FEDERAL TAXATION

*by Marilyn E. Phelan**

The Fifth Circuit decided fifteen cases involving federal taxation issues during the current survey period.[1] A few of the cases involved unprecedented issues. One case established that an employee may bring a tort action against an employer who fails to correct a W-2 form on a timely basis.[2] Another unique case involved the sixth appearance of an unfortunate taxpayer before the Fifth Circuit, a victim of a successful effort by the Internal Revenue Service ("IRS" or the "Service") to confirm its strict, and often harsh, investigative powers.[3]

The Fifth Circuit maintained its tradition of applying a strict interpretation of the Internal Revenue Code (the "Code") and its

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1. June 1, 1987 through May 31, 1988.

2. *See* Clemens v. USV Pharmaceutical, 838 F.2d 1389 (5th Cir. Mar. 1988); *see infra* notes 52-57 and accompanying text.

3. *See* United States v. Barrett, 837 F.2d 1341 (5th Cir. Feb. 1988), *petition for cert. filed*, 56 U.S.L.W. 3739 (U.S. Apr. 26, 1988) (No. 87-1705); *see infra* notes 100-46 and accompanying text.

regulations, and continued to narrowly construe statutes waiving governmental immunity. As a result, some taxpayers will continue to be without a remedy to seek redress against the IRS.

I. CORPORATION AS AN AGENT OF A PARTNERSHIP

The Supreme Court recently determined that a nominee corporation, used to borrow required partnership funds and to hold legal title to the secured property, may be treated as an agent of the partnership. Thus, the losses produced by the partnership's use of the borrowed funds and the secured property can be passed as deductions to the partners.[4] Prior to this decision, partnership investors were faced with a dilemma in states having usury laws permitting only corporations to borrow money at the higher interest rates. When a financial institution refused to loan money to members of a partnership because of the usury laws, partners were forced to borrow needed funds through a corporate entity and were faced with the problem that courts had generally not permitted the taxpayers to ignore the corporate existence for tax purposes.[5] As a result, the corporation, rather than the partnership, was entitled to the tax deduction. The deduction could not be passed through to the investors.[6]

To preclude recognition of a separate corporate status, taxpayers had frequently used an agency concept when a corporate entity was established solely for borrowing purposes.[7] Under this theory, legal title to the property was held in the name of a corporation, but the

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4. *See* Commissioner v. Bollinger, ____ U.S. ____, 108 S. Ct. 1173, 99 L. Ed. 2d 357 (1988).

5. *See, e.g.*, Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

6. *See, e.g.*, Ourisman v. Commissioner, 760 F.2d 541 (4th Cir. 1985), *aff'd sub nom.* Commissioner v. Bollinger, ____ U.S. ____, 108 S. Ct. 1173, 99 L. Ed. 2d 357 (1988); Roccaforte v. Commissioner, 708 F.2d 986 (5th Cir. 1983).

7. The test of agency was set out in National Carbide v. Commissioner, 336 U.S. 422 (1949). The Supreme Court determined that an agent can handle the property and income of its owner-principal without being taxed on such income if six conditions are met: (1) the corporation must operate in the name and for the account of the principal; (2) the corporation must bind the principal by its actions; (3) the corporation must transmit money received to the principal; (4) the receipt of income must be attributable to the services of employees of the principal; (5) the relations of the corporation with the agent must not be dependent upon the fact that the agent corporation is owned by the principal; and (6) the business purpose of the corporation must be the carrying on of the normal duties of an agent. *Id.* at 437. The fifth and sixth conditions have been crucial in determining whether the corporation is, in fact, an agent of the principal (*i.e.*, the limited partnership).

partners would enter into an agreement with the corporation wherein the corporation would transact no business on its own account.[8] The corporation would act as an agent with respect to the property. Applying the six-part test of *National Carbide v. Commissioner*[9] to determine whether the corporation was a true agent, the Tax Court had frequently found such a corporation to be a nontaxable agent of the partnership when the agreement provided both that the corporation had only record title and that the partnership was the legal and beneficial owner.[10] The Fourth and Fifth Circuits had disagreed however, determining that the fifth and sixth requirements of the six-part test in *National Carbide* were mandatory; that is, the requirement that the relations of the corporation with its principal must not be dependent upon the fact that the agent corporation was owned by the principal, and the requirement that the business purpose of the corporation must be the carrying on of the normal duties of an agent.[11] If a corporation did not exist independent of the partnership, the Fourth and Fifth Circuits had held that a true agency status did not exist.[12] The Sixth Circuit, on the other hand, agreed with the Tax Court's holdings that a corporation could be a true agent of the partnership based upon the overall substance of the agreement and had sustained a Tax Court finding of agency in *Commissioner v. Bollinger*.[13] In 1987 the Supreme Court affirmed the decision of the Sixth Circuit in *Bollinger* ruling that a controlled corporation can be a true agent of a partnership if a three-part test

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8. *See* George v. Commissioner, 803 F.2d 144 (5th Cir. 1986).

9. 336 U.S. 422 (1949).

10. *See, e.g.*, Ourisman v. Commissioner, 82 T.C. 171 (1984), *vacated*, 760 F.2d 541 (4th Cir. 1985), *aff'd sub nom.* Commissioner v. Bollinger, ___ U.S. ___, 108 S. Ct. 1173, 99 L. Ed. 2d 357 (1988). The Fourth Circuit, however, reversed the Tax Court on appeal. *See* Ourisman v. Commissioner, 760 F.2d 541 (4th Cir. 1985), *aff'd sub nom.* Commissioner v. Bollinger, ___ U.S. ___, 108 S. Ct. 1173, 99 L. Ed. 2d 357 (1988). The Tax Court's finding of agency was reversed in George v. Commissioner, 803 F.2d 144 (5th Cir. 1986). However, in Commissioner v. Bollinger, 807 F.2d 65 (6th Cir. 1986), the Sixth Circuit sustained the Tax Court's finding of agency. The Supreme Court affirmed the Sixth Circuit in Commissioner v. Bollinger, ___ U.S. ___, 108 S. Ct. 1173, 99 L. Ed. 2d 357 (1988).

11. *See* George v. Commissioner, 803 F.2d 144, 148 (5th Cir. 1986), *vacated*, ___ U.S. ___, 108 S. Ct. 1264, 99 L. Ed. 2d 476 (1988); Ourisman v. Commissioner, 760 F.2d 541, 547-48 (4th Cir. 1985), *aff'd sub nom.* Commissioner v. Bollinger, ___ U.S. ___, 108 S. Ct. 1173, 99 L. Ed. 2d 357 (1988); Roccaforte v. Commissioner, 708 F.2d 986, 989-90 (5th Cir. 1983).

12. *See* cases cited *supra* note 11.

13. 807 F.2d 65, 69 (6th Cir. 1986).

is met.[14] According to the Supreme Court in *Bollinger*, a corporation will be treated as an agent under the following circumstances: (1) the corporation is acting as an agent for its shareholders with respect to a particular asset as set forth in a written agreement at the time the asset is acquired, (2) the corporation functions as an agent and not the principal with respect to the asset for all purposes, and (3) the corporation is held out as the agent and not the principal in all dealings with third parties relating to the asset.[15]

In *George v. Commissioner*,[16] which was decided initially prior to *Bollinger*, the Fifth Circuit determined that the Tax Court's finding of agency in that case was clearly erroneous.[17] The Tax Court had ruled that a corporation formed for the sole purpose of borrowing money to purchase a hotel was the agent of a partnership.[18] A mortgage company had refused to loan money to the partnership on the grounds that the applicable interest rate would have been usurious to a partnership under Mississippi law.[19] Reversing the Tax Court, the Fifth Circuit denied the partnership any deductions for losses connected with the hotel project.[20] The Supreme Court, however, vacated that decision after its determination in *Bollinger* that a corporation could be a true nontaxable agent of a partnership and remanded the *George* case to the Fifth Circuit for further consideration of the issues in light of *Bollinger*.[21]

On remand, the Fifth Circuit determined that the corporation met the three-part test set forth by the Supreme Court in *Bollinger* and, thus, affirmed the Tax Court's finding of agency.[22] The Fifth Circuit noted that *Bollinger* had held that the fifth factor of *National Carbide* was not a rigid requirement, ruling that it was nothing more than a generalized statement of concern that the separate corporate entity doctrine not be subverted.[23] In *George II* the court concluded

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14. Commissioner v. Bollinger, ___ U.S. ___, 108 S. Ct. 1173, 99 L. Ed. 2d 357 (1988).

15. *Id.* at ___, 108 S. Ct. at 1179, 99 L. Ed. 2d at 366-67.

16. 803 F.2d 144 (5th Cir. 1986), *vacated*, ___ U.S. ___, 108 S. Ct. 1264, 99 L. Ed. 2d 476 (1988).

17. *Id.* at 149.

18. *Id.*

19. *Id.*

20. *Id.*

21. George v. Commissioner, 844 F.2d 225, 226 (5th Cir. May 1988) ("George II").

22. *Id.* at 226, 229.

23. *Id.* at 228; *see supra* note 7.

that when it is clear that the parties intended a corporation act only as an agent, there is no need to make a separate strict inquiry about the extent to which the agent corporation's status is dependent on the principal's ownership.[24]

George II upheld the Tax Court's method of allocating total income and deductions of the partnership between the partnership and a second corporation that was not an agent so that income and deductions attributable to the second corporation could not be passed through to the partners.[25] The Fifth Circuit noted that a taxpayer has the burden of introducing evidence as to the proper amount of income and deductions to allocate to each corporation.[26] Where the taxpayer introduces no evidence, the Tax Court may allocate based on the only evidence available to it.[27]

II. Factors to be Considered in Determining "Reasonable Compensation"

Section 162(a)(1) of the Code grants a tax deduction for "a reasonable allowance for salaries or other compensation . . . ."[28] The Service, however, may often determine that a portion of the salary paid to officers of a closely held corporation is unreasonable and thus not deductible. The Fifth Circuit pointed out in *Owensby & Kritikos, Inc. v. Commissioner*[29] that it is in the interest of all parties in a small closely held corporation to characterize amounts distributed to a shareholder-employee as compensation rather than as a dividend; compensation is deductible to the corporation and a dividend is not.[30] The deductibility of compensation is seldom questioned in large publicly held corporations because the corporation generally deals at arm's length with its employees.[31] In the small closely held corporation, however, the Service will permit a corporation to deduct compensation only to the extent it is reasonable, characterizing any payment that is "unreasonable" as a disguised dividend.[32] While the

24. 844 F.2d at 229.
25. *Id.* at 229-30.
26. *Id.* at 229.
27. *Id.*
28. I.R.C. § 162(a)(1)(1984).
29. 819 F.2d 1315 (5th Cir. June 1987).
30. *Id.* at 1323.
31. *Id.*
32. *Id.* at 1322-23.

reasonableness of compensation paid by a corporation is a question of fact,[33] a determination by the Service that payment for compensation is unreasonable carries a presumption of correctness; the burden is on the corporation to show that it is entitled to a deduction larger than that permitted by the Service.[34]

In *Owensby* the Fifth Circuit reviewed the factors a trial court should consider in determining whether compensation is reasonable.[35] One factor pointing toward a conclusion that compensation paid is in part unreasonable is that the payment is a large portion of the net income of the corporation.[36] Although the Fifth Circuit specifically rejected the "automatic dividend rule," whereby even reasonable compensation to a shareholder-employee is automatically deemed to include disguised dividends if the corporation has been profitable and has not paid dividends,[37] the court did conclude that the absence of dividend payments by a profitable corporation that can offer no specific reason for its failure to pay dividends is another factor for the trial court to consider in determining whether the compensation paid is reasonable.[38] The Fifth Circuit did agree with the taxpayer corporation that its dividend practices should be considered along with the fact that many of its investors prefer stock appreciation over dividends;[39] however, the court rejected the corporation's theory that there should be a substantial presumption that compensation paid a shareholder-employee is reasonable if the corporation is earning a sufficient return, after payment of compensation to the shareholder-employees, to satisfy an independent investor.[40] Instead, the court agreed that when a company's earnings on equity, after pay-

33. *Id.* at 1323.

34. *Id.* at 1324.

35. *See id.* at 1323. The factors were set out in Mayson Mfg. Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949). They include the following: the employer's qualifications; the nature, extent and scope of the employer's work; the size and complexities of the business; a comparison of paid salaries with gross income; the prevailing general economic conditions; comparison of salaries with distributions to shareholders; the prevailing rates of compensation for comparable positions in comparable concerns; and the salary policy of the taxpayer as to all employees. *Id.* at 119.

36. 819 F.2d at 1325-26.

37. *Id.* at 1326; *see* Elliot's Inc., v. Commissioner, 716 F.2d 1241 (9th Cir. 1983); McCandless Fire Serv. v. United States, 422 F.2d 1336 (Cl.Ct. 1970).

38. 819 F.2d at 1326.

39. *Id.*

40. *See id.* at 1326-27.

ment of compensation to its shareholder-employees, remain at a level which would satisfy an independent investor, there is a strong indication that compensation is reasonable and that this factor should be weighed in the taxpayer's favor.[41] Still the Fifth Circuit concluded that this so-called independent investor test is only another factor to be considered by the trial court.[42]

The Fifth Circuit disagreed with the Tax Court that an incentive bonus for shareholder-employees is a questionable practice.[43] Although the Tax Court reasoned that an incentive bonus tied to company performance is not needed for an employee who is also a shareholder, the Fifth Circuit decided that if an incentive bonus would be appropriate for a nonshareholder-employee, there is no reason to deny participation to a shareholder-employee.[44] According to the Fifth Circuit, a shareholder-employee should be treated as two distinct individuals for tax purposes—an independent investor and an employee.[45] If the shareholder improperly uses his role as an investor to influence his compensation, the compensation will likely be declared unreasonable.[46] However, his status as a shareholder should not prohibit him from receiving his appropriate return on his labor.[47] By the court's reasoning, that return may well include an incentive bonus.[48] The court concluded that the existence of work agreements are seldom a factor in determining whether compensation paid the shareholder-employee is reasonable.[49]

The Fifth Circuit held that the Tax Court's finding of fact in *Owensby*, that compensation paid the shareholder-employees by the corporation was in part unreasonable, was not clearly erroneous.[50] In reaching this conclusion, the Fifth Circuit noted that the controlling shareholders were paid in direct proportion to their stockholdings, that the corporations paid no dividends during the years at issue, that a large portion of net income to the shareholders was

41. *Id.*
42. *Id.*
43. *Id.* at 1328.
44. *Id.*
45. *Id.*
46. *Id.*
47. *Id.*
48. *Id.*
49. *Id.* at 1329.
50. *Id.* at 1334.

paid as compensation, and that the highest pay of the nonshareholder-employees was only a fraction of the amount paid to the average shareholder-employee.[51]

III. Failure to Correct a W-2 Form Gives Rise to Tort Action Against Employer

In *Clemens v. USV Pharmaceutical*[52] the Fifth Circuit held that an employee or an ex-employee may have a tort action against an employer who refuses to correct, on a timely basis, erroneous information reported to the IRS on the employee's W-2 form.[53] The court in *Clemens* stated that persons who undertake the duty of filing information returns concerning their employees and ex-employees have a duty to act with reasonable promptness to correct erroneous information they have sent to the IRS when such errors are brought to their attention.[54] This duty rests upon the person who files the return because the person who is shown to receive income is powerless to correct the mistake.[55] Failure to correct the form constitutes negligence if the person who erroneously filed the return, in exercising ordinary prudence under all the circumstances, should reasonably have foreseen some injury to the employee or ex-employee and if the person fails to exercise reasonable care to avoid that injury.[56] The court determined that an employee or ex-employee can recover out-of-pocket expenditures incurred in trying to correct the problem with the IRS and can recover for the value of the time reasonably devoted to that end.[57]

IV. Right of Action Under ERISA to Recover Contributions Mistakenly Overpaid

The Circuits have been split in deciding the issue of whether ERISA carries with it an implied right of action for recovery of mistaken contributions in the form of a direct suit by an employer

51. *See id.* at 1333.
52. 838 F.2d 1389 (5th Cir. Mar. 1988).
53. *Id.* at 1391.
54. *Id.* at 1395.
55. *Id.* at 1394.
56. *Id.* at 1395.
57. *Id.* at 1396.

against an employee benefit plan.[58] Although the Fifth Circuit in *South Central United Food & Commercial Workers Unions v. C&G Markets, Inc.*[59] stated that it agreed with those circuits holding that there is no affirmative right of action in favor of the employer under ERISA,[60] it did determine that an employer can offset mistakenly overpaid contributions against any delinquency owed by the employer.[61] Thus, according to the Fifth Circuit, when an action is brought by the plan trustee against the employer to collect a delinquency, the employer can counterclaim the overpayment.[62]

V. TAX PROCEDURE

A. Applicability of the Doctrine of Sovereign Immunity in Suits Against the Internal Revenue Service

The doctrine of governmental immunity generally prevents suits against the United States without its consent.[63] Although taxpayers and third parties may sue the government in limited circumstances to recover a tax that has been erroneously or illegally assessed or collected, or to clear title to property subject to a federal tax lien, the courts have held that any waivers of sovereign immunity must be narrowly construed.[64] Section 1346(a)(1) of title 28 gives district courts original jurisdiction of "any civil action against the United States for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority."[65] However, several courts, including the Fifth Circuit, have held that this statute permits

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58. *See* Coal Co. v. Combs, 796 F.2d 394 (11th Cir. 1986); Service Inc. v. Northern Cal. Retail Clerks Unions & Employers Joint Revisions Trust Fund, 763 F.2d 1066 (9th Cir. 1985), *cert. denied*, 474 U.S. 1081 (1986); Cork & Seal Co. v. Teamsters Pension Fund, 549 F. Supp. 307 (E.D. Pa. 1982), *aff'd*, 720 F.2d 661 (3d Cir. 1983).

59. 836 F.2d 221 (5th Cir. Jan. 1988), *cert. denied*, ___ U.S. ___, 108 S. Ct. 2823, 100 L. Ed. 2d 924 (1988).

60. *Id.* at 224.

61. *Id.* at 225.

62. *Id.*

63. *See* Lehman v. Nakshian, 453 U.S. 156 (1981); United States v. Testan, 424 U.S. 392 (1976).

64. *See, e.g.*, Garcia v. United States, 776 F.2d 116 (5th Cir. 1985).

65. 28 U.S.C. § 1346(a)(1) (1982).

only the "taxpayer" who has paid a tax to seek its refund.[66] According to the Fifth Circuit, the statute is not applicable to a "third party."[67]

The Fifth Circuit has narrowly interpreted the statute although conceding that the language of the statute is susceptible to a broader interpretation.[68] The Fifth Circuit's construction of 28 U.S.C. section 1346 gives effect to the policy of interpreting all waivers of governmental immunity narrowly.[69]

Another statute allows a "third party" holding title to real estate subject to a federal tax lien to sue the government for the purpose of securing an adjudication as to the validity of the lien.[70] Courts have questioned whether a "taxpayer" may use the statute, 28 U.S.C. section 2410, to contest the procedural regularity of a lien or whether the statute is applicable only to a "third party."[71]

A "third party" may also file a refund suit against the government under section 7426 of the Internal Revenue Code[72] when there has been a wrongful "levy" by the government on property belonging to the third party.[73] The Fifth Circuit has also narrowly construed the waiver of sovereign immunity under this statute. In *Interfirst Bank Dallas v. United States*[74] the Fifth Circuit ruled that no action is permitted under section 7426 unless there has been an actual "levy" upon the property claimed.[75] The Fifth Circuit denied Interfirst, the creditor bank, the right to sue the federal government for the return of accounts receivable subject to the bank's first lien that had been voluntarily surrendered to the IRS by the debtor's corporation to pay the corporation's delinquent employment taxes.[76] The Fifth Circuit held that because the debtor corporation voluntarily

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66. *See, e.g.*, Interfirst Bank Dallas v. United States, 769 F.2d 299 (5th Cir. 1985), *cert. denied*, 475 U.S. 1081 (1986); Busse v. United States, 542 F.2d 421 (7th Cir. 1976); Hofheinz v. United States, 511 F.2d 661 (5th Cir. 1975); Phillips v. United States, 346 F.2d 999 (2d Cir. 1965).

67. Snodgrass v. United States, 834 F.2d 537, 539 (5th Cir. Dec. 1987).

68. *Id.* at 539.

69. *Id.*

70. *See* 28 U.S.C. § 2410 (1982).

71. *See, e.g.*, United States v. Brosnan, 363 U.S. 237, 247 n.11 (1960); Aqua Bar & Lounge v. United States Dep't of Treasury, 539 F.2d 935 (3rd Cir. 1976).

72. 26 U.S.C. § 7426 (1982).

73. *Id.*

74. 769 F.2d 299 (5th Cir. 1985).

75. *Id.* at 304.

76. *Id.* at 302.

surrendered the accounts receivable to the IRS, there was no "levy" on the accounts.[77] Thus, the creditor bank could not sue for a recovery under section 7426.[78]

In two recent, and seemingly inconsistent, cases, the Fifth Circuit reviewed the rights of a taxpayer and a third party to sue the government under 28 U.S.C. sections 1346 and 2410.[79] Reconsidering the two statutes, the court again narrowly construed the provisions of 28 U.S.C. section 1346 affirming its position that the statute is only applicable to a "taxpayer."[80] The Fifth Circuit determined that the wife of a "taxpayer" is a "third party" and thus, is without a right to sue under section 1346.[81] On the other hand, the Fifth Circuit expanded the definition of a "third-party" who can sue the government under section 2410 to quiet title to property subject to a tax lien to include an executor of the estate of a "taxpayer."[82]

In *Snodgrass v. United States*[83] the Government had filed a lien on the residence of the claimant due to the failure of the claimant's husband to pay federal income taxes and social security taxes withheld from employees of companies of which the claimant's husband was an official.[84] When the home was sold, the Government demanded that it be paid the proceeds of the sale as a condition for releasing its tax lien so that the sellers could give the buyer clear title to the home.[85] The claimant, Mrs. Snodgrass, then filed suit against the United States to recover her one-half community interest in the proceeds.[86] The Fifth Circuit affirmed the district court's dismissal of her suit finding that she failed to establish that the Government had coerced her into paying the taxes.[87] It also ruled that the waiver of governmental immunity under section 1346 was not applicable because the claimant was not the "taxpayer"—the claimant's husband

77. *Id.* at 305.
78. *Id.* at 304-05.
79. Estate of Johnson v. United States, 836 F.2d 940 (5th Cir. Mar. 1988); Snodgrass v. United States, 834 F.2d 537 (5th Cir. Dec. 1987).
80. 834 F.2d at 539.
81. *Id.*
82. *See* 836 F.2d at 947.
83. 834 F.2d 537 (5th Cir. Dec. 1987).
84. *Id.* at 538.
85. *Id.*
86. *Id.*
87. *Id.*

was the "taxpayer."[88] Although the court recognized that its dismissal of the claimant's suit could result in her having no remedy against the government, the court commented that "a waiver of sovereign immunity is not one of generosity and broad interpretation."[89] By the Fifth Circuit's reasoning, courts lack jurisdiction to remedy the wrongs of democratic sovereigns.[90]

The Fifth Circuit was more concerned with the rights of "third parties" in *Estate of Johnson v. United States*,[91] deciding that the executor of an estate could bring suit against the government to challenge the priority of its tax lien even though the court admitted that the decedent "taxpayer" could not have done so.[92] Under section 2410(a), a "third party" may bring suit to quiet title to property subject to federal tax liens.[93] The Fifth Circuit stated that although much debate has centered on the question of whether taxpayers can bring suit to quiet title under section 2410(a), it would not decide that issue.[94] It concluded rather that the executor could bring suit under section 2410(a) because the executor qualified as a "third party."[95] The IRS had maintained that for tax purposes the executor was the equivalent of the decedent and thus could have no greater rights to bring suit under the statute than the decedent.[96] Although the Fifth Circuit admitted that the executor stepped into the shoes of the decedent with the respect to federal income tax liabilities, it determined that because the executor was required to pay debts of the estate, some of which that had arisen after the taxpayer's death, the executor was acting as a third party.[97] Thus, the court determined that the executor could bring an action under section 2410(a) to quiet title to property of the decedent that was burdened by federal tax liens.[98]

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88. *Id.* at 539.
89. *Id.* at 540.
90. *Id.*
91. 836 F.2d 940 (5th Cir. Mar. 1988).
92. *Id.* at 947.
93. *See* 28 U.S.C. § 2410 (1982).
94. 836 F.2d at 944-45.
95. *Id.* at 947.
96. *Id.* at 945.
97. *Id.* at 947.
98. *Id.*

B. *Assertation of the Fifth Amendment in Suits to Challenge Tax Deficiency*

In *Tweeddale v. Commissioner*[99] the Fifth Circuit reaffirmed its position that a taxpayer cannot sufficiently challenge a tax deficiency by failing to produce evidence and claiming a self-incrimination privilege.[100] The taxpayer in *Tweeddale* claimed an exemption from income taxes from 1978 through 1981 because he was a designated minister of the Basic Bible Church of America.[101] He was also earning a salary ranging from $55,000 to $82,000 during those years as a pilot for Braniff Airways.[102] Concerned that several other Braniff pilots claiming similar exemptions had been convicted of income tax evasion, the taxpayer, invoking his fifth amendment privilege, refused to answer questions regarding his salary from Braniff.[103] The Fifth Circuit affirmed the decision of the Tax Court that the taxpayer failed to carry his burden of proving that the Commissioner's findings in its deficiency notice were incorrect.[104] As the court stated, the taxpayer was not faced with the choice of testifying or accepting the entry of judgment against him; he had a third option of presenting evidence other than his own testimony.[105]

C. *Summonses of Records*

For the sixth time, the Fifth Circuit focused on the plight of a doctor who was the subject of what he deemed to be an unfair and prejudicial criminal tax investigation. In *United States v. Barrett*[106] the Fifth Circuit reviewed four of its previous decisions regarding the enforcement of IRS summonses that requested the names of the doctor's patients after an IRS agent revealed to the patients that the

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99. 841 F.2d 643 (5th Cir. Apr. 1988).
100. *Id.* at 645.
101. *Id.*
102. *Id.*
103. *Id.*
104. *Id.*
105. *Id.*
106. 837 F.2d 1341 (5th Cir. Feb. 1988), *petition for cert. filed*, 56 U.S.L.W. 3739 (U.S. Apr. 26, 1988) (No. 87-1705).

doctor was the subject of a criminal tax investigation.[107] In the current *Barrett* decision, *Barrett IV*, the Fifth Circuit sitting en banc determined that a district court cannot conditionally enforce an IRS summons to prevent the IRS from violating the nondisclosure requirement of section 6103 of the Code.[108] In so holding, the Fifth Circuit overruled an earlier decision, *United States v. Texas Heart Institute*,[109] which involved Barrett, but was filed initially by four of the hospitals in which Barrett had practiced.[110] The suits were filed in order to question the propriety of the summons issued to the hospitals requesting the production of the names of Barrett's patients.[111]

Barrett's personal and corporate income tax returns for the years 1976, 1977, and 1978 were audited in 1979; because a $100,000 discrepancy existed between Barrett's books and his bank records, the IRS transferred its case from its civil to its criminal division.[112] The agent to whom the case was transferred determined that letters should be mailed to Barrett's patients inquiring of them the amounts they had paid for Barrett's services.[113] Summonses were sent both to the hospitals in which Barrett practiced and to Barrett himself.[114] All but four of the hospitals complied with the summonses and provided the IRS with the names of many of Barrett's patients.[115] The IRS then mailed letters to those patients inquiring of them the amounts

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107. United States v. Barrett, 804 F.2d 1376 (5th Cir. 1986), *reh'g granted*, 812 F.2d 936 (5th Cir. 1987); United States v. Texas Heart Inst., 755 F.2d 469 (5th Cir. 1985), *overruled by*, United States v. Barrett, 837 F.2d 1341 (5th Cir. Feb. 1988); United States v. Barrett, 787 F.2d 958 (5th Cir. 1986), *withdrawn*, 804 F.2d 1376 (5th Cir. 1986); *see also In re* Grand Jury Subpoenas on Barrett, 818 F.2d 330 (5th Cir. 1987), *cert. denied*, ___ U.S. ___, 108 S. Ct. 163, 98 L. Ed. 2d 117 (1987) (Barrett's action to quash certain grand jury subpoenas and to terminate the criminal investigation dismissed); Barrett v. United States, 795 F.2d 446 (5th Cir. 1986) (reversing a summary judgment for the government in Barrett's civil action for damages against the IRS under § 7431 of the Internal Revenue Code).

108. 837 F.2d at 1351. Section 6103 of the Internal Revenue Code provides that returns and return information are confidential and, except as otherwise specifically authorized by § 6103, no officer or employee of the United States or of any state or any person who has or had access to returns or return information, may disclose any such information. *See* 26 U.S.C. § 6103(a) (1982).

109. 755 F.2d 469 (5th Cir. 1985).

110. *Id.* at 478.

111. *Id.*

112. 837 F.2d at 1343.

113. *Id.*

114. *Id.*

115. *Id.*

they had paid to Barrett for his services and informing them that Barrett was under criminal investigation by the IRS.[116]

The right of the IRS to enforce the summonses issued to the four noncomplying hospitals was litigated in *United States v. Texas Heart Institute.*[117] The Fifth Circuit remanded *Texas Heart* for a determination by the district court of whether the statements in prior mailings concerning the criminal investigation of Barrett were unauthorized disclosures of return information under section 6103 of the Code, and whether the district court's enforcement order should be modified so as to prohibit the Service from informing Barrett's patients of the criminal investigation.[118] However, in its *Barrett II* decision, which involved an enforcement order against Barrett, the Fifth Circuit did not make such a requirement of the district court.[119]

The Fifth Circuit had stated in *Barrett I* that a taxpayer's remedy for unlawful violations of section 6103 lies in the civil provisions set out in section 7431 of the Code which permits taxpayers to collect damages because of wrongful disclosures by the IRS of return information.[120] There, the Fifth Circuit ruled that a district court could refuse the unconditional enforcement of an IRS summons only if there was an abuse of its process.[121] It further determined that abuse of process is limited to those instances in which the summons was issued for an improper purpose "such as to harass the taxpayer or to put pressure on him to settle a collateral dispute or for any other purpose reflecting on the good faith of the particular investigation."[122]

Judge Brown dissented arguing that the *Barrett I* decision implicity overruled *Texas Heart.*[123] Upon Barrett's petition for rehearing, the *Barrett III* court withdrew its opinion in *Barrett I* affirming the enforcement of the summons but remanding the case to the district court instructing it to follow *Texas Heart* and to decide whether section 6103 was being violated.[124] If section 6103 was found to have

116. *Id.*
117. 755 F.2d 469 (5th Cir. 1985).
118. 837 F.2d at 1343.
119. *Id.*
120. United States v. Barrett, 787 F.2d 958, 960 (5th Cir. 1986).
121. *Id.* at 962.
122. *Id.* (citing United States v. Powell, 379 U.S. 48, 58 (1964)).
123. 837 F.2d at 1343.
124. *Id.*

been violated, the district court was to enforce conditionally the summons to prevent the IRS from making such disclosures.[125] However, after the government petitioned for a rehearing of *Barrett III*, the Fifth Circuit agreed to hear the case en banc.[126]

In *Barrett IV* the Fifth Circuit held that a district court cannot conditionally enforce an IRS summons to ensure that the IRS will not violate the nondisclosure of return information provisions of section 6103 of the Code during the course of a tax investigation.[127] The court then overruled *Texas Heart*.[128]

Barrett IV noted the four requirements set forth by the Supreme Court in *United States v. Powell*[129] to enforce an IRS summons.[130] An IRS agent must show: (1) that the investigation will be conducted pursuant to a legitimate purpose; (2) that the inquiry may be relevant to the purpose; (3) that the information sought is not already within the possession of the IRS; and (4) that the administrative steps required by the Code have been followed.[131] A court can inquire into the underlying reasons for the examination and should not permit its process to be abused, but the court cannot conditionally enforce a summons.[132] An abuse of process would occur "if the summons had been issued for an improper purpose, such as to harass the taxpayer, or to put pressure on him to settle a collateral dispute, or for any other purpose reflecting on the good faith of the particular investigation."[133]

The Fifth Circuit commented that the government bears the initial burden of proving that the four *Powell* requirements have been satisfied.[134] Once it makes the required *Powell* showing, the burdened then shifts to the party resisting the summons to challenge the summons on any appropriate ground.[135] The grounds include a failure of the IRS to meet any one of the four *Powell* requirements and the possibility that the enforcement of the summons would abuse

125. *Id.*
126. *Id.*
127. *Id.* at 1350-51.
128. *Id.* at 1351.
129. 379 U.S. 48 (1964).
130. 837 F.2d at 1344.
131. *Id.*
132. *Id.* at 1344-45, 1351.
133. *Id.* at 1345 (citing United States v. Powell, 379 U.S. 48, 58 (1964)).
134. *Id.*
135. *Id.*

the court's process.[136] The Fifth Circuit ruled in *Barrett IV* that the district court can only decide whether to enforce the summons; it cannot conditionally enforce the order.[137]

Although the Fifth Circuit has often held that an appeal from an order enforcing a summons becomes moot once the taxpayer complies with the summons,[138] it determined that the appeal in *Barrett IV* was not moot despite the fact that Barrett had complied with the order.[139] According to the court, the issue was not whether the enforcement order was valid but whether the district court could attach conditions on the government's use of the information obtained under the summons.[140]

Four justices dissented in *Barrett IV*, one vigorously, to the majority's decision to overrule *Texas Heart*. According to Justice Brown in his dissenting opinion, the majority opinion has the effect of preventing a district court from exercising its "residual, equitable discretion" to condition enforcement of an IRS summons so that return information will not be disclosed by the IRS.[141] Justice Brown commented that he would

> [A]dd to the cumulative literature of *Barrett I, II,* and *III,* only that to this day there has been no statement, either from on high in the Solicitor's office or the Department of Justice, or on the lower rungs of the IRS field agents, concerning why it was reasonably necessary to inform the patient interviewees that Dr. Barrett was under criminal investigation.[142]

Justice Brown noted that in a hearing to determine whether the standards of *Powell* have been followed, the IRS is already required to prove that it possesses a legitimate investigative purpose for the summons.[143] According to Justice Brown, the determination of whether a legitimate investigative purpose exists for the summons is not far removed from a determination of whether "the practices flowing from its enforcement are an unnecessary invasion of privacy or

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136. *Id.*

137. *Id.* at 1351.

138. *See* United States v. Sherlock, 756 F.2d 1145 (5th Cir. 1985); United States v. First Am. Bank, 649 F.2d 288, 289 (5th Cir. 1981); Baldridge v. United States, 406 F.2d 526, 527 (5th Cir. 1969); Lawhon v. United States, 390 F.2d 663 (5th Cir. 1968).

139. 837 F.2d at 1348.

140. *Id.* at 1351.

141. *Id.* at 1352 (Brown, J., dissenting).

142. *Id.* at 1356 (Brown, J., dissenting).

143. *Id.* (Brown, J., dissenting).

threaten injury to a taxpayer's reputation."[144] Justice Brown pointed out that the President, the Congress and its committees, the Department of Justice, and all other executive departments or agencies must comply with section 6103, but as Justice Brown stated, an IRS agent need not.[145] A further, more serious problem, according to Justice Brown, is that a court has no power to forbid the agent's violation because *Texas Heart* has now been overruled.[146]

VI. CONCLUSION

The Fifth Circuit had substantially less federal taxation cases decided during the current survey period than in the past. The most significant case of the survey period was *United Stated v. Barrett*[147] which established that a district court may not exercise its residual, equitable discretion to condition the enforcement of an IRS summons so as to prevent the IRS from disclosing return information procured by the summons. The latest decision of the Fifth Circuit found in the lengthy *Barrett* narrative has the effect of taking away most limitations on the expansive, discretionary power of the IRS in a summons enforcement proceeding and portends ill consequences for taxpayers.

In its holding in *Clemens v. USV Pharmaceutical*,[148] that an employee or ex-employee has a tort action against his or her employer for refusing to correct erroneous information reported on a W-2 form, the Fifth Circuit has provided employees and other taxpayers a remedy for the otherwise powerless state that they find themselves in when third parties must furnish the IRS financial information concerning them.

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144. *Id.* at 1357 (Brown, J., dissenting).
145. *Id.* at 1357-58 (Brown, J., dissenting).
146. *Id.* at 1358 (Brown, J., dissenting).
147. 837 F.2d 1341 (5th Cir. Feb. 1988), *petition for cert. filed*, 56 U.S.L.W. 3739 (U.S. Apr. 26, 1988) (No. 87-1705).
148. 838 F.2d 1389 (5th Cir. Mar. 1988).