,
with the aid of his wife and daughter, constituted an “incident of

46. 397 F.2d at 64.
47. See note 44 supra, and accompanying text.
48. 397 F.2d at 64.
49. See 397 F.2d at 63 n.5. Approaching the problem from a dif-
ferent direction, the circuit court appears to have duplicated what
they considered error on the part of the district court.
50. 233 F.2d 197 (2d Cir. 1956).
In United States v. Treganowan the Second Circuit held that where an employee can cancel an insurance policy on his life by substituting another in his place, such power is a sufficient incident of ownership to require inclusion of the proceeds in his gross estate at death. Also, Revenue Ruling 69-54 states that in the case of group insurance plans a decedent who had the power to cancel the insurance by terminating his employment will have the proceeds of such policies included in his gross estate because such a power to cancel is an incident of ownership with respect to the policy. Utilizing this line of reasoning it can be argued that since the decedent in Prichard was in a position to affect the disposition of the insurance policy by defaulting on the loan it secured, he possessed an incident of ownership with respect to the policy.

The Regulations provide that the question of property ownership under section 2042 must be decided on the basis of local law. Although the premium payment standard of incidents of ownership has been dropped, the source of funds for the payment of premiums remains critical in the determination of ownership in community property states. However, no determination as to the source of premiums was made in the instant case, leaving the strong presumption in favor of a finding of community property unrebutted. If, however, the court was correct in characterizing the insurance policy as the separate property of the wife-executrix, the Fifth Circuit’s determination of what constitutes incidents of ownership in an insurance policy seems contrary to that of the Supreme Court in Noel and that of the First Circuit as applied in Rhode Island Hospital Trust. The Fifth Circuit’s decision in Prichard arguably constitutes an unwarranted departure from that court’s own precedents and the standards recently announced by the Supreme Court.

51. Id. at 199. In Karagheusian the wife, who owned an insurance policy on her husband’s life, established an inter vivos trust and absolutely assigned the insurance policy to the corporate trustee along with other securities. The trust agreement was later amended to provide that the wife could, with the written consent of her husband and daughter, modify, alter or revoke the trust in whole or in part. Id. at 198–99.


53. In Treganowan decedent had held a seat on the New York Stock Exchange which entitled him to valuable retirement and death benefits. Decedent had “the power to sell his seat, thus divesting his beneficiary of any right to payments...” Id. at 292.


55. Id.
Federal Income Taxation: Bad Debt Reserve Restored to Income in Section 351 Transfer

Petitioner transferred the entire business of his sole proprietorship, including the accounts receivable, to a corporation in exchange for all of its capital stock. The exchange qualified as a tax-free transaction under section 351 of the Internal Revenue Code of 1954.1 Upon receipt of the assets and liabilities of the proprietorship, the corporation placed on its books a value for the accounts receivable identical to that disclosed on the books of the proprietorship prior to the transfer, and also set up a reserve for bad debts in the same amount as that carried by the proprietorship.2 The Commissioner increased petitioner's taxable income for the year of transfer by an amount representing two separate adjustments: first, the disallowance of a deduction claimed as an addition to the proprietorship's bad debt reserve in the year of transfer; and second, the restoration to income of the remaining balance in the proprietorship's bad debt reserve. The Tax Court held that the Commissioner was correct in restoring the bad debt reserve to income since the proprietorship ceased to exist at the time of the transfer of assets to the corporation and, therefore, could not incur any future bad debts. Schuster v. Commissioner, 50 T.C. No. 12, 1968 P-H Tax Ct. Mem. § 50.12.

It has long been held that any balance in a reserve for bad debts is to be restored to income of the year in which the need for maintaining the reserve ceases.3 Initially this doctrine was applied upon the termination of a business entity through complete liquidation. Subsequently, however, the Internal Revenue Service developed a policy of restoring reserves to income in tax-free liquidations concurrent with mergers and reorganizations.4 In Citizens Federal Savings and Loan v. United States,5

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1. Section 351 provides in part:
No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation.
INT. REV. CODE OF 1954, § 351(a).

2. The reserve was set up under the authority of section 166(c) of the Code, which states:
In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.


However, the United States Court of Claims, in dictum, noted the distinction between complete liquidation on the one hand and liquidation into a parent corporation on the other. The court stated that in the case of a subsidiary merger "the holder of the asset continues in existence, although in an altered form, and continues to experience the risk of bad debt loss." This distinction was recognized in *Calavo, Incorporated v. Commissioner,* where the corporation surviving a merger under section 332 carried all the accounts of the acquired corporation, including the bad debt reserve which the latter had set up. The Commissioner had restored to income the entire reserve on the ground it was no longer necessary after the acquired corporation was liquidated and dissolved. Before the Tax Court, however, the Commissioner conceded such reserve was not restored income in the case of a section 332 reorganization. A year later this distinction between liquidation and a continuing business was dispositive in *Home Savings and Loan Association v. United States.*

In a 1962 Revenue Ruling, the Service indicated that the continuing business distinction would not be applied to a transfer of a sole proprietorship's assets to a corporation controlled by the transferor in a nontaxable exchange under section 351. The Ruling held, instead, that a bad debt reserve was not transferable to any other entity and, therefore, represented ordinary income to the taxpayer for the taxable year during which the transfer of the accounts receivable was made. In support of this holding, the ruling cited two cases which both dealt with the liquidation of a corporation.

Between the time of the Ruling and the instant case only one decision has considered the problem. In *Estate of Heinz Schmidt v. Commissioner,* the taxpayer transferred the assets

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(Ct. Cl. 1961); Bird Management, Inc., 48 T.C. 586 (1965); J.E. Hawes Corp., 44 T.C. 705 (1965); Ira Handelman, 38 T.C. 560 (1961); West Seattle Nat'l Bank, 33 T.C. 341 (1959).

5. 290 F.2d 932 (Ct. Cl. 1961).
6. Id. at 937.
7. 304 F.2d 650 (9th Cir. 1962).
8. Section 332 provides that no gain or loss is recognized to the parent corporation when it completely liquidates a subsidiary which it controls. *Int. Rev. Code of 1954, § 332.*
12. 355 F.2d 111 (9th Cir. 1966).
of his sole proprietorship to a corporation in exchange for an agreement by the corporation to assume the liabilities of the business and to issue its capital stock to taxpayer. The exchange qualified as a tax-free transaction under section 351. In computing the stock's par value, the taxpayer deducted the balance of the bad debt reserve from the face value of the accounts receivable. The Tax Court upheld the Commissioner's assessment of a deficiency in the amount of the reserve on the taxpayer's return in the year of the exchange, but the Ninth Circuit Court of Appeals reversed on the ground that, although the taxpayer no longer needed the reserve, he had not in any economic sense recovered its value.\textsuperscript{13} The Commissioner had contended that the taxpayer, by obtaining for the accounts receivable stock equivalent to their net value, sustained a loss equal to the amount of the reserve, but that the loss was not recognized by reason of section 351. The court rejected this contention as creating fictitious income and concluded that no income is received, whether the exchange is for stock or cash, unless the consideration received exceeds the net amount of the receivables.\textsuperscript{14}

The \textit{Schmidt} rationale was not followed in the instant case. In upholding the Commissioner, the Tax Court reiterated the doctrine that a reserve for bad debts must be restored to income when events make the reserve no longer necessary. While defining a bad debt reserve as "a forecast of possible future bad debt losses,"\textsuperscript{15} the court determined that the taxpayer had terminated the activities of the proprietorship and had disposed of his assets including his accounts receivable. Therefore, he would never thereafter sustain any bad debt losses in respect of the debts thus transferred, and the deduction previously taken for such anticipated loss must be restored to income.\textsuperscript{16}

The \textit{Schuster} court categorized as inconsequential the fact that the taxpayer may have realized a loss on the transfer of accounts since such a loss cannot be classified as a bad debt.\textsuperscript{17} Instead, the loss must be deducted if possible under the applicable section of the Code for that type of loss.\textsuperscript{18} The deductions

\begin{footnotes}
13. Id. at 113.
14. Id. at 114.
16. Id.
17. Id.
18. At this point the \textit{Schuster} court was reiterating an argument often made in prior cases. For instance in Bird Management, Inc., 48 T.C. 586, 597 (1965), the Tax Court stated:
\end{footnotes}
comprising the bad debt reserve gain their validity from section 166 and are justified only as long as the possibility of incurring a bad debt exists. It was with this theory that the Schuster court rejected the holding in Schmidt, since in that decision the court disposed of the question on the basis of whether the creditor had received consideration on the disposition sufficient to cover the reserve. Schuster maintained that this question is irrelevant since any loss incurred will not be a bad debt loss.

The court concluded by noting the fact that its decision did not preclude the corporation, in the event it suffered the bad debt losses, from tax benefits either through additions to its own reserve or through deductions for bad debts when the losses are actually sustained.

By rejecting the precedent set in Schmidt and returning to the approach articulated in Revenue Ruling 62-128, the Tax Court followed a policy which ignores both the accounting principles underlying the reserve method and the purpose of section 351.

The court’s characterization of the bad debt reserve as a “forecast” of future bad debts, while not totally inaccurate, distorts the actual function of the reserve. By referring to the reserve as anticipating future bad debts, the court laid the basis for its theory that once the proprietorship terminated, the need

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It is not that the creditor has received something or has realized income in the usual sense. Rather, it is an accounting concept that one who has taken a deduction for bad debts in earlier years by reason of his method of accounting must, in accordance with that method of accounting, restore that deduction to income in a later year when it becomes clear that no bad debt loss will occur. If a different type of loss should occur, as a result of sale, that loss would then be deductible to the extent that and subject to such limitations as the Code prescribes for such losses.

This argument ignores the fact that a section 351 transfer is by definition tax-free. The ensuing loss, therefore, will not be recognized by the taxpayer.

20. Id. While this statement is merely dictum, it suggests a possibility that the Schmidt court specifically refused to pass upon. Estate of Heinz Schmidt v. Commissioner, 355 F.2d 111 (9th Cir. 1966).

Judge Simpson, in his dissent in Schuster, proposes a similar idea by stating that the reserve should be required to be carried over to the transferee corporation. 50 T.C. No. 12, 1968 P-H Tax Ct. Mem. ¶ 50.12, at 73.

for the reserve also ended. However, the reserve is actually a valuation account which attempts to reflect the actual current value of the receivables.\textsuperscript{22} Under the reserve method, the bad debt losses are matched against the income attributable to the accounts for which the reserve is set up. The bad debt losses are accounted for at the time the credit is given and the receivables accepted. It is at this time that the loss actually occurs. Because the accrual method taxpayer is taxed on the face value of accounts receivable at the time the debt is established rather than when it is paid, the function of a bad debt reserve is to reduce the taxable income on the receivables to a level consistent with its actual value by deducting that part of the income which the taxpayer can not reasonably expect to realize. It is, therefore, irrelevant that the sole proprietorship no longer "needs" the reserve after the assets are transferred in a section 351 transaction, since the taxpayer will never receive income from the accounts receivable even though he has paid a tax thereon.

Since the actual value of the receivables is the face value minus the reserve, a transfer of the accounts to the corporation without a corresponding transfer of the reserve produces an inaccurate valuation of the accounts on the books of the corporation. While the corporation is probably allowed to set up its own reserve after the transfer,\textsuperscript{23} the deductions it takes will be against income not representing the transactions from which the accounts resulted, clearly a departure from the underlying theory of the accrual method. By not allowing the reserve to be carried over to the corporation, the Tax Court allocates an item of income to the proprietorship, but puts the direct expense of earning that income on the corporation.

The requirement that the reserve be restored to income also goes against the purpose of section 351 as indicated in the legislative history.\textsuperscript{24} The basic philosophy of the section is that a transfer to a controlled corporation is to be treated as a mere change in the form of ownership with the business being seen as a single, continuous operation. Therefore, the section specifies

\textsuperscript{23} See text accompanying note 20 supra.
Congress indicated that the section similar to the present section 351 was passed to allow a tax free transfer where the proprietor retains control since the transfer would not generate any cash receipts out of which taxes could be paid.
that the event of incorporation will not precipitate recognized gain or loss.\textsuperscript{25} The weakness of the court's argument is apparent from its choice of cited cases, most of which involved entities which completely terminated business after the proprietor had received the full face value of the receivables in exchange for their transfer to another party.\textsuperscript{26} Such is not the case in a section 351 transaction. The enterprise continues to exist but in a different form. Moreover, no consideration passes to the proprietor.

It is difficult to understand the Tax Court's position, in view of the purpose of section 351, and since there is not a problem of tax avoidance. Section 166 of the Code allows only reasonable additions to a reserve at the discretion of the Secretary.\textsuperscript{27} Therefore, unreasonable or excessive deductions can be disallowed on an individual basis without upsetting the tax free incorporation transfers as \textit{Schuster} clearly does. Moreover, even an excessive reserve will have to be either offset by worthless debts or restored to income at some future date when it actually becomes unnecessary.

At the conclusion of \textit{Schuster}, the Tax Court states that "it would be inappropriate, in order to reach a seemingly equitable result, to proceed upon theories that . . . do violence to the statute."\textsuperscript{28} It is submitted that the decision in the instant case is where the violence to the statute is effected. It seems clear that where the policy of a section is apparent, a transaction which is not specifically dealt with in the Code should be handled by the Tax Court with the spirit of the section in mind. Such an approach was not taken in the instant case.\textsuperscript{29}

\textbf{Federal Income Taxation: “Right to Income” as Test for Income in Respect of a Decedent}

Decedent, a cash basis taxpayer, entered into an executory contract to sell the stock of a corporation in which he was the  

\begin{itemize}
  \item \textsuperscript{25} See note 1 \textit{supra}.
  \item \textsuperscript{26} Cases cited note 4 \textit{supra}.
  \item \textsuperscript{27} See note 2 \textit{supra}.
  \item \textsuperscript{28} Shuster v. Commissioner, 50 T.C. No. 12, 1968 P-H Tax Ct. Mem. ¶ 50.12, at 72.
  \item \textsuperscript{29} Two cases since \textit{Schuster}, however, have returned to the precedent set in \textit{Schmidt} and have refused to restore the reserve to income in a section 351 exchange. Rowe v. United States, 69-1 U.S. Tax Cas. ¶ 9162 (1969); Birmingham Trust Nat'l Bank v. United States, 22 Am. Fed. Tax R.2d 5202 (N.D. Ala. 1968).  
\end{itemize}
sole stockholder.\(^1\) Some of the conditions necessary for the closing not having been met prior to decedent's death,\(^2\) the transaction was subsequently closed by his executor.\(^3\) The Internal Revenue Service, claiming that the gain from the sale represented income in respect of a decedent,\(^4\) ruled that the stock's basis could not be stepped-up under section 1014(a). After paying the disputed taxes, the executor and beneficiaries applied for a refund, which was denied by the district court, ruling that the gain represented income in respect of a decedent, since it was primarily due to the decedent's economic activity.\(^5\) The Fifth Circuit affirmed per curiam, holding that although the "economic activity" of the decedent is not the determinative test, the gain was income in respect of a decedent since the decedent had acquired a "right" to the income by signing the executory contract. Trust Company of Georgia v. Ross, 392 F.2d 694 (5th Cir. 1967).

Section 1014(a) of the Internal Revenue Code allows the capital gains on investment property to pass to the beneficiaries of an estate without being subject to the federal income tax. After the federal estate tax is paid by the executor of the estate, the beneficiaries or personal representatives of the estate receiving the property are expected to pay income tax only on the difference between the fair market value at the time of death, or the alternate valuation date,\(^6\) and the proceeds from an eventual sale.\(^7\) However, section 1014(c) specifically makes this rule inapplicable to income in respect of a decedent under sec-

\(^1\) Actually this was part of a larger contract to sell the assets of a hotel chain in which the decedent was the major stockholder. The only question in this case has to do with the sale of stock of one of the corporations in the chain. Trust Co. of Georgia v. Ross, 262 F. Supp. 900, 901 (N.D. Ga. 1966).

\(^2\) Since the stock was in escrow, delivery of title and possession of the stock and of the papers necessary to effect the sale had not taken place. 262 F. Supp. at 902, 904. The $2,350,000 loan necessary to close the sale had not been obtained by the purchaser. 262 F. Supp. at 903-04.

\(^3\) The most significant modification the executor made to the contract dealt with his change from a strictly cash sale to sale based on cash and a $500,000 loan by the estate. 262 F. Supp. at 904.

\(^4\) Int. Rev. Code of 1954, § 691 [hereinafter referred to by section number only].


\(^6\) Section 2032.

\(^7\) See Estate of Burnett v. Commissioner, 2 T.C. 897 (1943). Although some doubt was thrown upon the principles established in this case by the decision of Commissioner v. Linde, 213 F.2d 1 (9th Cir. 1954), they were later recognized by the Internal Revenue Service. See Rev. Rul. 58-438, 1958-2 Cum. Bull. 366.
CASE COMMENTS

Section 691 finds its origin in an amendment to section 42 of the Revenue Act of 1934. Prior to 1934, a decedent paid tax only on that income found on his books at death. Thus, the accrual basis taxpayer was taxed on all income accrued at the time of his death while the cash basis taxpayer paid taxes only on income actually received prior thereto. This resulted in an obvious loss of revenue to the Treasury and an equally obvious inequity between decedents keeping their books on different bases. Congress, thus wanting to insure that a deceased cash basis taxpayer would return taxes on all the income that would have "accrued" had he kept his books on the accrual basis, enacted the 1934 amendment to section 42.

Most writers assumed that the term "accrued" used in section 42 would be interpreted in the ordinary tax accrual context. It was so interpreted by the Third Circuit in the case of Enright v. Commissioner. However, on appeal, the Supreme Court reversed the Third Circuit and held that "accrued" for purposes of section 42 did not necessarily have the same meaning as "accrued" in the ordinary tax accrual context. The Court, going beyond the tax accrual definition, held that certain partnership assets which would not normally have accrued to the taxpayer at the time of death were income in respect of the decedent. The Enright definition of accrual for the pur-

8. Section 1014(c).
11. See Commissioner v. Linde, 213 F.2d 1, 6-7 (9th Cir. 1954); Estate of Davidson v. United States, 292 F.2d 937, 941 (Ct. Cl. 1961); Keck v. Commissioner, 49 T.C. 313, 319-20 (1968).
12. . . . In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period. Act of May 10, 1934, ch. 277, § 42, 48 Stat. 694 (emphasis added).
. . . Sections 42 and 43 of the House bill were so drawn as to require the inclusion in the income tax return for the decedent of all items of income and deductions accrued up to the date of death regardless of the fact that the decedent may have kept his books on a cash basis.
S. REP. No. 558, 73d Cong., 2d Sess. 28 (1934). See also H.R. REP. No. 704, 73d Cong., 2d Sess. 24 (1934) (similar language).
14. 112 F.2d 919 (3d Cir. 1940).
poses of income in respect of a decedent resulted in a burden to the taxpayer by forcing much more income into the decedent's last taxable year than would normally have been expected.\textsuperscript{16} To avoid this "bunching of income" into the decedent's last return,\textsuperscript{17} Congress, in 1942,\textsuperscript{18} converted section 42 to section 126 of the Internal Revenue Code of 1939, which allowed the tax to be paid by the party actually receiving the income—the beneficiaries or the estate.\textsuperscript{19} Congress also dropped the use of the word "accrued" and inserted the word "right."\textsuperscript{20} In 1954 section 126 of the Internal Revenue Code of 1939 became the present section 691,\textsuperscript{21} with changes irrelevant to the present discussion.\textsuperscript{22}

Unfortunately, while Enright in effect disregarded the original Congressional intent of equalizing the income tax consequences of death for accrual basis and cash basis taxpayers, by applying an accrual test to each, neither Congress nor any subsequent court has supplied an alternative test to distinguish between income in respect of a decedent and that property which should receive a stepped-up basis under section 1014(a). In searching for a workable distinction, the courts have generally dealt in terms of the decedent earning the income or his "economic activity" contributing to it.\textsuperscript{23} However, no clear test has yet evolved and there has been substantial confusion over the proper test.

This confusion provided the basis for the appellant's argument in the Ross case. Prior to his death, the decedent entered into a contract to sell his corporate stock.\textsuperscript{24} The stock was placed

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\item \textsuperscript{16} Mertens § 12.100 (Supp. 1954).
\item \textsuperscript{17} See S. Rep. No. 1631, 77th Cong., 2d Sess. 100 (1942); H.R. Rep. No. 2333, 77th Cong., 2d Sess. 83 (1942).
\item \textsuperscript{18} Act of Oct. 21, 1942, ch. 619, § 134, 56 Stat. 830.
\item \textsuperscript{20} See also Estate of O'Daniels v. Commissioner, 173 F.2d 966, 968 (2d Cir. 1949); Trust Co. of Georgia v. Ross, 262 F. Supp. 900, 907 (N.D. Ga. 1966).
\item \textsuperscript{21} Act of Aug. 16, 1954, ch. 736, § 691, 68A Stat. 235.
\item \textsuperscript{22} The major concern when section 126 became section 691 of the Internal Revenue Code of 1954 had to do with inequities which arose in the event of successive deaths of decedents and with the inclusion of installment payments as part of income in respect of a decedent. S. Rep. No. 1622, 83d Cong., 2d Sess. 373-76 (1954); H.R. Rep. No. 1337, 83d Cong., 2d Sess. A218-A220 (1954). The lower court in Ross accepted, for purposes of discussing this case, that the differences between 126 and 691 were immaterial. 262 F. Supp. at 907. This analysis was accepted by the Fifth Circuit. 392 F.2d at 695.
\item \textsuperscript{23} E.g., Levin v. United States, 373 F.2d 434 (1st Cir. 1967); United States v. Ellis, 264 F.2d 325 (2d Cir. 1959).
\item \textsuperscript{24} 262 F. Supp. at 901-03.
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in escrow with the understanding that it would be returned to the decedent in the event that either the corporate premises were destroyed prior to the date set for closing or the purchaser could not raise the purchase money. In the latter instance, the earnest money paid was to serve as liquidated damages. At the time of decedent's death, neither title nor possession had passed to the purchaser, the papers necessary to effect such a passage having not been delivered. Indeed, there was serious question whether the purchaser could raise the necessary funds for closing. In light of these circumstances, the executor and beneficiaries argued that, at the time of decedent's death, he did not have an unqualified right and was not “entitled” to the purchase price. They reasoned that since that status of the transaction was uncertain at the time of death, any gain subsequently realized should not be considered part of the decedent's income. Rather, the stock should pass to the estate with a stepped-up basis under section 1014(a), thereby avoiding all federal income tax.

In rejecting this argument, the Fifth Circuit specifically

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25. Id. at 902.
26. Id.
27. When property is placed in escrow, title will pass according to the intention of the parties. E.g., Chaplin v. Commissioner, 136 F.2d 298 (9th Cir. 1943). In the instant case, clearly the decedent did not intend to pass title until and unless the purchaser could raise the money necessary to close the deal.

Also, as a general rule, until the performance of the condition upon which delivery in escrow is made, legal title remains in the grantor. E.g., Suratt v. Fire Ass'n of Philadelphia, 43 F.2d 467, 471 (4th Cir. 1930). This general rule has been applied to stock certificates. E.g., Chaplin v. Commissioner, 136 F.2d 298 (9th Cir. 1943).

28. The possession of the stock remained in the hands of the escrow agent until the date set for closing. 262 F. Supp. at 901-04 (by implication). The possession of the corporate premises remained in the hands of the decedent and his representatives up until the date set for closing. Brief for Appellant at 6 (never disputed in either the record, briefs of appellee or court opinions).

29. There was no reason to deliver the final papers which would effect the transfer until the closing date, which was after the decedent's death.

30. On the date of the decedent's death, the purchaser had not heard from the company from which it planned to borrow the money. Brief for Appellant at 7; Record at 119-20. The purchaser then approached the Trust Company of Georgia on the possibility of financing the loan. Finally, after some dispute and after getting the executor of the estate to agree to have the estate of the decedent participate in the loan to the extent of $500,000, the purchaser raised the money. 262 F. Supp. at 903-04.
32. Id.
discarded the "economic activity" test in favor of its own "entitlement" or "right to income" test. The opinion makes quite clear that unless the decedent's economic activity in some way evokes a "right" to the proceeds of a sale, the gain cannot be taxed as income in respect of a decedent under section 691. On the surface the court seems to have adopted an accrual accounting test consistent with the pre-Enright legislative history. "Right to income," or more specifically, the right to receive income, is the determinative factor in whether an item properly accrues for normal income tax purposes. Thus, the court seems to be treating a cash basis taxpayer in accrual terms—"right to income."

Closer analysis, however, reveals that the Fifth Circuit's definition of "right" is quite different from that commonly understood by tax lawyers and courts in returning income of accrual basis taxpayers. Although the "right" which produces the income must be present at death, a reasonable certainty that the "right" will in fact produce income does not seem to be required. The test is more hind sighted, the "right" being judged in light of the actual future events. If a decedent acquires any "right" to income before his death, and the right results in a realized gain, the same will be taxed as income in respect of a decedent. The fact that the right is contingent or not substantial seems immaterial. Indeed, there is authority to suggest that the right does not have to be legally enforceable. Under Ross, a vote by the shareholders and the board of directors of a corporation to sell its assets may well be sufficient to give stockholders a "right" to the later liquidation proceeds after his death, so as to render any gain income in respect of a decedent under section 691.
In standard tax accrual cases, an item properly accrues when all of the events which fix the right occur. The accrual basis taxpayer is under no obligation to pay taxes on income which is contingent and might never be received. There are no hard and fast rules for determining when a right becomes fixed or unconditional, and each transaction is decided on its own facts. However, it seems that there is no accrual when the purchaser has yet to receive a loan necessary to close even though the loan is almost assured. Indeed, there is authority that a "right" to income has not accrued when, under an executory contract, the seller has not tendered the papers necessary to effect the transfer, has not passed either title or possession, or has not demanded the purchase price. Therefore, if "right" had been used in the standard tax accrual context, the gain from the liquidation proceeds was income in respect of a decedent under § 691. The dissent stressed the fact that at the time of death the decedent was not entitled to the income. The most that could be said is that the corporation had a contingent right to any gain realized from the sale, but that the decedent had no right to the liquidation proceeds. At the time of his death, no formal action had been taken toward liquidation of the corporation and none of the stockholders, including the decedent, was committed to voting for liquidation. Nevertheless, the majority felt that there was enough of an informal understanding that the corporation would be liquidated once the sale was complete that the liquidation proceeds should be considered part of the decedent's income.

Although the majority decision was reached on the basis of the "economic activity" test employed by the lower court in Ross, the same result could have been reached using the Fifth Circuit's interpretation of the "right" test. This would be done by saying that the vote by the shareholders to sell the corporation's assets was tantamount to a vote to liquidate the corporation. Since in substance, if not in form, the liquidation had been decided prior to the stockholder's death, his "right" to the liquidation proceeds had vested. However, this case contains greater contingencies than were found in Ross, which could justify another court reaching a different result under the "right" test. At the time of the decedent's death in Keck, any right he had was, at best, very contingent in light of the lack of ICC approval of the sale and very informal in light of the lack of any formal action to liquidate. Also one should remember that Keck was a minority stockholder who could have done nothing if the majority stockholder had, for reasons of his own, decided not to liquidate.

40. Chaplin v. Commissioner, 180 F.2d 140 (8th Cir. 1950); Commissioner v. Segall, 114 F.2d 706 (6th Cir. 1940).
41. Chaplin v. Commissioner, 180 F.2d 140 (8th Cir. 1950). Here it was clear that there was greater surety of getting the necessary loan than in Ross.
gain from the sale of the stock in Ross would not have accrued to the decedent at the time of his death as his right to the income was never fixed or unconditional. Under neither generally accepted accounting principles, nor under standard income tax accrual concepts, would the income from the sale have accrued to the decedent at the time of his death. Whatever the test delineated in Ross is, it is not one of accrual as applied to the facts at bar.

If the Ross application of the “right” test is upheld, a dual definition of the word “right” will exist—the traditional meaning, judicially defined in the accrual taxpayer context, and the Ross definition. The result will be the continuation of a confusing and uncertain test for distinguishing between income in respect of a decedent and property which should receive a stepped-up basis under 1014(a).

The practical justification for this dual definition is probably to prevent certain property from receiving a stepped-up basis under 1014(a). Accepting the stepped-up basis provisions, there is presently no means other than an accrual test to distinguish between 1014(a) property and income in respect of a decedent. The Ross “right,” like the Enright “accrual,” is incapable of being defined by either Congress or the courts. In the final analysis, the Ross court's dual definition of the word “right” continues the confusion, failing to delineate what the test is and stating only what it is not. It would seem preferable to use the word “right” as it has been judicially defined in the accrual taxpayer context, thereby filling the hiatus in the present law and providing a much needed test for distinguishing between income in respect of a decedent under 691 and that property which should receive a stepped-up basis under 1014 (a). Such a test would have the dual advantage of certainty and administrative workability.44

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43. P. Grady, Inventory of Generally Accepted Accounting Principles for Business Enterprises 36 (1965).
44. If the Ross application of the “right” test is accepted, another possible problem deals with the effect of a rescission and/or renegotiation of the executory contract after the decedent's death. An essential element of the Ross test is that the “right,” even though contingent, must be present at the time of death. 392 F.2d at 696. Elementary contract law allows parties to a contract to rescind the instrument voluntarily, thereby destroying all the “rights” created by it. 5 A. Corbin, Corbin on Contracts § 1236 (1964). Such a rescission would seem to take a transaction outside the scope of the Ross test. The “right,” present at death, would be destroyed and thus incapable of producing income.

Although a contract rescission may well avoid the Ross result, the
Federal Procedure: Broadening of Taxpayer's Standing to Sue

The plaintiffs brought suit to enjoin the expenditures of federal funds by private schools under titles I and II of the Elementary and Secondary Education Act of 1965. They claimed standing to sue solely on the ground that they were federal taxpayers. The Government moved to dismiss for lack of standing. A three-judge district court ruled in favor of the Government. An appeal on the limited question of standing was taken directly to the Supreme Court, which held that under the circumstances of the case, and based on the application of a new test for determining the standing of federal taxpayers in federal courts, the plaintiffs should be permitted to maintain the action. Flast v. Cohen, 392 U.S. 83 (1968).

The judicial power of the United States is limited by article III of the Constitution to specific kinds of cases or controversies.

problem becomes much more complex when there is a subsequent renegotiation of the contract. See Knetsch v. United States, 364 U.S. 361 (1960) (transaction entered into only for the purpose of tax avoidance is considered a step transaction and will have no effect as far as avoiding income tax). In Ross the appellant argued that the modification of the contract by the executor resulted in a new contract quite different from that entered into by the decedent. Brief for Appellant at 30. The fact that the court did not even comment on the argument would seem to indicate that the court did not accept the reasoning and that to destroy a "right" to income there must be more than a substantial modification of contract. Indeed, since the Ross test uses hindsight in which the right does not have to be substantial, one could speculate that the courts may not consider a "right" to income effectively destroyed, even where there is a legitimate rescission and renegotiation of the contract for substantial non-tax reasons.

1. 79 Stat. 27 (1965); 80 Stat. 1199 (1965).
4. Flast v. Cohen has been commented upon in the following: Davis, Standing: Taxpayers & Others, 35 U. CHI. L. REV. 601 (1968); Comment, 35 BROOK. L. REV. 94 (1968); Comment, 3 SUFF. L. REV. 185 (1968); Comment, 21 VAND. L. REV. 850 (1968).
5. The judicial Power shall extend to all Cases, in Law and Equity, arising under this Constitution, the Laws of the United States, and Treaties made, or which shall be made, under their Authority;—to all cases affecting Ambassadors, other public Ministers and Counsuls:—to all Cases of admiralty and maritime Jurisdiction;—to Controversies to which the United States shall be a Party;—to Controversies between two or more States; —between a State and Citizens of another State;—between Citizens of different States,—between Citizens of the same State claiming Lands under Grants of different States, and between a
In terms of general requirements, the courts have established that for a case or controversy to be justiciable it must be susceptible of resolution through the judicial process, it must present a genuine confrontation of adverse interests, and it must contain the element of adverse consequence, or, otherwise stated, potential injury to the party bringing the action. Standing to sue is another important requirement of the doctrine of case or controversy. By requiring that the party seeking relief have a stake in the outcome of the litigation, it ensures the presence of adverse consequence. It is addressed to the question of whether the particular plaintiff is the proper party to seek judicial intervention.

The question of standing to sue has most frequently arisen

State, or the Citizens thereof, and foreign States, Citizens or Subjects.
6. The words “case” and “controversy” act to “... limit the business of federal courts to questions presented in an adversary context and in a form historically viewed as capable of resolution through the judicial process.” Flast v. Cohen, 392 U.S. 83, 95 (1968).
8. A court will act only where the litigation grows “... out of a controversy affecting legal or equitable rights as to a person or property. All questions of law arising in such cases are judicially determinable.” Marye v. Parsons, 114 U.S. 325, 330 (1884). More recently the Court held that “[t]he power of ... this Court, to pass upon the constitutionality of acts of Congress arises only when the interests of litigants require the use of this judicial authority for their protection against actual interference. A hypothetical threat is not enough.” United Pub. Workers v. Mitchell, 330 U.S. 75, 89-90 (1947). Viewed together these requirements reflect a determination that the Court’s power to declare the law extends only to particular cases; there is, for example, no power merely to declare acts of Congress void. Chicago & G.T. Ry. v. Wellman, 143 U.S. 339, 345 (1892); Marye v. Parsons, supra.

A justiciable case or controversy is not presented when the Court is faced with a moot question; the mootness puts the conflict beyond the power of the judiciary. California v. San Pablo & T. R.R., 149 U.S. 306 (1892). Similarly, there is no case or controversy when the action is collusive, Lord v. Veazie, 49 U.S. (6 How.) 251 (1850); when it seeks an advisory opinion, United States v. Fruehauf, 365 U.S. 146 (1960); or when it presents political questions. Commercial Trust Co. v. Miller, 282 U.S. 51 (1923); Luther v. Borden, 48 U.S. (7 How.) 1 (1849).
10. See Baker v. Carr, 369 U.S. 186, 204 (1962), where the Court stated that adverse consequence is necessary to the proper resolution of legal questions.
11. “... [W]hen standing is placed in issue in a case, the question is whether the person whose standing is challenged is a proper party to request an adjudication of a particular issue...” Flast v. Cohen, 392 U.S. 83, 99-100 (1968).
in cases involving attempts by federal taxpayers to challenge the validity of governmental action. In *Frothingham v. Mellon*, the first case dealing directly with the standing of taxpayers in federal courts, the plaintiff asserted his standing as a taxpayer to challenge the constitutionality of the Maternity Act of 1921. Plaintiff alleged that in enacting the statute, Congress had attempted to exercise powers not granted to it by the Constitution. It was claimed that the statute resulted in the taking of property, in the guise of taxes, without due process of law. In holding that the plaintiff-taxpayer lacked standing, the Court relied on three arguments: (1) that the relationship between the federal taxpayer and the federal government is very different from the relationship between the taxpayer and his municipal or state government whose actions taxpayers may challenge; (2) that entertainment of the present suit would result in a multitude of actions by disgruntled taxpayers testing almost every legislative appropriation; and (3) that the inherent power of the Court to review and annul acts of Congress on the ground that they are unconstitutional is limited. By holding that the harm suffered by a taxpayer is not the type of direct injury required by the "case or controversy" doctrine, the Court effectively removed the spending power of Congress from the scope of judicial review.

The *Frothingham* case presented two distinct issues. The first was whether lack of standing represents a constitutional bar to judicial intervention, or whether the concept is merely a rule of judicial convenience. The second was whether standing is a separate question to be decided in isolation from an inquiry into the merits of the case, or whether it is inextricably

15. *Id.* at 486.
16. The Court considered the federal taxpayer's interest in Treasury funds as relatively insignificant and minute in comparison to his interest in state or municipal moneys. *Id.* at 486-88.
17. *Id.* at 487.
18. The Court stated that annulment is proper only when the party asserting the claim can show actual or imminent injury from application of the act and not merely that he suffers in common with his fellow taxpayers. *Id.* at 488-89.
19. See note 8 supra.
20. Addressing itself to this issue, the Court in *Frothingham* stated that for the Court to act in a situation where the party seeking relief did not have standing would result in a violation of the Constitution as being beyond the scope of judicial power and an invasion of
bound up with and not severable from the merits.\textsuperscript{21}

The general reasons for denying an individual standing when the action is based solely on his status as a federal taxpayer are no longer persuasive.\textsuperscript{22} Moreover, the particular reasons relied on by the Court in \textit{Frothingham} are unrealistic in the context of our present tax system.\textsuperscript{23} The position taken by the state courts with respect to taxpayer suits is almost uniformly opposed to the approach taken by \textit{Frothingham}.\textsuperscript{24} The Court had previously upheld the right of federal taxpayers to bring suit asserting only that status.\textsuperscript{25} This might suggest that nothing in the Constitution demands that litigants asserting only their status as taxpayers be denied standing. Furthermore, to the extent that a taxpayer is denied standing to challenge Government action which adversely affects him, fundamental principles of justice are violated.\textsuperscript{26}

The Court in the instant case held that subject to certain limitations, plaintiffs asserting nothing more than their status as taxpayers now have standing to challenge federal spending. It reasoned that nothing in article III absolutely bars such suits,\textsuperscript{27} and that the basic premise of \textit{Frothingham}—that a single federal taxpayer does not have a substantial interest in the expenditure of funds by the Government—should be rejected as unwarranted. The Court concluded that a taxpayer could be

the powers of other branches of Government. 262 U.S. 447, 488-89 (1923). There is, however, substantial authority supporting the position that the doctrine of standing is nothing more than a rule of judicial convenience. Davis, Standing to Challenge Governmental Action, 39 Minn. L. Rev. 353, 427 (1955); Lewis, Constitutional Rights and the Misuse of Standing, 14 Stan. L. Rev. 433, 453 (1962).

21. Some justices feel that the question of standing is to be treated as a threshold inquiry. \textit{E.g.}, Joint Anti-Fascist Refugee Comm. v. McGrath, 341 U.S. 123, 150 (1950) (concurring opinion). It is argued that before the Court can act in a substantive manner, there must be a case or controversy. The presence or absence of this element is an inquiry distinct from the substantive issues which the plaintiff is seeking to raise. \textit{Id.} The opposite view is that constitutional rights and the concept of standing are inseparable. \textit{Id.} at 198.

22. Davis, supra note 20.

23. \textit{Id.} at 386.

24. \textit{Id.}

25. \textit{Id.} at 386-87.

26. \textit{Id.} at 355. To a certain degree, the \textit{Flast} Court shares these views. It states that there is no absolute bar in Article III to suits by federal taxpayers challenging allegedly unconstitutional federal taxing and spending programs. \textit{Flast v. Cohen}, 392 U.S. 83, 101 (1968). Also, after noting that commentators have criticized \textit{Frothingham} as outdated, the Court states that the very existence of the controversy suggests that a new inquiry ought to be made. \textit{Id.} at 94.

27. \textit{Id.} at 101.
sufficiently affected by an unconstitutional expenditure of funds to require that he be given the right to enjoin the expenditure.\textsuperscript{28}

The Court then proceeded to develop a test for determining when a taxpayer's economic interest in the outcome of a case is sufficient for standing to be conferred.\textsuperscript{29} The Court stated that the necessary stake may be found when there is a logical link between the status which the plaintiff asserts, and the claim he seeks to adjudicate.\textsuperscript{30} In order to establish the link, two showings must be made: (1) that there is a connection between the asserted taxpaying status and the type of legislative action contested;\textsuperscript{31} and (2) that the challenged congressional action directly contravenes some specific constitutional limitation on the taxing and spending power.\textsuperscript{32} It was stated that when both nexuses are established, the party challenging the Government action will have shown the requisite personal stake in the outcome, and standing will be conferred.\textsuperscript{33} The Court then concluded that the appellants had satisfied the requirements of the test.\textsuperscript{34} It also noted that \textit{Frothingham} was consistent with the stated test. The plaintiffs in that case had not satisfied the second aspect of the test since they had not alleged that the legislative enactment exceeded specific constitutional limits.\textsuperscript{35}

In \textit{Flast} the Court acted to secure review of Government action which had previously been beyond the scope of judicial supervision. In doing so, however, the Court may have relied upon a false assumption regarding the nature of the taxpayer suit. The Court viewed such actions as mere attempts to vindicate individual pecuniary wrongs.\textsuperscript{36} But it seems clear that this is not the sole function of taxpayer suits. It would be more accurate to view the plaintiffs in such actions not merely as individuals seeking redress of private grievances but as "private attorneys-general."\textsuperscript{37}

\begin{itemize}
\item \textsuperscript{28} Id. at 104 n.25.
\item \textsuperscript{29} Id. at 101.
\item \textsuperscript{30} Id. at 102.
\item \textsuperscript{31} Id. This means that litigants asserting their status as federal taxpayers may not challenge the constitutionality of exercises of congressional power which are essentially regulatory in nature. \textit{Id}.
\item \textsuperscript{32} Id. at 102-03. A contention that Congress has exceeded its general powers under the taxing and spending clause is not sufficient to confer standing. \textit{Id}. at 103.
\item \textsuperscript{33} Id.
\item \textsuperscript{34} Id. at 104.
\item \textsuperscript{35} Id. at 104-05.
\item \textsuperscript{36} This follows from the Court's discussion "whether the party invoking federal court jurisdiction has 'a personal stake in the outcome of the controversy' . . . ." \textit{Id}. at 101.
\item \textsuperscript{37} \textit{Associated Indus. v. Ickes}, 134 F.2d 694, 704 (2d Cir. 1943).
\end{itemize}
sonal interest, but are shared equally with a vast number of fellow taxpaying citizens. In effect, these plaintiffs sue as taxpayers representing all taxpayers. Such actions to vindicate public rights have long been considered judicially cognizable as within the scope of the requirements of the "case or controversy" doctrine.

Since the Court did not view the instant action in the broad manner suggested above, it did not attempt to prescribe general rules for determining when actions to vindicate public rights should be entertained. Its narrower view led it to adopt a test which will confer standing only when the circumstances of the particular case show that the taxpayer has a personal stake in the outcome of the litigation. But the circumstances giving rise to the personal stake of the plaintiff will not always be the same as those evidencing the public interest which the plaintiff attempts to assert. Consequently, the restrictive test employed by the Court in Flast will result in the denial of judicial relief to a litigant who, as an individual litigant, lacks the requisite personal stake in the outcome of the litigation, but attempts to assert the collective rights of the public at large.

Even apart from its arguably unrealistic approach to taxpayer suits, the test formulated to determine when a federal taxpayer will be deemed to have the personal stake necessary to confer standing seems of dubious merit. The first aspect of the Court's test—the requirement of a link between the status asserted and the type of legislative action contested—seems reasonable in light of the general standing requirements. In addi-

38. There is no allegation that the contested expenditure will affect the plaintiff's own tax liability. Any relief is not in the form of reductions of personal tax liability but "... consists entirely of the vindication of rights held in common by all citizens." 392 U.S. at 118 (dissenting opinion).

"Whatever the tax impact, it does not distinguish the plaintiff from the whole body of taxpayers." Jaffe, Standing to Secure Judicial Review: Public Actions, 74 Harv. L. Rev. 1265, 1294 (1961).

39. "... [T]he impact of the allegedly illegal expenditure on the plaintiff's own tax liability [is] irrelevant. [The taxpayer sues] not because of a particular wrong done to him but quite literally qua taxpayer, a characteristic which he shares with an indeterminate number of his fellows. ... [T]he amount of the tax is irrelevant." Jaffe, supra note 38, at 1294.

40. See Scripps-Howard Radio v. FCC, 316 U.S. 4 (1942); FCC v. Sanders Bros. Radio Station, 309 U.S. 470, 477 (1940); Reade v. Ewing, 205 F.2d 630 (2d Cir. 1953); Associated Indus. v. Ickes, 134 F.2d 694 (2d Cir. 1943).

41. 392 U.S. at 101.

42. See notes 8-10 supra. Davis takes a similar position. He states,
tion, it does not seem to pose insurmountable barriers to taxpayer suits since it does not take any conceptual gymnastics to see that unconstitutional expenditures of tax funds are injurious to individual taxpayers. To this extent, the stake of the taxpayer and the link between his status and claim are coextensive. The second aspect of the Court's test—the requirement that the congressional action challenged be shown to contravene directly some specific constitutional limitation imposed on the taxing and spending powers—appears ill-founded. If the test as a whole is designed to confer standing whenever the claimant possesses the requisite personal stake and interest that imparts an adversary nature to the proceedings, this second requirement will defeat that purpose.

One reason why this aspect of the Court's test is unwarranted is that it seems to ignore that ours is a Government which reserves to states the powers not conferred upon the federal government. Implicit in this concept is the rule that action by the federal government which does not derive from an enumerated power is unconstitutional. Such actions are subject to judicial review when challenged by proper parties. Thus, exercises of Government power which are not sanctioned by the Constitution are just as unconstitutional as acts which directly contravene particular provisions of the Constitution. Yet, in taxpayer suits, standing will only be conferred when the plaintiff shows that the Government action exceeds some particular constitutional provision, and not when he shows that it is generally beyond the powers delegated to Congress. There is no reason-

... [T]he American way of using courts to enforce constitutional and statutory limitations... is as appropriate when the statute under which the officers act has been enacted pursuant to the congressional power to tax and spend as it is when the statute has been enacted pursuant to some other congressional power. Davis, Standing: Taxpayers and Others, 35 U. Chr. L. Rev. 601, 636 (1968) (emphasis in original).

43. U.S. Const. amend. X. Kansas v. Colorado, 206 U.S. 46, 81 (1907) states: "By reason of the fact that there is no general grant of legislative power it has become an accepted constitutional rule that this is a government of enumerated powers."

"The Government, then, of the United States can claim no powers which are not granted to it by the constitution, and the powers actually granted, must be such as are expressly given, or given by necessary implication." Martin v. Hunter's Lessee, 14 U.S. (1 Wheat.) 304, 326 (1816). See also United States v. Harris, 106 U.S. 629, 635 (1882).

44. See note 43 supra. "... [I]f no such power has been granted, none can be exercised." Kansas v. Colorado, 206 U.S. 46, 92 (1907).

45. Id.

46. 392 U.S. at 102-03. The taxpayer must show that the challenged enactment exceeds some specific constitutional limitation, "... not
able basis for this distinction. Its result is that a taxpayer may be turned away for lack of standing even though his claim reflects the requisite stake in the outcome.

Another reason why the second aspect of the Court's test is unwarranted is that it requires a more difficult showing by taxpayers seeking to challenge allegedly unconstitutional Government action than is required of individuals asserting a different status. The latter need not refer to a specific constitutional limitation; it is sufficient to allege merely that the action exceeds the powers granted by the Constitution.

It seems likely that the restrictive nature of the Flast test will deter taxpayers from seeking judicial relief. In a system which guarantees "equal protection under the law," the taxpayer must seek relief against alleged unconstitutional Government action handicapped by conditions not imposed on litigants asserting a different status. The problems raised by the Court's decision are easy to solve. One solution, suggested by Justice Douglas, would be simply to overrule Frothingham and allow taxpayer suits on the same basis as they are allowed at the state and local level. If the Court fears that this approach would open the floodgates and turn the courts into forums in which taxpayers could "air their generalized grievances" about the conduct of the Government, it could merely eliminate the second aspect of its test for standing.

It is no answer to this call for liberalization of the Court's standing requirements to say that it would force the Court into facing difficult issues with respect to what actions are beyond the powers delegated to Congress under the taxing and spending clause. Since the Court attempts to solve spending problems in other contexts there is no reason why it should refuse to solve them when they are raised by taxpayers. Thus, it is clear simply that the enactment is generally beyond the powers delegated to Congress. . ." Id. at 102-03.

47. A litigant not asserting the status of taxpayer may secure standing by the mere allegation that an act of Congress generally exceeds the powers delegated to it. See cases cited note 40 supra.


50. At least 34 states permit taxpayer challenges to state legislation and almost all jurisdictions allow taxpayers to challenge local actions. Note, Taxpayers' Suits: A Survey and Summary, 69 YALE L.J. 895 nn.6, 7 (1960).
that 45 years after *Frothingham*, *Flast* is not the place to stop. Hopefully, it is but a short pause in a continuum which will ultimately put the taxpayer on an equal footing with other litigants.

**Torts: Accountant Liable to Third Party for Negligent Misrepresentation**

Before making a loan to a Rhode Island corporation, plaintiff, a banking corporation and factor, requested the corporate borrower to furnish certified financial statements. Defendant, a certified public accountant, prepared statements which represented the corporation as solvent. Plaintiff, relying on the statements, lent the corporation considerable funds, most of which proved unrecoverable due to the corporation's subsequent failure. Challenging plaintiff's claim of fraudulent or negligent misrepresentation in the financial statements, defendant moved to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6) on the grounds that (1) the action was barred by the Rhode Island statute of limitations,¹ and (2) lack of privity between the parties. After dismissing the statute of limitations claim,² the Rhode Island Federal District Court held, *inter alia*, that an accountant is liable for loss occasioned by negligent financial misrepresentation, relied upon by actually foreseen and limited classes of persons, regardless of the absence of privity between the litigants. *Rusch Factors Incorporated v. Levin*, 284 F. Supp. 85 (D.R.I. 1968).

Privity as a condition to recovery in tort has troubled the courts ever since the famous *Winterbottom v. Wright*³ de-

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¹. R.I. Gen. Laws Ann. § 9-1-14 (1956) applies a one-year limitation to actions for words spoken and a two-year limitation for injury to the person.

². The court felt that the pecuniary loss caused by fraudulent or negligent misrepresentation was neither personal injury nor injury by spoken word within the meaning of R.I. Gen. Laws Ann. § 9-1-14 (1956). Thus, the six-year catch-all limitation of § 9-1-13 was held to apply. Because of the relative unimportance of this issue compared to the substantive question raised by the second defense it will not hereafter be discussed. Similarly, the court's discussion of choice of law between New York and Rhode Island, 284 F. Supp. at 88-90, will not be discussed.

³. 152 Eng. Rep. 402 (Ex. 1842). In *Winterbottom* the defendant contracted to supply properly maintained coaches to the Postmaster-General. Plaintiff's employer was also under contract with the Postmaster-General to supply drivers for the coaches, and while in such service plaintiff was injured by a defective coach. A unanimous court held for the defendant. Lord Abinger emphasized that the ability to
cision recognized the restriction. Spurred by Justice Cardozo's opinion in *MacPherson v. Buick Motor Company*, the trend over the last 30 years has been to relax the requirement of privity in tort cases, at least where physical injuries are involved. Such relaxation, however, has not extended to cases where third party plaintiffs have suffered pecuniary losses. The reason for the difference in treatment between the two types of cases is not obscure. While the monetary liability for physical injury can be large, the number of potential parties that can be physically injured is generally quite limited. Furthermore, the personal injuries which result are usually readily foreseeable. Third party financial losses, on the other hand, generally result from reliance on fraudulent or negligent spoken or written representations. Thus, liability could potentially extend to all who heard or read the representations. For instance, a negligently prepared financial statement relayed to prospective investors could conceivably injure thousands. Primarily because of this potential imposition of large and unpredictable liability, the courts have been quite reluctant to fully relax the privity requirement in this area.

sue on such contracts must be confined to the parties who entered into them for “[t]here is no privity of contract between these parties; and if the plaintiff can sue, every passenger, or even any person passing along the road, who was injured by the upsetting of the coach, might bring a similar action.” *Id.* at 405.


5. See also Henningsen v. Bloomfield Motors, 32 N.J. 358, 161 A.2d 69 (1960); Prosser, *The Assault upon the Citadel (Strict Liability to the Consumer)*, 69 YALE L.J. 1099 (1960); Prosser, *The Fall of the Citadel (Strict Liability to the Consumer)*, 50 MINN. L. REV. 791 (1966).


7. Fraudulent misrepresentations generally result in broader liability than negligent misrepresentations. The leading English case of Derry v. Peek, [1889] 14 A.C. 337, established the action of deceit based upon knowingly false statements or statements made with a reckless disregard for their truth or falsity. As illustrated by *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931), discussed infra in text accompanying notes 12-15, an action for fraudulent misrepresentation will often be upheld where a negligent misrepresentation claim would be rejected.


9. The limitations and reasons advanced have often been criticized. See, e.g., Goodhart, *Liability for Innocent but Negligent Misrepresentation*, 74 YALE L.J. 288, 296 (1964); Meek, *Liability of the Accountant to Parties Other Than His Employer for Negligent Misrepre-
Two other Cardozo opinions are the principal authorities for imposing liability for negligent misrepresentations to parties not in privity. In *Glanzer v. Shepard*, a public weigher under contract with a seller of beans negligently weighed and certified bags of beans. The actual weight was considerably less than certified and the purchaser of the beans sued the weigher for the over-payment. In holding the defendant liable for his negligence, Cardozo reasoned that the defendant owed a duty of care to the purchaser since the defendant knew that reliance on its certification by the purchaser was the "end and aim of the transaction." As a result of the nature of the transaction and plaintiff's reliance on defendant's assertion of skill and care, Cardozo viewed the parties' relationship as nearly contractual.

Nine years later in the famous *Ultramares Corporation v. Touche* decision, Cardozo attempted to clarify his extension of liability to third parties. Defendant, a firm of public accountants, was employed by a company to prepare and certify a balance sheet to be used by the company to obtain extensive credit. Knowing they would be exhibited to numerous financial institutions, defendant supplied 32 copies of a certified balance sheet. Plaintiff relied on the balance sheet and lent funds to the company, which was declared bankrupt shortly thereafter. After reviewing the evidence and finding it sufficient to support the conclusion that the accountants had been negligent, Cardozo refused to hold that plaintiff was owed a duty of care. He stated that the balance sheets, unlike the weight certificate in *Glanzer*, were not designated for any particular party known to the defendant, but for a potentially larger unascertained class.

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There would seem to be no logical distinction between physical injury and damage to purely economic interests. Nor is there any sound reason for denying liability for the use of negligent words. . . . It has been said that the reckless writer should be held to as high a standard as the reckless driver, "for his pen may impoverish thousands, while his car can hurt but a few."

11. Id. at 239, 135 N.E. at 275-76.
13. Id. at 182-83, 174 N.E. at 445-46:

[In *Glanzer*] the bond was so close as to approach that of privity, if not completely one with it. Not so in the case at hand. No one would be likely to urge that there was a contractual relation, or even one approaching it, at the root of any duty that was owing from the defendants now before us to the indeterminate class of persons who, presently or in the future, might deal with the . . . company in reliance on the audit.
The purpose of, and anticipated reliance on, the weight certificate was known to the defendant in Glanzer. Furthermore, in Ultramares the defendant was only aware of the general purpose of the balance sheets whereas in Glanzer it knew the particular parties and their degree of reliance on the information supplied. Thus, Cardozo translated into a rule of law his concern with subjecting accountants to broad liability for their negligent misrepresentations.

Since Glanzer and Ultramares many courts have failed to develop the scope of duty theory formulated by Cardozo and have often clouded the relatively clear limitation he established. Much of the difficulty is the result of misinterpretations of Cardozo's alternative holding in Ultramares that "negligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud." On the facts presented in Ultramares, Cardozo felt that on remand a jury might find such an inference of fraud. Several decisions followed this fraud alternative after misinterpreting Ultramares as a rejection of liability for straight negligence without privy. One such decision was State Street Trust Company v. (14) Many writers have criticized the distinction as artificial, suggesting that the defendants in Ultramares were as aware as the defendant in Glanzer that their information would be relied upon by third parties, as well as by the contractual client. See, e.g., Levitin, supra note 8, at 445; Meek, supra note 9, at 382; Comment, 9 B.C. Ind. & Com. L. Rev. 137, 144-45 (1967).

15. One of Cardozo's most frequently quoted phrases expresses his fears of imposing extensive liability on accountants:

If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.

255 N.Y. at 179, 174 N.E. at 444.

16. Id. at 190-91, 174 N.E. at 449.

17. Hawkins, Professional Negligence Liability of Public Accountants, 12 Vand. L. Rev. 797, 818-19 (1959), criticizes Cardozo's shift to fraud theory as, neither desirable nor ... necessary ... because scope of duty in the negligence formula could have been adapted to the more restricted limits, while lack of reasonable care, or negligence, was still retained as the standard for determining breach of duty.

18. O'Connor v. Ludlam, 92 F.2d 50 (2d Cir.), cert. denied, 302 U.S. 758 (1937); State St. Trust Co. v. Ernst, 278 N.Y. 104, 15 N.E.2d 416 (1938); Duro Sportswear, Inc. v. Cogen, 131 N.Y.S.2d 20 (Sup. Ct. 1954); Candler v. Crane, Christmas & Co., [1951] 2 K.B. 164 (C.A.). Duro has been criticized for its failure to follow Glanzer despite analogous facts. The defendant auditor knew the purpose of his audit and that it would be exhibited to one of two shareholders of a corporation.
Ernst,\textsuperscript{10} in which the defendant accountants prepared 10 counterparts of an audit for use by their employer to obtain credit. The defendants knew what the balance sheets would be used for and also that the plaintiff was one of the lenders expected to rely on them. In rejecting the claim of liability based on ordinary negligence, the same court that decided Ultramares seven years earlier completely disregarded the Glanzer-Ultramares distinction as to the class of reliant parties and found that no duty was owed this particular plaintiff because of lack of privity.\textsuperscript{20}

In suits by third parties claiming reliance on negligent oral or written misrepresentations by professionals other than accountants, the Glanzer-Ultramares distinction has often been followed. Thus, where the reliant class is large, unknown, or unpredictable, many courts deny liability.\textsuperscript{21} On the other hand, where the plaintiff is known and his reliance foreseen, courts often follow Glanzer and permit recovery.\textsuperscript{22}

The decision in Rusch Factors is noteworthy as the first American or English decision which has held an accountant lia-

\begin{quote}


20. Id. at 111, 15 N.E.2d at 418:

We have held [in Ultramares Corp. v. Touche] that in the absence of contractual relationship or its equivalent, accountants cannot be held liable for ordinary negligence in preparing a certified balance sheet even though they are aware that the balance sheet will be used to obtain credit. See Investment Corp. v. Buchman, 208 So. 2d 291 (Fla. D.C. App. 1968) (a decision rejected in Rusch Factors, although clearly of the Glanzer type).


\end{quote}
ble for negligent misrepresentation to a reliant party not in privity. The decision is meritorious for its proper reading of the precedents, but, unfortunately, the precise rationale of the court is unclear. In reading its decision the court first discredited Cardozo's fear of unlimited liability and concomitant privity requirement as an "unwarranted inroad upon the principle that '[t]he risk reasonably to be perceived defines the duty to be obeyed.'" It was felt that accountants, rather than innocent reliant parties, should bear the burden of professional malpractice since, among other reasons, they can spread the risk through insurance.

Although discrediting the Ultramares rationale, the court found it unnecessary to overrule the decision. The facts in Rusch Factors were recognized as "qualitatively distinguishable" from Ultramares. In the latter the "plaintiff was a member of an undefined, unlimited class of remote lenders and potential equity holders not actually foreseen but only foreseeable." In the instant case plaintiff's complaint was acknowledged by the court as stating that "the defendant knew that his certification was to be used for, and had as its very aim and purpose, the reliance of potential financiers of the Rhode Island corporation." The court therefore turned to Glanzer for support and viewed the plaintiff as a "single party whose reliance was actually foreseen by the defendant." In espousing Cardozo's original distinction, the court attempted to establish a rule of law to define the class of third parties to whom accountants owe a duty of care. The test adopted was whether the third party plaintiff was actually foreseen and a member of a limited class of persons.

In defining the scope of liability of accountants the Rusch Factors court recognized that policy considerations other than compensation of the injured party by the wrongdoer are relevant. It noted, for example, that the ability of accountants to bear the risk of loss through the use of liability insurance mitigated in favor of rejecting the Ultramares rationale and imposing liability. This conclusion seems overly facile since in-

24. Id. at 91.
25. Id. at 92-93.
26. Id. at 91.

Why should an innocent reliant party be forced to carry the weighty burden of an accountant's professional malpractice? Isn't the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession, which can pass the
urance for accountants is apparently not readily available. Ins-
urance companies have become greatly alarmed over the rash of lawsuits against accountants\(^27\) and consequently their rates for liability coverage of accounting firms have increased almost to the point of being prohibitive.\(^28\) At increased rates the many small accounting firms and individual accountants certainly could not obtain adequate coverage. Moreover, those firms which can afford it will probably spend more money on insurance than is necessary since the amount of their potential lia-
bility is highly uncertain. The apparent result will be large increases in charges to the public for auditing services causing them to become unavailable to smaller businesses.

The Rusch Factors court also cites the progress of the ac-
counting profession in terms of both skill and importance to the community as a justification for extending the scope of liability.\(^29\) The responsibilities of the profession have greatly increased, as third party investors, creditors and the like have come to place more and more reliance on auditors' reports. Leaders and writers in the profession are aware of the increased responsibilities and have made proposals to update professional practices through the promulgation of uniform accounting principles.\(^30\) Despite these developments, the problem remains that many unsophisticated third party users of accounting reports ascribe

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27. The New York Times, March 27, 1966, § 3, at 1, col. 3, reported that approximately 80 lawsuits by investors and creditors had been filed against public accountants, and the Wall Street Journal, Nov. 15, 1966, at 13, col. 2, reported 100 such pending actions.

28. The typical large accounting firm was thought to carry about $15,000,000 in insurance in 1960. Wise, The Auditor Has Arrived, Pt. I, FORTUNE MAGAZINE, Nov., 1960, at 151. However, the Wall Street Journal, Nov. 15, 1966, at 1, col. 6, reports that many insurance companies have boosted their rates by 30% or more and others have nearly stopped writing these policies. Of 15 insurers who wrote coverage relatively freely in 1965, a year later only six handled it as "accommodation" for big accounts or in a limited manner. Id. at 13, col. 4.

29. See Texas Tunneling Co. v. City of Chattanooga, 204 F. Supp. 821, 833 (E.D. Tenn. 1962), rev'd, 329 F.2d 402 (6th Cir. 1964); Wyat, Auditor's Responsibilities, 12 St. Louis U.L. Rev. 331, 339-40 (1967); Bradley, supra note 18 at 195:

The courts have been markedly solicitous for the accountant's economic circumstances. . . . But in the light of the economic maturity of the independent accounting profession, further de-
pendence on judicial tenderness seems ill-founded.

30. New York Times, Nov. 20, 1966, § 3, at 1, col. 1; see Bradley, Auditor's Liability and the Need for Increased Accounting Uniformity, 30 LAW & CONTEMP. PROB. 898, 917-18 (1965). See generally Sym-
posium, 30 LAW & CONTEMP. PROB. 621 (1965).
a much higher degree of accuracy and reliability to the statements than is either justified or intended by accountants. Consequently, undue reliance may be placed on financial data, and when loss does occur it is too often inappropriately attributed to the inaccuracy of the reports.

Thus it is of great importance to the future of the accounting profession clearly to define and analyze the scope of liability under the Rusch Factors test. The opinion is unclear both as to the number of financiers who were to examine the financial statements, and defendant's actual knowledge of the potential reliance of these financiers. Questions thus arise as to what the court meant by someone "foreseen" as distinguished from someone "foreseeable," and how many constitute a "limited class."

Section 552 of the Restatement of Torts and its comments, which were relied on by the court in Rusch Factors, provide some guidance. Under the Restatement a negligent mis-

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31. Wyat, supra note 29, at 338, 344–45. Speaking for his profession Saul Levy said: "We do not insure, guarantee or warrant the accuracy of management's representations." The professional opinion of the CPA is only an:
1. Expert opinion.
2. Independent opinion.
3. Informed opinion.
4. Technical opinion.
5. Candid opinion.

32. According to WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 890 (1965), and 17 WORDS AND PHRASES 447–48 (1958), foreseeability is the ability to "reasonably anticipate" while foreseen refers to anticipation more "certain," "probable," "unavoidable," or "likely to happen."

33. (1) One who, in the course of his business, profession or employment, or in a transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) . . . the liability stated in subsection (1) is limited to loss suffered
(a) By the person or one of the persons for whose benefit and guidance he intends to supply the information, or knows that the recipient intends to supply it; and
(b) Through reliance upon it in a transaction which he intends the information to influence, or knows that the recipient so intends, or in a substantially similar transaction.


34. The court's use of the Restatement indicates its belief that the Restatement was based on Glanzer. 284 F. Supp. at 91. As will become apparent from the discussion that follows, the Restatement and its
representer would be liable to those for whose benefit and
guidance he intended the information or to those to whom he
knew it would be supplied. The defendant need not know the
plaintiff's name and identity; it is enough that he knows that
the information is intended to be relayed to a specified group
or class. According to the Restatement's series of illustrations, an accountant would be liable to an identified class
of banks under section 552, no matter how many potential lend-
ers this might include, if his employer mentioned that he was
seeking to negotiate a loan. On the other hand, liability would
not be imposed on an accountant who was not informed of the
specific use to which his financial reports would be put.

If the Rusch Factors court intended to adopt the Restate-
ment position, the "limited class" of potential plaintiffs "actually
foreseen" describes a broad test with potentially extensive lia-
ibility. Thus, on the facts of Rusch Factors, the class might in-
clude all actual financiers of the company since the defendant
knew his statements would be used to obtain financing. Fol-
lowing this rationale, if the company had received financing
from 50 different banks and factors, all of whom saw defendant's
accounting statements, all could hold defendant liable for their
losses. Similarly, the accountants in Ultramares would have
been liable since they knew the balance sheet they supplied
would be used to obtain credit.

A second possible interpretation of the court's test is that

comments prescribe an extension of liability much broader than Cardozo
intended in Glanzer.

35. Restatement, supra note 33, at 16.
36. Id., comment h, at 23:
In other words, it is not required that the person who is to
become the plaintiff be identified or known to the defendant as
an individual when the information is supplied. It is enough
that the maker of the representation intends it to reach and in-
fluence either a particular person or persons, known to him, or
a group or class of persons, distinct from the much larger class
who might reasonably be expected sooner or later to have
access to the information, and foreseeably to take some action in
reliance upon it. It is enough, likewise, that the maker of the
representation knows that the recipient intends to transmit the
information to a similar person, persons, or group. It is suffi-
cient, in other words, that the maker knows that the informa-
tion is intended for repetition to a certain group or class of per-
sons, and that the plaintiff proves to be one of them, even
though the maker never had heard of him when the informa-
tion was given.
37. Id. at 24-25. Judge Pettine uses one of the hypotheticals as
support for his decision. 284 F. Supp. at 92.
38. Ultramares Corp. v. Touche, 255 N.Y. 170, 173-74, 174 N.E. 441,
442 (1931).
"actually foreseen persons" refers only to those individual parties specifically known by name to the defendant, and "limited class" is restricted to those parties so known. It is very possible that the plaintiff was the only potential financier of the Rhode Island corporation and that the defendants knew it. If such were the case, the decision goes no farther than Glanzer, and, as precedent, might be limited to cases where the defendant knows the individual reliant parties as well as the "end and aim of the transaction."

Although language in the opinion would support either of the above interpretations, the court's rejection of the Ultra-mares rationale and reliance on the Restatement probably indicates an intent to extend the liability of accountants to third parties for negligent misrepresentations. The precise limit lies somewhere between a class composed of parties actually known by the accountant and one composed of all foreseeable parties.

Where the actual line should be drawn is also a troublesome question. It is virtually indisputable that accountants should at least be liable to those whom they actually know will rely on their reports. As expressed in Glanzer, such knowledge creates a relationship which is nearly contractual despite the absence of privity. Even with this limited extension of liability the burdens on accountants may still be large, but the profession should assume at least this much responsibility for its reports.

The Restatement position and almost any other intermediate extension of liability short of the extremity of foreseeability will subject the accounting profession to potentially large liabilities from possibly numerous plaintiffs. Attorney fees alone could

39. One indication that the court was thinking in terms of extensive liability is its concluding statement that it would leave open for future consideration the question of whether liability "ought to extend to the full limits of foreseeability." 284 F. Supp. at 93.

Certain authorities have advocated extending liability to the limits of foreseeability. Texas Tunneling Co. v. City of Chattanooga, 204 F. Supp. 821, 834 (E.D. Tenn. 1962), rev'd, 329 F.2d 402 (6th Cir. 1964); Levitin, supra note 8, at 449; Comment, supra note 14, at 149.

40. See note 11 supra, and accompanying text.

41. The plaintiff in Rusch Factors was claiming an injury in excess of $121,000.00.

42. It has been suggested that broad liability may be justified by the facts of certain cases. Meek, supra note 9, at 389:

Moreover, the liability though indeterminate is not totally unlimited. Recoveries in large amounts would ordinarily ensue only where there are large discrepancies in the balance sheet; large inaccuracies would usually indicate a high degree of negligence so that liability would not seem particularly unjust.
be enormous in defending such claims. Moreover, there is no reason to believe that numerous suits will not be brought since the recent decisions expanding the liability of accountants in other areas have been much publicized.

It seems likely that accountants will seek to protect themselves by the use of disclaimers and qualified certificates. They are convenient, legally acceptable means of protection. Disclaimers have, however, been criticized on the ground that they deny the recipient of the report the very security he seeks, they hamper the effectiveness of auditors, they cast adverse reflections on the credit standing of the client, and they are generally bad for the financial community. If the Rusch Factors decision lays the foundation for potentially large negligence recoveries against accountants, the profession may well overlook these criticisms in an effort to protect itself.

Perhaps the most practical approach for the accounting profession is to continue fighting these extended liability cases until it can obtain a relatively clear definition of the duty owed to third parties. Courts should move very cautiously in extending liability for professional negligence, allowing the members of the profession to adjust to any new responsibilities imposed, and clearly defining the limits or extensions of liabilities applied.

46. Id.