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

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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;

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