
DEALING WITH IRS SPECIAL AGENTS: THE RETURN OF THE IRS CRIMINAL TAX INVESTIGATION

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Role of the IRS Special Agent

Special Agents are employed by the Criminal Investigation Division (CID) which is the law enforcement arm of the Internal Revenue Service (IRS). Currently, there are approximately 2,900 Special Agents employed by CID. The present staffing level is significantly less than that of 1995 when approximately 3,360 agents were employed. However, the number of Special Agents has increased somewhat during the past several years, reflecting the government's recognition of the increased need for criminal tax enforcement.

Special Agents conduct tax investigations that are intended to result in criminal prosecutions. They are tasked with conducting criminal investigations concerning alleged violations of the Title 26 of the United States Code and other related violations involving various types of currency transactions and money laundering that fall under Title 18 of the U.S. Code. A list of the most commonly charged offenses is included as Tab 1. While civil tax consequences are inextricably linked to the outcome of tax prosecutions, the Special Agent is focused on the prosecution implications of the tax charges as opposed to other civil administrative tax functions.

The civil aspects of the IRS compliance and enforcement efforts are assigned to Revenue Agents who perform examinations of tax returns and Revenue Officers who enforce compliance regarding tax collections. Special Agents frequently interact with their civil counterparts, especially Revenue Agents. In virtually all criminal investigations, a cooperating Revenue Agent will be assigned to the Special Agent in a supporting role for accounting and technical tax assistance.

Statistics on Criminal Tax Investigations

The number of criminal investigations initiated by CID has declined markedly from ten years ago. For instance, CID initiated 6,538 investigations during 1992 compared with only 3,906 during 2002. However, the number of investigations has increased significantly during the last two fiscal year periods.¹ There was a 19% increase in the number of investigations that were initiated from FY 2001 (3,284) to FY 2002 (3,906). Through the first six months of FY 2003 the CID initiated 2,033 investigations, a year to date increase of approximately 16% over last year. Approximately 80% of all investigations result in prosecution recommendations; the other 20% are discontinued.

The IRS engages in strategic planning each year to emphasize certain areas of known or suspected areas of non-compliance. Until very recently, the CID devoted significant resources to investigations involving narcotics and money laundering. Also, following the World Trade Center bombing, many agents were detailed to anti-terrorist activities that included identifying funds and organizations supporting terrorist organizations and details for sky marshal duties. During the last year there has been a significant shift

¹ The fiscal year used by the federal government begins on October 1.

toward more traditional types of tax investigations. This is apparent from detailed CID statistical data showing the breakdown of investigations as reflected on Tab 2.

It is apparent that CID is now intent on pursuing more traditional types of investigations involving small and medium sized businesses and high income individuals.

Sources of Investigations

Investigations are initiated from any number of sources within and outside of the IRS. Traditionally, the largest single source of criminal tax investigations has been the General Fraud Program.² This includes matters involving legal and illegal source income.³ Most investigations are generated from referrals from other IRS operating divisions, primarily Examination and Collection. Data extracted from mandatory informational filings such as Form 1099, Currency Transaction Reports or Bank Suspicious Activity Reports is another important source of investigations. CID also has developed specialized projects designed to target certain industries where it is believed that tax fraud has flourished. Examples of these would be abusive trusts, check cashing agencies and labor leasing agencies. Starting in 2001, the CID placed increased emphasis on stimulating referrals from internal sources.

Currently, legal source income cases are CID's primary area of interest. During the current FY, approximately 43% of investigative time was devoted to these investigations. This represents a significant increase over the past two years. Approximately 41% of direct investigative time has been devoted to illegal source income investigations and the balance (16%) to narcotics related investigations which are being de-emphasized.

Another source of information would be referrals from other government agencies. Frequently, the CID cooperates in joint investigations with other federal agencies including the FBI, SEC and HHS. Most of these investigations are conducted as Grand Jury matters. In addition, CID also receives information items regarding alleged tax fraud from private individuals and companies.

Duration of Criminal Tax Investigations

Criminal tax investigations are protracted affairs. The average investigation takes two (2) years to complete. This is due not only to the complexity of some investigations, but also to the potentially lengthy time period involved in securing relevant documents. For instance, financial institutions may require months to respond to IRS demands for source document account information for multi-year periods. Substantial time may be required to analyze this information and to follow leads that require still further document requests. In certain instances, the CID may solicit information from dozens or even hundreds of clients of the target of an investigation.

² The Criminal Investigation Division also engages in other tax fraud programs, most notably the Narcotics Program.

³ Legal source income is income derived from legitimate sources; illegal source income is derived from activities such as illegal gaming and telemarketing fraud.

At the conclusion of an investigation, The Special Agent must prepare a formal Special Agent's Report (SAR) that addresses all of the evidence that forms the basis for a prosecution recommendation and that specifies all documents and witnesses. The SAR is subject to review at several levels (local IRS District Office and District Counsel) and ultimately at the Criminal Tax Division office in Washington, D.C. The report preparation and review process normally involves several months time. CID will not make the SAR available to defense counsel.

Conduct of a Criminal Investigation

During the course of a criminal investigation, the investigating agents will attempt to secure information from many different sources, including the subject, the subject's tax accountant, family members, business associates and third parties. As previously mentioned, most criminal tax investigations take two at least two years to complete so that it is likely that three years will elapse from the date an investigation starts until the filing of an Information or Indictment.

In most instances, the target of a criminal investigation will be noticed soon after investigative activity commences. The investigating agents will often attempt to surprise the subject by an attempted interview at to his/her residence or place of business. The agents try to elicit admissions or other information to further the investigation by catching the subject off guard or before the subject can consult with counsel. Depending on the nature of the investigation, the initial contact may be made in connection with the execution of a search warrant. Many defendants inadvertently provide the government with incriminating evidence by engaging in discussion with the Special Agent.

Shortly before or after contacting the subject, the agents will also contact the subject's tax return preparer or accountant. This individual is a critical witness in most tax investigations because the government must prove that any alleged tax return discrepancies resulted from the willful actions of the subject and cannot be attributed to actions of the return preparer. It should be noted that the federal government does not respect any accountant client confidentiality or privilege and that the return preparer/accountant is a prime witness. Consequently, any communications between the subject of an investigation and the return preparer/accountant should be strictly limited or prohibited.

Although the Special Agent may at times solicit information informally, the government generally secures documentation through a formal demand for documents in the form of an administrative summons or grand jury subpoena.⁴ Care should be exercised in responding to summons or subpoena requests by limiting production to only those records that are specifically enumerated. The production date may be negotiated in order to allow for additional time to inventory and assemble the requested records. Prior to furnishing any records, counsel should prepare a detailed document inventory and carefully review the documents with the subject to evaluate their significance. In the

⁴ The service of a subpoena indicates that the investigation is being conducted by means of a Grand Jury and involves an Assistant United States Attorney.

event that original records are demanded (the most likely scenario), counsel should arrange for the reproduction of any records that have potential relevance to the matter under investigation or any other issue deemed to be of concern. Counsel should also be alert to any record that might be protected from disclosure due to Fifth Amendment issues.

Frequently, CID will request current business documents that are essential to the conduct of ongoing operations. Many times, the government will accept photocopies of such records. The government may even be persuaded that such records are not germane to the matter under investigation.

Counsel should attempt to secure information from any other individuals and or entities who may have been contacted by the Special Agent. Oftentimes, individuals who are friendly with the subject will notify the subject of any contacts. Financial institutions must notify any customers whose records have been requested by the government.

In the event that records are seized during the execution of a search warrant, counsel should arrange to inspect these records as soon as reasonably practicable in order to ascertain their evidentiary potential. A document inventory should be prepared and copies of all relevant records should be secured.

Methods of Proof

Special Agents use three principal methods to present evidence to support a prosecution recommendation. These are the Specific Item method, the Bank Deposits and Expenditures method and the Net Worth method. The evidence and methodology used by the Special Agent are presented in a Special Agent's Report of Investigation.

The *Specific Item* method of proof is characterized as a direct method of proof. This is the simplest and most common method employed by Special Agents. Proof of criminal tax violations consists of specific transactions that were intentionally omitted or misrepresented on the tax return. These generally would be items of omitted or understated taxable income or overstated deductions. Examples are unreported gains from the sale of real estate or securities, unreported sales commissions or kickbacks, personal expenses paid by a taxpayer's corporation or overstated cost of sales.

The *Net Worth* method of proof is characterized as an indirect method of proof because it is based on an analysis of comparative data from successive tax years. The objective of the net worth method is to prove what a taxpayer did with sources of income that cannot be specifically identified. This method of proof is used to prove omitted income by comparing a taxpayer's net worth (assets less liabilities) at the beginning and end of tax years. The differences between increases in net worth and reported income for the respective tax years are presumed to have resulted from unreported taxable sources of income. This method is most commonly utilized when the taxpayer's business engages in

substantial cash transactions, when records are unavailable to the Special Agent or when the records are considered to be unreliable.

The ***Bank Deposits*** method is also characterized as an indirect method of proof and is also utilized when a taxpayer's business engages in substantial cash transactions or when records are of questionable value. The objective of this method is to demonstrate that regular or periodic deposits are business receipts derived from known or likely sources of income. Unreported taxable income is established by means of an analysis of the deposit activity in all of a taxpayer's accounts with financial institutions including banks, credit unions, mutual funds, securities brokers, etc. The amount of the total deposits (exclusive of transfers or non-taxable items) and payments in the form of cash is then compared with reported taxable income. The adjusted deposits and cash payments in excess of reported income are presumed to be evidence of unreported income.

Bank deposit analyses are also used to prove cash structuring violations. Structuring occurs when an individual makes bank deposits of cash in amounts less than \$10,000. The intent of structuring is to circumvent bank regulations that mandate the filing of a Currency Transaction Report (CTR) for all cash deposits in excess of \$10,000.⁵

Pertinent sections on methods of proof from the Special Agent's Handbook are reproduced in Tab 3.

Defense Strategy

Many federal criminal tax investigations are, by their nature, complex endeavors. Defense counsel in a typical criminal tax case might be required to develop knowledge about business issues specific to a particular industry, decipher documents involving complicated business transactions, gain an understanding of relevant accounting and tax issues or be required to consider the implications of other violations of law related to the subject tax transactions. Further complications may arise because of the need to deal with voluminous records or, in the alternative, incomplete or missing records.

In light of the above, the first step in defending a tax case is to obtain as much information as possible about the client's tax filings, business practices, record keeping procedures and the identity of other knowledgeable individuals. The client may not know the source of the information used by the IRS to initiate the investigation and, in certain instances, might even be unaware of the legal import of transactions that are being investigated. The client may also be unaware that certain others, such as his/her accountant, will be potential witnesses.

An attorney taking on the representation of a client under investigation by the IRS will generally need expert accounting advice, especially if the IRS is proceeding under one of the more complex theories. The use of the tax payer's regular account will be a problem,

⁵ Businesses that regularly engage in cash transactions, such as restaurants, may file forms with a bank exempting them from CTR filings.

as that account and his or her work papers will be subject to interview and subpoena, even if he or she is working for the attorney.

The best practice is for the lawyer to engage an account not previously employed by the client. That account's work product and his or her advice to the attorney are protected by the attorney-client privilege. The account is referred to as a "Kovel accountant", after the case of United States v. Kovel, 296 F.2d 918 (2d Cir. 1961); United States v. Rockwell International, 897 F.2d 1255, 1264 (3d Cir. 1990).

A formal letter of engagement from the attorney to the account should be drawn to evidence the agreement. In certain cases, the Kovel accountant may be designated as an expert witness at trial.

It is critical that the Kovel accountant carefully scrutinize the validity and methodology of the government's tax calculations. The investigating agents may have incorrectly interpreted records, may have made mistakes in applying accounting concepts or may have made other errors in calculating a tax deficiency. It is also possible that the investigating agents may have failed to give the defendant taxpayer the benefit of certain expenses or credits that could significantly mitigate the effect of the proposed tax adjustments.

Based on the information provided by the client, counsel should then seek to identify evaluate all potentially relevant sources of evidence that the government may use to prove the tax case and /or any other violations of law, even if such matters are not known to the government. Some of this information will be evident from subpoenas or administrative summonses that are directed to the client or other parties such as financial institutions that are required to notice taxpayers of government information requests. Sources of information would include documents (financial or other) and potential witnesses, especially the client's accountant or tax return preparer.

Based on the information provided by the client, counsel may decide to arrange for a meeting with the Special Agent and / or the Assistant United States Attorney assigned to the investigation (assuming that the investigation is a Grand Jury matter) in order to obtain further clarification. If the government believes that the evidence for prosecution is compelling, the Special Agent or AUSA may be willing to provide particulars as to anticipated charges and evidence in order to induce a plea agreement. However, if counsel can demonstrate that the government's theory of the case or evidence is faulty, it may be possible to persuade the government to discontinue the investigation. Approximately 40% of criminal tax cases are discontinued.

If the facts indicate culpability on the part of the client, counsel proceed with developing as much information as possible regarding potential criminal charges and attempting to track the progress of the investigation. Counsel should arrange for potential witnesses to be interviewed as soon as practicable. Since the accountant or tax return preparer is a critical witness in virtually all tax cases, and therefore a prime interview for the Special Agent, this individual should be assigned priority. Counsel should request copies of all

working paper files and tax returns. The client should be removed from the communication process in order to eliminate the possibility of admissions.

Based on an assessment of available evidence, counsel can ascertain the degree of potential exposure for the client. The criminal exposure may be more or less than the government has proved or is capable of proving. This may also be true for the civil tax consequences. In the event that the government's continued efforts at proving criminal tax violations have been unsuccessful, counsel may decide to make another attempt to convince the government to discontinue the criminal investigation.

Early intervention by counsel is vitally important. Investigations tend to gain momentum as they proceed and it becomes increasingly difficult to persuade the Special Agent that a case lacks merit or to engage in effective damage control as time passes. The original focus of an investigation may expand or be redirected to other more serious areas of exposure as the Special Agent accumulates information.

Tax Filing Issues During A Criminal Investigation

Fifth Amendment Tax Return

Once a criminal investigation has been initiated, a taxpayer cannot "cure" problem issues by filing delinquent or amended tax returns or paying additional taxes. Any tax filings or other information submissions made during the pendency of an investigation should be considered as potential admissions against the interest of the defendant that most likely would provide additional fodder for a prosecution recommendation.

During an investigation, a question always arises as to how a defendant taxpayer should handle the filing of currently due tax filings. Since information disclosed on a tax return conceivably might be against the best interest of the taxpayer, extreme caution should be exercised in observing filing requirements. The most prudent course of action is to file a "Fifth Amendment" tax return. This is simply a tax form (1040, 1120, 1065, etc.) that provides no information other than the identity of the taxpayer under investigation. Attached to the Fifth Amendment tax return should be a statement noting that upon the advice of counsel, the taxpayer is exercising his/her rights against self-incrimination and that the filing of a complete tax return is being deferred until the conclusion of the criminal investigation.

Although the Fifth Amendment privilege does not apply to corporations, the filing of such a document on the advice of counsel should preclude a prosecution for failure to file. Although partnership and Subchapter S tax returns are only informational returns, it generally is beneficial to also make Fifth Amendment filings for these tax returns.

Fifth Amendment tax returns should be filed for all years as returns become due during the period until the disposition of a criminal tax case either by means of a plea agreement, judicial adjudication or the investigation is discontinued. Please note that the filing of a Fifth Amendment tax return need not be made until all voluntary extension periods have

lapsed. Extension requests are automatic and will provide additional time to assess the significance of an investigation before resorting to a Fifth Amendment filing.

In many cases, the investigating agent will request that the taxpayer execute a Form 872 to extend the statute of limitations for the years under investigation. Absent some exigent reason, there is little to be gained by complying with the extension request.

Criminal Tax Calculations

The Special Agent's criminal investigation will be focused on proving a "criminal tax deficiency". The calculation of the criminal tax deficiency may or may not be the same as the civil tax deficiency. The primary reason for the difference is that the criminal tax calculation will include only those items to be included as evidence of alleged willful tax violations or related adjustments that are a function of the criminal tax features. For example, items of unreported income or overstated expense might be attributable to inadvertent errors. Likewise, there may be so-called technical adjustments such as incorrect depreciation deductions.

The criminal tax calculation is a function of the evidence that satisfies the required standard of proof for a criminal conviction. The criminal tax calculation will generally be conservative and will not include items with marginal evidentiary value.

While the IRS will not admit to specific monetary threshold tax amounts or other specific guidelines, CID generally observes certain standards for prosecution recommendations. Traditionally, the tax consequence of the criminal tax violations for all prosecution periods would be at least \$10,000 for tax evasion and approximately \$2,500 for failure to file cases. For false document cases, the tax threshold amount may be less than \$500. In addition, CID normally adheres to the multi-year prosecution period in order to establish a pattern of willful conduct.

Although CID generally adheres to the aforementioned standards, there are exceptions. These might include cases in a targeted area of non-compliance or cases involving public figures or cases in which the violations for a single year are sufficiently flagrant to clearly establish criminal intent.

It is important to note that the Special Agent often has an interest in maximizing the criminal tax calculations in order to enhance the apparent prosecution value or publicity potential of an investigation. More importantly, the amount of the criminal tax calculation is directly correlated with the severity of a potential sentence according to the Federal Sentencing Guidelines.

Criminal Penalties

If convicted of a tax offense, the penalty is determined by the application of the Federal Sentencing Guidelines. It is not within the scope of this program to present a comprehensive discussion of the FSG as they apply to tax offenses. The amount of the tax loss drives the severity of the punishment. It was one of the purposes of the drafters of the guidelines to increase the punishment for tax offenses. The object was to have

more tax offenders sentenced to jail. For example, the figure for starting to calculate a tax loss of \$12,500 to \$29,999, a level 12, is 10-16 months in prison. A tax loss of \$30,000 to \$79,000, a level 16, is 21-27 months in prison. Ordinarily, there is no probation above level 12. Under the FSG, there is no parole. The defendant will serve the entire prison sentence with very little relief for good behavior. There are significant increases for sophisticated means of perpetrating the offense. The old adage that a tax offense is not a violent crime and will be treated leniently no longer applies.

The criminal penalties do not include the civil fraud penalties and interest which can be considerable.

Civil Tax Calculations

In addition to issues pertaining to incarceration and the potential forfeiture of assets, the defendant in a tax prosecution will ultimately be forced to deal with the civil tax implications. The minimum baseline for the civil tax calculation will be the criminal tax amount, regardless of whether an investigation is resolved by virtue of a negotiated plea agreement or a conviction at trial. The IRS will not entertain any civil tax settlement below the determined criminal tax amount.

The civil tax issues may be resolved in conjunction with the disposition of the criminal tax prosecution in a plea agreement or at a later date. In a plea agreement, it is generally preferable to seek an agreement on both the civil and criminal tax amounts prior to sentencing. Depending on the facts and circumstances, the investigating agent may be flexible in order to achieve a plea agreement. In the event that the civil tax issues cannot be resolved prior to sentencing, a Revenue Agent will be assigned to conduct a follow up examination of the years included in the prosecution period and any subsequent periods.

The ultimate amount of the tax assessment will be substantially greater than the criminal tax deficiency. This is due to the imposition of the fraud penalty and accrued interest charges. The fraud penalty is equal to 75% of the deficiency attributed to fraud; interest is accrued at the applicable federal interest rates (plus three percentage points) for the quarterly time periods dating from the date that the subject tax returns were due. Because tax prosecutions most often involve periods that are several years past, the interest accruals are substantial. A general rule of thumb is that the aggregate amount of taxes, penalties and interest will result in an amount due of 2-3 times the actual tax due.

TAB 1

Criminal Statutes

VIOLATION	ELEMENTS OF THE OFFENSE
Title 26 U.S.C. §7201	Willful attempt to evade or defeat payment of tax.
Title 26 U.S.C. §7202	Willful failure to collect, account for or pay tax.
Title 26 U.S.C. §7203 (Failure to File)	Willful failure to make a return, keep records, supply information or to pay tax.
Title 26 U.S.C. §7206(1) (False Return)	Willful making of false declaration under penalty of perjury; assist in preparation of false document.
Title 26 U.S.C. §7206(2) (Tax Preparer)	Willfully aid or assist in preparation or filing of tax return or other document that is false as to a material matter.
Title 18 U.S.C. §1956 (Money Laundering)	Knowledge that property involved in a financial transaction represents proceeds of unlawful activity. Attempt to conduct financial transaction: <ul style="list-style-type: none">• With intent to promote specified unlawful activity• With intent to violate §7201 or §7206 of IRS Code <p style="text-align: center;">or</p> <ul style="list-style-type: none">• Knowing that transaction is designed to conceal or disguise the nature, location, source, ownership or control of proceeds <p style="text-align: center;">or</p> <ul style="list-style-type: none">• To avoid transaction reporting requirement
Title 18 U.S.C. §1957 (Money Laundering)	Knowingly engage or attempt to engage in monetary transaction in criminally derived property valued at more than \$10,000 and derived from specified unlawful activity.