The Case for Abrogation of Taxpayer Privilege in California

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The Case For Abrogation of Taxpayer Privilege

In California

Introduction

The taxpayer privilege in California was spawned in 1957 by the California Supreme Court’s anomalous construction of section 19282 of the California Revenue and Taxation Code in Webb v. Standard Oil Co.¹ The privilege retains its vitality, notwithstanding abandonment of a similar privilege in virtually all other jurisdictions.² This Note submits that the taxpayer privilege should be abrogated in California in favor of a more flexible mechanism whereby state and federal tax returns would be discoverable and admissible into evidence when they are relevant to matters being litigated. The protective order is suggested as a vehicle to permit accommodation of the competing confidentiality and discovery of relevant evidence interests.

The Origin of California’s Taxpayer Privilege

Webb v. Standard Oil Co.

In Webb v. Standard Oil Co.,³ a homeowner sued for the loss of his home from a fire allegedly precipitated by malfunctioning propane gas cylinders negligently installed by the defendant. Defense counsel sought to discover the plaintiff’s state and federal income tax returns for use in impeaching the plaintiff’s testimony on the value of his home.⁴ Plaintiff argued that section 19282 of the Revenue and Taxation Code created a taxpayer privilege which precluded discovery of either his state or federal tax returns. Section 19282 prohibits a member of the Franchise Tax Board or any other state official from revealing the contents of income tax returns.⁵ The California Supreme Court agreed with plaintiff and recognized the privilege as implicit in the statute. The court’s reasoning on the issue of state returns was based on its reading of the intent of the legislature in enacting section 19282. The court stated that the purpose of the

¹. 49 Cal. 2d 509, 319 P.2d 621 (1957).
². See notes 48-50, 55 & accompanying text infra.
³. 49 Cal. 2d at 514, 319 P.2d at 624.
⁴. Id. at 510-12, 319 P.2d at 622-23.
statutory provisions barring disclosure was to encourage full and truthful declarations in tax returns by removing the contingency that the returns might be used against the taxpayer for other purposes.\(^6\)

The court also foreclosed discovery of the federal returns for the same period. Its rationale as to the federal returns was that such disclosure would be tantamount to compelling disclosure of the state returns because the two returns contained essentially the same information.\(^7\)

**Aday v. Superior Court**

Four years after the decision in *Webb*, the California Supreme Court extended the scope of the taxpayer privilege to a corporation's tax return in a criminal proceeding not involving prosecution for tax violations in *Aday v. Superior Court*.\(^8\) A pornography dealer argued that certain business records had not been particularly described in a search warrant. The court found that the defendant's business' federal and state tax returns had been properly specified but that the forms were inadmissible because of the taxpayer privilege.\(^9\) The court noted that the language in Revenue and Taxation Code sections 26451 to 26453(c), dealing with corporation taxes, is substantially similar to that in the statutes interpreted in *Webb* to create the personal income tax privilege.\(^10\) The *Aday* court, therefore, extended *Webb* without analysis.

**Crest Catering v. Superior Court**

In 1965 in *Crest Catering Co. v. Superior Court*,\(^11\) the California Supreme Court recognized the taxpayer privilege in yet another taxation statute and addressed the new question of waiver of the privilege.\(^12\) Employees of the Crest Catering Company alleged that the

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\(^6\) *Id.* at 513, 319 P.2d at 624.

\(^7\) *Id.* at 513-14, 319 P.2d at 624.


\(^9\) *Id.* at 796-97, 362 P.2d at 51-52, 13 Cal. Rptr. at 419-20.

\(^10\) *Id.*


\(^12\) In *Wilson v. Superior Court*, 63 Cal. App. 3d 825, 134 Cal. Rptr. 130 (1976), the court found a waiver of the privilege in a recent case involving a negligence action against accountants who allegedly had improperly advised the plaintiff with respect to the tax consequences of a sale of real property. The court stated: "By her complaint, plaintiff has placed in issue the existence and the content of her tax returns and the tax consequences of the computations thereon. The gravamen of her lawsuit is so inconsistent with the continued assertion of the taxpayer's privilege as to compel the conclusion that the privilege has in fact been waived." See note 75 and accompanying text *infra*.

Although the vehicle of waiver may be available in some cases to avoid the privi-
company had failed to make contributions to the Employee Welfare and Retirement Fund in accordance with the terms of the contract between the company and the labor union. Because a fire had destroyed the firm's books and records, the defendant's employment tax returns, submitted quarterly to the California State Department of Employment, were the sole source of information concerning the amount of money that should have been paid on behalf of the employees. Crest claimed that the tax returns were privileged under sections 1094 and 2111 of the Unemployment Insurance Code. The court agreed that a privilege attached but found a waiver of the privilege in the terms of the trust agreement, incorporated by reference into the labor contract, which specified that "'[e]ach employer . . . shall promptly furnish all necessary information upon demand . . . .'" 

The employees had urged the court to recognize the waiver or, in the alternative, to overrule Webb. Because the court found a waiver of the privilege, it did not reach the question of whether Webb should be overruled. The court distinguished the statutes at issue in the two cases. It noted that the code sections relied upon in Crest mandate that information delivered to the Department of Employment "'shall not be open to the public, nor admissible in evidence in any action or special proceeding . . . and shall not be published or open to public inspection in any manner.'" The court stated that "'unlike the statutes considered in the Webb case, sections 1094 and 2111 leave no room for doubt that they create a privilege . . . . We are therefore not persuaded that we should re-examine the holding in the Webb case.'" The court thereby took notice that when the legislature intends to create a taxpayer privilege, and not just to regulate disclosures by taxing agency employees, it knows how to state so directly.

**Sav-on Drugs v. Superior Court**

In *Sav-on Drugs v. Superior Court*, yet another statute was interpreted by the California Supreme Court to create a taxpayer privi-
lege. A class action suit had been filed against Sav-on Drugs, which collected a sales tax on the full sales price of commodities sold and yet allegedly remitted revenues to the state on the basis of the sales price less a deduction covering the cost of trading stamps. The plaintiffs contended that this procedure precipitated an illegal windfall for the retailer. During the course of pretrial discovery, the plaintiffs posed three interrogatories, seeking revelation of deductions or adjustments that the defendant had taken in its sales tax returns for the four year period prior to the suit. The trial court granted the plaintiffs' motion for an order compelling the defendant to answer the interrogatories. The California Supreme Court issued a writ of prohibition on the ground that compelling the defendant to answer an interrogatory on its deductions and adjustments would, by indirect means, render "meaningless" the taxpayer privilege inherent in Revenue and Taxation Code section 7056. The interrogatories asking whether defendant had utilized a particular tax form or would voluntarily make copies of his returns available to the plaintiffs were allowed because they merely "invite[d] petitioner to waive voluntarily the privilege."

The court in Sav-on qualified its seemingly rigid interpretation of the taxpayer privilege announced in Webb. In interpreting Revenue and Taxation Code section 7056, containing substantially the same language as that in the statutes involved in Webb, the court said, "While this statute by its terms appears to be directed only toward administrative officers, and does not expressly establish a privilege of the nature claimed by petitioner, it does, however, manifest a clear legislative intent that disclosures made in tax returns shall not be indiscriminately exposed to public scrutiny." Only indiscriminate disclosures were explicitly proscribed; this dichotomy suggests that tax returns might be subject to discovery under appropriate circumstances.

Taxpayer Privilege: Susceptible to Attack

The Webb taxpayer privilege will be attacked by raising four

18. Id. at 3-5, 538 P.2d at 740-41, 123 Cal. Rptr. at 284-85.
19. Id. at 5, 538 P.2d at 741, 123 Cal. Rptr. at 285.
20. Id. at 7, 538 P.2d at 743, 123 Cal. Rptr. at 287.
21. Id.
22. CAL. REV. & TAX. CODE § 7056 (West 1970) provides in pertinent part: "[I]t is unlawful for the board or any person having an administrative duty . . . to make known in any manner . . . information pertaining to any retailer or any other person required to report to the board or pay a tax . . ., or the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any return, or to permit any return or copy thereof . . . to be seen or examined by any person."
23. 15 Cal. 3d at 6, 538 P.2d at 742, 123 Cal. Rptr. at 286 (emphasis added).
principal contentions: (1) the *Webb* statutes do not give rise to a privilege; (2) the California Evidence Code provisions relating to evidentiary privileges proscribe the establishment of judicially conceived privileges; (3) the policy basis supporting the privilege — the encouragement of full and truthful disclosure in income tax reporting — is not entirely sound conceptually and, in any event, may be achieved by a less restrictive means; and (4) virtually all other jurisdictions have not provided for a taxpayer privilege.

The Statutes Involved in *Webb*

The court in *Webb* discerns a taxpayer privilege in statutory language that facially lends no support to the court's construction of it. At the time *Webb* was decided, section 19282 of the Revenue and Taxation Code read as follows:

> Except as otherwise provided in this article, it is a misdemeanor for the Franchise Tax Board, any deputy, agent, clerk, or other officer or employee, to disclose in any manner information as to the amount of income or any particulars set forth or disclosed in any report or return required under this part.\(^24\)

Present section 19282 is virtually identical to its predecessor.\(^25\) Section 19283 creates an exception in enforcement cases: "Such information may be disclosed in accordance with proper judicial order in cases or actions instituted for the enforcement of this part or for the prosecution of violations of this part."\(^26\) The *Webb* court observed that sections 19284 through 19287 provide for disclosure to government officials in specific situations, none of which were pertinent to the facts of *Webb*.\(^27\)

The court's finding of an implicit taxpayer privilege in the statutory scheme rested on two related grounds. First, the court said, "The wording of the quoted sections discloses an intent to preserve the secrecy of the returns except in the few situations which are expressly noted."\(^28\) The court apparently concluded that the language of sections 19283 to 19287 barred disclosure except under those circumstances expressly enumerated.

The court's second basis for a finding of privilege was an "expressio unius" analysis of the statutory history. The court noted that, when the Income Tax Act of 1935 was enacted, no restriction was placed on the promulgation of court orders permitting disclosure. The new authorization of such orders in cases involving enforcement

\(^{24}\) 49 Cal. 2d at 512, 319 P.2d at 623.
\(^{26}\) CAL. REV. & TAX. CODE § 19283 (West 1970).
\(^{27}\) 49 Cal. 2d at 512, 319 P.2d at 623.
\(^{28}\) Id. at 512, 319 P.2d at 623-24.
or disclosure to designated government officials indicated, therefore, that disclosure would be permissible only in those cases specifically mandated.  

In concluding on two distinguishable yet related grounds that the legislature intended to allow disclosure only under certain specified circumstances, the Webb court failed to perceive that all the provisions in question are directed to those situations wherein government officials are authorized to examine tax returns. The court erred in construing the legislature's efforts to list circumstances under which disclosure to certain designated officials is appropriate as an attempt to restrict disclosure exclusively to those situations. Legislation that merely circumscribes the government official exception to the privilege should be strictly construed. The legislature's apparent intent in codifying the government official exceptions was to offer guidance in implementing the statute. Its objective was assertedly to refine and provide detail to the statutory scheme, rather than to alter its thrust. None of the code sections construed in Webb expressly addresses the issue of whether adverse parties in a civil action can lawfully require production of income tax returns or the information contained in them.

The provisions permitting discovery orders in specified enforcement cases pressed by government employees should be construed to foreclose extrastatutory discovery only in the province of government officials. This suggested limitation is supported by the notion that a broad field of law should be covered by a statute only to the extent that the statute purports to address that field. The provisions at issue in Webb depart from the personal Income Tax Act of 1935 only with respect to official disclosure, however. They do not alter the Act's apparently unrestricted posture with respect to taxpayer-litigants.

The court's policy basis for finding an implicit privilege, the encouragement of full and truthful disclosure to the Franchise Tax Board, is particularly puzzling. An incidental or collateral purpose to encourage full and truthful disclosure might have been gleaned from the language of the statutes. The court's perception that the privilege was intended to be invocable by the taxpayer as well as by state officials, however, assertedly constitutes an attenuated construction of the statutory framework. Sections 19282 to 19287 of the Revenue and Taxation Code were conceived as common sense administrative rules designed to curb potential abuses by employees of the Franchise Tax Board.

29. 49 Cal. 2d at 512-13, 319 P.2d at 624.
30. In Webb, this full disclosure impetus is characterized as the "primary legislative purpose" of CAL. REV. & TAX. CODE §§ 19282-19289 (West 1970).
The California Evidence Code

In 1965 the California legislature enacted the new California Evidence Code, which became effective on January 1, 1967.\textsuperscript{31} Evidence Code section 351 sets out the Code's major premise: "[e]xcept as otherwise provided by statute, all relevant evidence is admissible."\textsuperscript{32} The Code is replete with statutory provisions included by reference that narrow the scope of section 351;\textsuperscript{33} the importance of section 351, nevertheless, should not be minimized. Of this section, one commentator has observed: "[T]he starting point in understanding the structure of the Evidence Code — and the California law of evidence after January 1, 1967 — is section 351, which enacts the basic proposition that all relevant evidence is admissible. All else in the Evidence Code relates to and revolves around this basic provision."\textsuperscript{34}

Division 8 of the Evidence Code, sections 900 to 1070, presents an extensive catalogue of the laws of privilege. Section 911 warrants special attention because it discloses a legislative purpose inconsistent with the holding in \textit{Webb}. Section 911 complements section 351 by stating that no privileges are to be invoked unless provided by statute. It states that, except pursuant to a statutory provision, "[n]o person has a privilege to refuse to disclose any matter or to refuse to produce any writing, object, or other thing."\textsuperscript{35} In the absence of a statutory taxpayer privilege in the California Evidence Code, a relevant income tax return should thus be admissible into evidence and subject to the normal rules of discovery.

Evidence Code sections 351 and 911 require admission of all relevant evidence "except as provided by statute," a phrase that does not include decisional law.\textsuperscript{36} The official comment to section 911 explicitly limits courts in creating new privileges: "This is one of the few instances where the Evidence Code precludes the courts from elaborating upon the statutory scheme. Even with respect to privileges, however, the courts to a limited extent are permitted to develop the details of declared principles."\textsuperscript{37}

In \textit{Valley Bank of Nevada v. Superior Court},\textsuperscript{38} the California Su-
The Supreme Court addressed the question of whether privacy rights derived from the California Constitution gave rise to a privilege that could serve to shield from discovery relevant evidence in a civil suit. Plaintiff Valley Bank sought a protective order to bar discovery of bank records, asserting the privacy rights of its depositors. The court rejected the assertion of privilege, stating that "it is clear that the privileges contained in the Evidence Code are exclusive and the courts are not free to create new privileges as a matter of judicial policy." Although arising in the context of a constitutionally rather than statutorily derived claim of privilege, the foregoing language is nevertheless inconsistent with the establishment by implication of a taxpayer privilege in Webb. A taxpayer privilege, erroneously derived by implication from a statute, constitutes an elaboration upon the statutory scheme which is precluded by the Evidence Code. The court has exceeded its prerogative to develop "details of declared principles;" a new principle has been announced. If the court recognizes that Revenue and Taxation Code sections 19282 to 19289 have been misconstrued to create a taxpayer privilege, its statutory basis, and therefore effect, will be terminated.

The Policy Basis for a Taxpayer Privilege

The Webb court identified the principal objective of the statutes in issue as follows:

The purpose of the amended statutory provisions prohibiting disclosure is to facilitate tax enforcement by encouraging a taxpayer to make full and truthful declarations in his return, without fear that his statements will be revealed or used against him for other purposes. If the information can be secured by forcing the taxpayer to produce a copy of his return, the primary legislative purpose of the secrecy provisions will be defeated.

The court's reading of the statute's import is evident in its description of the administrative rules in question as "secrecy provisions." This terminology suggests that tax returns are to be viewed as solemnly inviolable instruments. The court correctly discerned a legislative purpose to encourage "full and truthful" tax reporting; it erred in its determination that the application of a taxpayer privilege was a necessary incident to that purpose. As a threshold matter, the court's

39. Id. at 655, 542 P.2d at 978, 125 Cal. Rptr. at 554.
41. 49 Cal. 2d at 513, 319 P.2d at 624.
42. Id.
43. See note 33 & accompanying text supra.
notion that a taxpayer privilege actually serves to promote full and truthful disclosure of tax matters in all situations is questionable. The so-called "secrecy provisions" are in some cases arguably of greater consequence in actually fostering misstatements on tax returns than in promoting full disclosure. The result of the privilege is to ensure that a taxpayer's return cannot be subjected to scrutiny of any sort other than that cursorily performed by the taxing agency. If, on the other hand, illicit matters, such as tax fraud, might be brought to light through examination of tax returns by a third party under appropriate circumstances, an incentive would be furnished to make full and truthful declarations.

Notwithstanding whatever impact the prospect of third party perusal of tax returns might have on taxpayers' candor, substantial criminal sanctions for a fraudulent filing must be viewed as a sufficient deterrent to the submission of untruthful returns. To justify the Webb privilege solely by declaring it an inducement to do that which is mandated by every taxation code is anomalous. The court in Webb may have perceived a collateral purpose in the language of the statutory scheme. This purpose can be characterized as a legislative desire to curb intrusions into citizens' personal financial affairs made possible by government reporting requirements. The opinion suggests an aversion to the use of government generated evidence to taxpayers' detriment in nontax litigation. The legitimate fear that privacy interests would be unnecessarily compromised if the privilege were discarded, however, may be addressed in a less restrictive manner by providing for protective orders in appropriate circumstances.

That lawmaking bodies and judiciaries of other jurisdictions have not established a taxpayer privilege, despite for example the availability of potential constitutional or Webb-like statutory sources for a privilege, suggests that the policy underpinnings of the California rule are insubstantial. In view of this assertedly modest policy foundation, the California Supreme Court's liberal construction of the statutory language in Webb to provide by implication for a taxpayer privilege, ostensibly in the interest of advancing a compelling public policy, is particularly striking.

The Rule in Other Jurisdictions

In interpreting the statutes in Webb to create a taxpayer privilege, the California Supreme Court has been uncharacteristically retro-
gressive. At least sixteen states have directly confronted the issue and have rejected the notion that taxpayer privilege should be afforded to private litigants. Five states have addressed the question by implication and have similarly rejected such a privilege. Only two state tribunals, in 1940 and 1945, have determined that a taxpayer privilege should be made available to private litigants. Several of the cases involve the interpretation of statutes similar to those in Webb. Such statutes generally bar revelation of tax returns by government employees but are silent with regard to disclosures in the context of private civil litigation.

In the federal courts a taxpayer privilege has not generally been recognized. The Internal Revenue Code provides that, pursuant to regulations approved by the President, tax returns are open to inspection by various governmental agencies and other specifically authorized parties having a legitimate interest in the subject matter.

47. That California stands virtually alone in providing a taxpayer privilege may encourage forum shopping when discovery of tax returns is contemplated. See generally Cervantes v. Time, Inc., 464 F.2d 986 n.5 (8th Cir. 1972); Application of Cepeda, 233 F. Supp. 465 (S.D.N.Y. 1964); RESTATEMENT (SECOND) OF CONFLICTS § 139.


52. See note 55 & accompanying text infra.

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The Internal Revenue Code provisions, although much more detailed, resemble the Webb statutes to the extent that they primarily address governmental duties with respect to the handling of tax returns. One commentator concludes that the great weight of authority recommends rejection of the taxpayer privilege:

A few decisions have thought that these provisions [barring disclosure by tax officials] make copies of the return privileged and that the taxpayer cannot be required to produce a copy of the return. There is, however, overwhelming authority to the contrary and the matter should now be considered resolved.

Although the United States Supreme Court has not expressly decided the taxpayer privilege issue, the accord evident in the lower federal courts may be attributed in some measure to a Supreme Court ruling on the question of census return privilege. In St. Regis Paper Co. v. United States, the Court held that a federal statute, couched in essentially the same language as section 19282 of the California Revenue and Taxation Code, barring the release of census returns by federal officials, did not create for a private litigant a privilege against disclosure of relevant matters contained in the returns. One significant factor leading to the Court's conclusion was that "the prohibitions against disclosure contained in [the statute] run only against the officials receiving such information and do not purport to generally clothe census information with secrecy." The Court commented:

54. See I.R.C. §§ 6103 & 7213.
55. Wright & Miller, 8 FEDERAL PRACTICE AND PROCEDURE 162-64 (1970).

In Heathman v. United States, 503 F.2d 1032 (9th Cir. 1974), the ninth circuit announced: "While it is true that some lower courts have held that § 6103(a)(2), along with 26 U.S.C. [I.R.C.] § 7213(a), reflects a public policy against disclosure of tax returns . . . . defendants cite no case (and we have found none) which has held that this section makes their copies of tax returns or the underlying data privileged . . . . The district courts have held in numerous cases that tax returns are subject to discovery in appropriate circumstances . . . . We hold that 26 U.S.C. [I.R.C.] § 6103(a)(2) only restricts the dissemination of tax returns by the government and that this section does not otherwise make copies of tax returns privileged." Id. at 1035. See also, Premium Service Corp. v. Sperry & Hutchinson Co., 511 F.2d 225, 229 (9th Cir. 1975).

The Tax Reform Act of 1976 apparently does not draw into question the continuing vitality of the foregoing analysis. Generally, that act codifies the manner in which tax returns are to be treated by government agencies and their employees.

57. 13 U.S.C. § 9, prior to its amendment, prohibited officers and employees of the Department of Commerce from using census information for other than statistical purposes, from making any publication of the names of those furnishing information, and from permitting anyone outside the Department to examine the reports filed. See note 24 & accompanying text supra.
58. 386 U.S. at 217-19.
59. Id. at 217-18.
[W]e cannot rewrite the Census Act. It does not require petitioner to keep a copy of its report nor does it grant copies of the report not in the hands of the Census Bureau an immunity from legal process. Ours is the duty to avoid a construction that would suppress otherwise competent evidence unless the statute, strictly construed, requires such a result.60

Although Congress amended the relevant statutes following St. Regis to abrogate the rule of that case,61 the Supreme Court's manner of construction of a statute substantially similar to that in Webb is nevertheless instructive. The Supreme Court in St. Regis stated that it is not within the province of the judiciary to wrench rules from language that does not state them.

The impact of St. Regis upon the California Supreme Court is evident in the text of Crest.62 Although the finding of privilege in Crest hinged on substantially broader statutory language than that construed in Webb, rendering reconsideration of Webb for purposes of deciding Crest nonessential, the court nevertheless raised a doubt concerning the correctness of Webb. Chief Justice Traynor wrote in Crest:

*St. Regis Paper Co. v. United States . . . held that statutes substantially the same as those considered in the Webb case did not create a privilege . . . . Moreover, unlike the statutes con-

60. *Id.* at 218.

61. The amendment to 13 U.S.C. § 9 provides in pertinent part that an evidentiary privilege shall attach to census returns apparently under virtually all circumstances: “Copies of census reports which have been so retained [by any establishment or individual] shall be immune from legal process, and shall not, without the consent of the individual or establishment concerned, be admitted as evidence or used for any purpose in any action, suit, or other judicial or administrative proceeding.” The foregoing language might be construed to reflect a legislative view that the court in St. Regis had misperceived the prior legislative intent. This view finds support in the legislative history to the extent that the legislative history indicates that Congress sought to perpetuate curbs which, prior to St. Regis, at least two federal courts had placed on the prerogatives of government agencies seeking copies of census returns held by taxpayers (see [1962] U.S. CODE CONG. & AD. NEWS 3188 at 3189). The legislative history does not, however, suggest that the very broad above-cited language of the amendment, extending on its face a census return privilege to private civil litigants, reflects the legislature's prior intent with respect to civil litigants, thus drawing into question the court's perception of that intent in construing the statutes in St. Regis. Rather, it would appear that the foregoing provision represents not a reassertion of prior intent abrogated in St. Regis but an expansion of prior protection. The Senate report cites language from Justice Black's dissenting opinion in St. Regis as indicative of its view: “Quite plainly, . . . it is . . . necessary that all the particular arms of government which are engaged in these activities [taxation, investigation, or regulation] be bound by Government pledges.” [1962] U.S. CODE CONG. & AD. NEWS 3188 at 3189 (quoting St. Regis Paper Co. v. United States, 368 U.S. 208, 229 (1961)) (emphasis added).

62. 62 Cal. 2d at 277, 398 P.2d at 151-52, 42 Cal. Rptr. at 111-12.
sidered in the Webb case, sections 1094 and 2111 leave no room for doubt that they create a privilege. Indeed, in the St. Regis opinion itself, the United States Supreme Court recognized that statutes similar to sections 1094 and 2111 created a privilege. 63

The foregoing declarations suggest that the California Supreme Court might embrace the United States Supreme Court's manner of statutory construction evident in St. Regis when presented with a statute sufficiently similar to the St. Regis census code provisions in the context of a compelling case.

**Protective Orders**

As a general postulate, disclosure of all relevant evidence is a manifestly desirable objective in any litigation. Competing against the need for full disclosure of relevant evidence are the interests in confidentiality and judicial economy, requiring that limits be placed on the nature and extent of matters probed in a lawsuit. No useful purpose is perceived, however, in circumscribing the scope of discovery by sustaining an inelastic taxpayer privilege which serves in some instances to deprive factfinders of relevant evidence without advancing by the least restrictive means the cause of protecting sensitive materials. When protection of the confidentiality interest is required, measures provided by statute, designed specifically to prevent abuses in the disclosure process, can be utilized. Code of Civil Procedure provisions dealing with discovery afford adequate means by which a court can fashion protective orders to guard against non-essential revelations of legitimately confidential material. Section 2019(b) of the Code of Civil Procedure, dealing with depositions on oral examination, provides in pertinent part:

[T]he court may make an order . . . that certain matters shall not be inquired into, or that the scope of the examination shall be limited to certain matters, books, documents, or other things, or that the examination shall be held with no one present except the parties to the action and their officers or counsel, or that after being sealed the deposition shall be opened only by order of the court . . . or that the parties shall simultaneously file specified documents or information enclosed in sealed envelopes to be opened as directed by the court; or the court may make any other order which justice requires to protect the party or witness from annoyance, embarrassment, or oppression. 64

Section 2030(c) of the Code of Civil Procedure, providing for written interrogatories, contains essentially the same safeguards.

63. 62 Cal. 2d at 277, 398 P.2d at 151-52, 42 Cal. Rptr. at 111-12.
64. CAL. CIV. PROC. CODE § 2019(b) (West Supp. 1977).
In *Valley Bank of Nevada v. Superior Court* the California Supreme Court specifically noted that protective orders are an appropriate vehicle to limit the scope or nature of matters sought to be discovered in cases involving confidential, private documents. The court advocated a balancing approach in the fashioning of protective orders and additionally placed the burden on the party seeking a protective order to demonstrate the need for it. The court set forth several factors to be weighed in determining the appropriate scope of discovery: the purpose for seeking the information; the effect that disclosure may be expected to have on the parties and on the trial; the nature of the objections urged by the party resisting disclosure; and the ability of the court to issue an alternative order in appropriate cases, such as a grant of partial disclosure, disclosure in another forum, or disclosure contingent upon certain equitable considerations.

Given, therefore, that the court has demonstrated a willingness to implement a balancing approach through the use of protective orders in discovery determinations, even in the face of constitutionally imposed restraints, the same approach would seemingly be appropriate in cases such as *Webb* presenting only by implication a statutory restraint to discovery prerogatives.

In some instances, discovery might be denied notwithstanding relevancy. If, for example, the taxpayer demonstrated that no compelling need for discovery of the returns existed because the information contained therein was otherwise available, the court, in its discretion, could bar disclosure.


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66. 15 Cal. 3d at 658, 542 P.2d at 980, 125 Cal. Rptr. at 556 (quoting Greyhound Corp. v. Superior Court, 56 Cal. 2d 355, 382, 364 P.2d 266, 293, 15 Cal. Rptr. 90, 117 (1961)).

67. "Where it is possible to do so, 'the courts should impose partial limitations rather than outright denial of discovery.'" *Id.* at 658, 542 P.2d at 983, 125 Cal. Rptr. at 556 (quoting Greyhound Corp. v. Superior Court, 56 Cal. 2d 355, 383, 364 P.2d 266, 280, 15 Cal. Rptr. 90, 104 (1961)). Several ways to implement partial discovery are suggested, notably the sealing of information coupled with an order, pursuant to CAL. CIV. PROC. CODE § 2019(b) (West 1955 & Supp. 1977), that it be opened only upon further order of court and the holding of in camera hearings. *Id.* at 658, 542 P.2d at 980, 125 Cal. Rptr. at 556. See note 74 infra.

68. In a 1964 federal case, Cooper v. Hallgarten & Co., 34 F.R.D. 482, 484 (1964), a similar test with respect to the discoverability of tax returns was announced. The court, in fashioning a protective order, held that the returns should not be discoverable unless: (1) they are clearly relevant, and (2) there is a compelling need for discovery of the returns because the information contained in them is not otherwise readily obtainable; cf. Fulenwider v. Wheeler, 262 F.2d 97 (5th Cir. 1958) (trial judge has great discretion in ruling on discoverability of tax returns).

manner in which protective orders might be invoked. Plaintiffs brought an action for fraud, breach of contract, and negligence when a speculative investment venture promoted by the Kidder Peabody Realty Corporation failed. They prayed for the recovery of the aggregate of their separate investments in the project. Plaintiffs alleged that they relied upon defendants' statement regarding the investment's long term profitability.

Defendant Kidder Peabody argued that plaintiffs had been concerned primarily with a representation in defendants' "Private Placement Memorandum," which projected substantial tax benefits from financial reversals in the first years of the project. They asserted that corroboration of the substantial tax benefits yielded by the investment by inspection of the plaintiff's tax returns would be relevant in analyzing the plaintiffs' investment sophistication and the course of dealing between the parties prior to the agreement. These considerations were relevant with respect to the fraud claim. Defendants sought to show that plaintiffs not only possessed sufficient knowledge of the speculative nature of the investment but also proceeded in a deliberate manner and at arms-length, fully apprised of the inherent risks.

In support of their argument, Kidder Peabody sought to compel answers to deposition questions relating to plaintiffs' federal and state tax returns for the relevant period. Plaintiffs asserted that the information sought was privileged or, in the alternative, irrelevant. They inferred that abrogation of the privilege, or a finding that it had been waived, would lead to indiscriminate public disclosure of sensitive private matters unrelated to the litigation. The trial court granted the motion to compel answers to the deposition questions, denying the existence of the privilege. The court of appeal subsequently issued a peremptory writ of mandate, thereby recognizing

71. Defendants additionally asserted that the tax returns might be relevant in the damages determination. Plaintiffs contended that the collateral source rule foreclosed a damages inquiry into tax benefits that may have served to mitigate investment losses. Under the collateral source rule, compensation received by plaintiff from a source entirely independent of the defendant tortfeasor may not be used to reduce damages recoverable from the tortfeasor. See De Cruz v. Reid, 69 Cal. 2d 217, 223, 444 P.2d 342, 346, 70 Cal. Rptr. 550, 554 (1968); Patent Scaffolding Co. v. Williams Construction Co., 256 Cal. App. 2d 503, 510, 64 Cal. Rptr. 187, 191 (1967). Although it is not clear whether the collateral source rule contemplates tax shelter transactions, the court apparently embraced the rule's basic tenet. The extent of a tortfeasor's liability should not turn on matters pertaining to indirectly related third party transactions.
the privilege and sustaining it against the claim of waiver. The California Supreme Court denied a hearing for review of the appellate court's hearing.\footnote{73}

Because appropriate protective orders could have been issued, no constructive purpose was served by denying the court access to this information.\footnote{74} A better result would have been to permit discovery pursuant to a protective order and subsequently to admit into evidence relevant elements of plaintiffs' tax returns as those elements reflected, albeit indirectly or incidentally,\footnote{75} the financial sophistication of plaintiffs and thereby the degree to which they had relied on various statements made by defendant in the "Private Placement Memorandum." The court in Monstavicius, for example, might have permitted review only of the tax-shelter considerations appearing in plaintiffs' returns that allegedly induced plaintiffs' participation in the investment and that, accordingly, would have been relevant in the fraud determination. Disclosure and use of this material, moreover, might have been restricted through issuance of a protective order to the preparation and presentation of the defendants' case. Certainly some procedure might have been formulated by the court within the framework of the above-mentioned discovery provisions so as to afford plaintiffs optimal protection consistent with the Evidence Code's mandate that all relevant evidence, unless privileged by statute, be admitted into evidence.\footnote{76}

\footnote{73. Id. (hearing denied, July 1, 1976).

74. Upon abrogation of the privilege, the vehicle of in camera inspection might be employed by the court to shape the scope of permissible discovery. See note 67 supra.

75. In Pacific Tel. & Tel. Co. v. Superior Court, 2 Cal. 3d 161, 172-73, 465 P.2d 854, 862-63, 84 Cal. Rptr. 718, 726-27 (1970), the court presented a summary of the liberal standards for discovery prescribed in California: "Although we have not been able to articulate a single, comprehensive standard of relevancy, we have established a few guidelines. Past cases make clear that the 'relevancy of the subject matter' criterion is a broader concept than 'relevancy to the issues . . . .' '[C]ourts may appropriately give the applicant substantial leeway . . . a decision of relevance for purposes of discovery is in no sense a determination of relevance for purposes of trial . . . [t]he relevance of the subject matter standard must be reasonably applied; in accordance with the liberal policies underlying the discovery procedures, doubts as to relevance should generally be resolved in favor of permitting discovery. Given this liberal and very flexible standard of relevancy . . . [a]n appellate court cannot reverse a trial court's grant of discovery under a 'relevancy attack' unless it concludes that the answers . . . cannot as a reasonable possibility lead to discovery of admissible evidence or be helpful in preparation for trial." Notably, in raising themselves the question of their financial sophistication by filing an action alleging fraud, plaintiffs should not have been permitted to employ a shield of privilege to thwart defendants and the court in probing the issue. See note 12 supra.

76. See notes 32, 35 & accompanying text supra.
Conclusion

The California Supreme Court should overrule its holding in Webb v. Standard Oil at the earliest opportunity. The court in construing Revenue and Taxation Code section 19282 announced that a taxpayer privilege was a necessary concomitant to full and truthful tax disclosure. The court failed to recognize that, had the legislature wished to create an evidentiary privilege, it would have articulated the proscription as it did in Unemployment Insurance Code sections 1094 and 2111, which prohibit "public disclosure [of tax information] in any manner."

If Webb is overruled, tax returns would be treated like other sensitive items of evidence. Discoverability and admissibility into evidence would be contingent upon relevancy. Protective orders would confine discovery within a designated sphere, bounded by relevancy and confidentiality considerations.

Until such time as the taxpayer privilege is discarded, litigants and courts will continue to be frustrated in their efforts in some cases to ascertain the truth of disputed matters. Such frustration can only benefit asserters of the privilege whose causes of action or defenses would falter or collapse if all the relevant facts came to light.

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77. In the alternative, the legislature should take steps to change the present rule.  
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