Keeping Your Tax Clients and Yourself out of Jail & Criminal Tax War Stories from the Trenches

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MR. WALTERS? IT'S YOUR ACCOUNTANT. I MAY HAVE MADE A MISTAKE ON YOUR TAX RETURN — DON'T SEND IT IN.
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<u>**Ethical requirements for CPA’s in the face of possible criminal tax issues raised by a current or potential client.**</u>

CPA’s are often faced with existing as well as potential new clients coming into their office, seeking advice because they have taken actions within their previous tax and or information filings that could potentially lead to prosecution for a tax crime. On rare occasions an existing client may come into the CPA’s office and state that they may already be under criminal investigation by the IRS or by another state or federal taxing authority.

Unfortunately for CPA’s, the CPA that prepared the tax returns at issue for such clients are usually the first person the client will contact in the face of a possible criminal investigation or where their past cheating starts to keep them up at night. The CPA must know in advance what the correct legal and ethical considerations he or she should consider in order to protect his or her client from criminal prosecution where his or her client is being investigated or merely faces the potential to be investigated. Moreover, the CPA must know what to do to protect his or her self from their own ethical and criminal misconduct exposure. After all, a CPA’s license is often the most valuable asset he or she possesses.

Moreover, CPA’s should be aware of the potential consequences that clients face as a result of undergoing a criminal investigation by the IRS or other taxing authority. Clients in these situations potentially face jail sentences and large financial penalties. If the client has a professional license they also could lose their livelihood in the process. While CPA’s, under ordinary circumstances, offer their clients invaluable professional advice regarding tax procedure and administration, once the CPA recognizes the emergence of a possible criminal issue in a client’s fact pattern, he or she should halt the client interview immediately and refer the client to an experienced criminal tax attorney.

The CPA should resist the urge to fully drill down on the potential criminal tax issue as the CPA can be forced to testify against the client. Because of the fiduciary relationship between client and CPA, the CPA often is the most damaging witness the government can muster against the accused taxpayer. Sometimes the greatest service a CPA can provide to a client is to protect them from themselves by resisting a client's often desperate pleas for help in this scenario. You can comfort them by telling them to quit talking and listen. Then explain to them why you cannot fully discus their issue with them because of the potential for you to be called as a witness against them.

Moreover, if the CPA had no knowledge of the method by which the client evaded taxes, or if he or she is the preparer of the return or returns under investigation, the CPA has a very real and pronounced conflict of interest with the investigated client. The CPA has a vested interest in protecting his or her own reputation with the investigating tax authority which places him or her at odds with the needs of his client to protect their own reputation. The bottom line is eventually the taxing authority is going to be able to determine it has returns in front of them that do not reflect the correct tax liability. The question then becomes, whose fault is that? The client or the CPA's? Unfortunately, in the face of a criminal prosecution by the client, and in the face of possible suspicion of the CPA's work product, a he said she said situation is very likely to unfold. This is the reason that CPAs are systematically trained to document the information provided by the taxpayer in the preparation of the return. The evidentiary waters become even murkier where the CPA compiled, reviewed or audited the accounting that underlies the returns under investigation.

Because of the high stakes consequences to both the client and CPA, It is important for CPA's to know the legal and ethical issues surrounding criminal investigations and prosecutions in order to know when referral is needed as well as to protect themselves from their own ethical, civil and criminal exposure.

Common Misunderstanding by the CPA of the Privileges Conferred by IRC Section 7525

Practitioners authorized to practice in front of the Internal Revenue Service may claim an attorney-client privilege in non-criminal tax matters under limited circumstances.

Misconceptions surrounding the strength of the protection provided by Section 7525 can present quite a dangerous dilemma for CPAs. Many CPAs mistakenly believe that their client communications are protected when representing an audited client. This is partially true where they did not prepare the original returns being audited. The dilemma occurs once that examination turns criminal where the CPA can find themselves compelled to divulge all the client's previously discussed secrets to the IRS under the IRS's subpoena power. Moreover, communications surrounding the preparation of the original return being audited are never privileged (even where the original return was prepared by an attorney) given that a tax return is a public disclosure and thus no expectation of confidentiality surrounded the communications at issue.

The 6th Circuit court of appeals has held that statements made in a civil examination may be admitted as evidence in a subsequent criminal prosecution. In *U.S. v. Rutherford,* 555 F.3d 190 (6th Cir. 2009), the defendants were represented by a CPA when the civil interviews were being conducted. Because the case was not handed over to a criminal tax attorney at the phase where the CPA should have realized that the taxpayers were in need of legal representation, the taxpayer's ability to protect his constitutional rights were weakened. Ultimately the statements made during the civil audit while the client was represented by a CPA, led directly to the taxpayer's criminal prosecution.

Protection Afforded to a Client Where the CPA Works for an Attorney Under a Kovel Agreement

In order to protect the client's constitutional rights where a possible criminal tax violation is identified by the CPA, the client should be referred to a criminal tax attorney at the earliest possible signs of a potential criminal tax violation with as little said between the CPA and the client as possible. 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.

It is important to note that the Attorney's duty of loyalty is to the client and not to the referring CPA. In situations where the CPA prepared the returns that are now under criminal investigation or where too much was said between the referring CPA and the client prior to the referral to the Tax Attorney being made, the Attorney might opt to advise the client to engage a disinterested third party CPA in order to avoid the procedural confusion that follows where pre Kovel letter communications and work papers prepared by the referring CPA are non-privileged as opposed to post Kovel Letter communications and work papers that are privileged.

"ACCORDING TO MY FIGURES, YOU DON'T NEED AN ACCOUNTANT, YOU NEED A LAWYER!"

Ethical Requirements under the AICPA Statement on Standards for Tax Services

The AICPA Statement on Standard for Tax Services also gives insight into the CPA's responsibilities when taking on new clients. (SSTS) no. 6, Knowledge of Error: Return Preparation and Administrative Proceedings states that when the CPA has a reason to believe that a taxpayer may be charged with any type of fraud or criminal violation, the client should be advised to consult with a tax attorney before speaking to the CPA in regard to the matter at hand. The CPA should also consider whether he is still able to represent the client in any role, or whether he should withdraw entirely from the relationship with the client.

The CPA should be aware of the fact that he or she could be subject to an investigative summons or grand jury subpoena as to *any* communication between him or herself and a client in a criminal context. Therefore, when the CPA is faced with a situation where a client has unfiled tax returns in years where they earned reportable amounts of income or where the CPA has identified intentional client errors on previously filed tax returns, the CPA should urged the client to speak with a tax attorney before proceeding with providing additional services.

Basic Criminal Tax Violations

Both federal and state taxing authorities can bring both felony and misdemeanor tax charges against a CPA's client, the most common of which include tax evasion, failure to file a return or pay tax and filing a false return. The IRS also prosecutes taxpayers under the Federal Criminal Code on charges such as presenting false claims to the government, conspiracy, and making false statements.

In order for the federal government to prevail in a criminal prosecution, they must prove each element of an accused tax crime beyond a reasonable doubt. Moreover, the Government must bring the action within the appropriate statute of limitations for prosecution which range from three years to six years under the internal revenue code and within five years for crimes prosecuted under the Federal Criminal Code.

To complicate matters further, individuals can be convicted of committing a tax crime with regards to another person's or entities tax liability, like for example, where a corporate officer falsifies the associated corporate returns. Corporations and other legal entities such as Estates, LLC and Partnerships may also be prosecuted.

Lastly, CPA’s should be aware of their own potential liability for tax crimes in preparing returns such as aiding and abetting the commission of an offense or conspiracy to commit tax evasion.

Tax Crimes Synopsis

A taxpayer can be simultaneously charged with a greater offense and with a lesser included offense within the legal definition of the greater offense (which often carries a lower burden of proof), and can be convicted of either individual charge, or both charges, although the law does not allow for consecutive sentences where a defendant is convicted of both the greater and the lesser included offenses. A single action on the part of a taxpayer may constitute a violation of several criminal tax statutes. When both criminal and civil remedies are available to the government, it has the discretion to pursue either criminal remedies, civil remedies or both under the law. The IRS will not rule in advance (private letter ruling) on whether a proposed transaction would subject a taxpayer to a criminal penalty.

- A defendant can be convicted of attempting to evade tax if, a tax deficiency can be proven to exist between the return at issue and the correct amount of tax as proven by the government, the government can prove that the defendant took affirmative actions in an attempt to evade or defeat the correct amount of tax and the defendant acted willfully.
- A defendant who is required to file a return and who willfully fails to file the return by the due date (or extended due date) can be convicted of failure to file a return.
- A defendant who is required by law to pay tax and who willfully fails to pay the tax as it becomes due can be convicted of failure to pay tax.

- A defendant can be convicted of making and subscribing a false return or other document if it can be proven that they willfully made and subscribed a return, the return contained a statement or included another document that included a statement that it is made under the penalties of perjury, and it can be proven that the defendant did not believe that the document was true and correct as to every material matter at the time of signature. Tax Preparers can also be convicted of the same crime if it can be proven that they aided or assisted in the preparation or presentation of a false return or other document. This creates an inherent conflict of interest between the tax preparer and the defendant taxpayer.
- Any person who is required to collect, account for and pay over any tax and who willfully fails to do so can be convicted of a felony.
- It is a crime for an employer to willfully fail to furnish, or to furnish a false or fraudulent, Form W-2, Wage and Tax Statement, to an employee.
- Convictions can be obtained under the Federal Criminal Code offenses include aiding and abetting the commission of a substantive offense, presenting the government with false or fraudulent claims, conspiring to commit a substantive offense, making a false statement to the United States or any of its agencies, using the mails to execute a fraudulent scheme, bribery, and forgery. Note: Preparers and promoters are often prosecuted under these code sections.
- Other miscellaneous tax crimes include making false statements, falsifying or destroying records or books, concealing property in connection with a compromise or a closing agreement, removing and concealing property that is subject to levy with the intent to evade or defeat tax, interfering with the administration of the internal revenue laws, and making unauthorized disclosures or inspections of returns or return information.
- Any person who is required to keep any records or supply information and who willfully fails to do so can be convicted of a misdemeanor.
- A person who willfully delivers or discloses to the Treasury Secretary (or his or her delegate) a list, return, account, statement, or other document that the person knows to be fraudulent or false as to any material matter can be convicted of a misdemeanor.

Defenses to Tax Crimes Synopsis

Willfulness is defined under the law as a voluntary and intentional violation of a known legal duty and several defenses focus on preventing the government from being able to establish this element. Defenses available to defeat the element of willfulness include inadvertence, negligence, mistake, uncertain legal duty, reliance on others and diminished mental capacity.

Note: Willfulness is often the easiest element of a tax crime to defeat because the government is basically required to prove to a jury what he defendant's state of mind was at the time of the complained of offense. The government is usually forced to resort to circumstantial evidence to establish this element. For this reason the government usually will not prosecute unless a pattern of complained of behavior can be established. The existence of the pattern itself tends to indicate to a jury that the behavior was intentional and willful rather than mere negligence for example. This is the reason that three years are often at issue in a criminal investigation.

Defenses commonly used in defending tax crimes by Tax Attorneys typically focus on the protecting the client's fifth amendment privilege against self-incrimination and fourth amendment privilege against unreasonable searches and seizures.

A Taxpayer's lack of education and personal difficulties such as health, advanced age or family problems generally are not considered defenses per se but may be used to attempt to discourage prosecution as they might make it harder to convince a jury to convict by creating sympathy for the defendant.

Vicarious Liability Involving Corporations and Other Entities

Although most tax crimes involve a taxpayer's own tax liability, a defendant may have vicarious criminal liability concerning actions he or she has taken regarding another person or entity's tax liability in a multitude of ways. Through the legal concept of vicarious liability, a corporate officer, director or employee could possibly be accused and convicted of attempted evasion of the related corporation's taxes. A corporations' attorney or CPA could possibly be convicted of attempted evasion of their client's taxes through vicarious liability as well. Similarly through the doctrine of vicarious liability, it is a crime to willfully subscribe false documents and accordingly, third party individuals are occasionally convicted for signing false documents relating to the tax liability of others, for example where a tax preparer knowingly signs a false return prepared for his or her client.

Another source of vicarious liability for third parties is the general federal aiding and abetting statute. This statute makes any person who aids or abets another person or entity in the commission of a federal offense subject to punishment as a principal. For the Government to impose aiding and abetting liability on a third party, it will be required to prove that third party defendant affirmatively assisted another person or entity to commit a federal crime and that they shared the criminal intent with the person or entity they acted on behalf of to commit the criminal offense. For example, a corporate officer may be criminally convicted of a corporation's willful failure to pay trust fund taxes. In many of the situations where a charge of aiding and abetting is appropriate, the government can also charge third parties with the general federal conspiracy statute, for entering into an agreement with another person or entity to commit a federal crime.

Under Federal Law, the term "person", which is used to describe corporations and other legal entities, is deemed to include corporate officers, partners, members, and even may include employees who have a duty to perform an act for their related corporation or entity for which a criminal violation occurs because the act does not occur as required. The government typically uses this definition of "person" in charging crimes involving a failure to act against third parties. For example, the president and sole operating officer of a corporation is held to be under a legal duty to file the related corporation's tax returns and thus may be criminally prosecuted for failing to file those returns. In summary, a "person" includes an individual, a trust, an estate, a partnership, an association, a company or a corporation.

Of course, corporations and other legal entities may themselves be subject to prosecution for tax crimes. Corporations or other entities are held liable for the criminal acts of its employees and owners if the criminal act is done on its behalf and the criminal act was within the scope of the employee's or owner's authority. For example, a corporation can be convicted of filing a false return where its president and majority owner deliberately caused it to file a false return, even though the individual employee who signed the return was unaware of the return's falsity. Moreover, even though a partnership is not subject to income tax at the entity level, it can still be subject to criminal prosecution at the entity level for crimes committed on its behalf by its owner's and employee's such as attempted evasion or failure to file.

Aiding and Abetting a Criminal Tax Violation and the Associated CPA

Several crimes set forth in the Federal Criminal Code can apply to CPAs in their capacity as tax preparers, advisors and representatives of clients. They most commonly charged include aiding and abetting, presenting a false, fictitious, or fraudulent claim to the government, conspiracy, making false statements to a U.S. agency, mail fraud, bribery, and forgery.

In practice, the aiding and abetting violations has historically been charged against persons who have aided and assisted another in tax evasion by concealing another person's sources of income or assets, such as CPA’s.

Elements of the Offense

To prevail in bringing a charge under the federal aiding and abetting statute, the government must prove beyond a reasonable doubt that:

- A substantive criminal offense was committed
- The defendant, by affirmative conduct, participated in, counseled, or assisted in the commission of the substantive offense
- The defendant shared with the principal the criminal intent to commit the substantive offense.

Any person who aids or abets the commission of a substantive federal offense is punishable as a principal in the underlying substantive federal offense. The principal who was aided and abetted does not need to be identified or convicted for the government to convict the party accused of aiding and abetting. Moreover, an outright acquittal of the principal will not bar the prosecution of the aider and abettor.

An accused must associate themselves in some manner with a criminal venture to be convicted of aiding and abetting the commission of an offense. Additionally they must participate in the criminal venture in a manner that demonstrates that it is something that they wish to bring about and seek by their actions to make succeed. However, the aider and abettor need not perform the substantive offense nor even know its details to be convicted. Moreover, the aider and abettor need not have been present when the offense was committed. To prevail in bringing an action for aiding and abetting, the government need only show that the defendant intentionally assisted in the commission of a specific crime in some substantial manor. For example, convictions for aiding and abetting have been secured against individuals who advised others to file false Form W-4 - Employee's Withholding Allowance Certificates.

Because the aiding and abetting statute does not create a separate offense, the applicable statute of limitations for bringing an aiding and abetting charge is the same as that of the underlying substantive crime that is of issue.

False, Fictitious, or Fraudulent Claims

It is a felony to present to the government a false, fictitious, or fraudulent claim, which on occasion involves a CPA where a taxpayer submits a false claim for refund of taxes. This crime is punishable by imprisonment of up to five years, a fine of up to $10,000, or both.

This statute has been applied to:

- a defendant who filed an income tax return falsely claiming a refund based on backdated documents
- a defendant who filed duplicate returns, one in his name and one in a fictitious name

- a defendant who filed returns claiming refunds in the names of other persons but using his own address

Elements of the Offense

For the government to secure a conviction for the presentation of a false claim, it must prove beyond a reasonable doubt that:

- The defendant made or presented a claim for money or property to a department or agency of the United States Government;
- The claim was false, fictitious, or fraudulent
- The defendant knew that the claim was false, fictitious, or fraudulent at the time presented.

The statute of limitations for prosecution for making a false claim to the government is five years.

"I got 2 years for filing false returns, but I did save a bundle by doing my own taxes."

Conspiracy

It is a felony to conspire with another to commit a crime. Conspiracy is much more likely to be charged when the complained of charge is against the United States. Conspiracy in the tax world is usually found where an agreement by two or more people if formed to commit an offense against, or to defraud, the United States usually involving income tax evasion or a false refund claim. Conspiracy is chargeable as a felony or a misdemeanor depending on whether the underlying criminal objective of the conspiracy is punishable as a felony or as a misdemeanor. If the underlying criminal objective of the conspiracy is a felony, conviction for conspiracy is punishable by imprisonment for up to five years and a fine of up to $10,000. If the underlying criminal objective of the conspiracy is punishable as a misdemeanor, conviction for conspiracy is punishable to the same extent as is the underlying misdemeanor criminal objective. In both felony and misdemeanor cases, greater fines may be imposed under the alternative maximum fine provisions.

Case law in this area shows the charges for conspiracy to defraud the United States have been use to attack agreements to impede, impair, obstruct, or defeat the lawful functions of governmental agencies such as the IRS. The IRS has used conspiracy charges surrounding attempts to impede and or impair the IRS in the lawful assessment or collection of revenue as a weapon in complex tax prosecutions typically involving corporations, abusive tax shelters and money-laundering schemes.

Elements of the Offense

For the government to earn a conviction for conspiracy it must prove beyond a reasonable doubt that:

- Two or more persons made an agreement
- The substance of the agreement was to commit an offense against the United States or to defraud the United States
- One or more of the conspirators committed an overt act in furtherance of the agreement.

A six-year statute of limitations applies to offenses arising under the conspiracy provisions of the Federal Code.

Agreement Between Two or More Persons

The agreement to violate the law does not have to be reduced to an express or formal agreement. Convictions have occurred where nothing more than a mere tacit understanding was able to be inferred from the apparent concert of action by two or more persons which evidenced a single design to accomplish a common criminal purpose. However, evidence presented by the government must be sufficient to show beyond a reasonable doubt that the conspirators had reached a mutual understanding involving the essential nature of the criminal plan. In the Tax arena for example, all that must be shown in a conspiracy to evade taxes case, is that the defendant knew of the conspiracy to evade taxes and knowingly participated in it. Moreover, the government is not required to establish that the conspirators agreed to the details of the plan for which the conviction was charged.

A corporation as a legal person can also be charged with conspiracy. Courts have held that a corporation may conspire with its officers or with its employees. Husband and Wife may also be found guilty of conspiring together against the United States.

The underlying substantive offense and the conspiracy to commit that offense are two separate and distinct offenses. Thus a person may be charged with both the commission of the underlying offense and with conspiracy to commit the underlying offense. Moreover, a conspiracy to commit an offense may be established even when the underlying substantive offense was not actually accomplished. aiding and abetting the commission of an offense

Filing a False Return and the Associated CPA

The CPA should be aware that filing a false return could lead to criminal prosecution of both the client and the CPA. The CPA should also be aware that client’s will often time try to point the blame at the preparer when the client faces the mere possibility prosecution as occurs during an audit of the false return. CPA’s should be mindful when preparing returns to withdraw from representation when there is evidence that the client is not being truthful such as where the client’s books have been purposefully manipulated to understate income or where extensive, unnecessary and unexplained use of cash has been made.

Case Law Examples:

- The 6th circuit held that a CPA was guilty of the crime of filing false returns when he set up S-Corporations and Partnerships (which is the unauthorized practice of law by the way) that owned his client’s personal residences by which the client’s claimed personal living expenses as business deductions.
- The U.S. Tax Court held that a preparer who overstated income to assist a client in obtaining an SBA-guaranteed loan was subject to prosecution for filing a false return.

To successfully prosecute a violation of the aiding or assisting provisions for aiding or assisting another to file a false form by a CPA, the government must prove beyond a reasonable doubt that;

- The defendant CPA aided, assisted, procured, counseled, or advised the preparation or presentation of a document
- The document was false as to a material matter
- The defendant CPA acted willfully.

Charges under this provision have historically been brought against accountants, bookers and an entity's employees who prepare or assist in the preparation of false tax returns. However, the statute is not limited solely to the direct preparation of a tax return but is much broader in that the statute reaches any intentional conduct that contributes to the presentation of a false document to the IRS.

To be charged under these provisions the accused need only assist in the preparation of, and need not sign or file the actual false document. The statute has thus been applied to individuals who communicate false information to their return preparers, thereby causing the tax preparer to file a false return. On the other hand, the statute specifically provides that the taxpayer who signs and files the return or document need not know of, or consent to, the false statement for the aiding and abetting statue to be brought against the preparer. For example, a tax preparer who inflates deductions, understates income or claims false credits on a client's return may be charged with aiding and abetting even if the taxpayer for whom the return is prepared is unaware of the falsity of the return he signed and filed. Moreover, a tax preparer who utilizes information provided by a client that the preparer knows to be false in the preparation of a return can be criminally charged with assisting in the preparation of a false return.

False as to Material Matter:

The courts that have ruled on what constitutes a material matter have held materiality to be a matter of law to be decided by the court and not a factual issue to be decided by the jury.

Willfulness:

To establish willfulness in the delivery or disclosure of a false document, the government need only show that the accused knew that the law required a truthful document to be submitted and that he or she intentionally violated the duty to be truthful. The crime of aiding or assisting in the preparation or presentation of a false return or document requires that the defendant's actions be willful in that the defendant knew or believed that his or her actions were likely to lead to the filing of a false return. The Ninth Circuit (the appeals court for Southern California and thus controlling precedent) has held that the government must prove not only that the accused knew that the conduct would result in a false return, but must additionally establish that tax fraud was in fact the objective of the allegedly criminal conduct.

Statute of Limitations:

The statute of limitations for the crime of aiding or assisting the preparation or presentation of a false return or other document is six years. The statute of limitations for charges involving delivery or disclosure of a false document starts to run from the date the document is disclosed or submitted to the IRS.

How to Help Your Clients Avoid Possible Criminal Tax Prosecution.

In a Criminal tax context, the CPA should be very diligent that the client does not share any information with the CPA in regards to possible criminal actions. The CPA should use zeal in order to make sure that the client does not put the CPA in a position where he or she can be a possible witness against the client. The client should be told to discuss the matter with a tax attorney at the first possibility of a fact pattern that indicates criminal tax exposure.

As a preparer, the CPA can help clients avoid criminal tax prosecution by knowing the procedures that the IRS uses to prosecute taxpayers. The majority of criminal tax investigations start as regular audits of returns in which the Examiner discovers possible taxpayer fraud.

The Internal Revenue Manual instructs IRS personnel on how to identify indicia of fraud during routine examinations. See IRM Part 25. The IRM instructs the agent to look for signs such as taxpayer or representative procrastination, uncooperative attitude, quick agreement to proposed audit adjustments or desire to immediately closing the case. Many other indicia of fraud, commonly called “badges of fraud” are identified in the IRM. Any one or a combination of these “badges of fraud” may then be interpreted as indicia of fraud and subject the taxpayer to a potential fraud investigation.

Once a Revenue Agent decides that there is a high indication that fraud is 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 in a given examination, 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. This made the seasoned and enlightened CPA’s job easy since the CPA would recognize the tell-tale signs that his client’s audit most likely has gone criminal. The seasoned and enlightened CPA would then consider withdrawing from the representation and refer their client to consult with a reputable criminal tax attorney.

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. These types of audits are commonly called “eggshell audits” in the Tax Controversy Representation legal community.

This change in policy obviously makes the CPA’s representation in an audit much more critical in minimizing his or her client’s criminal exposure and thus creates much more malpractice exposure for the CPA. The CPA, now, more than ever, needs to be very diligent in regards to being cognizant of the additional risks faced by his or her client in light of this policy change. CPAs should investigate for any issues in a client’s fact pattern that could turn criminal prior to the outset of a routine civil audit. If indicia of fraud is detected the CPA should advise the client of the possibility that the issue may silently turn criminal during the civil examination and advise the client to consult with a tax attorney. It is also advisable that the CPA seek the counsel of an experienced tax attorney themselves about whether or not it is a good idea to continue representation in light of all the facts of the particular case especially where the client refused to seek legal counsel.

Teaming up With a Tax Attorney to Solve a Current or Potential Client’s Criminal Tax Issues.

The CPA can play a major an invaluable role in helping a client avoid criminal conviction by entering into a Kovel Agreement with a Tax Attorney in appropriate circumstances. The 2nd Circuit case US v. Kovel established that a CPAs communication with a client and work product can fall under the attorney-client and work product privileges where the attorney, hires the CPA, rather than the CPA being hired directly by the client. In Kovel, the accountant in questions was actually a former IRS agent, and he was hired by a law firm to advise the law firm’s clients. The clients were under IRS criminal investigation. The IRS subpoenaed Mr. Kovel to testify against the law firms clients. Mr. Kovel rightfully refused to respond to questioning claiming that the communications he had with the Law Firm clients were privileged but he was wrongfully sentenced to a year in prison for his refusal. The 2^{nd} circuit then overturned the decision, and established the current precedent that and accountant's communications are privileged, if he or she is hired by an Attorney.

A Kovel agreement will generally protect communications and work papers not used in the production of the tax or information returns at issue before a court of law from discovery though IRS summons enforcement or at trial, since the communications and work papers fall under the attorney client privilege and work product doctrine.

Kovel has been under attack and has been somewhat limited through subsequent challenges by the IRS. In US v. Adlman, the court held that the work product protection of Kovel only applies to materials prepared by the CPA in anticipation of litigation. In Adlman, the corporation's accountant prepared a study for the entity's attorney that assessed what the outcome would be in the event of litigation in the event 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 court of appeals vacated and remanded the trial court's decision, and stated that the documents included "mental impressions, conclusions, opinions and theories" and that it did not lose its work product privilege protection just because it was prepared primarily to support future business decisions. The appeals court held that because the study evaluated the tax implications surrounding a large net operating loss which would have resulted in a large tax refund, litigation with the IRS was almost a certainty.

The 2^{nd} circuit, however, created precedent in Adlman that creates a window where the IRS might possibly undermine Kovel where the IRS is able to make a showing to the court that the document it is attempting to discover is otherwise unavailable.

In the Kovel setting, the CPA is able to provide valuable services to the attorney in anticipation of any possible litigation including the possibility of a criminal prosecution of the attorney and CPAs common client.

Voluntary Disclosures

Another way in which the CPA and Attorney can team up is in making voluntary disclosures to the IRS on behalf of a common client. You will know when you have a voluntary disclosure opportunity where the client will come into your office, state that he or she has cheated on their taxes but now they can't sleep at night and want your advice on what to do about it. Again resist the urge of drilling down into the facts until retained by a Tax Attorney and make the referral. You can explain the basic process to your client however in anticipation of teaming with a Tax Attorney to fix the problem should the attorney deem it advisable to use your services in doing so. However, remember that pre Kovel communications are not privileged and this presents exposure to your client and possibly yourself.

A voluntary disclosure is a process whereby the client's tax attorney basically knocks on the door of the IRS Criminal Investigation Division and states something to the effect as this: I'm bringing in a tax cheat. The tax cheat is willing to correct their previous behavior by amending previously filed fraudulent tax filings and make payment, or arrangements to pay, of the additional tax interest and penalties owed in exchange for the IRS passing on criminal prosecution.

Historically, between 1934 and 1952, the IRS had a written policy of refraining from prosecuting taxpayers who made a voluntary disclosure. Today, that written policy has changed so that a taxpayer's voluntary disclosure is a factor that is heavily weighted in a facts-and-circumstances evaluation of whether or not to prosecute, but the actual of practice of the IRS is quite similar to its past written policy.

Adapted from my website: http://www.klasing-associates.com/Tax-Law/Tax-Evasion-Fraud-Representation.shtml

The IRS's behavior is indicative of its true policy. Since 1952, the IRS has only decided to prosecute a handful of cases after a receiving a taxpayer's valid voluntary disclosure. Because of the IRS's previous written policy and the IRS's lack of prosecution of valid voluntary disclosure cases; many tax attorneys are generally convinced that the IRS has an unwritten de facto disclosure policy of refraining from prosecution.

The IRS's unwritten policy can be seen from its behavior, specifically, its decision to decline prosecution. One court admits, "there appears to have been few, if any, prosecutions of true voluntary disclosures [by] the IRS." United States v. Hebel, 668 F.2d 995, 998 (8th Cir. 1982).

Indeed, the IRS's conduct seems to show that it will prosecute after a voluntary disclosure only when extraordinary facts and circumstances are present. A number of tax scholars agree: "[T]he practice of the IRS has been that it will not prosecute taxpayers who satisfy all of the requirements of the voluntary disclosure program because, if it did initiate such prosecutions, no taxpayers ever would be willing to make a voluntary disclosure in the future." New York University Annual Institute on Federal Taxation § 27.06 (2010).

Thus, even though the IRS's official, written position is to leave the door open to pursuing criminal prosecution after a voluntary disclosure, it is unlikely it will do so.

Voluntary disclosures typically occurs in two situations:

(a) The taxpayer's wrongdoing is disclosed to his attorney or accountant because he wants to set matters straight; or

(b) The taxpayer discloses his wrongdoing to an attorney or accountant after he has been personally contacted by the IRS.

Generally, if a taxpayer has not been contacted by the IRS, or is not currently under audit, examination, or investigation, it is not likely he will be prosecuted after a voluntary disclosure - unless the IRS disputes the voluntary disclosure, or the IRS believes the taxpayer has engaged in an illicit income-producing activity (or is a threat to the voluntary assessment system, where the taxpayer is deemed a tax protester).

Note: The decision whether or not to make a voluntary disclosure to the IRS is not a simple one and should never be made without the counsel of an experienced tax attorney.

The following bolded content is the actual language of the IRS's Voluntary Disclosure Practice:

It is currently the practice of the IRS that a voluntary disclosure will be considered along with all other factors in the investigation in determining whether criminal prosecution will be recommended. This voluntary disclosure practice creates no substantive or procedural rights for taxpayers, but rather is a matter of internal IRS practice, provided solely for guidance to IRS personnel. Taxpayers cannot rely on the fact that other similarly situated taxpayers may not have been recommended for criminal prosecution.

A voluntary disclosure will not automatically guarantee immunity from prosecution; however, a voluntary disclosure may result in prosecution not being recommended. This practice does not apply to taxpayers with illegal source income.

A voluntary disclosure occurs when the communication is truthful, timely, complete, and when:

a. ***The taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his or her correct tax liability; and***
b. ***The taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.***

A disclosure is timely if it is received before:

a. ***The IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation;***
b. ***The IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance;***
c. ***The IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or***
d. ***The IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).***

Any taxpayer who contacts the IRS in person or through a representative regarding voluntary disclosure will be directed to Criminal Investigation for evaluation of the disclosure. Special agents are encouraged to consult Area Counsel, Criminal Tax on voluntary disclosure issues.

Examples of voluntary disclosures include:

A letter from an attorney which encloses amended returns from a client which are complete and accurate (reporting legal source income omitted from the original returns), which offers to pay the tax, interest, and any penalties determined by the IRS to be applicable in full and which meets the timeliness standard set forth above.

A disclosure made by an individual who has not filed tax returns after the individual has received a notice stating that the IRS has no record of receiving a return for a particular year and inquiring into whether the taxpayer filed a return for that year. The individual files complete and accurate returns and makes arrangements with the IRS to pay the tax, interest, and any penalties determined by the IRS to be applicable in full. This is a voluntary disclosure because the IRS has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intent to do so and because all other elements of (3), above, are met.

It has been our experience that taxpayers who have in many times blatantly and knowingly violated the tax laws, are none the less able to effectively avoid prosecution by self-reporting their prior tax violations to the IRS before the IRS has had the opportunity to begin an investigation by taking advantage of the IRS Voluntary Disclosure Program for domestic or international issues.

Making the Disclosure (Loud versus Quiet)

Currently in the legal profession there are two main schools of thought (and considerable controversy) regarding how to go about making a voluntary disclosure. The first school of thought is that it should be done "quietly" by sending in delinquent original or amended prior tax returns, with a check(s) in full payment through normal channels and gambling that the returns get processed without the taxpayer every hearing from the Criminal Investigation Division of the IRS because of the sheer volume of returns the taxing authority processes. Many Tax Attorneys prefer and thus direct their clients toward this method because in their opinion this method decreases the likelihood that the delinquent original or amended returns will be audited upon submission and avoidance of a perceived negative impact on a taxpayer’s ongoing reputation with the affected taxing authorities which occurs where a taxpayer makes a loud disclosure by knocking on the door of the criminal investigation division and makes the required "loud" admission of the fraudulent activity that is to be corrected.

Our office generally prefers "loud" disclosure over "quite" disclosures because if a taxing authority has begun an investigation prior to receipt of the “quiet” submission the “quite” disclosure will not be deemed to be voluntary and thus will not comply with its Voluntary Disclosure Practice. To make matters exponentially worse, the amended return could potentially be viewed as a criminal admission of the amount by which the tax liability was understated on the original return. Thus the amended returns intended to mitigate the client’s criminal exposure can be used by the IRS to meet its burden of proof as to willfulness (which is by far the hardest element of its case to prove) if it decides to prosecute. Additionally there is some support for a growing government position stemming from the 2009 and 2011 Offshore Voluntary Disclosure Initiatives that a quiet disclosure does not comply with the terms of its Voluntary Disclosure Practice because a quite disclosure bypasses the required communication with the Criminal Investigation Division of the IRS and only the Criminal Investigation Division of the IRS can recommend that the taxpayer not be referred to the Justice Department for Criminal Investigation.

The most common way the government establishes the element of willfulness is to subpoena the original tax preparer, or subsequent non attorney tax adviser, to testify regarding the client's conversations. Many taxpayers mistakenly believe that the communication privilege they enjoy surrounding communications with their CPAs and enrolled agents can be asserted in a criminal matter. Once an attorney has been engaged, the attorney can engage an accountant to assist him in the calculation of the correct tax under a "Kovel letter" in order to bring the client's communications with the accountant within the umbrella of the attorney client privilege.

Once again, the CPA’s first responsibility will be to tell the client to not discuss the matter with the CPA, and consult a tax attorney. Although the purpose of the voluntary disclosure is to prevent cases from becoming criminal, a tax attorney needs to be consulted for various reasons. First, the attorney will need to identify whether the client is eligible for a voluntary disclosure. The attorney needs to contact the IRS with the client’s information and do a “pre-check” to see whether the client can enter the voluntary disclosure process. If the client is accepted in the pre-check stage, the voluntary disclosure can begin. If the client is not accepted, it may mean that a criminal investigation has already begun.

In the voluntary disclosure process, the attorney will use the services of the CPA to amend all false and incorrect previous returns and submit these returns with the extra income, and the penalty calculations associated with the disclosure to the IRS.

Criminal Tax reference tools for CPA's.

The following are just a number of good reference tools for further reading on criminal tax issues:

Criminal Tax Fraud by George Crowley

BNA portfolio on Tax Crimes by Hochman, Perez, Popoff Rettig and Toscher.

BNA Treatise on Criminal Tax, Money Laundering and Bank Secrecy Act Litigation by Peter Hardy.

Tax Fraud & Evasion: Money Laundering, Asset Forfeiture, Sentencing by Harris, Feld, Comisky.

IRS Criminal Tax Bulletin, published Semi-Annually by Office of Chief Counsel Criminal Tax Division.

Client Criminal Matters and the CPA: AICPA Practice Guide by JAMES H. SCHLESSER, CPA

Strategies for Criminal Tax Cases: Leading Lawyers on Navigating Tax Law, Understanding Disclosure Guidelines, and Responding to Government Investigations, by Brian Andreoli and Caroline Ciraolo

Tax Crimes by John Townsend, Larry Capagna et al.

Representation in Criminal Tax Matters, a practical guide by Cary Martinez

California Tax Crimes and Tax Enforcement.

California has very similar statutes regarding tax crimes as the Federal Government. In addition, in California there are some statutes which also makes it a misdemeanor for failure to file or pay, or file a false or fraudulent return, even without a showing of intent or willfulness. Thus

California has a Strict liability statute where a defendant can be convicted for failure to file, regardless of his intent.

The Franchise Tax Board has in recent years stepped up their criminal investigation section. The criminal investigation section states their mission as being to:

- Identify, investigate, and effect prosecution of tax evasion, fraud, and employee misconduct.
- Encourage compliance with the California income tax laws.
- Maintain the public's trust through publicity.

The FTB currently has 42 special agents working in the criminal investigation division.

They maintain case inventories consisting of failure to file, and false income tax return cases; refund fraud cases, and joint task force operation cases. Joint task force operation cases can involve local, state, and/or federal agencies. Crimes typically investigated and prosecuted with income tax violations include identity theft, embezzlement, grand theft, money laundering, workers' compensation insurance fraud, employment taxes and labor crimes, medical fraud, and "capping." Capping is soliciting business for another, and becomes a crime when the business objectives include fraud and deception (recruiting patients for unnecessary medical procedures, for example).

The FTB states that the Special Agents perform most of the duties associated with a “peace officer” role. They write and serve search warrants, gather and analyze evidence, interview witnesses, interrogate suspects, make recommendations to prosecute, serve arrest warrants, assist prosecutors through all stages of the prosecution, track and apprehend fugitives, and monitor terms of probation.

While the FTB Special Agent force is currently relatively small, the FTB has showed intent to pursue criminal matters with vigor. I have had clients come into my office that was part of an FTB sting operation. More than 20 special agents with guns drawn showed up at my client’s home and business simultaneously, for failure to file tax returns. They also visited the client’s CPA at the same time…

Examples of Taxpayers that Ended up on the Wrong Side of Criminal Tax Law and How They Were Punished.

IRS Criminal Investigations usually lead to criminal tax convictions. Below are some recent statistics:

	FY 2011	**FY 2010**	**FY 2009**
Investigations Initiated	4720	4706	4121
Prosecution Recommendations	3410	3034	2570
Information/Indictments	2998	2645	2335
Total Convictions	2350	2184	2105
Total Sentenced*	2206	2172	2229
Percent to Prison	81.7%	81.5%	81.2%

Sentence includes confinement to federal prison, halfway house, home detention, or some combination thereof.

The IRS often prosecutes high profile taxpayers in order to send a message to all citizens that the IRS will prosecute tax crimes.

" That's the way Dad does it on his income tax. "

Recent Examples of Tax Practitioners That Were Prosecuted and What They did Wrong.

The following examples of abusive return preparer investigations are taken from public records consisting of court records in the judicial district in which the cases were prosecuted.

Two CPAs Sentenced in Tax Shelter Case

Chief U.S. District Court Judge John C. Coughenour has sentenced two Anderson's Ark & Associates (AAA) accountants for aiding and assisting in the preparation and filing of fraudulent income tax returns.

Tara LaGrand, of Naples, Florida, was sentenced to 24 months in prison, to be followed by one year of supervised release. Lynden Bridges, of Wheat Ridge, Colorado, was sentenced to

18 months in prison, to be followed by one year of supervised release.

LeGrand and Bridges, each a Certified Public Accountant, were part of AAA, an organization through which fraudulent tax shelters and investment scams were promoted and sold. From 1996 through 2001, AAA had approximately 1,500 clients, nearly 300 of whom reported over $120 million in fraudulent income tax deductions.

California Return Preparer Sentenced for Defrauding IRS of Nearly $8 Million

On April 24, 2012, in Los Angeles, Calif., Mario Placencia, an accountant and tax return preparer, was sentenced to 60 months in prison and ordered to pay $1,213,789 in restitution to the Internal Revenue Service (IRS). Placencia pleaded guilty in July 2011 to two counts of aiding and assisting in the preparation of fraudulent tax returns and one count of submitting false documents to the IRS in an attempt to substantiate the false deductions taken on tax returns. According to the plea agreement, for the tax years 2003 through 2009, Placencia admitted that he caused the government to incur a tax loss of $7,982,043 by intentionally inflating the amounts of home mortgage interest that he reported on his clients' federal income tax returns. Some of Placencia's clients received notices of audits for the 2004, 2005, and 2006 tax years. During the audits, Placencia provided the IRS with false documents to convince auditors that the clients had incurred expenses that he knew the clients had not incurred and were entitled to deductions that Placencia knew had been fabricated.

Former Partner at Major International Accounting Firm Sentenced for Tax Crimes

On April 16, 2012, in Newark, N.J., Stephen A. Favato, of Point Pleasant Beach, N.J., was sentenced to 18 months in prison for tax crimes. Favato was convicted in August 2010 by a jury of one count of corruptly endeavoring to obstruct and impede the Internal Revenue laws and one count of aiding and assisting in the preparation and filing of a false income tax return. Trial evidence proved that from late 2001 through April 2005, Favato attempted to obstruct the IRS by, among other conduct, advising his client on how to include false items on the 2002, 2003 and 2004 joint income tax returns for the client and his then-wife. Additionally, Favato knowingly prepared and signed false joint income tax returns for the client resulting in an over $114,000 tax loss to the IRS for 2002 and attempting to cause an over $70,000 tax loss for tax years 2003 and 2004. Favato advised the client to significantly reduce his salary payments from his corporation and to instead have this compensation paid to a limited liability company, Great Escape Yachts LLC, in the form of purported lease payments for the client's yacht. However, his corporation had not leased the yacht. This course of action enabled the client to fraudulently deduct his personal yacht expenses as business expenses. In addition, Favato advised the client on how to falsely increase his expenses to fraudulently eliminate a portion of the gain on three properties he sold in 2002 and 2004. Favato also advised the client to report inflated charitable contributions on his 2003 tax return.

California Tax Preparer Sentenced for Presenting False Income Tax Returns

On February 6, 2012, in Fresno, Calif., Bertha Renell Vaughn, aka Bertha Renell Milton, of Bakersfield, was sentenced to 30 months in prison, one year of supervised release, and ordered to pay more than $1 million in restitution to the Internal Revenue Service (IRS). Vaughn pleaded guilty in November 2011 to aiding and assisting in the presentation of false income tax returns. According to court documents, Vaughn owned and operated a tax preparation business, Nationwide Tax Solution, also referred to as Vaughn's Tax Service. Vaughn willfully prepared the false income tax returns by adding false items in the return, such as deductions, losses, income, wages, and withholdings. The added items were not claimed by the taxpayers, but were fabricated and created by Vaughn. The more complicated the return, the more Vaughn charged in professional fees to her clients. Vaughn added the false items on the tax return to have the IRS generate a refund to the taxpayer and to charge her clients the higher fees. Documents filed with the court showed that over 90 percent of the taxpayers using Vaughn's services received a tax refund from the IRS.

California Tax Return Preparer Sentenced for Filing Fraudulent Tax Returns

On November 28, 2011, in Los Angeles, Calif., Simon Jenkins, owner of Jenkins Tax Service, was sentenced to 15 months in prison, one year of supervised release, and ordered to pay $238,024 in restitution to the Internal Revenue Service (IRS). Jenkins pleaded guilty in

August 2011 to preparing and filing false tax returns. According to court documents, during the 2005 through 2009 tax filing seasons, Jenkins prepared at least 45 tax returns that contained false information by overstating the amount of one or more items claimed on the tax return. Jenkins prepared tax returns which included false deductions and expenses to obtain larger refunds with the IRS.