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The Enforcement and Impact of John Doe Summonses

by Megan L. Brackney

Megan L. Brackney is a partner at Kostelanetz & Fink LLP, where she focuses on civil and criminal tax controversies.

In this article, Brackney discusses the John Doe summons procedures and the decision partially enforcing a John Doe summons in *Coinbase*. She also identifies some practical considerations for taxpayers whose information may be turned over to the IRS in accordance with the summons.

The IRS had a recent success in enforcing a John Doe summons against Coinbase, a virtual currency exchange. It's likely that the IRS will continue to use the summons to collect information from other virtual currency exchanges because the IRS believes there is a substantial gap between the number of people transacting in virtual currency and the number of people reporting those transactions.¹

On November 30, 2017, the U.S. District Court for the Northern District of California granted the IRS's petition to serve a John Doe summons on Coinbase.² The summons potentially covers 8.9 million transactions and 14,355 Coinbase account holders. Enforcing this summons means not only that the IRS will obtain information on these taxpayers, but also that the statute of limitations for assessment of tax and criminal charges may be extended for them.

The John Doe Summons Procedures

A John Doe summons is one "which does not identify the person with respect to whose liability the summons is issued."³ Although the IRS generally has broad authority to conduct "inquiries, determinations, and assessments of all taxes,"⁴ that authority is limited regarding John Doe summonses. The government must file a petition in the court of the federal district in which the summoned party resides or can be found.⁵ This procedure is ex parte and based "solely on the petition and supporting affidavits" of the government.⁶ The court will issue the John Doe summons only if the IRS establishes that:

1. the summons relates to the investigation of a particular person or ascertainable group or class of persons;
2. there is a reasonable basis for believing that such person or group or class of persons may fail or may have failed to comply with any provision of any internal revenue law; and
3. 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.⁷

The rationale for requiring a court to approve the issuance of a John Doe summons is to provide "some restraint" on the IRS.⁸ The party receiving

¹ *United States v. Coinbase Inc.*, No. 3:17-cv-01431 (N.D. Cal. July 18, 2017); see also Treasury Inspector General for Tax Administration, "As the Use of Virtual Currencies in Taxable Transactions Becomes More Common, Additional Actions Are Needed to Ensure Taxpayer Compliance," 2016-30-083 (Sept. 21, 2016).

² *United States v. Coinbase Inc.*, No. 3:17-cv-01431 (N.D. Cal. Nov. 28, 2017).

³ Section 7609(f) (flush language).

⁴ *United States v. Clarke*, 816 F.3d 1310, 1313 (11th Cir. 2016) (quoting section 6201(a)).

⁵ Section 7609(h)(1).

⁶ Section 7609(h)(2); *Tiffany Fine Arts Inc. v. United States*, 469 U.S. 310, 317 (1985).

⁷ Section 7609(f).

⁸ *Matter of Does v. United States*, 688 F.2d 144, 148 (2d Cir. 1982) (quoting H.R. Rep. No. 94-68, at 311).

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the summons, such as a bank or other third party, might not have an interest in protecting the records from disclosure and thus would not oppose enforcement, so there would be no check on the IRS if it could issue John Doe summonses at will. Section 7609(f) also prevents the IRS from using its summons power to “look around for targets to investigate,” because of concern that such fishing expeditions would unjustifiably infringe on the privacy rights of taxpayers.⁹ “What section 7609(f) does is to provide some guarantee that the information that the IRS seeks through a summons is relevant to a legitimate investigation, albeit that of an unknown taxpayer,” and it puts the court in “the place of the affected taxpayer under section 7609(a) and (b) and exerts a restraining influence on the IRS.”¹⁰

Challenging a John Doe Summons

The party who receives the John Doe summons or the subject of the summons cannot intervene in the section 7609(f) proceeding or later argue that the IRS did not meet the requirements of section 7609(f).¹¹ Congress intended “that the question whether a John Doe summons could be served should not become embroiled in an adversary proceeding.”¹² These parties, however, can challenge the summons in an enforcement proceeding on the ground that the IRS failed to comply with the requirements of *Powell*¹³ or that it acted with bad faith or abuse of process.¹⁴

Powell identifies the limitations on the IRS’s general summons authority. Before a court will enforce a summons, the IRS must make a prima facie showing that:

1. its investigation is being conducted for a legitimate purpose;

2. the inquiry may be relevant to that purpose;
3. the government doesn’t already have the information; and
4. the IRS has complied with the administrative requirements of the code.¹⁵

In establishing these factors, the IRS’s burden is “a slight one.”¹⁶ The burden then shifts to the party challenging enforcement to show that the summons was issued in bad faith or that enforcement would constitute an abuse of the court’s process.¹⁷ This burden, unlike that on the IRS, is a “heavy burden” and requires the party challenging the summons to “allege specific facts and evidence to support his allegations.”¹⁸

Dual-Purpose Summonses

The IRS can avoid the John Doe summons procedure by serving on an identified taxpayer a summons that has a dual purpose of investigating that taxpayer’s liability as well as obtaining information about unidentified third parties. In *Tiffany Fine Arts*,¹⁹ the leading case on dual-purpose summonses, the IRS issued a summons to a holding company for various entities that promoted tax shelters for the names of the people who distributed licenses of a specific medical device from the taxpayer, and thus were likely to have reported the shelter’s bogus tax benefits. The taxpayer argued that the primary purpose of the summons was to audit the licensees, and not the taxpayer, and that because the IRS did not know the identity of the licensees, the summons was in fact a John Doe summons.

The Supreme Court found that the summons had a dual purpose — to collect information about the summoned taxpayer and about the unidentified parties. The Supreme Court explained that as long as the summoned party is under investigation, there is less concern about

⁹ *Tiffany Fine Arts*, 469 U.S. at 320 (citing S. Rep. No. 94-938, at 373; H.R. Rep. No. 94-658, at 311).

¹⁰ *Tiffany Fine Arts*, 469 U.S. at 321.

¹¹ *Matter of Does*, 688 F.2d at 148-149.

¹² *Id.* at 148.

¹³ *United States v. Powell*, 379 U.S. 48 (1964).

¹⁴ *Matter of Does*, 688 F.2d at 149-150 (“But it does not follow that denying the taxpayer the right to challenge the section 7609(f) criteria in the enforcement proceedings precludes him from relying on the four *Powell* standards and claiming bad faith or abuse of court process. All these substantive rights continue to be available.”).

¹⁵ *Powell*, 379 U.S. 48, 58.

¹⁶ *Coinbase*, No. 3:17-cv-01431 (N.D. Cal. Nov. 28, 2017), at *3 (quoting *Crystal v. United States*, 172 F.3d 1141, 1144 (9th Cir. 1999) (internal quotation omitted)).

¹⁷ *Coinbase*, No. 3:17-cv-01431 (N.D. Cal. Nov. 28, 2017).

¹⁸ *Coinbase*, No. 3:17-cv-01431 (N.D. Cal. Nov. 28, 2017), at *3 (quoting *United States v. LaSalle National Bank*, 437 U.S. 298, 316 (1978)).

¹⁹ *Tiffany Fine Arts*, 469 U.S. at 311.

the IRS engaging in a fishing expedition because a party with an interest in the investigation could challenge the enforcement. Thus, the IRS does not have to bring a petition under section 7609(f) “as long as all the information sought is relevant to a legitimate investigation of the summoned taxpayer.”²⁰ The IRS cannot avoid section 7609(f) by issuing a summons to a specific taxpayer as pretext for avoiding the John Doe summons requirements, but must show that it has a bona fide interest in the summoned party’s tax liability.²¹

The Coinbase Summons

The *Coinbase* summons was a John Doe summons the district court issued in accordance with section 7609(f). The summons initially sought information “regarding United States persons who, at any time during the period January 1, 2013, through December 31, 2015, conducted transactions in a convertible virtual currency as defined in IRS Notice 2014-21.”²² After the summons was issued, Coinbase and some John Doe customers attempted to quash it, and the government brought a summons enforcement action against Coinbase. The district court combined the proceedings and allowed the John Does to intervene.

While the proceedings were ongoing, the IRS narrowed its initial requests to information regarding users with at least the equivalent of \$20,000 in any one transaction (buy, sell, send, or receive) in any one year during 2013-2015 for which Coinbase had not filed a Form 1099-K, or whose identity was otherwise known to the IRS. The district court then decided the issue of whether it would enforce the narrowed *Coinbase* summons.²³

The court focused on whether the Coinbase summons served a legitimate purpose and sought relevant information. It first found that the legitimate purpose element was satisfied:

Coinbase is the largest U.S. exchange of bitcoin into dollars with at least 5.9 million customers served and 6 billion in transactions while only 800 to 900 taxpayers a year have electronically filed returns with a property description related to bitcoin from 2013-2015. This discrepancy creates an inference that more Coinbase users are trading bitcoin than reporting gains on their tax returns.²⁴

The district court found that most of the records sought through the *Coinbase* summons were relevant because they would allow the IRS to determine whether particular Coinbase users filed tax returns that accurately reflected their virtual currency transactions. However, it said some categories of records were irrelevant to that purpose, including the requests for copies of identification documents, such as passports and driver’s licenses, and other documents concerning “know your customer” due diligence. The court thus refused to enforce those aspects of the summons, and ordered Coinbase to produce “records of account activity including transaction logs or other records identifying the date, amount, and type of transaction (purchase/sale/exchange), the post transaction balance, and the names of counterparties to the transaction” for the approximately 14,000 account holders covered by the summons.²⁵ In issuing this order, the court rejected Coinbase’s claims that the IRS lacked a proper investigative purpose or that the summons was an abuse of process.

If a Client Is the Subject of a John Doe Summons

The IRS’s success in the *Coinbase* summons litigation may lead to more John Doe summonses of virtual currency exchanges, since this certainly is an area of interest for the IRS. Tax practitioners who represent clients engaging in virtual

²⁰ *Id.* at 324.

²¹ See *United States v. Gertner*, 65 F.3d 963, 970-972 (1st Cir. 1995) (“If the enforcement proceeding results in a determination that the IRS does not in fact intend to investigate a named party, then the IRS cannot obtain the data it seeks without observing the mandate of section 7609(f).”).

²² *Coinbase*, No. 3:17-cv-01431 (N.D. Cal. July 18, 2017), at *1. Notice 2014-21, 2014-16 IRB 938, states that virtual currencies are treated as property for tax purposes, *i.e.*, a taxpayer must recognize gain or loss on the sale or exchange of a virtual currency.

²³ *Coinbase*, No. 3:17-cv-01431 (N.D. Cal. Nov. 28, 2017).

²⁴ *Id.* at *3.

²⁵ *Id.* at *7.

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currency transactions should be thinking about at least two things right now.

First, for clients covered by the *Coinbase* summons, the statute of limitations for civil assessment of tax and criminal prosecution for tax offenses is suspended until Coinbase fully responds to the summons. Section 7609(e)(2) provides as follows:

In the absence of the resolution of the summoned party's response to the summons, the running of any period of limitations under section 6501 or under section 6531 with respect to any person with respect to whose liability the summons is issued (other than a person taking action as provided in subsection (b)) shall be suspended for the period —

- A. beginning on the date which is 6 months after the service of such summons; and
- B. ending with the final resolution of such response.²⁶

The final resolution of the response happens when “the summons or any order enforcing the summons is fully complied with and all appeals or requests for further review are disposed of, the period in which an appeal may be made has expired or the period in which a request for further review may be made has expired.”²⁷

The *Coinbase* summons was issued November 30, 2016, and at least as of November 28, 2017, the date of the district court's order, Coinbase had not responded. Accordingly, the suspension of the statute of limitations took effect on May 30, 2017, and will continue until Coinbase completes its response. Under section 7609(i), Coinbase was required to notify its customers covered by the summons of the suspension of the periods of limitations, but many customers may not have focused on that notice or understood its import.

Second, the practitioner should consider the various methods for the client to correct any past noncompliance before the IRS obtains the information from Coinbase and begins a civil

audit or criminal investigation. The service of a John Doe summons itself will not cause a taxpayer to be ineligible for voluntary disclosure. But once the government obtains information on a particular taxpayer, that taxpayer may no longer be eligible for voluntary disclosure.²⁸ The IRS's advice, stated in connection with the offshore voluntary disclosure program, is that “a taxpayer concerned that a party subject to a John Doe summons . . . will provide information about him to the Service should apply to make a voluntary disclosure as soon as possible” (FAQ 21). Accordingly, clients who have not been reporting their virtual currency gains and have or had an account that fits within the guidelines of the narrowed *Coinbase* summons should seriously consider self-correcting while they still can.

However, Coinbase customers covered by the John Doe summons cannot benefit from the qualified amended return (QAR) procedure. A QAR corrects an error in a previously filed return before the IRS contacts the taxpayer about that return, thereby avoiding the substantial understatement penalty under section 6662.²⁹ A taxpayer is disqualified from making a QAR if the IRS has issued a John Doe summons to any person, group, or class to which the taxpayer belongs regarding any activity for which the taxpayer reported a tax benefit.³⁰ Nevertheless, taxpayers who are covered by the *Coinbase* summons, or may be targets through their use of another virtual currency exchange, should consider all methods of self-correction before the IRS finds them. ■

²⁶ See also reg. section 301.7609-5(d)(1).

²⁷ Reg. section 301.7609-5(e)(3).

²⁸ See Internal Revenue Manual section 9.5.11.0 (Oct. 2, 2009).

²⁹ Reg. section 1.6664-2(c)(3).

³⁰ Reg. section 1.6664-2(c)(3)(i) and (c)(5) (examples 4-6).