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Can a taxpayer refuse an IRS summons?

A case before the Supreme Court may soon answer that question.

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During the course of an IRS investigation, the IRS has the authority to issue an administrative summons seeking records and testimony (Sec. 7602). The IRS may summons records, whether they are in the taxpayer's or a third party's possession, including in the possession of the taxpayer's business associates, acquaintances, prior employers, and even financial institutions (Internal Revenue Manual (IRM) §25.5.5.2). (One exception to this sweeping rule is that the IRS may not issue a summons or commence an enforcement proceeding if the IRS has referred a criminal tax case to the Department of Justice (Sec. 7602(d)).)

Assume that during an IRS audit of a company's tax returns, the IRS questions large interest expense deductions on the returns. Time is running out on the statute of limitation for assessing a liability for the year under examination, so the IRS asks the taxpayer for an extension of time. The taxpayer refuses. The IRS agent then prepares and signs her final audit report setting forth the proposed adjustments.

But before issuing the final report to the taxpayer, in an effort to gather information for the investigation, the agent issues a summons to the CFO of another company, who was the counterparty to the transactions that are under audit. The summons directs the CFO to give testimony and produce books and records relating to the IRS's investigation. The summonsed party is then placed in the not-so-desirable position of having to respond to the IRS summons (i.e., appear before the IRS to give testimony and produce for examination the documents identified in the summons).

At this stage in the proceedings, what options does the CFO have to resist the summons in court? Should a court allow an adversarial hearing where the summonsed party has the opportunity to examine the IRS agent about her motives for issuing the summons? Or is the summonsed party limited to making legal arguments based on the evidence already in his possession without the benefit of discovery?

Stepping back for a moment, one of the factors that the IRS considers before issuing an administrative summons is whether the Service has made an attempt to obtain the information from taxpayers and witnesses voluntarily before issuing a summons (IRM §25.5.1.4). Working with the IRS and complying with information document requests (IDRs) issued during an IRS examination helps to prevent the issuance of a summons.

The IRS Large Business and International Division (LB&I) recently announced a new directive on IDRs that governs the procedures for IDR issuance and enforcement (LB&I-04-0214-004). When both the IRS and taxpayers engage in robust, good-faith communication in advance of an IDR's being issued, summons enforcement procedures should be needed only infrequently, according to the new directive.

Nevertheless, if meaningful communication breaks down and/or the IRS considers the taxpayer's responses to the IDRs to be incomplete or inadequate, the IRS may issue an administrative summons to obtain the documents. Taxpayers have certain rights and privileges at this stage in the administrative proceedings, including the Fifth Amendment privilege against self-incrimination, the right to be represented by counsel, and the attorney-client privilege (IRM §25.5.5.4). The IRS may obtain the summonsed party's testimony in the presence of a court reporter at a federal building, and, unlike in a civil deposition, the rules of evidence do not apply. IRS counsel may be present, and the summonsed party has a right to a copy of the transcript of the proceedings. If the summonsed party fails to show up and comply with the summons, the IRS may bring an action in federal court seeking enforcement of the summons (IRM §25.5.10.4).

But what if the summonsed party wants to resist producing the records or giving testimony? A case pending before the Supreme Court may shed light on the options available to a summonsed party who argues that the IRS

issued the summons for an improper purpose and therefore the summons should not be enforced (*Clarke,* No. 13-301 (petition for *cert*. granted 1/10/14)).

In the appellate level, the Eleventh Circuit held that the recipients of an IRS summons were entitled to an adversarial hearing to explore allegations that the IRS issued administrative summonses for an improper purpose (*Clarke*, 517 Fed. Appx. 689 (11th Cir. 2013)). The IRS, during an examination of a partnership's tax returns for the 2005, 2006, and 2007 tax years, questioned a $17 million interest expense deduction claimed on both the 2006 and 2007 tax returns.

As part of the agent's examination, in September and October 2010 the IRS issued five administrative summonses to third parties directing the individuals to give testimony and produce for examination certain books, records, and papers. In December 2010, the IRS issued a Notice of Final Partnership Administrative Adjustment (FPAA), proposing adjustments to the partnership's tax returns for the 2005 through 2007 tax years. In February 2011, the partnership filed a petition in Tax Court challenging the IRS's proposed FPAA adjustments.

When the recipients did not comply with the IRS summons, the IRS, after the Tax Court proceedings had commenced, filed petitions for enforcement in the federal district court. To enforce the summons, the IRS had to establish all four of the so-called *Powell* factors: (1) The investigation will be conducted pursuant to a legitimate purpose; (2) the inquiry may be relevant to the purpose; (3) the information sought is not already within the IRS's possession; and (4) the administrative steps required by the IRS have been followed (*Powell*, 379 U.S. 48, 57–58 (1964)).

To meet these requirements, the IRS agent made a declaration that the *Powell* factors were satisfied. Once the IRS makes its initial showing of good faith, the burden is on the party challenging a summons to disprove one of the *Powell* factors or to demonstrate that enforcing the summons would constitute an abuse of the court's process (*Nero Trading, LLC*, 570 F.3d 1244, 1249 (11th Cir. 2009)).

In the *Clarke* case, the recipients of the summonses and the partnership as intervenor (the respondents) filed a response to the petition to enforce the summons and subsequently sent a letter to the IRS seeking materials concerning the issuance of the summonses and requesting depositions of the IRS agent and other IRS officials. The IRS declined, reasoning, in part, that the summons proceedings are summary in nature and that the taxpayer is not entitled to discovery.

The respondents asserted that the IRS may have issued the summons for improper purposes, one of which was in retribution for the taxpayer's refusal to extend the statute of limitation. If the IRS issued the summons only to retaliate, that purpose reflects on the good faith of the particular investigation and would be improper, according to the taxpayer. The respondents sought an evidentiary hearing to question IRS officials about the IRS's reasons for issuing the summonses. The district court flatly rejected their position and issued an order enforcing the summonses (*Clarke*, No. 11-80456-MC-RYSKAMP/VITUNAC (S.D. Fla. 4/16/12)).

The respondents appealed. Agreeing with them, the Eleventh Circuit vacated the district court's order and remanded the case for the district court to hold an adversarial hearing. The court held that the respondents were entitled to a hearing to explore the allegation of an improper purpose. And, at that hearing, the respondents could question IRS officials concerning the IRS's reasons for issuing the summons. According to the appeals court,

> [R]equiring a taxpayer to provide factual support for an allegation of an improper purpose, without giving the taxpayer a meaningful opportunity to obtain such facts, saddles the taxpayer with an unreasonable circular burden, creating an impermissible "Catch 22." [*Clarke,* 517 Fed. Appx. 689, slip op. at 6]

The *Clarke* case has sparked controversy because the Eleventh Circuit's holding conflicts with the decisions of every other court of appeals. In light of this, the government appealed the case to the Supreme Court, and as of this writing it was set for oral arguments on April 23. The precise issue before the court is "Whether an unsupported allegation that the IRS issued a summons for an improper purpose entitles an opponent of the summons to an evidentiary hearing to question IRS officials about their reasons for issuing the summons."

While the issue before the court is narrow, the Supreme Court's decision may provide guidance on what procedural options are available for a taxpayer who wants to resist an IRS administrative summons in federal court.

The government's position before the Supreme Court is that the IRS has broad authority to issue summonses and that summonses should be summarily enforced. In light of this sweeping authority, the government asserts that:

- A summons opponent is entitled to a reasonable opportunity, including, if appropriate, an in-person adversarial hearing to present *legal arguments* why a summons should be quashed;
- At that hearing, the opponent is entitled to apprise the court of any evidence *already in his possession* that substantiates the allegation; and
- If a summons opponent offers only an *unsupported* allegation of IRS bad faith, a district court does not abuse its discretion by declining to provide the opponent with an adversarial hearing giving the opponent the opportunity to examine IRS agents about their motives for issuing the summons.

See *United States of America, Petitioner v. Michael Clarke, et al., Brief for United States* at 18–22. In other words, someone who objects to a summons is not *automatically* entitled to an evidentiary hearing at which he may question IRS officials about their motives for issuing a summons, according to the government (id. at 10).

Whether the Supreme Court agrees with the government's position remains to be seen. Stay tuned, as a decision from the Supreme Court is expected later this year.

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