

PRESENTED AT

63rd Annual Taxation Conference

December 2-3, 2015

Austin, Texas

Eggshell Audits: Handling IRS Examinations When There Are Potential Criminal Issues

Larry A. Campagna

Author Contact Information:

Chamberlain, Hrdlicka, White, Williams, & Aughtry

1200 Smith Street, Suite 1400

Houston, Texas 77002

larry.campagna@chamberlainlaw.com

713.654.9609

TABLE OF CONTENTS

I.	RECENT DEVELOPMENTS HAVE CHANGED THE LANDSCAPE FOR TAXPAYERS AND THEIR REPRESENTATIVES	1
A.	Fraud Technical Advisors	1
1.	Avoidance of <i>Tweel</i>	1
2.	Result	1
B.	Parallel Civil and Criminal Cases	1
1.	History	1
2.	Recent Developments	2
C.	Corporate Prosecution Principles.....	2
1.	Organization of the USAM Principles.....	2
2.	<i>Respondeat Superior</i>	2
3.	Factors.....	2
4.	Payment of Attorneys Fees	3
5.	Yates Memorandum.....	3
6.	Consequences.....	4
II.	COUNSEL MUST BE ACUTELY AWARE OF POTENTIAL CRIMINAL ISSUES DURING CIVIL EXAMINATIONS.....	4
A.	What Is an Eggshell Audit?	4
1.	Eggshell Audits Can Lead to Criminal Charges	4
2.	Cooperation or Silence.....	5
3.	Cooperation Must Be Truthful.....	5
4.	Perils for the Representative	5
5.	Potential Outcomes	5
B.	Sources of Criminal Cases	6
1.	Informants.....	6
2.	Undercover Activities	6
3.	Civil Audits.....	6
4.	Independent Criminal Investigations	6
5.	Agency Referrals	6
6.	Monitoring and Matching Programs	6
III.	CONTROLLING AND ADVISING THE CLIENT	6
A.	Communicating the Priorities	6
1.	Primary Goal.....	6
2.	Secondary Goal.....	6
B.	Evidence and Document Control.....	6
1.	The Client’s Right to Remain Silent	6
2.	Advise the Taxpayer Against Tampering with Evidence or Talking with Witnesses	7
3.	Conduct a Shadow Investigation	7
4.	Public Documents	8
IV.	DEALING WITH THE AGENT	8
A.	Who Should Handle the Exam?.....	8
1.	The Problem.....	8
2.	The Choices	8
3.	Issues to Consider	8

B.	The Accountant's Roles.....	9
1.	Defining the Different "Hats".....	9
2.	Protect Communications and Work Product.....	10
C.	Accountant/Client Privilege Issues.....	10
1.	Limited Protection for Certain Communications.....	10
2.	Matters Covered.....	10
3.	Federally Authorized Tax Practitioner.....	10
4.	Effective Date.....	11
5.	Obvious Limitations of Section 7525.....	11
6.	Civil v. Criminal.....	13
7.	Work Product Covered.....	13
8.	Business Advice v. Tax Advice.....	14
D.	Recommendations to Seek to Bolster <i>Kovel</i> Accountant Privileges.....	14
1.	Burden.....	14
2.	Documentation.....	14
3.	Avoid Multiple Roles.....	14
4.	Execute a Contract.....	14
5.	Protect Work Product.....	15
E.	Signs of a Criminal Referral.....	15
1.	Surprises Abound.....	15
2.	Ask and Thou Might Receive.....	16
F.	Standards for Referral.....	16
1.	Firm Indication of Fraud.....	16
2.	The <i>Tweel</i> Case.....	16
G.	Cooperation.....	17
1.	The Dilemma.....	17
2.	Burden of Proof Considerations.....	17
3.	Non-Cooperation as a Badge of Fraud.....	18
4.	Sentencing Guidelines Considerations.....	18
H.	Access to the Taxpayer.....	19
1.	Resisting the Taxpayer Interview.....	19
2.	Controlling the Taxpayer Interview.....	19
3.	Refusing the Taxpayer Interview.....	19
4.	Economic Reality Audits.....	20
I.	Records Control.....	20
1.	Shadow Investigation.....	20
2.	Playing Catch-Up.....	20
3.	Third Party Documents.....	20
4.	Follow the Leads.....	20
5.	Protect Privileged Documents.....	20
J.	Notice of Third Party Contacts.....	21
1.	Notice Requirement.....	21
2.	No Remedy.....	21
V.	HANDLING THE CURRENT YEAR OR DELINQUENT RETURNS.....	21
A.	Consider Voluntary Disclosure.....	21
1.	Voluntary Disclosure Practice.....	21
2.	Solicitation Policy.....	21
B.	Filing The Current Year Return.....	22
1.	Tax Returns Filed During an Investigation.....	22
2.	Extensions.....	22

3.	Asserting the Fifth Amendment Privilege on Tax Returns	22
4.	Cash Bonds	25
5.	Payments v. Deposits	25
VI.	PRACTICAL CONSEQUENCES FOR CRIMINAL INVESTIGATIONS	27
A.	Representing the Corporation	27
1.	Early Bird Gets the Worm	27
2.	Statutory and Contractual Issues.....	27
3.	Death Penalty	27
B.	Representing the Employee	27
1.	Document Gathering.....	27
2.	Funding.....	27
3.	Joint Defense	28
C.	Parallel Proceedings Present Unique Challenges.....	28
1.	Third Party Documents and Witnesses	28
2.	The Song Remains the Same	28

TABLE OF AUTHORITIES

Cases

<i>Ameel v. United States</i> , 426 F.2d 1270, 1273 (6th Cir. 1970)	26
<i>Baskin v. United States</i> , 738 F.2d 975 (8th Cir. 1984).....	24
<i>Braswell v. United States</i> , 487 U.S. 99 (1988)	20
<i>Brennan v. Commissioner</i> , 752 F.2d 187 (6th Cir. 1984).....	24
<i>Canaday v. United States</i> , 354 F.2d 849 (8th Cir. 1966)	12
<i>Chemical Bank New York Trust Co. v. United States</i> , 275 F.Supp. 26, 30 (S.D.N.Y.), <i>aff'd</i> , 386 F.2d 995 (2d Cir. 1967)	26
<i>Colton v. United States</i> , 306 F.2d 633, 637 (2d Cir. 1962).....	12
<i>Conforte v. Commissioner</i> , 74 T.C. 1160, 1195-1995 (1980), <i>aff'd and</i> <i>rev'd on other issues</i> , 692 F.2d 587 (9th Cir. 1982).....	23
<i>Dorokee Co. v. United States</i> , 697 F.2d 277 (10th Cir. 1983).....	12
<i>Estate of Zeier v. United States</i> , 80 F.3d 1360 (9th Cir. 1996).....	26
<i>Ewing v. United States</i> , 914 F.2d 499, 503 (4th Cir. 1990)	26
<i>Gabelman v. Commissioner</i> , 86 F.3d 609 (6th Cir. 1996).....	26
<i>Garner v. United States</i> , 424 U.S. 648 (1976).....	22, 23
<i>Groder v. United States</i> , 816 F.2d 139 (4th Cir. 1987).....	16
<i>Grosso v. United States</i> , 390 U.S. 62 (1968)	23, 24
<i>Hill v. United States</i> , 363 F.2d 176 (5th Cir. 1966)	21
<i>In re Grand Jury Investigation (Schroeder)</i> , 842 F.2d 1223 (11th Cir. 1987)	12
<i>Mackey v. United States</i> , 401 U.S. 667 (1971)	23
<i>Marchetti v. United States</i> , 390 U.S. 39 (1968).....	23, 24
<i>Risman v. Commissioner</i> , 100 T.C. 191 (1993).....	26
<i>United States v. Abrahams</i> , 90-1 U.S.T.C. §50,310 (9th Cir. 1990).....	12
<i>United States v. Adlman</i> , 134 F.3d 1194 (2d Cir. 1998).....	13
<i>United States v. Arthur Young & Co.</i> , 465 U.S. 805 (1984).....	13
<i>United States v. Automated Medical Laboratories</i> , 770 F.2d 399, 407 (4th Cir. 1985).....	2
<i>United States v. Booher</i> , 641 F.2d 218, 220 n.2 (5th Cir. 1981).....	23
<i>United States v. Carlson</i> , 617 F.2d 518 (9th Cir.), <i>cert. denied</i> , 449 U.S. 1010 (1980).....	23
<i>United States v. Cincotta</i> , 689 F.2d 238, 241-242 (1st Cir. 1982).....	2
<i>United States v. Cote</i> , 456 F.2d 142 (8th Cir. 1972).....	12

<i>United States v. Davis</i> , 636 F.2d 1028 (5th Cir. Unit A), <i>cert denied</i> , 454 U.S. 862 (1981).....	12
<i>United States v. Dinnell</i> , 428 F. Supp. 205, 208 (D. Ariz. 1977), <i>aff'd without opinion</i> , 568 F.2d 779 (9th Cir. 1978)	22
<i>United States v. Doe</i> , 465 U.S. 605 (1984).....	20
<i>United States v. El Paso Co.</i> , 682 F.2d 530 (5th Cir. 1982), <i>cert. denied</i> , 466 U.S. 944 (1984).....	12
<i>United States v. Grunewald</i> , 987 F.2d 531 (8th Cir. 1993)	16
<i>United States v. Gurtner</i> , 474 F.2d 297 (9th Cir. 1973).....	12
<i>United States v. Hornstein</i> , 176 F.2d 217, 220 (7th Cir. 1949)	22
<i>United States v. Jordan</i> , 508 F.2d 750 (7th Cir.), <i>cert. denied</i> , 423 U.S. 842 (1975).....	24
<i>United States v. Kordel</i> , 397 U.S. 1 (1970).....	4
<i>United States v. LaSalle National Bank</i> , 437 U.S. 298 (1978)	13
<i>United States v. Lawless</i> , 709 F.2d 485 (7th Cir. 1983).....	12
<i>United States v. Mirelez</i> , 496 F.2d 915, 917 (5th Cir.), <i>cert. denied</i> , 419 U.S. 1069 (1974).....	23
<i>United States v. Pappas</i> , 806 F. Supp. 1, 2-5 (D.N.H. 1992)	5
<i>United States v. Peters</i> , 153 F.3d 445 (7th Cir. 1998)	16
<i>United States v. Powell</i> , 835 F.2d 1095 (5th Cir. 1988)	16
<i>United States v. Rischard</i> , 471 F.2d 105 (8th Cir. 1973).....	21
<i>United States v. Sullivan</i> , 274 U.S. 259 (1927).....	22
<i>United States v. Tenzer</i> , 950 F. Supp. 554 (S.D.N.Y. 1996), <i>rev'd</i> , 127 F.3d 222 (2d Cir. 1997).....	21
<i>United States v. Toussaint</i> , 456 F. Supp. 1069 (S.D. Tex. 1978).....	16
<i>United States v. Tweel</i> , 550 F.2d 297, 299 (5th Cir. 1977).....	1, 16
<i>United States v. Vaughn</i> , 589 F.Supp. 1528, 1531 (W.D. La. 1984)	24
Statutes	
26 U.S.C. § 7623.....	5
31 U.S.C. § 330.....	10
I.R.C. § 274(b)	17
I.R.C. § 6103(a)	22
I.R.C. § 6511	25, 26
I.R.C. § 6662.....	11
I.R.C. § 6702.....	24
I.R.C. § 7203.....	23

I.R.C. § 7206.....	5
I.R.C. § 7212.....	5
I.R.C. § 7430.....	17
I.R.C. § 7521(c)	18
I.R.C. § 7525.....	10, 11, 13, 14
I.R.C. § 7602.....	13, 19, 20
I.R.C. § 7491.....	17
Treas. Reg. § 301.7605-1	19
Other Authorities	
1998 IRS Restructuring and Reform Act.....	17, 20
C.C.D.M. § (31)360(2) (b)(2)	22
Freedom of Information Act	7, 20
I.R.M. § 25.1.2.....	16
I.R.M. § 25.1.2.....	16
I.R.M. § 25.1.2.2.....	18
I.R.M. § 9.5.11.9.....	21
Memorandum from U.S. Deputy Attorney General Mark R. Filip, Principles of Federal Prosecution of Business Organization (Aug. 28, 2008).....	2, 27
Memorandum from U.S. Deputy Attorney General Sally Q. Yates, Individual Accountability for Corporate Wrongdoing (Sep. 9, 2015)	3, 27
Rev. Proc. 84-58, § 4.02	25
Rev. Proc. 84-58, 84-2 C.B. 501	25
Siffert and Saltzman, "The Fifth Amendment and Tax Returns: The Viability of the Deferred Filing/Current Payment of Tax Approach Pending a Criminal Investigation," 4 White-Collar Crime Reporter 1 (Jan. 1990).....	22
Special Agent's Handbook § 342.142 (Aug. 25, 1995).....	21
The Taxpayer Relief Act of 1997	12
U.S. Attorney's Manual §§ 9-28.000 to 9-28.1300.....	2

Eggshell Audits: Handling IRS Examinations of Closely Held Businesses When There Are Criminal Tax Issues

By

Larry A. Campagna

I. RECENT DEVELOPMENTS HAVE CHANGED THE LANDSCAPE FOR TAXPAYERS AND THEIR REPRESENTATIVES.

A. **Fraud Technical Advisors.** The IRS has increased the use of fraud technical advisors, who are posted throughout the United States and attached to examination and collection groups. The purpose of fraud technical advisors is to assist revenue agents and revenue officers with case development. Anecdotal evidence reflects an increase in the imposition of civil fraud penalties and referral of cases to the Criminal Investigation Division.

1. **Avoidance of *Tweel*.** The IRS view is that use of a fraud technical advisor avoids the harm that concerned the Fifth Circuit in the *Tweel* case, that a taxpayer could be intentionally misled as to the civil nature of an examination when in fact a criminal investigator (special agent) was actually pulling the strings of the examination. *United States v. Tweel*, 550 F.2d 297, 299 (5th Cir. 1977).

2. **Result.** Essentially, the IRS has created a new level of criminal investigations, but inserted it within the examination and collection functions in order to avoid the appearance that a special agent was directing the inquiry. Thus, the Service conducts potential examinations and collection actions while gathering information to bolster a potential criminal case. The examination manual nominally requires agents to refer matters to Criminal Investigation once there is a “firm indication of fraud,” but by developing the fraud case on the civil side of the house with the assistance of a fraud technical advisor, the Service now essentially ignores the “firm indication of fraud” standard, as does most of the case law. [See discussion of *Tweel* and its progeny in Section IV.F. below.]

B. **Parallel Civil and Criminal Cases.** Recent events have shown that the IRS and the Tax Division of the Justice Department are now more prone to conduct civil examinations of taxpayers while simultaneously pursuing criminal investigations.

1. **History.** The general practice historically has been to suspend a civil examination once a criminal investigation of the taxpayer had begun.

- a. Delay of the civil case protects the integrity of the criminal investigation and avoids complications in the criminal defense.
- b. The demise of the “firm indication of fraud” standard also means that evidence of fraud is being developed extensively during civil

examinations, and then referred over to the criminal investigators only after multiple badges of fraud have been proven and even confessions have been obtained.

2. **Recent Developments.** Over the past several years, the spate of corporate scandals and the threat of the burgeoning corporate tax shelter industry caused the IRS and the Justice Department to rethink the strategy of suspending civil examinations during criminal investigations. In a number of high profile recent cases, civil examinations have preceded simultaneously with criminal investigations, including such notorious matters as the Enron Task Force and the KPMG grand jury investigation.

C. **Corporate Prosecution Principles.** The Department of Justice has issued a series of memoranda designed to increase scrutiny of corporate wrongdoing and reward corporate cooperation with Justice Department investigations. These memoranda contain a set of principles for Department of Justice prosecutors to use when deciding whether to seek charges against business organizations. The current version of these principles is embodied in the U.S. Attorney's Manual ("USAM") at §§ 9-28.000 to 9-28.1300 (referring to the Principles of Federal Prosecution of Business Organizations). The Principles previously had been referred to as the "Filip Guidelines," named for then Deputy Attorney General Mark Filip. Memorandum from U.S. Deputy Attorney General Mark R. Filip, Principles of Federal Prosecution of Business Organization (Aug. 28, 2008).

1. **Organization of the USAM Principles.** The USAM sets forth a series of general principles for federal prosecutors, followed by extensive commentary on those principles. Any corporation or other business organization at risk of a criminal prosecution should review the principles and comments in detail.
2. **Respondeat Superior.** To hold a corporation liable criminally, the Government must establish that the corporate agent's actions were: (i) within the scope of the agent's duties and (ii) intended at least in part to benefit the corporation. *See, e.g., United States v. Cincotta*, 689 F.2d 238, 241-242 (1st Cir. 1982) ("requires that the agent be performing acts of the kind which he is authorized to perform, and those acts must be motivated – at least in part – by an intent to benefit the corporation"). The requirement of intent to benefit the corporation supposedly insulates the business entity from criminal liability for actions of rogue agents that are inimical to the interests of the entity or that are undertaken solely for personal benefit. *United States v. Automated Medical Laboratories*, 770 F.2d 399, 407 (4th Cir. 1985).
3. **Factors.** Prosecutors are admonished in the USAM to consider the following factors in determining whether to charge a business organization:
 - a. Nature and seriousness of the offense, including risk of harm to the public;
 - b. Pervasiveness of wrongdoing, including complicity in, or condoning of, the wrongdoing by corporate management;
 - c. History of similar conduct;

Find the full text of this and thousands of other resources from leading experts in dozens of legal practice areas in the [UT Law CLE eLibrary \(utcle.org/elibrary\)](http://utcle.org/elibrary)

Title search: Eggshell Audits: Handling IRS Examinations When There Are Potential Criminal Issues

Also available as part of the eCourse

[Hot Topics in Taxation 2015](#)

First appeared as part of the conference materials for the
63rd Annual Taxation Conference session

"Eggshell Audits: Handling IRS Examinations When There Are Potential Criminal Issues"