

Recent Decisions: Federal Tax Procedure: The Fifth Amendment and the Sole Stockholder

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Repository Citation

Terry R. Gray, *Recent Decisions: Federal Tax Procedure: The Fifth Amendment and the Sole Stockholder*, 48 Marq. L. Rev. (1965).
Available at: <http://scholarship.law.marquette.edu/mulr/vol48/iss4/10>

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RECENT DECISIONS

Federal Tax Procedure: The Fifth Amendment and the Sole Stockholder: During an investigation of the tax liability of Corporations *A*, *B*, and *C*, an Internal Revenue Service subpoena was issued to one Rosen, the sole stockholder of *A*, in an attempt to obtain the books and records of *A* and of Corporations *B* and *C* which were wholly owned subsidiaries of *A*.¹ Rosen refused to produce the books and records called for by the subpoena.² He gave as a reason for his refusal the fact that the production of the books and records might tend to incriminate him, and thus compel him to be a witness against himself in violation of his rights under the fifth amendment. Pursuant to enforcement proceedings brought by the Internal Revenue Service,³ the district court issued an order requiring Rosen to comply with the subpoena. Rosen appealed the order of the district court to the Second Circuit, which affirmed the order of the lower court by holding that the individual's fifth amendment privilege does not extend to books and records of a solely-owned corporation. *Hair Industry, Ltd. v. United States*.⁴

The intent to draw a protective constitutional screen around the individual is clear from the words of the fifth amendment itself.⁵ This freedom extends not only to testimony, but also to an individual's personal books and records. Under the protection of this great privilege, an individual may refuse to produce his personal books and records even if he is faced with a subpoena requiring their production for pur-

¹ INT. REV. CODE OF 1954, §7602, authorizes the Secretary or his delegate to examine books and records which may be relevant for the purpose of ascertaining the correctness of any return. This section also authorizes the Secretary or his delegate to summon the person liable for tax or any officer or employee of such person, or any person having care or custody of the books of account containing entries relating to the business of the person liable for tax, to appear before the Secretary or his delegate and to produce such books and papers and to give testimony, under oath, relevant to the inquiry. Section 7603 provides for the service of the summons and also that books and records shall be described with reasonable certainty.

² INT. REV. CODE OF 1954, §7210, provides for a fine of not more than \$1000 or imprisonment for not more than one year or both, together with costs of prosecution, if a person neglects to appear to testify in response to the summons or to produce the books, accounts, records, memoranda, or other papers requested in the summons.

However, noncompliance with a summons under the Internal Revenue Code to appear and testify or to appear and produce books and papers before a hearing officer is not subject to prosecution under §7210 if the witness in fact appears but interposes a good-faith challenge to the summons. *Reisman v. Caplin*, 375 U.S. 440, 447 (1964).

³ INT. REV. CODE OF 1954, §7604(a), grants jurisdiction to district courts to compel by appropriate process such attendance, testimony, or production of books, papers, or other data. Section 7604(b) provides for punishment of noncompliance with the summons through contempt proceedings upon the application of the Secretary or his delegate to the judge of the district court.

⁴ 15 Am. Fed. Tax R. 2d 257 (2d Cir. 1965).

⁵ "No person . . . shall be compelled in any criminal case to be a witness against himself. . . ."

poses of investigation. Such a refusal can be validly based on the fact that forced production would violate the individual's right to be free from compulsory self-incrimination.⁶

While personal records can be withheld under the protection of the privilege even though they may be in the possession of another,⁷ the fifth amendment has long been held to be a personal privilege available only to individuals and cannot be raised by a corporation as to its books and records.⁸

The power to exist and act as a corporation is a privilege which can only be granted by the authority of the state. The denial of the fifth amendment privilege to a corporation is based on the theory that the state, in granting this privilege to exist and act as a corporation, impliedly reserves a power of visitation over the corporation for purposes of effective regulation.⁹ A higher degree of regulation is deemed necessary in respect to corporations because of some of the peculiar features of these legal entities, which features are not present in the usual sole proprietorship or partnership forms of business. One of these peculiar features is the fact that a businessman can place a limit on his personal liability by incorporation. Secondly, the actions of the corporation are controlled by a board of directors who may or may not also be owners of the corporation. For reasons such as these, a state in granting the privilege to exist and act as a corporation may lay down certain rules of conduct and retain specified powers of visitation over the creatures it has thus created. The corporation is therefore subject to public regulation in order to protect the creditors who deal with the corporation and the investors whose interests are entrusted to the integrity and good judgment of the board of directors.¹⁰

*Wilson v. United States*¹² dealt with the question of whether an officer of a large widely held corporation could claim the fifth amendment privilege with respect to corporate books and records of which he had custody on the ground that they contained material which would tend to incriminate him personally. Recognizing the reason for the visitatorial power over a corporation, the court there laid down the general doctrine that the custodian of corporate books and records could not refuse to produce them on the ground that they will tend to incriminate him personally. This doctrine was later applied in a case in which the officer having custody of the corporate books and records was also the sole stockholder of the corporation.¹²

⁶ *Boyd v. United States*, 116 U.S. 616 (1886).

⁷ *United States v. Guterma*, 272 F. 2d 344 (2d Cir. 1959); *Schwinner v. United States*, 232 F. 2d 855 (8th Cir. 1956).

⁸ *Hale v. Henkel*, 201 U.S. 43 (1906).

⁹ *Ibid.*

¹⁰ BALLANTINE, CORPORATIONS §19 (rev. ed. 1946).

¹¹ 221 U.S. 361 (1911).

¹² *Grant v. United States*, 227 U.S. 74 (1912).

In *United States v. White*¹³ the Supreme Court further limited the scope of the individual's fifth amendment privilege by declaring that an officer of an unincorporated association who has custody of the association's books and records cannot refuse to produce them on the ground that they may tend to incriminate him, if he holds them in a capacity representing the group interest of the association. That case denied the fifth amendment privilege to the officer who was custodian of the books of an unincorporated labor union because he was found to hold the books in a capacity representing the group interests of the labor union rather than a capacity representing his personal interests. The appellant in the instant case urged the Second Circuit to adopt the "group or personal interest" test laid down by the *White* case, arguing that the test developed there is whether the one claiming the privilege represents only his own interest, and further that in determining when the privilege can be invoked, form must give way to substance. The appellant urged that the "group or personal interest" test should be applied, presumably because he contended the *White* case reasoning was meant to apply to corporate records and he expected the court to find that he held the records in a capacity representing only his personal interest, since he was the sole owner of the corporation. Although admitting that there was some weight to the appellant's argument, the Second Circuit nevertheless rejected it because it could not be reconciled with the rationale of the *Hale* case which based its denial of the privilege to a corporation on the need of the sovereign for visitatorial powers over its corporate creatures. The court also pointed out that the *White* case actually reiterated the rule that the privilege cannot be utilized in respect to corporate records. In support of their holding, the Second Circuit stated that the need for powers of visitation has increased with the advent of laws allowing a corporation to accumulate income which is, under some circumstances, free from personal income tax on the stockholders. The court felt that limiting the individual's fifth amendment privilege in respect to corporate books and records is part of the price one must pay to incorporate. In the words of the court, "the visitatorial powers are more than ever necessary to the sovereign, and justify the courts in holding that any claim to the personal privilege is relinquished as to corporate records by the choice of the corporate form for an individual's business."¹⁴

The Ninth Circuit recently challenged this trend to limit the scope of the individual's fifth amendment privilege in *Wild v. Brewer*,¹⁵ involving the president and sole stockholder of a corporation who sought to claim the fifth amendment privilege to refuse to produce the books

¹³ 332 U.S. 694 (1944).

¹⁴ *Hair Industry, Ltd. v. United States*, *supra* note 4, at 258.

¹⁵ 13 Am. Fed. Tax R. 2d 1077 (9th Cir. 1964).

and records of his corporation. In its first opinion on that case the court allowed the sole stockholder to claim the privilege in respect to corporate books and records. Justice Madden, speaking for the court in a two-to-one decision, expressed a view which is diametrically opposed to the one set forth in the instant case. He dismissed the previously voiced arguments against the privilege thus:

[W]e confess, with deference, that the reason given in *Wilson v. United States* . . . viz. the impliedly reserved visitorial power of the states which created the artificial legal entity, which power is somehow transferred to the Federal Government, seems to us to be something of a make-weight in the cases in which it has been expressed. And we think that the argument that one who incorporates his business has only himself to blame if he thereby forfeits Constitutional rights is not of Constitutional weight.¹⁶

Justice Madden based his argument for a liberal construction of the fifth amendment privilege on the language of the 1956 case of *Ullman v. United States*¹⁷ wherein Mr. Justice Frankfurter, speaking for the Court, stated that the command of the fifth amendment

registers an important advance in the development of our liberty—'one of the great landmarks in man's struggle to make himself civilized.' Time has not shown that the protection from the evils against which this safeguard was directed is needless or unwarranted. This constitutional protection must not be interpreted in a hostile or niggardly spirit.¹⁸

However, this liberal view did not endure for long as the opinion of the Ninth Circuit. On rehearing,¹⁹ the other majority judge changed his position, reducing Justice Madden's view to the status of a dissenting opinion and bringing the final holding within bounds of the *Wilson* rule. The final decision affirmed the lower court order enforcing the summons against the president and sole stockholder of the corporation, requiring him to produce the books of his corporation.

It can be seen that Justice Madden flatly disagreed with the *Wilson* doctrine which was applied in the instant case, and in addition raised the question of how any impliedly reserved power of visitation is transferred from the state to the federal government.

Transferred or not, it seems clear indeed that the sole reason for denying the privilege to the sole stockholder of a corporation in respect to corporate books and records is the need for effective regulation of these corporate creatures which the state has created. In the absence of the visitorial power, the fifth amendment will be granted to the sole stockholder in respect to corporate books and records. Thus in *Applica-*

¹⁶ *Id.* at 1080.

¹⁷ 350 U.S. 422 (1956).

¹⁸ *Id.* at 426.

¹⁹ *Wild v. Brewer*, 329 F. 2d 924 (9th Cir. 1964), *cert. denied*, 85 Sup. Ct. 262 (1964).

tion of *Daniels*,²⁰ which involved the investigation of the sole stockholder of a corporation which had obtained its charter in Panama and had never been subject to the jurisdiction of the United States, the Federal District Court for the Southern District of New York held that the fifth amendment privilege against self-incrimination was available to the sole stockholder of the corporation in respect to corporate books and records. The court there declared that since the corporation was not within the jurisdiction of the United States, the books and records of the corporation would be considered as those of an unincorporated association and the "group or personal interest" test of the *White* case must be applied. And if in applying this test, the corporate officer was found to hold the books and records in a purely personal capacity, he must be afforded the constitutional protection of the privilege against compulsory self-incrimination.²¹

Some text writers feel that the circumstances which prompted the framing of the fifth amendment privilege against compulsory self-incrimination are no longer present in today's society, and therefore it should be severely curtailed or abolished completely.²² Recent opinions dealing with tax investigations, by emphasizing the importance of the visitatorial power over the corporation, have substantially diminished the fifth amendment's protection as to businessmen operating through the corporation.

TERRY R. GRAY

Constitutional Law: Search and Seizure Incident to Arrest for Traffic Violation: Defendant was stopped by two officers of the vice squad, narcotics division, and placed under arrest for a brake light violation. Informed that the violation justified a search of his person and the car, defendant stated: "Go ahead, I am clean." The search of the car revealed nothing, but with the aid of a flashlight, the officers discovered a few particles of marijuana in defendant's overcoat pocket. Defendant was arrested for possession of narcotics and subsequently convicted. On appeal, in *Barnes v. State*,¹ the Wisconsin Supreme Court reversed, holding that (1) there was no consent and (2) the search incident to arrest was unconstitutional.

Determining the issue of consent, Justice Currie stated "that the consent given was tainted with duress and therefore not freely and voluntarily given. Not only was defendant then under arrest but he knew from the statement of the officer that his person would be searched regardless of whether he consented or not."²

²⁰ 140 F. Supp. 322 (S.D. N.Y. 1956).

²¹ *Id.* at 326.

²² Baker, *Is the Privilege an Anachronism?* 42 A.B.A.J. 633 (1956); Fink, *Privilege Against Self-Incrimination—A Critical Reappraisal*, 13 W. Res. L. Rev. 722 (1962); Pittman, *Fifth Amendment: Yesterday, Today, and Tomorrow*, 42 A.B.A.J. 509 (1956).

¹ 25 Wis. 2d 116, 130 N.W. 2d 264 (1964).

² *Id.* at 123, 130 N.W. 2d 268.