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Commissioner May Examine Taxpayer's Records for Years Barred by Statute of Limitations Without Proving Reasonable Suspicion of Fraud--*United States v. Powell*

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RECENT DEVELOPMENTS

Commissioner May Examine Taxpayer's Records for Years Barred by Statute of Limitations Without Proving Reasonable Suspicion of Fraud— *United States v. Powell**

The Commissioner of Internal Revenue has power to summon witnesses and to examine records in order to ascertain the correctness of a taxpayer's return.[1] If a summons is not obeyed or if the records sought are not produced, the Commissioner may seek enforcement by applying to the proper federal district court.[2] Although the Commissioner's investigative powers are broad, they are not unlimited. In the absence of fraud, he must act within the confines of a three-year statute of limitations.[3] In addition, the Code makes it abundantly clear that taxpayers may not be subjected to unnecessary examinations or investigations[4] and that records sought must be relevant or material.[5]

In each of the principal cases, taxpayer was summoned to produce records for years which, in the absence of fraud, were no longer subject to examination because of the running of the statute of limitations. Upon taxpayer's refusal to produce his records, an internal revenue agent petitioned a federal district court to enforce the summons, claiming that examination was not foreclosed by the statute of limitations because the taxpayer had filed a fraudulent return. In issue in each of these cases was the question whether records for years barred by statute may be examined by means of an administrative summons if the issuing agent fails to disclose reasonable grounds for his suspicion of fraud. Prior to the Supreme Court's recent decisions in *Ryan v. United States*[6] and *United States v. Powell*,[7] holdings in cases dealing with this issue were in conflict.

In the Second[8] and Sixth[9] Circuits, an administrative summons

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* 379 U.S. 48 (1964). A companion case was Ryan v. United States, 379 U.S. 61 (1964).

1. INT. REV. CODE OF 1954, § 7602.

2. INT. REV. CODE OF 1954, § 7604(b).

3. INT. REV. CODE OF 1954, § 6501(a), (c)(1).

4. INT. REV. CODE OF 1954, § 7605(b). "No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary or his delegate, after investigation, notifies the taxpayer in writing that an additional inspection is necessary."

5. INT. REV. CODE OF 1954, § 7602.

6. Ryan v. United States, 379 U.S. 61 (1964).

7. United States v. Powell, 379 U.S. 48 (1964).

8. Foster v. United States, 265 F.2d 183 (2d Cir. 1959); Norda Essential Oil & Chem. Co. v. United States, 230 F.2d 764 (2d Cir. 1956) (per curiam); United States v. United Distillers Prod. Corp., 156 F.2d 872 (2d Cir. 1946); *In re* Paramount Jewelry

would have been enforced even in the absence of evidence to support the agent's suspicion of fraud. The agent was required to prove only that the summons was issued in good faith pursuant to statutory authority and that the records sought were relevant or material. Typical of the position of these circuits is the Sixth Circuit's decision in the *Ryan*[10] case. In that case, an administrative summons was enforced on the agent's statement that "reasonable grounds exist for a strong suspicion that defendant . . . has made a fraudulent understatement of income."[11] No evidence was introduced to support the agent's suspicion.

The First,[12] Third,[13] Fourth,[14] Seventh,[15] and Ninth Circuits[16] took a different position. They would not have enforced an administrative summons unless the agent disclosed facts indicating reasonable grounds for his suspicion of fraud.[17] In the *Powell* case, the Third Circuit refused to enforce a summons because no evidence was introduced to support the agent's assertion that on the basis of information obtained in investigation of the taxpayer's returns, he had reason to suspect that fraudulent returns had been filed.[18] Similarly, in *Martin v. Chandis Sec. Co.*,[19] the Ninth Circuit refused to enforce a summons when the only reason given for suspecting

Co., 80 F. Supp. 375 (S.D.N.Y. 1948). *Contra, In re* Brooklyn Pawnbrokers, Inc., 39 F. Supp. 304 (E.D.N.Y. 1941).

9. United States v. Ryan, 320 F.2d 500 (6th Cir. 1963), *aff'd*, 379 U.S. 61 (1964); Eberhart v. Broadrock Dev. Corp., 296 F.2d 685 (6th Cir. 1961) (per curiam), *cert. denied*, 369 U.S. 871 (1962); Corbin Deposit Bank v. United States, 244 F.2d 177 (6th Cir. 1957) (per curiam); Kurnick v. Commissioner, 232 F.2d 678 (6th Cir. 1956); Peoples Deposit Bank & Trust Co. v. United States, 212 F.2d 86 (6th Cir.) (per curiam), *cert. denied*, 348 U.S. 838 (1954). *Contra*, In the Matter of Wood, 130 F. Supp. 121 (W.D. Ky. 1955).

10. Note 9 *supra*.

11. United States v. Ryan, 320 F.2d 500, 501 (6th Cir. 1963).

12. Lash v. Nighosian, 273 F.2d 185 (1st Cir. 1959); O'Connor v. O'Connell, 253 F.2d 365 (1st Cir. 1958).

13. United States v. Powell, 325 F.2d 914 (3d Cir. 1963), *rev'd and remanded*, 379 U.S. 48 (1964); United States v. Carey, 218 F. Supp. 298 (D. Del. 1963); Application of Howard, 210 F. Supp. 301 (W.D. Pa. 1962), *rev'd on other grounds*, 325 F.2d 917 (3d Cir. 1963); *cf.* Farmers' & Mechanics' Nat'l Bank v. United States, 11 F.2d 348 (3d Cir. 1926).

14. Wall v. Mitchell, 287 F.2d 31 (4th Cir. 1961); *In re* Andrews, 18 F. Supp. 804 (D. Md. 1937).

15. McDermott v. John Baumgarth Co., 286 F.2d 864 (7th Cir. 1961); United States Aluminum Siding Corp. v. Eshleman, 170 F. Supp. 12 (N.D. Ill. 1958).

16. De Masters v. Arend, 313 F.2d 79 (9th Cir. 1963); Boren v. Tucker, 239 F.2d 767 (9th Cir. 1956); Martin v. Chandis Sec. Co., 128 F.2d 731 (9th Cir. 1942). The *De Masters* court spoke in terms of "rational judgment" rather than "probable cause," but it seems to have required an equivalent level of proof. De Masters v. Arend, *supra* at 88-90.

17. Although the Fifth Circuit has heard two cases dealing with the issue under discussion, Globe Constr. Co. v. Humphrey, 229 F.2d 148 (5th Cir. 1956); Falsone v. United States, 205 F.2d 734 (5th Cir. 1953), its position is not clear.

18. 325 F.2d 914, 916 (3d Cir. 1963), *rev'd and remanded*, 379 U.S. 48 (1964).

19. 128 F.2d 731, 735 (9th Cir. 1942).

fraud was that the return of the taxpayer's wife was being investigated. In both *Lash v. Nighosian*,[20] decided by the First Circuit, and *De Masters v. Arend*,[21] decided by the Ninth Circuit, administrative summonses were enforced. However, in these cases evidence was introduced to support the agent's suspicion of fraud. In *Lash*, the agent established that the taxpayer had made large, unsecured, low-rate loans to agents who had previously audited his returns. In *De Masters*, the agent testified that the increase in the taxpayers' net worth plus their estimated living expenses exceeded their reported income by more than ninety thousand dollars and that in one year bank deposits of their business exceeded reported gross receipts by more than seventeen thousand dollars.

In affirming the Sixth Circuit's decision in *Ryan* and reversing the Third Circuit's decision in *Powell*, the Supreme Court held:

> "[T]he Government need make no showing of probable cause to suspect fraud unless the taxpayer raises a substantial question that judicial enforcement of the administrative summons would be an abusive use of the court's process, predicated on more than the fact of re-examination and the running of the statute of limitations on ordinary tax liability."[22]

In so holding, the Court relied heavily upon the legislative history of section 7605(b)[23] and adopted several arguments previously offered in support of the position of the Second and Sixth Circuits: The Court felt that taxpayers must realize that fraudulent practices will be discovered and penalized if our system of self-assessed revenue collection is to operate effectively. Therefore, the Commissioner must be freed from frustrating limitations upon his statutory duty to administer the Internal Revenue Code. Proof of probable cause is not necessary because such a requirement would curtail the Commissioner's investigative power and hamper administration of the Code.[24] The taxpayer is still amply protected because enforcement of the summons will be denied if the investigation is made in bad faith, if oppressive or abusive procedures are employed, or if the records sought are neither relevant nor material.[25] Finally, the Court pointed out that other administrative agencies need not establish reasonable grounds for a suspicion of fraud in order to have summonses enforced.[26]

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20. 273 F.2d 185, 186-87 (1st Cir. 1959).
21. 313 F.2d 79, 83 (9th Cir. 1963).
22. United States v. Powell, 379 U.S. 48, 51 (1964).
23. *Id.* at 56.
24. *Ibid.*
25. *Id.* at 58. INT. REV. CODE OF 1954, § 7602.
26. United States v. Powell, 379 U.S. at 57; see Administrative Procedure Act § 6(c), 60 Stat. 240 (1946), 5 U.S.C. § 1005(c) (1958); 48 Stat. 899 (1934), 15 U.S.C. § 78u(a)-(c) (1958) (SEC); 38 Stat. 722 (1914), 15 U.S.C. §§ 49, 50 (1958) (FTC); 49 Stat.

These arguments are not convincing. According to the *Powell* decision at the Third Circuit level, the issuing agent would be required only to establish a reasonable basis for his suspicions in order to have a summons enforced; he would not actually have to prove fraud. Thus, the Commissioner's investigative power would not be significantly weakened, because enforcement of a summons would be denied only if the agent were carrying on a mere exploratory fishing expedition. In addition, the taxpayer would be given better protection because he could not be subjected to numerous exploratory investigations even if such investigations were relevant or material and made in good faith.

Although it is true that other administrative agencies need not establish reasonable grounds for suspicion of fraud in order to have an administrative summons enforced, it does not follow that this rule should also apply to the Internal Revenue Service. Unlike the Internal Revenue Service, other administrative agencies do not operate within the confines of a provision such as section 7605(b) of the Code, which prohibits unnecessary examinations.[27] The predecessor of section 7605(b) was enacted in 1921 in order to meet the objections of taxpayers that they were being subjected to onerous and unnecessarily frequent examinations.[28] Because the ordinary individual will of necessity deal with the Internal Revenue Service many more times during his life than he will deal with the other agencies, it was natural for Congress to respond to his special problems by enacting this unique provision. However, the Supreme Court in *Powell*, relying mainly on passages from the congressional debates, concluded that the primary purpose of section 7605(b) "was no more than to emphasize the responsibility of agents to exercise prudent judgment in wielding the extensive powers granted to them by the Internal Revenue Code" and that "to import a probable cause standard . . . would substantially overshoot the goal which the legislators sought to attain."[29] Such a conclusion seems fallacious. The debates on this point are, at most, equivocal.[30] They indicate that what is presently section 7605(b) limits the Commissioner to one examination unless he indicates that there is a necessity for further examination,[31] but there is nothing in the debates or in the Senate Report[32] which indicates what is meant by the word necessity. On the other hand, the one point that is clear from both the debates and the

856 (1935), 16 U.S.C. § 825f(a)-(c)(1958) (FPC); Cooper, *Federal Agency Investigations: Requirements for the Production of Documents*, 60 MICH. L. REV. 187 (1961).

27. INT. REV. CODE OF 1954, § 7605(b).
28. S. REP. No. 275, 67th Cong., 1st Sess. 31 (1921).
29. United States v. Powell, 379 U.S. 48, 56 (1964).
30. See 61 CONG. REC. 5202, 5855 (1921).
31. *Id.* at 5855.
32. S. REP. No. 275, 67th Cong., 1st Sess. 31 (1921).

Senate Report is that the provision was enacted solely for the taxpayer's benefit and protection. By deciding as it did in *Ryan* and *Powell*, the Supreme Court seems to have ignored congressional intent to protect the taxpayer and has reduced section 7605(b) to little more than a passive reminder to the Commissioner that taxpayers do have some rights.

Finally, it should be noted that the fourth and fifth amendments to the Constitution have afforded little protection to a taxpayer faced with an administrative summons.[33] The Supreme Court has held that the fourth amendment does not apply to any records that an individual is required by statute to keep[34] and that the enforcement of an administrative summons does not violate the fourth amendment's prohibition against unreasonable search and seizure.[35] Although the Supreme Court has not been faced with a tax case in which the fifth amendment's privilege against self-incrimination has been in issue, it appears that a taxpayer has no right to resist government procurement of records required by law to be kept.[36] As a result, the taxpayer may be forced to reveal incriminating records. But, by requiring, as a prerequisite to enforcement of an administrative summons, a showing of reasonable grounds for suspicion of fraud, courts will be able to retain some of the philosophy behind the enactment of the fourth and fifth amendments without seriously hampering the collection of revenue.

Mr. Justice Douglas' dissent in the *Powell* case suggests what seems to be the better criteria. In his opinion, re-examination of a taxpayer's statute-barred records is "unnecessary" within the meaning of section 7605(b) unless the court is shown that the taxpayer is not being subjected to administrative fiat or capriciousness and there is some evidence establishing a reasonable suspicion of fraud.[37] Such a test would more properly balance the public interest in maintaining the integrity of the tax collection system with the individual taxpayer's interest in freedom from unwarranted governmental investigation.

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33. U.S. CONST. amends. IV, V. See United States v. Wallace & Tiernan Co., 336 U.S. 793 (1949); United States v. White, 322 U.S. 694 (1944); Avakian, *Searches and Seizures*, N.Y.U. 17TH INST. ON FED. TAX 531 (1959); Redlich, *Searches, Seizures, and Self-Incrimination in Tax Cases*, 10 TAX L. REV. 191 (1954); Spilky, *Have We Lost Our Civil Rights in Tax Matters*, 37 TAXES 603 (1959); Note, 57 COLUM. L. REV. 676 (1957); 1958 WASH. U.L.Q. 277.

34. Shapiro v. United States, 335 U.S. 1 (1948).

35. Oklahoma Press Publishing Co. v. Walling, 327 U.S. 186 (1946). See generally De Masters v. Arend, 313 F.2d 79 (9th Cir. 1963); National Plate & Window Glass Co. v. United States, 254 F.2d 92 (2d Cir. 1958).

36. See Note, 57 COLUM. L. REV. 676, 696-99 (1957).

37. United States v. Powell, 379 U.S. 48, 59-60 (1964) (dissenting opinion). Mr. Justice Stewart and Mr. Justice Goldberg joined in the dissent in *Powell*. In the *Ryan* case, Mr. Justice Douglas dissented, but Mr. Justice Stewart and Mr. Justice Goldberg concurred in the result because they felt that the Government had not acted capriciously.