CHAPTER 37

TAX FRAUD

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37.1 INTRODUCTION: CIVIL TAX CASE VERSUS CRIMINAL TAX FRAUD CASE

Since the earliest days of the Internal Revenue Code (IRC) almost 90 years ago, the government and taxpayers have waged an ongoing battle over the assessment and collection of taxes. When courts began refereeing this fight, the terms *tax avoidance* and *tax evasion* emerged. Tax avoidance results in routine civil

adjustments, if any, to the taxpayer's tax returns. Tax evasion issues can result in civil and/or criminal tax fraud proceedings often ending with a jail sentence or significant civil fraud penalties, or both.

Tax avoidance generally describes legally permissible conduct, whereas tax evasion connotes intentionally fraudulent designs. A classic description of tax avoidance was penned by Judge Learned Hand:

> Anyone may arrange his affairs that his taxes shall be as low as possible. He is not bound to choose the pattern which best pays the Treasury, there is not even a patriotic duty to increase one's taxes. Over and over again courts have said that there is nothing sinister in so arranging [one's] affairs. ... Everyone does it, rich and poor alike, and all do right, for nobody owes a public duty to pay more than the law demands.[1]

In more recent years, the Internal Revenue Manual (IRM) itself has observed the "fine distinction" between tax avoidance and evasion. Nonetheless, after highlighting this delicate distinction, the current manual paints a fairly black-and-white picture distinguishing the two concepts:

> One who avoids tax does not conceal or misrepresent. He shapes events to reduce or eliminate tax liability and, upon the happening of the events, makes a complete disclosure. Evasion, on the other hand, involves deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events, or make things seem other than they are.[2]

The IRS concedes that "any attempt to reduce, avoid, minimize or alleviate taxes by legitimate means is permissible."[3] However, it has also established two tracks to determine if what a taxpayer believes is tax avoidance fits the government's definition of tax evasion. These two tracks—civil fraud audit and criminal investigation—do not operate on strictly parallel courses and, indeed, intersect at various junctures. In the current enforcement climate, born of corporate scandals and increased scrutiny of financial transactions, accountants should familiarize themselves with the IRS's civil fraud and criminal treatment of cases and the process by which an audit can transform itself into a criminal investigation.

Needless to say, accounting computations underlie all tax fraud cases, civil or criminal. In a criminal tax fraud case, the IRS usually assigns a team of experienced special agents from the IRS Criminal Investigation division (CI) and cooperating revenue agents for the investigation, pretrial preparation, and court testimony in tax fraud prosecutions. These well-qualified agents in most cases have much experience in tax fraud and perform an outstanding job. The high conviction rate in tax fraud cases brought to court demonstrates the thorough preparation by these government agents.

In response to any IRS effort to develop a tax fraud case against a taxpayer, the taxpayer needs to assemble his or her own defense team.[4] As discussed in Section 37.11(b) of this chapter, that team should include a tax lawyer who specializes in tax fraud and, necessarily, at least one accountant.

37.2 FOUR MOST COMMON TAX CRIMES

The IRC and Title 18 of the U.S.C. contain a variety of criminal penalties applicable in tax cases; however, almost all criminal tax investigations and prosecutions concern four felony statutes.

(a) 26 U.S.C. § 7201: Attempt to Evade or Defeat Tax. IRC § 7201[5] makes it a felony to willfully attempt to evade or defeat the assessment or payment of any tax. The elements of criminal tax evasion are identical to the elements for a civil fraud penalty. The Supreme Court has stated that § 7201 includes two offenses: (1) the willful attempt to evade or defeat the assessment of a tax and (2) the willful attempt to evade or defeat the payment of a tax.[6] Evasion of assessment entails an attempt to prevent the government from calculating a taxpayer's true tax liability. Evasion of payment entails an attempt to evade the payment of that liability.[7] The government takes the position that § 7201 proscribes a single crime—attempted evasion of tax—that one can commit by evading the assessment of tax or by evading the payment of tax. Whether one views them as separate offenses or as different means of committing the same offense, both evasion of assessment of taxes and evasion of payment of taxes require the taxpayer to take some action, that is, to carry out some affirmative act for the purpose of the evasion. A taxpayer can use several methods to attempt to evade taxes or the payment thereof, and § 7201 expressly refers to "attempts in any manner." The most common attempt to evade assessment of a tax is the affirmative act of filing a false tax return that omits income, or claiming deductions to which the taxpayer does not have entitlement, or both. This results in understated taxes on the return, an evasion of the correct assessment of the tax.

Historically, the principal revenue offense is the crime of willfully attempting to evade a tax through evasion of assessment, as opposed to willfully attempting to evade the payment of a tax. Although the crime has simple basic elements, investigators often find the proof difficult.

The three elements of tax evasion are set forth in § 7201: a tax deficiency must exist, the defendant must commit an affirmative act that constitutes an evasion or attempted evasion of the tax, and the defendant must act willfully.[8] The state-of-mind requirement for imposing the civil fraud penalty is identical to what the IRS must prove in a criminal prosecution for tax evasion under § 7201.[9] "Willfulness" is defined for criminal purposes in all tax crimes as a "voluntary, intentional violation of a known legal duty"[10] and in the civil fraud arena as an "intentional wrongdoing on the part of the taxpayer with the specific purpose to evade a tax believed to be owing."[11] As a practical matter, these two definitions are identical. Thus, the government establishes civil tax fraud and criminal tax evasion through the same elements.

(b) 26 U.S.C. § 7206(1): Fraud and False Statement. Section 7206(1) makes it a felony to willfully make and subscribe a false document if the document was signed under penalties of perjury. Simply stated, § 7206(1) makes it a crime for a person to sign his or her name to a tax return, if the person has in mind that the return is false as to a material matter. The person signing the return does not have to be the taxpayer; it might be an officer authorized to sign for a corporation. Section 7206(1) offers one of the more flexible prosecutorial weapons in the government's arsenal against criminal tax offenses. Practitioners refer to § 7206(1) as the tax perjury statute, because it makes the falsehood itself a crime. Historically, because § 7206(1) does not require proof of a tax deficiency, it permits prosecution in cases that do not involve a tax deficiency,[12] a minimal tax deficiency, or a tax deficiency that the IRS would find difficult to prove.

Section 7206(1) sets forth the four elements of subscription:

1. The defendant must make and sign a return, statement, or other document that contained falsehoods as to a material matter.
2. The return, statement, or other document must contain a written declaration that it was made under the penalties of perjury.
3. The defendant must not believe the return, statement, or other document to be true and correct as to every material matter.
4. The defendant must act willfully.[13]

(c) 26 U.S.C. § 7206(2): Assisting in the Preparation of a False Return. One court has described § 7206(2) as the IRC's "aiding and abetting" provision.[14] The IRS frequently uses § 7206(2) to prosecute individuals, such as fraudulent tax return preparers, who advise or otherwise assist in the preparation or presentation of false documents. Congress did not limit this statute to preparers, however, but applied it to anyone who assists in filing a false return.[15] Even though the false document will frequently be a tax return or information return, any document filed with the IRS can give rise to the offense.

Section 7206(2) sets forth the three elements of aiding and abetting:

1. The defendant must aid or assist in, procure, counsel, or advise the preparation or presentation of a document in connection with a matter arising under the internal revenue laws.
2. The document must be false as to a material matter.
3. The defendant must act willfully.[16]

(d) 18 U.S.C. § 371: Conspiracy to Defraud the United States (*Klein* Conspiracy). The criminal tax statutes in the IRC do not include a statute for the crime of conspiracy. As a result, the government prosecutes tax-related conspiracies under 18 U.S.C. § 371, the general conspiracy statute. § 371 sets out two types of conspiracies, but we will concern ourselves only with the most common of the two, the *Klein* conspiracy, or a conspiracy to defraud the United States. "To conspire to defraud the United States means primarily to cheat the Government out of property or money, but it also means to interfere with or obstruct one of its lawful governmental functions by deceit, craft, or trickery, or at least by means that are dishonest."[17] Criminal tax prosecutions typically charge this conduct as a *Klein* conspiracy: the government alleges that the defendant conspired to defraud the United States for the purpose of "impeding, impairing, obstructing and defeating the lawful government functions of the Internal Revenue Service of the Department of the Treasury in the ascertainment, computation, assessment, and collection of the revenue: to wit, income taxes."[18] The *Klein* conspiracy argument presents the most formidable weapon in the tax prosecutor's arsenal because of its breadth.

18 U.S.C. § 371 sets forth the three elements of a *Klein* conspiracy:

1. There must exist an agreement by two or more persons to defraud the United States.
2. The defendant must knowingly and voluntarily participate in the conspiracy.

3. One conspirator must commit an overt act in furtherance of the conspiracy.[19]

Note that, unlike the crimes defined in the IRC, the *Klein* conspiracy does not contain an element for willfulness.

37.3 GENERAL OBSERVATIONS ABOUT THESE FOUR TAX CRIMES

Criminal tax fraud cases differ from other criminal cases and from civil tax cases. In a conventional criminal case the existence of the crime is a foregone conclusion: a bank has been robbed or someone has been stabbed. The government only needs to prove who did it. In a criminal tax case, the government faces the difficult task of proving the existence of the tax crime, which always turns on the defendant's subjective intent or knowledge.

Criminal tax cases also differ from civil tax cases. In civil tax cases, the government and the taxpayer argue over money or technicalities. In a criminal tax case, the government publicly accuses the defendant of committing a crime, with the possibility of time in prison.

37.4 PROOF BEYOND A REASONABLE DOUBT IN A TAX PROSECUTION

Prosecutors find criminal tax fraud difficult to prove. Once the government goes through the monumental effort to put a tax case together, however, the case becomes difficult to defend.

A key distinction between civil and criminal fraud lies in the burden of proof. In a criminal case, the prosecution must prove fraud beyond a reasonable doubt.[20] Civil fraud, however, requires only clear and convincing evidence.[21] If the government establishes that any portion of a tax underpayment relates to fraud, however, the entire underpayment is treated as attributable to fraud, triggering fraud penalties on the full amount of the tax liability. The taxpayer, however, may establish by a preponderance of the evidence that all or a portion of the tax liability is not attributable to fraud.[22]

Whether the government first pursues a criminal or civil case can prove crucial. If the criminal case proceeds first, a conviction under § 7201 precludes the defendant from litigating the issue of civil fraud in any subsequent civil tax proceeding in which the government asserts the fraud penalty.[23] The defendant, however, can still litigate the amount of tax deficiency in the civil proceeding.[24] The collateral estoppel doctrine that results in a finding of civil fraud applies because the willfulness requirement of § 7201 includes the specific intent to evade the payment of tax, which is the same intent requirement for a civil fraud penalty.[25] If the government proves willfulness beyond a reasonable doubt in the criminal case, that finding necessarily meets the clear and convincing standard of the civil fraud case. On the other hand, a criminal felony conviction for subscribing to a false return under IRC § 7206 does not collaterally estop a taxpayer from contesting the civil fraud penalty, since the elements for this offense do not mirror those for the civil fraud penalty.[26]

37.5 SHORTHAND FORMULA FOR A CRIMINAL TAX CASE

Criminal tax fraud focuses on two necessary factors:

1. A solid and substantial tax deficiency.
2. The badges of fraud: provable, sneaky behavior usually (but not always) concerning the tax deficiency.

The criminal tax case becomes stronger for the government as the tax deficiency increases and becomes more evident. The government's criminal tax case also strengthens with the more badges of fraud it can uncover.

37.6 METHODS OF PROVING THE TAX DEFICIENCY

The government considers a tax deficiency a necessary element of the four tax crimes discussed in Section 37.2 of this chapter. Only one of these tax crimes, evasion, found at 26 U.S.C. § 7201, has tax deficiency as an element. The other two Title 26 sections, § 7206(1) (signing a false return) and § 7206(2) (assisting in the preparation of a false return), simply require that the false item on the return be material. The jury must decide whether any alleged false statement was material as the indictment uses that word. The law deems a statement on a tax return as material if it is necessary for a correct computation of the tax due or if it has a natural tendency to influence or impede the IRS in ascertaining the correctness of the tax declared or in verifying or auditing the taxpayer's returns. In theory, a material false statement could have no effect on the calculation of the tax liability, as when a taxpayer lies about whether he or she has signature authority over a foreign bank account. The Klein conspiracy does not refer to a tax item at all.

For obvious reasons, the government usually does not prosecute a taxpayer unless it has evidence of a substantial criminal tax deficiency. The unofficial rule of thumb is a $40,000 criminal tax deficiency total for all years being prosecuted. With a $40,000 tax loss, the defendant goes to jail, even if he or she pleads guilty. A criminal tax deficiency is a deficiency that the taxpayer cannot explain away. Contrast with the civil tax deficiency on a statutory notice of deficiency, which the investigation's target can easily explain, in whole or in part.

The fact that 26 U.S.C. § 7201(evasion) has tax loss as an element makes evasion a lot harder to prove than § 7206(1)(signing a false return) or § 7206(2)(assisting in the preparation of a false return). This is true because to prove the criminal tax deficiency, the government has to deal with every line of a tax return (referred to as *proving up*), which totals 65 lines on a Form 1040, for example. When proving a § 7206(1) subscription or § 7206(2) preparation case, however, the government usually deals with only one line on the return, the line with the material false statement, typically a line containing income or deductions.

(a) Direct versus Indirect Methods of Proving the Deficiency. In general, the government can use all legal methods available to establish and prove unreported income.[27] We list five of them here and discuss them in subsequent sections.

1. **Specific items method** consists of direct evidence of the items of income received by a taxpayer in a given year, such as testimony by third parties as to

monies paid to the taxpayer for goods or services. The specific items method is the only method of proving false expenses.

2. **Bank deposits method**, an indirect method of proof, reconstructs income by analyzing bank deposits by a taxpayer who has an income-producing business and makes regular and periodic deposits to bank accounts.
3. **Net worth method**, another indirect method of proof, reflects increases in the taxpayer's wealth, as contrasted with reported income.
4. **Expenditures method** (a variation of the net worth method) reflects the expenditures made by a taxpayer. The government uses the expenditures method in the case of a taxpayer who does not purchase durable assets, such as stocks and real estate, but spends monies for consumable items, such as vacations, entertainment, food, drink, and the like.
5. **Cash method**, a variation of the expenditures method, compares the taxpayer's cash expenditures with the known cash sources. As of May 2006, this method has appeared in only one case, in the Seventh Circuit.

The specific items method of proof is a direct method of proof used to establish unreported income. This method of proof differs from the indirect methods of proof (bank deposits, net worth, and expenditures) in that it focuses on specific financial transactions and does not attempt to reconstruct the defendant's overall financial situation. The specific items method primarily relies on direct evidence, although the government can introduce circumstantial evidence. By contrast, the indirect methods generally rely on circumstantial evidence to prove an understatement of income. Using the indirect methods of proof, the government shows "either through increases in net worth, increases in bank deposits, or the presence of cash expenditures, that the taxpayer's wealth grew during a tax year beyond what could be attributed to the taxpayer's reported income, thereby raising the inference of unreported income."[28] The government often resorts to indirect methods of proof when the defendant deals in cash and has maintained inadequate records from which to reconstruct income.

(b) Specific Items Method of Proof. This method has several advantages: prosecutors can easily present it and juries can easily understand it, the method involves less evidence and has relatively simple criminal computations compared with the indirect methods, and the government does not have to follow all of the technical requirements of the indirect methods of proof. The specific items method aims to prove that a defendant earned more money than the tax returns reflect, or that the tax returns report nonexistent or overstated deductions, expenses, or credits. The government can introduce both testimonial and documentary evidence. This evidence includes the defendant's admissions, the defendant's books and records, bank records, the testimony of inside witnesses (e.g., the defendant's employees and ex-spouse), testimony and documentation of witnesses engaged in the transactions that have been reported inaccurately, and the testimony of the defendant's accountant.

Specific items cases have four categories:

1. Unreported income, where the evidence establishes that the total amount of income received exceeds the amount reported

2. Unreported income, where the evidence establishes that the defendant didn't report identified items of income
3. Failure to report a business or other source of income
4. Overstated deductions or expenses, including fictitious deductions and inflated legitimate deductions

Specific items cases generally deal with income rather than deductions or expenses. The government usually attempts to produce evidence that the defendant received income that the defendant either did not report or underreported.[29]

The government goes through four steps to develop a specific items case that involves unreported income: (1) proving that the relevant amounts are taxable income to the defendant; (2) proving that the defendant received the income; (3) proving that the defendant did not report income; and (4) showing willfulness, in other words, the defendant's personal involvement in the failure to report the income and in the disposition of the unreported income. Although the government must show that the defendant received unreported taxable income, it need not show how the defendant spent the money after it became his or her income.[30]

(c) Bank Deposits Method of Proof. The bank deposits method of proof is one of the primary indirect methods of proof used by the government in computing taxable income. The bank deposits method of proof has certain features in common with the net worth method of proof (discussed in Section 37.6(d) of this chapter). Both methods develop approximations that seek to show by circumstantial means that the taxpayer had income that the taxpayer did not report.[31]

However, unlike the net worth method, which considers year-end bank balances as well as asset acquisitions and liabilities, a bank deposits case focuses on funds deposited during the tax year. Although "the mechanics of arriving at an income figure are different, both methods involve similar underlying assumptions and afford much of the same inferences for and against the accused."[32]

The Eighth Circuit case of *Gleckman v. United States* presents the classic bank deposits case.[33] As noted in *Gleckman*, "the bare fact, standing alone, that a man has deposited a sum of money in a bank would not prove that he owed income tax on the amount; nor would the bare fact that he received and cashed a check for a large amount, in and of itself, suffice to establish that income tax was due on account of it."[34] The court in *Gleckman* went on to describe the foundation for using the bank deposits method of proof as follows:

> On the other hand, if it be shown that a man has a business or calling of a lucrative nature and is constantly, day by day and month by month, receiving moneys and depositing them to his account and checking against them for his own uses, there is most potent testimony that he has income, and, if the amount exceeds exemptions and deductions, that the income is taxable.

The Gleckman decision and its progeny teach that to use the bank deposits method of proof, the government must initially introduce evidence that shows the following:

- The taxpayer was engaged in a business or income-producing activity from which the jury can infer that the unreported income arose.

- The taxpayer made periodic and regular deposits of funds into accounts in the taxpayer's name or over which the taxpayer had dominion and control.
- The government made an adequate and full investigation of those accounts to distinguish between income and nonincome deposits.
- Unidentified deposits have the inherent appearance of income, such as the size of the deposits, or consistent or variable amounts, fluctuations in amounts corresponding to seasonal fluctuations of the business involved, source of checks deposited, dates of deposits, accounts into which deposited, and so on.[35]

(d) Net Worth Method of Proof. The government has long used this indirect method of reconstructing taxable income in criminal tax cases when the government cannot establish income through direct evidence. For example, consider *United States v. Johnson*,[36] a case that involved gambling transactions in which all records had been destroyed. The net worth method produces an approximation[37] and operates on the concept that if a taxpayer has more wealth at the end of a given year than at the beginning of that year, and the increase does not result from nontaxable sources such as gifts, loans, and inheritances, then the increase represents an approximate measure of taxable income for that year. Because this method adds nondeductible expenditures to any net worth increase, practitioners sometimes refer to it as the *net worth and expenditures method.*

When constructing a net worth computation, one must include only items or transactions that reflect tax consequences. For this reason, the analysis must eliminate nontaxable items received during a prosecution year from the computation of additional taxable income.

A net worth computation identifies not only that the defendant had income but how the defendant spent that income. In essence, the computation depicts the taxpayer's financial life, both prior to and during the prosecution period.[38]

Although endorsing the net worth method, the Supreme Court has cautioned that "it is so fraught with danger for the innocent that the courts must closely scrutinize its use." Despite its reservations, the Supreme Court has approved use of the net worth method a number of times.[39]

The First Circuit described the net worth method as follows:

> The Government makes out a prima facie case under the net worth method of proof if it establishes the defendant's opening net worth (computed as assets at cost basis less liabilities) with reasonable certainty and then shows increases in his net worth for each year in question which, added to his nondeductible expenditures and excluding his known nontaxable receipts for the year, exceed his reported taxable income by a substantial amount. The jury may infer that the defendant's excess net worth increases represent unreported taxable income if the Government either shows a likely source, or negates all possible nontaxable sources.
>
> [T]he jury may further infer willfulness from the fact of underreporting coupled with evidence of conduct by the defendant tending to mislead or conceal.[40]

The Fifth Circuit summarized the steps necessary to establish income when applying the net worth method of proof:

> The government established its case through the "net worth" approach, a method of circumstantial proof which basically consists of five steps: (1) calculation of net worth

> at the end of a taxable year, (2) subtraction of net worth at the beginning of the same taxable year, (3) addition of non-deductible expenditures for personal, including living, expenditures, (4) subtraction of receipts from income sources that are non-taxable, and (5) comparison of the resultant figure with the amount of taxable income reported by the taxpayer to determine the amount, if any, of underreporting.[41]

(e) Expenditures Method of Proof. The expenditures method of proof and the net worth method of proof present accounting variations of the same approach, with the expenditures method a variation of the net worth method.[42]

In *United States v. Johnson* (1943), the Supreme Court approved the use of the expenditures method of proof to establish unreported income.[43] Subsequently, the Third Circuit defined the expenditures method of proof as follows:

> It starts with an appraisal of the taxpayer's net worth situation at the beginning of a period. He may have much or he may have nothing. If, during that period, his expenditures have exceeded the amount he has reported as income and his net worth at the end of the period is the same as it was at the beginning (or any difference accounted for), then it may be concluded that his income tax return shows less income than he has in fact received. Of course it is necessary, so far as possible, to negate nontaxable receipts by the taxpayer during the period in question.[44]

The expenditures method of proof tracks a taxpayer's expenditures for consumable goods and services (i.e., items that do not increase one's net worth), as opposed to any acquisition of assets (i.e., items such as stocks, bonds, or real estate, which increase one's net worth). The expenditures method accounts for the taxpayer who spends his income on consumable items that do not increase net worth, such as food, vacations, travel, or gifts to third parties.

The First Circuit summarized one advantage of using the expenditures method of proof, rather than the net worth method:

> The government proceeded on a "cash expenditure" theory. This is a variant of the net worth method of establishing unreported taxable income. Both proceed by indirection to overcome the absence of direct proof. The net worth method involves the ascertaining of a taxpayer's net worth positions at the beginning and end of a tax period, and deriving that part of any increase not attributable to reported income. This method, while effective against taxpayers who channel their income into investment or durable property, is unavailing against the taxpayer who consumes his self-determined tax free dollars during the year and winds up no wealthier than before. The cash expenditure method is devised to reach such a taxpayer by establishing the amount of his purchases of goods and services which are not attributable to the resources at hand at the beginning of the year or to non-taxable receipts during the year.[45]

The requirements for establishing an expenditures case are identical to those required for establishing a net worth case. Thus, in an expenditures case, the government must do the following:

- establish an opening net worth with reasonable certainty and demonstrate that the taxpayer's expenditures did not result from cash on hand, or the conversion of assets on hand at the beginning of the period
- Establish through independent evidence that the expenditures charged to the taxpayer are nondeductible
- Establish a likely source of income from which the expenditures sprang, or negate nontaxable sources of income

- Investigate all relevant, reasonable leads that are reasonably susceptible of being checked[46]

(f) Cash Method of Proof. The Seventh Circuit has approved a variation of the expenditures method, referred to as the cash method of proof.[47] This method compares the taxpayer's cash expenditures with the known cash sources, including cash on hand, for each tax period. If such expenditures exceed sources, the government presumes the excess to be unreported income. As of February 2006, this method is limited to the single Seventh Circuit case.

37.7 PROVING INTENT: BADGES OF FRAUD

The second key element in a tax crime is the defendant's intent. Ultimately the jury must read the mind of the taxpayer to decide whether the taxpayer intentionally violated a known legal duty. The government tries to show the jury enough *badges of fraud* to circumstantially demonstrate the taxpayer's criminal intent.

(a) Classic *Spies* Badges of Fraud. Although each element listed in the following excerpt and discussed in Section 37.7(b) of this chapter can be an innocent error or an anomalous legitimate transaction, such elements may also indicate fraud, particularly when they occur with a frequency or pattern, or combine with other elements. In *Spies v. United States*, the Supreme Court stated the classic list of badges of fraud that provide circumstantial evidence of tax fraud:

> By way of illustration, and not by way of limitation, we would think affirmative willful attempt may be inferred from conduct such as
>
> - keeping a double set of books,
> - making false entries or alterations, or false invoices or documents,
> - destruction of books or records,
> - concealment of assets or covering up sources of income,
> - handling of one's affairs to avoid making the records usual in transactions of the kind, and
> - any conduct, the likely effect of which would be to mislead or to conceal.
>
> If the tax-evasion motive plays any part in such conduct, the offense may be made out even though the conduct may also serve other purposes such as concealment of other crime.[48]

(b) More Badges of Fraud. The IRM now provides a lengthy list of badges of fraud that can trigger scrutiny by the IRS. The Fraud Handbook[49] described six categories of badges:

1. **Income.** This includes unreported sources of income, unexplained increases in net worth over a period of years, unusually high personal expenditures, and unexplained bank deposits that substantially exceed reported income.
2. **Expenses or deductions.** This includes substantial deductions for personal expenditures claimed as business expenses, lack of substantiation for unusually large deductions, or making a claim for dependency exemptions for nonexistent, deceased, or self-supporting persons.
3. **Books and records.** The IRS will scrutinize taxpayers who keep the classic two sets of books—one for their bank that inflates their net income, and one

for the IRS deflating the same income—or engage in similar mischief with invoices, purchase orders, gift receipts, and the like. The IRS will also examine taxpayers whose business books and tax returns do not reconcile.

4. **Allocations of income.** Taxpayers who move income or deductions out of the correct account and into a more taxpayer-friendly line item, or issue checks to third parties who then endorse them back to the taxpayer, will likewise draw the attention of the IRS. The IRS's fraud spotlight will also shine on distributions of profits to fictitious parties or inclusions of income or deductions in the tax return of a related person whose tax rate differs substantially.
5. **Conduct of taxpayer.** The taxpayer's conduct presents one of the more important variables that can transform a civil inquiry into a criminal investigation. These badges of fraud include hindering examinations by failing or refusing to answer important questions, repeatedly canceling appointments, refusing to provide records or consistently omitting key records, and attempting to threaten or corruptly influence witnesses. When taxpayers assert that they completed their returns on the basis of a good faith reliance on an accountant or lawyer, the IRS will analyze whether the taxpayer followed the advice or fully disclosed the relevant facts to the professional in question. The IRS will also consider the tax sophistication, education, training, and experience of the taxpayer.
6. **Methods of concealment.** If any of the badges of fraud concerning concealment emerge, the likelihood of a criminal referral looms large. Red flags include placing assets in others' names, transferring assets in anticipation of a tax assessment or during an investigation, use of secret bank accounts or entities (particularly offshore entities) to disguise the source and destination of a financial transaction, and use of nominees for property or banking transactions.

A taxpayer's tax counsel should thoroughly investigate the situation for the presence of badges of fraud, both before and during the civil audit. That will provide an opportunity to formulate a strategy for dealing with these sensitive issues, hoping that the parties will conclude the audit without a referral to CI or the assertion of civil fraud penalties. The tax lawyer should also consult criminal counsel to help prevent issues from emerging during the civil audit that could contribute to a CI referral.

37.8 GOVERNMENT'S SOURCES FOR CRIMINAL AND CIVIL TAX FRAUD CASES

(a) Fraud Referral Specialists. A case works its way from a civil audit to a criminal investigation through the IRS's long-standing fraud referral program. When a revenue agent or revenue officer investigates a case and identifies "firm indications of fraud," the agent or officer must transfer or refer the case to the IRS CI division.[30]

The IRS's Small Business/Self-Employed Division has selected fraud referral specialists (FRS), both on the civil audit side and the collection side, to identify civil fraud cases that have civil fraud penalty and criminal referral potential. Those agents designated as FRS have experience and special training in detecting and developing fraud cases. The IRS has approximately 64 fraud referral specialists, who act as consultants to revenue agents as they conduct civil audits. The FRS

help the examining agent identify badges of fraud and develop fraud cases through the gathering of documentation and the interviewing of witnesses, including the taxpayer.

Deciding whether a taxpayer/client should submit to an interview request by a civil agent has become an increasingly sensitive question, since an FRS might be consulting on the audit if it has criminal potential. The government can force the taxpayer to submit to an interview,[51] but the taxpayer can assert constitutional protections if asked a question that could incriminate him or her. Claiming a Fifth Amendment privilege, however, could strengthen the agent's suspicions and could become a factor leading to a referral to CI. Thus, having tax counsel handle all interaction with the agent in the hope of persuading the agent to gather information through means other than a taxpayer interview is often the most prudent strategy.

(b) IRS Criminal Referrals. If a firm indication of fraud exists, the civil revenue agent suspends the civil audit without informing the taxpayer of the reason and prepares a Form 2797 (Referral Report of Potential Criminal Fraud Cases).[52] The FRS assists the agent in preparing this report, which must specify factors that support the fraud referral, including but not limited to the affirmative acts of fraud, the taxpayer's explanation of the affirmative acts, the estimated criminal tax liability, and the method of proof used for income verification.[53]

The fraud referral report then goes to a CI lead development center, and within 10 days of receipt a referral evaluation conference must take place among the referring civil agent, IRS management, and the FRS.[54] Within 30 workdays thereafter, the same parties, possibly accompanied by IRS counsel, meet again at a disposition conference to discuss the CI's decision to accept or decline the criminal referral.[55] A final decision on whether the referral meets criminal criteria should occur no later than 30 workdays after the disposition conference.[56]

This long, unexplained period of silence after much investigative activity by the revenue agent or officer is but one of the warning signs that the civil agent has consulted an FRS and is contemplating a fraud referral. Civil agents almost always remain silent about this step, so experienced practitioners have learned to identify certain activities (listed and discussed in the following) by the agent, even prior to the period of silence, as indicators of a potential referral to CI.

- In cases involving allegations of unreported income, the agent's request, summonsing, and photocopying of all bank account information could raise the specter of a criminal referral, especially if the agent has stumbled on a side account that was not accounted for in calculating the taxpayer's income. By summonsing the information, the agent ensures that the file will include copies of all bank documents and deposit items that could provide evidence of unreported income.
- A civil agent's questions about the taxpayer's lifestyle, expenditures, and other information indicate that the agent is undertaking a financial status audit[57] to ascertain whether the income reported on the return supports the taxpayer's lifestyle.
- Requests for information about assets and liabilities at the beginning and end of a given year suggest that the agent has ascertained that the taxpayer's books and records do not adequately reflect income and that the agent is considering an "indirect method of proof of income," such as the net worth method.[58]

- The civil agent requests supplier invoices, price lists, customer ledger cards, and the like to use as circumstantial evidence to prove unreported gross receipts.
- The civil agent requests the taxpayer either to submit to an interview or to answer in writing questions concerning the taxpayer's knowledge or intent about the facts and circumstances surrounding the alleged unreported income or false deductions.
- The agent refuses to discuss in detail the status of the audit and the possibility of concluding the audit in the near future.

In considering a fraud referral report, the question of willfulness will heavily influence a decision to proceed with a criminal investigation. Willfulness, a necessary element of every criminal tax felony, including tax evasion, is usually proved through evidence of the taxpayer's conduct. The more egregious the conduct, the more likely a successful prosecution. Thus, CI looks for understatements of income or nonfiling over a period of years (usually three or more) as evidence of willfulness.[59]

In contrast, when a taxpayer understates income for a single year and claims it was a result of a miscommunication with a bookkeeper or gives some other plausible explanation for the income understatement, the government would find it more difficult to prove willfulness. A mere understatement of income by itself, even if it occurs in a pattern over several years, generally does not justify a CI investigation. To buttress the argument for willfulness, therefore, the government often looks for other badges of fraud, such as acts of concealment, destruction of records, altered documents, and other conduct from which one could infer willful behavior.

CI also recognizes that the taxpayer's level of education and sophistication could tip the scales. For example, lawyers educated or experienced in tax law and accountants and business owners familiar with the financial details of their business present better prospects for criminal prosecution than persons who do not have tax or financial training or who operate outside the financial realm of the business under investigation.

Tax practitioners need to understand the process by which a civil tax case works its way through the system, who makes the decisions, and the factors they consider. Practitioners need to master the facts of each case and anticipate which, if any, badges of fraud can emerge in order to prepare a cogent response should these issues arise during the civil agent's examination. Of equal importance, forcefully counseling clients not to accumulate even more badges of fraud during the investigation (including activities such as falsifying, destroying, or altering records; continuing questionable practices into the present and future years; or transferring or concealing assets under investigation) can stave off the final badge that could tip the balance toward a criminal referral.

37.9 INVESTIGATION BY CI: ADMINISTRATIVE VERSUS GRAND JURY INVESTIGATIONS

A CI investigation typically begins with the receipt by CI of information concerning potential criminal violations of one or more of the statutes discussed in Section 37.2 of this chapter. This information can come from the general public,

another IRS component, a U.S. Attorney's office, another law enforcement agency, or another CI investigation. Although a division chief must approve the opening of a CI investigation of an individual or entity, he or she can delegate this authority to a branch chief for all but money laundering violations.

Once CI has opened an investigation, a special agent will conduct an investigation and prepare a Special Agent Report (SAR) that the agent's superiors will use to decide whether to refer the case to the Department of Justice (DOJ). If the DOJ decides to prosecute and brings charges against the target, the special agent will assist the prosecutor in the trial of the case.

If the special agent considers an administrative investigation as inviable or inappropriate, he or she will then seek to conduct the investigation through a federal grand jury.[60] Special agents request grand jury investigations when such an option appears more efficient (i.e., the administrative process cannot develop the relevant facts within a reasonable period of time), or when an investigation has proceeded as far as the administrative process allows, but the grand jury process would strengthen the prosecution's case.

37.10 GOVERNMENT'S STANDARD OF REVIEW FOR A CRIMINAL TAX CASE

The government's standard underlying review of criminal tax matters for authorization of prosecution requires that the government have evidence supporting a *prima facie* case, that is, minimal evidence supporting a jury's findings on each element of the crime. The government also requires a reasonable probability of conviction.[61]

Note that the standard is a trial standard. The entire case is investigated, reviewed, and processed with a view toward winning a conviction at trial. If the government has a *prima facie* case, then the government survives the taxpayer's motion to dismiss and the case goes to the jury. Then, if a reasonable probability exists that the government prosecutor's closing argument will persuade the jury to convict, the prosecution will be authorized.

The standard is a "reasonable probability" standard, not a "substantial," or "significant," or "more likely than not" probability. In practice, the criminal tax cases authorized for prosecution have a very high probability of conviction; however, there remains the specter (which happens occasionally) that the government will go forward on a very weak criminal tax case. In such circumstances, because of the highly subjective nature of a criminal tax prosecution, even an innocent taxpayer has reason to be nervous.

37.11 ROLE OF THE ACCOUNTANT IN THE DEFENSE OF A CRIMINAL OR CIVIL TAX FRAUD CASE

Little difference exists between defending a civil tax fraud matter and a criminal tax fraud matter because the six-year statute of limitations for criminal prosecution[62] has not ended in most civil tax fraud cases that the government investigates. As a result, the people defending a civil tax fraud matter must prepare for a potential criminal investigation and prosecution.

(a) Role of the Historical Accountant. Circumstances limit the role of the historical accountant (i.e., the accountant having some past connection to the tax case when

the fraud occurred) to that of witness for the government in a criminal tax case. This holds true because communications between the historical accountant and the taxpayer lack the protection of privilege in a criminal tax matter. The tax practitioner privilege provided by IRC § 7525 applies in civil matters only.[63] Thus, in a criminal tax investigation, the government will look to the historical accountant as a major witness in the criminal case. The government will question the historical accountant with a view toward establishing that the taxpayer did not give the accountant correct information or that the taxpayer made damaging admissions to the historical accountant. An accountant who discovers that a client has engaged in allegedly fraudulent tax activity should know that the government can discover every conversation and every piece of paper generated about the subject. For this reason, the historical accountant should refer the client to an attorney who can have a privileged conversation with the client to plan a defense.

(b) Role of the Kovel Accountant.[64] After the taxpayer hires a defense attorney, that attorney can formally retain an accountant to help the attorney defend the case. Communications among this accountant, the attorney, and the client during the course of rendering legal advice fall under the protection of attorney-client privilege. Named after the case of its origin, practitioners refer to this as a *Kovel privilege* and refer to an accountant retained by an attorney in these circumstances as a *Kovel accountant*. Likewise, the attorney's work product privilege protects he work product of the Kovel accountant.

The attorney and the Kovel accountant need to document their relation carefully. The attorney should send a retaining letter to the Kovel accountant to clarify several items:

- The accountant is working under the direction of the attorney in connection with the attorney's rendering of legal services to the client.
- The communications between the accountant and the client are confidential and occur solely to enable the attorney to give legal advice to the client.
- The accountant's workpapers are part of the attorney's work product and are subject to the attorney's right to demand the return of his or her work product at any time.

The Kovel privilege may not apply to situations in which the accountant (although working for the attorney) provides accounting services or advice that are distinguishable from assisting the attorney in providing the legal services or advice the accountant is engaged to render. For example, if the Kovel accountant also prepares tax returns for filing, the tax preparation files would not be privileged, despite the Kovel arrangement, because tax preparation files are never privileged. This Kovel privilege does not protect disclosures made to the accountant after the attorney has rendered legal advice or completed his or her engagement.

Kovel accountants help develop the financial data for analyzing the method of proof used by the government. With the current emphasis of the IRS on economic reality audits, the examination division submits fraud referrals with an extensive financial history of the taxpayer. CI and revenue agents assigned to special fraud groups develop evidence that results in the ultimate calculation of unreported income.

If the taxpayer has the financial resources, the defense team will conduct a parallel investigation in a tax fraud case. The Kovel accountant will request copies of bank records and other records that the special agent summons. By following the investigation, the defense team can reconstruct the information and evidence that the IRS has.

(c) Role of the Summary Expert Witness at Trial. The taxpayer almost always uses an accountant as a summary expert witness at the trial of a tax fraud case, whether civil or criminal. Accountants or other experts can testify as to an opinion with respect to questions of fact. Rule 703 of the Federal Rules of Evidence allows an expert to opine using otherwise inadmissible facts or data if these are reasonably relied on by experts in a particular industry or field of practice.[65] The areas of possible testimony include interpretation of tax law related to a specific case and the use of hypothetical facts on which to base an opinion. Other areas of testimony include the standards of care and responsibility of tax preparers in tax planning, tax preparation, and representation during IRS examinations. An expert will prepare exhibits and charts to use when testifying. The expert must objectively analyze the exhibits of the government's summary witness and rebut the calculations contained therein, if possible. To provide effective rebuttal testimony and demonstrate the taxpayer's lack of willfulness, the summary expert witness must understand indirect methods of proof.

The summary expert witnesses must have the ability to explain complex financial and tax concepts to a group of laypersons: the jury. Taxpayers in criminal tax cases commonly use the defense that they relied on the advice of professionals. The government responds by establishing that the client did not provide all the facts to the tax expert or advisor, who has become just another victim of the taxpayer's fraud. Both parties can call an outside expert to opine as to what facts one would reasonably expect the taxpayer to provide and what questions one would reasonably expect a preparer to ask.

Although the Kovel accountant may have the most knowledge about the facts of the case, placing the Kovel accountant on the witness stand has several drawbacks. When the Kovel accountant becomes a witness for the taxpayer, the defense team may lose the attorney-client and work-product privileges regarding the attorney-accountant relation. Vigorous cross–examination may cause workpapers to surface or be disclosed, including any uncovered facts that can damage the taxpayer's defense. Therefore, this writer recommends use of another accountant to testify.

(d) Civil Tax Fraud Cases with no Criminal Potential. Rarely, taxpayers defend a civil tax fraud case that has no potential of becoming a criminal case. This occurs when the statute of limitations for a criminal tax prosecution has expired. In such situations, the accountants can take advantage of the tax practitioner privilege provided by IRC § 7525 and the historical accountant will not become the government's star witness. This reduces the need for a separate Kovel accountant, and the historical accountant can participate in the defense. With no criminal potential, the taxpayer need not hire a lawyer before it becomes apparent that the civil tax fraud case will go to trial. The factual and legal development of the civil tax fraud case, as indicated in Section 37.3 of this chapter, will resemble that of a tax evasion case brought under § 7201.

(e) Pre-IRS Referral and Voluntary Disclosure. The accountant can play a critical role in taking advantage of the IRS's voluntary disclosure policy. Practitioners often struggle with whether a taxpayer can avoid a criminal tax investigation by disclosing prior tax crimes to the IRS. Through such a voluntary disclosure, the taxpayer reports previously undisclosed income (or eliminates previously taken false deductions) through an amended return or the filing of a delinquent return. A taxpayer who makes a voluntary disclosure faces the problem of making a *de facto* confession to the IRS of filing incorrect returns. Thus, the taxpayer runs the risk of conviction of a tax crime on the basis of admissions derived from the voluntary disclosure itself. However, a taxpayer's timely, voluntary disclosure of a significant unreported tax liability becomes an important factor to the IRS in considering whether to refer the matter to the DOJ for criminal prosecution.[66] The DOJ will also consider a voluntary disclosure in deciding whether to prosecute a taxpayer.[67] Properly filed, such a disclosure can lead the IRS to excuse the criminal charges of filing a fraudulent return or failing to file a return.

A voluntary disclosure must be truthful, timely, and complete, and the taxpayer must demonstrate a willingness to cooperate (and must in fact cooperate) with the IRS in calculating the correct tax liability.[68] The taxpayer must make good faith arrangements with the IRS to pay in full the tax, interest, and any penalties that the IRS identifies as applicable.[69] Often the IRS will make the taxpayer pay the civil fraud penalty in a voluntary disclosure. Thus, the voluntary disclosure policy does not help the taxpayer regarding a civil fraud penalty. Additionally, the policy only applies to income earned through a legal business, referred to as *legal source income*. Al Capone could not take advantage of the policy.

The recent revisions to the policy clarify the timeliness requirement of the policy, an issue long troubling to practitioners. To be timely, the IRS must receive the disclosure before the IRS has done the following:

- 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
- Received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance
- Initiated a civil examination or criminal investigation that directly relates to the specific liability of the taxpayer
- Acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena)[70]

Examples of timely voluntary disclosures include the following:

- A letter from an attorney that encloses amended returns from a client that include complete and accurate data (reporting legal source income omitted from the original returns). This letter should also offer to pay the total tax, interest, and any penalties that the IRS deems applicable and meet the timeliness standard set forth above.
- A disclosure made by a taxpayer of omitted income facilitated through a widely promoted tax evasion scheme for which the IRS has begun a civil compliance project. The IRS considers such a disclosure voluntary if the IRS has already obtained information that might lead to an examination of the

taxpayer but has not yet begun to examine or investigate the taxpayer or notified the taxpayer of such an intent. In other words, the civil compliance project involving the scheme does not yet directly relate to the specific liability of the taxpayer.

- 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 entire tax, interest, and any penalties that the IRS deems applicable. The IRS considers this a voluntary disclosure because the IRS has not yet begun to examine or investigate the taxpayer or notified the taxpayer of such an intent.[71]

Under the revised policy, a voluntary disclosure does not occur until the taxpayer or a representative has contacted the IRS. Therefore, the disclosure must occur as quickly as possible. The IRS will rarely recommend criminal prosecution if a timely voluntary disclosure has occurred. Since returns filed pursuant to a timely voluntary disclosure have significant audit potential, they need to correctly reflect the taxpayer's income items. Various federal-state information sharing agreements suggest that one should contemporaneously file or amend any applicable state returns with the federal returns. One should also contemporaneously file returns for related entities. The taxpayer should resolve questions or doubts in the government's favor. A voluntary disclosure that contains inaccurate information compounds rather than helps the problem.

How many returns must one file or amend? Most practitioners suggest six tax years because the applicable statute of limitations for most tax-related crimes is six years.[72] The disclosure should eliminate any IRS concern regarding a particular tax year for which the applicable statute of limitations for criminal prosecutions has not already expired. Additional returns could be in order since the statute of limitations for a criminal prosecution is tolled (i.e., suspended) for the period of time a taxpayer is outside the United States or is a fugitive from justice.[73]

(f) Pre-CI Referral: The Eggshell Audit. An *eggshell audit* refers to the situation in which an income tax return that could have potential criminal exposure has been assigned to either a revenue agent or an office auditor for examination. The examiner assigned to conduct the audit need not know of the potential criminal exposure. However, the civil examination poses the possibility of turning into a criminal investigation if the routine audit uncovers badges of fraud. In these situations, the attorney and the Kovel accountant must exercise care in ensuring that neither the attorney, nor the client, nor the Kovel accountant provide false or misleading information to the examiner. Professionals involved in an eggshell audit must not mislead the IRS investigation; otherwise, they run a risk of prosecution and loss of their license to practice. Often the best case scenario in an eggshell audit is to limit the taxpayer's exposure to civil liability only, without the IRS addressing the potential fraud-sensitive issues.

The historical accountant should not assume that a notice of exam is just an ordinary computer-generated event. A client's tax situation could have caught the attention of the IRS in many ways that could also predispose the examiner to focus closely on possible badges of fraud.

37.12 CONCLUSION: SOME PARTING ADVICE REGARDING CRIMINAL AND CIVIL TAX FRAUD

So how do you bulletproof yourself and your clients from any possible criminal or civil tax fraud liability? Simple: don't give the government any badges of fraud to work with. Even with an enormous tax deficiency, without badges of fraud, the government does not have a criminal tax fraud case or a civil tax fraud case.

NOTES

1. *Helvering v. Gregory*, 69 F. 2d 809, 810 (2d Cir. 1934), *aff'd*, 290 U.S. 465 (1935).
2. Internal Revenue Manual 9781 §412 (Jan. 18, 1980).
3. I.R.M. 9781 § 412 (January 18, 1980).
4. The rules for tax fraud discussed in this chapter apply equally to people or entities.
5. All references to the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended.
6. *Sansone v. United States*, 380 U.S. 343, 354 (1965).
7. *United States v. Hogan*, 861 F.2d 312, 315 (1st Cir. 1988); *United States v. Dack*, 747 F.2d 1172, 1174 (7th Cir. 1984).
8. *Sansone*, 380 U.S. 343.
9. *Kahr v. Commissioner*, 414 F. 2d 621, 627 (2d Cir. 1969).
10. *United States v. Pomponio*, 429 U.S. 10, 12 (1976).
11. *McGee v. Commissioner*, 61 T.C. 249, 256 (1976), *aff'd*, 519 F. 2d 1121 (5th Cir. 1975).
12. For example, an intentional failure to check the box on a Form 1040 Schedule B showing signature authority over a foreign bank account, if false, would violate § 7206(1).
13. *United States v. Bishop*, 412 U.S. 346, 350 (1973).
14. *United States v. Williams*, 644 F.2d 696, 701 (8th Cir. 1981).
15. *United States v. Searan*, 259 F.3d 434, 443-44 (6th Cir. 2001).
16. *United States v. Searan*, 259 F.3d 434, 441, 443-44.
17. *Hammerschmidt v. United States*, 265 U.S. 182, 188 (1924); *United States v. Collins*, 78 F.3d 1021, 1037 (6th Cir. 1996).
18. *United States v. Klein*, 247 F.2d 908, 915 (2d Cir. 1957).
19. *United States v. Falcone*, 311 U.S. 205, 210 (1940).
20. *Holland v. United States*, 348 U.S. 121, 126 (1954).
21. 26 U.S.C. § 7454(a); U.S. Tax Court R. of Prac. & Proc. 142(b); *Edelson v. Commissioner*, 829 F. 2d 828, 832 (9th Cir. 1987), *aff'g* T.C. Memo 1986-223.
22. *Morrow v. Commissioner*, T.C. Memo 1967-242. *See also* 26 U.S.C. § 6663(b).
23. *Tomlinson v. Lefkowitz*, 334 F. 2d 262 (5th Cir. 1964), *cert. denied*, 379 U.S. 962 (1965); *McKinon v. Commissioner*, T.C. Memo 1988-323 (granting summary judgment against taxpayer for fraud penalties on account of conviction for all years).
24. *Delgado v. Commissioner*, T.C. Memo 1988-66.
25. 26 U.S.C. § 6663.
26. *Wright v. Commissioner*, 84 T.C. 636, 643 (1985).
27. *Holland v. United States*, 348 U.S. 121, 132 (1954); *United States v. Baum*, 435 F.2d 1197, 1201 (7th Cir. 1971); *United States v. Doyle*, 234 F.2d 788, 793 (7th Cir. 1956).
28. *United States v. Black*, 843 F. 2d 146, 148 (D.C. Cir. 1988).
29. *United States v. Marabelles*, 724 F.2d 1374, 1377 n.1 (9th Cir. 1984); *United States v. Horton*, 526 F.2d 884, 886 (5th Cir. 1976). *See also United States v. Genser*, 582 F.2d 292, 295-96 n.1 (3d Cir. 1978); *United States v. Allen*, 551 F.2d 208 (8th Cir. 1977); *United States v. Bray*, 546 F.2d 851, 856-57 (10th Cir. 1976).

30. *United States v. Martin*, 525 F.2d 703, 707 (2d Cir. 1975).
31. *Holland*, 348 U.S. at 129 (1954); *United States v. Hall*, 650 F.2d 994, 999 (9th Cir. 1981); *United States v. Bray*, 546 F.2d 851, 856 (10th Cir. 1976) ("the bank deposits method of proof is not an exact science").
32. *United States v. Hall*, 650 F.2d at 999.
33. *Gleckman v. United States*, 80 F.2d 394 (8th Cir. 1935).
34. *Id.* at 399.
35. *United States v. Abodeely*, 801 F.2d 1020, 1023 (8th Cir. 1986); *United States v. Stone*, 770 F.2d 842, 844 (9th Cir. 1985); *United States v. Helina*, 549 F.2d 713, 720 (9th Cir. 1977); *United States v. Morse*, 491 F.2d 149, 152 (1st Cir. 1974); *United States v. Slutsky*, 487 F.2d 832, 841-42 (2d Cir. 1973); *United States v. Venuto*, 182 F.2d 519, 521 (3d Cir. 1950).
36. *United States v. Johnson*, 319 U.S. 503, 517 (1943).
37. *Holland v. United States*, 348 U.S. 121, 129 (1954); *United States v. Giacalone*, 574 F.2d 328, 332 (6th Cir. 1978). *See also United States v. Gomez-Soto*, 723 F.2d 649, 655 (9th Cir. 1983); *United States v. Schafer*, 580 F.2d 774, 777 (5th Cir. 1978).
38. *Holland*, 348 U.S. at 132; *United States v. Mastropieri*, 685 F.2d 776, 778 (2d Cir.1982).
39. *Massei v. United States*, 355 U.S. 595 (1958); *United States v. Calderon*, 348 U.S. 160 (1954); *Smith v. United States*, 348 U.S. 147 (1954); *Friedberg v. United States*, 348 U.S. at 142 (1954); *Holland*, 348 U.S. at 121; *United States v. Johnson*, 319 U.S. 503.
40. *United States v. Sorrentino*, 726 F.2d 876, 879-80 (1st Cir. 1984) (citations omitted).
41. *United States v. Schafer*, 580 F.2d 774, 775 (5th Cir. 1978).
42. *United States v. Breger*, 616 F.2d 634, 635 (2d Cir. 1980); *Taglianetti v. United States*, 398 F.2d 558, 562 (1st Cir. 1968), *aff'd*, 394 U.S. 316 (1969); *United States v. Caserta*, 199 F.2d 905, 906 (3d Cir. 1952).
43. *United States v. Johnson*, 319 U.S. 503, 517 (1943).
44. *United States v. Caserta*, 199 F.2d at 907.
45. *Taglianetti*, 398 F.2d at 562 (footnotes omitted).
46. *Id.* at 562 (cited in *United States v. Sutherland*, 929 F.2d 765, 780 (1st Cir. 1991)).
47. *United States v. Hogan*, 886 F.2d 1497 (7th Cir. 1989).
48. *Spies v. United States*, 317 U.S. 492, 499 (1942).
49. I.R.M. 25.1.2.2 (Jan. 1. 2003) (Indicators of Fraud).
50. Review of the Internal Revenue Service's Criminal Investigation Division (Apr. 1999) (citing I.R.M. 104.2.4.3 and I.R.M. 4.4565.21(1)).
51. 26 U.S.C. §7602.
52. I.R.M. 25.1.3.2(1) (Jan. 1, 2003) (Preparation of Form 2797).
53. I.R.M. 25.1.3.2(2) (Jan. 1, 2003) (Preparation of Form 2797).
54. I.R.M. 25.1.3.3(1) (Jan. 1. 2003) (Referral Evaluation).
55. *Id.*
56. I.R.M. 25.1.3.3(2) (Jan. 1, 2003) (Referral Evaluation).
57. *See* 26 U.S.C. § 7602(e).
58. The net worth and expenditures method is a recognized indirect method of proof that has been used in reconstructing income in criminal tax cases. *See* I.R.M. 9.5.8.6.2 (Mar. 19, 1999) (Net Worth Investigation); *Holland*, 348 U.S. at 121.
59. *Holland*, 348 U.S. at 121.
60. IRM 9.5.2. (Nov. 5, 2004) (Grand Jury Investigations).
61. U.S. Department of Justice, Criminal Tax Manual, Standards of Review, §6-4.211 (1994).
62. 26 U.S.C. § 6532.
63. § 7525 applies the "same common law protections of confidentiality which apply to communication between a taxpayer and an attorney" to any communication between a taxpayer and "any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney" in civil matters only.

64. *See United States v. Kovel*, 296 F. 2d 918, 922 (2d Cir 1961).
65. *Kumo Tire Company, Ltd., v. Carmichael*, 119 S. Ct. 1167 (1999), *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993).
66. I.R.M. 9.5.3.3.1.2.1 (9/9/04) (Voluntary Disclosure Practice)
67. U.S. Department of Justice, Criminal Tax Manual, Memorandum From: James A. Bruton, Acting Assistant Attorney General, Tax Division, *re* Tax Division Voluntary Disclosure Policy, February 17, 1993.
68. I.R.M. (9.5).3.3.1.2.1 (12/11/02).
69. I.R.M. (9.5).3.3.1.2.1 (12/11/02).
70. I.R.M. (9.5).3.3.1.2.1 (12/11/02).
71. I.R.M. (9.5).3.3.1.2.1 (12/11/02).
72. 26 U.S.C. § 6531.
73. 26 U.S.C. § 6531.