

Checkpoint Contents

Federal Library

Federal Editorial Materials

WG&L Journals

Journal of Taxation (WG&L)

Journal of Taxation

2009

Volume 110, Number 03, March 2009

Articles

Summons Issued by the Service to Taxpayer's Advisor Upheld Despite DOJ Referral,
Journal of Taxation, Mar 2009

FRAUD & NEGLIGENCE

Summons Issued by the Service to Taxpayer's Advisor Upheld Despite DOJ Referral

Author: By Kevin E. Packman

KEVIN E. PACKMAN is a partner in the Miami office of the law firm of Holland & Knight LLP, and has previously written for The Journal.

Copyright © 2009, Kevin E. Packman.

A measure enacted more than a quarter-century ago to protect taxpayers from an IRS summons when the Justice Department has been brought into the picture has recently engendered a case of first impression in the Seventh Circuit. A summons to the taxpayers' accountant was enforced, despite the possibility that the accountant had been referred to the DOJ. The protection does not extend to third-party witnesses, as the court found the Regulations to be reasonable under Chevron.

EDITED BY ROBERT S. FINK, LL.M.

The IRS is prohibited from issuing a summons under Section 7602 and the government is prohibited from enforcing a summons under Section 7604 with respect to any person, if a Department of Justice referral is in effect "with respect to" such person. ¹ The breadth of the "with respect to" language was recently considered and clarified by the Seventh Circuit in a case of first impression. In *Khan*, 102 AFTR 2d 2008-7038, 548 F3d 549 (CA-7, 2008), *rev'g* 101 AFTR 2d 2008-729, 537 F Supp 2d 944 (DC Ill., 2008), the appellate court determined that the words "with respect to" relate to the taxpayer's liability, and do not restrict the Service from issuing a summons to a third party to obtain information related to the taxpayer's liability even if that third party was the subject of a Department of Justice referral.

The Seventh Circuit reversed the decision reached by the district court, and held that the IRS could issue, and the government could enforce, summonses issued to the taxpayers' accountant, even if the accountant was the subject of a Department of Justice referral. The appellate court noted that since the case turned on the meaning of a statute, Section 7602, and Treasury promulgated a Regulation to interpret the statute, it would review the Regulation consistent with the criteria set forth in *Chevron U. S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 US 837, 81 L Ed 2d 694 (1984).

BACKGROUND

Khan stemmed from the Service's examination of Shahid and Ann Khan's federal income tax returns for 1999 through 2003, as well as returns filed on behalf of five entities in which Shahid was either a partner, member, or owner.² The net effect of the taxpayers' investment in these entities was a tax savings of approximately \$85 million for the years in question.³ The IRS believed that at least five of the investments constituted "potentially abusive tax shelters," which were designed to shelter approximately \$250 million of income. *Forbes* magazine reported in its 1/12/09 edition that three of the shelters were "Son of BOSS" shelters, and the other two were "distressed asset/debt" shelters.⁴

The taxpayers paid the accounting firm of BDO Seidman approximately \$8.5 million in fees, which they claimed as expenses on their returns. When interviewed by the revenue agent, the taxpayer-husband was unable to identify what services were rendered by BDO in exchange for the fees it charged. The taxpayer also was unable to answer many of the agent's questions regarding his investment in the entities, as well as the role BDO played in assisting him to enter the transactions. The taxpayer ultimately advised the agent to seek the information he needed directly from BDO.

Robert Greisman was the taxpayers' accountant, and he also happened to be an attorney. He was employed by BDO, and was affiliated with their Tax Solutions Group. Greisman was referred to by the appellate court as an expert in tax shelters. The revenue agent stated in an affidavit that Greisman had met with the taxpayers, provided them with accounting and professional services, and "may have been involved with the execution of the tax shelter transactions during the periods under examination."

THE DISTRICT COURT

Following the agent's investigation, and based on his affidavit, the IRS issued six summonses to Greisman on 4/16/07 requiring him to appear before the revenue agent on or before 5/22/07 to give testimony related to the taxpayers' tax liability and the five potential abusive shelters.

On 5/7/07, the taxpayers filed petitions to quash the summonses, and each petition was supported by seven arguments as to why the summonses were deficient. One of the arguments that was not addressed by the court was that Greisman's testimony was protected on the grounds of the work product, attorney-client, and tax-practitioner privileges.⁵

The government filed oppositions to each petition, as well as a motion to enforce the summonses. Attached to the government's filing was the revenue agent's affidavit, which stated that the purpose of the Service's examination was to ascertain the correctness of the taxpayers' federal tax liabilities for the years in question. The agent believed Greisman might be able to "shed light on the losses reported on taxpayers' 1999-2003 tax returns and the \$8.5 million in fees deducted from taxpayers' income for those years."

When the taxpayers responded to the government's filings, in addition to repeating the same seven arguments, they also argued for the first time that the summonses violated Section 7602(d)(1) because the affidavit did not state whether the IRS had referred Greisman to the Department of Justice. The taxpayers' position was that Section 7602(d)(1) protects both taxpayers whose liabilities are under investigation as well as third-party witnesses, by providing that "no summons may be issued under this title with respect to any person" who is the subject of a Justice Department referral.

The government responded that it was only prohibited from issuing a summons to a taxpayer if the IRS

was auditing the taxpayer and had referred the taxpayer to the Department of Justice. It further stated that Reg. 301.7602-1(c)(1) explicating the prohibition on issuing a summons was interpreted by the IRS as protecting only a taxpayer under audit, and not a third party.

The district court accepted the taxpayers' argument that a criminal referral of Greisman might be in effect, and without a statement from the IRS that Greisman was not the subject of a referral, it was barred from issuing a summons to him as a third-party witness in conjunction with the Service's investigation of the Khans' tax liability. Consequently, the district court did not address any of the taxpayers' seven arguments, including whether they could claim privilege to bar Greisman's testimony.

IRS AUTHORITY TO ISSUE SUMMONSES

Before reviewing the appellate court's analysis, it is important to recall that Section 7602(a) provides the Service with broad authority to issue a summons for the purpose of examining documents and taking testimony for any offense connected with the administration or enforcement of the tax laws.⁶ While the IRS may use the information summonsed simultaneously for both a civil and criminal investigation, before 9/4/82 (when Sections 7602(b) and (c) were enacted) the IRS was unable to issue a summons if it was to be used solely for purposes of a criminal investigation. Consequently, so long as there is no Justice Department referral in effect, the IRS may issue a summons to the following persons:

- (1) The person liable for any internal revenue tax or required to perform the act of collecting such tax liability.
- (2) Any officer or employee of such person.
- (3) Any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for the tax or required to perform the act.
- (4) Any other person who may be considered proper by the officer issuing the summons.⁷

A Justice Department referral is in effect regarding a taxpayer if (1) the IRS has recommended to the Attorney General a grand jury investigation or the criminal prosecution of the taxpayer for any offense connected with the administration or enforcement of the internal revenue laws, or (2) if any request is made of the IRS for the disclosure of a return or return information relating to the taxpayer by the Attorney General, the Deputy Attorney General, or an Assistant Attorney General.⁸ Even if the IRS has made a referral on a taxpayer, it still may issue a summons related to the same taxpayer so long as it is for a tax year that is not part of the referral.⁹

A referral is no longer in effect when:

- (1) The Attorney General notifies the IRS in writing that (a) he will not prosecute the taxpayer for any offense connected with the administration or enforcement of the internal revenue laws, (b) he will not authorize a grand jury investigation of the taxpayer with respect to such an offense, or (c) he will discontinue such a grand jury investigation;
- (2) A final disposition is made of any criminal proceeding instituted against the taxpayer by the Attorney General pertaining to the enforcement of the internal revenue laws; or
- (3) The Attorney General notifies the IRS in writing that he will not prosecute the taxpayer for any offense connected with the administration or enforcement of the internal revenue laws relating to a request for a return or return information.¹⁰

If a summoned party refuses to comply with a properly issued summons, Section 7604 provides the government with the authority to enforce it in court. Pursuant to *Powell*, 14 AFTR 2d 5942, 379 US 48,

13 L Ed 2d 112, 1965-1 CB 547 (1964), the government has to meet the following standards to enforce a summons:

- (1) The summons was issued for a legitimate purpose;
- (2) The summoned data may be relevant to that purpose;
- (3) The data is not already in the government's possession; and
- (4) The administrative steps required by the Code for issuance and service have been followed.

The government can satisfy the *Powell* standard by using an IRS agent's affidavit.

THE SEVENTH CIRCUIT'S ANALYSIS

As stated above, the appellate court's review of the Regulation interpreting Section 7602 was subject to the *Chevron* criteria, which consist of two steps. The first step is a focus on the plain meaning of the statute. If a court determines that the plain meaning of the statute either supported or refuted the Regulation, then the analysis would stop. If the statutory language was insufficient to resolve the issue, then the court would look to the reasonableness of the Regulation.

In step one, the *Khan* court considered the government's position that the specific statutory text in Section 7602(d)(1) demonstrated Congress's intent that the Service is barred from issuing a summons only where the taxpayer whose liability is in question was referred to the Justice Department, as opposed to a third party. In so arguing, the government stated that the words "with respect to" apply to the issuance of a summons to a witness, "but with respect to the investigation of a particular taxpayer." The government contended that the district court improperly interpreted the "with respect to" language as meaning the IRS could not issue a summons to any person.

The taxpayers argued that there was inconsistency with the government's position because Congress had used limiting language in other places within the very same statute. For example, Section 7602(a)(2) reads "to summon the person liable for tax" and Section 7602(c)(1) reads "with respect to the determination or collection of the tax liability of such taxpayer." This limiting language was contrasted with the general language found in Sections 7602(d)(1) and (2), which reads "with respect to any person." This inconsistency, the taxpayers argued, meant that Congress had the ability to draw a distinction when it wanted to; because it did not, the "with respect to" language in Section 7602(d)(1) must relate to both the taxpayer whose liability is in question as well as to third-party witnesses.

The Seventh Circuit found both arguments persuasive, and as a result concluded that the statutory phrase was ambiguous. Specifically, the court stated "[w]hen we focus on context, the petitioners' interpretation seems persuasive; when we focus on the ordinary meaning of 'with respect to,' the government's argument seems superior. The inability to decipher 'plain' meaning leads to the conclusion that the statute is unclear and ambiguous regarding the issue in this case." Consequently, the appellate court was forced to proceed to *Chevron* step two where, if it found the Regulation to be reasonable, it would side with the government.

In a rather short analysis, the court determined that the Regulation was reasonable and comported with the statute. It further noted that the legislative history indicated that there was no intent to prohibit a summons from being issued to a third party if the third party had been referred to the Department of Justice. Rather, the legislative history clearly indicated that a summons could not be issued to a taxpayer if the *taxpayer* has been referred to the Department of Justice.

ANALYSIS

The *Khan* opinion, although ruling for the Service, did not allow the IRS to reach as far as it may have desired. A close reading of both the lower court opinion and the Seventh Circuit opinion reveals that the IRS may have been attempting to push the envelope even further. The court could have gone on to rule that Section 7602 only served to invalidate a summons when three facts existed:

- (1) The IRS was auditing a taxpayer;
- (2) The IRS had referred that same taxpayer to the DOJ; and
- (3) The IRS was summoning *that* taxpayer.

In the Khans' case, this would have meant that even if the IRS had referred the Khans (which it did not do), the Service still would have been able to issue a summons to the accountant because, although he may have been referred, the IRS was not summoning the Khans, but rather, was summoning the accountant who was not under audit.

Instead, on appeal the Seventh Circuit made clear that the summons was appropriate as to the accountant only *because* the IRS had *not* referred the Khans to the DOJ. Had the IRS referred the Khans, the summons would fail by virtue of it being "with respect to" a taxpayer whose tax liability was being investigated and whom the IRS had referred (irrespective of the fact that the accountant was a third party). According to the court, a summons fails if two facts exist:

- (1) The IRS was auditing a taxpayer; and
- (2) The IRS had referred *that* taxpayer to the DOJ, irrespective of whom the IRS summoned.

Section 7602(d), which was enacted in 1982 as part of TEFRA, was intended to provide a bright-line rule limiting the Service's ability to issue summonses when a referral to the DOJ has been made. This case, however, by allowing a summons to issue even when a DOJ referral is in effect, blurs that line and leads to a result that some would say is contrary to the spirit of TEFRA.

CONCLUSION

The IRS was able to issue and enforce the six summonses served on Greisman. This case, however, may have involved much more than the government's simply trying to determine the taxpayers' proper tax liability. While a review of tax shelter litigation is well beyond the scope of this article, the government has been seeking from BDO, as far back as 2003, the identity of its clients who were involved in potentially abusive tax shelters. ¹¹

The *Khan* case may have been an attempt by the government to get information on the promotion of tax shelters that it could use in other investigations. A Google search reveals that *Khan* is not the only case in which the IRS sought Greisman's testimony. On 11/24/08, four days after the appellate court issued its ruling, Greisman filed a motion for a Protective Order in the District Court for Northern Illinois (Dkt. No. 08 CV 6717) relating to *LIVRPOL, LLC* (D. Conn., Dkt. No. 3:07-cv-00796-JBA). In the motion, Greisman argued that pursuant to Fed. R. Civ. P. 26(c), the government was prohibited "from taking his deposition on the grounds that the Government is impermissibly using civil discovery in this case for other civil cases and/or for a criminal investigation."

Practice Notes

Taxpayers under audit who are issued a summons may find some protection in Section 7602(d), but it will be cold comfort: The summons can be quashed only if the taxpayer has been referred to the Department of Justice, which would suggest a heap more trouble is waiting.

[1](#)

Section 7602(d)(1).

[2](#)

Shahid Khan was president of Flex-N-Gate Corp., an auto parts maker in Urbana, Illinois, which in 2008 was ranked by Forbes magazine as the 155th largest private company in the U.S., with \$2.72 billion in revenues for the fiscal year that ended in June and 11,500 worldwide employees.

[3](#)

In an article in the East Central Illinois News Gazette on 1/17/09, Shahid Khan stated that the entire tax liability was \$68 million, not \$85 million; that it had been paid; and he was seeking a refund.

[4](#)

A distressed asset/debt transaction involves a U.S. taxpayer and a tax-indifferent party (such as a foreign company) who enter into a relationship wherein the tax-indifferent party contributes an interest in a debt and the U.S. taxpayer contributes other assets. To the extent the debt is uncollectible, it is used as a deduction to offset taxable income of the U.S. taxpayer. See IRS Publication UIL 9300.99-05 (4/18/07); Notice 2008-34, 2008-12 IRB 645.

[5](#)

The attorney-client privilege protects communications that are between a client and an attorney related to legal advice if the privilege is not waived. Only communications related to legal advice or legal services are protected. Communications relating to accounting services, even when provided by the attorney, are not protected. Section 7525, enacted in 1998, extends a privilege to communications between a client and accountant provided that the communication would have been protected had it been between a client and an attorney.

[6](#)

Section 7602(b).

[7](#)

Section 7602(a)(2); Reg. 301.7602-1(b)(1).

[8](#)

Section 7602(d)(2)(A); Reg. 301.7602-1(c)(2).

[9](#)

Section 7602(d)(3).

[10](#)

Section 7602(d)(2)(B); Reg. 301.7602-1(c)(3).

[11](#)

BDO Seidman, 92 AFTR 2d 2003-5443, 337 F3d 802 (CA-7, 2003).

© 2009 Thomson Reuters/RIA. All rights reserved.