Washington and Lee Law Review

Volume 37 | Issue 2 Article 19

Spring 3-1-1980

XIV. Tax

XIV. TAX

A. *Deductibility of Lease Payments Allocated to Reserve Account*

In *Jack's Cookie Co. v. United States*[1] the Fourth Circuit addressed the issue of whether "reserve" payments as part of monthly rentals are deductible under section 162(a)(3) of the Internal Revenue Code (Code)[2] as ordinary and necessary business expenses. Section 162(a) of the Code allows tax deductions for all ordinary and necessary expenses paid or incurred during the taxable year for carrying on a trade or business.[3] If a payment meets the criteria of section 162(a), the taxpayer may deduct the amount of the payment from the business' gross income under section 62(1) of the Code.[4] If, however, the payment is not allowed as a deduction under section 162(a), the payment is deductible, if at all,[5] as a capital expenditure[6] under section 263 of the Code.[7] A capital expenditure, unlike an ordinary and necessary expense, cannot be deducted totally in the year of payment; rather, a capital expenditure must be amortized from year to year.[8] Courts have consistently had difficulty determining whether a particular expense is an ordinary and necessary expense or a capital expenditure.[9] The courts have therefore resorted to applying the statutory language of section 162(a), inquiring whether the expense is "ordinary," in order to distinguish between ordinary and necessary expenses and capital expenses.[10]

Among the items which are deductible as ordinary and necessary

---

[1] 597 F.2d 395 (4th Cir.), *cert. denied*, 444 U.S. 899 (1979).

[2] I.R.C. § 162(a).

[3] *Id.; see* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 352 (1971).

[4] Section 62(1) of the Internal Revenue Code of 1954 (Code) allows the deduction of expenses attributable to a trade or business conducted by the taxpayer from the gross income of the taxpayer as defined in § 61. I.R.C. § 62(1).

[5] Section 162 of the Code, which grants deductibility for ordinary and necessary business expenses, and § 263 of the Code, which denies deductibility for specified capital expenditures, are neither mutually exclusive nor all inclusive. Therefore, payments not deductible under one section are not necessarily deductible under the other. *See* General Bancshares Corp. v. Commissioner, 326 F.2d 712, 716 (8th Cir.), *cert. denied*, 379 U.S. 832 (1964); Consumers Water Co. v. United States, 369 F. Supp. 939, 945 (D. Me. 1974).

[6] A capital expenditure is a payment made to acquire property which has a useful life substantially beyond the taxable year. Treas. Reg. § 1.263(a)-2(a) (1960).

[7] Section 263 expenditures are considered capital because they produce benefits beyond the taxable year. *See* I.R.C. § 263.

[8] Commissioner v. Tellier, 383 U.S. 687, 689-90 (1966).

[9] The Supreme Court has indicated that the difficulty in determining whether a payment is currently deductible lies in the often minute distinctions between those payments that are classified as ordinary and necessary expenditures and those classified as capital expenditures. *See* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. at 353; 383 U.S. at 689.

[10] 383 U.S. at 689-90. An expenditure is "necessary" within the meaning of § 162(a) if it is "appropriate and helpful [to] the development of the taxpayer's business." *Id.* at 689 (quoting Welch v. Helvering, 290 U.S. 111, 113 (1933)). Thus, it is not difficult to demon-

expenses under section 162(a) are rentals or other payments required as a condition to continued use or possession of property.[11] Although section 162(a)(3) provides for the deduction of rent, that section has not been construed to require the allowance of a deduction for all payments characterized as "rent" by the involved parties.[12] A payment which a taxpayer seeks to deduct as rent must fulfill both the specific criteria of section 162(a)(3) relating to rent[13] and the general criteria of section 162(a) relating to the requirements of an ordinary and necessary expense.[14]

Courts have used various tests to determine whether an expense is ordinary and necessary. In *Commissioner v. Lincoln Savings and Loan Association*[15] the Supreme Court established the "separate assets" test for determining whether an expenditure is ordinary and necessary or capital.[16] The Court held that a payment which creates or enhances a separate and distinct asset for the taxpayer is necessarily capital in nature, and cannot be deducted under section 162(a) of the Code.[17] In *Lincoln Savings,* the Court found that a separate and distinct asset had been created by the taxpayer's payments because the taxpayer obtained a property interest in the fund into which the payments were made.[18] The Court also indicated that the potential for future benefit is not controlling

---

strate that an expenditure is necessary. The determination that a payment is "ordinary" has therefore become the crucial factor in concluding that the payment may be deductible under § 162(a). "Ordinary," defined as "normal, usual, or customary," requires that a determination of the ordinariness of a payment must relate to the particular facts and context from which the expense arises. 403 U.S. at 353 (quoting Deputy v. du Pont, 308 U.S. 488, 493, 495-96 (1940)).

[11] Section 162(a)(3) of the Code specifically provides for the deduction of rental payments:

> [R]entals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

I.R.C. § 162(a)(3). *See also* Treas. Reg. § 1.162-1 (1960).

[12] The characterization of certain payments as "rent" by the parties contracting for a lease is not dispositive of the deductibility of those payments under § 162(a)(3). *See, e.g.,* Foyt v. United States, 561 F.2d 599, 602-03 (5th Cir. 1977) (monthly "rental payments" under sublease were actually contributions to capital, not rent, because taxpayers' interest in real estate was determined by amount of capital contributions which included credit for all such "rental payments" made by taxpayer); M & W Gear Co. v. Commissioner, 446 F.2d 841, 844, 846 (7th Cir. 1971) ("rental payments," which were very high for area, and fact that fair market value of leased land was at least twice taxpayer's option price indicated that payments were applied in reduction of purchase price, and were not "rent"); West Virginia N.R.R. v. Commissioner, 282 F.2d 63, 65 (4th Cir. 1960), *cert. denied,* 366 U.S. 929 (1961) ("rent" paid to satisfy personal stock debt not considered "rent").

[13] *See* text accompanying note 11 *supra.*

[14] *See* text accompanying note 3 *supra.*

[15] 403 U.S. 345 (1971).

[16] *Id.* at 354.

[17] *Id.*

[18] *Id.* at 355. The *Lincoln Savings* Court noted that the FSLIC fund into which the payments were made was a fund of last resort, to be used only if all other funds were exhausted, thus indicating a further separate and distinct character of the payments. *Id.*

on the deductibility of a payment.[19] The extent of the possible future benefit of a payment is, however, important to the determination of deductibility.[20] Courts have used tests other than the separate assets test to standardize deductibility of payments with future benefits. One alternative test, the one-year rule,[21] addresses the deductibility of payments with future benefits by requiring that an expenditure is a capital expenditure if it has a useful life of greater than one year, or if the expenditure secures benefits to the taxpayer which have a life of greater than one year.[22] Under the one-year rule, a capital expenditure is characterized by the intention of the taxpayer in making the payment to produce a favorable business benefit with effects beyond the taxable year.[23] The one-year rule is based upon the principle that section 162(a) allows for deductions of payments which realize and exhaust attendant benefits in a single tax year.[24] Such a policy reflects the general policy of the Code, that the taxation system should match income and expenses of the tax year in order to tax only net income.[25]

In *Jack's Cookie Co. v. United States*,[26] the Fourth Circuit utilized the one-year and separate assets tests to determine whether a lessee's "rent" payments in accordance with the terms of a lease were deductible under section 162(a)(3).[27] The Fourth Circuit held certain payments characterized as "rent" under the lease were not rentals within the meaning of section 162(a)(3), and therefore reversed the district court's allowance of taxpayer's deduction.[28] The Fourth Circuit stated that although the one-year and separate assets tests can be distinguished, the one-year test is incorporated into the separate assets test.[29] The court reasoned that a separate and distinct asset, by definition, will serve the taxpayer beyond the year in which the payment was made.[30] The court

---

[19] *Id.* at 354.

[20] *See* note 6 *supra.*

[21] The one-year rule was announced by the Tenth Circuit in United States v. Akin, 248 F.2d 742, 744 (10th Cir. 1957); *see* text accompanying notes 22-25 *infra.*

[22] 248 F.2d at 744. *See* Richmond Television Corp. v. United States, 345 F.2d 901, 907 (4th Cir.), *vacated and remanded,* 382 U.S. 68 (1965) (expenses incurred in pre-operative employee training capital in nature because benefits extended beyond year in which incurred).

[23] *See* Darlington-Hartsville Coca-Cola Bottling Co. v. United States, 273 F. Supp. 229, 231 (D.S.C. 1967), *cert. denied,* 393 U.S. 962 (1968) (payments intended to produce more favorable contract relationships capital in nature because such payments obtained intangible business advantage which would extend beyond current accounting year).

[24] Georator Corp. v. United States, 485 F.2d 283, 284 (4th Cir. 1973), *cert. denied,* 417 U.S. 945 (1974). *See* Darlington-Hartsville Coca-Cola Bottling Co. v. United States, 273 F. Supp. 229 (D.S.C. 1967), *cert. denied,* 393 U.S. 962 (1968); Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir.), *vacated and remanded,* 382 U.S. 68 (1965).

[25] 345 F.2d at 907.

[26] 597 F.2d 395 (4th Cir. 1979).

[27] *Id.* at 399-406.

[28] *Id.* at 406.

[29] *Id.* at 405.

[30] *Id.*

cautioned, however, that the one-year element of the separate assets test is not dispositive; rather, the one-year rule is an indicator that a particular expenditure may be capital in nature. Such an indication functions only as a threshold determination of deductibility, subject to the further determination of whether the expenditure creates a separate asset.[31]

In *Jack's Cookie Co.*, the taxpayer, Jack's, agreed to lease a county-owned industrial building for thirty years.[32] Funding for the construction of the building was obtained from the proceeds of two municipal bond issues.[33] To ensure repayment of the principal and interest, the lease required "monthly rentals" consisting of several components.[34] The first component was one-sixth of the interest due on each bond issue for the six months following each payment. Second, taxpayer was required to pay one-twelfth of the next principal payment due on each bond issue. The third component consisted of administrative expenses incurred by the Trustee and Paying Agent, a Memphis bank. In addition to these three components designed to repay the bonds, the lease further required Jack's to pay "reserve payments" in equal monthly installments for the first fifteen years of the lease.[35] At the end of the fifteen years the total of the reserve payments was to equal $285,000.[36] Unlike the other three components, the reserve payments were not to be used to service the bonds routinely.[37] The reserve payments were to be used according to Jack's limited discretion, and were not controlled by the repayment requirements of the bond issue.[38] The most important option under

---

[31] *Id.* The Fourth Circuit explicitly stated in *Jack's* that the one-year rule is still viable, even though the intervening decision in First Nat'l Bank of S.C. v. United States, 558 F.2d 721 (4th Cir. 1977), did not refer to the one-year rule or to *Richmond Television* or *Darlington-Hartsville. See* notes 21-23 *supra.* The *Jack's* court stated that *First Nat'l Bank* incorporated the one-year rule into the separate assets test of *Lincoln Savings.* 597 F.2d at 404.

[32] 597 F.2d at 396.

[33] The two bond issues were authorized by the County Court of Giles County, Tennessee in accordance with two Tennessee building bond acts. One issue was established pursuant to The Industrial Building Revenue Bond Act of 1951, TENN. CODE ANN. §§ 6-1701 to 1716 (1971), which provided for the issuance of construction financing bonds and the renting of the industrial buildings constructed with the proceeds from the bonds. The statute further authorized the municipalities to charge rent sufficient to retire the bonds. The second issue was established pursuant to The Industrial Building Bond Act of 1955, TENN. CODE ANN. §§ 6-2901 to 2916 (1971), which provided for a reserve fund composed of rent payments on industrial buildings constructed under the bond issue.

The principal amount of each bond issue was $1,250,000. Each bond issue was to mature serially over the term of the 30 year lease. Repayment of both bond issues was secured by an indenture of mortgage and deed of trust between Giles County and the trustee bank. 597 F.2d at 396-97.

[34] 597 F.2d at 397.

[35] *Id.; see* TENN. CODE ANN. §§ 6-1701 to 1716; 6-2901; note 33 *supra.*

[36] 597 F.2d at 397.

[37] The reserve payments were not to be used for the routine service of the bonds. According to the lease, however, if Jack's defaulted on its rent so that no funds were available to service the bonds, the reserve payments would be so utilized. *Id.* at 397 n.5.

[38] Under the lease, Jack's could direct the trustee to invest the reserve fund in United States obligations, returning all interest earned from that investment to the fund. Further,

Jack's discretion was the election to credit the amount of the reserve fund to the rent obligations remaining at the end of the first fifteen years on the prepayment of those remaining obligations.[39] Although the control of the reserve fund was largely at Jack's discretion, the payments into that fund were nonetheless required by the lease.[40] Under the lease, if Jack's failed to pay the "monthly rentals," the *sum* of the four components set out in the lease,[41] the county could cancel the lease.[42]

Jack's claimed a deduction under section 162(a)(3) for the monthly rental payments[43] made during the taxable year.[44] The IRS disallowed only the amount of the reserve payments component from Jack's total rental payment deduction and assessed a deficiency for that partial disallowance.[45] Jack's paid the deficiency and filed a petition for refund.[46] Following the denial of the petition for refund,[47] Jack's filed suit in the United States District Court for the Western District of North Carolina to recover the amount of the tax deficiency paid.[48] The district court granted summary judgment for the taxpayer for the full amount of the deficiency and interest,[49] reasoning that the mandatory nature of the reserve payments qualified the payments as "rentals" within the meaning of section 162(a)(3).[50] The Government appealed the district court's

---

the lease entitled Jack's to credit, equal to the amount of the fund, toward prepayment of rental obligations, either at the end of fifteen years or in case of condemnation or damage of the building. *Id.* at 397.

[39] *Id.* The Fourth Circuit's opinion does not state whether the parties contemplated that the amount of the reserve fund at the end of fifteen years, $285,000 plus any interest earned from investments, would equal the amount of the remaining rental obligations. If such an equation was contemplated, the issue of trade or business expenses versus capital expenses clearly would be decided under the settled law relating to advance payments of rent.

[40] *Id.*

[41] *See* text accompanying notes 34-35 *supra.*

[42] 597 F.2d at 397.

[43] *See* text accompanying note 35 *supra.*

[44] 597 F.2d at 398.

[45] Jack's paid monthly rental payments totalling $191,720.92 in the taxable year in controversy. The IRS disallowed $20,479.08 of that amount. The disallowed portion equaled the amount of the reserve payments made during that year. *Id.*

[46] A petition for refund for overpayment is made to the Commissioner or the District Director of the IRS. The petition must be made within the prescribed period of time. The claim for refund must set forth the detailed grounds upon which the refund is claimed and include a statement of the relevant facts. The petition must be made and verified under penalties of perjury. The filing of a claim for refund is a prerequisite to suit upon disallowance by the Commissioner. 10 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 58.03, 58.17 (1976).

[47] 597 F.2d at 396.

[48] *Id.*

[49] *Id.*

[50] *Id.* at 399 (citing Jack's Cookie Co. v. United States, No. C-C-75-358 (W.D.N.C. June 3, 1977)). The lease's condition requiring payments for possession of the premises convinced the district court of the propriety of deducting the reserve payments under § 162(a)(3). The district court also noted with approval Jack's good faith compliance with the terms of the bond issue lease. Although unclear, the district court apparently referred to § 162(a)(3) only.

decision to the Fourth Circuit.[51]

The Fourth Circuit analyzed the reserve payment deductibility issue under the established "usual and ordinary sense" definition of "rentals" contained in section 162(a)(3).[52] The court stated that, although compulsion or requirement of payment is an essential characteristic of "rentals" within the meaning of section 162(a)(3),[53] compulsion alone is not sufficient to qualify a payment as a "rental."[54] Indeed, the Fourth Circuit determined that an obligation to pay addresses only the issue of whether a payment is of the type contemplated by section 162(a)(3).[55]

According to the *Jack's* court, the scope of inquiry beyond that determination of compulsion has two levels.[56] The first level of inquiry addresses the "nature of the cost,"[57] whether the payments were ordinary and necessary expenses, capital expenses, or something else.[58] In order for a taxpayer to argue successfully for deductibility under 162(a)(3), the taxpayer must show that the payment was ordinary and necessary in nature, and not capital. Once a payment has been categorized, a court must consider the second level of the inquiry relating to deductibility. On the second level, the inquiry addresses the statutory guidelines relating to whether, when, and in what amounts disbursements of the same kind as those in controversy may be considered in the calculation of taxable income.[59] The ultimate question addressed by this two part inquiry is whether the cost in dispute can be deducted in full in the year in which it was incurred.[60]

Applying the two part test to the facts in *Jack's,* the Fourth Circuit determined that the only necessary inquiry was the "nature of the cost" categorization of the reserve payments as a trade or business expense or a capital expense.[61] To determine whether the payments were trade or

---

The court addressed the requirement of payment issue of § 162(a)(3), but did not address the requirements of § 162(a). *See* text accompanying notes 3 & 11 *supra.*

[51] 597 F.2d at 396.

[52] The Fourth Circuit adopted the Supreme Court's definition of "rentals" stated in Duffy v. Central R.R., 268 U.S. 55 (1925). 597 F.2d at 399. Rent under *Duffy* is a fixed sum or equivalent property paid at set intervals for the use of property. 268 U.S. at 63.

[53] Section 162(a)(3) (requirement of payment as element of rent). I.R.C. § 162(a)(3).

[54] *See* note 12 *supra.*

[55] 597 F.2d at 400.

[56] *Id.* at 401.

[57] *Id.*

[58] In determining the "nature of the cost" incurred, the Fourth Circuit in *Jack's* alluded to the importance of statutory provisions regarding different types of costs. Section 162 relates to trade or business expenses, and § 263 relates to capital expenses. I.R.C. §§ 162, 263. The court also alluded to the fact that these statutory provisions are neither mutually exclusive nor all inclusive. 597 F.2d at 401; *see* note 5 *supra.*

[59] 597 F.2d 401; *see* note 58 *supra.*

[60] If a payment is an ordinary and necessary expense under § 162(a), it can be deducted in the current year. I.R.C. §§ 162(a), 62(1); *see* note 4 *supra.*

[61] Categorization of the reserve payment as a trade or business expense or a capital expense was the only necessary inquiry in *Jack's* because both parties conceded the treatment of the possible categorizations. If the reserve payments were trade or business ex-

business expenses or capital expenses, the Fourth Circuit first applied the one-year rule.[62] By the terms of the lease, the reserve payments produced benefits beyond the taxable year in the forms of investment returns and rent credit after fifteen years.[63] After applying the one-year rule, the *Jack's* court considered whether the reserve payments created a separate and distinct asset for Jack's.[64] The Fourth Circuit determined that Jack's had a property interest in the reserve fund, and thus, the fund was an asset with an ascertainable and real value.[65] The court held that Jack's disbursements to the reserve fund were not ordinary and necessary business expenses, and thus, were not deductible for the current year.[66]

The Fourth Circuit's holding that Jack's reserve payments were not ordinary and necessary business expenses was correct. The one-year test[67] and the separate assets test[68] are appropriate to the determination of deductibility of business expenses. These tests isolate the critical issue, whether the payment can be deducted in full in the year in which it was incurred.[69] The *Jack's* court correctly analyzed the reserve payments under those tests. The benefits of the reserve payments clearly accrued to Jack's beyond the tax year, most dramatically in the fifteenth year, when the fund could be applied to remaining rent obligations.[70] Further, the reserve fund was a separate and distinct asset produced by the reserve payments.[71]

The formula which the Fourth Circuit devised in *Jack's* facilitates the policy of the Code by matching income and expenses of the tax year to tax only net income. The court established a step-by-step analysis to determine whether a payment is an ordinary and necessary business expense under section 162(a) or a capital expense under section 263 of the Code. The Fourth Circuit in *Jack's,* by providing a formula rather than a strictly technical rule relating only to rental payments, created a rule which applies generally to questions of deductibility of business expenses.

MARGARET HUTCHINS CAMPBELL

---

penses, then they would be deductible under § 162(a)(3); if they were capital, or something else, they would not be deductible under § 162(a)(3). *See* text accompanying notes 3, 5-7 *supra.*

[62] *See* text accompanying notes 21-25 *supra.*

[63] *See* note 38 *supra.*

[64] *See* text accompanying notes 15-19 *supra.*

[65] 537 F.2d at 406.

[66] *Id.*

[67] *See* text accompanying notes 21-25 *supra.*

[68] *See* text accompanying notes 15-19 *supra.*

[69] *See* text accompanying note 60 *supra.*

[70] *See* text accompanying note 39 *supra.*

[71] *See* text accompanying note 65 *supra.*

B. Good Faith Purpose for Issuing Summons

Congress has consistently granted the Secretary of the Treasury authority to investigate a taxpayer's[1] financial status regarding that taxpayer's taxation liabilities.[2] Section 7602 of the Internal Revenue Code (Code)[3] vests the Secretary with the further authority to issue summonses for the purpose of examining books, records, and testimony relevant to a particular, present investigation.[4] A section 7602 summons is issued by an examiner authorized by the Commissioner of Internal Revenue after a taxpayer under investigation has refused to comply voluntarily with an IRS agent's request for specific relevant materials.[5] The purview of a section 7602 summons was originally perceived as limited to investigations of civil liabilities[6] and the purposes enumerated in the statute.[7] An IRS in-

[1] Section 7701(a)(14) of the Internal Revenue Code defines "taxpayer" as "any person subject to any internal revenue tax." "Person" is defined broadly in § 7701(a)(1) to "mean and include an individual, a trust, estate, partnership, association, company or corporation." I.R.C. § 7701(a)(1), (14). The regulations draw the definition of "person" more broadly, including a wider range of organizations and individual capacities. Treas. Reg. § 301.7701-1(a) (1977).

[2] Section 7601 of the Internal Revenue Code imposes a broad duty on the Secretary of the Treasury to cause Treasury officers and employees to investigate and audit the returns of "persons," *see* note 1 *supra*, in each internal revenue district. I.R.C. § 7601. This statutory mandate is of such broad scope that the Supreme Court held that the traditional probable cause prerequisite for searches is not required for IRS investigatory practices, reasoning that inquiry, not accusation, is the focus of § 7601. United States v. Bisceglia, 420 U.S. 141, 146 (1975). The authority granted to the Secretary by § 7601 is further derived from the general duty required of the Secretary by § 7801 of the Internal Revenue Code, which requires the Secretary to administer the provisions of the Code. I.R.C. § 7801(a).

Section 7601 evolved from early taxation provisions, and in 1894 was reenacted without change. The substance of the provisions of § 7601 remained intact through several tax acts, and was also contained in the 1939 Code. Int. Rev. Code of 1939, ch. 34, § 3600, 53 Stat. 435 (now I.R.C. § 7601).

[3] I.R.C. § 7602.

[4] Courts have consistently held that the power to issue summonses under § 7602 of the Internal Revenue Code should be construed liberally because the investigatory process serves a vital public purpose with regard to the efficient function of the IRS. *See, e.g.*, De Masters v. Arend, 313 F.2d 79, 87 (9th Cir.), *cert. dismissed*, 375 U.S. 936 (1963) (procedural statute § 7605 of the Code should not be read so broadly as to limit the latitude of the grant in § 7602).

[5] *See generally* [1979] I INTERNAL REVENUE MANUAL—AUDIT, part IV (CCH) §§ 4021, 4022.11, 4022.3.

[6] Section 7602, on its face, addresses only civil purpose. I.R.C. § 7602; *see* note 7 *infra*; G. CROWLEY & R. MANNING, CRIMINAL TAX FRAUD—REPRESENTING THE TAXPAYER BEFORE TRIAL 225 (1976). Further, the Supreme Court has generally indicated that the scope of § 7602 summonses is limited to discovery information relating to a civil investigation. *See* Reisman v. Caplin, 375 U.S. 440, 449 (1964) (taxpayer may challenge summons on ground that it was used to discover evidence for criminal case); *cf.* Abel v. United States, 362 U.S. 217, 226 (1960) (use of administrative summons to discover evidence for criminal case "must meet stern resistance by the courts"). Section 7608(b) of the Code, which confers authority on a "criminal" investigator of the Intelligence Division to execute and serve search and arrest warrants and to serve subpoenas and summonses, supports the conclusion that § 7602 was intended to address only civil investigations. *See* I.R.C. § 7608(b); Lipton, *Investigative Authority; The Commissioner's Summons; Search Warrants; Contempt; Constitutional Rights and Other Defenses* in TAX FRAUDS 63, 65 (1977) [hereinafter cited as Lipton].

[7] Section 7602 sets out five purposes for which a summons may be legitimately issued

vestigation is dual in nature, however, because the Internal Revenue Code sets out civil and criminal penalties for tax fraud.[8] The scope of section 7602 summonses has expanded, therefore, to include investigations relating to criminal liabilities.[9] This expansion has created a confusing body of law.[10]

The Supreme Court attempted to resolve this confusion in *United States v. LaSalle National Bank.*[11] In *LaSalle,* the Court held that the proper standard for determining whether a section 7602 summons should be enforced is whether the summons was issued in good faith[12] prior to an

---

under that section:

1) ascertaining the correctness of any return;
2) making a return where none has been made;
3) determining the liability of any person for any internal revenue tax;
4) determining the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax; or
5) collecting any internal revenue tax liability.

I.R.C. § 7602.

[8] The concept of duality in IRS investigations was enunciated in Donaldson v. United States, 400 U.S. 517 (1971). Because the Internal Revenue Code provides for both civil and criminal penalties relating to tax liabilties, and because the information basic to a determination of either penalty is the same, the civil and criminal elements of an investigation are "inherently intertwined." United States v. LaSalle Nat'l Bank, 437 U.S. 298, 309 (1978). The Supreme Court interpreted the legislative history of § 7602 to support the statutory premise that civil and criminal tax investigations are interrelated, and that Congress intended for them to be conducted as such. *Id.* at 309-11. This duality of the scope of investigation under § 7602 was previously emphasized in Couch v. United States, 409 U.S. 322, 326 (1973).

An important development in the evolution of the duality concept is the irrelevance of the primary purpose of the summons. The primary purpose is that aspect of the investigation, either civil or criminal, in which the IRS is most interested, and for which the IRS issues the summons. *See* Note, *Constraints on the Administrative Summons Power of the Internal Revenue Service,* 63 IOWA L. REV. 526, 535 (1977). The blending of the civil and criminal aspects of an IRS investigation accomplished by the duality concept has created inconsistencies in the interpretations of the requirements of a § 7602 summons. *See* 437 U.S. at 305 n.6.

There are still, however, distinct consequences of civil and criminal tax violations. Section 6653(b) imposes a civil penalty of 50% of the underpayment upon a taxpayer who willfully has submitted a false or fraudulent tax return. I.R.C. § 6653(b). Section 6659(a) provides additionally that penalties provided by that chapter constitute a portion of the taxpayer's liability. I.R.C. § 6659(a). *See* 437 U.S. at 308. Sections 7206 and 7207 provide for the imposition of penalties of fines and imprisonment for tax fraud. I.R.C. §§ 7206-7207.

[9] *See* note 8 *supra.* The duality concept provides a premise for the conclusion that § 7602 summonses authorize joint criminal and civil investigations at preliminary stages. The *LaSalle* Court recognized the validity of the duality concept, but reaffirmed the basic principle that a valid civil purpose must exist in order for a § 7602 summons to be enforceable. While primacy of purpose is not determinative, a summons issued solely in aid of a criminal investigation is invalid and unenforceable. 437 U.S. at 316 n.18 (1978).

[10] *See, e.g.,* United States v. LaSalle Nat'l Bank, 437 U.S. 298, 305 n.6 (1978) (various courts of appeals adopted differing interpretations of the law concerning § 7602 summonses).

[11] 437 U.S. 298 (1978).

[12] The good faith element includes, but is not limited to, the components identified in United States v. Powell, 379 U.S. 48 (1964). In *Powell,* the Court held that the investigation

institutional commitment to recommendation for criminal prosecution.[13] The *LaSalle* Court based its adoption of the subjective institutional commitment standard on the premise that a summons could be issued in bad faith prior to recommendation to the Department of Justice for criminal prosecution if the IRS were committed to make a recommendation at the time of the issuance.[14] The purpose of the subjective standard announced in *LaSalle* is to protect the taxpayer from those few situations in which the institutional commitment to recommendation for prosecution exists and a section 7602 summons is used to obtain information for the Department of Justice's criminal prosecution.[15] The effect of the *LaSalle* standard is to impose a heavy burden on the taxpayer to disprove the actual

---

must be conducted pursuant to a legitimate purpose, the inquiry must be relevant to the purpose, the information sought must not be already within the Commissioner's possession, and the administrative steps required by the Code must be followed. *Id.* at 57-78; *see* 437 U.S. at 313-14. The *LaSalle* Court reiterated the *Powell* conclusion that harassment or coercion to settle a collateral dispute would constitute bad faith. *Id.* at 314. The Supreme Court in *LaSalle* did not limit the definition of good faith to that set out in *Powell.* Id. at 317 n.19.

[13] The Supreme Court expanded the criteria for enforcement of a § 7602 summons in Donaldson v. United States, 400 U.S. 517 (1971). In *Donaldson,* the Court held that a § 7602 summons must be issued prior to recommendation for criminal prosecution for tax fraud. *Id.* at 536. The Court determined that recommendation occurs when the IRS refers the criminal elements of its investigation under a § 7602 summons to the Department of Justice with a recommendation for prosecution. *Id.* at 534-35; *accord* United States v. Billingsley, 469 F.2d 1208, 1210 (10th Cir. 1972).

LaSalle introduced the concept of institutional commitment to the criteria established by *Powell* and *Donaldson* for enforcement of § 7602 summonses. The concept relates to both the good faith standard of *Powell* and the recommendation of criminal prosecution standard of *Donaldson. See* notes 12 & 13 *supra.*

After *LaSalle,* the relevant good faith inquiry is directed at the IRS, not the individual agent conducting an investigation. 437 U.S. at 314. The conceptual difficulty with this standard is the forced application of a subjective standard to a bureaucratic unit. Saltzman, *Supreme Court's* LaSalle *Decision Makes it Harder to Successfully Challenge a Summons,* 49 J. TAX. 130, 133 (1978) [hereinafter cited as Saltzman]. The practical difficulty with the institutional element is the lack of "meaningful guidance" in *LaSalle* regarding the intended definition or interpretation of the concept. *Id.*

The *LaSalle* Court acknowledged that institutional good faith would be difficult to question before recommendation for criminal prosecution. The Court posited, however, two instances in which institutional bad faith could be proved. 437 U.S. at 316-17 n.19. The Court recognized that delay of recommendation for evidence-gathering purposes and information gathering for other departments are illustrative of the *Donaldson* recommendation for criminal prosecution standard in the institutional commitment situation.

[14] *See* 437 U.S. at 316. After the recommendation for criminal prosecution to the Department of Justice, the issuance of a § 7602 summons clearly would be in bad faith under an objective standard.

Although the *LaSalle* majority refused to accept such an objective standard, the dissenting members of the Court, in the 5-4 decision, supported the adoption of the objective standard, indicating judicial support for such a standard. *Id.* at 319-21. *See also* United States v. Marine Midland Bank, 585 F.2d 36, 38 (2d Cir. 1978) (appropriate test for enforcement of § 7602 summons is whether summons was issued prior to recommendation for criminal prosecution).

[15] *See* note 13 *supra.*

existence of a valid civil tax liability investigation.[16] The nature of this burden results from the duality of IRS investigations.[17]

In *United States v. McGuirt* and *United States v. Maryland Lumber Co. and Union Trust Co.*,[18] the Fourth Circuit addressed the practical application of the *LaSalle* rule.[19] In *McGuirt*, the Fourth Circuit considered whether a summons issued on the basis of information from an informant regarding criminal tax liabilities was issued in bad faith. The *McGuirt* court also considered whether a summons issued to obtain records to which the IRS previously had ample access was tantamount to harassment.[20] In *Union Trust*, the Fourth Circuit addressed the sufficiency of an agent's affidavit to show institutional good faith under the *LaSalle* rule.[21]

The Fourth Circuit in *McGuirt* held that the section 7602 summons was enforceable.[22] In *McGuirt*, the IRS had received information from an unnamed informant,[23] apparently relating to the taxpayer's criminal tax violations,[24] prior to the assignment of an IRS agent to the taxpayer's case. The agent contacted the taxpayer and, during the succeeding four months, examined the taxpayer's records. The agent had access to study and copy the taxpayer's records and documents for twenty to twenty-five hours.[25] At some time during the four month period, the IRS agent met with the informant.[26] The IRS agent referred his findings to the Intelligence Division of the IRS, at which time a Special Agent was assigned to conduct a criminal investigation.[27] The Special Agent summoned bank records and the taxpayer's records, but the taxpayer refused to comply.[28]

The IRS petitioned to enforce the summons in the United States Dis-

---

[16] 437 U.S. at 316.

[17] *See* note 8 *supra*.

[18] 588 F.2d 419 (4th Cir. 1978), *cert. denied*, 100 S. Ct. 52. (1979).

[19] The Fourth Circuit combined the appeals in *McGuirt* and *Union Trust* in order to consider whether a § 7602 summons is enforceable if issued in aid of an IRS criminal investigation. The court delayed its decision until *LaSalle* was decided by the Supreme Court. 588 F.2d at 420.

[20] *Id.* at 421.

[21] *Id.* at 420-21; *see* text accompanying notes 49-63 *infra*.

[22] 588 F.2d at 422.

[23] In the district court trial, the court found the nondisclosure of the identity and testimony of the informant fatal to a fair hearing of the case because the court considered those factors essential to a determination of the purpose underlying the issuance of the summons. United States v. McGuirt, 428 F. Supp. 95, 97 (W.D.N.C. 1977).

[24] Brief for Appellees at 4, United States v. McGuirt, 588 F.2d 419 (4th Cir. 1978) [hereinafter cited as Brief for Appellees].

[25] *Id.* at 3. The agent had free access to the records during his visits and the taxpayer and his employees were fully cooperative with the agent's investigation. *Id.*

[26] *Id.* The IRS agent's meeting with the informant was prior to at least two of the agent's visits to the taxpayer's corporate office. The agent would not disclose at trial the substance of his conversation with the informant at the advice of the agent's superiors and government counsel. *Id.*

[27] *See* text accompanying note 9 *supra*.

[28] Brief for Appellees, *supra* note 24, at 3-4.

trict Court for the Western District of North Carolina.[29] At the hearing to determine enforceability of the summons, the IRS did not reveal to the court information provided by the informant, information provided to the Special Agent by the preliminary agent, or the name of the informant.[30] Further, the IRS did not allow the taxpayer's attorney to cross-examine the agents regarding the information provided by the informant.[31] The district court found that the Government's posture completely frustrated the court's duty to determine the threshold issue of good faith,[32] and therefore refused to enforce the summons.[33] The Government appealed the case to the Fourth Circuit.[34] The nature of the case was significantly altered before the Fourth Circuit heard the appeal, however, when the IRS abandoned its criminal fraud investigation.[35]

The taxpayer in *McGuirt* relied on two distinct grounds in asserting that the section 7602 summons was issued in bad faith.[36] First, the taxpayer argued that, because the summons was issued on the basis of the informant's information relating to criminal tax liabilities, the summons was issued solely in aid of a criminal investigation, thereby constituting bad faith.[37] Second, the taxpayer asserted that the information sought by the IRS was effectively in the IRS's possession because of the inordinate amount of time during which the IRS agent had access to that particular information, and therefore, enforcement of the summons would be tantamount to harassment.[38]

---

[29] Sections 7402 and 7604 of the Code vest the appropriate district court with jurisdiction to enforce the provisions of the Code. I.R.C. §§ 7402, 7604.

[30] *See* note 23 *supra.*

[31] 428 F. Supp. at 97.

[32] The district court in *McGuirt* relied on *Donaldson* and refused to be compelled to make an *ex parte* decision on the issue of good faith based on an *in camera* inspection. *Id.* The district court judge made this decision because the Government refused to allow cross-examination and the court did not incorporate reports which the Government submitted to the court. The reports, which the record showed to contain a copy of the agent's description of the informant's report and a copy of the information which passed between the IRS agent and Special Agent, were not retained by the judge and were not considered by him in his review of the case. *Id.*

[33] *Id.*

[34] 588 F.2d at 419.

[35] *Id.* at 421.

[36] *Id.* Neither the taxpayer nor the Government made any arguments based on *LaSalle* because the briefs were filed and the arguments were given before the Supreme Court decided *LaSalle.* The Fourth Circuit delayed only its decision until after the *LaSalle* decision. *See* note 19 *supra.*

[37] If the § 7602 summons for McGuirt's records was, in fact, issued solely in aid of a criminal investigation, it would be unenforceable under the *Lasalle* rule. *See* note 9 *supra.*

[38] Under the *Powell* rule, if the Commissioner possesses the information sought prior to the issuance of the summons, the summons cannot be enforced because it was issued in bad faith. 379 U.S. at 57-58. *See* note 12 *supra.* The taxpayer in *McGuirt* argued that the information sought under the § 7602 summons of his documents was effectively in the Commissioner's possession because the agent had access to the summoned material for 20 to 25 hours. *See* United States v. Pritchard, 438 F.2d 969, 971 (5th Cir. 1971) (information considered in Commissioner's possession when agent had access to material for three to four hours).

The Fourth Circuit held that the taxpayer's contention that the summons was issued solely in aid of a criminal investigation was mooted by the IRS's abandonment of its criminal fraud investigation prior to the appeal.[39] The court further held that, while the taxpayer's contention that the issuance of a summons subsequent to governmental access to the summoned information led to an inference of inconvenience, such inconvenience was not tantamount to harassment.[40] The agent's investigatory activities were not, therefore, indicative of institutional bad faith.[41] The Fourth Circuit therefore directed the district court to enforce the summons on remand.[42]

The Fourth Circuit's disposition of *McGuirt* reflects the lack of direction and definition which exists regarding the enforcement of section 7602 summonses after *LaSalle*.[43] Because the Fourth Circuit could not reach the moot criminal purpose issue in *McGuirt*, the court was forced to determine whether the facts before it justified a finding of bad faith under *LaSalle*.[44] The *McGuirt* court's finding that the inconvenience present in *McGuirt* did not constitute institutional bad faith, however, does little to elucidate *LaSalle*'s vague bad faith standard.[45] Presumably, there must

---

[39] 588 F.2d at 421; *see* text accompanying note 35 *supra*. The court's dismissal of the appeal in *McGuirt* for mootness is consistent with the judicial policy against advisory opinions in tax summons questions. S. Taylor, *The Commissioner's Summons—Its Scope—Who May Object* in DEFENDING TAX FRAUD PROSECUTIONS 24 (1969) [hereinafter cited as Taylor]. *See also* Birdsall v. United States, 272 F. Supp. 308 (S.D. Fla. 1967).

[40] 588 F.2d at 421-22.

[41] The *McGuirt* court intimated that the taxpayer might have a cause of action under § 7605(b) of the Code, which limits second inspections. *Id.* at 422 n.1. The court failed to state that in order to have such a cause of action, the taxpayer must have made an immediate objection to the second examination. Where no such objection is made, the taxpayer is presumed to have consented to the examination and waived his right to attack its validity. Taylor, *supra* note 39, at 23.

[42] 588 F.2d at 420.

[43] *See generally* Saltzman, *supra* note 13, at 130-33.

[44] Although the *McGuirt* court was unable to reach the criminal purpose issue because of mootness, *see* text accompanying notes 35 & 39 *supra*, the court purported to reverse the district court's judgment on the criminal purpose issue. The first sentence of the opinion, which states that the issue presented to the Fourth Circuit was whether a summons issued for a criminal fraud investigation is enforceable, indicates that the court intended to so dispose of the case. *See* 588 F.2d at 420. Further, the juxtaposition of the court's order for reversal and its invalidation of the district court's premise also indicates that intention. The district court's premise which the Fourth Circuit invalidated stated that a summons could not be issued in good faith if used for a criminal fraud investigation. *Id.*

The purpose of the Fourth Circuit's statement of intention regarding the disposition of *McGuirt* may have been to indicate the court's inclination on a future substantive application of *LaSalle*. If that was the court's intention, then the court indicated that the facts of *McGuirt* would be insufficient to defeat a petition to enforce a § 7602 summons. Presumably, such a conclusion would be based on the petitioner's failure to disprove the existence of a valid civil purpose investigation by the IRS, which *LaSalle* would require for a showing of bad faith. *See* note 13 *supra;* text accompanying note 16 *supra*.

[45] The Fourth Circuit exercised appropriate authority to categorize the IRS's investigatory activity as manifesting institutional good or bad faith, since the *LaSalle* Court disclaimed any exclusivity of definition of good faith within the *LaSalle* opinion, *see* note 12 *supra*, and proposed a case-by-case factual analysis. 437 U.S. at 317 n.19, 318 n.20.

be some point at which IRS investigative activity crosses *McGuirt*'s undefined line between inconvenience and harassment.[46] The Fourth Circuit, however, did not indicate where that point lies,[47] and thus imposed no meaningful limitations on IRS investigations prior to the issuance of a summons.

The Fourth Circuit's judicial deference to the power of the IRS is manifested not only in *McGuirt* but also in the companion case, *United States v. Maryland Lumber Co. and Union Trust Co.*[48] In *Union Trust*, the Fourth Circuit addressed the issue of whether a petition for enforcement, with an affidavit asserting continuing good faith, is sufficient to establish a prima facie case for enforcement of a section 7602 summons under the *LaSalle* rule.[49] In *Union Trust*, the Government brought a summons enforcement proceeding against the taxpayer, Maryland Lumber Company. The taxpayer had refused to comply with the IRS summons, claiming that the summoned bank records had been stolen from its accountant's office.[50] The judgment of the court was adverse to the taxpayer, and the Fourth Circuit dismissed the taxpayer's appeal.[51] In order to obtain the previously summoned records, the IRS issued a summons to the Union Trust Company for the taxpayer's records. The bank did not comply,[52] and the Government instituted a second enforcement proceeding, on appeal before the Fourth Circuit with *United States v. McGuirt*.[53]

In the second enforcement proceeding, the IRS agent submitted an affidavit in support of his petition for enforcement which stated that the summons had been issued in good faith, and, that at the time of issuance, no recommendation for criminal prosecution had been made to the Department of Justice.[54] The taxpayer, asserting that the summons was issued solely in aid of a criminal investigation, requested discovery and an evidentiary hearing. The district court denied the request and enforced the summons.[55]

---

[46] Harassment constitutes bad faith under *LaSalle* because *LaSalle* incorporated *Powell* standards, which categorized harassment as bad faith. 437 U.S. at 314.

[47] Because the *LaSalle* Court proposed a case-by-case factual analysis of good faith determinations, *see* note 45 *supra*, all of the pertinent facts of *McGuirt*, which include timing, degree of taxpayer cooperation, and opportunity to copy relevant documents, must be considered as the basis for the court's analysis and determination.

[48] 588 F.2d 419 (4th Cir. 1978); *see* note 19 *supra*.

[49] 588 F.2d at 421. The factual questions in *Union Trust* were resolved in the first hearing of the case. *Id.*

[50] 599 F.2d at 420.

[51] *Id.* at 422 (Widener, J., concurring) (citing United States v. Maryland Lumber Co., No. 77-1338 (4th Cir. Oct. 5, 1978)).

[52] Because the IRS petitioned Union Trust for the taxpayer's bank records, the taxpayer was entitled to intervene under § 7609(b) of the Code to stay compliance with the third party summons. I.R.C. § 7609(b).

[53] *See* note 19 *supra*.

[54] 588 F.2d at 420-21.

[55] *Id.* at 421. The United States District Court for the District of Maryland denied the taxpayer's request for discovery in *Union Trust* because the court was bound by its determination of the factual situation in the first enforcement proceeding. *Id.* Judge Widener, in

The Fourth Circuit in *Union Trust* determined that the agent's petition for enforcement and the supporting affidavit established a prima facie case for enforcement under *LaSalle*,[56] and held the summons enforceable.[57] The court reasoned that an evidentiary hearing and discovery were not warranted because the taxpayer presented no new evidence or affidavits countering the agent's affidavit.[58] The court did not address the taxpayer's defense that the summons was issued solely in aid of a criminal prosecution, because that issue had been decided in the first enforcement proceeding.[59]

As in *McGuirt*, the Fourth Circuit in *Union Trust* was unable to address the application of the *LaSalle* rule regarding the criminal investigation defense to the enforcement of a section 7602 summons.[60] In addressing the procedural issue of burden of proof, however, the *Union Trust* court announced a rule consistent with some decisions since *LaSalle*,[61] but inconsistent with the spirit of *LaSalle*. The *LaSalle* Court admitted that the burden of proof it established for the taxpayer was heavy, but the Court clearly did not intend for the burden to be impossible to meet.[62] The Fourth Circuit in *Union Trust* attempted to provide some practical standards for the application of the *LaSalle* rule, but instead created a virtually impossible burden of proof for the taxpayer. The *Union Trust* court established two components of a prima facie case for the IRS in a section 7602 summons enforcement proceeding, an investi-

---

his concurrence in the Fourth Circuit result, underscored that rationale, applying the principle of collateral estoppel to support his conclusion. *Id.* at 422 (Widener, J., concurring).

[56] The petition for enforcement filed by the IRS in *Union Trust* alleged compliance with the *Powell* good faith requirements. *See* note 12 *supra*. The affidavit of the agent supported the conclusion. 588 F.2d at 420; *see also* Lipton, *supra* note 6, at 81, citing United States v. McCarthy, 514 F.2d 368 (3d Cir. 1975) (agent's affidavit is sufficient to support his statement of compliance with *Powell*). In light of *LaSalle*, however, the question of whether the individual agent was competent to make such allegations for the institution should be an important inquiry. Judge Widener addressed that question in *Union Trust*, stating that the affidavit of the IRS agent was insufficient evidence to establish a prima facie showing of the institutional commitment of the IRS because the affidavit gave no factual basis for the conclusion of compliance with *LaSalle*. 588 F.2d at 422 (Widener, J., concurring).

[57] 588 F.2d at 420.

[58] *Id.* at 421.

[59] *Id.*

[60] *See* note 44 *supra*.

[61] In United States v. O'Henry's Film Works, Inc., 598 F.2d 313, 320 (2d Cir. 1979), the court held that discovery and evidentiary hearings should be allowed only where the taxpayer makes a "substantial preliminary showing" to support his burden of proof. In United States v. Broadview Sav. & Loan, [1979] FED. TAX. REP. (CCH) (79-2 U.S.T.C.) ¶ 9490 at 87,766, 87,769 (N.D. Ohio 1979), the court stated that only minimal discovery or evidentiary hearing should be allowed, if at all, because Congress intended enforcement proceedings to be summary in nature.

[62] *See* 437 U.S. at 316. Although the Supreme Court in *LaSalle* established a heavy burden of proof on the taxpayer to show bad faith in an enforcement proceeding because of policy considerations, the Court specifically stated that the good faith inquiry in such proceedings cannot be abandoned. *Id.* There are countervailing policy considerations which support the taxpayer's right to challenge a summons on bad faith grounds before the recommendation for prosecution. *See* note 13 *supra*.

gating agent's petition for enforcement and a supporting affidavit,[63] which are relatively easy to produce. To rebut that prima facie evidence, however, a taxpayer would have to produce facts to which he has no access because of court-sanctioned strict limitations on discovery.[64] The result in *Union Trust* is that the Fourth Circuit accords too much deference to the IRS, giving the IRS too much power while depriving the taxpayer of any effective defense in a summons enforcement proceeding.

The Supreme Court in *LaSalle* purported to resolve the confusion and inconsistencies in the law relating to enforcement of section 7602 summonses.[65] The decision in *LaSalle* provided no concrete standards, however, to guide lower federal courts in the implementation of the policy enunciated in *LaSalle*.[66] As *Union Trust* illustrates,[67] in the absence of such standards taxpayers well may be stripped of their rights as courts defer to the power of the IRS. If, as it appears, the judiciary is unable to deal effectively with the interpretation of section 7602, perhaps congressional action to define the rights and responsibilities of the IRS and the taxpayer under section 7602 is the answer to the dilemma of the lower federal courts.

MARGARET HUTCHINS CAMPBELL

---

[63] *See* note 56 *supra*.
[64] *See* note 61 *supra* and text accompanying note 55 *supra*.
[65] *See* note 13 *supra*.
[66] *See* text accompanying notes 12 & 13 *supra*.
[67] *See* text accompanying notes 48-64 *supra*.