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Taxation--Federal Tax Liens--Surety's Right Held Inferior to Federal Tax Liens (United States v. R.F. Ball Constr. Co., 355 U.S. 587 (1958))

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While the principal cases firmly fix the public policy limitation in the tax law, they do little to clarify its application. This is especially true with regard to the operating expenses of an illegal business: just how far the *Sullivan* rule will be applied to other illegal businesses is unclear.

TAXATION — FEDERAL TAX LIENS — SURETY'S RIGHT HELD INFERIOR TO FEDERAL TAX LIENS.—In return for a surety's execution of a performance bond that guaranteed completion of subcontracting work on a Texas housing project, the subcontractor assigned to the surety all sums due or to become due from the general contractor under the subcontract. These sums were to serve as collateral security not only for losses incurred on the housing project but for any other indebtedness or liability the subcontractor might incur to the surety "whether heretofore or hereafter incurred." Subsequent to this assignment, the surety executed for the subcontractor a second bond covering another job in Kentucky. Then, in sequence, the Texas work was completed and the subcontractor became entitled to the sums held by the general contractor, no payment being actually made; the federal government filed tax liens against the subcontractor; and finally, the surety was forced to perform under the Kentucky bond because of the subcontractor's default. In an interpleader action to determine whether the federal government or the surety had the right to the retained percentages still due on the Texas project, the lower courts [1] held that the surety was a mortgagee under the provisions of section 3672(a) of the Internal Revenue Code of 1954, and therefore its rights took precedence over the government's tax lien. The Supreme Court, per curiam with four justices dissenting, reversed, *holding* that the tax lien took precedence because the instrument creating the surety's right was "inchoate and unperfected." *United States v. R. F. Ball Constr. Co.*, 355 U.S. 587 (1958).

A federal tax lien arises when any person liable to pay any federal tax neglects or refuses to pay the tax after a demand, and it attaches to all property and rights to property owned by the delinquent taxpayer.[2] In most cases the lien is a secret charge against the property, known only to the taxpayer and the Internal Revenue Service, for it arises at the time the tax assessment is made [3] by the District Director of Internal Revenue,[4] whose records are not open

[1] United States v. R. F. Ball Constr. Co., 140 F. Supp. 60 (W.D. Tex.), *aff'd per curiam,* 239 F.2d 384 (5th Cir. 1956).
[2] INT. REV. CODE OF 1954, § 6321.
[3] INT. REV. CODE OF 1954, § 6322.
[4] INT. REV. CODE OF 1954, § 6203; Treas. Reg. 301.6201-1 (1954).

to public scrutiny.[5] But special protection is afforded "any mortgagee, pledgee, purchaser, or judgment creditor," for as to them the lien is not valid until it has been filed by the Secretary or his delegate.[6]

When the taxpayer is insolvent, satisfaction of the tax lien takes priority over any other debts he may owe.[7] But in other cases the principle that "the first in time is the first in right" controls, since the federal statute imposing tax liens does not define the priority of competing liens.[8]

However, the Supreme Court has ruled that for any lien to compete successfully with a federal tax lien it must be choate and perfected when the tax lien attaches. In *United States v. City of New Britain*,[9] the Court said that a lien may be considered choate "... when the identity of the lienor, the property subject to the lien, and the amount of the lien are established." [10] If all three tests have not been met at the time the tax lien attaches, the tax lien will prevail.[11] In *United States v. Security Trust & Sav. Bank*,[12] a case dealing with an attachment lien, it was held that the lien is unperfected until judgment is awarded and recorded in the suit that caused the attachment. In determining the question of when a lien is choate, the Court has been extremely strict in examining liens competing with tax liens. In brief opinions [13] that do not reveal the reasons for the conclusions drawn, the Court has regularly subordinated statutory liens to the federal tax lien. Moreover, a decision by a state court that a competing lien is "choate" is not binding on the federal courts.[14]

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[5] INT. REV. CODE OF 1954, §§ 6103, 7213.

[6] INT. REV. CODE OF 1954, § 6323(a). The Code provides that the tax lien may be filed in the following places: in the place designated by the law of the state where the property subject to the lien is situated; if there is no such place designated by state law, in the office of the clerk of the district court in the district where the property is situated; if the property is in the District of Columbia, the lien is filed in the district court there. *Ibid.* In New York City, liens on realty are filed with the county clerks or with the city register, exclusive of Richmond County. Liens on personalty are filed in the city register's office in four counties of New York City, the office of the clerk of the County of Richmond, or in town and city clerks' offices elsewhere. N.Y. LIEN LAW § 240 (Supp. 1958). The form of the notice of the tax lien is regulated by federal law and not by state law. INT. REV. CODE OF 1954, § 6323(b).

[7] REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1952).

[8] United States v. City of New Britain, 347 U.S. 81 (1954).

[9] *Ibid.*

[10] *Id.* at 84. This is also the standard used in determining relative priority of liens under 31 U.S.C. § 191, dealing with the distribution of an insolvent's assets. See Illinois v. Campbell, 329 U.S. 362 (1946).

[11] 347 U.S. at 86.

[12] 340 U.S. 47 (1950).

[13] United States v. Vorreiter, 355 U.S. 15, *reversing per curiam* 134 Colo. 543, 307 P.2d 475 (1957); United States v. White Bear Brewing Co., 350 U.S. 1010 (1956), *reversing per curiam* 227 F.2d 359 (7th Cir. 1955); United States v. Colotta, 350 U.S. 808, *reversing per curiam* 244 Miss. 33, 79 So. 2d 474 (1955); United States v. Scovil, 348 U.S. 218 (1955).

[14] United States v. Acri, 348 U.S. 211 (1955).

In the *Ball* case, the assignment contract was valid by state law when made, even though the fund that was to provide the surety's collateral was not yet in existence.[15] Section 6323, allowing special protection to mortgagees against tax liens, does not define "mortgagee," but the lower federal courts and the dissenting opinion held that the assignment was a mortgage within the meaning of the section because it was an assignment of personal property as security for the performance of an obligation. Since the sums assigned were not in existence at the time of the assignment, the mortgage would technically be a mortgage of after-acquired property [16] and the mortgagee's lien by the general rule would arise when the property came into existence.[17] The majority of the Supreme Court referred to the assignment only as an "instrument" but did not seem to quarrel with its characterization as a mortgage. Instead, they took the position that the lien of the surety was "inchoate and unperfected," even though the federal lien did not attach to the property until after the sums came into existence and the mortgagee's lien attached.

Applying the *New Britain* tests to the instant case, it would seem that the amount of the surety's lien was not fixed when the tax lien was filed. It was only subsequent to the filing of the tax lien that the surety's obligation on its bond became an actual liability. To this extent the decision represents but another precedent indicating that the courts will find any lien not precisely fixed in amount with a certitude equivalent to that of a final judgment inferior to a federal tax lien.[18]

The major importance of the case, however, lies in the fact that the Supreme Court has for the first time subordinated an antecedent contractual lien—as opposed to a statutory lien—to a federal tax lien.[19] On this ground the decision has been criticized as judicial legislation extending the "inchoate" doctrine to an area where Congress has by section 6123 protected certain interests without including mention of a "choate-inchoate" test.[20]

The effect of the decision is to make it impossible for a surety, accepting as collateral security for a contingent obligation money due or to become due under an existing contract, to protect that security against a subsequently arising tax lien. Since this form of credit arrangement enjoys wide commercial use, the implications of the

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[15] See Southern Sur. Co. v. Bering Mfg. Co., 295 S.W. 337, 341 (Tex. Civ. App. 1927); Williams v. Silliman, 74 Tex. 626, 12 S.W. 534 (1889).

[16] See OSBORNE, MORTGAGES §§ 37-40 (1951).

[17] *Id.* § 40.

[18] See United States v. White Bear Brewing Co., 350 U.S. 1010 (1956), *reversing per curiam* 227 F.2d 359 (7th Cir. 1955) (mechanic's lien); United States v. Security Trust & Sav. Bank, 340 U.S. 47 (1950) (attachment lien); United States v. Texas, 314 U.S. 480 (1941) (insolvency).

[19] See Cross, *Federal Tax Claims: Nature and Effect of the Government's Weapons for Collection,* 27 FORDHAM L. REV. 1, 27 (1958); Plumb, *Federal Tax Collection and Lien Problems,* 13 TAX L. REV. 459, 475 (1958).

[20] Cross, *supra* note 19, at 29.

case are far-reaching. There is some hope that two subsequent cases may point the way to minimizing its effects. In *United States v. Bess*,[21] the Supreme Court has adopted the position of some lower courts[22] that the federal tax lien can attach only to the property and rights to property of a delinquent taxpayer as those rights are defined by state law. And in *Aetna Cas. & Sur. Co. v. United States*,[23] the New York Court of Appeals considered a situation analogous to that of the *Ball* case. A corporation agreed to do landscaping work for the New York City Housing Authority, the contract providing that its right to final payment was conditioned on faithful completion and payment of all claims for labor and materials. An additional clause provided that the Authority might condition final payment on the contractor's furnishing the written consent of his surety to such payment. The contractor defaulted, and between the time of the execution of the surety bond and the surety's performance of its obligation, the federal government asserted tax liens against the contractor. The Court of Appeals held that because the contractor had not performed, the contract by its terms deprived him of any right to final payment from the Housing Authority. As a consequence, the tax lien could not attach to those funds.

While the facts of the *Aetna* decision are not identical to those of the *Ball* case, it would seem that, at least in New York, the effect of the latter case can be vitiated if a surety refuses to issue a performance bond unless the construction contract contains a clause requiring the surety's consent as a condition precedent to the contractor's release of any retained sums to the subcontractor. If by state law a subcontractor has no right to the sums due under a contract unless he has met all conditions precedent as required by the contract, then a contract conditioned upon the surety's consent to the release of the sums to the subcontractor would effectively protect the surety's rights. Until the surety's consent to payment is obtained, the subcontractor would have no rights to the retained sums to which a federal tax lien could attach. The question of whether a surety's rights to the fund were "choate" or "inchoate" need never be raised in any case involving a tax lien.

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[21] 357 U.S. 51 (1958).

[22] See, *e.g.*, Fidelity & Deposit Co. v. New York City Housing Auth., 241 F.2d 142, 144 (2d Cir. 1956).

[23] 4 N.Y.2d 639, 152 N.E.2d 225, 176 N.Y.S.2d 961 (1958). It should be noted that in the *Aetna* case, the government argued that the question of what property belonged to the delinquent taxpayer was a matter of federal law in tax lien cases. *United States v. Bess* was decided on June 9, 1958, and the *Aetna* case was decided on June 30, 1958. The court ruled against the government's claim in the *Aetna* case on the strength of the decision of the United States Supreme Court in *United States v. Bess.*

TAXATION — PROOF OF LIKELY TAXABLE SOURCE OF INCOME HELD UNNECESSARY TO ESTABLISH TAX EVASION USING NET WORTH METHOD.—Defendant was convicted of attempting to evade the federal income tax. The conviction was based on the "net worth" method. The Court of Appeals for the First Circuit set aside the verdict and remanded the case for a new trial. The court held that proof of a likely taxable source is an indispensable element of the net worth method in any of its applications.

On certiorari, the Supreme Court of the United States affirmed the ruling of the circuit court in remanding the case for a new trial. The Court, however, *held* that proof of a likely taxable source is not necessary where all possible sources of non-taxable income are negated. *United States v. Massei,* 355 U.S. 595 (1958).

The net worth method of proof of income in criminal tax evasion prosecutions aims to demonstrate by such indirect evidence as bank deposits, expenditures and net worth increases that the taxpayer has not reported a substantial portion of his taxable income.[1] Using this method the government must establish, with reasonable certainty, the taxpayer's net worth for the beginning of the year in question.[2] This serves as a starting point to calculate future increases in the taxpayer's assets throughout that year. This amount is then subtracted from the taxpayer's net worth as calculated for the close of the year. The closing-year figure is increased by amounts spent for personal expenditures and is reduced by liabilities and non-taxable income.[3] If there is substantial increase in the taxpayer's net worth, his income tax return must necessarily reflect it.

When the net worth method was first upheld it was utilized to corroborate direct proof of specific unreported income.[4] In 1943, however, in *United States v. Johnson,*[5] the Court approved its use in supporting the inference that the taxpayer, owner of a vast and elaborately concealed network of gambling houses from which he had declared no income, had indeed received unreported income in a substantial amount.

Since the *Johnson* case, the United States Supreme Court has been asked to review an increasing number of criminal cases in which proof of tax evasion rested on this method.[6] In view of the dangers inherent in the method and the frequency of its use the court has

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1 United States v. Venuto, 182 F.2d 519 (3d Cir. 1950); United States v. Fenwick, 177 F.2d 488 (7th Cir. 1949); Stinnett v. United States, 173 F.2d 129 (4th Cir.), *cert. denied,* 337 U.S. 957 (1949).

2 Holland v. United States, 348 U.S. 121 (1954); United States v. O'Connor, 237 F.2d 466 (2d Cir. 1956); Sasser v. United States, 208 F.2d 535 (5th Cir. 1953); 10 MERTENS, LAW OF FEDERAL TAXATION § 55A.27a, at 123 (1958).

3 Sasser v. United States, *supra* note 2.

4 Guzik v. United States, 54 F.2d 618 (7th Cir. 1931); Capone v. United States, 51 F.2d 609 (7th Cir. 1931).

5 319 U.S. 503 (1943).

6 See Holland v. United States, 348 U.S. 121, 124 (1954).

expressed concern regarding its implications. It has been stated that a series of theoretical estimates and computations as to the defendant's net worth, which are allowed to take the place of direct proof,[7] endanger the principle that a defendant is presumed innocent until proven guilty.[8] Reiterating this position, the Supreme Court, in the leading case of *Holland v. United States*,[9] set up certain prerequisites which the government must establish it has fulfilled in order to prove a prima facie case. These prerequisites comprise, in addition to the establishment of a definite net worth for the beginning of the taxable year: [10] full government investigation of relevant leads furnished by the taxpayer; [11] wilfullness (which can be inferred from a consistent pattern of under-reporting large amounts of income); [12] and government negation of the possibility of the unreported income coming from a non-taxable source (proof of a likely taxable source is deemed sufficient).[13]

This last-stated prerequisite was the point at issue in the present case. The circuit court, in reversing the conviction, held that proof of a likely taxable source was indispensable in all such cases based on the net worth method. In other circuits the view was different. The Third Circuit, for example, has held that a taxpayer's wilful misrepresentations as to the source from which he received his income was sufficient, in addition to evidence of unexplained increase in his net worth, to sustain a conviction.[14] In the Second Circuit, the court has held that the government must reasonably negate all possible non-taxable sources and show that the unreported income came from "some source." [15]

The Supreme Court, in disagreeing with the First Circuit, decided that proof of a likely taxable source is not necessary where all possible sources of non-taxable income are negated. The Court stated that the lower court misconstrued the holding of the *Holland* case, which deemed proof of a likely taxable source sufficient—not "indispensable"—in establishing that the unreported income came from a taxable source. This decision greatly clarifies the proof necessary to sustain a tax evasion conviction based on the net worth method. It is only in those cases where the government has not negated the possibility that the unreported income came from non-taxable sources that proof of a likely taxable source becomes a factor in the government's case.

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[7] 10 MERTENS, LAW OF FEDERAL TAXATION § 55A.27a, at 119-20 (1958).

[8] Demetree v. United States, 207 F.2d 892 (5th Cir. 1953); see, *e.g.*, United States v. Altruda, 224 F.2d 935 (2d Cir. 1955).

[9] 348 U.S. 121 (1954).

[10] *Id.* at 132.

[11] *Id.* at 135.

[12] *Id.* at 139.

[13] *Id.* at 137.

[14] United States v. Adonis, 221 F.2d 717 (3d Cir. 1955).

[15] United States v. Ford, 237 F.2d 57 (2d Cir. 1956), *vacated as moot*, 355 U.S. 38 (1957) (per curiam).

The holding in this case appears to be sound. Since the defendants in this type of prosecution are on trial for tax evasion it would be an undue burden to compel the government to prove not only the crime charged, but also the likely taxable source from which the unreported income came. Once a discrepancy is shown to exist between the taxpayer's increase in net worth and his reported income and the government has negated all possible non-taxable sources, it is not unjust that he be compelled to explain this discrepancy or remain quiet at his peril. However, in clarifying the issue the Court leaves unanswered the question of the limits to which the government must go in negating possible sources of non-taxable income.

TORTS—NEGLIGENCE—DOCTOR HELD LIABLE IN DAMAGES FOR CANCEROPHOBIA.—Plaintiff was burned by X-ray treatments administered by defendants. Approximately two years later she consulted a dermatologist, who treated the burns and advised a checkup every six months because the burned area might become cancerous. The New York Court of Appeals *held* that an award of $15,000 for the mental anguish of cancerophobia resulting from the dermatologist's advice was proper, as plaintiff's consultation with another doctor was the natural result of defendant's negligence. *Ferrara v. Galluchio,* 5 N.Y.2d 16, 152 N.E.2d 249, 176 N.Y.S.2d 996 (1958).

Responsibility for the ultimate results of negligent acts is a recognized principle of common law.[1] The doctrine that the law looks to the proximate and not the remote cause was embodied in legal texts by Lord Bacon.[2] Proximate cause has been defined as that which naturally leads to and might be expected to directly produce the result.[3] Common sense has been the primary tool urged by courts for determining the real, true cause of the damage.[4] Intervention by doctors has been recognized as one of the natural and probable con-

[1] See Kilduff v. Kalinowski, 136 Conn. 305, 71 A.2d 593, 595 (1950). "If one is negligent, he is liable for all the injurious consequences that flow from his negligence, until diverted by the intervention of some efficient cause which makes the injury its own. . . ." *Ibid.* See also Christianson v. Chicago, St. P., M. & O. Ry., 67 Minn. 94, 69 N.W. 640, 641 (1896); Osborne v. Montgomery, 203 Wis. 223, 234 N.W. 372 (1931).

[2] "In jure non remota causa, sed proxima, spectatur. . . ." See *Proximate and Remote Cause,* 4 AM. L. REV. 201-02 (1870). (All italicized in original.)

[3] See State v. Manchester & Lawrence R.R., 52 N.H. 528, 552 (1873); McGrew v. Stone, 53 Pa. 436, 442 (1866).

[4] See Topsham v. Lisbon, 65 Me. 449, 462 (1876). See also Smethurst v. Congregational Church, 148 Mass. 261, 12 Am. St. Rep. 550, 553-54 (1889); Hoadley v. Northern Transp. Co., 115 Mass. 304, 15 Am. Rep. 106, 109 (1874).