Corporate Tax - USA

Enforcing non-US tax authority requests for taxpayer information

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Introduction

As the world's citizens engage in more international transactions, the world's tax authorities struggle to keep up. In particular, a governmental tax authority's ability to investigate tax-related issues involving one of its corporate or individual citizens or residents may be hampered by the foreign nature of the transaction or record keeping. This is consistent with the notion that a sovereign's authority to obtain information, through compulsory processes or otherwise, is limited to its borders.

Over the years, however, the tax authorities have developed legal means to obtain information located outside their jurisdictions. To enable their tax authorities to acquire information relevant to the enforcement of their revenue laws, many countries have entered into bilateral tax treaties or information exchange agreements. Bilateral tax treaties allow tax authorities to request and acquire information from partnering foreign nations to further their own tax investigations and fight offshore tax evasion. These agreements allow a non-US tax authority to use the US Internal Revenue Service (IRS) as an agent of its investigation and extend its reach into the United States. Indeed, a non-US taxpayer may be confused to find that the IRS has served a summons on a US entity (eg, a US bank) to obtain information that will assist the non-US tax authority's investigation of him, her or it.

This update:

- provides an overview of the information exchange articles under the US Model Income Tax Convention of 2006 ('US model treaty'), as well as the enforcement procedures in the US courts;
- reviews US case law concerning the enforcement of summonses issued on behalf of treaty partners; and
- provides practical considerations for non-US taxpayers that find that the IRS has issued a summons on behalf of a non-US tax authority.

Bilateral tax treaties and enforcement process

In general, bilateral income tax treaties include provisions for both the prevention of double taxation and information exchange. The US Treasury Department has developed a model income tax treaty, the US Model Income Tax Convention of 2006, which is used as the starting point for bilateral treaty negotiations with other countries.(1) Article 26 of the US model treaty provides the basis for information exchange. Paragraph 1 of Article 26 imposes an obligation on the competent authority(2) of each contracting state to exchange such information as is necessary to carry out the treaty provisions. Paragraph 4 provides that "[i]f information is requested by a Contracting State… the Contracting State shall use its information gathering measures to obtain the requested information" Thus, the bilateral treaty does not provide a compulsory process for information exchange;(3) instead, it authorises the treaty partners to use each other's administrative processes to access information about their respective taxpayers. For example, if a treaty partner requests information from the United States(4) under the treaty,(5) Paragraph 4 of Article 26 authorises the United States to use its administrative processes, including the issuance of a summons under Section 7602(6) of the Internal Revenue Code,(7) to acquire such information. In pursuing the request for information on behalf of the treaty partner, the United States must follow its statutory requirements, which includes providing notice to the taxpayer when a summons is issued to a third-party record keeper. It is irrelevant that the treaty partner may not need the information for its own purposes, and a treaty partner cannot decline to supply information solely because it has no domestic interest in the information.

Once the IRS issues a summons on behalf of a foreign treaty partner, the non-US taxpayer is entitled to file a petition to quash the summons in the US district court in the district within which the person to be summoned resides or is found within 20 days after it has received notice of the summons.(8) If the summons has been issued to a third party (eg, a US bank) with regard to the non-US taxpayer, the non-US taxpayer has the right to intervene in a summons enforcement proceeding commenced by the United States and has a right to file a motion to quash.(9) In most instances, when a taxpayer files a petition to quash a summons, the IRS will counterclaim for enforcement of the summons.(10)

The IRS must satisfy a number of requirements to enforce a summons in a US court. The *prima facie* case for the enforcement of any IRS summons was established by the US Supreme Court in *United States v Powell*(11). Under *Powell*, the government bears the burden of showing that:

- the summons was issued for a legitimate purpose;
- the material sought is relevant to that purpose;
- the information sought is not already within the possession of the commissioner; and
- the administrative steps required by the code have been followed.(12)

Considering the IRS's broad authority to issue a summons under Section 7602, the *Powell* factors are relatively easy to satisfy.

Once the IRS has made the requisite showing, the burden shifts to the taxpayer (US or non-US) to disprove one of the *Powell* factors or otherwise show that the IRS is attempting to abuse the court's process. Such an abuse would take place if the summons had been issued for an improper purpose, such as to harass the taxpayer or to put pressure on it to settle a collateral dispute, or for any other purpose reflecting on the propriety of the particular investigation.(13) For the taxpayer challenging an IRS enforcement order on behalf of a foreign tax authority, only evidence of the IRS's abuse of process, not that of the non-US government, is relevant.

In addition to the *Powell* factors, courts consider the specific treaty in question in determining the enforceability of the summons. Paragraph 3 of Article 26 of the US model treaty provides that information exchange articles shall not require a contracting state "to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State" or "to supply information that is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State".(14) In other words, the requesting state may not use the summons to expand its own rights and procure information that it could not acquire under its own laws. At least one US district court has denied enforcement of a summons based on these grounds.(15) A greater number of courts do not closely scrutinise these grounds as long as the IRS submits an affidavit confirming that the same information could be acquired under the treaty partner's law.

US jurisprudence

The first case in which a US court addressed whether the United States could use an administrative summons on behalf of a treaty partner where there was no domestic tax claim was *United States v AL Burbank & Co, Ltd*(16). In *Burbank*, Canadian tax authorities requested information about a Canadian taxpayer and the IRS issued a summons to two banks for records in their possession. The banks did not comply and asserted that the summonses were illegal, unenforceable and not authorised under the code or the treaty.(17) On appeal, the Second Circuit held that the "American administrative procedures [which includes the summons] are properly utilized where the purpose is solely to assist the investigation of a Canadian potential tax liability". (18) In reaching this conclusion, the Second Circuit held that the IRS's power to determine the liability of a person "for *any* internal revenue tax" under Section 7602 was not limited to domestic revenue laws and included the revenue laws of the treaty partner. In addition, the language of the tax treaty indicated an intent to "provide a means of cooperation… whereby information could be exchanged after it was collected through the administrative processes provided by the statutory law of each".(19) If the court interpreted Section 7602 to apply solely to domestic revenue laws, it would frustrate the treaty itself and the purpose of information exchange under all bilateral income tax treaties.

In another early case, *United States v Lincoln Bank, NA*(20), the US district court implemented a limitation on the IRS's authority to enforce a summons on behalf of a treaty partner and denied the IRS's petition for the enforcement of a summons issued on behalf of Norway. The *Lincoln* court held that for the IRS to be entitled to enforcement, it must show that the request complied with the code, treaty and applicable laws and administrative practices of both countries. The court reviewed the US-Norway treaty and held that, to be entitled to an enforcement order, the treaty required the IRS to prove that enforcement of the particular request would not be inconsistent with the laws and administrative practices of Norway. The IRS claimed that that under the treaty, pursuant to a provision similar to Paragraph 3 of the US model treaty, it had discretion to supply the information to Norway even if it would not be authorised under Norwegian law. The *Lincoln* court rejected the IRS's argument and did not read such discretion into the treaty. Thus, the summons was unenforceable to the extent that the IRS could not show that the summons complied with Norwegian and US laws. In addition, the court held that the summons was unenforceable to the extent that the IRS provided no notice to the taxpayers as prescribed by Section 7609(f). Notably, taxpayers generally do not succeed in challenging an IRS enforcement action on the grounds of defective notice.(21)

In *United States v Stuart*(22) the US Supreme Court reviewed the IRS's order for enforcement of a summons that was issued to various US banks on behalf of the Canadian tax authority pursuant to the treaty between the United States and Canada. The Canadian taxpayers filed a petition to quash the summonses, arguing that Section 7602(c),(23) which prohibits the IRS from issuing a summons once a case is referred to the Justice Department for prosecution, prohibited the IRS from using its summons authority here, as the taxpayers were already under criminal investigation in Canada. The court rejected the taxpayers' argument, concluding that:

- as long as the summons was issued in good faith, it was enforceable irrespective of whether the taxpayer was under criminal prosecution or investigation in Canada; and
- neither the Internal Revenue Code nor the treaty imposed additional requirements on the IRS.

Turning to the IRS's *prima facie* case for enforcement, the court held that as long as the IRS satisfied the requirements of good faith, as set forth in *Powell*(24), the IRS was entitled to enforcement of its summons. The court assessed the *Powell* factors and concluded that the IRS met its burden because an IRS official submitted an affidavit stating that neither tax authority possessed the information sought, the information might be relevant to the Canadian investigation and the Canadian authorities could obtain the same type of information under Canadian law. In addition, the IRS issued its summons in conformity with the US statutory requirements and provided notice to the Canadian taxpayers. Such a showing "unequivocally" established the IRS's good faith. The taxpayers failed to rebut any *Powell* factor, as their argument under Section 7602(c) was not relevant to the IRS's good faith.

The court next reviewed the treaty and the code to determine whether either constrained the IRS's authority to enforce the summons. The court noted that Section 7602(c) did not apply because there was no pending US Justice Department referral or domestic tax investigation of any kind; the Canadian criminal investigation was irrelevant for purposes of US law. The court also reviewed the treaty and held that the language of the treaty did not impose additional factors for enforcement; it required only, in essence, that each state provide the other with information it could obtain under its respective revenue laws. The court, having already determined that the IRS satisfied its obligations under US law (ie, Section 7602(c) and the *Powell* factors), concluded that the treaty did not impose additional limits on enforcement. In sum, because the IRS met the *Powell* requirements, the taxpayer failed to rebut those elements and neither US law nor the treaty imposed additional limits, the IRS was entitled to enforcement.

Following the Supreme Court's decision in *Stuart*, many US courts have readily affirmed the IRS's motion for enforcement. For example, in *Marzurek v United States*(25) the French tax authority issued a request for information to the United States concerning a French taxpayer's civil liability for taxes. The taxpayer filed a motion to quash the summons and, in response, the IRS moved to dismiss the motion and sought an order to enforce the summons. The *Marzurek* court held that to enforce the summons, the IRS must first establish its *prima facie* case, as set out in *Powell*. The court held that the IRS met its burden because an IRS official submitted an affidavit establishing that those factors had been met.(26) The court also noted that the IRS can satisfy the "legitimate purpose" element because fulfilling a treaty obligation and assisting the investigation of a non-US tax authority is itself a "legitimate purpose".

To rebut the IRS's *prima facie* case, the taxpayer argued that:

- the French tax authority's investigation was not for a legitimate purpose because, during the time implicated, he was not a resident of France; and
- the French tax authority could not obtain access to information under French law.

The court rejected the taxpayer's first argument because the legitimacy or propriety of the French tax authority's investigation was irrelevant; the IRS had no obligation to prove the good faith of the requesting nation.(27) The court also rejected the taxpayer's second argument, holding that Paragraph 2 of the information exchange article in the US-France treaty (which is essentially identical to Paragraph 3 of Article 26 of the US model treaty) gave the IRS discretion to supply the information because the plain language of the treaty neither mandated nor forbade compliance with an otherwise proper treaty request. Although the *Lincoln* court held otherwise, the *Marzurek* court called the *Lincoln* holding into question and hypothesised that the Supreme Court's decision in *Stuart* overruled *Lincoln Bank*.(28)

Finally, the *Marzurek* court upheld the district court's denial of the taxpayer's request for discovery and an evidentiary hearing. The district court held that the taxpayer's discovery requests and requests for admission would deal with French governmental actions and interpretations of French law that were beyond the power of the district court. Such a conclusion was not an abuse of discretion.

A case now pending in the US Supreme Court that has the potential to alter the *Marzurek* court's holding on discovery requirements. In *United States v Clarke*(29) the Eleventh Circuit held that a taxpayer was entitled to a discovery and an evidentiary hearing on the taxpayer's allegation that the IRS summons was made for an improper purpose. If the Supreme Court upholds the Eleventh Circuit's decision, it will permit discovery and an evidentiary hearing in summons enforcement actions – at least where the taxpayer requests it – including those issued on behalf of a treaty partner. This pending review not only has the potential to alter the US administrative procedural requirements, but it could also slow down the summons enforcement process altogether.(30) Notably, allowing discovery might enable taxpayers to build a stronger argument against the IRS's case for enforcement.

Expanded use of treaty requests

All of the cases discussed thus far have considered summonses that identify the taxpayer by name. However, pursuant to Section 7609, the IRS is also empowered to issue a so-called 'John Doe' summons, which does not identify a specific person. Rather, a John Doe summons is intended to capture information about an unnamed individual or group of taxpayers with similar circumstances. Until recently, the IRS has never issued a John Doe summons on behalf of a treaty partner. However, in July 2013 the IRS petitioned several district courts for *ex parte* orders(31) to allow the issuance of John Doe summonses on several US banks. In these cases, Norway issued a request for information to the United States regarding several of its taxpayers who were using specific credit card and debit cards issued by US financial institutions and were suspected of evading Norwegian tax laws. The United States issued the summons to obtain the identities of persons who used these cards so that Norway could determine whether those persons had complied with Norwegian tax laws. Seven district courts have granted those petitions and the petitions are pending in three other district courts. These John Doe summonses represent an important expansion of the use of bilateral tax treaties to acquire information on behalf of treaty partners and "reflect[s] [the United States'] continuing efforts to work with international partners on offshore tax evasion".(32)

Comment

A review of the US jurisprudence shows the relative ease with which the IRS can obtain an enforcement order on behalf of a treaty partner. To enforce a summons, the IRS need prove only that it satisfied the *Powell* elements required for a showing that the summons was issued in good faith. Even though a summons issued on behalf of a treaty partner involves non-US tax authorities and legal issues, the US Supreme Court has held that neither the Internal Revenue Code nor the specific treaty under review added additional restrictions to the *Powell* requirements. As the case law reveals, the IRS's burden can be satisfied with a single affidavit establishing each of the four *Powell* requirements and a showing that the IRS satisfied procedural requirements. Also significant is that the 'legitimacy' element can be satisfied by the mere fact that the IRS is fulfilling its treaty obligations by issuing a summons on behalf a treaty partner request; any questions as to the legitimacy of the non-US investigation are irrelevant. Ultimately, the IRS has a light burden in proving its *prima facie* case for enforcement and, as previously discussed, the US courts have not applied significant limitations on the IRS's authority to enforce a summons issued on behalf of its treaty partners. One court has even gone so far as to posit that the IRS has discretion to supply information to its treaty partners even if the treaty request does not comply with the partnering country's laws. Even if the IRS does not have such discretion, the IRS still maintains broad authority in the summons enforcement arena, as especially evidenced by its issuance of multiple John Doe summonses on behalf of Norway.

Conversely, the taxpayer challenging an IRS enforcement action has a heavier burden, especially considering that:

- US courts generally do not closely scrutinise whether the request complies with the foreign treaty partner's laws;
- courts do not consider the good faith or legitimate purpose of the investigation of the treaty partner (only the good faith of the IRS); and
- the IRS's good faith is satisfied by the mere fact that it is responding to a treaty

request.

Given these limitations on the judicial review of summons enforcement cases in the United States, a taxpayer's arguments against a treaty partner's information request rarely succeed.

In reviewing the US jurisprudence, it is important to keep in mind that each court is examining the terms of a different tax treaty. Therefore, one court's holding regarding the enforcement of a summons pursuant to one treaty may not apply to a non-US taxpayer which is summonsed by the United States on behalf of a treaty partner under a different treaty. The variations in the terms or provisions governing exchange of information can have material effects on the exchange of information process. Because bilateral tax treaties are unique to the respective contracting states, taxpayers must scrutinise the particular treaty at issue to evaluate the taxpayer's rights and the obligations of the treaty partners. In addition, the technical explanations of the treaties provide important insight into the scope and purpose of the specific treaty articles.

So what should a non-US taxpayer that receives a notice of a summons by the United States on behalf of a treaty partner? The taxpayer must exercise its right to intervene and move to quash the summons immediately. The taxpayer must closely review the particular treaty at issue and the technical explanations in developing arguments against the summons enforcement. Once the taxpayer has initiated its motion to quash, the taxpayer should engage the IRS and the Department of Justice regarding the information requested. Considering the IRS's history of success in enforcing summonses on behalf of treaty partners, negotiating with the IRS before the enforcement order is likely to be the taxpayer's best option to minimise the scope of information released to the non-US tax authority and limit any over-reaching requests by the non-US tax authority.

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Endnotes

(1) The United States published its first model treaty in 1977. Before 1977, the Organisation for Economic Cooperation and Development (OECD) model was the predominant model treaty used by developed nations. Both the OECD Model Treaty and the US model treaty are used as a starting point for bilateral negotiations. This update focuses solely on the US model treaty.

(2) The competent authorities of each treaty partner country handle information requests, assist taxpayers with respect to matters covered by treaties and are the only persons authorised to exchange information. The delegated US competent authority is the director, international (Large and Mid-Size Business Division). IRM 4.60.1.2 (01-01-2002).

(3) Information may be provided to a treaty party without a formal request for information. Such an exchange is called a spontaneous exchange of information.

(4) 'US competent authority', 'IRS' and 'United States' (in relevant instances) are used interchangeably throughout this update.

(5) When a foreign tax authority requests information from the US competent authority, it must provide:

- a specific identification of the taxpayer;
- an itemised list of all information requested;
- a detailed narrative identifying the tax nexus or relevance of the information sought to the taxpayer and issues being examined; and
- an explanation of how the request for transactions, facts or documents pertains to a tax or tax liability covered by the tax treaty. IRM 4.60.1.2.5 (1) (01-01-2002).

IRS personnel are required to review the request to ensure that it meets IRS criteria and, once reviewed, the personnel will forward the request to the appropriate office for further processing. That office will either obtain the requested information itself or determine whether a summons is needed. IRM 4.60.1.2.5.1.1-2 (01-01-2002).

(6) The administrative summons allows the IRS, for purposes of ascertaining the correctness of any return and determining the liability of any person for any tax, to examine any books, papers, records or other data that may be relevant to such inquiry, and to summon any person to produce such material and to give testimony under oath as may be relevant to the inquiry. IRC § 7602.

(7) All 'section' references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

(8) IRC §§ 7609(b)(2)(B); 7609(h)(1).

(9) IRC § 7609(b)(1).

(10) IRC § 7609(b)(2)(A) ("In any such [motion to quash] proceeding, the Secretary may seek to compel compliance with the summons").

(11) 379 US 48 (1964).

(12) See *Powell*, 379 US at 57-58.

(13) *Id* at 58.

(14) The third exception to the obligation to supply information to a requesting contracting state is if supplying the information "would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy".

(15) See *United States v Lincoln First Bank, NA*, 1980 WL 1500 (SDNY February 14 1980).

(16) M 18-304, 1974 WL 687 (SDNY August 1 1974), aff'd in part, rev'd in part, 525 F2d 9 (2d Cir 1975).

(17) The full procedural history is more complex, but is not relevant for purposes of this update.

(18) *Burbank*, 525 F2d at 16-17.

(19) *Id* at 13.

(20) 1980 WL 1500 (SDNY February 14 1980).

(21) See, for example, *Carlos Javier Terroba Wolff v United States*, 12-60368 (SD Fla July 30 2012) (dismissing taxpayers motion to quash because it was untimely even though taxpayer did not receive notice until after the 20-day period had run); *Bull D, SA de CV v United States*, 487 F Supp 2d 772 (WD Tex 2007) (holding that even if the IRS did not exactly abide by the administrative requirements, the good-faith standard for enforcement could still be satisfied).

(22) 489 US 353 (1989).

(23) Section 7602(c) as enacted when *Stuart* was decided was re-designated as the current Section 7602(d). Internal Revenue Service Restructuring and Reform Act of 1998, Pub L 105-206, § 3417(a), 112 Stat 685, 757 (1998).

(24) 379 US at 57-58.

(25) 271 F3d 226 (5th Cir 2001).

(26) The affidavit specifically stated that the request was properly made, the information was not in the possession of either tax authority, the information could be relevant to the French tax authority's investigation, the same type of information could be obtained under French law and, if the situation were reversed, the United States could properly request such information from France, *Id* at 230 ("The government's minimal burden at this stage can be fulfilled by a 'simple affidavit'").

(27) Other courts have rejected taxpayers' arguments because the legitimacy or legality of the non-US authority's investigation is irrelevant. See, for example, *Villareal v United States*, 2:11-CV-1594 JCM, 2013 WL 474790 (D Nev February 7 2013); *United States v Hiley*, 07cv1353-IEG(LSP), 2007 WL 2904056 (SD Cal October 2 2007); *Urtuzuastegui v United States*, CIV 00–381 TUC ACM, 2000 WL 1931333 (D Ariz December 5 2000).

(28) See also *Azouz v United States*, 99 Civ 0020 (AKH), 1999 WL 1581401 (SDNY December 14 1999) (holding that the US-Canada Tax Convention allowed the IRS discretion to obtain information on behalf of Canada and that *Lincoln Bank* could not be relied on because it pre-dated the US Supreme Court's holding in *Stuart*).

(29) 12-13190, 517 Fed Appx 689 (11th Cir April 18 2013).

(30) Summons enforcement proceedings are conducted as summary proceedings under Fed R Civ P 81(a)(5).

(31) The procedures for issuing a John Doe summons are different from a regular summons. Section 7609(f) requires the IRS, before issuing the summons, to file an *ex parte* petition showing that:

- the summons relates to the investigation of a particular person or ascertainable group or class of persons;
- there is a reasonable basis for believing that this person or group of persons has failed or may fail to comply with any provision of any internal revenue law; and
- the information sought to be obtained from the examination of the records or testimony (and the identity of the person or persons with respect to whose liability the summons is issued) is not readily available from other sources.

(32) DOJ Press Release July 29 2013 (quoting Douglas O'Donnell, IRS Assistant Deputy Comm'r, LB&I).