XELAN, INC. et al. v. UNITED STATES OF AMERICA

CIVIL ACTION NO. 03-6433

UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA

2004 U.S. Dist. LEXIS 8126; 2004-2 U.S. Tax Cas. (CCH) P50,294; 93 A.F.T.R.2d (RIA) 2269

May 6, 2004, Decided
May 6, 2004, Filed; May 7, 2004, Entered

PRIOR HISTORY: *Cohen v. United States, 2004 U.S. Dist. LEXIS 6483 (E.D. Pa., Apr. 9, 2004)*

DISPOSITION: [*1] Petitions to quash summonses denied. Government's motion for summary enforcement granted. Government's request for attorneys' fees denied.

LexisNexis(R) Headnotes

COUNSEL: For Plaintiff or Petitioner: E. David Chanin, Phila., PA.

For Defendant or Respondent: Stuart D. Gibson, U.S. Dept. of Justice, Washington, D.C.

JUDGES: Stewart Dalzell, J.

OPINIONBY: Stewart Dalzell

OPINION:

MEMORANDUM

Dalzell, J

May 6, 2004

Petitioner xelan, The Economic Association of Health Care Professionals, offers physicians the opportunity to make purportedly tax-deductible contributions to a trust that purchases supplemental malpractice insurance for its participants from the xelan Insurance Company, which is domiciled in the British Virgin Islands.

Between 1999 and 2001, petitioners Ronald and Patricia Baughman claimed tax deductions totalling $ 290,000 for their contributions to the trust. These deductions attracted the attention of the Internal Revenue Service, which opened an investigation into the Baughmans' tax liability for those years. Pursuant to the investigation, the Service has issued two summonses directing SEI Private Trust Company of Oaks, Pennsylvania, **[*2]** to produce all documents in its possession concerning the trust, including records relating to other participants. Xelan and the Baughmans have filed petitions to quash the summonses, and the Government has filed a motion for summary enforcement.

This action came to us because it is factually related to *Cohen v. United States, 306 F. Supp.2d 495 (E.D. Pa. 2004)*, a case involving summonses that the Service issued to SEI in connection with another xelan insurance trust program. In Cohen, we denied the petitions to quash and granted the Government's motion for summary enforcement. n1 After independent review of the record in this case, and for the reasons set forth at greater length in Cohen, we will also dismiss the petitions now before us and grant the Government's motion for summary enforcement.

n1 Our decision in Cohen is now on appeal.

Discussion

The Internal Revenue Code grants the Service broad authority to issue administrative summonses for the production of "books, **[*3]** papers, records, or other

data" to determine the correctness of any return or the tax liability of any persons. *I.R.C. § 7602(a)(1)*. This Court has jurisdiction under *I.R.C. § § 7402(b)* and *7604(a)* to enforce summonses, and in making this determination, we apply the burden-shifting regime set forth in *United States v. Powell, 379 U.S. 48, 13 L. Ed. 2d 112, 85 S. Ct. 248 (1964)*.

The Government must first make a prima facie showing that (1) the investigation will be conducted pursuant to a legitimate purpose, (2) the inquiry may be relevant to that purpose, (3) the information sought is not already within the Commissioner's possession, and (4) the administrative steps that the Code requires have been followed. The petitioner must then prove either that the Government has not satisfied the elements of its prima facie case or that enforcement of the summons would be an abuse of the court's process. *Id. at 57-58*. Although the petitioner need not conclusively disprove the prima facie case, he must point to serious weaknesses in the Government's proffer or create a "substantial question in the court's mind" concerning the **[*4]** Government's purpose. *United States v. Gertner, 65 F.3d 963, 967 (1st Cir. 1995)*.

A. The Government's Prima Facie Case

In support of its prima facie case, the Government has offered the declarations of Internal Revenue Agent Catherine Johns, who is conducting the Baughman audit, and Agent John L. Marien, an IRS Technical Advisor who specializes in the improper use of employee welfare benefit funds and is assisting Agent Johns.

First, Agent Johns has declared that the Service is seeking information from SEI for the legitimate purpose of determining the Baughmans' tax liability and that it can properly proceed under *§ 7602* because there has been no Justice Department referral. Johns Decl. PP 3, 10. Agent Johns's declaration satisfies the first prong of the Government's prima facie case. See *Gertner, 65 F.3d at 966* (an affidavit of the investigating officer suffices to establish the Service's prima facie case).

We also find that the Service has made a prima facie showing that the examination of SEI's records may be relevant to the Baughman audit. Agent Marien's declaration offers two reasons for the sweeping investigation these summonses contemplate. **[*5]** First, an examination of all the records in SEI's possession may enable the Service to confirm whether the trust is actually a program of insurance. Second, even if the Service concludes that the trust qualifies as insurance, the investigation may assist it in determining whether the Baughmans were entitled to a tax deduction for the full amount of their contributions.

We begin with the Service's concern that the trust may not qualify as insurance. For tax purposes, a plan qualifies as insurance if it shifts to itself the risk that a participant will experience a loss and distributes each participant's risk of loss among all the participants. In the absence of both of these features, the plan is merely a savings arrangement whose participants are not entitled to the Code's generous treatment of insurance premiums. See *Helvering v. Le Gierse, 312 U.S. 531, 539-40, 85 L. Ed. 996, 61 S. Ct. 646 (1941)*.

As Agent Marien explains, the structure of the malpractice insurance trust has prompted the Service's suspicion that it does not employ risk shift and distribution. Xelan allows physicians to pay into the trust "premiums" of up to forty percent of their net practice income. See **[*6]** Policy, P 16 (Pets.' Resp. Ex. A). Moreover, the trust will invest up to ninety-four percent of a participant's contributions in a "segregated account" where, according to xelan, they can grow on a tax-deferred basis because "they represent assets inside of an insurance policy and also the reserves necessary to pay certain claims in the event of your being threatened or sued for malpractice." "Key Questions and Answers Relating to the xelan Malpractice Equity Trust", at 3 (Marien Decl. Ex. A). If, in fact, the funds in the Baughmans' "segregated account" are not available to pay other participants' claims -- which is certainly a fair reading of the above-quoted pamphlet language -- then it is possible that the disability trust is not so much an insurance plan as it is an IRA-like tax-deferred savings scheme with an extremely generous upper limit on annual contributions.

Second, Agent Marien has explained that the investigation into SEI's records may help it calculate the qualified cost of any insurance the trust has actually provided the Baughmans, which will then enable it to determine whether the Baughmans were entitled to the deductions they claimed from 1999 to 2001. Marien Decl. **[*7]** P 8.b; *Cohen, 306 F. Supp.2d at 501*.

Both of these inquiries are relevant to the Baughman audit and justify a root-and-branch investigation of the workings of the trust. The more interesting question -- and the question that has prompted xelan to oppose these summonses so strenuously -- is whether the Service has made a prima facie showing that it is entitled to the disclosure of other trust participants' identities and financial information. As we explained in Cohen, such information is indeed relevant to the Service's inquiry. With access to the financial records of other participants, the Service can develop a complete understanding of how xelan and the other participants treat their contributions and earnings, determine whether trust accounts provide evidence of risk shifting and distribution, and calculate the limits (if any) on the

deductibility of contributions to the trust. See *id. at 501-02*.

Here, as in *Cohen*, we reject the petitioners' efforts to foreclose this aspect of the investigation by "conceding" that other participants' account information will not demonstrate risk shifting and distribution. See Suverkrubbe Admission **[*8]** and Concession (Pets.' Reap. to Govt.'s Mot. Summary Enforcement). As we noted in Cohen, not only is xelan's concession unresponsive to the qualified cost issue, but there is no authority for the proposition that a taxpayer or other interested party can stipulate to certain facts and thereby preclude the Service from examining documents and drawing its own conclusions in an investigation. *Id. at 505*. Finally, as in Cohen, we cannot endorse the petitioners' assertion that Agent Marien's declaration is insufficient to support the Service's assertions concerning the relevance of the investigation. See *Cohen v. United States, 2004 U.S. Dist. LEXIS 6483, No. 03-3234, 2004 WL 792373, at *1 (E.D. Pa. Apr. 9, 2004)* (Dalzell, J.) (on motion to stay, holding that Court may consider Government's arguments justifying investigation that are reasonable glosses on agent's declaration).

Turning to the third and fourth prongs of the *Powell* test, we conclude that the Government has discharged its burden. Agent Johns has declared that the information the Service seeks from SEI is not already in its possession, and she has also declared that the Service has followed all administrative **[*9]** steps required under the Code for the issuance of the summonses. Johns Decl. PP 6-8.

B. The Petitioners' Response to the Service's Prima Facie Case

Because the Service has established a prima facie case for the enforcement of these summonses, the burden shifts to xelan and the Baughmans to prove either that the Service has not satisfied one of the elements of its prima facie case or that enforcement of the summonses would be an abuse of the court's process. n2

> n2 We have already discussed the petitioners' arguments that the Government has failed to establish the relevancy of this investigation and that Agent Marien's declaration is insufficient to sustain the Government's burden on this issue.

The petitioners first reiterate the argument xelan made in Cohen that the Service is acting in had faith for the purpose of obtaining the other participants' identifies and that it should have complied with the "John Doe" summons procedures of *I.R.C. § 7609(f)*. These claims are without **[*10]** merit. Even if the Service does intend to use the SEI records to investigate the tax liability of other participants, it is entitled to act for the dual purpose of investigating both known and unknown taxpayers where, as here, the information it seeks is relevant to a legitimate investigation of the known parties. Moreover, the Service is not required to comply with *§ 7609(f)* when it serves a summons with such a dual purpose. *Tiffany Fine Arts, Inc. v. United States, 469 U.S. 310, 323-24, 83 L. Ed. 2d 678, 105 S. Ct. 725 (1985)*.

The petitioners also assert that these summonses must be quashed because the Service failed to comply with *§ 7609(a)(1)*, which requires it to give notice to "any person (other than the person summoned) who is identified in the summons ...." They argue that because the summonses seek information related to other malpractice trust participants, any participants who are already known to the Service were entitled to notice.

Even if we assume that the petitioners have standing to assert this argument and that it is correct as a matter of statutory interpretation, the Service's lack of compliance with *§ 7609(a)(1)* would not be a basis for quashing the summonses. **[*11]** Where a taxpayer has received every benefit of an administrative procedure required under the Code, "a failure by the IRS to meet the technical niceties of the statute will not bar enforcement of the summons." *United States v. Texas Heart Institute, 755 F.2d 469, 478 (5th Cir. 1985)*, overruled in part on other grounds by *United States v. Barrett, 837 F.2d 1341 (5th Cir. 1988)*; see also *Cook v. United States, 104 F.3d 886, 890 (6th Cir. 1997)* ("The district courts possess discretionary authority to excuse the Service's technical notice errors where the party in interest suffered no actual prejudice."); *Sylvestre v. United States, 978 F.2d 25, 27 (1st Cir. 1992)*.

Xelan has vigorously defended the interests of its members in Cohen and this action, it has filed an appeal in Cohen, and it will surely do so in this case as well. Under the circumstances, we cannot conclude that any identified-but-not-notified trust participants could have suffered any prejudice from the lack of notice, assuming they were entitled to it in the first place.

Conclusion

The Government has established its prima facie case, and **[*12]** the petitioners have failed to show that enforcement of the summonses would be an abuse of process. Moreover, for all the reasons provided above, the petitioners have failed to support their request for an evidentiary hearing by factually refuting material Government allegations or factually supporting an affirmative defense. *United States v. Garden State Nat'l Bank, 607 F.2d 61, 71, (3d Cir. 1979)*. We therefore deny the request for an evidentiary hearing, deny the

petitions to quash, and grant the Government's motion for summary enforcement.

An appropriate Order follows.

ORDER

AND NOW, this 6th day of May, 2004, upon consideration of petitioners' petitions to quash summonses and the Government's response thereto, the Government's motion for summary enforcement (docket entry # 4) and the petitioners' response thereto, and in accordance with the accompanying Memorandum, it is hereby ORDERED that:

1. The petitions to quash summonses originally docketed under Miscellaneous Action Nos. 03-216 and 03-217 are DENIED;

2. The Government's motion for summary enforcement is GRANTED;

3. The Government's request for attorneys' fees is DENIED; n1

n1 As we explained in *United States v. Cohen, 306 F. Supp.2d 495, 506 n.12 (E.D. Pa. 2004)*, fee-shifting is unwarranted in the xelan litigation because the petitioners' positions are "much more than frivolous taxpayer intransigence."

[*13]

4. SEI Private Trust Company shall COMPLY with the summonses whose enforcement was challenged in the petitions originally docketed under Miscellaneous Action Nos. 03-216 and 03-217; and

5. The Clerk of Court shall CLOSE this action statistically.

BY THE COURT:

Stewart Dalzell, J.