HOW TO IDENTIFY, PREPARE FOR AND SUCCEED IN AN IRS EGGSHELL EXAMINATION

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I. INTRODUCTION

Any IRS exam can be a nerve-wracking experience for a tax advisor. If there is a large mistake or pattern of mistakes, an ordinary exam may become an eggshell exam requiring much thought and skill to come through the exam unscathed. This article will address the IRS exam areas that can lead to IRS eggshell exams, the IRS tactics and, finally, steps a tax advisor can take to minimize the negative consequences.

II. RECENT IRS FOCUS: WHY ARE WE HERE?

A. DOMESTIC EMPHASIS

In the last decade, coverage rates and audit rates for small business entities and high-net-worth individuals have grown significantly. In the last 10 years, for example, audit rates for pass-through entities, such as S Corporations, have increased nearly 300% and Partnership examinations have increased nearly 240%.[1] Indeed, it seems this trend will continue. Former Commissioner of the Small Business/Self-Employed Division of the Internal Revenue Service (IRS), Faris Fink, confirmed in 2013 that the audit coverage at the Small Business/Self-Employed Division of the IRS (SB/SE) is at a recent high, and that SB/SE will "continue [to heavily audit] the high income/high wealth group."[2]Another focus of the IRS is seen through the Global High Wealth Industry Group, also known as the "Wealth Squad."[3] This group targets individuals with $10 million or more in income or assets and conducts each examination of these high-net-worth individuals holistically, by examining all the taxpayer's investments, including

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[1] Internal Revenue Service Fiscal Year 2013 Enforcement and Service Results, *available at* http://www.irs.gov/PUP/newsroom/FY%202013%20Enforcement%20and%20Service%20Results%20--%20WEB.pdf (applies to all bullets under "Entity Examinations" Heading).

[2] T. Steel Rose, *A Sit Down with IRS Commissioner Faris Fink*, CPA Magazine (December/March 2013), *available at* http://www.cpataxmag.net/cover-stories/56-decembermarch-cover-story/484-a-sit-down-with-irs-commissioner-faris-fink46.

[3] *See Holistic Audits: The Price of Being Rich*, Tax Practice, Kathryn Keneally and Charles P. Rettig page 18.

related business enterprises. Moreover, the IRS has also expressed a continued focus on documented abusive transactions and has published listed transactions labeled "Recognized Abusive and Listed Transactions," for which it is always on the lookout.[4]

B. INTERNATIONAL EMPHASIS

The Foreign Account Tax Compliance Act (FATCA) was enacted in March 2010 by the United States Congress as part of the Hiring Incentives to Restore Employment (HIRE) Act.[5] Congress' main purpose in passing FATCA was to target and combat non-compliant U.S. taxpayers that utilize foreign or offshore accounts to hold undeclared assets.[6] Under FATCA, Foreign Financial Institutions (FFIs) are required to report information on their U.S. account holders to the IRS, and other foreign entities must provide information regarding their beneficial owners to U.S. withholding agents.[7] However, because FFIs in jurisdictions such as Switzerland, the Cayman Islands, and Dubai have a long history of zealously protecting the identity of their banking clients as required by their sovereign law[8], individuals have asked why businesses in these countries would feel compelled to abide by FATCA. The answer is relatively simple: "Because "FFIs that do not sign an IRS agreement will face withholding on U.S.-source interest

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[4] IRS, *Recognized Abusive and Listed Transactions*, http://www.irs.gov/Businesses/Corporations/Listed-Transactions---LB&I-Tier-I-Issues.

[5] FATCA refers to sections 1471-74 of the Internal Revenue Code (1986) as amended. I.R.C. §§ 1471-74 (2012).

[6] *See* Department of the Treasury, http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx. Indeed, sections 1471-1474 fall under "Chapter 4—Taxes to Enforce Reporting on Certain Foreign Accounts" of Subtitle A of the Internal Revenue Code.

[7] *See generally* Reporting and Withholding by FFIs, Prop. Treas. Reg. §1.1471-1, 77 Fed. Reg. 9022 (Feb. 15, 2012).

[8] *See generally* Emily Wang, *The Opaque Future of Tax Information Sharing Between the United States and China: An Analysis of Bank Secrecy Laws and the Likelihood of Entrance into a Tax Information Exchange Agreement*, 35 **Hastings Int'l & Comp. L. Rev.** 411, 414-25 (2012) (describing how offshore accounts facilitate tax evasion especially in foreign jurisdictions that have strict bank secrecy laws).

and dividends, gross proceeds from the disposition of U.S. securities, and pass-thru payments."[9]

The withholding amount is *significant*: 30% on all U.S. and certain non-U.S. payments, and it is treated as a tax.[10] One need not be an astute businessman to know that a 30% "tax" in addition to regular taxes paid by an entity is unbelievably cumbersome. Indeed, "[s]anctions for FATCA noncompliance are so severe that failure to undertake the requisite reporting and disclosure can conceivably result in penalties in excess of the unreported foreign assets."[11] As a result, it is unsurprising that FATCA has caught the attention of international banks. Assuming that an FFI bites the bullet and agrees to enter into an agreement with the IRS, thereby avoiding the imposition of a 30% withholding tax, the FFI is now faced with an affirmative obligation to provide a bevy of information to the U.S. Government.[12] Under this obligation, FFIs must submit the name, address, and TIN of each account holder and, in the case of any account holder which is a United States owned foreign entity, the name, address, and TIN of each substantial United States owner of such entity, the account number, the account balance, and the gross receipts and gross withdrawals or payments from the account (in such manner as the Secretary may provide).[13]

Foreign countries and their constituent corporate entities are now stuck between two unappealing alternatives: give over client information which their sovereign law deems to be confidential, or attempt to avoid the FATCA altogether by ridding themselves of all U.S. clients

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[9] Behrens, Frederic. Comment. *Using A Sledgehammer to Crack A Nut: Why FACTA Will Not Stand*, 2013 **WIS. L. REV.** 205 (2013).

[10] 26 U.S.C. § 1472(a)(1)-(2) (2012).

[11] NATIONAL TAXPAYER ADVOCATE, 2013 ANNUAL REPORT TO CONGRESS at 238, *available at* http://www.taxpayeradvocate.irs.gov/2013-Annual-Report/full-2013-annual-report-to-congress/.

[12] 26 U.S.C. § 1471(a), (c).

[13] 26 U.S.C. § 1471(c)(1)(A)-(D).

and investments.[14] Unfortunately, some FFIs are choosing the latter and, as a result, are shedding those customers required to file U.S. tax returns. Indeed, in the wake of FATCA, some notable FFIs, such as DeutcsheBank, HSBC, and ING have begun purging the foreign accounts held at their institutions by those subject to U.S. tax reporting.[15] These FFIs are simply weighing the cost of the client versus the significant costs of compliance with the unwieldy regulation. Therefore, similar to FFIs, taxpayers with foreign account holdings are now faced with a new reality – report their holdings to the IRS or be reported by their banks.

C. DOMESTIC & OFFSHORE VOLUNTARY DISCLOSURE PROGRAMS

Nevertheless, taxpayers need not fear that past noncompliance with reporting requirements leaves them with no option but to wait for an IRS examination or investigation. Rather, the IRS has adopted a voluntary disclosure process, the Offshore Voluntary Disclosure Initiative (OVDI), which was first announced in March 2009. Though this article will not discuss the requirements for participation in the OVDI, it is beneficial for individuals and their representatives to know there is an option to "get a pass" for past noncompliance.

The OVDI allows U.S. taxpayers with unreported foreign accounts the opportunity to be in compliance with U.S. tax laws, avoid criminal charges, and reduce civil penalties by voluntarily disclosing foreign account holdings to the IRS.[16] After this temporary program was

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[14] Alison Bennett, *Tax Legislation: Dozens of Stakeholders from around Globe Raise Concerns on FATCA Regime*, 29 **TAX MGMT. WKLY. REP.** 1535 (2010).

[15] Rowan Morrison, *When Banks Pay the Price*, **Editions Financial** (Aug. 30, 2012), *available at* http://www.editionsfinancial.co.uk/2012/08/30/when-banks-pay-the-price/; *see also* Sofia Yan, *Banks Lock out Americans Over New Tax Law*, **CNNMoney** (Sept. 15, 2013), available at http://money.cnn.com/2013/09/15/news/banks-americans-lockout.

[16] *See* IRS, *Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers* (June 26, 2012), http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers.

met with success in 2009, the IRS and Department of Justice determined that a similar program would be available in 2011.[17] The success of the OVDI from 2009-2011 was tangible – over 33,000 U.S. taxpayers avoided criminal prosecution and participated in 2009 and 2011, resulting in the collection of over $5 billion in unpaid taxes, interest, and penalties.[18] The IRS continues to run an offshore voluntary disclosure program today.

Similar to the OVDI, taxpayers who have underreported or failed to report income items to the IRS can benefit from enrollment in the Domestic Voluntary Disclosure Program (DVDP).[19] Enrollment in this program requires a submission of a taxpayer's identification information to the IRS Criminal Investigation (CI) Division, and is usually recommended when a taxpayer has engaged in willful conduct that may subject them to the 75% fraud penalty or criminal prosecution.

D. SOURCES THAT CAN TRIGGER IRS EXAMS

There are a myriad of ways in which a taxpayer can find themselves subject to IRS examination or investigation, whether through bad luck, poor decisions, or hidden informants.[20] Informants come in all varieties, and include old-fashioned revenge informants, such as ex-spouses or disgruntled employees, that can alert the IRS of a taxpayer's failure to report income. Similarly, greedy informants, also known as "whistleblowers," motivated by a reward of up to 10% of the tax and penalty ultimately recovered by the IRS under I.R.C. § 7023 also exist. As

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[17] *See generally* Kevin E. Packman, *IRS Renews Its Focus on Unreported Foreign Accounts and Assets: The 2011 Disclosure Program*, 114 **J. Tax.** 197 (Apr. 2011).

[18] IR-2012-64, *IRS Says Offshore Effort Tops $5 Billion, Announces New Details on the Voluntary Disclosure Program and Closing of Offshore Loophole* (6/26/12), available at www.irs.gov/uac/IRS-Says-Offshore-Effort-Tops-$5-Billion,-Announces-New-Details-on-the-Voluntary-Disclosure-Program-and-Closing-of-Offshore-Loophole).

[19] http://www.irs.gov/uac/How-to-Make-a-Domestic-Voluntary-Disclosure

[20] IRM 4.16.1.4.2, Internal Revenue Manual (June 14, 2011).

seasoned tax advisors know, revenge informants and greedy informants are not mutually exclusive. Moreover, a taxpayer or tax preparer can find themselves under investigation after being the subject of "sting" cases, such as the old business buyer trick and/or through a hidden video camera in the tax preparer's office. Additionally, an examination of a taxpayer can be intensified when a civil examination is referred through a Fraud Technical Advisors (FTA) or a civil collection case is referred through a FTA.[21] Finally, an exam can be conducted by the Special Enforcement Program (SEP) exam team of SB/SE from initiation[22], or commence as a result of (1) a spinoff from another taxpayer's IRS formal/loud voluntary disclosure, (2) Lead Development Centers (newspapers, internet articles, court filings), or (3) a referral from other Government agencies.[23]

E. VOLUNTARY DISCLOSURE TIMING ISSUES

Taxpayers can also make a voluntary disclosure to the IRS before they are confronted by IRS examination. A voluntary disclosure must be truthful, timely, and complete.[24] Moreover, the taxpayer must be cooperative in determining the appropriate tax liability, and also make a good faith effort to pay the tax, interest, and penalties in full.[25] Furthermore, the general rule is that a voluntary disclosure is not timely if the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence an examination or investigation.[26] However, a voluntary disclosure is still timely when it is a

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[21] IRM 25.1.6.2, Internal Revenue Manual (Oct. 30, 2009).

[22] IRM 4.16.1.3.1, Internal Revenue Manual (June 14, 2011).

[23] IRM 4.16.1.4.2, Internal Revenue Manual (June 14, 2011).

[24] IRM 9.5.11.9, Internal Revenue Manual (Dec. 2, 2009).

[25] *Id.*

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.[27] On the other hand, a voluntary disclosure is not timely if it is made by a taxpayer who is not currently under examination or investigation, or omitted gross receipts from a partnership, but whose partner is already under investigation for omitted income skimmed from the partnership.[28] This is not deemed to be a voluntary disclosure because the IRS has already initiated an investigation which is directly related to the specific liability of this taxpayer, and the conclusion would be the same whether or not the taxpayer knew of the ongoing investigation.[29] As such, it is more important than ever for taxpayers to be proactive in reporting past noncompliance with reporting obligations.

III. INCREASED FREQUENCY OF EGGSHELL AUDITS AND TAXPAYER'S GOALS IN AN EGGSHELL AUDIT

Eggshell audits are expected to increase in light of the continuing efforts of the IRS to mine sources of information for potential fraudulent activities. The return preparer in these cases will become aware of the problems that will likely be discovered by an IRS examiner.[30] The main goals of an eggshell audit are to avoid a criminal referral to the IRS Criminal Investigation (CI) division, avoid the 75% civil fraud penalty[31] under I.R.C.§ 6663, and ensure that a

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[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] Larry A. Campagna, Caroline D. Ciraolo, & Eric L. Green, *The Eggshell Audit Part I: A Primer*, J. Tax Prac. & Proc., June-July 2012, at 29.

[31] *See Ward v. Comm'r*, T.C. Memo. 2013-133 (May 29, 2013), which details the factors utilized by the court in determining whether a 75% civil fraud penalty applies.

reasonable tax deficiency assessment does not unduly take advantage of the taxpayer's current "eggshell" situation.

IV. INVESTIGATING FRAUD: WHAT WILL THE IRS DO?

A. OVERVIEW

The IRS has a multitude of weapons at their disposal in investigating improper actions by taxpayers. However, taxpayers and their representatives have one distinct advantage when it comes to predicting the moves of the IRS. This advantage is found in the Internal Revenue Manual (IRM). Because the IRS should follow the protocol detailed in the IRM, and that protocol is published, taxpayers and their representative can understand the IRS examination process more fully. Indeed, the "Overview" section of each "Part" of the IRM will provide that the IRM handbook is a guide for IRS employees. For example, in regards to examination of fraud under the IRS' National Fraud Program, the applicable section of the IRM states that "[t]his handbook is a comprehensive guide for IRS employees service-wide in the recognition and development of potential fraud issues; referrals for criminal fraud; duties and responsibilities in joint investigations; civil fraud cases; and other related fraud issues."[32] Additionally, the IRM provides that "[t]he primary objective of the fraud program is to foster voluntary compliance through the recommendation of criminal prosecutions and/or civil penalties against taxpayers who evade the assessment and/or payment of taxes known to be due and owing."[33]Moreover, the IRM guides IRS examiners that "[t]he discovery and development of fraud are the result of effective investigative techniques."[34]

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[32] IRM 25.1.1.1, Internal Revenue Manual (Jan. 23, 2014).

[33] *Id.*

[34] *Id.*

Techniques employed by examiners are designed to disclose not only errors in accounting and application of tax law, but also irregularities that indicate the possibility of fraud."[35] As a general rule, for fraud to be considered by the IRS, an IRS employee must show either (i) an additional tax due and owing due to a deliberate intent to evade tax or (ii) the willful and material submission of false statements or false documents in connection with an application and/or return.[36] Notably, the FTA will be consulted in all cases involving potential criminal and civil fraud and will play a vital role in the development of a potential fraud case.[37] When an examiner suspects indicators of fraud (i.e. "Badges of Fraud"), the employee will discuss the case at the earliest possible opportunity with his/her manager.[38] Unsurprisingly, compliance managers will encourage the early involvement of the FTA in all potential fraud cases.[39]

B. CIVIL VS. CRIMINAL FRAUD PENALTIES AND AVOIDANCE VS. EVASION

Tax fraud offenses may result in both civil and/or criminal penalties. However, there are a few differences between criminal and civil fraud cases, most notably, the burden of proof to be satisfied by the Government. In criminal cases, the Government must present sufficient evidence to prove guilt beyond a reasonable doubt.[40] On the other hand, in civil fraud cases, the

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[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] IRM 25.1.1.2.2, Internal Revenue Manual (Jan. 23, 2014). "Reasonable doubt" is defined as "a doubt that would cause a prudent person to hesitate before acting in matters of importance to themselves. Such a doubt will leave a juror's mind uncertain after examination of the evidence." *See* IRM 25.1.1.2.1, Internal Revenue Manual (Jan. 23, 2014).

Government must prove fraud by clear and convincing evidence.[41] Other noteworthy differences between civil and criminal fraud cases are the potential resulting penalties. "Criminal fraud results in a punitive action with penalties consisting of fines and or imprisonment, and criminal penalties:

- Are enforced only by prosecution;
- Are provided to punish the taxpayer for wrongdoings; and
- Serve as a deterrent to other taxpayers."[42]

Meanwhile, "[c]ivil fraud results in a remedial action taken by the Government such as assessing the correct tax and imposing civil penalties as an addition to tax, as well as retrieving transferred assets."[43] Furthermore, civil penalties are assessed and collected administratively as part of the unpaid balance of assessment.[44]

Just as there is a distinction between the burden of proof for civil and criminal penalties, there is also a fine delineation between an individual legally avoiding taxes and an individual running afoul of the law by evading taxes. Taxpayers have the right to reduce, avoid, or minimize their taxes by legitimate means, and a taxpayer that avoids tax does not conceal or misrepresent, but rather shapes and preplans events to reduce or eliminate tax liability within the parameters of the law.[45] On the other hand, evasion involves some affirmative act to evade or

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[41] IRM 25.1.1.2.2. Internal Revenue Manual (Jan. 23, 2014). "Clear and convincing evidence" is defined as "evidence showing that the assertion made is highly probable or reasonably certain. This is a greater burden of proof than preponderance of the evidence but less than beyond a reasonable doubt." *See* IRM 25.1.1.2.1, Internal Revenue Manual (Jan. 23, 2014).

[42] IRM 25.1.1.2.3, Internal Revenue Manual (Jan. 23, 2014).

[43] *Id.*

[44] *Id.*

[45] IRM 25.1.1.2.4, Internal Revenue Manual (Jan. 23, 2014).

defeat a tax, or payment of tax. Examples of affirmative acts include deceit, subterfuge, camouflage, concealment, attempts to color or obscure events, or any act done to make things seem different than they truly are.[46] Common evasion schemes include:[47]

- Intentional understatement or omission of income;
- Claiming fictitious or improper deductions;
- False allocation of income;
- Improper claims, credits, or exemptions; and/or
- Concealment of assets.

C. INDICATORS ("BADGES") OF FRAUD VS. AFFIRMATIVE ACTS OF FRAUD

Taxpayers who knowingly understate their tax liability often leave evidence in the form of identifying earmarks or indicators (also known as "badges") of fraud that provide a sign or symptom that actions may have been done for the purpose of deceit, concealment or to make things seem other than what they are.[48] IRS examiners undergo intense training to identify these first badges of fraud. "Examples include substantial unexplained increases in net worth, substantial excess of personal expenditures over available resources, bank deposits from unexplained sources substantially exceeding reported income, and documents that appear to be altered or false."[49] Exhibit 1 of this article provides a non-exhaustive list of examples of the badges of fraud contained in the IRM, broken down by category.[50]

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[46] *Id.*

[47] *Id.*

[48] IRM 25.1.1.3, Internal Revenue Manual (Jan. 23, 2014).

[49] *Id.*

[50] IRM 25.1.2.3, Internal Revenue Manual (Apr. 24, 2014).

In contrast to badges of fraud, taxpayers can also engage in affirmative actions that *establish* that a particular action was deliberately done for the purpose of deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events, or make things seem other than what they are.[51] Significantly, fraud cannot be established without proof of affirmative acts of fraud.[52] Examples include omissions of specific items where similar items are included; concealment of bank accounts or other assets; failure to deposit receipts to business accounts; and covering up sources of receipts.[53]

D. FRAUD DEVELOPMENT PROCEDURES, FRAUD PLAN, AND EXAMPLES OF FRAUD INDICATORS

After reviewing the potential fraud indicators and possible barriers to a successful referral, if the examiner, examiner's group manager, and FTA agree the potential for fraud exists, a plan is implemented that outlines the steps required to establish affirmative acts (proof) of fraud, and the case is subsequently placed in fraud development status.[54] This results in the examiner preparing Form 11661: Fraud Development Recommendation—Examination or Form 11661-A: Fraud Development Recommendation—Field Collection.[55]

The examiner then proceeds with the plan until affirmative acts of fraud are established or a determination is made that the potential for fraud no longer exists. If affirmative acts of fraud are established:[56]

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[51] *Id.*

[52] *Id.*

[53] *Id.*

[54] IRM 25.1.2.2, Internal Revenue Manual (Apr. 24, 2014).

[55] *Id.*

[56] *Id.*

1. The examiner must suspend collection or examination activity, and immediately notify the group manager and the FTA.
2. The FTA recommends a referral to Criminal Investigation (CI), if criminal criteria are met (see IRM 25.1.3, Criminal Referrals).
3. If criminal criteria has not been met or the case is returned by CI subsequent to a criminal investigation, the IRS will consider imposition of:
   a. the civil fraud penalty under IRC 6663 and/or
   b. the fraudulent failure to file penalty under IRC 6651(f), and/or
   c. the 10-year earned income tax credit (EITC) ban under IRC 32(k).

Notably, the decision to impose any of these punishments is the shared responsibility of the examiner, the examiner's group manager and the FTA. The final decision rests with the examiner's group manager.[57]

E. INVESTIGATIVE TECHNIQUES AND PENALTIES FOR AIDING AND ABETTING

The minimum plan of action for the examiner must include following up on all leads identified as fraud indicators (signs or symptoms); securing copies of all relevant data relating to indicators of fraud; and noting the individuals or persons who provided the leads and when that information was obtained.[58] Unusual, inconsistent or incongruous items will alert examiners to the possibility of fraud and will be subject to further investigation.[59] As such, examiners will attempt to secure the taxpayer's explanation(s) for any discrepancies.[60] In doing so, the IRS understands that the first contact with the taxpayer offers the most valuable opportunity to obtain

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[57] *See* IRM 25.1.6.2, Internal Revenue Manual (Oct. 30, 2009).

[58] IRM 25.1.2.4, Internal Revenue Manual (Apr. 24, 2014).

[59] *Id.*

[60] *Id.*

useful information and records.[61] This first contact is often the most damaging aspect of the examination for a taxpayer who is misunderstood by or, worse, lies to the examiner.

IRS examiners are also directed to document, (verbatim) the questions asked of, and the answers provided from, the taxpayer, and to also record nonresponsive answers.[62] Significantly, examiners are given discretion in deciding what information is relevant to the fraud inquiry, and are given permission to utilize affidavits as a tool in their investigation.[63]

In cases where a return has not been filed and fraud is suspected, the examiner cannot demand a return from the taxpayer.[64] The IRS wants the examiner to avoid soliciting the return. Rather, a Letter 3798, Non-filer Appointment Letter, in place of the regular initial appointment letter, will be used. Nonetheless, books and records pertaining to the unfiled year(s) will still be requested from the taxpayer.[65] While fraud may be present in any type of tax return, and committed by taxpayers with various levels of sophistication, the IRS has noted that most fraud cases involve individual and business taxpayers with poor or nonexistent internal controls, and/or where there is little or no separation of duties.[66]

In regards to workpapers completed during the examination, the examiner is directed to record the tax year, the date of the contact, who was present during the contact, and the author of

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[61] *Id.*

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] *Id.*

the examination work papers. Furthermore, the examiner must include the following information on examination work papers:[67]

- Who prepared the information used to complete the tax return,
- Who approved and classified expense items,
- Who deposited business receipts, and
- How business gross receipts, per the tax return, were determined.

Additionally, the examiner must prepare a Memorandum of Interview, summarizing information obtained and statements made. This becomes part of the Collection case file or Examination work papers, and aids in the fraud development.[68] The IRS also directs examiners to probe beneath the surface to validate and determine the consistency of information provided and to formulate statements to evaluate the credibility of evidence and testimony provided by the taxpayer. Amazingly, the IRM emphasizes that fraud is not ordinarily discovered when the examiner readily accepts the completeness and accuracy of records presented and explanations offered by the taxpayer.[69]

Taxpayers and their tax advisors must also be aware of penalties that can be imposed for aiding and abetting the understatement of tax liability. For an individual that aids and abets an understatement of tax liability, civil penalties apply under I.R.C. § 6701.[70] An individual who willfully aids and assists with the understatement of a tax liability can also be criminally charged

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[67] *Id.*

[68] *Id.*

[69] *Id.*

[70] IRM 25.1.2.5, Internal Revenue Manual (Apr. 24, 2014).

under I.R.C. § 7206(2).[71] To be charged, an individual must be directly involved in the preparation or presentation of the false or fraudulent document. These individuals can include independent parties such as lawyers, accountants, return preparers, and appraisers who counsel on a course of action.[72] Thus, it is possible for criminal referrals and/or civil penalties to apply to both the taxpayer and the person assisting the taxpayer.[73]

V. WHAT CAN WE DO?

A. PRE-EGGSHELL AUDIT INTERNAL INVESTIGATIONS

Counsel for taxpayers can provide valuable advice to clients before the need for an eggshell audit arises. This can be done by keeping a pulse on clients' activities. For example, periodic discussions and questions with clients can foster proactive discovery of non-compliant issues that can be addressed before IRS involvement. For example, counsel can conduct internal investigations of the individual taxpayer and small businesses, medium-sized businesses, large entities (such as corporations, partnerships, and LLCs), and family offices in search of traditional red flags that may trigger an IRS examination. Subsequent to the internal investigation, counsel can then produce internal investigation findings to the taxpayer. Significantly, it is imperative that taxpayer counsel ensure that the internal investigation and drafted internal investigation report is appropriately documented to preserve all applicable privileges, especially the attorney-client privilege. Notably, the internal investigation may look much different if the attorney represents the corporation/entity as opposed to an employee/individual. Thereafter, counsel can

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[71] *Id.*

[72] *Id.*

[73] *Id. See also* IRM 4.32.2.1, Internal Revenue Manual (June 8, 2012).

approach the Government through a formal or informal disclosure program, such as the OVDP and DVOP, and offer to timely file a voluntary disclosure.[74]

B. ACTION AFTER IRS CONTACT AND RELATED ISSUES

If the client has already been contacted by an examining agent of the IRS, there are important first steps to take before any formal action is taken in responding to IRS inquiries. An obvious, but extremely important step is to determine what type of IRS individual is performing the investigation. An examiner's title can provide valuable indications of the type of examination or investigation that will ensue. As such, it is imperative to determine whether a taxpayer is dealing with a Revenue Officer, Revenue Agent, a Revenue Agent from the SEP, a FTA, or a Special Agent. Furthermore, ask for, and maintain, a copy of the IRS agent's card in your records.

It is also important to be aware of potential traps and issues. As noted in Part V.A. above, protect all privileges, including the attorney-client privilege, the accountant-client privilege under I.R.C. § 7525, constitutionally provided Fifth Amendment privilege, any joint defense agreement privilege, and any spousal privilege. Caution must be exercised when providing written or oral information to the IRS, and one must take care to ensure that an inadvertent waiver of one or all of the above privileges does not result. Specifically, there is a high probability that if the taxpayer talks to the IRS, the taxpayer will not only waive their privilege, but may also be misunderstood, make inadvertent misstatements, or may outright lie to IRS agents. As a result, it is important that the tax advisor avoid any entre nous, i.e. "just between us" conversations with the IRS agent.

It should be the expectation of the client and the tax advisor that every conversation with any IRS employee will subsequently be memorialized by the examiner in the exam contact sheet

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[74] See discussion infra Part I. Recent IRS Focus: Why are We Here?

and/or a memorandum of interview. Because there is a high likelihood that the taxpayer will be approached by an IRS agent without the taxpayer's representative present, it is important that the taxpayer know that there are multiple alternatives. First, the taxpayer can politely refuse to speak with the IRS agent by simply telling the agent they are not going to talk without counsel present. At a later date, the tax advisor can also agree to a limited scope interview at another time or an interview with written questions and answers.

Issues regarding current and past-due returns are also present in an examination, such as an IRS agent's solicitation that previously unfiled returns be filed. Other practical issues arise, such as ensuring that all tax returns filed after the beginning of the examination are correct. It is wise for the taxpayer to exercise any extensions for their tax returns at that time as well. Moreover, there are also some Fifth Amendment protections that may be available with the tax return for specific line items.

Finally, in some cases, it is necessary to "waive the white flag." In cases where no meaningful substantive or factual arguments will aid in a favorable resolution to the client's tax matter, the taxpayer may consider whether to concede and accept their wrongdoings. While this path may result in a myriad of substantive tax issues and penalties, even the 75% civil fraud penalty, it may ultimately bring closure to a bad scenario.

V. <u>CONCLUSION</u>

A close look at the IRM Sections on fraud and fraud development are sobering. The IRS is doing its homework in these cases, and tax advisors must do the same. Often, the returns in issue were prepared many years ago, and the background facts need to be developed. The exercise of extreme due diligence cane make the difference between a fraud case and an ordinary exam.

EXHIBIT 1: INDICATORS ("BADGES") OF FRAUD

1. **Indicators of Fraud—Income**
   - A. Omitting specific items where similar items are included.
   - B. Omitting entire sources of income.
   - C. Failing to report or explain substantial amounts of income identified as received.
   - D. Inability to explain substantial increases in net worth, especially over a period of years.
   - E. Substantial personal expenditures exceeding reported resources.
   - F. Inability to explain sources of bank deposits substantially exceeding reported income.
   - G. Concealing bank accounts, brokerage accounts, and other property.
   - H. Inadequately explaining dealings in large sums of currency, or the unexplained expenditure of currency.
   - I. Consistent concealment of unexplained currency, especially in a business not routinely requiring large cash transactions.
   - J. Failing to deposit receipts in a business account, contrary to established practices.
   - K. Failing to file a tax return, especially for a period of several years, despite evidence of receipt of substantial amounts of taxable income.
   - L. Cashing checks, representing income, at check cashing services and at banks where the taxpayer does not maintain an account.
   - M. Concealing sources of receipts by false description of the source(s) of disclosed income, and/or nontaxable receipts.
2. **Indicators of Fraud—Expenses or Deductions**
   - A. Claiming fictitious or substantially overstated deductions.
   - B. Claiming substantial business expense deductions for personal expenditures.
   - C. Claiming dependency exemptions for nonexistent, deceased, or self-supporting persons. Providing false or altered documents, such as birth certificates, lease documents, school/medical records, for the purpose of claiming the education credit, additional child tax credit, earned income tax credit (EITC), or other refundable credits.
   - D. Disguising trust fund loans as expenses or deductions.
3. **Indicators of Fraud—Books and Records**
   - A. Multiple sets of books or no records.
   - B. Failure to keep adequate records, concealment of records, or refusal to make records available.
   - C. False entries, or alterations made on the books and records; back-dated or post-dated documents; false invoices, false applications, false statements, or other false documents or applications.
   - D. Invoices are irregularly numbered, unnumbered or altered.
   - E. Checks made payable to third parties that are endorsed back to the taxpayer. Checks made payable to vendors and other business payees that are cashed by the taxpayer.
   - F. Variances between treatment of questionable items as reflected on the tax return, and representations within the books.
   - G. Intentional under- or over-footing of columns in journal or ledger.
   - H. Amounts on tax return not in agreement with amounts in books.
   - I. Amounts posted to ledger accounts not in agreement with source books or records.
   - J. Journalizing questionable items out of correct account.
   - K. Recording income items in suspense or asset accounts.
   - L. False receipts to donors by exempt organizations.
4. **Indicators of Fraud—Allocations of Income**
   - A. Distribution of profits to fictitious partners.
   - B. Inclusion of income or deductions in the tax return of a related taxpayer, when tax rate differences are a factor.
5. **Indicators of Fraud—Conduct of Taxpayer**
   - A. False statement about a material fact pertaining to the examination.
   - B. Attempt to hinder or obstruct the examination. For example, failure to answer questions; repeated cancelled or rescheduled appointments; refusal to provide records; threatening potential witnesses, including the examiner; or assaulting the examiner.
   - C. Failure to follow the advice of accountant, attorney or return preparer.
   - D. Failure to make full disclosure of relevant facts to the accountant, attorney or return preparer.
   - E. The taxpayer's knowledge of taxes and business practices where numerous

questionable items appear on the tax returns.

F. Testimony of employees concerning irregular business practices by the taxpayer.
G. Destruction of books and records, especially if just after examination was started.
H. Transfer of assets for purposes of concealment, or diversion of funds and/or assets by officials or trustees.
I. Pattern of consistent failure over several years to report income fully.
J. Proof that the tax return was incorrect to such an extent and in respect to items of such magnitude and character as to compel the conclusion that the falsity was known and deliberate.
K. Payment of improper expenses by or for officials or trustees.
L. Willful and intentional failure to execute pension plan amendments
M. Backdated applications and related documents.
N. False statements on Tax Exempt/Government Entity (TE/GE) determination letter applications.
O. Use of false social security numbers.
P. Submission of false Form W–4.
Q. Submission of a false affidavit.
R. Attempt to bribe the examiner.
S. Submission of tax returns with false claims of withholding (Form 1099-OID, Form W-2) or refundable credits (Form 4136, Form 2439) resulting in a substantial refund.
T. Intentional submission of a bad check resulting in erroneous refunds and releases of liens.
U. Submission of false Form W-7 information to secure Individual Taxpayer Identification Number (ITIN) for self and dependants.

6. **Indicators of Fraud—Methods of Concealment**
   A. Inadequacy of consideration.
   B. Insolvency of transferor.
   C. Asset ownership placed in other names.
   D. Transfer of all or nearly all of debtor's property.
   E. Close relationship between parties to the transfer.
   F. Transfer made in anticipation of a tax assessment or while the investigation of a deficiency is pending.
   G. Reservation of any interest in the property transferred.
   H. Transaction not in the usual course of business.
   I. Retention of possession or continued use of asset.
   J. Transactions surrounded by secrecy.
   K. False entries in books of transferor or transferee.
   L. Unusual disposition of the consideration received for the property.
   M. Use of secret bank accounts for income.
   N. Deposits into bank accounts under nominee names.
   O. Conduct of business transactions in false names.