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Taxation--Section 7605(b)--Internal Revenue Service Not Required to Show Probable Cause in Obtaining Subpoena of Tax Records (United States v. Powell, 379 U.S. 48 (1964))

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that the statute as literally read is constitutional. However, even if this position is correct, it would not adversely affect the majority's holding, since they were justified in performing "judicial surgery" based on the "drastic result" concept.

Even though damages are limited to the portion of exaggeration attributable to willfulness, the effectiveness of section 39-a is still guaranteed. For example, if a lienor has a valid claim for $10,000, but files a lien for $20,000—including in this $10,000 exaggeration, $2,000 due to honest, though mistaken belief, and $8,000 due to willfulness—he will forfeit the lien and, in addition, pay a penalty of $8,000. Under these circumstances a lienor would be foolish to attempt to enforce the lien. If the lienor does attempt to enforce an exaggerated lien, as a matter of legal strategy, he might well be advised to discontinue his action if the defendant-owner threatens to institute a counterclaim pursuant to section 39-a, since a foreclosure proceeding is in fact a condition precedent to the enforcement of the statute.

It is submitted that the majority's construction of section 39-a still affords adequate protection to owners and contractors against whom exaggerated liens have been filed. It also insulates lienors from the sting of unnecessary penalties, which the legislature probably did not intend. Thus, since there does not appear to be *direct* comment or legislative history on the statute, the majority was warranted in utilizing a construction process designed to ascribe the most reasonable legislative intention.[23]

TAXATION — SECTION 7605(b) — INTERNAL REVENUE SERVICE NOT REQUIRED TO SHOW PROBABLE CAUSE IN OBTAINING SUBPOENA OF TAX RECORDS. — The Internal Revenue Service summoned one Powell to produce records concerning prior tax returns made by a corporation of which Powell was president. Powell refused to comply, claiming that since the three-year statute of limitation had expired, the assessment must be predicated on fraud,[1] and in order to examine the records for fraud there must be a showing of "probable cause." The Supreme Court, in reversing

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[23] Chief Judge Cardozo wrote that "the legislator has only a fragmentary consciousness of the law" and when the question is one of fixing meaning to the rules which he prescribes, one should search at their source, that is, social utility. CARDOZO, THE NATURE OF THE JUDICIAL PROCESS 122 (1932). See generally Note, *Statutory Doubts and Legislative Intention*, 40 COLUM. L. REV. 957, 970-74 (1940).

[1] INT. REV. CODE OF 1954, §§ 6501(a), (c). See generally 5 RABKIN & JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION §§ 76.01(1), (2) (1964).

the Third Circuit Court of Appeals, ordered compliance with the summons and *held* that the Commissioner need not show probable cause of suspected fraud until the taxpayer raised a "substantial question" of abuse of process. *United States v. Powell,* 379 U.S. 48 (1964).

Whether the Commissioner must, in order to support his subpoena for the production of records, show probable cause to suspect fraud after the expiration of the statute of limitations on assessment has been the subject of conflicting decisions among various circuits.[2]

In *O'Connor v. O'Connell,*[3] a First Circuit case, the taxpayer was summoned to testify concerning certain tax liabilities after the statute of limitations had run. When the taxpayer refused to comply, the Commissioner sought an order enforcing the subpoena contending that the revenue agent's testimony concerning his belief that the taxpayer had filed fraudulent returns was sufficient. The court refused to grant the order and held (1) that the Service must establish probable cause to suspect fraud in order to justify its investigation into a closed year, and (2) that the agent's testimony in and of itself was not sufficient to constitute such probable cause.[4] The court, relying on Section 7605(b) of the Internal Revenue Code of 1954 which protects taxpayers from unnecessary examinations and limits the Service to one examination for each taxable year unless the taxpayer is notified in writing that an additional inspection is necessary, reasoned that by the enactment of this section, Congress must have intended to impose a requirement of probable cause.[5]

In a subsequent case, the same court stated that the purpose of this construction was to prevent the Commissioner from conducting "fishing expeditions" into a taxpayer's closed years and from "acting upon a mere hunch or a vague surmise."[6]

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[2] See Wall v. Mitchell, 287 F.2d 31 (4th Cir. 1961), wherein the court noted the conflict among the several circuits.

[3] 253 F.2d 365 (1st Cir. 1958).

[4] *Id.* at 370.

[5] *Ibid.* Pursuant to this decision, the issue of probable cause was adjudicated, not by affidavits, but at a hearing which inquired into the question of a reasonable suspicion of fraud. 8A MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 47.48 (rev. ed. 1964).

[6] Lash v. Nighosian, 273 F.2d 185, 189 (1st Cir. 1959). The Ninth Circuit, in an early decision, adopted the requirement of probable cause, but did so without expressing an opinion as to its soundness. Martin v. Chandis Sec. Co., 128 F.2d 731, 735 (9th Cir. 1942). This rule was later modified by Boren v. Tucker, 239 F.2d 767, 773-74 (9th Cir. 1956). Recently, this circuit stated that an examination of books for a closed year cannot be unnecessary if it is in accordance with statutory purposes. The court considered the investigation of fraud to be within these authorized purposes and concluded with the statement that if "justification" was necessary, the evidence presented was sufficient to satisfy this requirement. De Masters v. Arend, 313 F.2d 79, 87-91 (9th Cir.), *cert. denied,* 375 U.S. 936 (1963). Thus, the trend in this circuit appeared to be toward an elimination of the probable cause requirement.

The position of the Second Circuit is exemplified by the case of *United States v. United Distillers Prod. Corp.*[7] Rejecting the probable cause contention and reasoning that while the statute of limitations bars additional assessment, it does not preclude investigation, the court noted that the Service should not "be required to prove the grounds of its belief prior to an examination of the only records which provide the ultimate proof."[8]

In a subsequent decision, this circuit, relying on its prior position, ruled in favor of the Commissioner upon the mere submission of affidavits. It was noted that there was no requirement to show probable cause for the enforcement of administrative subpoenas. In holding the Service's summonses similarly unrestricted,[9] the court espoused the principle that an examination was neither unnecessary nor unreasonable merely because the statute of limitations had expired. Therefore, it permitted the Commissioner to conduct his examination in order to determine whether liability did in fact exist.[10]

In the instant case, the Third Circuit Court of Appeals was of the opinion that since any additional assessment must be based on fraud, any re-examination would be unnecessary unless probable cause for such examination is shown.[11] Furthermore, there must be an adversary proceeding to determine the reasonableness of the revenue agent's suspicion.[12]

The Supreme Court, in reversing this decision, refused to construe section 7605(b) as requiring a showing of probable cause.[13] The majority reasoned that such an interpretation would seriously

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[7] 156 F.2d 872 (2d Cir. 1946).

[8] *Id.* at 874.

[9] Foster v. United States, 265 F.2d 183, 186 (2d Cir.), *cert. denied*, 360 U.S. 912 (1959). *Contra, In re* Brooklyn Pawnbrokers, Inc., 39 F. Supp. 304 (E.D.N.Y. 1941). The Second Circuit has also decided that section 7605(b), which prohibits unnecessary examinations, applies only to taxpayers and not to third-party examinations. Application of Magnus, 299 F.2d 335, 336 (2d Cir.), *cert. denied*, 370 U.S. 918 (1962). See generally 5 RABKIN & JOHNSON, *op. cit. supra* note 1, § 71.02A(6); Cooper, *Federal Agency Investigations: Requirements for the Production of Documents*, 60 MICH. L. REV. 187, 204 (1961).

[10] Foster v. United States, *supra* note 9, at 187. The Sixth Circuit has also held that Congress does not specifically require the Service to show, as a condition precedent to the exercise of its investigatory power, a probable cause. The court reasoned that to hold otherwise would seriously curtail the ability of the Commissioner to perform his assigned duties. The court noted, however, that it may inquire into the good faith and purpose of the examination and may grant relief from oppressive procedures. United States v. Ryan, 320 F.2d 500, 502 (6th Cir. 1963), *aff'd*, 379 U.S. 61 (1964).

[11] United States v. Powell, 325 F.2d 914, 915 (3d Cir. 1963), *rev'd*, 379 U.S. 48 (1964); Comment, 39 N.Y.U.L. REV. 878 (1964).

[12] United States v. Powell, *supra* note 11, at 916. *Accord*, Lash v. Nighosian, *supra* note 6; O'Connor v. O'Connell, 253 F.2d 365, 370 (1st Cir. 1958).

[13] United States v. Powell, 379 U.S. 48, 53 (1964).

hamper the investigatory power of the Commissioner and that the legislative history of the section indicated that Congress did *not* intend to impose such a severe limitation.[14]

The Court further noted that its decision was in accord with earlier holdings which refused to apply the probable cause requirement to investigative subpoenas of other administrative agencies.[15] Thus, it was concluded that probable cause is not required to obtain enforcement of a summons either before or after the running of the statute of limitations.[16]

The Commissioner must, however, show (1) that the investigation is pursuant to legitimate purpose; (2) that it is relevant to that purpose; (3) that the information sought is not in the possession of the Commissioner; and (4) that the required administrative procedures have been followed. [17] A taxpayer may challenge the summons for failure to comply with these requirements and upon such a challenge, the enforcing court may inquire into the reasons for the examination. The burden of proof, however, to establish an abuse is on the taxpayer.[18]

The dissent,[19] on the other hand, considered that the expiration of the statute of limitations created a presumption that the examination is "unnecessary" within the meaning of 7605(b) and, as a consequence, the burden is on the Service to show the necessity for the examination.[20] They also felt that this interpretation would give substance to the statute of limitations by protecting taxpayers "from invasion by mere administrative *fiat*."[21]

The present decision has formulated a concrete guideline for the circuits in reviewing the Service's requests for the enforcement of subpoenas requiring the production of records. In those circuits which heretofore required probable cause, the holding will greatly broaden the investigatory power of the Service.

Furthermore, by holding that the burden is upon the taxpayer to come forward in the initial instance, the Court is, in effect, re-

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[14] The Court, in its review of legislative intent, relied on the discussion of Senators Penrose and Walsh which revealed that the purpose of section 7605(b) was to relieve honest taxpayers from the petty annoyance of repetitive examinations by overzealous investigators. The Court felt that to require a probable cause standard "would substantially overshoot the goal which the legislators sought to attain." *Id.* at 54-55.

[15] *Id.* at 57. See Oklahoma Press Publishing Co. v. Walling, 327 U.S. 186, 216 (1946); DAVIS, ADMINISTRATIVE LAW § 3.12 (1959). See generally Cooper, *Federal Agency Investigations: Requirements for the Production of Documents,* 60 MICH. L. REV. 187 (1961).

[16] United States v. Powell, *supra* note 13, at 57.

[17] This last factor is generally a writing notifying the taxpayer of the additional examination. *Id.* at 57-58.

[18] *Ibid.*

[19] Mr. Justice Douglas wrote the dissenting opinion in which Mr. Justice Stewart and Mr. Justice Goldberg concurred.

[20] United States v. Powell, *supra* note 13, at 60.

[21] *Ibid.*

quiring the taxpayer to produce the records. This assumption is predicated on the fact that it would be almost impossible for the taxpayer to otherwise obtain evidence of harassment or irrelevancy.

Thus, as a practical matter, it appears that the Service can inquire into closed years without considering the expiration of the statute of limitations. If, however, an investigation into such a year revealed a tax deficiency which was not fraudulent, the taxpayer would still be protected against additional assessment because of the statute.[22]

In addition, tax investigations are limited by several pragmatic considerations. The Service cannot afford to investigate indiscriminately because its heavy workload prohibits additional examinations unless there is a valid reason for suspecting fraudulent conduct. Thus, it would appear that the Court recognized that the earlier fears of Congress concerning harassment of taxpayers by unnecessary and repetitive examinations have not materialized and that the internal procedures of the Service are sufficient to prevent excessive abuses.

Since this decision is directly supported by legislative intent, by direct analogy to the requirements of other administrative agencies, and by certain practical safeguards, the majority appears to be justified in its elimination of the often burdensome probable cause requirement. Certainly, if the Service were to attempt to use this decision as a spring board for various "fishing expeditions" into the taxpayer's closed years, the courts could prevent such excesses by recourse to the abuse of process limitation. Therefore, this decision should have a beneficial effect upon the investigatory power of the Service while providing sufficient protection to the taxpayer.

TORTS — MUNICIPAL CORPORATIONS — CITY HELD NOT LIABLE FOR FAILURE TO ENFORCE MULTIPLE RESIDENCE LAW. — Following a fire in a multiple residence, a fire captain verbally ordered that the use of a defective oil heater be discontinued. No further action was taken by the city. Subsequently a fire caused by the defective heater occurred in the same building, and plaintiff, a resident of the building, brought a negligence action against the city alleging that the fire captain failed to report the defective heater as required by Section 303 of the Multiple Residence Law. In affirming the trial court's dismissal of the complaint, the Court of Appeals *held* that the Multiple Residence Law creates no liability for damage resulting from failure to comply with its provisions.

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[22] INT. REV. CODE OF 1954, §§ 6501(a), (c). See generally 5 RABKIN & JOHNSON, *op. cit. supra* note 1, § 76.01.