Formal Document Requests under Section 982: New Case Expands Definition of "Foreign-Based Documentation"

By Hale E. Sheppard

Hale E. Sheppard examines formal document requests under Code Sec. 982 in light of a recent District Court decision, *LaRue*. This article analyzes the case, arguments that might have changed its outcome, and the potential impact on future international tax disputes.

Introduction

Gone are the days when the IRS primarily audits purely domestic taxpayers, *i.e.*, those living, working, operating and investing solely in the United States. Globalization has affected everyone and everything, including the IRS. Now, in addition to keeping domestic taxpayers in check, the IRS must ensure U.S. tax compliance by international players. This can be challenging for the IRS because of differences in local laws, languages, document-retention policies, accounting methods, currencies, *etc.* Another major hurdle for the IRS during a tax dispute can be obtaining documents held in a foreign country.

Congress passed Code Sec. 982 decades ago to help in this regard. This tax provision authorizes the IRS to issue a formal document request (FDR) during an audit seeking "foreign-based documentation," which is defined as relevant items located "outside the United States." Unlike many tools available to the IRS, this one actually has teeth. Taxpayers failing to adequately respond to an FDR during an audit cannot later present the previously-withheld documentation to a

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court in defending its tax/legal positions. In other words, the thrust of Code Sec. 982 is that taxpayers must give during an audit all "foreign-based documentation" that the IRS demands *via* an FDR or forfeit the opportunity to use such documentation to their advantage later, if the dispute ultimately advances to court. It is hard to win a tax case when you cannot present key, favorable evidence.

Gone are the days when the IRS primarily audits purely domestic taxpay ers, i.e., those living, working, operating and investing solely in the United States. Globalization has affected everyone and everything, including the IRS.

Many in the tax community have long believed that, based on the express language of Code Sec. 982 and the rationale behind its enactment, an FDR strictly applies to materials that are physically located in a foreign country, materials that the IRS would have serious trouble accessing were it not for the threat of evidence preclusion. However, a decision issued by a District Court in April 2016, *LaRue*, shatters this understanding.[1] This article analyzes the case, arguments that might have changed the outcome, and the potential impact on future international tax disputes.

Overview of Code Sec. 982

Code Sec. 982(a) generally provides that, if a taxpayer fails to "substantially comply" with an FDR issued by the IRS during an examination/audit regarding the proper tax treatment of any item, then, if the IRS later files a Motion with the court tasked with determining the proper tax treatment, such court shall prohibit the taxpayer from introducing at trial any "foreign-based documentation" covered by the FDR.[2] There are exceptions to this general rule, of course. Code Sec. 982(b)(1) states that the prohibition against a taxpayer presenting as evidence at trial certain "foreign-based documentation" does not apply in situations where the taxpayer can demonstrate that the failure to provide the documentation in response to the FDR was due to "reasonable cause."[3] The fact that a foreign government would impose a civil or criminal penalty on the taxpayer or any other person for disclosing the "foreign-based documentation" does not constitute "reasonable cause."[4]

The main events commonly leading to a dispute over an FDR are as follows.[5] The IRS initiates an audit. The Revenue Agent then issues Information Document Requests (IDRs) to the taxpayer requesting certain information and/or documentation, some of which may pertain to international issues. The taxpayer has several practical and strategic reasons for "cooperating" during an audit, which requires responding to IDRs. First, if a taxpayer provides the IRS with all potentially relevant data during an audit, including items requested in IDRs, there is a chance (albeit small) that the taxpayer convinces the Revenue Agent that the tax returns under audit are accurate, and the IRS should issue a "no change" letter to conclude the matter.

Second, Code Sec. 7491(a) and Tax Court Rule 142(a)(2) generally provide that if a taxpayer introduces "credible evidence" with respect to any factual issue relevant to determining the liability of the taxpayer, then the IRS will have the burden of proof in any court proceeding.[6] Code Sec. 7491(a)(2) states that this burden-shifting rule only applies if the taxpayer has complied with all substantiation requirements, has maintained all necessary records and has "cooperated" with reasonable requests from the IRS for witnesses, information, documents, meetings and interviews.

Third, a taxpayer responds to IDRs in order to potentially shift the burden of proof to the IRS in situations where the IRS is relying on so-called "naked Forms 1099" to assess additional income taxes against a taxpayer. Code Sec. 6201 provides that if a taxpayer raises a reasonable dispute with respect to an information return filed with the IRS by a third-party, and the taxpayer has "fully cooperated" with the IRS during the audit, then the burden of proof shifts to the IRS. In the context of Code Sec. 6201, "cooperation" means allowing the IRS access to all witnesses, information and documents within the taxpayer's control.

Finally, a taxpayer responds to IDRs for purposes of positioning itself for fee reimbursement if the taxpayer manages to defeat the IRS. Code Sec. 7430 generally indicates that a taxpayer that is the "prevailing party" in a tax dispute may recoup reasonable costs from the IRS. The taxpayer will not be considered the "prevailing party" if the tax/legal position taken by the IRS was "substantially justified," and a significant factor in making this determination is whether the taxpayer presented "all relevant information" under the taxpayer's control, as well as "all relevant legal arguments" supporting the taxpayer's position. In other words, whether a taxpayer can recover fees pursuant to Code Sec. 7430 depends, in part, on the taxpayer "cooperating" during the tax dispute process.

Despite these four reasons for adequately responding to IDRs, some taxpayers do not do so. The Revenue Agent has several options if this occurs. These include, but are certainly not limited to, (i) generating an unfavorable Examination Report for the taxpayer based on the limited data available, thereby obligating the taxpayer to challenge issues either with the Appeals Office or the Tax Court, (ii) issuing an administrative Summons, and possibly seeking assistance from IRS attorneys to enforce the Summons in court if the taxpayer neglects to fully comply and/or (iii) sending the taxpayer an FDR, if the situation involves "foreign-based documentation."

Assuming for purposes of this article that the Revenue Agent selects the third option (*i.e.*, resorting to an FDR), various actions could ensue. For instance, the taxpayer could simply ignore the FDR, in which case the Revenue Agent could conclude the audit based on the data at hand and then issue an Examination Report or Notice of Deficiency, as appropriate. If the taxpayer were to later challenge the proposed taxes and penalties in Tax Court or another appropriate court, the IRS could file a Motion under the general rule in Code Sec. 982(a) to prohibit the taxpayer from introducing as evidence at trial any "foreign-based documentation" that the taxpayer did not deliver in a timely manner to the Revenue Agent in response to the FDR. The taxpayer, of course, could raise defenses to this proposed exclusion of evidence. Those most common defenses would be that the taxpayer "substantially complied" with the FDR, and, even if this were not the case, there was "reasonable cause" for the taxpayer's noncompliance.[7] The legislative history provides the following guidance about what "substantial compliance" means here:

> Whether a taxpayer has substantially complied with [an FDR] will depend on all the facts and circumstances. For instance, if the [IRS] presents a taxpayer [an FDR] for 10 items and the taxpayer produces 9 of them but fails (without reasonable cause) to produce the one requested document that appears to a court to be the most significant item, a court may decide that there has not been substantial compliance and exclude all of the items. However, when the [IRS] issues multiple requests in the course of an audit, and when, for example, the taxpayer fails to comply with one particular request for only one document, the taxpayer's timely satisfaction of other requests is one factor (but not the only factor) to be considered in determining whether his overall compliance has been substantial. If overall compliance in such a situation has been substantial, the document requested but not supplied could be admissible. The determination of whether a taxpayer has substantially complied with [an FDR] will be made on an issue-by-issue basis … .[8]

The legislative history also gives some insight into what Congress wanted the IRS and the courts to consider in determining whether a taxpayer had "reasonable cause" for not fully responding to an IDR. It indicates that minority ownership status in a foreign entity can prevent a taxpayer from being able to produce records held by such entity but recognizes that some taxpayers might seek to hide behind their minority status to avoid production of foreign-based documentation. Accordingly, the decision about whether minority status constitutes "reasonable cause" will depend on the facts and circumstances of each individual case.[9]

Instead of ignoring the FDR, a taxpayer could proactively fight it. Code Sec. 982(d) describes this mechanism. It provides that any person (not just the taxpayer) to whom the IRS mails an FDR has the right to file a Motion to Quash the FDR with the appropriate District Court.[10] If this occurs, then the IRS has the right to seek an Order from the District Court during the same proceeding compelling the person to comply with the FDR.[11] The legislative history clarifies that, if the taxpayer challenges an FDR, then the IRS has the burden of proving several things to the District Court, including that (i) the documentation requested in the FDR is material and relevant to the audit, (ii) the audit is being conducted for a legitimate purpose, (iii) the documentation sought in the FDR is not already in the IRS's possession and (iv) the IRS followed all obligatory administrative steps before issuing the FDR.[12]

Some will try to dismiss LaRue, *characterizing it as an aberration, an unpublished decision, by a court not specializing in tax, resulting from incomplete arguments, and based on questionable legal reasoning. The IRS, of course, might see it differently.*

The devil is nearly always in the details when it comes to tax, and Code Sec. 982 is no exception. An important detail is the meaning of specific terms, two of which have particular importance to this article. First, an "FDR"

means a request by the IRS, for foreign-based documentation, made after the normal request procedures have failed to obtain the pertinent documentation.[13] The legislative history indicates that this means that the IRS must first issue an IDR to the taxpayer before resorting to an FDR and emphasizes that "Congress did not intend that the [FDR] procedure be used as a routine beginning of an examination."[14] The IRS must send the FDR by registered or certified mail to the taxpayer's last known address, and it must state the time and place for the taxpayer to produce the relevant documentation, an explanation of why any documentation previously supplied by the taxpayer is insufficient, a description of the documentation that the IRS is seeking and a warning of the consequences if the taxpayer fails to comply with the FDR; that is, the inability to later present such documentation as evidence at trial.[15]

The second important term for purposes of this article is "foreign-based documentation." It is defined as "any documentation *which is outside the United States* and which may be relevant or material to the tax treatment of the examined item."[16] The legislative history does little to clarify this issue, simply stating that "foreign-based documentation" refers to "any documentation *which is outside the United States* and which may be relevant or material to the tax treatment of an examined item [and] it includes documents held by a foreign entity whether or not controlled by the taxpayer."[17] As explained below, the key issue in *LaRue* was whether the items demanded by the IRS in the FDR constituted "foreign-based documentation."

Description of Relevant Case

Summary of the Facts

The facts in *LaRue* were compiled from a large number of documents filed with the District Court, which are summarized here.[18]

The IRS was auditing Forms 1040 of the LaRues for 1997 through 2009 and 2011 through 2013. Apparently, an earlier audit concerning 2010 resulted in a "no change." The IRS came to believe, either before or during the audit, that the LaRues were involved with federal income tax evasion through the use of foreign trusts, foreign accounts and other foreign entities.

On August 27, 2013, the Revenue Agent issued an IDR requesting several things, among them "copies of any and all foreign income information, including bank statements, foreign trust documents, or information related to interest in foreign trusts and/or entities." The LaRues did not respond to the IDR and refused to participate in an interview with the Revenue Agent. Therefore, on May 8, 2014, the Revenue Agent issued a Summons. It required the LaRues to respond to a second IDR, which was identical to the first IDR. Thus, it asked for "copies of any and all foreign income information, including bank statements, foreign trust documents, or information related to interest in foreign trusts and/or entities." On June 16, 2014, the LaRues appeared before the Revenue Agent, with counsel, but did not provide documents and declined to be interviewed. On September 8, 2014, the Revenue Agent issued a third IDR, which was more expansive than its two predecessors. The third IDR sought "[a]ll records created, obtained, and/or maintained from January 1, 1997, through the present, that are in your care, custody, or control, relating to all bank, securities, or other types of financial accounts in any foreign country in which you have (or had) a present or future financial interest, legal interest, beneficial ownership interest, or over which you have signature … or other authority." The third IDR also sought a long list documents for the same timeframe related to foreign trusts and foreign business entities. The LaRues, consistent with their earlier behavior, failed to respond to the third IDR. The result was the issuance by the Revenue Agent of a second Summons on October 20, 2014, requesting exactly the same materials requested in the third IDR. In response to the second Summons, the LaRues appeared on December 8, 2014, handed the Revenue Agent a document indicating that, based on advice from their attorneys, they were refusing to provide documents or answer questions pursuant to their Fifth Amendment right against self-incrimination. Notably, the IRS did not enlist the help of the court to enforce the first or second Summons.

On January 26, 2015, the Revenue Agent issued an FDR. It sought all the documents requested previously in the third IDR, the corresponding second Summons, and more. The FDR consisted of three pages of instructions and nine pages of detailed requests divided into the following categories: bank records, brokerage or securities accounts, ownership of foreign entities and foreign trusts. The LaRues pro-actively challenged the FDR by filing a timely Motion to Quash with the District Court, while the IRS, through the U.S. Department of Justice Tax Division, urged the District Court to enforce the FDR.

The LaRues asserted a series of defenses to the FDR in their Motion to Quash, including (i) they were not required to respond thanks to their Fifth Amendment right against self-incrimination; (ii) the IRS had not proven, as required by the legislative history to Code Sec. 982,

that the FDR was issued for a legitimate purpose, it seeks documentation relevant to such purpose, the documentation is not already in the IRS's possession and the IRS complied with all administrative steps before issuing the FDR; (iii) the FDR demands documentation related to years whose assessment periods are closed for income tax purposes; and (iv) the regulations related to Form TD F 90-22.1 and FinCEN Form 114 (both referred to as "FBAR") only require taxpayers to retain records for five years, such that the IRS's demands for bank records for 1997 through 2009 are unreasonable.[19]

The IRS conceded that the LaRues were only required to maintain foreign bank records for five years, but disputed all other arguments presented in the Motion to Quash. According to the affidavit by the Revenue Agent attached to one of the court filings, the IRS had obtained information showing that the LaRues used a company to implement a "scheme" to avoid paying U.S. income tax involving the formation of trusts in the Cook Islands, depositing funds into a foreign account held by the foreign trusts, transferring funds to an entity in the Cayman Islands, engaging in various transactions in the Cayman Islands, *etc.* The briefing by the IRS also indicated that the LaRues had previously filed information returns (*i.e.*, Forms 3520 or Forms 3520-A) for 1997 through 2001 regarding the foreign trusts, and the IRS had secured documentation related to at least one foreign trust, including the Certificate of Registration, Trust Agreement, Letter of Wishes and Deed of Indemnity. The IRS explained to the court that the documents sought in the FDR were relevant because the IRS was auditing (i) the nature of the funds sent offshore, (ii) whether foreign-source income was properly reported, (iii) what happened to the funds when foreign entities and accounts were closed and (iv) whether appropriate international information returns (for foreign trusts, foreign financial accounts, *etc.*) were properly filed.

The LaRues acknowledged in later filings with the District Court that the IRS had satisfied all relevant administrative requirements, as mandated by legislative history, Code Sec. 982 and common law. Consequently, the dispute was narrowed to just two issues, namely: were the documents sought by the IRS in the possession, custody or control of the LaRues, and even if they were, did the Fifth Amendment right against self-incrimination shield the LaRues from producing the documents to the IRS in response to the FDR. As noted above, Code Sec. 982(d) specifically states that an FDR only applies to "foreign-based documentation," which is defined as "any documentation which is outside the United States and which may be relevant or material to the tax treatment of the examined item." In advancing the position that the LaRues did not have access to the items listed in the FDR, their attorney indicated to the District Court that "[e]ach of the [LaRues] have declared that he or she has no documents in his or her possession, custody, or control in a foreign country that are responsive to the FDR." The government attorney did not focus on the key phrase in the declarations by LaRues, "in a foreign country," arguing instead that such declarations lacked credibility because they were "self-serving" and the LaRues failed to demonstrate that they made sufficient efforts to obtain the items listed in the FDR from other sources.

First Ruling by the District Court

The District Court rejected the two remaining arguments by the LaRues. First, the District Court acknowledged that while lack of access to the requested documentation is a feasible defense to an FDR, the LaRues provided no "credible evidence" that this is true, they admitted that they owned foreign entities as recently as five years ago, and they failed to demonstrate that they made sufficient efforts to get the items identified in the FDR from other parties. Second, as to the Fifth Amendment defense, the District Court ruled that it does not apply to the LaRues because of the "foregone conclusion exception" to the privilege against self-incrimination. The District Court pointed out that the IRS had shown, through evidence and/or lack of counter-arguments by the LaRues, that (i) documents concerning foreign trusts, accounts and other entities existed; (ii) the documents are authentic; and (iii) the documents are in the custody or control of the LaRues. The District Court then issued an Order and Opinion directing the LaRues to comply with the FDR within 30 days.

Second Ruling by the District Court—Focus on Code Sec. 982

The LaRues then filed a Motion for Clarification Opinion, asking the District Court to clarify the definition of "foreign-based documentation," as defined in Code Sec. 982(d)(1).

The LaRues contended that an FDR only applies to documentation that is physically located outside the United States; therefore, if the relevant documentation is found in the United States at the time the FDR is issued, then it is not subject to the FDR. The LaRues supported this argument on the following grounds. First, the express language of Code Sec. 982(d) indicates that "foreign-based documentation" is that "which is outside

the United States." Second, the legislative history to Code Sec. 982 indicates that, in determining whether there was "reasonable cause" for not complying with an FDR, the IRS should consider whether the documents are located abroad. This would not even be a factor, suggested the LaRues, if FDRs covered items situated in the United States. Finally, the LaRues highlighted the fact that a recent International Practice Unit issued by the IRS states that one of the criteria to be analyzed before issuing an FDR is whether the documents are located outside the United States.[20]

The IRS, predictably, disagreed with the interpretation of Code Sec. 982(d) by the LaRues. The crux of the IRS's argument seems to be that, if a document was either created abroad or held abroad at some point, then it should always be considered "foreign-based documentation." In other words, the IRS seems to maintain that the foreign "taint" can never be purged, and this "taint" applies not only to original documents, but copies, too. Below are more details.

In its response to the Motion for Clarification Opinion, the IRS stated that it now understands that the LaRues already may have in their possession, in the United States, copies of certain documentation identified in the FDR. The IRS summarized its position as follows: "Those copies have the same classification as the original documents that are overseas (*i.e.*, the copies, like the originals, are foreign-based documentation)." The sole support for this position cited by the IRS was one case, yielding an unpublished opinion, which was not precedential, and which is not directly on point, *Chris-Marine USA, Inc*.[21] Even the IRS recognized the weakness of this case in its submission to the District Court, making this acknowledgment: "While the court did not specifically say the documents in the [Florida] office [sent from abroad] were foreign-based documentation, the court found that the documents were responsive to the FDR." The IRS tends to further undermine its position when attempting to support it. Indeed, the filings with the District Court by the IRS concede that (i) the key provision, Code Sec. 982(d), does not expressly address whether copies of foreign-based documentation held in the United States retain the classification; (ii) the IRS never clarified this and other issues by issuing regulations under Code Sec. 982; and (iii) the legislative history does not offer clarity. The lack of support for the position notwithstanding, the IRS requested the following ruling: "The United States asks the Court to find that copies of foreign-based documentation held in the United States are considered foreign-based documentation for purpose of responding to the FDR."

In what was a surprise to the tax community, particularly those practicing in the area of international tax, the District Court ruled in favor of the IRS for four reasons. First, while the District Court recognized that the plain language of Code Sec. 982(d)(1) does not address the issue at hand, it indicated that it is "untenable that copies of documents would lose their 'foreign-based' status, making them unresponsive to an FDR, by virtue of being held by taxpayers domestically." Second, the IRS's own guidance to its Revenue Agents (*i.e.*, the International Practice Unit cited by the LaRues) about the need to consider the location of the items requested before issuing an IDR is not precisely on point and not binding on the District Court. Third, after tacitly acknowledging that the only case cited by the IRS in support of its positon was not directly on point, the District Court found that "it is reasonable to infer that the *Chris-Marine* court found that the copies of foreign-based documents do not lose their 'foreign-based' status upon arrival to the United States." Finally, alluding to the proverbial "slippery slope" and notions of tax administration, the District Court explained that, if "a copy of a foreign-based document were to cease being 'foreign-based' upon arrival in the United States, [then] every foreign-based document that the IRS requests with an FDR would automatically become unresponsive to that very FDR as soon as it reaches the taxpayer in the United States."

Obscure Issues Triggered by *LaRue*

Courts largely depend on the briefing by the parties in rendering their decisions, and most attorneys are under significant time, financial and other pressures when preparing cases. The inevitable result is that potentially relevant issues and arguments are not always addressed in the submissions to the court and thus do not factor into the decisions. This seems to be true with *LaRue*. Analyzed below are several items that might have impacted the recent rulings by the District Court, had they been raised.

Legislative History

The LaRues raised several arguments in support of their position that Congress intended FDRs only to cover documentation located outside the United States, one of which focused on the legislative history to Code Sec. 982. Based on a review of the submissions for the LaRues, it appears that they were relying on the following portion of the history, which centered on whether

a taxpayer had "reasonable cause" for not complying with an FDR.

> The sanction of nonadmissibiility does not arise if the taxpayer establishes that the failure to provide the documentation as requested by the Secretary is due to reasonable cause. In determining whether there was reasonable cause for failure to produce, a court may take into account whether the request was reasonable in scope, *whether the requested documents or copies thereof were available within the United States*, and the reasonableness of the requested place of production within the United States.[22]

The District Court gave little importance to the preceding legislative history. Although it did not elaborate in its rulings, the District Court might have interpreted such history to mean that it was more "reasonable" for a taxpayer not to fully comply with an FDR if the documents sought by the IRS were located abroad, and the taxpayer did not have easy, immediate, local access to the originals or copies.

The District Court might have assigned more weight to this argument by the LaRues if they had cited a different portion of the legislative history, one that more clearly indicates that one legitimate ground for disputing an FDR is that the documents sought by the IRS are located in the United States. The portion of the legislative history, which was not cited by the parties or the District Court, states the following:

> Any person to whom a formal document request is mailed *has the right to begin a proceeding to quash* that request not later than the 90th day after the day such request was mailed. *In this proceeding, the taxpayer may contend*, for example, that all or part of the documentation requested is not relevant to the tax issue, that the place of requested production with the United States is unreasonable, *that the requested documents or copies thereof are available within the United States*, or that there is reasonable cause for failure to produce or delay in production.[23]

Internal Revenue Manual

The IRS and various courts have questioned the precedential value of information in the Internal Revenue Manual, but it is undeniable that the Supreme Court has cited it as support in at least one opinion.[24] Neither party referenced the Internal Revenue Manual in *LaRue*. It contains pertinent information, though. For instance, the guidelines state that Revenue Agents should consider several things before issuing an FDR, such as whether "the books and records are available in the United States."[25] Perhaps more telling, the Internal Revenue Manual expressly distinguishes between foreign-based and U.S.-based documentation and clarifies that an FDR only applies to the former:

> IRC Section 982 FDRs and IRC Section 7602 summonses are not mutually exclusive. Both may be issued simultaneously. Example. *FDRs apply only to foreign-based documentation, not to US-based documentation*. If the location of the documents is unknown, then IE should issue both an FDR and a summons for the same information. In this situation, the IE should follow the separate procedures for the issuance of an FDR and a summons.[26]

International Practice Unit Regarding FDRs

The Large Business and International division of the IRS trains its personnel in various ways, one of which is issuing them so-called International Practice Units (IPUs). The IPUs began in 2012 and were first released to the public two years later, in 2014. IPUs do not constitute legal precedent, but many Revenue Agents give them considerable weight in conducting audits, determining whether penalties apply, *etc.*[27]

The LaRues briefly cited the most relevant IPU to buttress their argument that FDRs are unique to documents situated outside the United States, but the District Court swiftly discredited the IPU because it did not answer the specific question about whether documents that were originally foreign-based lost their "foreignness" when later sent to the United States, as originals or copies. Moreover, indicated the District Court, an IPU is not precedential.[28] The District Court might have given more credence to the IPU if the parties had directed it to the language that was directly on point. Page 4 of the IPU lists the criteria that must be met before an FDR can be issued. It states that "[t]he documents requested are located outside the US, i.e., foreign-based documentation." The IPU provides a "Summary of Process," which is comprised of eight steps. Step 1 is to "Determine where the records are located." It describes the following considerations, among others:

- "Determine where the records are located—*FDRs only apply to foreign-based documentation, i.e., records located outside the US*."
- "For each [accounting and/or legal item] requested above, *identify in which country it is located*."

- "[Taxpayer] may maintain all of the foreign entity's original accounting records and legal documents. [Taxpayer] may only maintain the general ledger and accounting journals but not the supporting documentation such as invoices, purchase orders, and receipts. [Taxpayer] might not maintain any of the foreign entity's records. Any combination is possible. *Further, when you issue the FDR for records located outside the US, [Taxpayer] may relocate the records to its custody in the US. For these reasons, on the same date the FDR is issued, issue a summons under § 7602 for the same documents. A summons under § 7602 is for records held in the US by a [taxpayer].*"

Comparison to Code Sec. 7456(b)

Another tool for the IRS to deal with intransigent taxpayers is Code Sec. 7456(b). It was enacted by Congress in 1954, nearly three decades *before* Code Sec. 982 came into existence in 1982. Code Sec. 7456(b) allows the IRS to solicit the assistance of the Tax Court in imposing sanctions against certain foreign taxpayers (*i.e.*, foreign corporations, foreign trusts and nonresident alien individuals) who refuse to provide documents, often foreign documents, related to a case. Notably, Code Sec. 7456(b) and the corresponding regulation, Reg. §301.7456-1, set forth below, both allow the IRS to seek this judicial remedy with respect to the tax-related items "wherever situated." In other words, they are not expressly limited to US-based documentation or foreign-based documentation.

> The Tax Court or any division thereof, upon motion and notice by the [IRS], and upon good cause shown therefor, shall order any foreign corporation, foreign trust or estate, or nonresident alien individual, who has filed a petition with the Tax Court, to produce, or, upon satisfactory proof to the Tax Court or any of its divisions, that the [taxpayer] is unable to produce, to make available to the [IRS], and, in either case, to permit the inspection, copying, or photographing of such books, records, documents, memoranda, correspondence and other papers, *wherever situated*, as the Tax Court or any division thereof, may deem relevant to the proceedings and which are in the possession, custody or control of the [taxpayer], or of any person directly or indirectly under his control or having control over him or subject to the same common control. If the [taxpayer] fails or refuses to comply with any of the provisions of such order, after reasonable time for compliance has been afforded to him, the Tax Court or any division thereof, upon motion, shall make an order striking out pleadings or parts thereof, or dismissing the proceeding or any part thereof, or rendering a judgment by default against the [taxpayer] … .[29]
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> Upon motion and notice by the [IRS] and upon good cause shown therefor, the Tax Court or any division thereof shall order any foreign corporation, foreign trust or estate, or nonresident alien individual, who has filed a petition with the Tax Court, to produce, or upon satisfactory proof to the Tax Court or any of its divisions that the [taxpayer] is unable to produce, to make available to the [IRS], and, in either case, to permit the inspection, copying, or photographing of, such books, records, documents, memoranda, correspondence and other papers, *wherever situated*, as the Tax Court or any of its divisions may deem relevant to the proceedings and which are in the possession, custody or control of the [taxpayer], or of any person directly or indirectly under his control or having control over him or subject to the same common control.[30]

Research indicates that only one case involving Code Sec. 7456(b) has focused on the concept of foreign-based documentation, *Hongkong & Shanghai Banking Corp.*[31] In that case, the taxpayer was a foreign corporation primarily engaged in the banking business with worldwide operations. During the relevant years, the taxpayer had assets and operations in certain parts of the United States, as well as branch offices in three major U.S. cities. The taxpayer filed timely Forms 1120F, *U.S. Income Tax Return of a Foreign Corporation*, for the relevant years to report the income, deductions and other items related to the business that it was conducting in the United States. The IRS decided to audit the Forms 1120F, disallowing certain deductions on grounds that the taxpayer failed to provide adequate substantiation. The IRS filed a Motion with the Tax Court pursuant to Code Sec. 7456(b) asking it to order the taxpayer to produce certain books and records that were located in its home office in Hong Kong. The Tax Court granted the Motion, reasoning as follows:

> [The IRS] has shown "good cause" for some form of order under section 7456(b). We turn now to the type of order to be granted. We agree with [the taxpayer] that it would be wholly impractical for [the taxpayer] to produce in Court the books and records specified

in the above-quoted rider. Section 7456(b) deals with this kind of contingency, however, by directing the Tax Court to order [the taxpayer] to make the relevant "books, records, documents, memoranda, correspondence and other papers" (herein called books and records), *wherever situated,* available to the [IRS] for inspection, copying or photographing. Since the books and records *are located in Hong Kong*, an appropriate order under section 7456(b) will direct [the taxpayer] to make relevant books and records available to [the IRS] *in Hong Kong*.[32]

The taxpayer in *Hongkong & Shanghai Banking Corp.* presented several defenses to the Motion filed by the IRS under Code Sec. 7456(b), one of which was that such provision, passed in 1954, was implicitly superseded by Code Sec. 982 when it was enacted approximately 30 years later, in 1982. The Tax Court explained the following in dismissing the taxpayer's suggestion of tacit repeal:

> We reject [the taxpayer's] interpretation of the scope of section 982. The Senate report under TEFRA made it clear that section 982 is intended to supplement the [IRS's] administrative summons power *to cover those situations where a procedure is necessary to insure timely production of documents held abroad*. Conf. Rept. 97-760, to accompany H.R. 4961, 1982-2 C.B. 600, 657-660 (quoting the Senate report) … .[33]

Based on *Hongkong & Shanghai Banking Corp.*, the LaRues might have argued that Congress, at the time it enacted Code Sec. 982, undoubtedly knew how to identify the scope of an IRS audit or discovery tool. Code Sec. 7456(b) specifically allows the IRS to urge the Tax Court to order a taxpayer to produce relevant materials "wherever situated." Nevertheless, in drafting Code Sec. 982, Congress decided to limit its applicability to documentation "which is located outside the United States." The LaRues might also have pointed out that the Tax Court, in ordering the taxpayer in *Hongkong & Shanghai Banking Corp.* to make certain records "located in Hong Kong" accessible to the IRS, observed that Congress passed Code Sec. 982 in order to supplement the summons power of the IRS in situations involving "documents held abroad."

The IRS and Courts Have Narrowly Construed Code Sec. 982

The position of the LaRues might have been fortified if they had explained that both the IRS and the Tax Court have narrowly and literally defined terms found in Code Sec. 982. Case in point, Chief Counsel Advisory 201333013,[34] where the issue was whether a person related to the taxpayer to whom an FDR was issued would be barred under Code Sec. 982 from presenting as evidence foreign documents if the taxpayer did not comply with the FDR. The IRS reasoned as follows in Chief Counsel Advisory 201333013: "We conclude that IRC 982 may be read *literally* to bar *only* the taxpayer from introducing the foreign documents as evidence. Thus, if the [IRS] seeks to bar documents reliably from trial, it should make [an FDR] to each potential party with access to the foreign documents." Chief Counsel Advisory 201333013 went on to recognize that the Tax Court has also interpreted Code Sec. 982 in a precise manner. It cited *S. Maria*,[35] wherein the Tax Court held that the FDR issued to the wholly-owned corporation of individual taxpayers, and not to the taxpayers themselves, did not preclude the taxpayers from presenting foreign-based documentation in their defense at trial.

Those who are unaware of the unique consequences of not adequately responding to FDRs may find themselves in the undesirable position of trying to battle the IRS in court without the use of key evidence.

IRS Rulings Demonstrate Aim of FDRs

The case for limiting Code Sec. 982 to materials located in a foreign country might have been buttressed if the LaRues had introduced certain litigation-related publications by the IRS. For example, Nondocketed Significant Advice Review 020093 (Apr. 22, 2002) is a legal memo from the Associate Area Counsel to an Examination Team Manager about what to do in a situation where the Revenue Agent is having problems obtaining substantiation from a taxpayer to prove the foreign tax credits claimed in response to IDRs. The IRS attorney first suggested that the Revenue Agent could "merely deny the claimed credits due to the taxpayer's failure to substantiate its entitlement." Alternatively, the IRS attorney suggested a two-part method, consisting of issuing an FDR and a summons. This advice makes

it clear that the former is for foreign documents, while the latter is for domestic: "*Since the 982 request affects only foreign based documents, we suggest the issuance of the FDR be accompanied by the issuance of an administrative summons for the same documents. Through use of a summons, the [IRS] can compel the production of the documents, should the documents turn out to be domestic based*." Another example is Chief Counsel Advice 200107032 (Feb. 16, 2001), which states that "*Section 982 regards the admissibility by a taxpayer of documentation maintained in a foreign country*, as part of a civil proceeding involving an examined tax issue, if the IRS served the taxpayer during the examination with a formal document request *for such records maintained abroad* and the taxpayer failed 'to substantially comply' with such request within 90 days."

Statutory Construction

The parties did not raise statutory-construction arguments with respect to Code Sec. 982. Several such arguments, examined below, might have favored the LaRues.

No Need for Outside Sources if Language Is Clear

The first step in statutory construction is to determine whether the language at issue is plain, clear and unambiguous.[36] When a statute is plain, clear and unambiguous, it should be interpreted according to its plain meaning rather than by referring to outside sources. The Supreme Court has maintained this position for nearly a century. In *Caminetti*, the Supreme Court stated:

> It is elementary that the meaning of a statute must, in the first instance, be sought in the language in which the act is framed, and if that is plain, and if the law is within the constitutional authority of the lawmaking body which passed it, the sole function of the courts is to enforce it according to its terms. Where the language is plain and admits no more than one meaning, the duty of interpretation does not arise, and the rules which are to aid doubtful meanings need no discussion.[37]

Later, in *Locke*, the Supreme Court similarly stated:

> [W]e are not insensitive to the problems posed by congressional reliance on the words "prior to December 31." But the fact that Congress might have acted with greater clarity or foresight does not give courts a *carte blanche* to redraft statutes in an effort to achieve that which Congress is perceived to have failed to do. "There is a basic difference between filling a gap left by Congress' silence and rewriting rules that Congress has affirmatively and specifically enacted." Nor is the Judiciary licensed to attempt to soften the clear import of Congress' chosen words whenever a court believes these words lead to a harsh result. On the contrary, deference to the supremacy of the Legislature, as well as recognition that Congressmen typically vote on the language of a bill, generally requires us to assume that "the legislative purposes is expressed by the ordinary meaning of the words used." "Going behind the plain language of a statute in search of a possibly contrary congressional intent is 'a step to be taken cautiously' even under the best of circumstances."[38]

Still later, in *Barnhart v. Sigmon Coal Co., Inc.*, the Supreme Court reaffirmed its longstanding position regarding respect for the plain meaning of a statute:

> Our role is to interpret the language of the statute enacted by Congress. This statute does not contain conflicting provisions or ambiguous language. Nor does it require a narrowing construction or application of any other canon or interpretative tool. "We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there. When the words of a statute are unambiguous, then, this first canon is also the last: 'judicial inquiry is complete.'" We will not alter the text in order to satisfy the policy preferences of the Commissioner. These are battles that should be fought among the political branches and the industry. Those parties should not seek to amend the statute by appeal to the Judicial Branch.[39]

The specific issue in *LaRue* is the following: What did Congress mean when it stated in Code Sec. 982(d)(1) that the IRS can only issue FDRs in connection with "any documentation *which is outside the United States* and which may be relevant or material to the tax treatment" of an item under audit? The intent of Congress is relatively free of ambiguity on this definitional issue. According to *Caminetti*, *Locke* and *Barnhart*, if Congress has spoken to the precise question at issue, and if the intent of Congress is clear, then that is the end of the matter because the court and the IRS *must* give effect to congressional intent.

Titles and Headings in the Code

The title of a statute cannot limit the plain meaning of the text of the statute; however, it can be used to help interpret

any ambiguity in a statute.[40] The IRS takes the position in *LaRue* that Code Sec. 982(d)(1) is ambiguous and/or incomplete because it is silent with respect to whether items that began as "foreign-based documentation" retain this classification, even if they are later transferred to the United States, and even if they are only copies of the original items.

Accepting for the sake of argument that ambiguity exists, it would be appropriate to seek clarity in various sources, including the title/headings. Code Sec. 982 is found at the following location in the Internal Revenue Code: Chapter 1, Subchapter N, Part III (*Income from Sources Without the United States*), Subpart I (*Admissibility of Documentation Maintained in Foreign Countries*) and Section 982 (*Admissibility of Documentation Maintained in Foreign Countries*). It is telling that this provision, which refers only to "foreign-based documentation," is found in the portion of the Internal Revenue Code limited to foreign-source income and "documentation maintained in foreign countries."

Statutory Ambiguity Must Be Resolved in Favor of the Taxpayer

Contractual provisions generally are interpreted against the party who drafted the contract, the thought being that the drafting party had ample opportunity to say what it meant. A similar notion exists in the tax arena. There is a long line of cases that stands for the proposition that any statutory ambiguity or doubt must be resolved in favor of the taxpayer, not the IRS. See, for example, *F.L. Merriam*,[41] ("On behalf of the government it is urged that taxation is a practical matter and concerns itself with the substance of the thing upon which the tax is imposed rather than with the legal forms or expressions. But in statutes levying taxes the literal meaning of the words employed is most important for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the government and in favor of the taxpayer."); *Maryland Casualty Co.*,[42] ("[Tax] statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the government and in favor of the taxpayer. Such acts, including provisions of limitation embodied therein, are to be construed liberally in favor of the taxpayer. There must be certainty as to the meaning and scope of language imposing any tax, and doubt in respect to its meaning is to be resolved in favor of the taxpayer.")(citations omitted); *E.D. Bryson*,[43] ("It is familiar doctrine that taxing acts, including provisions of limitation embodied therein [are] to be construed liberally in favor of the taxpayer."); *Holmes Limestone Co.*,[44] ("These rules of construction guide this court in most situations, however, materially different rules have been adopted for the interpretation of a revenue statute. '[A]s for any statute, the starting point is the words of the statute, taking the words in their ordinary meaning in the field of interest, and giving full effect to 'every word Congress used.' [However, a]s a special rule in tax cases, 'if doubt exists as to the construction of a taxing statute, the doubt should be resolved in favor of the taxpayer.'")

The IRS takes the position in *LaRue* that Code Sec. 982(d)(1) is ambiguous because it is silent with respect to whether items that began as "foreign-based documentation" retain this classification, if transferred to the United States and/or copied. If that is the case, then, based on the precedent described above, such ambiguity should be resolved in favor of the LaRues in that FDRs would pertain to documents held abroad at the time the FDR was issued.

Conclusion

Some will try to dismiss *LaRue*, characterizing it as an aberration, an unpublished decision, by a court not specializing in tax, resulting from incomplete arguments, and based on questionable legal reasoning. The IRS, of course, might see it differently. From its perspective, the decision could be a landmark, a case of first impression, validation of a powerful international audit tool and support for the notion that an FDR covers not only all documents currently located abroad but also all documents previously located abroad, and all copies. Regardless of the proper interpretation of *LaRue*, taxpayers and practitioners should take note of the case because it might encourage the IRS to issue FDRs with greater frequency during international audits. Those who are unaware of the unique consequences of not adequately responding to FDRs may find themselves in the undesirable position of trying to battle the IRS in court without the use of key evidence. Seasoned tax litigators can often take over a case and remedy procedural or strategic blunders committed earlier by taxpayers and/or their accountants during the audit phase. However, Code Sec. 982, as seemingly expanded by *LaRue*, could limit these powers of resuscitation when it comes to "foreign-based documentation." To avoid this scenario, taxpayers facing an audit with international aspects should seek, from the outset, assistance from those with specialized experience in the field.

ENDNOTES

[1] *LaRue*, No. 3:15-cv-00705-HZ (U.S. Dist. Ct. of Oregon).

[2] Code Sec. 982(a). The taxpayer's response to the FDR must also be timely, which means within 90 days of the date on which the IRS mailed the FDR. *Id*.

[3] Code Sec. 982(b)(1).

[4] Code Sec. 982(b)(2).

[5] This article is not a treatise on the numerous methods available to the IRS to find foreign evidence related to a U.S. tax issue. Details about such methods can be found in various sources, including Martin M. Van Brauman. *Foreign Evidence Gathering and Discovery For U.S. Civil Tax Determination Purposes*, 39 International Lawyer 589 (1996), & James P. Springer. *An Overview of International Evidence and Asset Gathering in Civil and Criminal Tax Cases*, *22* George Washington Journal of International Law and Economics 277 (1988).

[6] For purposes of Code Sec. 7491, "credible evidence" means "the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness)." *R. Griffen*, CA-8, 2003-1 USTC ¶50,186, 315 F3d 1017, 1021.

[7] Code Sec. 982(a) contains the "substantial compliance" defense and Code Sec. 982(b)(1) contains the "reasonable cause" defense.

[8] *See* Senate Rep. No. 97-494 (vol. 1) (July 12, 1982), at 298; House Rep No. 97-760 (Aug. 17, 1982), at 590–594; U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (JCS-38-82) (Dec. 31, 1982), at 244–249; and U.S. Joint Committee on Taxation. Summary of the Revenue Provisions of H.R. 4961 (The Tax Equity and Fiscal Responsibility Act of 1982), JCS-31-82 (Aug. 24, 1982), at 53–54.

[9] *See* note 8, *supra*.

[10] Code Secs. 982(c)(2)(A) and (B). The person must file begin the proceeding to quash the proceeding within 90 days after the IRS mailed the FDR.

[11] Code Sec. 982(c)(2)(A).

[12] *See* note 8, *supra*.

[13] Code Sec. 982(c)(1).

[14] *See* note 8, *supra*.

[15] Code Sec. 982(c)(1).

[16] Code Sec. 982(d)(1).

[17] *See* note 8, *supra*.

[18] Petition to Quash Formal Document Request filed April 24, 2015; Brief in Support of Petition to Quash Formal Document Request filed April 24, 2015; Motion to Deny Petition to Quash Formal Document Request and Counter-Petition to Enforce the Formal Document Request filed October 15, 2015; Answer to Counter-Petition to Enforce the Formal Document Request filed November 16, 2015; Reply to Motion to Deny Petition to Quash the Formal Document Request and Counter-Petition to Enforce the Formal Document Request filed December 10, 2015; Opinion and Order dated December 28, 2015; Motion for Clarification Opinion filed February 5, 2016; Response in Opposition to Motion for Clarification Opinion filed February 25, 2016; Reply to Motion for Clarification Order dated March 7, 2016; and Opinion and Order filed April 14, 2016.

[19] Please note the following with respect to the document-retention rules for FBARs. 31 CFR §103.32 (which is now 31 CFR §1010.42) states the following: "Records of accounts required by § 103.24 to be reported to the Commissioner of Internal Revenue shall be retained by each person having a financial interest in or signature or other authority over any such account. Such records shall contain the name in which each such account is maintained, the number or other designation of such account, the name and address of the foreign bank or other person with whom such account is maintained, the type of such account, and the maximum value of each such account during the reporting period. *Such records shall be retained for a period of 5 years* and shall be kept at all times available for inspection as authorized by law. In the computation of the period of 5 years, there shall be disregarded any period beginning with a date on which the taxpayer is indicted or information instituted on account of the filing of a false or fraudulent Federal income tax return or failing to file a Federal income tax return, and ending with the date on which final disposition is made of the criminal proceeding."

[20] It also appears from the filings with the District Court that the LaRues were attempting to belatedly raise a "reasonable cause" defense based on their good-faith misunderstanding of Code Sec. 982(d). The attorney for the LaRues stated the following on this topic: "Petitioners have been requesting foreign-based documents from third parties in and outside the United States that they believe may have the foreign-based documents the Court has ordered Petitioners to produce. In their communications with third parties, Petitioners have defined foreign-based documentation to mean books and records held outside the United States. If Petitioners' definition is wrong, then the taxpayers would need to take a different tack in trying to get their hands on documents ordered to be produced."

[21] *Chris-Marine USA, Inc.*, 1998 U.S. Dist. LEXIS 12280, *10-11 (M.D. Fla. July 22, 1998).

[22] *See* note 8, *supra*.

[23] *Id*.

[24] *R.W. Boyle*, SCt, 85-1 USTC ¶13,602, 469 US 241, 105 SCt 687.

[25] IRM Exhibit 4.61.4-1 (May 1, 2006).

[26] *Id*.

[27] Jasper L. Cummings, Jr. *LB&I International Practice Units*, Tax Notes, Nov. 23, 2015, at 1077; Kristen A. Parillo and Jaime Arora, IRS Plans to Release International Training Materials, Tax Notes, Mar. 24, 2014, at 1317.

[28] The LaRues cited the following IPU: "Issuing a Formal Document Request when a US Taxpayer is Unresponsive to an IDR," August 29, 2014.

[29] Code Sec. 7456(b).

[30] Reg. §301.7456-1.

[31] *Hongkong & Shanghai Banking Corp.*, 85 TC 701, Dec. 42,465 (1985). The only other case involving Code Sec. 7465(b) is *Aruba Bonaire Curacao Trust Co., Ltd.*, CA-DC, 85-2 USTC ¶9815, 777 F2d 38, 56 AFTR 2d 85-6465 (1985). The taxpayer in this case was a foreign taxpayer, but the case did not focus on whether the documentation requested by the IRS as part of the audit and later in the Motion filed with the Tax Court under Code Sec. 7465(b) was foreign-based.

[32] *Hongkong & Shanghai Banking Corp.*, 85 TC 701, 708, Dec. 42,465 (1985) (first emphasis in original).

[33] *Id*.

[34] CCA 201333013 (May 6, 2013).

[35] *S. Maria*, 68 TCM 1468, Dec. 50,299(M), TC Memo. 1994-622.

[36] *See Coggin Auto. Corp.*, CA-11, 2002-1 USTC ¶50,448, 292 F3d 1326, 1332; *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, SCt, 467 US 837, 843–844 (1984); *Horton Homes, Inc.*, CA-11, 2004-1 USTC ¶70,215, 357 F3d 1209, 1211.

[37] *Caminetti*, SCt, 242 US 470, 485 (1917) (citations omitted).

[38] *Locke*, SCt, 471 US 84, 95 (1985) (citations omitted).

[39] *Barnhart v. Sigmon Coal Co., Inc.*, SCt, 534 US 438, 461–462 (2002)(citations omitted).

[40] *Montero-Martinez v. Ashcroft*, CA-9, 277 F3d 1137, 1143 (2001); *Buculei*, CA-4, 262 F3d 322, 331–332 (2001); *Emery Worldwide Airlines, Inc.*, FedCl, 49 FedCl 211, 227 (2001).

[41] *F.L. Merriam*, SCt, 1 USTC ¶84, 263 US 179, 187–188, 44 SCt 69 (1923).

[42] *Maryland Casualty Co.*, CA-7, 49 F2d 556, 558 (1931).

[43] *E.D. Bryson*, CA-9, 35-2 USTC ¶9556, 79 F2d 397, 402 (1935).

[44] *Holmes Limestone Co.*, DC-OH, 97-1 USTC ¶70,068, 946 FSupp 1310, 1319 (1996).