Procedures and Strategies for Resolving Cases at Exam (Part 1)

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THE PURPOSE OF this article is to provide a general overview of the substantive rules of practice and procedure as set forth in the Internal Revenue Code (the "Code"),[1] the Treasury Regulations and decided cases that apply to federal income tax controversies and to offer practical strategies on how to represent a taxpayer before the Internal Revenue Service (the "IRS" or the "Service") in examinations.

THE IRS MISSION AND ORGANIZATION FOR EXAMINING TAXPAYERS AND TAX RETURNS

• In 1998 the IRS revised its long-standing mission statement to read: "Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."[2] This mission statement was required to be revised by the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, hereafter referred to as "the Restructuring Act," to provide greater emphasis on serving the public and meeting the needs of taxpayers.

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[1] All references to sections are to the Internal Revenue Code of 1986, as amended.

[2] Prior to revision, the mission statement read: "The purpose of the IRS is to collect the proper amount of tax revenue at the least cost to the public, and in a manner that warrants the highest degree of public confidence in our integrity, efficiency and fairness."

The mission of the Examination Division of the IRS is to further public confidence in the enforcement of the tax laws:

> "Examination supports the mission of the service by maintaining an enforcement presence and encouraging the correct reporting by taxpayers of income, estate, gift, employment, and certain excise taxes in order to instill the highest degree of public confidence in the tax system's integrity, fairness, and efficiency." I.R.M. 1135.11.

Before the Restructuring Act, the IRS conducted its examination of taxpayers' returns by Examination Division personnel within one of 33 district offices for the district in which the taxpayer resided or had its principal place of business. The Examination Division's activities were coordinated at the regional level through the Regional Commissioner in each of four IRS geographical regions (Northeast, Southeast, Midstates and Western) and, at the national level, under the supervision of the Assistant Commissioner, Examination Division.

The Restructuring Act initiated a change in this organizational structure, one which abandoned geographical regions and created operating divisions to serve particular groups of taxpayers with similar needs and characteristics. The new operating divisions became: (1) wage and investment income; (2) small business and self-employed; (3) large and mid-size business (now called Large Business & International (LB&I)); and (4) tax exempt. Rossotti, *Modernizing America's Tax Agency*, 64 Fed. Reg. (January 5, 1999); *see also* IRS Announcement 99-106, 1999 WL 975106 (Oct. 27, 1999) establishing the locations of the new operating divisions. IRS officials said at the time that the new organizational structure should speed up the resolution of examination and appeals issues for corporate taxpayers. As discussed below, the restructuring also was intended to facilitate early referral and fast-track mediation programs to identify and resolve developed issues early in the examination cycle. Within each division, there are industry groups with their own senior technical advisers who work with industry specialists.

The IRS believed that its efforts to reform itself had reached the point where the public would measure its business results in the number of cases closed. The IRS Large and Midsize Business Division ("LMSB")[3] said in March, 2002 that the IRS "is still working on becoming a world-class organization sensitive to customer needs." One way to do so was for LMSB (now LB&I) to further develop issue management strategies with the IRS Chief Counsel's office and Treasury. As times and IRS Commissioners change, however, so does the IRS's strategic plan. The agency's broad goals through 2009 cited improved service to taxpayers as only one of three priorities, including enhanced enforcement of the tax laws and modernized business processes and technology. IRS Commissioner Mark W. Everson said in July, 2004, "In recent years, the IRS has made significant progress in improving service. . . . While the agency's commitment to service continues, the IRS must now sharpen the focus on enforcement." IR-2004-95 (I.R.S.), 2004 WL 1575450 (July 15, 2004). However, according to a study released on April 14, 2008, the Transactional Records Access Clearinghouse (TRAC) said that the audit rate for companies with $250 million or more in assets dropped to 26% in fiscal 2007 from 34% in fiscal 2006. These findings were criticized by

[3] The LMSB division was renamed the Large Business and International Division ("LB&I") effective October 1, 2010. The purpose for changing the name and realigning the division was to create a more centralized organization dedicated to improving international tax compliance. As part of this change, in November, 2010, the IRS moved international examiners out from under the industry directors, having them report directly to the deputy commissioner (international) in LB&I. The two designations for the large business division are used interchangeably throughout this outline depending on whether the authority or events referred to occurred during the LMSB or LM&I regime.

the LMSB Commissioner, saying the drop was the result of numerous factors including a new focus on risk areas, alternative dispute resolution techniques, a shrinking universe of large corporate taxpayers and a shifting of resources to the partnership area. IRS Commissioner Douglas Shulman responded to the TRAC report stating, "…I want to make one thing perfectly clear… Targeting noncompliance with our tax laws by large corporations will be a high priority at IRS while I am Commissioner."

The year 2015 has brought severe budget cuts and other problems for the IRS. As a consequence, some of the practices and policies of the IRS have changed. Nonetheless, the IRS remains committed to fighting large cases. Chief Counsel William J. Wilkins stated in May, 2015, that despite a reduced staff "IRS attorneys will continue to devote the time necessary to litigate the disputes involving large corporate and individual taxpayers." With IRS enforcement remaining a high priority at the IRS despite the cutbacks, an understanding of the examination, appeals, and litigation process is essential.

Revenue agents conduct the IRS's civil tax examinations. The revenue agent is the principal contact for the taxpayer or its representative. These revenue agents may specialize in a particular area such as Team Examination Program (formerly "large case") cases, excise and employment tax, insurance, fraud, etc. The role of the revenue agent is to find facts and assert positions based on the factual findings. Generally a revenue agent can decide whether to raise an issue and often has the power to determine whether related entities or other tax years should be examined. Today, these examiners in the field work under 10 territorial managers, who are subject to technical alignment directly through the IRS National Office in Washington.

The revenue agent's authority to reach conclusions based on the facts can afford sufficient flexibility for the taxpayer to dispose of the case. The revenue agent may have other IRS personnel assisting in the audit, including the: Agent's immediate supervisor;

- Valuation engineers;
- Market segment experts;
- Economists;
- International Examiners;
- Industry specialists; and
- Attorneys in the Field Counsel's Office of the IRS.

Although revenue agents may not volunteer information on who is assisting them in the audit, a taxpayer or representative may inquire in this regard. Oftentimes the agents will provide this information.

There are six potential phases of a team examination case in a traditional audit. These are:

- Opening phase;
- Information gathering phase;
- Issue presentation phase;
- Examination closing phase;
- Appeals phase; and
- Litigation phase.

The balance of this outline describes some of the legal and procedural issues addressed during each of these phases.

IRS AUTHORITY TO OBTAIN TESTIMONY, INFORMATION, AND DOCUMENTS

• Section 6001 of the Code requires all taxpayers to maintain and keep records sufficient to establish their tax liability for as long as the records are material to the administration of the internal revenue laws. I.R.C. § 6001; Treas. Reg. §1.6001-1. *See also* Rev. Proc. 98-25, 1998-1 C.B. 689 and I.R.C. §§ 6038A (records of foreign controlled corporations) and 6038C (records of foreign corporations engaged in U.S. businesses). In addition to permitting the IRS to examine any books, papers, records or other data that may be relevant or material in

ascertaining the correctness of any tax return, the IRS is authorized to examine books and records for the purpose of making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person respecting any internal revenue tax or collecting such tax. I.R.C. §§ 7602(a).

The IRS gathers information for use in an examination from the following primary sources:

- The taxpayer's tax and information returns;
- Information returns filed by third parties;
- The taxpayer's books and records;
- The workpapers of the taxpayer's accountant;
- Informal information provided to the IRS by the taxpayer, the taxpayer's employees or other third parties; and
- Information provided from summonses issued to third parties.

Since 1999, taxpayers have had an important right in connection with the examination of their tax liability. I.R.C. § 7602(c). Pursuant to the Restructuring Act, the IRS is prohibited from contacting a third party in connection with a tax examination or for the collection of tax without first providing the taxpayer with reasonable notice that contacts with persons other than the taxpayer may be made. Unfortunately, no remedy is provided for the IRS's failure to give such notice or to give the notice late. It will be up to creative lawyers to seek to exclude statements and evidence obtained from third parties before reasonable notice was given. The IRS's first pass at providing the required notification was fraught with problems and sparked considerable controversy. The notices were generic, sent to taxpayers as a matter of course during the beginning of examinations and before the taxpayers had a chance to present the information sought. The letters failed to identify who may be contacted, when and why. They were detrimental to the cooperative spirit that the IRS had been directed to pursue by Congress. Accordingly, the IRS modified its notification letters in response to the criticism they engendered. The amendments to section 7602 also require the IRS to "periodically provide" the taxpayer with a record of persons contacted during the examination or investigation and, in any case, to do so upon request of the taxpayer. Although there are exceptions to this rule, described below, taxpayers and their representatives will be in a much better position to evaluate the information known to the IRS during an investigation and to chart a strategy for how to deal with it. They will also be able to find the "witnesses" who provided information and to seek them out for debriefing. Up to now, debriefing cooperative witnesses who had spoken to the IRS was hit or miss. The taxpayer only learned of the IRS contact if the witness or someone associated with the witness notified the taxpayer. Often, witnesses were reluctant to do so and taxpayer's counsel remained in the dark about the information being communicated to the IRS by a taxpayer's competitors, customers or clients, suppliers, etc. Frequently, the information imparted by these contacted persons was spontaneous and unreliable.

The exception to the disclosure requirements placed on the IRS generally apply in situations that one would expect. Disclosure is not required if the taxpayer authorized the third party contact, if it is made in connection with tax collection where the IRS determines for good cause shown that giving notice would jeopardize the collection or where it may involve reprisal against a person, or in a pending criminal investigation. A civil tax fraud examination is not excluded.

The IRS cannot require a taxpayer to create records where none exist. *United States v. Davey,* 543 F.2d 996 (2d Cir. 1976); *United States v. Brown,* 536 F.2d 117 (6th Cir. 1976). Thus, for example, the IRS cannot require the preparation of a summary of voluminous information. Practical considerations, however, may warrant a taxpayer's agreement to prepare a summary or schedule of otherwise ob-

tainable data for delivery to the IRS. This may be a good strategy, for example, if the documents that would otherwise be provided to establish the information sought in a summary contain other information that would be better kept from the IRS. But, if summaries are provided, it is imperative that they be accurate and complete lest the IRS challenge them in a court proceeding.

During an examination, an IRS agent may request an onsite inspection of the taxpayer's premises. Any such inspection permitted by the taxpayer should be highly controlled so that IRS personnel are not free to casually wander about the premises, question employees or copy random documents.

Although the IRS cannot compel a taxpayer to submit to an interview without issuing a summons (discussed further, below), the IRS frequently requests that taxpayers submit to an interview during the examination process. I.R.C. § 7521 affords certain rights to taxpayers in connection with any in-person interview by an IRS employee. These rights include:

- The right not to appear unless a summons is issued;
- The right to tape record the interview if 10-days advance notice is given to the IRS (*see* IRS Notice 89-51, 1989-1 C.B. 691);
- The right to obtain a transcript of the IRS's recording of the interview, at the taxpayer's expense;
- The right to stop the interview if the taxpayer clearly expresses the desire to consult with an attorney; and
- The right to be represented by counsel at the interview.

If the IRS asks questions that require research or further consideration, no immediate answer should be given. When an answer is provided, it should be in writing.

Information Document Requests (IDRs)

The general written method used by the IRS to request information during an examination is the Information Document Request ("IDR"). Although the IRS may informally request information orally or by letter, it is in the taxpayer's interest to insist on an IDR, which is usually presented on Form 4564 or a similar computer-generated request. In large cases, an IDR identifies the particular issue being examined and sets forth by numbered paragraphs the information or documents requested. Multiple IDRs are the norm. The Market Segment Specialization Program ("MSSP") training manual provides guidance to auditors on the types of IDRs to issue for particular industries and provides sample IDRs to be used. Coordinated issue papers further describe how to use IDRs to obtain certain information, such as to evaluate a research tax credit.

On February 28, 2014, LB&I issued Directive LB&I 04-0214-004 ("the Directive"), which provides updated guidance for IRS examining agents with respect to IDRs. This Directive supersedes two 2013 directives issued by LB&I and emphasizes that taxpayers and the IRS should engage in "robust discussions" that include the issue that is the subject of the IDR. The discussions should address: (1) what information is necessary to evaluate the issue and why; (2) what information the taxpayer has and how long it will take to provide it; and (3) how long it will take the IRS to review the information for completeness and to respond to the taxpayer. The Directive emphasizes that meaningful communication between the IRS and the taxpayer "in advance of an IDR being issued" is essential.

Attached to the Directive is a summary of the requirements for issuing an IDR. If a taxpayer does not timely and completely respond to an IDR, a new enforcement process must be used which involves three stages: first, issuing a delinquency notice, second, issuing a pre-summons letter, and finally, serving a summons for the information. This enforcement process is mandatory and has no exceptions

other than to permit the agent to grant one extension per IDR for up to an additional 15 business days before the enforcement process begins. (See the Directive and its attachments for more detail on the extension and enforcement process.)

The taxpayer's responses to IDRs should be in writing and specifically identified to the issues and requests presented by the IRS. Copies of the requests and responses, including copies of all documents provided to the IRS, should be maintained in organized files by the taxpayer so that they are easily retrievable for quick reference. The taxpayer should also maintain a log of each IDR, the date received and the date of response. If the taxpayer discovers that any documents responsive to a request have been lost, destroyed or misplaced, this information should be disclosed promptly to the examining agent. An effort should be made to provide the missing information from other sources. Documents that are covered by the attorney-client privilege or work-product protection should be segregated by the taxpayer and identified in a privilege log that could be presented to a court for inspection should a summons enforcement proceeding ensue at a later date.

Where a taxpayer's records are maintained within an automatic data processing system pursuant to Rev. Proc. 86-19, 1986-1 C.B. 558, an IDR can request acknowledgment that the taxpayer will conform to the record-keeping requirements for such system. *See* Rev. Proc. 91-59, 1991-2 C.B. 841, superseded by Rev. Proc. 98-25, 1998-1 C.B. 689. The IRS's IDRs may be imprecise, overly broad or ambiguous at times. In these circumstances, it is important that the taxpayer work with the examining agent to clarify imprecise requests, limit overly broad requests and obtain a restatement of ambiguous requests. When responding to the restated requests, the taxpayer should clearly identify in writing what the restated request is and the response thereto. Where agreement with the auditor cannot be obtained, the taxpayer should supply a response to the question or document request that specifically incorporates and states the taxpayer's interpretation of the request. If the original request was overly broad, it may be necessary to object to production on that ground.

Access to Tax Accrual Workpapers

The IRS can compel the production of a corporation's internal tax accrual workpapers under I.R.C. § 7602. *United States v. Arthur Young & Company*, 465 U.S. 805 (1984). There is no accountant-client privilege that would protect the tax accrual workpapers from production. This is true even if counsel maintains the tax accrual workpaper file. *See United States v. Rockwell International*, 897 F.2d 1255 (3d Cir. 1990). However, in a number of significant cases on this issue, various courts have held that tax accrual workpapers are protected from disclosure to the IRS under the work product privilege under certain circumstances. *See*, *United States v. Textron*, 507 F. Supp. 2d 138, 150 (D.R.I. 2007) ("there would have been no need to create a reserve in the first place, if Textron had not anticipated a dispute with the IRS that was likely to result in litigation or some other adversarial proceeding."), Judgment Vacated by *U.S. v. Textron Inc. and Subsidiaries*, 577 F.3d 21 (1st Cir., 2009), *cert. denied*, U.S. 560 U.S. 924, (2010). In the lower court decision in *Textron,* the court found that not only did the reserve constitute work product but its disclosure to Textron's outside auditors did not waive the privilege. Textron and its auditors shared a common interest. The outside auditors, therefore, could not be viewed as a conduit of information to a potential adversary. On appeal to the First Circuit, in a 2 to 1 ruling, the court held that Textron and its auditor were not potential adversaries and the company's disclosure to the auditors was not a waiver of work-product immunity. *United States v. Textron*, 553 F.3d 87 (1st Cir. 2009). Although the First Circuit upheld the district court's ruling on whether the work papers were protected work-product, the court later vacated the

determination that work-product protection was not waived by disclosure to an outside auditor and scheduled a rehearing *en banc*. *United States v. Textron*, 560 F.3d 513 (1st Cir. 2009). Then, in the rehearing en banc, the First Circuit determined that the work product protection did not extend to tax accrual workpapers which were prepared by lawyers or others in the corporation's tax department for purposes of establishing tax reserve entries on the audited financial statements. *United States v. Textron Inc. & Subs.*, supra. Examining the circumstances surrounding the taxpayer's workpapers' preparation, the en banc panel noted that an "experienced litigator" would consider workpapers to be merely tax documents and not case preparation materials. The court also found that the workpapers at issue were required for securities law and accounting/audit purposes and were prepared in the ordinary course of business, not in anticipation of litigation. In a district court case decided prior to the last decision in *Textron*, a corporation's tax accrual workpapers were held to be protected by the work product privilege; the privilege was not waived by providing the documents to an independent auditor. *Regions Financial Corp. v. United States*, No. 2:06-CV-00895 (N.D. Ala. 5/8/08); *see also, United States v. Roxworthy,* 457 F.3d 590, 594-95 (6th Cir. 2006) (finding that the existence of a memorandum analyzing the likely outcomes of litigation arising out of a taxpayer's corporate structuring was itself evidence that the memorandum was made in anticipation of litigation); in an action on decision, the IRS announced it would not acquiesce in *Roxworthy*. AOD 2007-04 (Oct. 1, 2007). The District of Columbia District Court also held that documents given to an accounting firm did not constitute a waiver of work product protection. *United States v. Deloitte & Touche USA LLP,* 623 F. Supp. 2d 39 (D.C. D. 2009), *vacated in part and aff'd in part sub nom, United States v. Deloitte LLP,* No. 09-5071 (D.C. Cir. June 29, 2010).

Recently, a district court judge in Minnesota ruled that a corporation served with a summons for tax accrual workpapers concerning the possible use of tax shelter transactions could depose IRS agents prior to an evidentiary hearing on the corporation's motion to quash the summons. Discovery was found to be appropriate because there was a substantial showing that enforcement could infringe on the corporation's right to invoke work-product privilege. *Wells Fargo & Co. v. United States*, 108 A.F.T.R 2d 2011-5094 (D.C. Minn. 2011).

Prior to 2002, the IRS had a self-imposed voluntary restraint policy regarding production of internal workpapers. This policy existed since 1984. I.R.M. 4024; Announcement 84-46, 1984 WL 256332 (Apr. 30, 1984). Pursuant to this former policy, workpapers would be requested with discretion and not as a matter of standard examination procedure. The agent first had to ask the accountant for a supplementary analysis of facts relating to specific issues, limiting the request only to the portion of the workpapers believed to be material and relevant to the examination. The agent had to complete his reconciliation of Schedule M before requesting production of the workpapers. The written approval of the district office's Chief, Examination Division, was necessary prior to the request. The tax accrual workpapers were only to be used as a collateral source of information and only when the taxpayer's records were inadequate.

In 2002, the IRS modified its self-restraint policy for prohibited tax shelter transactions. In Announcement 2002-63, 2002 WL 31961482 (July 8, 2002), the IRS said it was revising its policy on tax accrual and other financial audit workpapers relating to the tax reserve for deferred tax liabilities and to footnotes disclosing contingent tax liabilities appearing on audited financial statements. The IRS could request these documents in examining any return filed on or after July 1, 2002, that claimed any tax benefit from a transaction on the IRS's list of prohibited tax shelters. Whether the request for the workpapers will be routine or merely discretionary, or whether it will be limited to the abusive trans-

action rather than all the workpapers, will depend on several factors. These factors include whether the abusive transaction was disclosed, whether the taxpayer is claiming benefits from multiple investments in listed transactions, and whether there are financial accounting irregularities. On July 9, 2004, the IRS issued changes to the Internal Revenue Manual expounding on the workpaper policy. Doc. 2004-14682; 204 TNT 138-16.

Chief Counsel Notice CC-2003-012 (April 9, 2003) provides that the IRS may request tax accrual workpapers in the course of examining any return filed on or after July 1, 2002, that claims any tax benefit arising out of a transaction that the IRS requires to be listed within the meaning of Treas. Reg. § 1.6011-4(b)(2). These are transactions considered by the IRS to be potentially abusive. If the listed transaction is disclosed in the taxpayer's tax return as set forth in Treas. Reg. § 1.6011-4, the IRS will routinely request only the tax accrual workpapers that pertain to the listed transaction. If the listed transaction was not disclosed, the IRS will routinely request all tax accrual workpapers. If multiple investments in listed transactions are claimed on a return, whether or not disclosed, the IRS will request all tax accrual workpapers. Financial accounting irregularities will also cause the IRS to request all tax accrual workpapers. For a return filed prior to July 1, 2002, that claims any tax benefit arising out of a listed transaction, the IRS may request the tax accrual workpapers pertaining to the listed transaction if the taxpayer was required to disclose the transaction and failed to do so. Although the IRS perceives the full disclosure rule as one of the smartest things it has done in combating tax shelters, it raises significant work product privilege concerns. Future litigation over disclosure of tax accrual workpapers is a virtual certainty.

The IDR seeking tax accrual workpapers will be limited to this issue and will be directed to either the taxpayer or the taxpayer's independent accounting firm based on the IRS's determination as to the location of the tax accrual workpapers. The Announcement also sets forth the procedures for issuing summonses for the tax accrual workpapers and for enforcement of the summons, if necessary. The Announcement makes clear that it does not apply to requests for tax reconciliation workpapers which are used in assembling and compiling financial data preparatory to placing the information on a return. Workpapers include final trial balances for each entity and a schedule of consolidating and adjusting entries. These workpapers may be routinely requested in the course of an examination.

The Announcement also does not apply to audit workpapers which may include work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor. The audit workpapers are retained by the independent accountant.

Recently, the Department of Justice has been making "last chance contact" calls before filing summons enforcement actions, discussed below, to gain access to corporate taxpayers' tax accrual workpapers for listed transactions. *See, United States v. Textron, supra; Regions Financial Corp. v. United States, supra*. And, in the wake of *Textron*, the Chief Counsel indicated that it was not going to change its policy of requesting tax accrual workpapers when a taxpayer has engaged in more than one listed transaction. The IRS's position and procedures are set forth in its website (www.irs.gov) in a section called Tax Accrual FAQs. With the issuance of FIN 48, Accounting for Uncertainty in Income Taxes, by the FASB, however, it is arguable that tax accrual workpapers will lose work product protection because they will be developed in the ordinary course of preparing financial statements. FIN 48 is beyond the scope of this outline, but *see* Aland, Trott, Gerdes, Lerner, Abell and Adams, *FIN 48: Impact on Federal Tax Audits and Litigation,* Taxes – The Tax Magazine, March 2008; Sonnier, Hennig and Lassar, *Tax Accrual Work*

papers and the Work Product Doctrine After Textron, Taxes – The Tax Magazine, April 2008.

The Administrative Summons

The IRS has extremely broad authority to issue summonses requiring the production of books and records or testimony by any person relevant to the determination of the taxpayer's tax liability. Section 7602(a) of the Code provides:

> "AUTHORITY TO SUMMON, ETC. – For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary is authorized –
>
> (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;
>
> (2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary may deem proper, to appear before the Secretary at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and
>
> (3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry."

A summons is not self-executing. I.R.C. § 7604. Therefore, if a summoned party refuses to comply with the summons, the IRS must bring on an enforcement action. To do so, the IRS must petition a United States District Court and establish the following elements:

- The summons is being issued for a legitimate purpose;
- The inquiry is relevant to that purpose;
- The information is not already in the IRS's possession; and
- The administrative steps required by the Code have been followed. *United States v. Powell*, 379 U.S. 48, 57-58 (1964) ("*Powell* factors").

The constitutionality of the section 7602 summons procedure has been upheld against Fourth and Fifth Amendment challenges. *United States v. Reis*, 765 F.2d 1094, 1096 (11th Cir. 1985).

As a general rule, the IRS will issue a summons only after it has failed to receive compliance with an IDR or other informal request for information. In the past, it seemed that even in these situations the IRS was reluctant to issue summonses, perhaps because of the added administrative burden attendant to issuing a summons and the delay in closing cases if summons enforcement proceedings were needed. Today, this reluctance has all but disappeared and summons enforcement proceedings are on the rise. The IRS can issue a summons to aid a tax investigation conducted by a foreign country if the matter being investigated is covered by a treaty with an information exchange agreement with the foreign country. *Mazurek v. United States*, 271 F.3d 226 (5th Cir. 2001) (IRS entitled to enforcement of summons issued at the request of the French government requiring a bank to turn over financial records of an individual under investigation by French government concerning his French tax liability); *Lidas Inc. v. United States*, 83 A.F.T.R. 2d 99-1112 (C.D.Ca. 1999), *aff'd*, 238 F.3d 1076 (9th Cir. 2001), *cert. denied*, 533 U.S. 903 (2001) (summons issued by the

IRS at the request of French tax authorities under Article 27 of the United States-France Income Tax Treaty was enforceable); *Barquero v. United States*, 18 F.3d 1311 (5th Cir. 1994); *United States v. A.L. Burbank & Co.*, 525 F.2d 9, 13-14 (2d Cir. 1975), *cert. denied*, 426 U.S. 934 (1976); *Fernandez-Marinelli v. United States*, 1995 WL 704965 (S.D.N.Y. Nov. 29, 1995); *United States v. Hiley et al.,* No. 3:07-cv-01353 (S.D. Ca. 10/2/07) (court enforced two IRS summonses under the Canadian-U.S. tax treaty which Canada requested as part of its investigation of a charitable foundation and its donors). *See Lestrade v. United States*, 945 F. Supp. 1557 (S.D. Fla. 1996) (service of summons for information to be used in a French tax investigation complied with the Hague Convention). But if the court does not have jurisdiction over a foreign entity, the summons will not be enforced. *Cayman National Bank Ltd. v. United States,* 2007 WL 641176 (M.D. Fla. Feb. 26, 2007)) (Cayman National did not reside, nor was it found in the Middle District of Florida; doing business with U.S. citizens was not sufficient to confer jurisdiction).

In a legal memorandum, the IRS Chief Counsel has concluded that a summons is the appropriate method for obtaining access to restricted portions of a taxpayer's internet website. The IRS noted that while there is no authority authorizing the use of a summons to gain access to information on a restricted website, there is a strong argument that a website constitutes "records or other data" under section 7602.

In the Chief Counsel Advice, the IRS articulated what amounted to a policy decision that before a summons issued to a journalist would be enforced over a claim of journalist's privilege, Chief Counsel approval is required. CCA 200631001 (Mar. 10, 2006). This advice was requested in connection with two third-party summonses issued to two credit rating agencies. These credit rating agencies have been held to be members of the news media and, therefore, the Chief Counsel referred to the Department of Justice procedures for summons enforcement found at 28 CFR 50.10, stating:

> The Service would have to convince the Department that the summoned information is 'essential to the successful completion of the litigation in a case of substantial importance.' This is a significantly high threshold to meet. The mere fact that large amounts of tax dollars are at stake may not satisfy this element because the Department handles many seven and eight figure cases, but it seldom seeks information from the press.

A summons must contain the following information:

- The name and address of the person whose taxes are being inquired into along with the periods under consideration. I.R.M. 4022.62 (1977).
- The identity of the person summoned. A summons directed at a corporation must be served on a corporate official, director, management agent or other person authorized to accept service of process. I.R.M. 4022.63 (1977).
- A description of the items summoned, which must be described with reasonable certainty. I.R.C. § 7603. The summoned party must know what is required of him with "sufficient specificity to permit him to respond adequately to the summons." *See*, *United States v. Medlin*, 986 F.2d 463-467 (11th Cir. 1993); rehearing denied, 996 F.2d 316 (11th Cir. 1993), *cert. denied*, 510 U.S. 933 (1993); *United States v. Wyatt*, 637 F.2d 293, 302 n.16 (5th Cir. 1981).
- The date, place and time for compliance. I.R.M. 4022.65 (1994). The summons must provide at least 10 days for the party to respond. I.R.C. § 7605(a). (In Temporary Regulations issued on September 10, 2002, the IRS includes officers and employees of the IRS Office of Chief Counsel as officers and employees before whom

summoned information or testimony under oath may be given.)

A summons is required to be served by delivery in hand or left at the taxpayer's last and usual place of abode. I.R.C. § 7603(a). A technical flaw in service of the summons, such as mailing the summons by certified mail instead of by personal delivery, in the absence of government bad faith, may constitute substantial compliance with section 7603 allowing the summons to be enforced. *See, United States v. Richey, et. al.*, 632 F.3d 559 (9th Cir. 2011). The taxpayer may move to quash the summons in court, as set forth below.

The IRS has authority to issue a summons to a third party record keeper for the production of business records of an identified person. I.R.C. § 7603(b). It may serve the third party record keeper summons in person or by certified or registered mail. A third party record keeper is a financial institution, consumer reporting agency, credit card lender, broker, attorney or accountant, enrolled agent, barter, exchange, regulated investment company, and any owner or developer of a computer software source code. I.R.C. § 7603(b)(2). An employer is *not* a third party record keeper. *Covington v. United States*, 853 F. Supp. 888 (W.D. N.C. 1994), aff'd 27 F.3d 562 (4th Cir. 1994).

Each person identified in the summons is entitled to notice and a copy of the summons within three days, but not later than twenty-three days before the date of compliance. I.R.C. § 7609(a). Notice to the taxpayer may be made by mailing the third-party summons to the taxpayer. In a case of first impression, the Sixth Circuit held that the Service's failure to afford 23 days' notice of the summons to the taxpayer under investigation did not void the third-party summons where the taxpayer was not prejudiced by the failure to comply with the notice requirement. *Cook v. United States,* 104 F.3d 886 (6th Cir. 1997).

The taxpayer has the right to protest the enforcement of a summons by filing a petition to quash and the third party record keeper may intervene in this proceeding. I.R.C. § 7602(b). The summoned party has no independent ability to initiate a proceeding to quash the summons. *Monumental Life Insurance Company v. United States*, 86 A.F.T.R. 2d ¶2000-5063 (W.D. Ky. 2000). When a taxpayer files a petition to quash, its statute of limitations will be suspended beginning on the date that the petition is filed. I.R.C. § 7609(e)(1). Similarly, in the absence of the resolution of the summoned party's response to the summons, the taxpayer's statute of limitations will be suspended beginning on the date which is six months after the Service's issuance of the summons. I.R.C. § 7609(e)(2)(A). The suspension period ends when the proceeding is concluded, including any appeals thereof. Reg. § 301.7609-5(b). The summoned party's full or partial compliance with the summons does not have any effect on the tolling of the statute of limitations. *Id.*; *Hefti v. Commissioner*, 983 F.2d 868 (8th Cir. 1993), *aff'g* 97 T.C. 180 (1991), *cert. denied*, 508 U.S. 913 (1993).
In certain situations, it might be advantageous for the IRS to issue a very broad (and maybe even unenforceable) summons under I.R.C. § 7609 to a taxpayer who refuses to extend the statute of limitations in hopes that the taxpayer will file a petition to quash.

One of the trends in third-party information gathering is to serve tax shelter promoters with summonses seeking the identity of customers who engaged in tax shelter transactions and the details of those transactions. *United States v. BDO Seidman*, 337 F.3d 802 (7th Cir. 2003), cert. denied, 540 U.S. 1178 (2004); *United States v. Arthur Andersen LLP*, 92 A.F.T.R. 2d 2003-5800 (N.D. Ill. 2003); *In re Does*, 92 A.F.T.R. 2d 2003-7001 (D.D.C. 2003); *United States v. KPMG LLP* 2003 WL 22336072 (D.D.C. Oct. 10, 2003); *United States v. KPMG LLP*, 316 F. Supp. 2d 30 (D.D.C. 2004). Summonses to promoters are cleared with Department of Justice attor-

neys before they are served on the promoters. The IRS also has been issuing summonses to law firms, accounting firms, investment banks and others who may have been involved in the promotion of questionable transactions. Speech by Chief Counsel B. John Williams, Jr. at the Texas Federal Tax Institute, June 6, 2002. *See, In re Does*, 92 A.F.T.R. 2d 2003-7190 (S.D. Fla. 2003); *United States v. Jenkens & Gilchrist, P.C.*, 93 A.F.T.R. 2d 2004-2074 (N.D. Ill. 2004); *United States v. Sidley Austin Brown & Wood LLP*, 93 A.F.T.R. 2d 2004-1849 (N.D. Ill. 2004); *Doe #1 v. Wachovia Corporation*, 268 F. Supp. 2d 627 (W.D.N.C. 2003).

The Restructuring Act expanded the quashing procedures under section 7609 to all summonses issued to third parties with respect to a taxpayer. Accordingly, a taxpayer whose liability is being investigated will now receive notice of all summonses and may bring an action to quash the summons in district court. I.R.C. § 7609(a)(1). However, a taxpayer may not move to quash a summons issued to it or any of its officers or employees. Other exceptions include a summons:

- Issued to determine whether business records have been made or kept;
- Issued solely to determine the identity of a person with a numbered account;
- Issued to aid collection of a taxpayer's or a transferee's tax liability;
- Issued by an IRS Special Agent in connection with investigation of a criminal tax offense and served on a person who is not a third-party record keeper; and
- Any John Doe summons or where notice of the summons may lead to destruction or concealment of records or the intimidation of witnesses, etc. (*see* I.R.C. § 7609(f) and (g)).

The scope of an administrative summons has been extended to reach as far as documents which are in the possession of a foreign corporation.

If a taxpayer files a motion to quash a summons, it must timely serve its petition on the IRS office specified within the summons, as required by I.R.C. §7609(b)(2)(B). If a petition to quash is timely filed but the petitioner fails to timely serve the petition on the IRS, the court will dismiss the petition on jurisdictional grounds finding that the United States' waiver of sovereign immunity had lapsed. *Tarpla* that may be relevant to the determination of any U.S. tax liability. I.R.C. § 6038C(d)(1).

A summons has no expiration date and can be enforced at any time in connection with a legitimate investigation. *United States v. Administrative Enterprises, Inc.,* 46 F.3d 670 (7th Cir. 1995) (even though there was a three and one-half year delay between the issuance of the summons and the enforcement proceeding, the summons was enforceable; latches did not apply because there was no prejudice from the delay).

The Internal Revenue Manual sets forth the factors the IRS will consider in determining whether to issue a summons:

- The possibility of securing the desired information through other means without a summons;
- The importance or necessity of the information sought;
- The adverse effect on voluntary compliance if enforcement is abandoned; and
- The tax liability involved. I.R.M. 4022.

There are limitations on the use of material obtained by a summons when the taxpayer's case is pending in the United States Tax Court. The Tax Court issued a protective order banning the use in the Tax Court proceeding of information obtained by summons when the summons was issued after the Tax Court petition had been filed by the taxpayer and with a view to using the information in the Tax Court case. *Universal Manufacturing v. Commissioner*, 93 T.C. 589 (1989). The Tax Court also issued a protective order where the IRS issued a summons after the Tax Court petition was filed by the taxpayer but where the summons covered

post-petition years. *Westreco v. Commissioner*, T.C. Memo. 1990-501. *Westreco* was a very contentious section 482 pricing case in which the section 482 issue in the post-petition years was identical to the issue in the years before the Tax Court. The Court not only banned the use of information obtained by means of the summons in the Tax Court, but also barred the IRS attorney who was involved with the later years from handling the Tax Court case. The Tax Court retreated from *Universal Manufacturing* and *Westreco* in *Ash v. Commissioner*, 96 T.C. 459 (1991) and adopted new standards for the issuance of protective orders. *Ash* involved both a pre-petition summons served on the corporation and a post-petition summons. The Tax Court determined that it would not interfere with enforcement of, or use of information obtained by, a pre-petition summons. Where a post-petition summons is issued on the same taxpayer for the same years as the years before the court, the court will issue a protective order unless the IRS can show a valid independent purpose for the summons.

There also may be limitations imposed on the use of documents produced in response to a summons in the district courts or the U.S. Court of Federal Claims. For example, in *Jade Trading, LLC, et al v. United States*, 65 Fed. Cl. 641 (2005), the Court of Federal Claims granted a protective order to maintain the confidentiality of BDO Seidman's return information during the discovery phase of a case of a taxpayer whose transactions were challenged by the IRS and who was pursuing tax refund litigation. The documents at issue were produced by BDO in response to a summons issued in the BDO promoter audit, not in the case before the Court. The Court found that BDO had a strong interest in protecting information it deemed confidential under 26 U.S.C. § 6103 and granted the protective order for purposes of the remaining discovery.

The John Doe Summons

The IRS also has the authority to issue a "John Doe" summons, which is a summons issued to a third party record-keeper that does not identify the person whose liability is at issue. I.R.C. § 7609(f), *see also* I.R.M. 4022.13. A "John Doe" summons may be issued only after a proceeding is held in a district court for the district where the person to be summoned resides or is found. I.R.C. § 7609(h)(1). The IRS must establish:

- The summons relates to the investigation of a particular person, group or class of persons;
- There is a reasonable basis for believing such person, group or class may have failed to comply with the Internal Revenue laws;
- The information sought is not readily available from other sources.

Presently, the circuits are split as to whether a District Court's determination to issue a John Doe summons may be challenged. The Eighth and Ninth Circuits have held that a third party may not challenge the validity of a District Court's *ex parte* determination to issue a summons. *United States v. John G. Mutschler & Assocs., Inc.*, 734 F.2d 363, 366 (8th Cir. 1984); *United States v. Samuels, Kramer & Co.,* 712 F.2d 1342, 1345-46 (9th Cir. 1983). The Tenth Circuit, by comparison, has held that an *ex parte* determination to issue a summons can be challenged at a later enforcement hearing. *United States v. Brigham Young Univ.,* 679 F.2d 1345, 1347-48 (10th Cir. 1982), *vacated,* 459 U.S. 1095 (1983).

To make a *prima facie* showing that a John Doe summons is enforceable, the IRS must satisfy the criteria in *Powell*. *United States v. Powell*, *supra*. A John Doe summons is not required if the IRS has a dual motive, such as an investigation aimed at unnamed as well as named persons, so long as the investigation of the named party is legitimate, *i.e.*, it satisfies *Powell*. *Tiffany Fine Arts, Inc. v. United States*, 469 U.S. 310 (1985); *United States v. Merrill Lynch & Co.*, 1993 WL 22117 (S.D.N.Y. Jan. 25, 1993). A dual purpose

summons was used to obtain the names of partners and partnerships from a financial advisor that provided financial advice to the partnerships for a fee even though the advisor was not a partner in the partnerships. *United States v. Merrill Lynch & Co., Inc.*, *supra*.

Although the John Doe summons does not identify the person whose liability is at issue, it will not be enforced if it is unclear as to the category of individuals named. *In re Does*, 1990 WL 264130 (D. Nev. Oct. 5, 1990) (unclear to whom the summons referred where the term used in the summons, "indirectly tipped gaming employees," was undefined and imprecise).

The IRS has successfully used the John Doe summons to obtain the names of taxpayers with credit and debit cards issued by offshore banks. This action was prompted by the IRS's frustration with taxpayers moving assets to offshore banks in tax havens. The information will be used to pursue the taxpayers for tax evasion. The companies who received John Doe summonses so far are Visa International, American Express and MasterCard. *See, e.g., In the Matter of the Tax Liabilities of John Does* (No. 4:03 cv 142) (E.D. Va. 2003); *In re Tax Liabilities of John Does,* __ F.Supp.__ (S.D. Ohio, 2002); *In The Matter of the Tax Liabilities of John Does*, 2000 TNT 209-24 (S.D. Fl. 2000). Similarly, a John Doe summons was authorized to be served on Paypal, the Internet funds transfer company, in connection with an investigation of transfers to and from offshore accounts. *United States v. Doe*, No. C05-04167 JW (N.D. Cal. 2/21/06). In the first case of its kind, the IRS also served a John Doe summons on Jenkens & Gilchrist, a law firm, to identify U.S. taxpayers who participated in a transaction which was or later became a listed transaction or other "potentially abusive tax shelter. *In the Matter of the Tax Liabilities of John Does*, 92 A.F.T.R. 2d 2003-5420 (N.D. Ill. 2003). The law firm contested enforcement of the summons claiming, among other things, that the identity of its clients was privileged. The court rejected its argument and ordered Jenkens & Gilchrist to provide its clients' names and documents. *United States v. Jenkens & Gilchrist, P.C.*, 93 A.F.T.R. 2d 2004-2288 (N.D. Il. 2004).

An additional consequence of the IRS's issuing a John Doe summons is that it cuts off a taxpayer's ability to file qualified amended returns under Prop. and Temp. Reg. § 1.6665-(c)(3). A qualified amended return is one for which no penalty will be imposed on the reported tax. The regulations end the period for filing a qualified amended return when a John Doe summons is served on a third party with respect to "the tax liability of a person, group or class that includes the taxpayer (or pass-through entity of which the taxpayer is a partner, shareholder, beneficiary or holder of a residual interest in a REMIC) with respect to an activity for which the taxpayer claimed any tax benefit on the return directly or indirectly."

The Designated Summons

The IRS may issue a "designated summons" which suspends the running of the statute of limitations on assessment of tax on corporate taxpayers during the period of judicial enforcement, *i.e.* the period beginning on the day the summons enforcement proceeding is commenced and ending on the day of the final resolution. I.R.C. § 6503(j). A designated summons is a summons issued to determine the amount of any internal revenue tax of a corporation for which a return was filed if certain additional requirements are satisfied. This provision, which was enacted as part of the Taxpayer Bill of Rights 2, requires that before issuance of a designated summons, the proposed summons must be reviewed by the IRS Regional Counsel for the region in which the examination of the corporation's return is being conducted. I.R.C. § 6503(j)(2)(A)(i). Because the office of regional counsel no longer exists, the review must be completed by the Division Commissioner and the Division Counsel of the Office of Chief Counsel for the organizations

that have jurisdiction over the corporation whose liability is the subject of the summons.

A "designated summons" is defined to include "any summons issued for purposes of determining the amount of any tax imposed by the Code." I.R.C. § 6503(j)(2)(A). The IRS is authorized to issue a designated summons pursuant to pre-existing procedural mechanisms used for all summonses. Pursuant to section 7605(a) and I.R.M. 4022.95(7), a summonsed party will be given a minimum of 10 days from the date of service of the designated summons to comply.

Prior to enactment of the Taxpayer Bill of Rights 2, the Service's policy was to limit the use of designated summonses to large case (now referred to as team examination) program examinations. I.R.M. 4022.95 (1995). Under the Bill of Rights, designated summonses are statutorily limited to corporations or transferees of their records that are being examined as part of the Coordinated Examination Program or any successor program. I.R.C. § 6503(j)(1). The successor program to the Coordinated Examination Program is the coordinated issue case (CIC) program.

The IRS must (i) state on the summons that the document is a "designated summons," and (ii) issue the summons at least 60 days before the stature of limitations on assessment has run (determined with regard to extensions). I.R.C. § 6503(j)(2)(A). In general, only one summons relating to any particular tax return can be considered a "designated summons." I.R.C. § 6503(j)(2)(B). The Internal Revenue Manual provides that the IRS will issue only one designated summons with regard to a corporation's tax returns. I.R.M. 4022.14-19. The tolling provisions also apply to a "related summons" which is defined as "any other summons . . . which relates to the same return as such designated summons" that is issued during the 30-day period beginning on the date on which the designated summons is issued. I.R.C. § 6503(j)(1)(a)(ii) and (B). The statute of limitations on assessment is tolled for the judicial enforcement period (the date a court proceeding (in a U.S. district court either to quash or enforce a designated or related summons) is brought with respect to the summons until its final resolution), plus an additional 60 days (or 120 days if the court requires compliance with the designated summons). I.R.C. § 6503(j)(1)(A). Under proposed regulations issued on April 25, 2008, the final resolution of a designated summons occurs when no court proceeding remains pending and the summoned party complies with the summons to the extent required by the court. If time remains to appeal a court's order, final resolution occurs when all appeals have been either disposed of or the appeal period has expired. The IRS intends to create administrative procedures by which the taxpayer can inquire about the suspension of its period of limitations under section 6503(j) and to publish these procedures in the Internal Revenue Manual. Treas. Reg. 301.6503(j)-1. The proposed regulations also address the relationship between the section 6503(j) suspension period with other suspension periods in the Code, such as under section 7609(e).

The use of designated summonses raises the concern that the IRS may employ such a summons to cover for agents who have not been diligent in the audit process. The designated summons provision also lends itself to being used by the IRS as a tool to unfairly delay the issuance of a statutory Notice of Deficiency giving the IRS more time to develop substantive issues. In addition, the provision may encourage fishing expeditions by the IRS. Although the Internal Revenue Manual says that the designated summons provision was enacted as a means to counter taxpayers who either refuse to extend the statute of limitations or terminate a statute of limitations before the IRS has fully developed a case (I.R.M. 4022.95 (1994)), the government is not required to show that a taxpayer did not cooperate with the IRS before issuance of the designated summons. *United States v. Derr*, 968 F.2d 943 (9th Cir. 1992). Accordingly, a taxpayer is not entitled to an

evidentiary hearing on cooperativeness before enforcement of the designated summons is ordered. *Id*. Nor do the Service's internal policies concerning issuance of a designated summons provide taxpayers with legally enforceable rights. *Id.* Only the requirements meeting the *Powell* standard for enforceability of any section 7602 summons need be satisfied to enforce a designated summons. Typically, taxpayers comply with the designated summons in order to avoid an enforcement action and the extension of the statute of limitations that would ensue.

Summons Enforcement Procedures

Because a summons is not self-enforcing, if a taxpayer fails to respond, the IRS must initiate an enforcement proceeding in a federal district court. *United States v. Samuels, Kramer & Co.*, *supra*. A taxpayer cannot move to quash an IRS summons where there is no threat of consequence for refusal to comply and, unless the IRS has sought to enforce the summons in court, no case or controversy giving rise to jurisdiction. *Schulz v. Internal Revenue Service*, 395 F.3d 463 (2d Cir. 2005). The IRS does not routinely seek enforcement of every summons because of the extra burden of initiating an enforcement proceeding. And although it is quite possible that the IRS will not seek to enforce a summons against a nonresponsive taxpayer, the IRS is prepared to pursue summons enforcement proceedings. The Service's Examination Program Letter for fiscal year 1997, which set forth the Examination Division's priorities, provided that in CEP (now referred to as CIC) audits taxpayer procrastination would be dealt with effectively using upper level management and "the available enforcement techniques including summonses where appropriate." Examination Program Letter, 97 TNT 32-45 (12/1/96). More recently, the IRS has moved aggressively in enforcing summonses in its investigations and examinations of tax shelters. *See, for example, Xelan, Inc. v. United States*, 93 A.F.T.R.2d 2004-2269 (E.D. Pa. 2004); *Xelan, Inc. v. United States*, 361 F. Supp. 2d 459 (D. Md. 2005). With respect to the procedures the IRS will follow for enforcement of a summons against a limited liability company (LLC) that has elected to be treated as a partnership for tax purposes, *see Chief Counsel Advice*, 200543054 (July 22, 2005).

The affidavit of the agent asserting the *Powell* factors is sufficient to establish a *prima facie* case for enforceability of a summons. *United States v. Rockwell International*, 897 F.2d 1255 (3d Cir. 1990). To prevent enforcement, the summoned party must either rebut the Service's allegations or present an affirmative defense. *United States v. McCarthy*, 514 F.2d 368, 372-73 (3d Cir. 1975). Once the *Powell* factors are met by the agent's affidavit, the burden shifts to the taxpayer to disprove the *Powell* factors. The following is a partial listing of possible challenges to prevent enforcement:

Improper Purpose

The summons was issued for an improper purpose, such as pure research. *Powell*, *supra* at 58. In *United States v. Clarke*, 11th Cir., 2013 WL 1668345 (11th Cir. Apr. 18, 2013), *vacated and remanded,* 134 S.Ct. 2361 (2014), *on remand,* 573 Fed. Appx. 826 (11th Cir. 2014), *on remand,* 2015 WL 1324372 (S.D. Fla. Feb. 18, 2015), *aff'd,* 816 F.3d 1310 (11th Cir. 2016), it was alleged that the summons was issued to retaliate for the refusal to extend the statute of limitations. Citing *Powell*, the Eleventh Circuit said that after the IRS makes its four-part *prima facie* showing that demonstrates the investigation will be conducted for a legitimate purpose, the burden shifts to the opposing party to disprove one of the four elements or convince the court that enforcement would be an abuse of the court's process. The United States Supreme Court reversed the Eleventh Circuit, holding that "as part of the adversarial process concerning a summons's validity, the taxpayer is entitled to examine an IRS agent when he can point to specific facts or circumstances plausibly raising an inference of bad faith. Naked allegations of improper purpose are not enough: The taxpayer must offer some

credible evidence supporting his charge." 134 S. Ct. 2361 (2014).

Irrelevant Material

The summons was issued to obtain irrelevant materials. *Id*. But the IRS is allowed considerable latitude in arguing relevance. For example, relevance is satisfied if the materials might throw light upon the correctness of a return. *United States v. Arthur Young & Co.*, 465 U.S. 805, 813-15 (1984). *See also Merrill Lynch, supra*; *Triple A Machine Shop, Inc. v. United States*, 74 A.F.T.R. 2d 94-7330 (N.D. Cal. 1994).

IRS Possession

The materials subject to the summons are already in the Service's possession. *Powell, supra*. Even if the materials sought were given to the IRS by the taxpayer, they would not be deemed to be in the possession of the IRS if they are difficult for the IRS to retrieve. *United States v. First National Bank of New Jersey*, 616 F.2d 668, 673-74 (3d Cir. 1980), *cert. denied sub nom. Levey v. United States*, 447 U.S. 905 (1980). If, however, the materials received from the taxpayer are retrievable by the IRS, the court may limit enforcement of the summons. *United States v. Moseley*, 832 F. Supp. 56 (W.D.N.Y. 1993).

Failure To Follow Procedure

The administrative steps required by the Code for the issuance of a summons have not been followed. *Id.* In order for this challenge to be successful, the IRS must violate a constitutional or statutory provision. *United States v. I.C. Indus., Inc.*, 555 F. Supp. 219, 222 (N.D. Ill. 1983). *See Digby v. Commissioner*, 103 T.C. No. 441 (1995), however, where the failure to provide written notice of a second inspection under I.R.C. § 7605(b) did not prevent enforcement of the summons for that year. After an IRS agent examined taxpayers' 1987 return and determined a deficiency, a second agent's audit of 1988 produced disallowances for both 1987 and 1988 based on taxpayers' failure to have adequate basis to claim an S corporation loss. Review of the same records for another taxable year that results in a proposed deficiency for an already examined year is *not* a second inspection under section 7605(b). If the IRS merely violates its own internal procedures or manual guidelines, this exception will not prevent a District Court form enforcing the summons. *Id., United States v. Price Waterhouse & Co.*, 515 F. Supp. 996, 999 (N.D. Ill. 1981).

Burdensome Request

The summons requests materials unrelated to the investigation or is unduly burdensome. *United States v. Darwin Constr. Co.*, 632 F. Supp. 1426, 1430 (D. Md. 1986), *subsequent proceeding*, 679 F. Supp. 531 (D. Md. 1988), *aff'd*, 873 F.2d 750 (4th Cir. 1989).

Prosecution Recommended

The summons was issued after a recommendation has been made to the Justice Department that prosecution or a grand jury investigation should be commenced. I.R.C. § 7602(d). This determination is made as of the date the enforcement petition is filed. If the petition for enforcement is filed before a Justice Department referral is made but there is a subsequent referral in effect during the pendency of an appeal of the enforcement order, the summons is enforceable. *United States v. Natco Petroleum, Inc.*, 1999WL 44064 (10th Cir. 1999).

Harassment

The underlying reason for the issuance of a summons was harassment. *Powell, supra.* However, bad faith on the part of an examining agent alone will not satisfy the "institutional" bad faith required to quash a summons. *2121 Arlington Heights Corp. v. Internal Revenue Service*, 109 F.3d 1221 (7th Cir. 1997) (although examining agent said he would ruin the taxpayer's business, the agent's "tough language" was not enough to show bad faith on the part of the government).

Lack of Possession

The summoned party does not possess the documents requested. *United States v. Rylander*, 460 U.S. 752, 757 (1983).

Privileged Material

The summoned materials are protected by the attorney-client privilege or work product doctrine. *United States v. Bell*, 74 A.F.T.R. 2d 94-7271, (N.D. Cal. 1994); *United States v. McCorkle*, 74 A.F.T.R. 2d 94-5323 (N.D. Ill. 1994); *United States v. Hankins*, 631 F.2d 360, 365 (5th Cir. 1980) (attorney-client privilege); *United States v. Brown*, 478 F.2d 1038, 1041 (7th Cir. 1973) (work product doctrine). Corporations can assert the attorney-client privilege. *See Upjohn Co. v. United States*, 449 U.S. 383 (1981). The privilege protects both the facts and advice rendered by the attorney. The court may conduct an *in camera* review of the documents to determine whether the privilege claim was properly asserted. *United States v. BDO Seidman, LLP and Robert S. Ciullo, et al.,* No. 02C4822 (N.D. Il. March 30, 2005). Communications between employees of a subsidiary and counsel for the parent corporation may be privileged if the employee possesses information critical to the representation of the parent company concerning matters within the scope of employment. *Admiral Ins. v. United States District Court for the District of Arizona*, 881 F.2d 1486, 1493 n.6 (9th Cir. 1989); *United States v. Mobil Corp.*, 149 F.R.D. 533 (N.D. Tex. 1993) (memorandum by foreign subsidiary's counsel to parent's counsel was protected by the attorney-client and work product privileges). Communications with in-house counsel are generally covered if the customary formulation of the attorney-client privilege exists. *Cf.* business advice, which is not covered by the privilege, even if it is given or received by in-house counsel. *See United States v. Adlman*, 68 F.3d 1495 (2d Cir. 1995); *Karme v. Commissioner,* 73 T.C. 1163, 1183 (1980), *aff'd*, 673 F.2d 1062 (9th Cir. 1982). *See also Georgia-Pacific Corp. v. GAF Roofing Manufacturing Corp.*, 1995 U.S. Dist. LEXIS 671 (S.D.N.Y. Jan. 24, 1996) (an in-house lawyer's business judgments were not protected); *In re Kidder Peabody Securities Litigation*, 168 F.R.D. 459 (S.D.N.Y. 1996) (memos and notes from an outside counsel's investigative report were not entitled to work product protection because it was based more on business concerns than anticipated litigation); and *In re Woolworth Corp. Securities Class Action Litigation*, 1996 U.S. Dist. LEXIS 7773 (S.D.N.Y. June 6, 1996) (outside committee's internal investigation was protected because it was unrealistic to distinguish between legal and business purposes during pending litigation). *See also, Levi Strauss & Co. v. United States*, No. C 03 3212 MMC (N.D. Cal.),, in which a terminated in-house lawyer tried to deliver corporate documents to the IRS over the corporation's claim of theft and privilege.

Neither the attorney-client nor work product privilege applies to materials created for the preparation of tax returns or disclosure to third parties. *United States v. Lawless*, 709 F.2d 485 (7th Cir. 1983). Advisory memoranda and other materials prepared in anticipation of litigation may be subject to work product protection even if prepared prior to the audit or transaction, *United States v. Adlman*, *supra*; *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985), *aff'd in part, rev'd in part and remanded,* 856 F.2d 855 (7th Cir. 1988). In some cases the in-house counsel's work product protection has been said to be somewhat tricky, such as in the insurance business, which "is always conducted with an eye to litigation." *United States v. First Midwest Bank*, 79 A.F.T.R. 2d ¶ 97-1502 (N.D. Ill. 1997).

The attorney-client privilege may apply to outside consultants working for the attorney, such as accounting firms, economists and appraisers. *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961). In *Bell*, *supra* (also known as *Conner Peripherals*), for example, the privilege was found to apply to a transfer pricing report of an outside accounting firm that had been prepared at the request and direction of outside counsel. *See also Bernardo v. Commissioner*, 104 T.C. 677 (1995). Not all non-business communi-

cations with counsel are covered by the attorney-client privilege. Non-confidential communications with counsel are excluded, as are law firm billing statements in most cases. *See United States v. Massachusetts Institute of Technology,* 957 F. Supp. 301 (D. Mass. 1997), *aff'd in part, vacated in part,* 129 F.3d 681 (1st Cir. 1997). The attorney-client privilege can be waived by producing privileged documents, even in the case of an inadvertent disclosure, or by communicating the privileged information to a third-party not covered by the privilege. *See Massachusetts Institute of Technology*, *supra*; *Westinghouse Electric Corp. v. Republic of the Philippines*, 951 F.2d 1414, 1425-27 (3d Cir. 1991); *In re Subpoenas Duces Tecum*, 738 F.2d 1369-1370 (D.C. Cir. 1984); *Permian Corp. v. United States,* 665 F.2d 1214, 1221-22 (D.C. Cir. 1981); *cf. Diversified Industries Inc. v. Meredith,* 572 F.2d 596 (8th Cir. 1977) (en banc), which recognizes a selective waiver as to one person but the ability to continue to assert the privilege as to another.

Fifth Amendment

The summoned information is protected by the right against self-incrimination.[4] *United States v. Troescher*, 99 F.3d 933 (9th Cir. 1996); *United States v. Peters*, 73 A.F.T.R. 2d 94-2058, (C.D. Cal. 1994); *United States v. Wirenius*, 94-1 U.S.T.C. (CCH) ¶ 50,132 (C.D. Ca. 1994). However, a corporation's sole shareholder and custodian of records cannot refuse to turn over corporate records on the grounds of the self-incrimination privilege. *See United States v. Maxey & Co.*, 956 F. Supp. 823 (N.D. Ind. 1997); *United States v. Stone*, 976 F.2d 909 (4th Cir. 1992), *cert. denied,* 507 U.S. 1029 (1991). The act of production privilege does not extend to the business records of a corporation and an individual cannot invoke the Fifth Amendment privilege to avoid producing corporate records, even if the records might incriminate the person in possession of them. *See, United States v. Doe*, 465 U.S. 605 (1984); *United States v. Back to Health Chiropractic, et al.*, Nos. 1:05-cv-129, 1:05-cv-130 (E.D. Tenn. 11/1/2005). The act of producing the corporate records by the single shareholder is not admissible in a criminal trial of the shareholder. *See, e.g., In Re Grand Jury Subpoenas*, 959 F.2d 1158, 1164 (2d Cir. 1992). The Fifth Amendment privilege does not extend to documents being held by trusts, which are collective entities. *See, United States v. Crum*, 87 A.F.T.R. 2d ¶2001-2301 (N.D. Ind. 2001), *aff'd*, 288 F.3d 332 (7th Cir. 2002). If documents sought to be protected by the Fifth Amendment privilege are determined not to be entitled to such protection because, for example, they are not incriminating, the summons will be enforced. *United States v. Pate,* 94 A.F.T.R. 2d 2004-5480 (5th Cir. 2004).

If the summons satisfies the *Powell* factors on the date of issuance it is valid and will be enforced notwithstanding events occurring after the issuance of the summons. *United States v. Cromer*, 483 F.2d 99, 101 (9th Cir. 1973). Issuance of an IRS administrative determination, such as a Final Partnership Administrative Adjustment Notice (FPAA) is not a grounds for overturning a summons issued after the administrative determination. *Russian Recovery Fund, Ltd. and Russian Recovery Advisors, LLC. v. United States*, 103 A.F.T.R.2d 2009-681 (D. Mass 2009); *PAA Management Ltd. v. United States*, 962 F.2d 212 (2d Cir. 1992). Assessment of taxes and payment thereof does not moot a summons' enforceability. *See United States v. V-1 Oil Co.*, 1993 U.S. App. LEXIS 30183 (9th Cir. Nov. 10, 1993). Except in the case of third-party record keeper and designated summonses, there is no suspension of the statute of limitations during the pendency of the summons enforcement proceeding. A summons enforcement proceeding therefore can be used as a delaying tactic, particularly where expiration of the statute of limitations is imminent.

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[4] This discussion applies to income tax returns and does not address the required records exception to the Fifth Amendment as applied to the Bank Secrecy Act, particularly with respect to a Report of Foreign Bank and Financial Accounts (FBAR). The application of the Fifth Amendment to FBARs is beyond the scope of this article.

Third party compliance with a summons does not moot the issue of enforceability. *Church of Scientology v. United States*, 506 U.S. 9 (1992).

Taxpayers rarely prevail in summons enforcement actions. *See Clearwater Consulting Concepts LLP et al. v. United States*, 102 A.F.T.R.2d 2008-5307 (D.V.I. 2008), vacated, 104 A.F.T.R. 2d 7313 (D.V.I. 2009 (court enforced a third-party summons issued to a Virgin Islands bank in the investigation of whether two U.S. Virgin Islands partnerships were required to report income and file U.S. tax returns). Moreover, courts may refuse to stay enforcement pending appeal of a district court's enforcement order (so that production of the records may moot the appeal). *See, United States v. Marra*, 96 A.F.T.R.2d 2005-6471 (D.N.J. 2005). But see the argument presented in the taxpayer's brief in *Estate of Kenneth H. Reisirer v. United States*, No. 05-35615 (5th Cir. 2005), where a district court stayed enforcement of an IRS summons for bank records. In addition to the foregoing challenges, taxpayers should consider, as a possible fallback position, a request to limit the Service's use of the summoned information (*i.e.*, a conditional enforcement order). In *United States v. Zolin*, 491 U.S. 554, 560-62 (1989), the Supreme Court held that a district court has the authority to issue a conditional enforcement order. *Zolin* represents a major departure from the earlier majority view that a district court's only task is to determine whether the summons should be enforced. *United States v. Barrett*, 837 F.2d 1341, 1350 (5th Cir. 1988), *cert. denied*, 492 U.S. 926 (1989). It will be interesting to observe what circumstances other district courts will consider in granting conditional enforcement orders. Perhaps one scenario for its application is in the section 482 area to prevent the IRS from disclosing a taxpayer's confidential proprietary information (*e.g.*, technical data or product line financial data) to competitors or outside experts. *See* O'Brien and Cunningham, *Protecting Against the Disclosure of Trade Secrets to Independent Experts and Third-Party Witnesses During an Internal Revenue Service Examination*, 42 Tax Exec. 99 (1990).

Failure to comply with a summons that has been enforced by a court is punishable as a civil contempt. *United States v. Bosset*, 101 A.F.T.R.2d 2008-2633 (M.D. Fla. 2008).

Formal Document Requests

Section 982 provides procedures for the use of "Formal Document Requests" to obtain documentation or information from foreign sources and sanctions for noncompliance with such requests. *See* Aland, *Expanding IRS Access to Foreign-Based Documents and Information in U.S. Tax Audits and Litigation*, 64 Taxes 890 (1986). A Formal Document Request is neither an IDR nor an administrative summons. It is a separate, written document request expressly stating that it is being made under section 982 which seeks the production of foreign-based documents. The IRS may issue a Formal Document Request after normal administrative procedures have been unsuccessful in obtaining foreign-based documentation. I.R.C. § 982(c)(1). Foreign-based documentation means any documentation located outside of the United States which may be relevant or material to the tax treatment of the item under examination. I.R.C. § 982(d)(1). In a legal memorandum, the IRS has advised its district counsel that the Formal Document Request should not be used if service of a summons under section 7602 can be made. If the summoned party fails to comply, a summons enforcement proceeding should be initiated. ILM 199938002 (July 28, 1999).

Within ninety days after a section 982 request is mailed, the recipient of the Formal Document Request may commence a proceeding to quash in a district court. The decision of the district court is a formal, applicable order. I.R.C. § 982(c)(2). Statutes of limitations on assessment, collection and criminal prosecution are suspended during the pendency of the proceeding. I.R.C. § 982(e).

Grounds for quashing the request include contentions that all or part of the documentation is ir-

relevant to the tax issue, the place of production within the United States is unreasonable, the requested documents or copies thereof are available in the United States or there is reasonable cause for the failure to produce or delay in production. H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. (1982); *see also*, *Good Karma LLC v. United States*, 103 A.F.T.R.2d 2009-2333 (N.D. Ill. 2008) taxpayer argued it would cost millions of dollars to comply with the request and would be unduly burdensome). If a criminal investigation of the taxpayer is contemplated but no recommendation of prosecution has been made to the Department of Justice, a Formal Document Request will be enforced as long as the IRS maintains an ongoing civil interest in the taxpayer's tax liability. This is the case even if a foreign jurisdiction, in cooperation with the IRS, has commenced a criminal investigation of the taxpayer whose records are being sought. *Chris-Marine USA, Inc. v. United States*, 892 F. Supp. 1437 (M.D. Fla. 1995).

As in the case of administrative summonses, the IRS has the burden of proof with respect to relevance and materiality of any document requested. In addition, the IRS must show the investigation is being conducted for a legitimate purpose, the documents are not already in its possession and the administrative steps established by the Code have been followed. H.R. Conf. Rep. No. 760, *supra*; *International Marketing, Ltd. v. United States*, 90-2 U.S.T.C. (CCH) ¶ 50,476 (N.D. Cal. 1990); *Yujuico v. United States*, 818 F. Supp. 285 (N.D. Cal. 1993).

If the taxpayer fails to substantially comply with the Formal Document Request, the court which has jurisdiction over the civil tax proceeding may grant the Service's motion to prohibit the taxpayer from introducing into evidence the foreign-based documentation. I.R.C. § 982(a). *See Flying Tigers Oil Co., Inc. v. Commissioner*, 92 T.C. 1261 (1989). The court will admit foreign-based documentation if the taxpayer establishes that such failure is due to reasonable cause. I.R.C. § 982(b)(1). Reasonable cause, however, is not satisfied merely because the foreign jurisdiction would impose a civil or criminal penalty on the taxpayer or any other person for disclosing the requested documentation. I.R.C. § 982(b)(2). Taxpayers should exercise every effort to avoid having the IRS issue a Formal Document Request because failure to comply or establish a reasonable cause defense can greatly prejudice future settlement negotiations or litigation.

Demands for Computer Software

In large-case audits, the IRS routinely will demand access to computer records and to the computer program used to calculate the taxpayer's tax return, as well as for assistance from the taxpayer's personnel to run the program. Computer Audit Specialists will ask for direct access to run sampling and other programs using the taxpayer's computers and data. I.R.M. 42(13)2 (Computer Assisted Audit Program (CAAP)). The IRS can compel the taxpayer to produce original computer tapes comprising part of its financial recordkeeping system pursuant to section 7602. *United States v. Davey*, *supra* (purpose of section 7602 was to allow the IRS access to all relevant or material records and data in the taxpayer's possession no matter in what form the records are kept).

Not infrequently, the computer program is licensed to the taxpayer by a third-party and constitutes the proprietary information of the third-party. The IRS frequently seeks these computer programs from the taxpayer-licensee on the theory that it is relevant to its tax examination. Prior to enactment of the Restructuring Act there were no specific statutory restrictions on the IRS's ability to demand the production of computer records, programs, source code or similar materials. The taxpayer's only recourse was to seek a protective order barring the Service's use of the computer program in examining other taxpayers. *See, e.g.*, *United States v. Norwest Corp.*, 116 F.3d 1227 (8th Cir. 1997) (affirming the District of Minnesota's restricted enforcement of a summons for production of a copyrighted com-

puter program created by Arthur Andersen LLP and licensed to a large bank holding corporation to prepare its returns). The lower court rejected the argument that the Copyright Act trumps the IRS's statutory authority to issue a summons. The Eighth Circuit followed the restrictions placed on enforcement by the lower court and limited the IRS's use and disclosure of the program and required its return at the conclusion of the audit); *Cf.* I.R.M. 2340 (proprietary computer software should not be obtained by the IRS unless the IRS is licensed and pays appropriate fees).

The enactment of section 7612 now imposes special procedures and protections for the summoning of computer software. Subsection (a)(1) of section 7612 provides a general prohibition on the use of an IRS summons and the commencement of a summons enforcement proceeding for any tax-related computer software source code. But this new general rule is swallowed up by its exceptions.

The exceptions include:

- Ascertaining the correctness of an item on the taxpayer's return where the need for source code information outweighs the risks of unauthorized disclosures of trade secrets;
- Inquiring into an offense connected with the internal revenue laws;
- Internal use computer software source codes;
- Communications between the taxpayer or related persons and the owner of the computer software source code; and
- Computer software source codes required to be disclosed under any other provision of Title 26.

The primary exception described above applies to situations where the IRS is unable to reasonably ascertain whether a tax return item is correct from the taxpayer's books and records or from computer software executable code to which the source code and associated data relates. In these situations, the IRS may seek the tax-related computer software source code if it identifies the portion of the source code needed to verify the tax return item and determines that this need outweighs the risk of trade secret disclosure. Tax-related computer source code is the source code for any computer software program intended for accounting, tax return preparation or compliance or tax planning. The IRS will satisfy the showing required to reach the source code information if it:

- Determines it is not feasible to determine the item's correctness without access to the computer software executable code and associated data;
- Makes a formal request to the taxpayer for the code and data and to the source code owner; and
- Fails to receive the code and data within 180 days of the request.

In an IRS legal opinion on confidentiality agreements, the IRS Chief Counsel's Office advised that the IRS should not enter into a confidentiality agreement to protect the source code of software summoned by the IRS, even though the software license agreement requires the taxpayer/licensee to procure a confidentiality agreement prior to turning the software over to a governmental agency. C.C.A 200305010 (Oct.17, 2002)). This Chief Counsel Advice concluded that a separate confidentiality agreement was not necessary because Code section 7612(c) gives adequate protection to the software source code. Section 7612(c) provides with respect to software or source code that otherwise comes into the IRS's possession in the course of an examination that:

- The use of the software is limited to the particular taxpayer's examination;
- The specific IRS personnel who will have access to the software must be identified in advance to both the taxpayer and the software owner;
- The software must be kept in a secure location and source code must not be removed from the owner's place of business without the owner's permission or a court order;

- Copying of the software is strictly limited; and
- All copies and related material, together with a written certification, must be returned to the owner after the permitted examination. However, these protections might still cause concern that the terms of a software license agreement might nevertheless be violated if turned over to the IRS without a separate confidentiality agreement.

If a summons enforcement proceeding is commenced to obtain this data, any party may obtain a hearing before the court to determine whether the requirements of any of the exceptions to the rule of non-disclosure have been satisfied. If the summons is served on any owner or developer of a software source code, the third-party record keeper rules apply. The court in any such enforcement proceeding may make any non-disclosure or protective order necessary to protect trade secrets and other confidential information. I.R.C. § 7612(c). In addition, the IRS may not use the information it acquires in connection with any other taxpayer and it must provide the taxpayer and the software owner with a written list naming those who will have access to the software. It must also maintain the software in a secure place. In the case of computer software source code, the code may not be removed from the owner's place of business in the absence of a court order or the owner's permission. The Code also sets out the requirements on the IRS for controlling the making of copies of the software, the return of the original, the destruction and deletion of all copies and the certification of same by the IRS. Written agreements must also be obtained from third parties who analyze the software on the government's behalf, including a non-compete clause. All software is treated as tax return information for section 6103 purposes. I.R.C. § 7612(c)(2).

Privilege Logs

Both the IRS and the courts will require a taxpayer asserting privilege in a summons enforcement matter or discovery to prepare a detailed privilege log identifying the documents for which a privilege is claimed. These logs generally require disclosure of the following information about each document:

- The date of the document;
- The nature of the document—i.e. memorandum, letter, e-mail, etc.;
- The addressee of the document;
- The author or signatory of the document;
- The names of the individuals and entities shown as copied on the document;A general description of the subject matter of the document.

In Chief Counsel Notice CC-2002-028, issued on July 19, 2002, the IRS established requirements for the review and disclosure of privilege logs or similar documents that identify third parties in court actions. This notice was issued in response to a well-publicized and embarrassing incident in which the names of third parties who had participated in certain tax shelters were revealed in a privilege log attached to a publicly-filed motion. The notice directs Chief Counsel attorneys to closely examine any privilege log that will be made public in the course of litigation to determine whether the information concerning the identity of any third party should be redacted. The redaction is to be made before the log is provided to the Tax Court or the Department of Justice. Unredacted information will continue to be given to the Department of Justice with a request to take appropriate steps to protect the information from disclosure, except as the interests of justice require.

Part 2 of this article will appear in the Fall issue and will address Protecting Confidentiality, Document Retention and Destruction, and Traditional Privilege Defenses, Audit Planning Techniques and more.