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# Federal Income Taxation Validity of Deficiencies Assessed Where Commissioner Fails to Conform with Section 7605(b)

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Federal Income Taxation: Validity of Deficiencies  
Assessed Where Commissioner Fails  
To Conform With Section 7605(b)

In 1957 taxpayers filed an application for a tentative net operating loss carryback to 1954 and 1955 which necessitated a second examination of their books for those years by the Commissioner.<sup>1</sup> Without the taxpayers' knowledge certain deductions allowed in the prior years were also reconsidered and disallowed and a deficiency was assessed. The taxpayers contended that this assessment was improper because it resulted from an inspection not conforming to requirements imposed by Section 7605(b) of the Internal Revenue Code of 1954. This section permits only one inspection for any taxable year unless the taxpayer requests otherwise or is notified by the Commissioner in writing that an additional inspection is necessary.<sup>2</sup> A majority of the Tax Court *held* that since taxpayers knew a second examination was being conducted and failed to object until the result proved unfavorable, they had waived the written notice otherwise required by section 7605(b). *M. O. Rife, Jr.*, 41 T.C. 732 (1964). Five judges concurred on the ground that the failure of the Commissioner to comply with the provisions of section 7605(b), even if not waived, should not invalidate a deficiency assessment. Since it is well established that the failure of a taxpayer to object to an investigation of which he is aware constitutes a waiver of the requirements of section 7605(b),<sup>3</sup> this Comment focuses upon the issues raised in the concurring opinion.

Section 7605(b) is a long-standing<sup>4</sup> limitation on the Commis-

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1. Under INT. REV. CODE OF 1954, § 6411, no examination of a taxpayer's books prior to the allowance of a tentative net operating loss carryback is contemplated. However, provision is made for an examination subsequent to such allowance to determine the finality of the tentative adjustment.

2. INT. REV. CODE OF 1954, § 7605(b):

RESTRICTIONS ON EXAMINATION OF TAXPAYER. — 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.

3. See, *e.g.*, *United States v. O'Connor*, 237 F.2d 466 (2d Cir. 1956); *United States v. Young*, 215 F. Supp. 202 (E.D. Mich. 1963); *Philip F. Flynn*, 40 T.C. 770 (1963); *J. S. McDonnell*, 6 B.T.A. 685 (1927).

4. Section 7605(b) was originally enacted as the Revenue Act of 1921, ch. 136, § 1309, 42 Stat. 310.

sioner's broad investigatory powers<sup>5</sup> that was designed to protect taxpayers from the harassment of repeated, unnecessary examinations of their books for the same tax year.<sup>6</sup> The protection afforded the taxpayer by section 7605(b) has received strict judicial construction. Although the taxpayer is entitled to resist examination on any appropriate grounds without penalty<sup>7</sup> and the Commissioner is not automatically entitled to court enforcement of an order to produce records,<sup>8</sup> such enforcement is easily obtainable. Formerly the courts of appeals were divided on whether the Commissioner was required to show probable cause to re-examine the taxpayer's books.<sup>9</sup> However, in *United States v.*

5. INT. REV. CODE OF 1954, §§ 7601-06; see 8A MERTENS, FEDERAL INCOME TAXATION §§ 47.48, .51 (1964). See also Barnes, *Inquisitorial Powers of the Federal Government Relating to Taxes*, 28 TAXES 1211 (1950). The Supreme Court recently outlined the scope of the Commissioner's power in *United States v. Powell*, 85 Sup. Ct. 248, 255 (1964).

6. H.R. REP. NO. 350, 67th Cong., 1st Sess. 16 (1921); S. REP. NO. 275, 67th Cong., 1st Sess. 31 (1921); H.R. REP. NO. 356, 69th Cong., 1st Sess. 55 (1926) (conference committee report); 61 CONG. REC. 5855 (1921) (remarks of Senator Penrose); 61 CONG. REC. 5202 (1921) (remarks of Representative Hawley). In 1926 the Senate passed a provision allowing two examinations for any tax year and eliminating the power of the Commissioner to reexamine further upon giving notice. Senator Reed argued that permitting the Commissioner to re-examine a taxpayer's books merely upon giving written notice of necessity afforded the taxpayer no protection. 67 CONG. REC. 3855-57 (1926). However the House version, retaining the unlimited right of reexamination upon notice, was finally reenacted. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861, at 666 (1938).

7. The taxpayer may challenge the administrative summons when enforcement is sought under § 7604(a) and avoid the criminal sanctions of § 7210, or he may challenge the summons when "an attachment . . . as for contempt" is sought under § 7604(b). *Reisman v. Caplin*, 375 U.S. 440, 447, 449 (1963).

8. In *U.S. Aluminum Siding Corp. v. Eshleman*, 170 F. Supp. 12 (N.D. Ill. 1958), the Government contended that § 7605(b) required only written notice and that the duty of the taxpayer to respond is automatically established with the service of this notice. Recognizing the split of authority discussed in note 9 *infra*, the court stated that all courts were agreed on one thing—the taxpayer is entitled to contest the reexamination as unnecessary in a court hearing and the "court is not required to give 'approval as a rubber stamp upon the administrative subpoena without further investigation.'" *Id.* at 14. After carefully reviewing all the sections of the 1954 Code relating to examinations (§§ 7601-06), the court concluded that the Commissioner's discretion is limited and subject to judicial review.

9. The majority of cases held that investigations were not "unnecessary" even though facts indicating probable cause were not alleged. *E.g.*, *United States v. Ryan*, 320 F.2d 500 (6th Cir. 1963) (reasonable grounds for strong suspicion based on net worth); *Globe Constr. Co. v. Humphrey*, 229 F.2d 148 (5th Cir. 1956) (allegations in affidavit of IRS officer sufficient); cf. *Application of United States (Carroll)*, 246 F.2d 762 (2d Cir. 1957), *cert. denied*, 355

*Powell*,<sup>10</sup> the Supreme Court recently decided that the Commissioner need show only that the proposed reexamination has a legitimate purpose, that he does not presently possess the information, and that he has complied with the notice provisions of section 7605(b).<sup>11</sup> Thus, in *Powell* and a companion case,<sup>12</sup> evidence indicating that the Service had reason to suspect fraud, without any showing of records or evidence upon which such suspicion was based, was held to be sufficient to avoid the prohibition of "unnecessary examinations."<sup>13</sup> The Court said that while "Congress recognized a need for a curb on the investigating powers of low-echelon revenue agents" and sought to encourage them to exercise "prudent judgment" in performing their duties, it also "considered that it met this need simply and fully by requiring such agents to clear any repetitive examination with a superior."<sup>14</sup>

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U.S. 857 (1957) (good discussion of the judicial concept of "necessity"). However, the Government did present some evidence in all these cases, even if no more than the unsubstantiated testimony of a revenue agent. *E.g.*, *United States v. Ryan*, *supra*; *Globe Constr. Co. v. Humphrey*, *supra*.

The minority view required the Commissioner to go forward with evidence to show probable cause or reasonable grounds for suspicion (usually fraud) in order to reexamine the records for a closed year. *E.g.*, *Lash v. Nighosian*, 273 F.2d 185 (1st Cir. 1959) (determined by same test as applied to arrest without warrant); *O'Connor v. O'Connell*, 253 F.2d 365 (1st Cir. 1958) (no probable cause to reopen year barred by statute shown).

The *O'Connor* case, *supra*, bases its holding upon an excellent analysis of the legislative history and purpose of § 7605(b). The court stated that if administrative determination by the IRS is sufficient to reopen years "closed" by the statute of limitations, § 7605(b) "would be relegated to hardly more than a pious exhortation directed to the tax authorities." *Id.* at 370. See 8A MERTENS, *op. cit. supra* note 5, § 47.48, at 134-35; Note, *Taxation: Proof Required To Open a "Closed" Tax Year*, 10 HASTINGS L.J. 211 (1958) (minority view advocated as better rule).

For an excellent discussion and extensive citation of the law as viewed in the circuits prior to 1964, see *De Masters v. Arend*, 313 F.2d 79, 88 n.28 (9th Cir. 1963).

10. 85 Sup. Ct. 248 (1964).

11. *Id.* at 255.

12. *Ryan v. United States*, 85 Sup. Ct. 232 (1964).

13. Three Justices dissented in *Powell*, stating that an examination of years barred by the statute of limitations is presumptively "unnecessary" under § 7605(b), and that the presumption must be overcome by a showing of probable cause. They urged that the district court should require a showing that the Service was not acting capriciously before compelling the production of records for a closed year. 85 Sup. Ct. at 256. However, two of the dissenters in *Powell* joined the majority in *Ryan*, finding that the testimony of the agent was sufficient to show that the Government was not acting capriciously. One Justice dissented on the basis of the dissent in *Powell*. 85 Sup. Ct. at 233-34.

14. 85 Sup. Ct. at 254; see note 6 *supra*.

The status of a deficiency determined as a result of an improper second examination is not treated in the Code. The only cases directly dealing with this question are *Reineman v. United States*<sup>15</sup> and *Application of Leonardo*.<sup>16</sup> In *Reineman* the taxpayers' books and records for 1954 had been examined by a revenue agent. The Government subsequently examined the taxpayers' books during an investigation of their 1955 return. This examination resulted in the disallowance of some 1954 deductions and the assessment of a deficiency. The court found that the adjustments could have been made only through a reexamination of the 1954 records. Since the taxpayers were unaware that the 1954 books were to be reexamined, they had not waived the protection of section 7605(b). It was held that since the written notice required by section 7605(b) was not given, the deficiency assessment was void. In *Leonardo*, as in *Reineman*, taxpayers' records were contained in one set of ledgers and a reexamination of the "closed" years was made without notice to the taxpayers in connection with a legitimate examination of other years. Expressly following the decision in *Reineman*, the *Leonardo* court suppressed the evidence thereby obtained in a criminal tax law prosecution.

The holdings of *Reineman* and *Leonardo* conflict with dicta pronounced in a long series of cases,<sup>17</sup> which held that the taxpayer had waived the protection of section 7605(b). In these cases it was apparently assumed that section 7605(b) was not intended to void deficiencies resulting from improper reexaminations.<sup>18</sup> The *Reineman* court expressly refused to follow their view.<sup>19</sup> The *Rife* majority specifically left open its attitude toward the hold-

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15. 301 F.2d 267 (7th Cir. 1962).

16. 208 F. Supp. 124 (N.D. Cal. 1962).

17. See, e.g., *Blevins v. Commissioner*, 238 F.2d 621 (6th Cir. 1956), *affirming per curiam* 14 CCH Tax Ct. Mem. 840, 843 (1955); *Philip Mangone Co. v. United States*, 54 F.2d 168, 172 (Ct. Cl. 1931); *Philip F. Flynn*, 40 T.C. 770, 774 (1963); *Executors of the Estate of George E. Barker*, 13 B.T.A. 562, 566 (1928); *J. S. McDonnell*, 6 B.T.A. 685, 691, (1927).

18. The development of the doctrine that deficiencies discovered as a result of a second examination made without the required notice are not void is an interesting example of the construction of a rule of law without a sound foundation. The dictum first appeared in *J. S. McDonnell*, 6 B.T.A. 685, 691 (1927), without discussion or elaboration. It was then picked up and repeated in a series of cases, though never fully discussed by any court. Apparently it was the generally accepted doctrine prior to the decision in *Reineman*. See INT. REV. CODE OF 1954, § 7605(b); 6 CCH 1964 STAND. FED. TAX REP. ¶ 5923.

19. 301 F.2d at 271-72. The court stated that the situation involved was one of first impression and that no previous cases were in point.

ings in *Reineman* and *Leonardo*.<sup>20</sup> The concurring judges asserted that the oft-repeated dictum that "failure . . . to comply . . . with section 7605(b) . . . does not invalidate the deficiency. . . ." should have the weight of precedent<sup>21</sup> and *Reineman* should be disapproved.<sup>22</sup> Unfortunately, however, the concurring opinion does not present a reasoned analysis of the relative merits of its posi-

20. The majority may have avoided considering *Reineman* and *Leonardo* because of factual distinctions between those cases and the instant case in addition to the finding of waiver. Unlike *Reineman*, the taxpayers in *Rife* failed to show that the information used to determine their deficiency was to be found only in their books and records, and in fact it appeared that such information might well have been available elsewhere.

The application for allowance of a tentative carryback adjustment in the instant case might be tantamount to a request for reexamination of the taxpayers' books. Or written notice of reexamination might be predicated upon the taxpayers' signing of the tentative carryback allowance form, U.S. Treasury Dept. Form 1045. This form contains the printed statement "this allowance is a tentative adjustment pending an audit of the returns concerned."

The instant case might be distinguished from *Leonardo* (although not *Reineman*) by the fact that *Leonardo* was a criminal prosecution in which the burden of proof was on the Government. The majority in the instant case stated that the holding in *Leonardo* was that evidence obtained by the unauthorized examination could not be used in a criminal prosecution. While this is literally true, it is probably too narrow a reading since the *Leonardo* court announced that it was following *Reineman*, a civil tax case.

Finally, in *Reineman* the facts forming the basis of the deficiency assessment were obtained by an improper reexamination while in the instant case the facts were stipulated at trial. The taxpayers could object to the admission in evidence of any stipulated fact only on the grounds of materiality and relevancy. It would appear that by failing to object to the use of evidence obtained by the second examination on these grounds, all rights to contest the validity of a deficiency assessment based on such evidence could be considered waived. 41 T.C. 732, 750-51 n.6.

21. 41 T.C. at 751-52.

22. On numerous occasions the Tax Court has expressed unwillingness to follow the decisions of the courts of appeals even where review of its decision would lie in the court whose rule it rejects. *E.g.*, *Stacey Mfg. Co.*, 24 T.C. 703 (1955), *rev'd*, 237 F.2d 605 (6th Cir. 1956); *Houston Farms Dev. Co.*, 15 T.C. 321 (1950), *rev'd per curiam*, 194 F.2d 520 (5th Cir. 1952); see Muir, *A Country Lawyer's Memorandum: Stare Decisis and the Tax Court*, 44 A.B.A.J. 857 (1958); Comment, 9 STAN. L. REV. 827 (1957); 70 HARV. L. REV. 1313 (1957). This unwillingness to follow courts of appeals' decisions reflects a desire to achieve uniform application of the tax laws. Arthur L. Lawrence, 27 T.C. 713, 718 (1957). Both the higher courts, *e.g.*, *Sullivan v. Commissioner*, 241 F.2d 46 (7th Cir. 1957); *Stacey Mfg. Co. v. Commissioner*, 237 F.2d 605 (6th Cir. 1956), and legal commentators, *e.g.*, Muir, *supra*, have been highly critical of this attitude. Until Congress or the Supreme Court resolves the controversy the Tax Court will apparently continue to decide cases before it according to its own judgment.

tion and the *Reineman* rule.

The Supreme Court's recent *Powell* decision appears to support *Reineman* and casts doubt upon the concurring opinion in the instant case. Since the Court emphasized the right of a taxpayer to contest a reexamination in a court hearing, it may logically be inferred that it would afford an appropriate remedy if the Commissioner, by making a reexamination without notice, were to deprive a taxpayer of the opportunity to have his rights adjudicated prior to that inspection. The only effective remedy is avoidance of any deficiency assessed as a result of the reexamination.<sup>23</sup>

The public interest in collecting taxes<sup>24</sup> may on occasion conflict with the public interest in protecting taxpayers from harassment, much as the public interest in convicting criminals may, in particular instances, run afoul of civil liberties. It is presently unclear whether the settled rule rendering inadmissible evidence obtained in violation of the Constitution<sup>25</sup> applies by analogy to require the avoidance of deficiency assessments based upon evidence obtained by means of reexaminations of taxpayers' books in violation of a statute.<sup>26</sup> The courts summarily rejected such

23. This reading of the *Powell* case is conjectural since the issue was not before the Court. It should be noted that in *Ryan v. United States*, 85 Sup. Ct. 232 (1964) (companion to *Powell*), the "necessity letter" was not sent to the taxpayer and the district judge made no mention of this—probably because counsel did not press the point. The Court specifically stated that it would not interpret the necessity letter requirement of § 7605(b) since the issue was not raised on appeal. 85 Sup. Ct. at 233.

24. *Falsone v. United States*, 205 F.2d 734, 742 (5th Cir. 1953). Section 7605(b) should not be read to defeat this purpose. *E.g.*, *De Masters v. Arend*, 313 F.2d 79, 86-87 (9th Cir. 1963); *Application of United States (Carroll)*, 246 F.2d 762, 765 (2d Cir. 1957).

25. *E.g.*, *Wong Sun v. United States*, 371 U.S. 471 (1963) (evidence obtained after arrest without probable cause); *Mapp v. Ohio*, 367 U.S. 643 (1961) (illegal search and seizure); *Spano v. New York*, 360 U.S. 315, 320 (1959) (coerced confession); *Weeks v. United States*, 232 U.S. 383 (1914) (illegal search and seizure); *United States v. Klosterman*, 248 F.2d 191 (3d Cir. 1957) (entrapment); see, *e.g.*, Broeder, *Wong Sun v. United States: A Study in Faith and Hope*, 42 NEB. L. REV. 483, 516-56 (1963); Traynor, *Mapp v. Ohio at Large in the Fifty States*, 1962 DUKE L.J. 319, 322.

26. *Cf.* *United States v. Young*, 215 F. Supp. 202 (E.D. Mich. 1963). A doctor kept two sets of books to facilitate a tax fraud. Certain records obtained by the Government as a result of an illegal search and seizure were held to be the fruits of a violation of the taxpayer's constitutional rights and were therefore suppressed. However, the bulk of the evidence consisted of records which the taxpayer "voluntarily" (under pressure) handed over to the tax authorities. The court held this to be a waiver of § 7605(b) and subsequently admitted the evidence, thus seemingly taking the position that while constitutional guarantees should be jealously guarded, waiver of statutory rights may be freely recognized.

an analogy in a number of older cases.<sup>27</sup> In the more recent civil tax cases, such as the instant case and *Reineman*, they have simply ignored the question.

Federal Rule of Criminal Procedure 41(e) requires that property obtained by unlawful search and seizure be restored unless otherwise subject to lawful detention, and prohibits its admission into evidence. The *Leonardo* court refused to decide whether rule 41(e) excluded evidence obtained in violation of statute as well as that seized unconstitutionally.<sup>28</sup> However, on the basis of analogy to rule 41(e), it did assert the power to exclude evidence obtained in violation of section 7605(b).<sup>29</sup> This action was predicated on the "inherent disciplinary power" of the judiciary to protect persons from illegal or improper acts by an officer of the court in violation of a statute.

A reasonable distinction may exist between the violation of a fundamental constitutional guarantee, which can result in the deprivation of personal liberty, and the disregard of a statutory protection, which can result only in the assessment of additional income tax liability. The argument for the application of an exclusionary rule in dealing with violations of section 7605(b) is nonetheless compelling. A taxpayer subject to civil penalties<sup>30</sup> may also be criminally liable,<sup>31</sup> and at the discretion of the Government, a civil inquiry may be changed to a criminal tax prosecution without notice.<sup>32</sup> Thus, a violation of the statutory protection of section 7605(b) may be comparable in result to a violation of the constitutional guarantee against unreasonable search and seizure.

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27. See, e.g., *Philip Mangone Co. v. United States*, 54 F.2d 168, 172 (Ct. Cl. 1931); *J. S. McDonnell*, 6 B.T.A. 685, 691 (1927). In *Philip Mangone* the court said, "The plaintiff likens the testimony . . . to testimony illegally forced from defendants in criminal cases. We feel confident the analogy is not sustainable . . ."

28. 208 F. Supp. at 126.

29. *Id.* at 127.

30. See INT. REV. CODE OF 1954, §§ 7321-25 (forfeiture), 6211 (deficiency assessments); 10 MERTENS, *op. cit. supra*, note 5, §§ 55.02, .03, .08a, .09; 6 CCH 1964 STAND. FED. TAX REP. ¶¶ 5520-75.

31. Felonies are punishable by imprisonment up to five years and fines not more than \$10,000, or both, and misdemeanors punishable by imprisonment of not more than one year and fines not more than \$10,000, or both. INT. REV. CODE OF 1954, §§ 7203-07; see 10 MERTENS, *op. cit. supra* note 5, § 55A.01; 6 CCH 1964 STAND. FED. TAX REP. ¶¶ 5701-25.

32. *E.g.*, *United States v. Sclafani*, 265 F.2d 408, 415 (2d Cir. 1959); *United States v. Young*, 215 F. Supp. 202, 203-04 (E.D. Mich. 1963) (numerous cases cited). *Contra*, *Application of Bodkin*, 165 F. Supp. 25 (E.D.N.Y. 1958); *United States v. Guerrina*, 112 F. Supp. 126 (E.D. Pa. 1953).

Even if a criminal prosecution is never brought, judicial failure to void deficiency assessments resulting from noncompliance with the statute would leave the taxpayer without remedy and encourage the Commissioner to continue his improper conduct.<sup>33</sup> Courts have a duty to exercise their inherent disciplinary power over public officials to protect persons brought before them from the improper acts of such officials.<sup>34</sup>

As the Supreme Court has stated in another context, "courts can protect the innocent against such invasions only indirectly and [only] through the medium of excluding evidence obtained against those who frequently are guilty."<sup>35</sup> Consequently the courts ought to exclude evidence obtained through violation of section 7605(b) whether a criminal prosecution or merely a civil tax liability is involved.

The requirements established by Congress in section 7605(b) are reasonable and impose no substantial burden upon the Commissioner in his efforts to collect taxes. The right of a taxpayer to contest the necessity of a reexamination in a court hearing does not afford protection against reexamination as such but only from unfair investigations. If the Commissioner were allowed to make enforceable deficiency assessments on the basis of information acquired in violation of section 7605(b), as suggested by the concurring opinion in the instant case, the taxpayer would be effectively deprived of his right to contest a reexamination. Since circumstances do exist in which a reexamination can be made without the taxpayer's knowledge, such a rule would be an open invitation for the Commissioner to disregard section 7605(b) whenever possible. However, by voiding deficiency assessments based upon violations of section 7605(b), courts can ensure compliance with the statute.

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33. *Reineman v. United States*, 301 F.2d 267, 271-72 (7th Cir. 1962).

34. *E.g.*, *Go-Bart Importing Co. v. United States*, 282 U.S. 344, 355 (1931); *Silverthorne Lumber Co. v. United States*, 251 U.S. 385, 390 (1919); *Grant v. United States*, 282 F.2d 165, 168-69 (2d Cir. 1960); *United States v. Maresca*, 266 Fed. 713, 717-18 (S.D.N.Y. 1920); see 29 GEO. WASH. L. REV. 941, 944-45 (1961).

35. *Brinegar v. United States*, 338 U.S. 160, 181 (1949) (Jackson, J., dissenting), quoted in *Elkins v. United States*, 364 U.S. 206, 218 (1959). In *Olmstead v. United States*, 277 U.S. 438, 485 (1928), Mr. Justice Brandeis said in dissent: "In a government of laws, existence of the government will be imperilled if it fails to observe the law scrupulously. . . . If the Government becomes a lawbreaker, it breeds contempt for law; it invites every man to become a law unto himself . . ." Since that time there has been a progressive evolution in the area of criminal law to insure that law enforcement officers strictly comply with the law. See, *e.g.*, *Mapp v. Ohio*, 367 U.S. 643 (1961); *Elkins v. United States*, *supra*.