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TAX CONTROVERSY LEGAL ALERT

SUPREME COURT'S DECISION IN *CLARKE*:
IMPLICATIONS IN LIGHT OF NEW IDR DIRECTIVES

On June 19, the U.S. Supreme Court, in *U.S. v. Clarke*,[1] addressed when a taxpayer is entitled to an evidentiary hearing at which IRS officials can be examined on their reasons for issuing a summons. The Court held that while a naked allegation of improper purpose is not sufficient to challenge the issuance of a summons, when "the taxpayer can point to specific facts or circumstances plausibly raising an inference of bad faith," the taxpayer is entitled to an evidentiary hearing on the question of whether the summons was issued for an improper motive. While the taxpayer is not required to possess direct evidence of bad faith, the taxpayer "must offer some credible evidence supporting his charge."

As discussed below, the Supreme Court's recent decision in *Clarke* has potentially far-reaching implications in view of the IRS Large Business and International Division's (LB&I's) recent directives on the issuance and enforcement of Information Document Requests (IDRs). The new IDR directives provide, *inter alia*, a mandatory three-step enforcement process culminating with the required issuance of a summons, when the taxpayer fails to timely comply with IRS requests for documents and information. The new IDR directives may well lead to more frequent issuance of summonses to large corporate taxpayers (and certain high net worth individuals)[2], at least in the short run as the implementation of the new IDR directives are worked through by taxpayers and the IRS. In such event, taxpayers considering their options in summons enforcement proceedings will need to fully understand the guidelines set forth in *Clarke*.

Brief Background to Summons Enforcement

The IRS's ability to investigate a taxpayer's tax liability has long been viewed as a fundamental backstop to our system of self-reporting. Taxpayers report what they owe to the government on a filed tax return, and the government has the opportunity to then examine whether the taxpayer has properly reported for that tax period. In general, the IRS requests taxpayer information by

[1] *U.S. v. Clarke*, Slip Op. No.13-301, 573 U.S. ___ (2014).

[2] LB&I is generally responsible for audits of corporations and partners with assets in excess of $10,000,000 and certain high net worth individuals.

issuing an IDR. If a taxpayer refuses to provide the information sought by the IDR, the IRS may then issue an administrative summons for such information. Code[3] Section 7602(a).

In the event a taxpayer fails to comply with a summons, the IRS may bring an action to enforce the summons in federal district court. Code Sections 7402(b); 7604. At a summons enforcement proceeding, the IRS has the initial burden of making a *prima facie* showing that the summons is valid. In order to carry this burden, the government must satisfy what have become known as the *Powell* factors[4]; namely, that: (1) the summons was issued for a legitimate purpose; (2) the information sought is relevant to that purpose; (3) the information sought is not already within the IRS's possession; and (4) the administrative steps required by the Code have been followed. The government is often able to satisfy its initial burden by means of an affidavit from the responsible IRS revenue agent (submitted to the district court as an attachment to the initial petition). If the government makes its *prima facie* showing, then the burden shifts to the taxpayer to either establish that the *Powell* factors have not been satisfied or that the issuance of the summons constitutes an "abuse" of the judicial process. Taxpayers may also assert that the information sought is protected by various legal privileges, such as the attorney-client privilege, the tax practitioner privilege of Code Section 7525, or the work-product doctrine.

Supreme Court Decision in Clarke

As noted above, the Supreme Court in *Clarke* addressed the circumstances under which a taxpayer is entitled, as part of a summons enforcement proceeding, to examine IRS officials on the reasons for issuance of the summons. The Court in *Clarke* made clear that while a taxpayer is not entitled to an evidentiary hearing based on nothing more than the bare allegation of an improper purpose, a taxpayer may obtain an evidentiary hearing when there are specific facts and circumstances plead that plausibly raise an inference of bad faith.

The basic facts in *Clarke* are relatively straight forward. The taxpayer partnership refused the IRS's third request to extend the statute of limitations. The IRS then summoned six individuals associated with the partnership that the IRS believed had information and records relevant to determination of the partnership's tax liability for the relevant period. All but one of the individuals failed to comply with the summons. Shortly thereafter, the IRS issued a FPAA (final partnership administrative adjustment) proposing changes to the partnership's returns resulting in additional income. The partnership responded by filing a petition with the U.S. Tax Court challenging the adjustments. Several months later, the IRS instituted proceedings in district court to enforce the previously issued summonses. The taxpayer asserted that the IRS had two

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

[4] From the U.S. Supreme Court case, *U.S. v. Powell*, 379 U.S. 48 (1964).

improper motives for issuance of the summonses: (1) to punish the taxpayer for refusing to extend the statute of limitations; and (2) to avoid limitations on discovery in the Tax Court proceedings.

The Supreme Court, in a unanimous opinion authored by Justice Kagan, held that 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." Thus, a bare or naked allegation of improper purpose is not sufficient to entitle a taxpayer to an evidentiary hearing. The taxpayer is required to offer "some credible evidence" supporting the charge. Circumstantial evidence, however, may be sufficient to satisfy the taxpayer's burden. Moreover, the Court reasoned, the taxpayer is not required to present a "fleshed out" case; instead, "[t]he taxpayer need only make a showing of facts that give rise to a plausible inference of improper motive."

Implications of Clarke In Light of New IDR Directives

The Supreme Court's decision in *Clarke* has potentially far-reaching implications for taxpayers subject to the IRS's new IDR directives.

In the past year, LB&I has issued three directives, the most recent of which was released on February 28, 2014 (the "February Directive"),[5] implementing new procedures for the IRS's issuance and enforcement of IDRs. The new directives became effective March 3, 2014.

As a general matter, the new procedures require that IDRs must now be issue focused ("transparent" in aim), discussed with the taxpayer before issued in final form, and, to the extent possible, reflect an agreed upon response date. More specifically, (i) all IDRs (other than general requests for books and records) must identify and focus on a single issue (using clear and concise language and customized to the taxpayer and the industry), (ii) the revenue agent must explain to the taxpayer how the information requested is related to the issue under examination, (iii) after having an initial discussion with the taxpayer, the revenue agent must issue a draft of the IDR to the taxpayer, and discuss with the taxpayer the contents of the draft as well as the timetable for responding to the IRS, and (iv) the revenue agent must seek to determine with the taxpayer a

[5] See Large Business and International Directive on Information Document Requests Enforcement Process (LB&I -04-0214-004) February 28, 2014; Large Business International Directive on Information Document Requests Enforcement Process (LB&I-04-1113-009), November 4, 2013; and Large Business and International Directive on Information Document Request (LB&I-04-0613-004) June 8, 2013.

reasonable time for a response to the IDR, and if agreement cannot be reached, the agent must then establish a reasonable response date.[6]

The centerpiece of the new IDR directives is the mandatory enforcement process that is triggered when a taxpayer fails to comply with the deadline for responding to an IDR. The new IDR enforcement process[7] involves three graduated steps: *first*, issuance of a Delinquency Notice (Letter 5077), which occurs when the due date for the IDR has expired without a response (or the response is determined to be incomplete);[8] *second*, in the event the taxpayer fails to provide a complete response to the IDR by the new response date specified in the Delinquency Notice, issuance of a Pre-Summons Letter (Letter 5078);[9] and *finally*, in the event the taxpayer fails to provide a complete response to the IDR by the response date provided in the Pre-Summons Letter, issuance of a summons.[10]

Importantly, because the new IDR procedures effectively eliminate a revenue agent's discretion to extend the IDR deadline after an IDR has been issued, and because mandatory enforcement procedures are set in motion by the taxpayer's failure to timely comply with an IDR deadline, the new procedures place greater emphasis on up-front planning for IDR responses. There will need to be careful consideration that IDRs are properly focused and provide adequate time for the taxpayer to respond in full (achieving deadlines that the taxpayer is relatively certain it will be

[6] The revenue agent is instructed to commit (in writing noted on the IDR) to a date by which the IDR will be reviewed and by which a response will be provided to the taxpayer on whether the information received satisfies the IDR.

[7] Before the enforcement process is triggered, a revenue agent has the authority to grant the taxpayer an extension of up to 15 business days under limited circumstances. Only one extension may be granted with respect to the same IDR.

[8] The Delinquency Notice must be issued within 10 days of the missed IDR deadline. The IDR directive provides for a very limited extension of the IDR deadline, no more than 15 business days from the date the extension determination is communicated to the taxpayer (which determination itself should be made within 5 business days of the original IDR deadline). The new response date specified in the Delinquency Notice should generally be no more than 10 business days from the date of issuance of the Delinquency Notice.

[9] The IRS Territory Manager is instructed to issue the Pre-Summons Letter (after consultation with the taxpayer) to the taxpayer management official that is at a level equivalent to the LB&I Territory Manager. This should be a level of management above the taxpayer management level that received the Delinquency Notice. No further guidance is provided as to precisely what management position this would be within the typical large corporate structure.

[10] The responsible revenue agent is instructed to work with IRS Counsel to prepare and issue the summons to the taxpayer. The IDR directives do not provide a timeframe for issuing the summons; however, it would be prudent to assume the issuance would be relatively immediate.

able to satisfy). When it is apparent at the outset of the examination process that information sought by the government is not readily accessible, it will be imperative to seek realistic deadlines and evaluate the availability of personnel needed to properly and timely respond. As noted above, an IDR deadline will not be subject to change once the IDR has been issued.

Under certain circumstances, it may be desirable to initiate the information gathering process while the IDR is essentially held in "draft" form. To the extent practicable, the IRS would then issue the IDR when sufficient progress had been made in collecting the required information.[11]

When materials have to be reviewed for claims of privilege, the time required for this analysis should be taken into account in considering the time needed to respond to the IDR. Because it is possible that a taxpayer's decision to withhold materials on the basis of privilege will be viewed as a failure to comply with the IDR—resulting in the three step mandatory enforcement process—it is essential to record and log discussions with the IRS (including discussions regarding the potential for withholding certain privileged information) from the very outset of the examination process. Consequently, if there is a subsequent dispute about whether the taxpayer's response satisfies in full the IDR, this information may be helpful in evaluating the reasonableness of the IRS's response to the taxpayer's submission and in mounting an appropriate defense.

The importance of maintaining a contemporaneous record of discussions with the LB&I audit team during the examination process is even more critical following the Supreme Court's recent decision in *Clarke*. In the short run, there would seem to be a very real risk that the uncertainty in the interpretation and application of the new IDR procedures, together with the mandatory nature of the process, will in fact yield a greater number of summonses as part of the examination process. The impact of the new IDR directives on the frequency of summonses in the long run is more difficult to predict.[12] In any event, when the IRS does issue a summons to a taxpayer for failure to comply with an IDR deadline, a taxpayer seeking to challenge the summons in a district court proceeding will need, post-*Clarke*, to be able to point to specific facts and circumstances that plausibly raise an inference of bad faith to warrant an evidentiary hearing. To the extent the taxpayer has maintained contemporaneous documentation of audit communications with the LB&I team, including the taxpayer's efforts to collect the requested information, this should improve the taxpayer's chances of demonstrating compliance with the

[11] The February Directive provides that the process (presumably after consultation with the taxpayer as to the information requested by the IDR) of providing a draft of the IDR, and discussing its contents with the taxpayer, should generally be completed within 10 business days.

[12] The February Directive states that the "new procedures should improve [the IRS's] ability to gather information and reduce the need to enforce IDRs through summonses."

IDR, or if necessary a "plausible inference" of improper motive or bad faith sufficient to warrant an evidentiary hearing in the summons enforcement proceedings.[13]

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Contacts

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Information

A copy of the Supreme Court's decision in *U.S. v. Clarke* is available **here.**

A copy of the February 28, 2014 directive is available is available **here.**

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[13] It remains to be seen whether revenue agents' lack of discretion under the new IDR procedures will make it more difficult in certain circumstances for a taxpayer to demonstrate facts or evidence raising a "plausible inference" of improper motive or bad faith.