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' 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 89 federal cases decided between June 1, 2016, and May 31, 2017, involving IRS summons enforcement issues. The government was the initiating party in 65 cases, while the taxpayer was the initiating party in 24 cases. Overall, taxpayers fully prevailed in three cases, while three cases were split. The IRS prevailed in the remaining 83 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. Tax Cas. (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 *Id.* at 2367-68.

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 now listed in the IRC. *See* Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at 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, 145-46 (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, 1172-76 (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, 119-20 (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. Tax Cas. (CCH) ¶ 50,732 (S.D. Fla. 2012).

30 *Id.* at 2367-68.

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).

In July 2016, the IRS issued final regulations providing that outside parties with whom the IRS or the Office of Chief Counsel contracts for services — such as economists, engineers, consultants, or attorneys — may receive books, papers, records, or other data summoned by the IRS and, in the presence of an IRS officer or employee, participate fully in the interview of a person who the IRS has summoned as a witness to provide testimony under oath.[41] However, in a significant recent development, the Department of the Treasury has recommended that the President consider revoking these regulations in part.[42] Noting that the regulations have generated substantial public attention and criticism and expressing concern that the IRS's use of outside attorneys creates a risk that the government will lose control of its own investigation, Treasury stated that it and the IRS are considering a prospectively effective amendment that would prohibit outside attorneys from participating in an IRS exam, including a summons interview.[43] However, the amendment would continue to allow outside subject matter experts, such economists or engineers, to participate in summons proceedings as the IRS may have a compelling need to use such experts and they do not present the same risks as outside attorneys.

ANALYSIS OF LITIGATED CASES

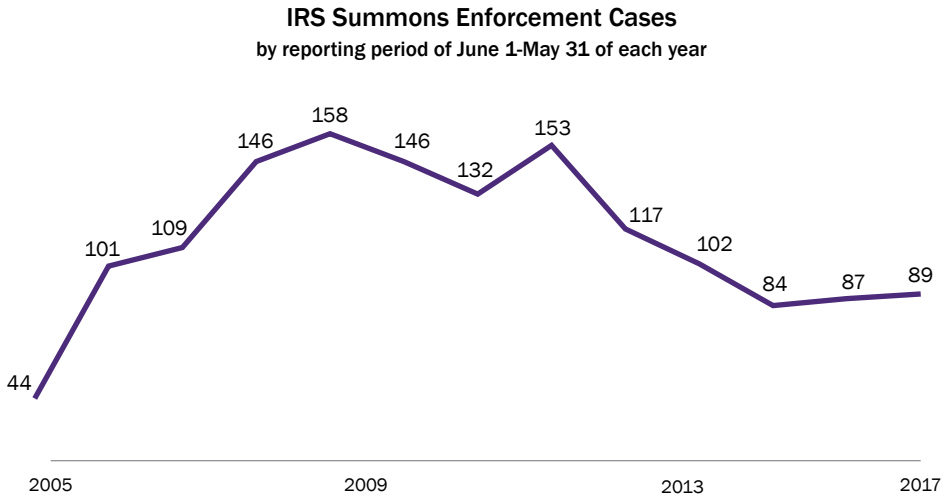
Summons enforcement has been a Most Litigated Issue in the National Taxpayer Advocate's Annual Report to Congress every year since 2005, when TAS identified only 44 cases but predicted the number would rise as the IRS became more aggressive in its enforcement initiatives. The number of cases peaked at 158 for the reporting period ending on May 31, 2009, but had steadily 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 rose slightly, as TAS identified 89 cases for the reporting period ending on May 31, 2017, an increase from the 87 cases TAS identified during last year's reporting period. A detailed list of these cases appears in Table 3 of Appendix 3.

41 See Treas. Reg. § 301.7602-1(b)(3). As we noted in our 2015 Annual Report, the IRS issued temporary regulations on this topic in June 2014. See Temp. Treas. Reg. § 301.7602-1T(b)(3); National Taxpayer Advocate 2015 Annual Report to Congress 470-71. We also discussed these regulations and summons enforcement litigation involving the IRS's use of an outside law firm in an audit of Microsoft Corporation's transfer pricing arrangements in our 2016 Annual Report to Congress. See National Taxpayer Advocate 2016 Annual Report to Congress 463.

42 See U.S. Department of the Treasury, *Second Report to the President on Identifying and Reducing Tax Regulatory Burdens* 4-5 (Oct. 2017).

43 The Treasury recommendation mentioned concerns expressed by the court in the *Microsoft* summons litigation, which we discussed in our 2016 Annual Report. See National Taxpayer Advocate 2016 Annual Report to Congress 463. We briefly discuss recent developments in the *Microsoft* litigation below.

FIGURE 3.3.1



Of the 89 cases TAS reviewed this year, the IRS prevailed in full in 83, a 93 percent success rate, which is a slight increase from the IRS's 91 percent success rate during the 2016 reporting period.[44] Taxpayers had representation in 25 cases (28 percent) and appeared *pro se* (*i.e.*, on their own behalf) in the remaining 64. This is a notable drop in the percentage of represented taxpayers as 44 percent of taxpayers were represented during the 2016 reporting period.[45] This year's percentage of represented taxpayers is a return close to the percentage TAS observed in the 2015 reporting period, where 27 percent of taxpayers had representation.[46] Seventy-three cases involved individual taxpayers, while the remaining 16 involved business taxpayers, including sole proprietorships.[47] Cases generally involved one of the following themes.

Petitions to Enforce and *Powell* Requirements

The United States petitioned to enforce a summons in 64 cases and successfully met its burden under *Powell* in all 64 cases.[48] An example of an unsuccessful *Powell* challenge by a taxpayer can be found in *United States v. Clower*.[49] In *Clower*, the taxpayer, a real estate appraiser specializing in conservation easements, appealed a Georgia district court order enforcing a summons to the Unites States Court of

44 See National Taxpayer Advocate 2016 Annual Report to Congress 459.

45 *Id*.

46 See National Taxpayer Advocate 2015 Annual Report to Congress 471.

47 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.

48 See, e.g., *U.S. v. Gibson*, 117 A.F.T.R.2d (RIA) 2037 (W.D. Mo. 2016), *adopting* 117 A.F.T.R.2d (RIA) 2035 (W.D. Mo. 2016); *U.S. v. McConnell*, 119 A.F.T.R.2d (RIA) 942 (N.D. Ga. 2017), *adopting* 119 A.F.T.R.2d (RIA) 939 (N.D. Ga. 2017); *U.S. v. Siripane*, 119 A.F.T.R.2d (RIA) 1407 (E.D. Cal. 2017), *adopting* 119 A.F.T.R.2d (RIA) 1062 (E.D. Cal. 2017). As mentioned above, the government initiated summons litigation in 65 cases during the current reporting period. The government petitioned to enforce a summons in 64 of these cases. In one case, *In re Tax Liabs. of Doe*, 118 A.F.T.R.2d (RIA) 6780 (N.D. Cal. 2016), the government filed an *ex parte* petition with the court for leave to serve a "John Doe" summons. As discussed both above and below, "John Doe" summonses have special statutory requirements and differ from regular summons enforcement proceedings.

49 *U.S. v. Clower*, 666 F. App'x 869 (11th Cir. 2016), *aff'g* 117 A.F.T.R.2d (RIA) 1446 (N.D. Ga. 2016).

Appeals for the Eleventh Circuit.[50] The IRS was investigating the taxpayer's preparation of conservation easement appraisals and requested various documents and files to determine whether the taxpayer was liable for civil penalties under the IRC. After the taxpayer raised concerns about the scope of the request, the government indicated that it was only seeking appraisal documentation relating to conservation easements, and the district court enforced the summons.[51]

On appeal, the court examined the district court's application of the *Powell* requirements for clear error. First, with respect to the legitimate purpose *Powell* requirement, the court found that the IRS's summons was issued as part of an investigation into whether the taxpayer owed tax penalties relating to his preparation of conservation easement appraisals. The court dismissed the taxpayer's argument that the IRS's investigation had no legitimate purpose as it requested land appraisals prepared by the taxpayer that were not ultimately filed with the IRS by the taxpayer's clients. The court noted that the focus of the IRS investigation was on the taxpayer and not his clients. In addition, the court stated that the IRS has broad summons power and, contrary to the taxpayer's contention, is not limited to only investigating filed tax returns.[52]

Second, with respect to the *Powell* requirement that the material sought by the IRS be relevant to its investigation, the court noted that the government's burden of demonstrating relevance is "slight." The court then stated that the district court had properly determined that the information requested by the government in the summons was relevant to its investigation of the taxpayer. It pointed out that the district court had properly limited the summons to appraisal documentation relating to conservation easements and, with this limitation, all items listed in the summons were relevant to the IRS's investigation of the taxpayer.[53]

Third, with respect to the *Powell* requirement that the information sought by the IRS is not already in its possession, the court stated that while the IRS might have in its possession the tax returns and accompanying forms actually filed by the taxpayer's clients, it did not have the taxpayer's original appraisal reports or unfiled versions of the forms that he signed. The court stated that the fact that there is some redundancy between these documents is not a bar to the enforcement of the summons. In addition, the court noted that the taxpayer's files contained information that was not in the IRS's possession and would be relevant to its investigation. Finally, with respect to the *Powell* requirement that the IRS follow all necessary administrative steps, the court stated that it was unclear from the taxpayer's brief whether he was challenging this factor and thus it did not address this issue. Therefore, the court affirmed the district court's enforcement of the summons.[54]

50 As described in the court's opinion, a conservation easement restricts the development and use of real property to achieve certain conservation or preservation goals. Assuming the conservation easement contribution meets the statutory requirements, the property owner may claim a charitable contribution deduction on his or her tax return. For a detailed discussion of conservation easements, see Most Litigated Issue: *Charitable Contribution Deductions Under Internal Revenue Code (IRC) § 170*, *infra*.

51 *U.S. v. Clower*, 666 F. App'x 869, 871-2 (11th Cir. 2016), *aff'g* 117 A.F.T.R.2d (RIA) 1446 (N.D. Ga. 2016).

52 *Id.* at 873-4. The court also dismissed two other arguments the taxpayer made regarding the legitimate purpose of the IRS's investigation as they were not raised at the district court level and were therefore deemed waived.

53 *Id*. at 874.

54 *Id.* at 874-5.

Petitions to Quash and Lack of Subject Matter Jurisdiction

Taxpayers petitioned to quash an IRS summons to a third party in 24 instances;[55] however, in many of these cases, courts dismissed the petitions for lack of jurisdiction on procedural or notice grounds. For example, a district court dismissed 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.[56]

In *Presley v. United States*, the taxpayers, comprised of individuals, a law firm, and a family limited partnership, sought to quash three IRS third-party summonses issued to their bank as part of examinations into their 2014 tax liabilities.[57] The taxpayers opposed the bank producing records regarding the law firm's client trust and escrow accounts and argued that under Florida law, the clients of the law firm, whose financial information might be contained in the records requested by the IRS, had a reasonable expectation of privacy in those records.[58]

The court noted that the summonses complied with federal law, as they were narrowly drawn to meet the *Powell* requirements and, if the *Powell* requirements were met, the summonses did not violate the Fourth Amendment's reasonable expectation of privacy. Also, the court pointed out that both the taxpayers and the clients of the law firm lacked standing to raise a Fourth Amendment argument as they did not have a reasonable expectation of privacy in records maintained by a third-party bank. Finally, the court stated that although Florida law recognized a reasonable expectation of privacy in records held by a third-party bank, under the Supremacy Clause of the U.S. Constitution, federal summons law preempted any state laws that conflict with it. Therefore, the court granted the government's motion to dismiss the taxpayers' petition to quash. The taxpayers have appealed this decision to the U.S. Court of Appeals for the Eleventh Circuit.[59]

Privileges

As in past years, taxpayers attempted to invoke various privileges, including Fifth Amendment, attorney-client, or other privileges in response to an IRS summons. In two cases, taxpayers successfully invoked Fifth Amendment privilege claims for certain requested documents or testimony.[60] In two other cases, the United States Court of Appeals for the Second Circuit vacated and remanded rulings from district courts due to Fifth Amendment privilege claims.[61]

In *United States v. Micro Cap KY Insurance Company*, the government sought to enforce an IRS summons issued to two captive insurance companies ("taxpayers") that were set up, after consultation

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

56 *Harrison v. U.S. Comm'r*, 2017 U.S. Dist. LEXIS 9742 (S.D. Tex. 2017), *adopting* 119 A.F.T.R.2d (RIA) 593 (S.D. Tex. 2016). 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.

57 *Presley v. U.S.*, 119 A.F.T.R.2d (RIA) 313 (S.D. Fla. 2017), *appeal docketed*, No. 17-10182 (11th Cir. Jan. 11, 2017).

58 *Id*.

59 *Id*.

60 *See U.S. v. Azarian*, 118 A.F.T.R.2d (RIA) 5526 (D. Minn. 2016), *adopting* 118 A.F.T.R.2d (RIA) 5523 (D. Minn. 2016), *appeal dismissed*, No. 17-1954 (8th Cir. May 23, 2017) (parties stipulated to dismissal); *U.S. v. Ukazim*, 118 A.F.T.R.2d (RIA) 6502 (S.D. Fla. 2016), *appeal dismissed*, No. 16-16859 (11th Cir. Nov. 28, 2016) (case dismissed after government's motion for dismissal).

61 *U.S. v. Fridman*, 665 F. App'x 94 (2d Cir. 2016), *vacating and remanding* 118 A.F.T.R.2d (RIA) 6890 (S.D.N.Y. 2015); *U.S. v. Greenfield*, 831 F.3d 106 (2d Cir. 2016), *vacating and remanding* 118 A.F.T.R.2d (RIA) 5309 (S.D.N.Y. 2015), *motion to dismiss case*, No. 14-mc-00350 (S.D.N.Y. Oct. 27, 2016) (government abandoned pursuit of summons enforcement action), *order to dismiss*, No. 14-mc-00350 (S.D.N.Y. Oct. 28, 2016).

with attorneys, by two doctors who co-owned dermatology businesses.[62] The IRS was investigating the tax liabilities of the taxpayers and requested various documents. The taxpayers provided most of the summoned documents but withheld a series of email communications between the doctors and their attorneys, claiming that they were subject to the attorney-client privilege. The government then petitioned the court to compel the taxpayers to produce the emails.[63]

As is common in summons enforcement cases, this case was initially assigned to a magistrate judge,[64] who found that the taxpayers had properly invoked the attorney-client privilege as the emails primarily involved the legal advice of counsel. The magistrate judge also found that each taxpayer had not waived the privilege by sharing the information in question with the doctor who formed the other captive insurance company as the doctors had jointly hired their attorneys to assist with captive insurance company formation and management and had a "clear commonality of interests." Therefore, the magistrate judge issued a report and recommendation that the government's petition to enforce the summons be denied.[65]

The government objected to the magistrate judge's report and recommendation, and raised a new argument that the taxpayers had waived their attorney-client privilege by filing a Tax Court petition against the IRS. Specifically, the government claimed this waiver of attorney-client privilege because the taxpayers had asserted in the Tax Court proceeding that they had a "reasonable cause" defense in relying on counsel for the tax positions they took in the years at issue.[66]

The district court found that the government had waived its argument that the taxpayers had waived their attorney-client privilege because, although it knew of the Tax Court proceeding at the time the magistrate judge heard the summons enforcement case, it did not timely raise this argument before the magistrate judge. In addition, the court found that even if it were to consider the government's argument on the merits it would still not prevail.[67]

The court noted that although a taxpayer's invocation of a reasonable cause defense could result in a waiver of the attorney-client privilege in Tax Court, it did not automatically lead to a disclosure of privileged documents. Rather, the assertion of the defense provides the IRS with a basis to request that the Tax Court compel a taxpayer to produce documents that were subject to the attorney-client privilege, but a taxpayer could avoid having to disclose privileged documents by withdrawing the reasonable cause defense. The court stated that the government had not yet made such a request in the taxpayers' Tax

62 *U.S. v. Micro Cap KY Ins. Co.*, 246 F. Supp. 3d 1194 (E.D. Ky. 2017), *adopting* 119 A.F.T.R.2d (RIA) 1279 (E.D. Ky. 2017), *motion to dismiss case*, No. 17-5611 (6th Cir. June 6, 2017) (government decided not to pursue appeal), *appeal dismissed*, No. 17-5611 (6th Cir. June 7, 2017). As we noted in our 2016 Annual Report, a captive insurance structure is where a business sets up an insurance company to protect against certain risks. While this may be structured with legitimate tax benefits, there are situations where it can be abused. *See* National Taxpayer Advocate 2016 Annual Report to Congress 460; *see also* IRS, *IRS Warns of Abusive Tax Shelters on 2017 "Dirty Dozen" List of Tax Scams* (Feb. 17, 2017), https://www.irs.gov/newsroom/irs-warns-of-abusive-tax-shelters-on-2017-dirty-dozen-list-of-tax-scams; IRS Notice 2016-66, 2016-47 I.R.B. 745, *Transaction of Interest — Section 831(b) Micro-Captive Transactions* (Nov. 21, 2016), *modified by*, IRS Notice 2017-8, 2017-3 I.R.B. 423, *Transaction of Interest — Section 831(b) Micro-Captive Transactions* (Jan. 17, 2017).

63 *U.S. v. Micro Cap KY Ins. Co.*, 246 F. Supp. 3d 1194, 1195-6 (E.D. Ky. 2017), *adopting* 119 A.F.T.R.2d (RIA) 1279 (E.D. Ky. 2017), *motion to dismiss case*, No. 17-5611 (6th Cir. June 6, 2017) (government decided not to pursue appeal), *appeal dismissed*, No. 17-5611 (6th Cir. June 7, 2017).

64 *See* 28 U.S.C. § 636(b).

65 *U.S. v. Micro Cap KY Ins. Co.*, 246 F. Supp. 3d 1194, 1196 (E.D. Ky. 2017), *adopting* 119 A.F.T.R.2d (RIA) 1279 (E.D. Ky. 2017), *motion to dismiss case*, No. 17-5611 (6th Cir. June 6, 2017) (government decided not to pursue appeal), *appeal dismissed*, No. 17-5611 (6th Cir. June 7, 2017).

66 *Id.*

67 *Id.*

Court proceeding, and even if it had, it was not certain that the taxpayers would ultimately have to disclose the privileged documents. Expressing concern that the government was requesting disclosure of attorney-client privileged documents in district court based on what it predicted would happen in Tax Court, the court declined to order such a disclosure. Therefore, the court adopted the magistrate judge's report and recommendation to deny enforcement of the IRS summons and overruled the government's objection. The government initially appealed this decision to the United States Court of Appeals for the Sixth Circuit but subsequently decided not to pursue the appeal.[68]

Finally, as we noted in our 2015 and 2016 Annual Reports, Microsoft Corporation had obtained an evidentiary hearing in a summons enforcement case where the IRS used an outside law firm to assist in an audit of the company.[69] However, the IRS was ultimately successful in having the summons enforced.[70] The *Microsoft* litigation continued during the current reporting period as the corporation withheld some summoned documents from the IRS, asserting the tax practitioner, work-product, and attorney-client privileges. In May 2017, the court ordered *in camera* review for some of these documents to determine whether they are protected by these privileges and held, to the extent that they contained legal advice, that certain documents were protected by the attorney-client privilege and *in camera* review of them was not necessary.[71]

Civil Contempt

A taxpayer who "neglects or refuses to obey" an IRS summons may be held in civil contempt.[72] In five cases this year, taxpayers were held in civil contempt for failing to comply with a court order enforcing an IRS summons.[73] In *United States v. Chabot*, which we discussed last year in the privilege context, a district court found the taxpayer in contempt for failing to comply with a summons enforcement order, a finding which was affirmed by the United States Court of Appeals for the Third Circuit.[74] Overall, contempt proceedings accounted for approximately six percent of all summons-related cases. Unless the taxpayers complied with the court order, they were subject to arrest[75] or fines.[76]

68 *U.S. v. Micro Cap KY Ins. Co.*, 246 F. Supp. 3d 1194, 1197-8 (E.D. Ky. 2017), *adopting* 119 A.F.T.R.2d (RIA) 1279 (E.D. Ky. 2017), *motion to dismiss case*, No. 17-5611 (6th Cir. June 6, 2017) (government decided not to pursue appeal), *appeal dismissed*, No. 17-5611 (6th Cir. June 7, 2017).

69 See National Taxpayer Advocate 2016 Annual Report to Congress 463; National Taxpayer Advocate 2015 Annual Report to Congress 471.

70 See *U.S. v. Microsoft Corp.*, 154 F. Supp. 3d 1134 (W.D. Wash 2015).

71 See *U.S. v. Microsoft Corp.*, 119 A.F.T.R.2d (RIA) 1724 (W.D. Wash. 2017).

72 IRC § 7604(b).

73 See *U.S. v. Belcik*, 118 A.F.T.R.2d (RIA) 5129 (M.D. Fla. 2016), *interlocutory appeal dismissed*, 2017 U.S. App. LEXIS 20091 (11th Cir. 2017) (court dismissed appeal due to taxpayer's fugitive status); *U.S. v. Lonnen*, 118 A.F.T.R.2d (RIA) 5431 (M.D.N.C. 2016); *U.S. v. Pfeifer*, 117 A.F.T.R.2d (RIA) 2106 (S.D. Ill. 2016); *U.S. v. Chabot*, 119 A.F.T.R.2d (RIA) 1179 (D.N.J. 2016), *aff'd*, 681 F. App'x 134 (3d Cir. 2017), *petition for cert. filed*, No. 17-477 (Oct. 2, 2017); *U.S. v. Chabot*, 681 F. App'x 134 (3d Cir. 2017), *aff'g* 119 A.F.T.R.2d (RIA) 1180 (D.N.J. 2016), *petition for cert. filed*, No. 17-477 (Oct. 2, 2017).

74 *U.S. v. Chabot*, 681 F. App'x 134 (3d Cir. 2017), *aff'g* 119 A.F.T.R.2d (RIA) 1180 (D.N.J. 2016), *petition for cert. filed*, No. 17-477 (Oct. 2, 2017); See National Taxpayer Advocate 2016 Annual Report to Congress 461.

75 *U.S. v. Pfeifer*, 117 A.F.T.R.2d (RIA) 2106 (S.D. Ill. 2016).

76 *U.S. v. Chabot*, 119 A.F.T.R.2d (RIA) 1180 (D.N.J. 2016) (court imposed fine due to taxpayer's contempt), *petition for cert. filed*, No. 17-477 (Oct. 2, 2017).

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.[77] In *In re Tax Liabilities of Doe*, the government filed an *ex parte* petition in a California district court for leave to serve a "John Doe" summons on Coinbase Inc., a virtual currency exchange company, seeking information about the company's customers.[78] The court found that the IRS had met the three "John Doe" summons requirements under IRC § 7609(f): its investigation related to an ascertainable group or class of persons; it had a reasonable basis for believing that this group or class of persons may have failed to comply with the tax laws; and it could not obtain the information it sought from another readily available source. Therefore, the court permitted the IRS to serve the summons on Coinbase.[79]

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.[80] 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.

77 See IRS Notice 2014-21, 2014-16 I.R.B. 938, *IRS Virtual Currency Guidance* (Mar. 26, 2014); 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 249-55 (Most Serious Problem: *DIGITAL CURRENCY: The IRS Should Issue Guidance to Assist Users of Digital Currency*).

78 *In re Tax Liabs. of Doe*, 118 A.F.T.R.2d (RIA) 6780 (N.D. Cal. 2016). As discussed earlier, under IRC § 7609(f), a district court must approve a "John Doe" summons prior to issuance. This proceeding is conducted *ex parte*. See IRC § 7609(h)(2).

79 *Id*. In a subsequent proceeding after the close of our reporting period, the court granted a motion by a "John Doe" to intervene and challenge the government's attempt to enforce the summons. See *U.S. v. Coinbase, Inc.*, 120 A.F.T.R.2d (RIA) 5239 (N.D. Cal. 2017).

80 IRC § 7602(a).