

# THE DAILY RECORD

WESTERN NEW YORK'S SOURCE FOR LAW, REAL ESTATE, FINANCE AND GENERAL INTELLIGENCE SINCE 1908

## CivilLITIGATION

# Beware the 'Badges of Fraud' this tax season

Since the 1913 ratification of the Sixteenth Amendment to the U.S. Constitution granting Congress the "power to lay and collect taxes on incomes," taxpayers have been pitted against the government as to their accurate assessment and collection. Nearly a century's worth of litigation on the issue has created and defined the concepts of "tax evasion" and "tax avoidance."

In an effort to maximize receipt of taxes owed, the government has increased its focus on tax fraud. The Internal Revenue Service has acknowledged the fine distinction of discerning between tax avoidance and evasion by establishing two avenues of enforcement — the civil tax audit and the criminal investigation.

When preparing a return for an individual client or a business, the preparer must always be mindful of the risk of triggering an audit to determine civil tax evasion or, worse, criminal activity. Knowing the circumstances that may lead to a criminal investigation will assist the preparer in determining when its time to refer a client to an attorney well versed in such exposure.

### Investigative Stage – Badges of Fraud

Section 25.1.2.3 of the Internal Revenue Manual (IRM) identifies six "badges of fraud" that may prompt an audit. They are a taxpayer's income, expenses or deductions, books and records, allocations of income, conduct and methods of concealment.

In the context of taxpayer conduct, for example, indicators of fraud include: (a) false statements about material facts during the audit; (b) attempts to hinder the audit by failing or refusing to answer questions, cancelling appointments, or refusing to supply complete and accurate records; (c) testimony of third parties (e.g. employees) about irregular business practices; (d) destruction of books and records; and (e) transfers of assets for purposes of concealment. An agent may initiate an audit based on relatively ambiguous conduct. The IRM states that "[u]nusual,

inconsistent or incongruous items should alert examiners to the possibility of fraud and the need for further investigation. Taxpayer misconduct should be an early warning sign of possible fraudulent conduct."

Revenue agents are trained on the importance of the "initial contact" with the taxpayer as it provides "the opportunity to obtain valuable information which may not be readily available later." Agents will document all statements made by a taxpayer as well as a filer's failure to respond to questions.

The Fraud Development Procedures in IRM 25.1.2.2 provide that, when signs of fraud are uncovered, an agent is to take the matter to their group manager. If the group manager concurs that there are indicators of fraud warranting fraud development, the compliance employee is to contact the fraud technical advisor assigned to that area.

If the case is ultimately placed in fraud development status, a plan of action is formulated as early as possible to develop and document affirmative acts of fraud. Note that some cases may not require a face-to-face meeting with the fraud technical advisor. Although in-person interviews are preferred, consultations may occur over the telephone or by email.

Several warning signs that an audit may turn into a criminal investigation include a period of unexplained silence from the agent after some investigative activity. This may be the result of the agent's consultation with a fraud specialist regarding a potential criminal fraud referral. Another red flag is the refusal of the agent to discuss the status of the audit or its conclusion. The government may also issue subpoenas or request information from third parties (e.g. banks, suppliers, or customers).

### Referral to Tax Counsel

A taxpayer may be inclined to continue to work with an accountant even after issues of fraud arise. A fraud investigation

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will generate anxiety and a client may be eager to simply see the investigation conclude rather than face the uncertainty and/or embarrassment of IRS agents contacting business associates and family members as part of their examination.

This may result in the taxpayer directing the return preparer to cooperate with the government. However, due to potential criminal prosecution, it is extremely important for the preparer to instruct the client to retain a criminal tax attorney as early in the course of the proceedings as possible, and before voluntarily providing significant information.

The advice to hire tax counsel is not mandated by differences in expertise of attorneys and accountants but rather by the rules of privileged communications. There is no state or federal accountant-client privilege that may protect the shared information and work product of the accountant. Note, however, that information obtained from an accountant hired by counsel for forensic accounting analysis is privileged as attorney work product.

It is also important to remember that the attorney represents the interests of the taxpayer and not the accountant. Since revisions to the definitions of criminal tax fraud in the New York Tax Law, return preparers face criminal exposure for assistance in a scheme to defraud the Department of Tax. As a result, a return preparer with concerns about his or her own conduct related to a client's alleged scheme to defraud is advised to retain separate, personal counsel.

Once a client retains tax counsel, it's important for the return preparer to limit their role, regardless of one's experience or rapport with a client, due to the limitations of privilege. This will prevent the preparer from developing knowledge that he or she may later have to surrender to the government. In addition, delinquent or amended returns should not be filed unless and until directed by counsel.

Care should be taken in this circumstance as information on a current return may provide evidence for a fraud investigation into conduct extending over several years. Although an ongoing criminal investigation does not exempt a taxpayer from filing a currently owed return, the taxpayer's attorney will need to

develop a defense and to ensure that there is no continuing fraudulent activity.

## **Special Agents**

Audits are conducted by agents who, as employees of the IRS, are instructed to notify the proper officials once badges of fraud are discovered. The criminal investigation will be conducted by a Revenue Crimes Specialist and/or a Special Agent of the U.S. Treasury. Taxpayers are well advised to exercise their right to remain silent and immediately contact an attorney if a special agent appears at their doorstep.

Special agents almost always arrive in pairs and they will have already established a significant portion of their case. Additional agents will often appear, simultaneously, at the taxpayer's residence and at the residences or places of business of potential witnesses. If a special agent attempts to interview a return preparer in connection with tax compliance work, then the accountant should request that the client's attorney also attend. While not acting as the accountant's attorney, the presence of the taxpayer's counsel will allow for better monitoring of the progress of the investigation and will ultimately help to protect the taxpayer's rights.

## **Summary**

Although one can not predict a tax audit or its conversion into a criminal investigation, it is necessary for tax practitioners to know the procedure and steps of a civil tax case. One must be intimately familiar with the facts and prepare appropriate responses in anticipation of the government's discovery of "badges of fraud" during audit.

A client should be advised of the risks of acquiring additional badges during an investigation as well as the need to obtain criminal tax counsel early in the process and before voluntarily providing harmful information.

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