

**TAX FRAUD:
PITFALLS REPRESENTING CLIENTS
BEFORE THE IRS**

**Note: This article appeared in Connecticut CPA Magazine, A publication of
the Connecticut Society of Certified Public Accountants in their
March/April 2008 Edition, Volume 49, Issue 2**

www.cscpa.org

TAX FRAUD:
PITFALLS REPRESENTING CLIENTS BEFORE THE IRS¹

Richard G. Convicer, Esq.

Eric L. Green, Esq.

The stage is set. Your client has been selected for an audit before the Examination Division of the Internal Revenue Service. You are fully prepared to cite your client's strengths and concede some weaknesses. You are expecting to negotiate and compromise to reach a settlement of the matter. The problem: an issue involving the possibility of tax fraud is raised against your client. You continue to be straightforward and candid as you believe that cooperation with the IRS will lead to the best result for your client. You have just made a critical error. Why? Read on.

IRS Objectives in Tax Fraud Cases

Tax fraud has been defined by the United States Supreme Court as the intentional violation of a known legal duty. The usual case of tax fraud occurs when the taxpayer knowingly files a false return. How do you know when your client's case is being referred to the Criminal Investigations (CI) division of the Internal Revenue Service? Unfortunately, the IRS examiner does not announce to either the taxpayer or to his representative when he suspects tax fraud.

According to the Internal Revenue Manual, fraud referrals from the Examination Division should occur whenever the examiner has "firm indications" of fraud.

The examination will continue while the CI case is being evaluated for further investigation, and the examiner will continue to gather evidence which will be shared with the CI division. Neither you nor your client will receive any statement by the Service that a CI case is being considered for criminal referral, and neither the taxpayer nor his representative will be given a Miranda warning.

According to Internal Revenue Manual Section 25.1.1.1(6):

¹ A previous version of this article appeared in the June 1992 edition of Connecticut CPA Quarterly. Richard Convicer would like to thank Eric Green for his assistance in revising and updating this article.

“When a compliance employee suspects a potentially fraudulent situation, the employee will discuss the case at the earliest possible opportunity with his/her manager. If the group manager concurs, the FRS [Fraud Referral Specialist] will immediately be contacted and both the group manager and FRS will provide guidance to the compliance employee on how to proceed. Managers will encourage the early involvement of the FRS in all potential fraud cases.”

Once the examiner, manager and FRS agree that the case has fraud potential, the civil examination will cease and the case will be referred to the CI division, where the case will be reviewed and, if accepted for investigation, will be assigned to a special agent. The special agent’s job is to investigate the case by gathering all the facts, and to determine whether or not there is sufficient evidence to result in a probable conviction. The special agent is not at all interested in collecting the tax or penalty. As stated in the Internal Revenue Manual: “The primary objective of CI is the prosecution, conviction and incarceration of individuals who violate the tax laws and related offenses.” Too often, taxpayers or their representatives attempt to resolve a case with a special agent by offering to pay any asserted tax and penalties. In the course of their efforts, representatives sometimes advise clients to admit wrongdoing. This advice may prove extremely harmful to the client since the agent’s only objective is to build a strong case for prosecution. Any admissions made by the taxpayer or his representative will merely make the agent’s case that much stronger. Admission of wrongdoing should never be made in a tax fraud case, except in the course of a plea bargain arrangement. *No amount of tax or penalty paid will ever result in the termination of a criminal investigation.*

CPAs should also be aware that the amount of tax underpayment considered by CI as suitable for commencing a criminal investigation is surprisingly low. While the IRS recommends prosecution of celebrities and others with high visibility, the Service also investigates ordinary working people. Although the amount of tax dollars ultimately recoverable in a civil proceeding (after conclusion of the criminal tax case) may be far less than the cost of the investigation, the rationale is that this type of investigation will foster compliance among the entire population. Under Internal Revenue Manual guidelines inadvertently published years ago, the Service considered a case worthy of prosecution if a taxpayer fraudulently underreported a tax liability for a given year by at least \$2,500. As noted above, however, the IRS’s objective is

to incarcerate tax offenders, and therefore it will most likely seek to develop cases which involve a tax loss sufficient to require a mandatory jail sentence in accordance with the Federal Sentencing Guidelines discussed below. Depending on the nature of the case, however, the Service may seek to prosecute a case with even smaller tax underreporting. The point is that there is no safe harbor for underreporting. Clearly, the notion that the IRS only goes after the “big fish” is mistaken.

The Accountant’s Privilege

If a CPA suspects that his client may have committed tax fraud, his first inclination may be to ask his client why such a particular sum was omitted or deducted. Such an inclination could be a serious miscalculation. The CPA should refrain from eliciting any information from his client regarding a potentially fraudulent transaction. Why?

Prior to 1998 there was no privilege for communications between an accountant and his client. The Internal Revenue Service Restructuring and Reform Act of 1998 created an accountant-client privilege under Internal Revenue Code Section 7525; however, such privilege extends only to civil matters, not criminal matters. Once the issue becomes a criminal matter, there is no longer any privilege for the CPA, and thus, a CPA may be compelled by an IRS summons or Grand Jury subpoena to disclose any statement or admission made by his client. Obviously, such testimony could prove extremely damaging to the legal defense of the taxpayer’s case.

What then should a CPA do in circumstances where he suspects his client may have committed tax fraud? He should first explain to his client that a question exists with respect to his return, and that the client should not divulge any information unless he is certain that there is nothing fraudulent about the item. The accountant should advise the client that any statement he makes is not privileged. Finally, he should advise him to engage an attorney experienced in criminal tax matters.

In contrast to the accountant-client relationship, there does exist an attorney-client privilege, and the taxpayer will be able to speak freely about the issues to any attorney. Often, the tax attorney will require the assistance of a CPA in advising or representing the taxpayer. If the attorney directly engages the accountant to assist him, all statements made by the taxpayer after the engagement to the accountant, and the accountant’s work product after the engagement,

will be protected from disclosure under the attorney-client privilege. An accountant so engaged is referred to as a “Kovel” accountant, so named based on the court case of the same name upholding the attorney-client privilege to statements made to an accountant who had been engaged by counsel. Hence, it may be possible for the accountant who referred that client to tax counsel to remain on the case as a “Kovel” accountant. Sometimes, however, counsel will recommend that a new accountant be engaged, not because of any dissatisfaction with the taxpayer’s original accountant, but because the engagement of a new accountant will avoid any question as to whether or not statements made to the accountant are privileged. If the original accountant is employed by counsel, any statements made by the taxpayer before the engagement will not be privileged, while statements made after the engagement will be privileged. Bringing on board a new accountant avoids the issue altogether.

Taxpayer’s Records

It may also be advisable for an accountant to return any of the taxpayer’s records. Such records in the hands of the CPA, if summoned by the IRS, would have to be turned over to the government; however, if the records are in the taxpayer’s possession, he may be able to resist turning them over by asserting his right against testimonial self-incrimination under the Fifth Amendment to the Constitution. Although the contents of the taxpayer’s records are not privileged, the courts have carved out protection under what is known as the “Act of Production Doctrine.” Under this doctrine, the act of producing the records is itself testimonial in nature. By submitting records, a taxpayer is in effect saying that the records exist, are in his possession, and are authentic. Since these implicit statements have been held to be testimonial in nature, courts have upheld a taxpayer’s defense against producing business records. Presumably, if the government could provide, independently of the taxpayer, the aforementioned testimonial aspects (perhaps through the testimony of the accountant), the taxpayer would have to turn over the records since the contents themselves are not privileged. In any event, if the records are in the possession of the accountant, the taxpayer will not have the opportunity to rely on the Act of Production Doctrine to resist turning over his records.

Methods of Proof

The Service relies on several methods for proving underreporting of taxable income. The most straightforward is the specific items method of proof, which, as its name suggests, is based upon a showing of an omission or mischaracterization of a specific transaction. In addition, there are indirect methods often used, such as the bank deposits method and the net worth/personal expenditure method. Under these methods, the IRS determines total income without specifically identifying a particular transaction.

The bank deposits theory of proof is a reconstruction of gross receipts made by analyzing bank deposits. Total deposits made to the taxpayer's accounts are tallied to determine gross receipts. Nonincome items such as gifts, loans, redeposits and transfers between accounts are deducted. Amounts deposited from income earned in prior years are deducted. The result is net deposits. The IRS then adds to the net deposits cash expenditures from funds which were never deposited. The result is gross receipts. The gross receipts, as calculated, are then compared to the total income reported on the return, with the net difference constituting unreported receipts.

The net worth/personal expenditures method involves selection of the beginning of a taxable year as a starting point, and determining net worth as of such time. Net worth is calculated by taking the total value of assets (at cost or adjusted basis) minus total liabilities. The same calculation is made as of the end of the taxable year to arrive at an increase or decrease in net worth for the year. Additions are made of nondeductible expenditures such as personal living expenses, federal income taxes paid and gifts. Subtractions are made for nontaxable items received, such as gifts, inheritances, life insurance proceeds, etc., and for certain statutory adjustments. The result of the calculation will be adjusted gross income from which are subtracted itemized deductions (included previously in personal living expenses) and exemptions to arrive at corrected taxable income.

Disposition of Case: Termination of Investigation, Plea Bargain or Trial

In criminal cases, the Service must present sufficient evidence to prove guilt beyond a reasonable doubt. The first priority of tax counsel is to convince the Service that it will be unable to meet the criteria for criminal prosecution (i.e. establish a probability of proving each element of the offense beyond a reasonable doubt), and have the investigation terminated. Failing this, counsel and client must then determine whether to negotiate a plea bargain or proceed to trial. It is of more than passing interest to note that the government has a better than

97% conviction rate at trial. Therefore it may be more advantageous for the client to enter into a plea agreement. Among the most critical elements of a plea agreement will be the stipulation of the amount of tax loss since such loss determines the recommended range of sentence. Counsel's efforts, often with the assistance of an accountant, will be focused on establishing the lowest amount of tax loss possible.

Taxpayers are often surprised to learn that the sanctions for tax fraud, in the criminal context, do not primarily involve pecuniary consequences, but rather provide for incarceration. The federal sentencing guidelines are applicable to tax offenses. Below is the Tax Table from the 2007 Federal Sentencing Guidelines.

<u>Tax Loss</u>	<u>Offense Level</u>	<u>Zone</u>	<u>Sentence Range in Months</u> ²
\$2,000 or less	6	A	0-6
More than \$2,000	8	A	0-6
More than \$5,000	10	B	6-12
More than \$12,500	12	C	10-16
More than \$30,000	14	D	15-21
More than \$80,000	16	D	21-27
More than \$200,000	18	D	27-33
More than \$400,000	20	D	33-41
More than \$1,000,000	22	D	41-51
More than \$2,500,000	24	D	51-63
More than \$7,000,000	26	D	63-78
More than \$20,000,000	28	D	78-97
More than \$50,000,000	30	D	97-121
More than \$100,000,000	32	D	121-151
More than \$200,000,000	34	D	151-188
More than \$400,000,000	36	D	188-235

Under these guidelines, assuming a 28% tax rate, an underreporting of \$17,858 of taxable income would result in a minimum of 6 months of incarceration. The seriousness of tax fraud

² Assuming the individual has no prior criminal history and therefore is being sentenced in Criminal History Category I. If an individual has a prior record, the sentence would be subject to increasingly higher sentences for each offense level.

should not be underestimated. The court is expected to impose a sentence within the guideline range unless the defendant can establish extenuating circumstances not already taken into account in the sentencing guidelines.

A taxpayer may be sentenced to probation, community confinement, home confinement or incarceration depending upon which Zone his Offense Level falls. In Zone A, the court is authorized to sentence a taxpayer to probation, community confinement, home confinement or incarceration, or a combination of the these, depending upon the facts and circumstances involved in the taxpayer's case. In Zone B the court is authorized to impose a sentence of community confinement or home confinement in lieu of incarceration. If the Offense Level falls in Zone C, at least one half of the minimum term must be served by incarceration, and, finally, in Zone D, the entire minimum sentence must be served by incarceration.

The Federal Sentencing Guidelines do allow for an Offense Level reduction "if the defendant clearly demonstrates acceptance of responsibility for his offense." In such a case the Offense Level is reduced by 2 levels. If the Offense Level prior to any such reduction is level 16 or greater, a 3 level reduction for acceptance of responsibility is permitted. Thus, for example, a taxpayer with an Offense Level of 10, who accepts responsibility could receive a reduction of 2 levels to Offense Level 8, moving him from Zone B to Zone A, and possibly allowing him to avoid serving any time in prison.

The United States Supreme Court held in a 2005 case, *United States vs. Booker*, and subsequently affirmed in a pair of 2007 decisions, *Gall vs. United States* and *Kimbrough vs. United States*, that the federal sentencing guidelines are not mandatory but merely serve as guidelines from which the court may depart based upon a consideration of specific factors present. Nevertheless, the guideline sentence will be the presumptive starting point in the vast majority of cases.

Civil Tax Aspects

There are important civil tax aspects relating to a criminal tax case of which CPAs should be aware. The government has six years from the last date of the offense in which to issue an indictment for tax evasion. For purposes of determining how long the IRS has to assess the civil tax liabilities, however, ordinarily there is a three year statute of limitations commencing from the due date of the return, or from the date the return was filed, if later (six years if more than

25% of gross income is omitted). There is no statute of limitations on civil tax assessment if fraud is involved. Thus, the IRS can still pursue the taxpayer for the tax liability itself (together with interest and civil penalties) after the normal statute of limitations has run in the case of fraud, but the IRS bears the burden of proof of showing fraud in the civil context as well as in the criminal case. This is in contrast to the usual burden placed on the taxpayer when the deficiency is presumed correct unless the taxpayer proves otherwise.

One tactic that the IRS frequently employs is to solicit consent to extend the statute of limitations in civil assessments while the criminal investigation is pending. In the usual civil context where no question of fraud is involved, taxpayer representatives frequently extend the statute of limitations on assessment by executing, or advising their clients to execute, a consent form. Failure to do so usually results in a notice of deficiency being issued by the IRS forcing the taxpayer to pay the tax or file a petition in Tax Court. Where there is a criminal case pending, however, the IRS will rarely issue a notice of deficiency because if the taxpayer goes to Tax Court he will have rights of discovery under the Tax Court rules and may be able to force the IRS to divulge details of its case before the criminal investigation is complete. Accordingly, the IRS almost invariably will not issue a notice of deficiency while a criminal case is pending in order to avoid premature disclosure. Hence, in the criminal tax case context, soliciting a consent from the taxpayer is a trap for the unwary. Executing the consent merely extends the period during which the IRS may assess tax liabilities without having to prove fraud. By the time the criminal case has run its course, the normal three year statute of limitations will have expired. If an extension of time is not given to the IRS, then the IRS would have to prove fraud in order to make a civil tax assessment at that point. Executing the consent simply relieves the IRS of its burden of proof of civil fraud in order to assess a tax deficiency. Moreover, in borderline cases, the IRS may weigh the merits of instituting a criminal case against the potential loss of income on the civil side if fraud is not provable and the statute of limitations on assessment has run. Executing a consent removes all incentive for the IRS in these borderline cases to “fish or cut bait” since the IRS will then be able to pursue the criminal case and still have plenty of time to pursue the civil assessment later.

Conclusions

Accountants must be alert to the seriousness of tax offenses and the harmful use of traditional techniques often relied upon in resolving civil tax examinations. Representatives must proceed cautiously in matters of tax fraud. Failure to do so may result in disastrous consequences.

About the Authors

Richard G. Convicer of Convicer & Percy, LLP in Glastonbury, Connecticut, specializes in corporate and individual tax planning. Attorney Convicer represents individuals and businesses in criminal and civil tax proceedings before the Internal Revenue Service and the Connecticut Department of Revenue Services. He has been named in the Best Lawyers in America and is a Fellow of the American College of Trust and Estate Counsel. Before entering private practice, Mr. Convicer served as trial attorney in the Office of District Counsel, Internal Revenue Service in Hartford, Connecticut. Attorney Convicer is an honors graduate of Boston College Law School and received his Master of Laws degree in Taxation from New York University School of Law.

Eric L. Green is Of Counsel to Convicer & Percy, LLP in Glastonbury, Connecticut, where he specializes in representing individuals and businesses in criminal and civil tax proceedings before the Internal Revenue Service and the Connecticut Department of Revenue Services, business tax planning and estate planning. He is currently the Vice Chair of the Closely Held Business Tax Committee of the American Bar Association, and has been quoted in several national publications. Attorney Green is an honors graduate of New England School of Law and received his Master of Laws degree in Taxation from Boston University School of Law.