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Representation in Connection with an IRS Audit

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Representation in Connection with an IRS Audit – Do you have to allow your client to be interviewed during an audit?

Illustrative Fact Pattern—IRS auditor requesting taxpayer be present at next meeting

Client and his businesses (oil and gas operating Sub-S and some Schedule E rental properties) are going through audit on 2 tax years, main issue at outset is several sales of real estate not reported. Initial audit request included an inspection of the business premises.

Does client have to be present for that?

Client has not been present for any of the 4 scheduled meetings with the auditor so far, and does not want to go if he doesn't have to. Auditor acknowledges that he can't make you produce the taxpayer, then says he might put a request on the next Information document request. Client is not produced, and audit continues.

Next document request includes “Based on several unknown questions on certain items, request taxpayer husband be present to answer questions”, and then numbered document items requested are listed.

Both years are joint returns, and neither spouse wants to go. In a subsequent telephone conversation with the auditor he asks if that document request was likely to produce the taxpayer. You answer "probably not, he's paying me to be there so he doesn't have to." Auditor then makes some noise about possibly issuing a subpoena, then kind of backs off and says, "well, not a subpoena." Auditor goes on to explain that once you answered some of the questions he's asked, additional questions come up, and “it just seems like the taxpayer could answer the questions quicker.” He then makes more noise about the fact that there are ways he can make him appear, and says he just wants to understand what the client does.

It may be that if the client appeared he could easily answer most of the questions, but he will make a lousy witness, he'll exhibit major nervousness, and the CPA who took over the returns as well as your staff who have worked on this all believe he needs to stay away.

No mention of any criminal issues so far. Again, neither spouse taxpayer wants to have to go, but they also do not want to be summoned.

Can taxpayer and/or wife be subpoenaed?

How do you tell if you need to refer the client to a criminal defense tax attorney?

Additional Facts

In addition to the audit, taxpayer and wife are going through a divorce from a long-term marriage. You represent both spouses for the audit, but husband is the one with the business dealings that are being looked at, and he is pretty nervous about having to deal with the IRS at all, as well as any other government agencies. He's not trying to hide anything as far as you can tell, but his books and records are a mess. CPA who was doing his taxes for the year before the audit died real close to when the extended tax returns were due for current audit year.

New CPA got it all kind of dumped on him after the other CPA's death. There are some pretty serious numbers that were either put on the return in the wrong places, or were just left completely off. The couple is likely going to owe some taxes and they know that but with the divorce and all, they really don't want to deal with the auditor too. Although they do want to get the audits over with as it's going to affect any divorce settlement.

On top of everything else, the client's brother (with whom he was a partner in several business ventures) died several years before the first audit year, and brother's estate got settled during the two years being audited. So there are distributions from that sub-S to client and heirs of deceased, looks like possibly erroneously treated as distributions when at least some should have been capital gain due to negative basis. Now the IRS (same auditor) is also auditing the brother's family but you don't represent them. The businesses were/are oil and gas related. Brothers were the operators for a lot of oil and gas wells. They also owned some wells and/or minerals individually and/or within the Sub-S and it appears they may not have always titled the properties correctly.

In a divorce hearing, client couldn't remember a LOT of things, and kept asking judge if he could have his helper answer, which got him in trouble with the judge. A lot of what the client does to produce his income is in his head. Example, client individually owns multiple rental properties (over 70), mostly mobile homes — Auditor had requested insurance documents and listed at least that many; Virtually all tenants pay by check or money order, and it all gets deposited; Client does not keep a rent roll or other list.

Client's workers are compiling a list of the units based on the insurance statements to see if the client can provide information regarding what months out of the audit years each one was rented and when they sat idle - but we're talking a few years ago. Between client and the girl that's been helping produce documents, almost everything he remembers she's been able to substantiate. Client has been a really generous man with a big heart, just didn't keep good records.

All this with the divorce, the previous CPA being deceased and can't help, (also, you have reason to know the previous CPA had some major issues with his work) and the new CPA possibly leaving things off the return and/or putting stuff

on wrong forms (mostly because he got it all really late and was unfamiliar with the client's stuff, you think) and all that, client's stuff is just in a mess.

Furthermore…

- No W2 forms or 1099 forms have ever been filed with the government for any of the businesses.
- Some 1099 forms were filled out by hand by a former worker, and possibly mailed to the recipient payee, and copies are available.
- Auditor has asked to see the hand written 1099's, even after being told that they don't balance with anything and that they will be re-done as part of finishing the audit.
- Cash that had been stored in a safe during a year subsequent to the 2 audit years has had to be disclosed to the auditor due to his request for a copy of a police report that backed up client's claim that corporate documents were lost when the safe was stolen.
- The former worker who did the handwritten 1099 forms has some severe memory problems, but won't admit it, so client took away a lot of duties and worker quit a few months ago.
- Auditor requested her name and found an address and sent her a letter asking for information on the rental properties. You were told this person has a "vendetta" against client, that she had called the auditor and told him she knew nothing and would have to get it from client, and then have heard that she is saying he's called her. Neither client nor you have been notified of auditor's contact with this person, except from the person sending a copy of the letter to the new CPA.

Overview of authority on point with this issue – Do I have to produce my client?

The investigative tools of an administrative agent are wide and varied. These include the use of informants, surveillance, and sometimes sting operations performed by persons in undercover roles. However, the most effective information gathering device is the ability to conduct interviews and gather witness statements. The purpose of an initial interview is to obtain an understanding of the taxpayer's financial history, business operations, and the accounting records. This information is then used to evaluate the accuracy of the books and records and determine the depth and scope of the examination. To facilitate investigations, agents are endowed with the power to issue a summons. A summons is an administrative discovery device similar in intent and reach to a grand jury subpoena, which commands the summoned person to appear, testify, or produce documentary evidence.

Power and Procedure for a Summons

Like other investigative tools, the Service may issue a summons for several purposes, among them: 1) determining the correctness of any return; 2) making a return where none has been made; 3) determining the liability of any person for any federal tax; 4) collecting any internal revenue tax; and 5) inquiring into any offense connected with the administrative or enforcement of the tax code. The evidentiary standard for the issuance or enforcement of an administrative summons is lower than in the criminal sense. Principally, the Service needs only to show that the summoned information is relevant and material. In the past summons have been upheld for such items as business records, handwriting samples, videotapes, and computer software.

In the event a summoned party does not submit, it is not within the Service's power to compel compliance. Rather, the Service must elect whether to request the Department of Justice to bring an enforcement action. Such actions are generally brought in federal district court for the district where the summoned party resides or is found and the burden lies with the Service. An order enforcing or denying the summons is final and appealable. Moreover, at the court's discretion sanctions may be brought against a party that does not comply with the court's order. However, it should be noted that a person summoned does not have to wait for an enforcement action to quash the summons.

A summons may target directly the taxpayer whose liability is being investigated or some third party. According to the IRS Restructuring and Reform Act of 1998 the Service may not contact a third party about the determination or collection and a taxpayer's liability without providing notice to the taxpayer. A third party administrative summons is typically aimed at financial institutions, employers, and business associates. It is issued in the ordinary course and must identify the target the taxpayer by name as well as allow sufficient time for the summoned party to gather the requested information. The taxpayer is normally given three days notice after service is made on the third party. Unlike the taxpayer, a third party does not have the right to attempt to quash the third party summons. Rather, the taxpayer has 20 days from the date notice of the third party summons is given to sue in district court to quash the summons and block the third party from disclosing any information to the Service.

Client's Right to Representation

IRC §7521(c) permits a representative authorized by a taxpayer to represent him or her at any interview. **Generally, the taxpayers' presence is not required unless an administrative summons has been issued** so long as the representative: 1) has first hand knowledge of the taxpayer's business, business practice, bookkeeping methods, accounting practices, and the daily operations of the business; 2) provides factual, reliable information to questions asked by the examiner; 3) timely provides follow-up information for any questions that could not be answered at the time of the initial interview; and 4) has properly executed Form 2848 or Form 8821. However, if the examiner concludes that the

representative does not have sufficient knowledge or refuses to comply, the examiner should request an interview with the person that possesses the information i.e. the taxpayer. For purposes of this section a representative may be an attorney, certified public accountant, enrolled agent, enrolled actuary, or other appointed person by the taxpayer.

At the outset of an interview or audit, Service personnel are required to supply taxpayers with Publication 556, which explains the examination process. Additionally, the agent must inform the taxpayer of his or her rights including the right to seek the advice of a tax professional at any time. If a taxpayer invokes this right the agent must immediately halt the examination and permit the taxpayer counsel. But if the interview is compelled by court order or pursuant to an administrative summons, the interview will not be suspended. **Where an agent or Service employee disregards such provisions a civil suit may be brought under IRC §7433.**

Criminal Defense Basics

Attorneys may become involved in Criminal Investigation Division (CID) cases at any stage. The earlier a knowledgeable and experienced attorney is consulted the better the chances of a favorable outcome. Therefore, it is essential for tax preparers to recognize potential badges of fraud ripe for investigation. From a policy perspective, CID chooses Cases for full investigation with the goal of deterring Criminal Tax violations by covering a wide cross section of taxpayers. When deciding to make a referral for criminal tax representation things to be mindful of include:

1. Education of the client,
2. Amount of tax loss,
3. Whether the taxpayer or a third party prepared the return under audit,
4. Issues of attorney client privilege,
5. Deterrent value of the fact pattern,
6. Badges of fraud (i.e. Maintaining inadequate records or destroying records; failing to file tax returns; providing implausible or inconsistent explanations during civil examination; concealing assets during collection of tax liabilities or examination, failing to cooperate with tax authorities; attempting to conceal unrelated illegal activities; Excessive dealing in cash; Filing false returns; intentionally underreporting or omitting income; Overstating deductions or claiming false deductions; Claiming personal expenses as business expenses; hiding or transferring income with relatives or related entities; keeping false records of your income or “second set of books”; diverting unreported income to offshore bank accounts; falsifying books or records “forgery”; claiming fake dependents; falsely claiming credits; engaging in sham “step transactions”; Arranging affairs for the sole purpose of tax avoidance in a manner that lacks economic substance; prematurely destroying records; taking positions on

a return that are “more likely than not” to be disallowed if discovered without sufficient disclosure; etc)

7. Number of fraudulent returns (especially 3 years open under statute)
8. Industry reputation with tax authority for industry clients - I.E. Mortgage Brokerages currently have a bad reputation because of their perceived role in crashing the economy.
9. Attorney’s reputation for providing criminal tax services, and
10. Factors that indicate the presence of an eggshell audit
    a. Does the agent bring his or her manager to meetings?
    b. Is the agent contacting and interviewing third parties?
    c. Have there been questions regarding the taxpayer’s state of mind or intent with respect to specific items of income or deductions?
    d. Has the investigating agent gone silent?

Once a revenue agent decides that there is a high indication of fraud involved in a civil examination, they will ordinarily contact employees within the IRS called Fraud Referral Specialists. The Fraud Referral Specialist’s job is to determine whether this is solely a civil issue or whether the case should be referred to the Criminal Investigation Division for development for possible criminal prosecution. In the past, a Revenue Agent would suspend the audit without telling the taxpayer or the CPA the reason for the sudden and unexplained suspension. However, in 2009, the IRS changed their fraud procedures in a very quiet manner by not publicizing the change and by instituting the use of parallel criminal investigations while the civil audit is still ongoing creating a dangerous scenario for both the CPA and his or her client. The revenue agents are instructed not to tell the taxpayer, or his representative that a criminal investigation has started or is ongoing.

Criminal Tax Defense Strategies and Defenses

Governmental auditors are all taught to "take it to cash". Commonly, auditors will begin an audit by first assuring themselves they have identified all of the business, personal, checking, savings and investment accounts utilized by an individual or a business and its owners. They will then sum up all of the deposits into a taxpayers business and personal accounts. His or her attitude is that every deposit and withdrawal is taxable income unless proven otherwise. This along with “communication risk” is the principle reason representation is needed during an audit. For example, if the examiner misinterprets or misstates a taxpayer utterance into a criminal admission, it ends up being their word versus the taxpayer. To effectively traverse such pitfalls there are certain strategies and defenses to consider.

The first and possibly best defense to any audit or CID investigation is to make sure that the taxpayer remains silent from the outset. Tax defense counsel should endeavor to prevent their client's from offering testimony or evidence during a civil examination where it is indicative or probative of criminal intent,

including making false statements and creating any record or displaying conduct that is likely to mislead or conceal especially in cases where there is an arguable Fifth Amendment claim. Agents recognize the taxpayer's right to consult with an attorney and will not interpret it as an indication of guilt nor will it be perceived as uncooperative. A substantial majority of reported convictions in criminal tax cases involve taxpayers who cooperated fully and early in the investigation, without counsel, and either lied or made damaging admissions to CID agents. There will be plenty of time to cooperate after getting the advice of counsel. Consequently, every taxpayer should be advised to say nothing to the agent except, "*I do not wish to be interviewed and I would like to consult my attorney*."

Because of the case law surrounding the fourth and fifth amendments in the tax arena, cooperation with CID special agents may not be the best tactic for every taxpayer. For some situations, fighting the investigation at every turn is appropriate. This means acting to monitor and anticipate the course of an investigation in the hopes of limiting or where possible eliminating potential criminal tax exposure. To this end, the taxpayer's tax defense counsel or a hired investigator can interview potential witnesses before the CID special agent has made contact. Doing so allows the attorney to ascertain facts, take his or her own notes, and develop a good record for impeachment should it become necessary down the road.

A second strategy that should be considered is voluntary disclosure. A voluntary disclosure must be truthful, timely, and complete. As it stands, IRS policy makes prosecution unlikely for nonfilers (as opposed to tax evaders) when the taxpayer: 1) informs the IRS that he or she has not filed a return for one or more periods; 2) has income from legal sources only; 3) makes disclosure before being contacted by the IRS or before an event occurs that is likely to cause and audit; 4) has filed a correct return or cooperated with the IRS in determining the correct tax liability; and 5) either paid the full amount due or made bona fide arrangement to pay. It should be noted that direct contact with a local CID representative is not necessary. Sometimes, taxpayers can fall under this policy simply by filing past due returns in the ordinary course.

A third strategy is immunity. Defense counsel may attempt to convince CID or Grand Jury investigators that his or her client is much more valuable to them as a witness against other potential or actual targets than as a criminal tax defendant. As a witness for the prosecution, the defense counsel's client may receive a grant of use immunity, under which he or she cooperates fully with the IRS in exchange for an agreement that charges will not brought against him or her. Complete immunity from prosecution arising out of a transaction is called transactional or pocket immunity. Although courts have historically expressed displeasure with pocket immunity it currently continues to be routinely granted. It is important to note that testifying under a grant of immunity is not without risks. Witnesses who receive immunity are prohibited from subsequently refusing to testify on the grounds that they might incriminate themselves. Moreover, if a case

can be built against the immunized witness on evidence that is independent of the immunized testimony, the immunized witness may still face criminal prosecution.

Other defenses commonly raised center around process and procedure. These include claims of the Fifth Amendment right against self-incrimination, tolling of the statute of limitations, lack of criminal intent, no tax due, defects in method of proof, dual prosecution, health, and the improbability of a conviction.

A Fifth Amendment defense is weak for several reasons principally because agents assume they will have to build cases without the taxpayer's cooperation Furthermore, recent decisions have indicated that under the required records exception, Fifth Amendment rights are not violated if: 1) the government's inquiry is essentially regulatory; 2) the information is a preserved record of a kind customarily retained; and 3) the records have taken on public aspects making them analogous to a public document.

With respect to a statute of limitations, each specific tax crime has its own statute of limitations that establishes a time frame under which a criminal charge must be brought or else the charge is mute under the law. But under specified circumstances, the statute of limitations may be extended.

Lack of intent or proving that a taxpayer acted intentionally in violation of a known legal duty is a critical element of most of the government's criminal tax cases and is often the most difficult one for the prosecution to prove. In the absence of a confession or the testimony of an accomplice, intent usually must be established by circumstantial evidence concerning the taxpayer's actions. The admissibility of circumstantial evidence is frequently a close question that criminal tax counsel can endeavor to suppress.

Both the IRS and the Department of Justice regard the probability of conviction to be an important standard of review. A number of factors that are not sufficient by themselves to cause declination, when viewed together, might be sufficient reason to decline a case. A combination of a health condition, personal tragedy, and prepayment of liabilities could form the basis for declination. If a physical or mental health defense is raised, it should be supported by a medical opinion letter, medical records, and the curriculum vitae of the medical professional who treated the taxpayer.

Basics of the Kovel Accountant Arrangement

In *U.S. v. Kovel* 296 F.2d 918 (2nd Cir. 1961), a law firm employed an accountant on its own staff. In the course of representing a client that was the target of a grand jury investigation for various income tax offenses the taxpayer conveyed information to the accountant, which the accountant communicated to an attorney in the firm to aid in the client's defense. The government subpoenaed

the law firm's files on the grounds that the communications involving the accountant were not subject to the attorney-client privilege. The Second Circuit held that because the law firm's use of an accountant to assist it in understanding the content of the client's business facilitated attorney-client communication and the provision of sound legal advice, the accountant's communication with both the attorney and the taxpayer were privileged.

A taxpayer with a potential criminal matter often requires both legal and accounting assistance to defend his or her case. Where the Attorney deems it advantageous for his or her client, the Attorney may engage the referring CPA under a Kovel Agreement to help him or her represent the client in the criminal tax matter. The Kovel arrangement generally assures that communications between the CPA and the client fall under the attorney client privilege and the work papers prepared by the CPA generally fall under the Attorney's work product privilege by making the CPA and his or her staff an extension of the Attorney's firm as to the common clients representation. A Kovel arrangement should be documented in writing, preferably through an engagement letter prepared by the attorney that evidences the accountant is working directly for the attorney.

Kovel has been under attack and consequently somewhat limited through subsequent challenges by the IRS. In *U.S. v. Aldman*, the corporation's accountant prepared a study for the entity's attorney that assessed what the outcome would in the event of litigation if the IRS ever audited the company. The trial court concluded that the main purpose of the report was not made in anticipation of litigation and thus the report was not privileged. The 2nd Circuit vacated and remanded this decision, stating that the documents included "mental impressions, conclusions, opinions and theories," which did not lose privilege just because they were prepared primarily to support future business decisions. However, the court did create precedent that opens a window where the IRS might undermine Kovel if they can show discoverable evidence is otherwise unavailable.

Relevant Internet Links:

Internal Revenue Manual – Table of Contents
http://www.irs.gov/irm/index.html

Internal Revenue Manual, Part 4 – Examining Process
http://www.irs.gov/irm/part4/index.html

Internal Revenue Manual, Part 4, Chapter 10, Section 3 – Examination Techniques
http://www.irs.gov/irm/part4/irm_04-010-003.html

Audit Techniques Guides

http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Audit-Techniques-Guides-(ATGs)

Cash Intensive Businesses Audit Techniques Guide
http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Cash-Intensive-Businesses-Audit-Techniques-Guide---Chapter-3