MLI #3 Summons Enforcement Under IRC §§ 7602, 7604, and 7609

SUMMARY

Pursuant to Internal Revenue Code (IRC) § 7602, the IRS may examine any books, records, or other data relevant to an investigation of a civil or criminal tax liability.[1] To obtain this information, the IRS may serve a summons directly on the subject of the investigation or any third party who may possess relevant information.[2] If a person summoned under IRC § 7602 neglects or refuses to obey the summons; to produce books, papers, records, or other data; or to give testimony as required by the summons, the IRS may seek enforcement of the summons in a United States District Court.[3]

A person who has a summons served on him or her may contest its legality if the government petitions to enforce it.[4] Thus, summons enforcement cases are different from many other cases described in other Most Litigated Issues because often the government, rather than the taxpayer, initiates the litigation. If the IRS serves a summons on a third party, any person entitled to notice of the summons may challenge its legality by filing a motion to quash or by intervening in any proceeding regarding the summons.[5] Generally, the burden on the taxpayer to establish the illegality of the summons is heavy.[6] When challenging the summons's validity, the taxpayer generally must provide "some credible evidence" supporting an allegation of bad faith or improper purpose.[7] The taxpayer is entitled to a hearing to examine an IRS agent about his or her purpose for issuing a summons only when the taxpayer can point to specific facts or circumstances that plausibly raise an inference of bad faith.[8] Naked allegations of improper purpose are not enough, but because direct evidence of IRS's bad faith "is rarely if ever available," circumstantial evidence can suffice to meet that burden.[9]

TAS identified 85 federal cases decided between June 1, 2017, and May 31, 2018, involving IRS summons enforcement issues. The government was the initiating party in 61 cases, while the taxpayer was the initiating party in 24 cases. Overall, taxpayers fully prevailed in three cases, while four cases were split. The IRS prevailed in the remaining 78 cases.

1 Internal Revenue Code (IRC) § 7602(a)(1); Treas. Reg. § 301.7602-1.

2 IRC § 7602(a).

3 IRC § 7604(b).

4 *U.S. v. Powell*, 379 U.S. 48, 58 (1964).

5 IRC § 7609(b).

6 *U.S. v. LaSalle Nat'l Bank*, 437 U.S. 298, 316 (1978).

7 *U.S. v. Clarke*, 134 S. Ct. 2361, 2367 (2014), *vacating* 517 F. App'x 689 (11th Cir. 2013), *rev'g* 2012-2 U.S.T.C. (CCH) ¶ 50,732 (S.D. Fla. 2012).

8 *Id.* (stating that "[t]he taxpayer need only make a showing of facts that give rise to a plausible inference of improper motive").

9 *U.S. v. Clarke*, 134 S. Ct. 2361, 2367-68 (2014), *vacating* 517 F. App'x 689 (11th Cir. 2013), *rev'g* 2012-2 U.S.T.C. (CCH) ¶ 50,732 (S.D. Fla. 2012).

TAXPAYER RIGHTS IMPACTED[10]

- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

The IRS has broad authority under IRC § 7602 to issue a summons to examine a taxpayer's books and records or demand testimony under oath.[11] Further, the IRS may obtain information related to an investigation from a third party if, subject to the exceptions of IRC § 7609(c), it provides notice to the taxpayer or other person identified in the summons.[12] In limited circumstances, the IRS can issue a summons even if the name of the taxpayer under investigation is unknown, *i.e.*, a "John Doe" summons.[13] However, the IRS cannot issue a summons after referring the matter to the Department of Justice (DOJ).[14]

If the recipient fails to comply with a summons, the United States may commence an action under IRC § 7604 in the appropriate United States District Court to compel document production or testimony.[15] If the United States files a petition to enforce the summons, the taxpayer may contest the validity of the summons in that proceeding.[16] Also, if the summons is served upon a third party, any person entitled to notice may petition to quash the summons in an appropriate district court, and may intervene in any proceeding regarding the enforceability of the summons.[17]

Generally, a taxpayer or other person named in a third-party summons is entitled to notice.[18] However, the IRS does not have to provide notice in certain situations. For example, the IRS is not required to give notice if the summons is issued to aid in the collection of "an assessment made or judgment rendered against the person with respect to whose liability the summons is issued."[19] Congress created this exception because it recognized a difference between a summons issued to compute the taxpayer's taxable income and a summons issued after the IRS has assessed tax or obtained a judgment.

10 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are also codified in the IRC. *See* IRC § 7803(a)(3).

11 IRC § 7602(a). *See also LaMura v. U.S.*, 765 F.2d 974, 979 (11th Cir. 1985) (citing *U.S. v. Bisceglia*, 420 U.S. 141, 145-146 (1975)).

12 IRC § 7602(c). Those entitled to notice of a third-party summons (other than the person summoned) must be given notice of the summons within three days of the day on which the summons is served to the third party but no later than the 23rd day before the day fixed on the summons on which the records will be reviewed. IRC § 7609(a).

13 The court must approve a "John Doe" summons prior to issuance. In order for the court to approve the summons, the United States commences an *ex parte* proceeding. The United States must establish during the proceeding that its investigation relates to an ascertainable class of persons; it has a reasonable basis for the belief that these unknown taxpayers may have failed to comply with the tax laws; and it cannot obtain the information from another readily available source. IRC § 7609(f).

14 IRC § 7602(d). This restriction applies to "any summons, with respect to any person if a [DOJ] referral is in effect with respect to such person." IRC § 7602(d)(1).

15 IRC § 7604.

16 *U.S. v. Powell*, 379 U.S. 48, 58 (1964).

17 IRC § 7609(b). The petition to quash must be filed not later than the 20th day after the date on which the notice was served. IRC § 7609(b)(2)(A).

18 IRC § 7609(a)(1); Treas. Reg. § 301.7609-1(a)(1). *See, e.g., Cephas v. U.S.*, 112 A.F.T.R.2d (RIA) 6483 (D. Md. 2013).

19 IRC § 7609(c)(2)(D)(i). The exception also applies to the collection of a liability of "any transferee or fiduciary of any person referred to in clause (i)." IRC § 7609(c)(2)(D)(ii).

For example, the IRS does not have to give notice to the taxpayer or person named in the summons if it is attempting to determine whether the taxpayer has an account in a certain bank with sufficient funds to pay an assessed tax because such notice might seriously impede the IRS's ability to collect the tax.[20] Courts have interpreted this "aid in collection" exception to apply only if the taxpayer owns a legally identifiable interest in the account or other property for which records are summoned.[21] Additionally, the IRS is not required to give notice when, in connection with a criminal investigation, an IRS criminal investigator serves a summons on any person who is not the third-party record-keeper.[22]

Whether the taxpayer contests the summons in a motion to quash or in response to the United States' petition to enforce, the legal standard is the same.[23] In *United States v. Powell*, the Supreme Court set forth four threshold requirements (referred to as the *Powell* requirements) that must be satisfied to enforce an IRS summons:

1. The investigation must be conducted for a legitimate purpose;
2. The information sought must be relevant to that purpose;
3. The IRS must not already possess the information; and
4. All required administrative steps must have been taken.[24]

The IRS bears the initial burden of establishing that these requirements have been satisfied.[25] The government meets its burden by providing a sworn affidavit of the IRS agent who issued the summons declaring that each of the *Powell* requirements has been satisfied.[26] The burden then shifts to the person contesting the summons to demonstrate that the IRS did not meet the requirements or that enforcement of the summons would be an abuse of process.[27]

The taxpayer can show that enforcement of the summons would be an abuse of process if he or she can prove that the IRS issued the summons in bad faith.[28] In *United States v. Clarke*, the Supreme Court held that during a summons enforcement proceeding, a taxpayer has a right to conduct an examination of the responsible IRS officials about whether a summons was issued for an improper purpose only when the taxpayer "can point to specific facts or circumstances plausibly raising an inference of bad faith."[29] Blanket claims of improper purpose are not sufficient, but circumstantial evidence can be.[30]

20 H.R. Rep. No. 94-658 at 310, *reprinted in* 1976 U.S.C.C.A.N. at 3206. *See also* S. Rep. No. 94-938, pt. 1, at 371, *reprinted in* 1976 U.S.C.C.A.N. at 3800-01 (containing essentially the same language).

21 *Ip v. U.S.*, 205 F.3d 1168, 1172-1176 (9th Cir. 2000).

22 IRC § 7609(c)(2)(E). A third-party record-keeper is broadly defined and includes banks, consumer reporting agencies, persons extending credit by credit cards, brokers, attorneys, accountants, enrolled agents, and owners or developers of computer source code but only when the summons "seeks the production of the source or the program or the data to which the source relates." IRC § 7603(b)(2).

23 *Kamp v. U.S.*, 112 A.F.T.R.2d (RIA) 6630 (E.D. Cal. 2013).

24 *U.S. v. Powell*, 379 U.S. 48, 57-58 (1964).

25 *Fortney v. U.S.*, 59 F.3d 117, 119-120 (9th Cir. 1995).

26 *U.S. v. Dynavac, Inc.*, 6 F.3d 1407, 1414 (9th Cir. 1993).

27 *Id.*

28 *U.S. v. Powell*, 379 U.S. 48, 58 (1964).

29 *U.S. v. Clarke*, 134 S. Ct. 2361, 2367 (2014), *vacating* 517 F. App'x 689 (11th Cir. 2013), *rev'g* 2012-2 U.S.T.C. (CCH) ¶ 50,732 (S.D. Fla. 2012).

30 *U.S. v. Clarke*, 134 S. Ct. 2361, 2367-68 (2014), *vacating* 517 F. App'x 689 (11th Cir. 2013), *rev'g* 2012-2 U.S.T.C. (CCH) ¶ 50,732 (S.D. Fla. 2012).

A taxpayer may also allege that the information requested is protected by a constitutional, statutory, or common-law privilege, such as the:

- Fifth Amendment privilege against self-incrimination;
- Attorney-client privilege;[31]
- Tax practitioner privilege;[32] or
- Work product privilege.[33]

However, these privileges are limited. For example, courts reject blanket assertions of the Fifth Amendment,[34] but note that taxpayers may have valid Fifth Amendment claims regarding specific documents or testimony.[35] However, even if a taxpayer may assert the Fifth Amendment on behalf of him or herself, he or she cannot assert it on behalf of a business entity.[36]

Additionally, taxpayers cannot, on the basis of the Fifth Amendment privilege, withhold self-incriminatory evidence of a testimonial or communicative nature if the summoned documents fall within the "foregone conclusion" exception to the Fifth Amendment. The exception applies if the government establishes its independent knowledge of three elements:

1. The documents' existence;
2. The documents' authenticity; and
3. The possession or control of the documents by the person to whom the summons was issued.[37]

The attorney-client privilege protects "tax advice," but not tax return preparation materials.[38] The "tax shelter" exception limits the tax practitioner privilege and permits discovery of communications between a practitioner and client that promote participation in any tax shelter.[39] Thus, the tax practitioner privilege does not apply to any written communication between a federally authorized tax practitioner and "any person, any director, officer, employee, agent, or representative of the person, or any other person holding a capital or profits interest in the person" which is "in connection with the promotion of the direct or indirect participation of the person in any tax shelter."[40]

31 The attorney-client privilege provides protection from discovery of information where: (1) legal advice of any kind is sought, (2) from a professional legal advisor in his or her capacity as such, (3) the communication is related to this purpose, (4) made in confidence, (5) by the client, (6) and at the client's insistence protected, (7) from disclosure by the client or the legal advisor, (8) except where the privilege is waived. *U.S. v. Evans*, 113 F.3d 1457, 1461 (7th Cir. 1997) (citing 8 John Henry Wigmore, Evidence in Trials at Common Law § 2292 (John T. McNaughten rev. 1961)).

32 IRC § 7525 extends the protection of the common law attorney-client privilege to federally authorized tax practitioners in federal tax matters. Criminal tax matters and communications regarding tax shelters are exceptions to the privilege. IRC § 7525(a)(2), (b). The interpretation of the tax practitioner privilege is based on the common law rules of attorney-client privilege. *U.S. v. BDO Seidman, LLP*, 337 F.3d 802, 810-12 (7th Cir. 2003).

33 The work product privilege protects against the discovery of documents and other tangible materials prepared in anticipation of litigation. Fed. R. Civ. P. 26(b)(3); *see also Hickman v. Taylor*, 329 U.S. 495 (1947).

34 *See, e.g., U.S. v. McClintic*, 113 A.F.T.R.2d (RIA) 330 (D. Or. 2013).

35 *See, e.g., U.S. v. Lawrence*, 113 A.F.T.R.2d (RIA) 1933 (S.D. Fla. 2014).

36 *Braswell v. U.S.*, 487 U.S. 99 (1988).

37 *U.S. v. Bright*, 596 F.3d 683, 692 (9th Cir. 2010).

38 *U.S. v. Frederick*, 182 F.3d 496, 500 (7th Cir. 1999).

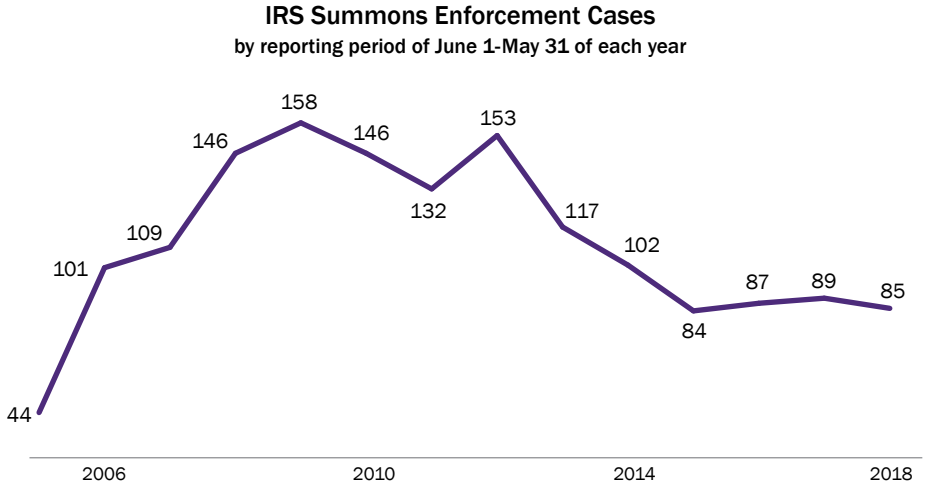
39 IRC § 7525(b). *See also Valero Energy Corp. v. U.S.*, 569 F.3d 626 (7th Cir. 2009).

40 IRC § 7525(b). A tax shelter is defined as "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." IRC § 6662(d)(2)(C)(ii).

ANALYSIS OF LITIGATED CASES

Summons enforcement has been a Most Litigated Issue in the National Taxpayer Advocate's Annual Report to Congress every year since 2005, when TAS identified only 44 cases but predicted the number would rise as the IRS became more aggressive in its enforcement initiatives. The number of cases peaked at 158 for the reporting period ending on May 31, 2009, but had generally declined, except for a one-year increase for the year ending May 31, 2012, as shown in Figure 3.3.1. This year, the number of summons enforcement cases fell slightly, as TAS identified 85 cases for the reporting period ending on May 31, 2018, a decrease from the 89 cases TAS identified during last year's reporting period. A detailed list of these cases appears in Table 3 of Appendix 3.

FIGURE 3.3.1



Of the 85 cases TAS reviewed this year, the IRS prevailed in full in 78, a 92 percent success rate, which is one percent less than the 2017 reporting period.[41] Taxpayers had representation in 34 cases (40 percent) and appeared *pro se* (*i.e.*, on their own behalf) in the remaining 51. This is a notable increase in the percentage of represented taxpayers as 28 percent of taxpayers were represented during the 2017 reporting period.[42] This year's percentage of represented taxpayers (40 percent) is a return close to the percentage we observed during the 2016 reporting period, where 44 percent of taxpayers had representation.[43] Sixty-four cases involved individual taxpayers, while the remaining 21 involved business taxpayers, including sole proprietorships.[44] Cases generally involved one of the following themes.

41 *See* National Taxpayer Advocate 2017 Annual Report to Congress 395.

42 *Id.*

43 *See* National Taxpayer Advocate 2016 Annual Report to Congress 459.

44 There were cases in which the IRS issued summons for investigations into both the individual taxpayer and his or her business. For the purposes of this Most Litigated Issue, TAS placed these cases into the business taxpayer category.

Petitions to Enforce and *Powell* Requirements

The United States petitioned to enforce a summons in 61 cases and successfully met its burden under *Powell* in 58 cases.[45] In two cases, taxpayers partially prevailed with *Powell* challenges. An example of a partially successful *Powell* challenge can be found in *United States v. Lui*.[46] In *Lui*, the taxpayer, an individual with interests in foreign entities and bank accounts, was served with summonses on two occasions related to his alleged tax liabilities. In the first summons, the IRS requested testimony from the taxpayer, and in the second summons, the IRS requested testimony and documents concerning the taxpayer's foreign interests. Pursuant to the first summons, the taxpayer refused to testify on privilege grounds. Following the second summons, the taxpayer refused to testify once more, and provided only a portion of the requested documents. The IRS sought a court order to enforce both summons. Based on the initial petition and accompanying declaration, the court found that the IRS had established a *prima facie* case under *Powell*. Once the government met its initial burden, the burden shifted to the taxpayer. Consequently, the court ordered the taxpayer to show cause as to why he should not be compelled to testify and to produce all the requested documents.

In showing why he should not be compelled to produce all the requested documents, the taxpayer argued that he did not possess, control, or have custody of the requested documents. The IRS had sought a broad range of documents in connection with the taxpayer's foreign holdings and posited that the taxpayer had not provided credible evidence showing that he no longer possessed the documents. In evaluating the parties' claim, the court adopted a sliding scale test from *United States v. Malhas*,[47] *i.e.*, "the more the IRS's evidence suggests the taxpayer possesses the documents at issue, the heavier the taxpayer's burden to successfully demonstrate that he does not." In *Malhas*, the taxpayer had the burden of showing that he was not in possession of documents requested by the IRS. The court found that the taxpayer failed to provide credible evidence, as he relied only on his own affidavits and testimony. In contrast, the IRS provided a plethora of documents and records illustrating the taxpayer's connection with the requested documents. Based upon those facts, the court in *Malhas* found that the taxpayer failed to satisfy his burden.

In contrast to *Malhas*, in the instant case, the court found that the taxpayer had a substantially more compelling position. The taxpayer presented far more than his own affidavit to support his argument of non-possession. The taxpayer showed that he had transferred his interest in the foreign holdings (upon which the document summons were directed) to the control and custody of his siblings by the date of the summons. Since the taxpayer transferred the documents, the documents were effectively out of his control. The IRS offered little evidence to the contrary, but pointed out the "suspicious timing" of the transfers. The court noted that suspicious timing alone was insufficient to overcome the plethora of evidence that the taxpayer presented, finding that the taxpayer succeeded in demonstrating that he did not possess documents directly related to the assets he had transferred. However, the court found that the taxpayer had not met the burden of showing that he had no documents related to the transfer of those assets. Accordingly, the court ordered the taxpayer to turn over all records in his possession regarding the transfers, or to submit a declaration under penalty of perjury that no such documents exist.

45 *See, e.g.*, *U.S. v. Cavins*, 121 A.F.T.R.2d (RIA) 2220 (S.D. Ill. 2018); *U.S. v. Elridge*, 121 A.F.T.R.2d (RIA) 1341 (E.D. Ark. 2018); *U.S. v. Morton*, 2017 U.S. App. LEXIS 20409 (6th Cir. 2017), *reh'g denied*, 2017 U.S. App. LEXIS 22757 (6th Cir. 2017), *aff'g* 119 A.F.T.R.2d (RIA) 362 (W.D. Mich. 2016); *U.S. v. Earth, Wind, and Solar, Inc.*, 120 A.F.T.R.2d (RIA) 5328 (E.D. Cal. 2017), *adopting* 119 A.F.T.R.2d (RIA) 2335 (E.D. Cal. 2017); *U.S. v. Pardue*, 120 A.F.T.R.2d (RIA) 5283 (M.D. Fla. 2017), *adopting* 120 A.F.T.R.2d (RIA) 5281 (M.D. Fla. 2017).

46 *U.S. v. Lui*, 120 A.F.T.R.2d (RIA) 5332 (N.D. Cal. 2017).

47 *U.S. v. Malhas*, 116 A.F.T.R.2d (RIA) 6724 (N.D. Ill. 2015).

In showing why he should not be compelled to testify, the taxpayer invoked his Fifth Amendment privilege. A taxpayer may "invoke his Fifth Amendment rights in response to an IRS summons when there are substantial hazards of self-incrimination that are real and appreciable," but mere blanket assertions of the Fifth Amendment are disallowed. Since the taxpayer asserted his Fifth Amendment privilege to almost every question asked of him during his testimony, the court found that the taxpayer's invocation of the Fifth Amendment privilege was overbroad and that he should be required to answer at least some additional questions. More specifically, the court ordered the taxpayer to answer the general background questions. However, the court decided not to compel any follow-up questions about the taxpayer's interests in foreign accounts or his ownership and reporting of foreign entities, except for one question with respect to which *Lui* waived his Fifth Amendment privilege as this topic was included in his declaration to the court. The court also allowed a series of specific follow up questions regarding the taxpayer's declaration.

Finally the court addressed the taxpayer's challenge to the IRS's *prima facie* case and analyzed the *Powell* factors.[48] It concluded that summonses were properly verified following all required administrative steps, were relevant to the taxpayer's tax liabilities, would lead to discovery of new information, and were not made in bad faith.

Accordingly, the IRS's petition to enforce summons against the taxpayer was granted in part and denied in part as to the documents he did not possess.

Petitions to Quash and Lack of Subject Matter Jurisdiction

Taxpayers petitioned to quash an IRS summons to a third party in 25 instances;[49] however, in many of these cases, courts dismissed the petitions for lack of jurisdiction on procedural or notice grounds. For example, an appellate court affirmed a district court's dismissal of a taxpayer's petition to quash a summons issued to the taxpayer's bank because the summons was issued to aid in the collection of a tax and the taxpayer therefore had no recourse under IRC § 7609.[50] In *Rifle Remedies, LLC v. United States*, the taxpayer, a limited liability corporation, sought to quash a summons issued by the IRS to a third party, the Marijuana Enforcement Division of the Colorado Department of Revenue.[51] The IRS was investigating the taxpayer on the basis of IRC § 280E, which prohibits deductions or credits for amounts acquired through the trade or business of trafficking in controlled substances.[52]

The IRS's burden to enforce the summons "is a slight one because the statute must be read broadly in order to ensure that the enforcement powers of the IRS are not unduly restricted."[53] After the IRS shows compliance with the *Powell* factors which is usually established by the affidavits of the IRS employees who issued the summons, the burden then shifts to the taxpayer resisting enforcement of the summons. This burden is a heavy one because the taxpayer should show that enforcement would "constitute an

48 *U.S. v. Powell*, 379 U.S. 48, 57-58 (1964).

49 In some instances, the taxpayer made the motion to quash in its answer to the government's petition to enforce.

50 *Ngo v. U.S.*, 699 F. App'x 617 (9th Cir. 2017), *aff'g* 118 A.F.T.R.2d (RIA) 5453 (N.D. Cal. 2015). Under IRC § 7609(c)(2)(D)(i), the IRS is not required to provide notice to the taxpayer, and the taxpayer therefore has no right to quash the summons if the summons is issued to aid in the collection of the taxpayer's liability.

51 *Rifle Remedies, LLC v. U.S.*, 120 A.F.T.R.2d 6385 (D. Colo. 2017).

52 *See* IRC § 280E (prohibiting a deduction or credit for carrying on any trade or business if such trade or business consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act)). For more information about IRS enforcement of IRC § 280E, see Leslie Book, *Court Allows IRS to Proceed With Summons Issued to Taxpayer in the Medical Marijuana Business*, Procedurally Taxing Blog, http://procedurallytaxing.com/court-allows-irs-to-proceed-with-summons-issued-to-taxpayer-in-the-medical-marijuana-business/ (Apr. 20, 2017).

53 *Rifle Remedies, LLC v. U.S.*, 120 A.F.T.R.2d 6385 (D. Colo. 2017) (internal citations omitted).

abuse of the court's process, or that in issuing the summons the IRS lacked institutional good faith."[54] To meet this burden the taxpayer must factually oppose the IRS's allegations by affidavit and refute the government's *prima facie Powell* showing or factually support a proper affirmative defense. Thus, the court started its analysis with an evaluation of the taxpayer's position with respect to the *Powell* requirements.

First, with respect to the legitimate purpose *Powell* requirement, the court found that the IRS's summons was issued to verify the taxpayer's financial records and to determine whether information reported in the taxpayer's tax returns could be substantiated. The taxpayer raised several illegitimate purpose arguments rebutting the IRS's position, but the court rejected all of them. The taxpayer's primary argument was that the IRS was essentially conducting a criminal investigation, as the taxpayer was being investigated for trafficking in a controlled substance. The court rejected this argument (alongside the other illegitimate purpose arguments), noting that the primary purpose of the investigation was to determine whether the taxpayer was entitled to a deduction or credit, and the IRS's inquiry into whether IRC § 280E applies to the taxpayer is not a criminal prosecution.

In respect to the second *Powell* requirement, the taxpayer did not contest that the IRS agent's declaration sufficiently established that the information sought by the summons would be relevant to the purpose of the IRS's investigation.

With respect to the *Powell* requirement that the information sought by the IRS was not already in its possession, the taxpayer argued that the IRS possessed the information it sought to summon. The taxpayer believed that the IRS obtained '.xls files' which contained private taxpayer information. These files were allegedly large enough to contain all the requested information already. The court rejected this argument, concluding that the IRS did not possess the specific information that it has requested in the summons.

With respect to the last *Powell* requirement that the material sought by the IRS be relevant to its investigation and that the IRS follow all necessary administrative steps, the court found that the IRS satisfied its burden through its declaration. The taxpayer did not contest this. Accordingly, the court found that IRS satisfied its burden under *Powell,* and thus the burden shifted to the taxpayer. Construing the taxpayer's arguments challenging the purpose of the IRS' investigation as attempting to satisfy the taxpayer's burden of showing that enforcement of the summons will be an abuse of process or that the IRS lacked institutional good faith, the court rejected those arguments as insufficient. Those arguments were "based upon rank speculation, on a lack of facts, or a combination of both."[55] Accordingly, the Court denied the taxpayer's petition to quash summonses, and granted the IRS's motion to enforce summonses.

Privileges

As in past years, taxpayers attempted to invoke various privileges, including Fifth Amendment and attorney-client privileges in response to an IRS summons. In one case, the taxpayers successfully invoked the attorney-client privilege for certain requested documents or testimony.[56] In another case,

54 *Rifle Remedies, LLC v. U.S.*, 120 A.F.T.R.2d 6385 (D. Colo. 2017) (internal citations omitted).

55 *Id.*

56 *See U.S. v. Owensboro Dermatology Associates*, 120 A.F.T.R.2d (RIA) 5119 (W.D. Ky. 2017).

the United States Court of Appeals for the Ninth Circuit vacated and remanded rulings from a district court to review memos *in camera* for privilege concerns.[57]

In *United States v. Servin*, the taxpayer, an attorney, appealed a district court order enforcing two administrative summonses issued by the IRS on the basis of attorney-client privilege.[58] The IRS suspected that the taxpayer owed delinquent taxes and sought to verify the income the taxpayer generated from his law practice. To accomplish this, the IRS requested information concerning the taxpayer's client list, which encompassed the names and addresses of each client. The taxpayer responded to the summons, appearing, but did not disclose the requested information.

In appealing the district court's decision, the taxpayer argued that state attorney-client privilege laws and the duty of confidentiality (drawn from the state rules of professional conduct) prohibited the unconsented disclosure of a client's name and address. The Court of Appeals for the Third Circuit rejected this position on both grounds. First, the Court of Appeals held that federal law concerning attorney-client privilege preempted state law, and that on the federal level, the privilege only shielded against the disclosure of confidential information. Absent rare circumstances, the attorney-client privilege did not shield against disclosing clients' identities. Since the taxpayer did not present any unusual circumstances that would warrant a different approach, the court rejected the argument on privilege grounds. Second, the appellate court rejected the taxpayer's reliance on the state rules of professional conduct. The court reasoned that the duty of confidentiality is extensive under state law, but it is not substantive law because it governs only disciplinary proceedings against attorneys practicing in the state who violate the rules—it does not affect judicial application of the attorney-client privilege. Accordingly, since the taxpayer failed to provide a compelling argument, the Court of Appeals upheld the lower court's decision.

Civil Contempt

A taxpayer who "neglects or refuses to obey" an IRS summons may be held in civil contempt.[59] In five cases this year, taxpayers were held in civil contempt for failing to comply with a court order enforcing an IRS summons.[60] However, in *United States v. Lui*, discussed earlier, the government's motion for contempt was denied.[61] In another case, *United States v. Ali*, the Court of Appeals for the Fourth Circuit affirmed a district court finding a taxpayer in contempt for failing to produce certain documents subject to an enforcement order.[62] The taxpayer had refused to produce the documents at the contempt stage on grounds of nonpossession and asserted Fifth Amendment privilege.[63] The court rejected the taxpayer's position on the ground that those defenses were to be raised at the enforcement stage, since allowing the taxpayer to rely on these defenses at the contempt stage would lead to a retrial of the original

57 *See U.S. v. Sanmina Co. and Subsidiaries*, 707 F. App'x 865 (9th Cir. 2017), *vacating and remanding* 115 A.F.T.R.2d (RIA) 1882 (N.D. Cal. 2015). We discussed the lower court's decision in our 2015 Annual Report. *See* National Taxpayer Advocate 2015 Annual Report to Congress 473-474.

58 *U.S. v. Servin*, 721 F. App'x 156 (3d. Cir. 2018), *aff'g* 121 A.F.T.R. 2d (RIA) 646 (E.D. Pa. 2017).

59 IRC § 7604(b).

60 *See U.S. v. Briseno*, 121 A.F.T.R.2d (RIA) 1540 (E.D. Cal. 2018); *U.S. v. Ali*, 874 F.3d 825 (4th Cir. 2017), *aff'g* 119 A.F.T.R.2d (RIA) 1145 (D. Md. 2016); *U.S. v. Barela*, 120 A.F.T.R.2d (RIA) 6494 (E.D. Cal. 2017); *U.S. v. Conner*, 120 A.F.T.R.2d (RIA) 6244 (N.D. Tex. 2017), *appeal docketed*, No. 17-11417 (5th Cir., Dec. 1, 2017), *adopting* 120 A.F.T.R.2d (RIA) 6241 (N.D. Tex. 2017); *U.S. v. Posner*, 120 A.F.T.R.2d (RIA) 5812 (S.D. Cal. 2017).

61 *U.S. v. Lui*, 121 A.F.T.R.2d (RIA) 1537 (N.D. Cal. 2018).

62 *U.S. v. Ali*, 874 F.3d 825 (4th Cir. 2017), *aff'g* 119 A.F.T.R.2d (RIA) 1145 (D. Md. 2016).

63 We discussed the *Ali* case in the privilege section of our 2015 Annual Report summons enforcement most litigated issue narrative. *See* National Taxpayer Advocate 2015 Report to Congress 473.

controversy. The court relied on the Supreme Court in *United States v. Rylander*[64] that if a taxpayer contests a summons, he or she must raise all applicable defenses at the enforcement stage, not for the first time in a contempt proceeding.[65]

The taxpayer's appeal of the district court's contempt order relied on three arguments. First, Ms. Ali contended that because she asserted her Fifth Amendment privilege against self-incrimination during the enforcement proceeding, she could not also assert a defense of nonpossession at that time. The Court of Appeals refused to allow the taxpayer to invoke the Fifth Amendment to satisfy her burden of production at the contempt stage even if she previously asserted that right at the enforcement stage based on *Rylander*. Then the court addressed the taxpayer's second and third arguments. Ms. Ali contended that once she produced some documents in response to an enforcement order, she could not be held in contempt unless the IRS could prove by clear and convincing evidence that she failed to produce all the responsive documents in her possession or control. She also argued that the district court erroneously switched the burden from the IRS to her by requiring her to affirmatively show that she had produced all responsive documents in her possession or control. The Court rejected these arguments. First of all, a summons enforcement order establishes a presumption that the defendant possesses responsive documents. Thus, the IRS did not need to show that the taxpayer had actual possession of other responsive documents that she failed to produce. Instead, the failure to produce documents presumptively within the taxpayer's possession constitutes an actual or constructive violation of the enforcement order. Therefore, it was enough for the IRS to show, by clear and convincing evidence, that the taxpayer's production was presumptively incomplete, *e.g.*, a production of bank records omitting bank statements is presumptively incomplete. The IRS is not required to identify each missing bank statement and need not prove that the taxpayer has access to that specific statement.

After the IRS establishes that the taxpayer violated the enforcement order, the burden shifts to the taxpayer to show that she made reasonable efforts to comply in good faith.

The Court of Appeals agreed with the district court's finding that the taxpayer had not satisfied this burden, concluding that a bare assertion of nonpossession or the production of some responsive documents do not demonstrate all reasonable efforts to comply with the summons enforcement order. Accordingly, the Court of Appeals for the Fourth Circuit found that the district court did not abuse its discretion in finding the taxpayer in contempt.

Overall, contempt proceedings accounted for approximately seven percent of all summons-related cases. Unless the taxpayer complied with the court order, the taxpayer was subject to arrest.[66]

Virtual Currency and "John Doe" Summons

The IRS has taken the position that virtual currency, such as Bitcoin, is considered property for tax purposes and therefore general tax principles apply to transactions involving such currency.[67] In *United States v. Coinbase, Inc.*, the IRS served a John Doe summons on a virtual currency exchange seeking

64 460 U.S. 752 (1983).

65 The Supreme Court recognized "present inability to comply" as the only exception, *i.e.*, when an inability to comply arises after the enforcement proceeding and exists at the time of the contempt proceeding. 460 U.S. at 756-757.

66 *U.S. v. Briseno*, 121 A.F.T.R.2d (RIA) 1540 (E.D. Cal. 2018); *U.S. v. Barela*, 120 A.F.T.R.2d (RIA) 6494 (E.D. Cal. 2017); *U.S. v. Posner*, 120 A.F.T.R.2d (RIA) 5812 (S.D. Cal. 2017).

67 *See* IRS Notice 2014-21, 2014-16 I.R.B. 938; IRS Pub. 525, *Taxable and Nontaxable Income* 4 (Jan. 2017). In her 2013 Annual Report to Congress, the National Taxpayer Advocate recommended that the IRS issue guidance to assist users of digital currency. *See* National Taxpayer Advocate 2013 Annual Report to Congress 249-255 (Most Serious Problem: *DIGITAL CURRENCY: The IRS Should Issue Guidance to Assist Users of Digital Currency*).

records regarding nearly all of its customers for a two-year period.[68] After the exchange failed to comply with the summons, the IRS filed a petition to enforce the summons. The court heard oral argument on a motion to quash the summons and a motion to intervene, leading the IRS to narrow the scope of its summons.[69] Whereas the initial summons sought information from nearly all the exchange's users, the narrowed summons sought information regarding accounts "with at least the equivalent of $20,000 in any one transaction type."[70] The currency exchange refused to comply with the narrowed summons, and subsequently, the court granted a motion by a "John Doe" to intervene and challenge the government's attempt to enforce the summons.[71]

The Right to Intervene

An intervenor must satisfy a four-part test to qualify:

(1) file a timely motion;

(2) assert an interest relating to the property or transaction which is the subject of the summons enforcement action;

(3) be so situated that without intervention the disposition of the action may impair or impede the intervenor's ability to protect that interest; and

(4) have an interest not adequately represented by other parties.[72]

The party seeking to intervene bears the burden of showing the four elements are met, but the requirements are broadly interpreted in favor of intervention.[73] The IRS did not dispute that John Doe had timely applied to intervene. Thus, the Court turned to the remaining three factors. John Doe did not claim privilege in his Coinbase records, but contended that the broad scope of the summons suggests an abuse of process sufficient to support intervention as of right. The IRS did not explain how it can "legitimately use most of these millions of records on hundreds of thousands of users."[74] It claimed that as long as it submitted a declaration from an IRS agent that it is conducting an investigation to determine the identity and correct tax liabilities of taxpayers who had conducted transactions in virtual currencies, the summons does not involve an abuse of process. The Court refused to adopt the IRS argument stating that under this reasoning "the IRS could request bank records for every United States customer from every bank branch in the United States because it is well known that tax liabilities in general are under reported and such records might turn up tax liabilities."[75] The court noted that the IRS could not cite a single case to support such broad discretion. The IRS also argued that because the summons was issued pursuant to 15 U.S.C. § 7609(f), John Doe did not have a protectable interest, claiming that only the direct subject of the summons may challenge the government's good faith. The Court was unpersuaded commenting that nothing in the John Doe summons procedure adopted by Congress suggests that when the John Doe nonetheless learns of a summons from other means the John Doe has no interest in challenging the enforcement of that summons. The court also rejected the

68 *U.S. v. Coinbase, Inc.*, 120 A.F.T.R.2d (RIA) 5239 (N.D. Cal. 2017). For the related case, see also *U.S. v. Coinbase, Inc.*, 120 A.F.T.R.2d (RIA) 6671 (N.D. Cal. 2017). We discussed the Coinbase "John Doe" summons litigation in our 2017 Annual Report. *See* National Taxpayer Advocate 2017 Annual Report to Congress 400.

69 *See U.S. v. Coinbase, Inc.,* 120 A.F.T.R. 2d (RIA) 5239 (N.D. Cal. 2017).

70 *U.S. v. Coinbase, Inc.*, 120 A.F.T.R. 2d (RIA) 5239, 5241 (N.D. Cal. 2017).

71 *See U.S. v. Coinbase, Inc.*, 120 A.F.T.R. 2d (RIA) 5239 (N.D. Cal. 2017).

72 *See U.S. v. Oregon*, 839 F.2d 635, 637 (9th Cir. 1988).

73 *See Prete v. Bradbury*, 438 F.3d 949, 954 (9th Cir. 2006).

74 *U.S. v. Coinbase, Inc.*, 120 A.F.T.R. 2d (RIA) 5239, 5243 (N.D. Cal. 2017).

75 *Id*.

IRS's argument that John Doe's intervention would place an undue burden on the IRS's legitimate use of John Doe summons. Finally, the court disagreed with the IRS's assertion that John Doe was merely trying to shield his or her identity. The IRS had consented to its proceeding as a John Doe. John Doe had offered to reveal his or her identity provided the IRS would agree not to then withdraw the summons to moot John Doe's interest in the proceeding, but the IRS had rejected John Doe's offer. The Court determined that John Doe has a protectable interest in this enforcement proceeding. Moving to the next prong, the court concluded that if the IRS would obtain John Doe's personal information and other transaction history at Coinbase, it would impair the intervenor's ability to protect his or her protectable interest in the summons proceeding. Lastly, the court concluded that John Doe's interests were not adequately represented by other parties, distinguishing the intervenor's and Coinbase's interests. Coinbase's financial interest as an entity is that the IRS's investigation does not affect its profits or valuation. The intervenor's personal interest, however, is in the very documents the IRS seeks. As a result, Coinbase and John Doe may have differences as to a proper resolution of the summons enforcement action. For these reasons the court concluded that John Doe has a right to intervene.

The Narrowed Summons

Following the oral argument on the intervention motions, the IRS narrowed the scope of its summons seeking information regarding accounts "with at least the equivalent of $20,000 in any one transaction type (buy, sell, send, or receive) in any one year during the 2013-2015 period."[76] According to Coinbase the summons would apply to 8.9 million transactions and 14,355 account holders. Coinbase refused to comply with the Narrowed Summons, opposing the summons enforcement by the IRS along with John Doe.[77] Three *amici* briefs in opposition were filed by the Competitive Enterprise Institute; the Coin Center; and the Digital Currency and Ledger Defense Fund. Because the parties did not dispute that the third and fourth *Powell* factors were satisfied, the court only addressed the first and second *Powell* factors: whether the summons serves a legitimate purpose, and whether it seeks relevant information. With respect to the legitimate purpose *Powell* requirement, the court noted that over a two-year period, the exchange had conducted over 6 billion in transactions and had at least 5.9 million customers. Despite this, in the same period, only 800 to 900 taxpayers a year have electronically filed returns with a property description related to bitcoin. This discrepancy led to the inference that more of the exchange's users are trading virtual currencies than reporting gains on their tax returns. Subsequently, the court found that the revised summons had the legitimate purpose of investigating the "reporting gap between the number of virtual currency users [the exchange] claims to have had during the summons period" and "U.S. bitcoin users reporting gains or losses to the IRS during the summoned years."[78] Although the respondents raised a number of counterarguments, the court rejected them, emphasizing that the IRS's burden is minimal at this stage in the proceeding.

With respect to the relevance *Powell* requirement, the court agreed that while the requested records would permit the IRS to investigate unreported taxable gains, the IRS's demand for information was too broad. In addition to transaction records and information concerning account holder identity, the IRS sought "account opening records, copies of passports or driver's licenses, all wallet addresses, all public keys for all accounts/wallets/vaults, records of Know-Your-Customer diligence, agreements or instructions granting a third-party access, control, or transaction approval authority, and correspondence between Coinbase and the account holder."[79] The court found that at this stage in the proceeding, these

76 *U.S. v. Coinbase, Inc.*, 120 A.F.T.R. 2d (RIA) 5239, 5241 (N.D. Cal. 2017).
77 120 A.F.T.R.2d (RIA) 6671 (N.D. Cal. 2017).
78 120 A.F.T.R.2d (RIA) 6671, 6674 (N.D. Cal. 2017).
79 120 A.F.T.R.2d (RIA) 6671, 6676 (N.D. Cal. 2017).

requests sought information that was broader than necessary. The court reasoned that the first question the IRS had to resolve was whether an account holder had a taxable gain. If the account holder did not, then correspondence between the exchange and the account holder was irrelevant. Consequently, the court narrowed the type of documents that the IRS may acquire to documents material to identifying the account holder and any unreported gains. For instance, while the court permitted enforcement of records concerning the taxpayer's ID number, name, date of birth, address, and transaction history, the court found that documents concerning Records of Know-Your-Customer diligence, agreements or instructions granting a third-party access, control, or transaction approval authority, and correspondence between Coinbase and the account holder as unnecessary. Accordingly, the outcome resulted in a split decision, with court granting the IRS's petition to enforce in part.[80]

CONCLUSION

The IRS may issue a summons to obtain information to determine whether a tax return is correct or if a return should have been filed to ascertain a taxpayer's tax liability or to collect a liability.[81] Accordingly, the IRS may request documents and testimony from taxpayers who have failed to provide that information voluntarily.

Summons enforcement continues to be a significant source of litigation and the number of litigated cases rose slightly from last year. The IRS also continues to be successful in the vast majority of summons enforcement litigation. Taxpayers and third parties rarely succeed in contesting IRS summonses due to the significant burden of proof and strict procedural requirements.

The increase in virtual transactions and gig economy seem to attract legitimate IRS attention,[82] but may also lead to overreaching by the government in its summons' demands for information. We anticipate more summons enforcement activity in this area with IRS seeking information from third-party platforms.

80 120 A.F.T.R.2d (RIA) 6671 (N.D. Cal. 2017).

81 IRC § 7602(a).

82 *See* National Taxpayer Advocate 2017 Annual Report to Congress 165-171 (Most Serious Problem: *Participants in the Sharing Economy Lack Adequate Guidance From the IRS*).