New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 252—NO. 55
THURSDAY, SEPTEMBER 18, 2014

TAX LITIGATION ISSUES

Expert Analysis

IRS Summons Enforcement After 'United States v. Clarke'

IRS agents conducting audits have the power to issue summonses requiring taxpayers and third parties to produce documents and testify under oath. Recipients of summonses can avoid providing the requested evidence by showing that the summons was issued for an improper purpose. This past term, the U.S. Supreme Court resolved a circuit split as to what showing a party must make to obtain an evidentiary hearing as to whether a summons was improper. In *United States v. Clarke*,[1] the court unanimously decided this discrete, but important question by holding that the party must "plausibly rais[e] an inference of bad faith" to receive a hearing. While the decision resolves this issue, it leaves open other potentially significant questions that counsel representing recipients of summonses must consider.

By
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Background

Under 26 U.S.C. §6201, the IRS is "authorized and required to make the inquiries, determinations, and assessments of all taxes" imposed by the Internal Revenue Code. Further to this responsibility, Congress has provided the IRS broad statutory authority to issue summonses "[f]or 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 collecting any such liability."[2] A summons may require an individual to appear before the IRS, produce documents relevant or material to the inquiry, and/or give testimony.

An IRS summons is not self-executing, however. If an individual does not comply, the IRS must seek to have the summons enforced in district court, and bears the prima facie burden of demonstrating that it was issued in good faith. Specifically, the IRS must demonstrate the factors set out in *United States v. Powell*: namely, "that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the [IRS's] possession, and that the administrative steps required by the [Internal Revenue] Code have been followed."[3] This showing is usually accomplished through an affidavit submitted by the investigating IRS agent.

If the IRS meets its initial burden, the individual has the opportunity to challenge the agency's motive for issuing the subpoena. A summons will be found to be abusive if it was "issued for an improper purpose, such as to harass the taxpayer or to put pressure on him to settle a collateral dispute, or for any other purpose reflecting on the good faith of the particular investigation."[4]

In order to demonstrate abuse of process, a summoned party may request an evidentiary hearing to examine IRS officials under oath concerning their reasons for issuing a disputed summons. Prior to *Clarke*, a circuit split existed as to the showing necessary to obtain the requested hearing. The U.S. Court of Appeals for the Eleventh Circuit had held that a mere "allegation of improper purpose" was sufficient,[5] but every other circuit that considered the question had held that some greater showing was needed. For example, a litigant in the U.S. Court of Appeals for the Second Circuit was required to make "a substantial preliminary showing" of abuse, while the U.S. Court of Appeals for the Ninth Circuit required only "some minimal amount of evidence."[6]

'United States v. Clarke'

Clarke arose from the IRS's examination of interest expenses reported by Dynamo Holdings Limited Partnership for the 2005–2007 tax years. Prior to the issuance of the summonses, Dynamo had agreed to two extensions of the three-year limitations period for assessing tax liability. In 2010, Dynamo refused to agree to a third extension. Shortly thereafter, the IRS issued summonses to four individuals associated with Dynamo, none of whom complied with the summonses.

In April 2011, the IRS instituted an action to compel compliance with the summonses, supported by an agent's affidavit attesting to the Powell factors. In response, the recipients of the summonses asserted that the IRS had issued the summonses (a) to punish Dynamo for refusing to grant the third extension and (b) to circumvent discovery limitations imposed in a related tax-court litigation that Dynamo had filed against the IRS. The district court, stating that the respondents "ha[d] made no meaningful allegations of improper purpose," denied their request for a hearing.

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The court dismissed the statute of limitations allegation as "mere conjecture" and held that the discovery circumvention allegation was "incorrect as a matter of law," because the validity of a summons is tested at the date of issuance, at which point the tax-court litigation had not yet commenced. The Eleventh Circuit reversed,

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holding that under binding circuit precedent, a mere "allegation of improper purpose," even one lacking any "factual support," entitles an individual to "question IRS officials concerning the service's reasons for issuing the summons."[7]

The Supreme Court reversed. Reasoning that the IRS's summons authority is "a crucial backstop in a tax system based on self-reporting," and noting that it had in the past rejected rules that would "thwart and defeat the [IRS's] appropriate investigatory powers," the court determined that the Eleventh Circuit's rule could turn "every summons dispute into a fishing expedition for official wrongdoing." Instead, the court held, a hearing should be ordered when "[the taxpayer] can point to specific facts or circumstances plausibly raising an inference of bad faith." While "[n]aked allegations of improper purpose" would not be sufficient, credible circumstantial evidence could suffice, since "direct evidence of another person's bad faith, at this threshold stage, will rarely if ever be available." Accordingly, the court vacated the Eleventh Circuit's judgment and remanded the case for further proceedings.[8]

Open Questions After 'Clarke'

Clarke leaves open at least two significant questions. First, what evidence is required to raise a plausible inference of bad faith? To date, no court has answered this question under the court's newly announced standard. In *Clarke* itself, the recipients of the summonses submitted sworn statements attesting (a) that the IRS had issued the summonses immediately following Dynamo's refusal to grant a third extension of the limitations period, and (b) that the IRS attorneys handling the related Tax Court matter had attended the interview of another Dynamo associate who had complied with a summons addressed to him.

Noting that none of the agents investigating Dynamo's tax returns had attended the complying associate's interview, the respondents in *Clarke* argued that the IRS decided to enforce the summonses after Dynamo filed the Tax Court action in order to avoid limitations on discovery and to gain an unfair advantage in that case. While the Supreme Court found that "mere allegations" of abuse are insufficient, it remanded the case to the Eleventh Circuit to determine whether the sworn statements submitted in opposition to the summonses warranted a hearing.

Under one reading of *Clarke*, the decision simply affirmed the circuit courts that had held some showing greater than a mere allegation of improper purpose is required for a hearing. Under this reading, it is business as usual everywhere but the Eleventh Circuit, and attorneys seeking to inquire into the IRS's motivations in issuing summonses to their clients should take their lead from the pre-Clarke cases in which hearings have been granted.[9]

But this interpretation may mask *Clarke's* differing impact on the range of standards previously employed by different circuits. In some cases, these standards appeared to require materially different showings: For example, the Ninth Circuit's "some minimal amount of evidence" requirement appeared to be far less robust than the Second Circuit's "substantial preliminary showing" standard. Depending on the particular standard previously in use, different circuits may end up reducing or heightening their standard of review in light of *Clarke*.

The Southern District of New York's decision in *St. German of Alaska Eastern Orthodox Catholic Church v. United States*[10] provides a useful illustration. In *St. German*, the church, a related monastery, and their wholly owned real estate holding corporations moved to quash five summonses served on their attorneys pursuant to a civil and criminal investigation of a church reverend. The petitioners argued that the investigation was, in fact, secretly directed at the church itself. In support of this argument, they submitted affidavits by the church's accountant and one of its attorneys alleging that one of the investigating agents had asked probing questions regarding the church that had little to do with the investigation of its leader.

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In denying their motion to depose the agent, the district court held that the petitioners had not made the requisite "substantial preliminary showing" of bad faith, and distinguished *United States v. Millman*, which, the court found, involved "a much stronger showing of possible bad faith than is present here." If the petitioners in *St. German* had only been required to present evidence supporting a "plausible inference" of bad faith, as *Clarke* now requires, the court may well have reached a different conclusion.

Clarke also leaves open the related question of what constitutes an improper purpose that may invalidate an IRS summons. In *Clarke* itself, the court did not address whether issuing a summons in retaliation for a taxpayer's refusal to extend the limitations period, or to circumvent discovery limitations in a related case, would amount to bad faith on the IRS's part. Rather, the court explicitly "state[d] no view on those issues; they are not within the question presented for our review." The court instead left them for the Eleventh Circuit on remand.[11] One might speculate that, if the court concluded that these allegations, even if accepted as true, could not constitute an improper purpose, it might have indicated as much to the Eleventh Circuit.

In the only case addressing the issue after *Clarke,* the court held that allegations that an IRS agent (a) threatened to pull the individual tax returns of a corporate officer if she did not comply with a summons related to the investigation of the corporation, and (b) stated that "this could become a serious matter" and that she "could go to jail for a long time," do not constitute evidence of an improper purpose. In the district court's view, such statements amounted only to "tough language."

The court further concluded that, even if accepted as true, the allegations would not constitute evidence of improper purpose since the relevant issue is the institutional motive of the IRS, as opposed to the personal intent of a single agent. Finally, the court also rejected the respondents' alternate argument, that the summonses were issued to put pressure on the respondents to settle a collateral dispute, as inconsistent with the procedural history of the dispute.[12]

Conclusion

Petitioners challenging IRS summonses have long faced a difficult road in convincing courts to hold a hearing on allegations that a summons was issued for an improper purpose. While the Supreme Court's decision in *Clarke* appears to have increased the burden on individuals opposing a summons enforcement, it is far from clear that all litigants will be disadvantaged by the new standard and practitioners should approach summons enforcement matters with a fresh eye.

1. 134 S. Ct. 2361 (2014).
2. 26 U.S.C. §7602
3. 379 U.S. 48, 57-58 (1964).
4. Id. at 58.
5. See *Nero Trading v. U.S. Dept. of Treasury*, 570 F.3d 1244, 1249 (11th Cir. 2009)
6. See *United States v. Tiffany Fine Arts*, 718 F.2d 7, 14 (2d Cir. 1983), aff'd, 469 U.S. 310 (1985); *Fortney v. United States*, 59 F.3d 117, 121 (9th Cir. 1995); see also *Sugarloaf Funding, LLC v. U.S. Dept. of Treasury*, 584 F.3d 340, 350-51 (1st Cir. 2009) ("a sufficient threshold showing"); *United States v. Kis*, 658 F.2d 526, 540 (7th Cir. 1981) ("facts from which a court might infer a possibility of some wrongful conduct"); *United States v. Garden State Nat'l Bank*, 607 F.2d 61, 71 (3d Cir. 1979) ("factual[ ] support[ ] by the taxpayer's affidavits").
7. See *Clarke*, 134 S. Ct. at 2366.
8. Id. at 2367-69.
9. See, e.g., *United States v. Millman*, 765 F.2d 27, 30 (2d Cir. 1985) (district court abused its discretion in not granting hearing where respondent presented documentary evidence supporting his allegation that IRS had issued summons to punish him for his "zealous and successful legal representation" of clients in income-tax audits); *PAA Mgmt. v. United States*, No. M24-1 (Part 1) (WK), 1992 WL 188334, at *1-2 (S.D.N.Y. July 23, 1992) (evidentiary hearing granted in light of affidavits casting doubt on IRS's purported reasons for requesting documents and alleging that IRS agent had admitted the records were unnecessary for his examination).
10. 653 F.Supp. 1342 (S.D.N.Y. 1987).
11. *Clarke*, 134 S. Ct. at 2369.
12. *Hawaii Pacific Finance v. United States*, 2014 WL 3849921, at *5-6 (D. Hawai'i Aug. 14, 2014).