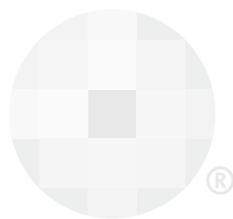


How to Handle Internal Investigations in a Tax Case

By Sandra R. Brown

Sandra R. Brown examines the best practices and potential conflicts inherent in internal investigations and provides insight into corporate voluntary disclosures.



Whether your client is a public or private company, there is an ever-increasing likelihood that some issue may arise which will result in the need for an internal investigation. Determining who should handle the internal investigation, what steps should be taken in handling the internal investigation, and when, if ever, information obtained from the internal investigation should be shared externally are some of the key challenges faced by lawyers in any internal corporate investigation. Where the issue implicates financial aspects of the company then, as often as not, the internal investigation will also need to take into consideration the potential for tax issues.

An understanding of “best practices” to reach the ultimate goals in determining (a) what, if anything, went wrong, (b) how something went wrong, and/or (c) who, whether by omission or commission, was party to the wrongdoing, is prudent and necessary to the determination of not only the client’s exposure based upon the seriousness of any financial errors, but also to assist in advising the client as to both remedial and preventative courses of action. Moreover, when implementing these decision, professionals should be cognizant that the interests of the client may conflict with the interests of the client’s employees, particularly in the context of a criminal tax investigation where both the company and its employees are the targets of the grand jury investigation.

Internal Investigations

The client has reason to be concerned that something has gone wrong. In a best-case scenario, the need for an internal investigation is flagged by the client and the lawyer’s investigation is concluded *before* a government agent knocks on the door. In a worst-case scenario, the internal investigation comes on the heels of a grand jury *subpoena*. While the later situation is obviously likely to be more stressful for everyone involved, in either case, the goal of the lawyer remains the

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same. Discover the facts and the truth so that the client is able to make an informed decision.

Who Should Handle the Internal Investigation?

When a company already has inhouse counsel, the tendency may be to expect that this is the best person to handle the internal investigation. There are a number of advantages in deciding to use inhouse counsel to handle an internal investigation, including cost control, disclosure control and investigative control. Compliance issues and vague or unsubstantial allegations, are examples of situations that may best be served when handled by inhouse counsel. Allegations involving lower level employees or matters that do not involve work done by inhouse counsel and do not rise to the level of a threat of significant civil or criminal liability, may also be appropriate for inhouse counsel. It may also be that inhouse counsel's familiarity with both the business structure and the personnel will facilitate a more expeditious and less contentious investigation.

However, there are also several advantages to hiring outside counsel to handle the internal investigation, such as objectivity, expertise, and an absence of a potential conflict of interest. Allegations that may touch upon advice provided by inhouse counsel to the company, high-level officers, or a particularly sensitive regulatory issue or significant criminal exposure, are also situations which may be best suited for outside counsel. Furthermore, in complex financial tax cases, retaining a *Kovel* accountant in addition to hiring an outside counsel should be considered.

While the final decision as to who should handle the internal investigation does not come with a bright line rule, and furthermore, it may change over time, more often than not, when making this decision, the company should give primary consideration to the nature and strength of the allegations, the role of the alleged wrongdoer within the company structure, and the likelihood of government involvement or reporting requirements.

What Steps Should Be Considered in Handling the Internal Investigation?

The primary goal of any investigation is to uncover facts relevant to the pertinent situation. Secondary goals may be to determine how the situation arose at all or to prevent

the situation from arising again. A further goal may be to minimize the damage or take the necessary steps to correct any wrongdoing. Each of these goals starts with the initial step of collecting information. Information to be collected will be in the form of documents or witness statements or both. As a general matter, to effectively determine the appropriate documents to review and the witnesses to interview, taking the upfront time to consider both the substance and the scope of the internal investigation is well worth the time.

Scope of the Investigation

Where the internal investigation is in response to some factor outside of notice of a government investigation of the client, counsel may wish to take steps to ensure that the scope of the investigation isn't any broader than it needs to be to accomplish the goals. On the other hand, where the internal investigation is specifically in response to notice of a government investigation of the client, not only should counsel be aware that while thoroughness may be the objective, the government's presence rarely affords a client the luxury of time, especially if the government's presence is accompanied by the issuance of a grand jury *subpoena*. In such a situation, the internal investigation, which is still focused on discovering the facts to ensure that the client's position is both accurate and credible, must also be done with some expediency. Additionally, it is important that in handling the internal investigation in a manner which protects confidentiality and privileges, actions on that front are not viewed by the government as interfering with its own investigation. Securing documents is a key step in ensuring that counsel will be able to both accurately and credibly uncover facts. Securing documents and avoiding spoliation, is also a key step in ensuring that the government is also able to view the client as not interfering with its investigation.

Litigation Holds and Document Preservation Measures

An initial course of action is to implement litigation holds and document preservation measures. While discretion is often of great importance in any internal investigation, it is nearly impossible to effectively implement a litigation hold or put into place effective document preservation measures if the company's internal IT and HR staff are not included in this aspect of the investigation. Include them early. Never forget that allegations of destruction of evidence can be as damaging, if not more so than the underlying misdeeds. Even in a post-*Marinello*¹ world, there is a fine line between

inviting an obstruction of justice charge and creating a new affirmative (or overt) act.

Preparing for, and Conducting, Witness Interviews

The next course of action is generally to begin to interview witnesses. Decisions will need to be made as to who and how many individuals should be present for the interviews, and whether notes should be taken *versus* making recordings of the interviews. Counsel should consider interviewing not only current but former employees. Unless exigent circumstances exist, a familiarity with relevant documents in advance of any witness interview is key. It should not be lost on anyone that in a financial investigation, especially a tax matter, nothing speaks louder than the documents. Simply put, reviewing the documents early in the investigation will assist with routine decisions such as who to interview, the order of the witness interviews, the questions to be asked of each witness, and which, if any documents, counsel may wish to show to a particular witness. Of equal import, it will also assist in ensuring that when the time comes to sit down and interview witnesses, any written report will not only be a contemporaneous and comprehensive report so as to minimize the risk of inconsistent future recollections, the witness interviews, and thus, the resulting reports will not be prepared prematurely, prior to having a full grasp of the facts, so as to not undermine the credibility and objectivity of the final investigation report.

In all situations, counsel should maintain professionalism while being prepared to face a witness who may be anxious, defensive or even hostile. The witness may also have as many questions as counsel does. As such, counsel must also remember that the witness is not the client and that it is even possible that one or more of the witnesses are actually part of the problem. Moreover, one or more of the witnesses may have already reached out to the government.

Ethical Issues Involving Witness Interviews

There are a fair number of ethical issues which counsel should keep in mind when handling an internal investigation for a corporate client. First, and foremost, is understanding who the client is and ensuring that the rights and privileges of that client are protected. An attorney's ethical duties, which include the duty to zealously represent, maintain trust and confidentiality, protect the attorney-client privilege, and the duty to abide by the client's wishes, belong only to the client. Regardless of whether the investigation is handled by inhouse counsel

or an outside lawyer, it is important to remember that the attorney-client privilege belongs to the company; not the employee. As such, the decision to waive the attorney-client privilege belongs to the company; which it can waive at its sole discretion. Counsel may wish to obtain some form of written acknowledgment from the witnesses regarding the issuance of an *Upjohn*² warning, which in substance is as follows:

- (1) Counsel represents the company not the witness;
- (2) Counsel's purpose is to investigate certain matters on behalf of, and provide legal advice to, the company;
- (3) The attorney-client privilege over the interview belongs to the company, which may decide at any time and in its sole discretion to waive the privilege and thus, disclose the contents of the interview to third-parties, including law enforcement; and
- (4) The interview should be kept confidential by the witness to assist in protecting the company's privilege.

Additional issues can arise regarding the prospect of employee whistleblowers, particularly in a tax case. The federal tax laws³ with respect to paying awards to individuals who provide specific and credible information to the IRS which results in the collection of taxes, penalties, interest or other amounts from the non-compliant taxpayer have in recent years provided more financial incentives to those who wish to avail themselves of the whistleblower tax program. Therefore, the likelihood that an employee has provided information to the government is very real. As such, the odds are even greater that the very employee who counsel expects to have the most helpful information to the internal investigation may also be the employee who has the status as a whistleblower. In which case, while that employee has various obligations to cooperate with counsel in the investigation, employment retaliation laws and regulations should be considered in such situations.

Concluding the Investigation

Ultimately, correcting the wrongdoing, minimizing the damage, and determining who needs to be held accountable and whether the misconduct must or, in considering the best interests of the company, should be reported to the government is all about closure. Sometimes closure may appropriately occur without "dis"closure. However, it is often the case that a client will be faced with a situation that counsels in favor of disclosure. The decision to disclose information obtained from an internal investigation is not a decision to be taken lightly. In highly regulated businesses, there may be little choice if there is a direct disclosure obligation. In other non-mandatory reporting situations, the following facts and circumstances should be

considered: (1) the potential exposure to the company as a result of the issues uncovered in the internal investigation; (2) the potential to mitigate the exposure to the company by self-reporting to the appropriate external entities; and (3) the likelihood that the information is going to be disclosed otherwise.

The Corporate Disclosure

Both the IRS and the Department of Justice have long encouraged voluntary disclosure of criminal misconduct in exchange for a significant likelihood, albeit non-binding, understanding that the entity will not be prosecuted. In the realm of corporate disclosure, DOJ's "non-binding" policy, at least in the arena of Foreign Corrupt Practices Act ("FCPA") matters, as recently as November 2017, provides for a "presumption" of declination, in the absence of aggravating factors, for companies which voluntarily disclose misconduct, fully cooperate, timely and appropriately remediate, and agree to disgorge profits from the misconduct, and pay restitution. In short, DOJ looks beyond disclosure to cooperation and remediation. These conditions substantially mirror the perimeters set forth under the IRS's Offshore Voluntary Disclosure Program ("OVDP"), which ended on September 28, 2018,⁴ as well as the IRS's longstanding domestic Voluntary Disclosure policy set forth in IRM 9.5.11.9.⁵ For tax purposes, when conducting an internal investigation, counsel may wish to consider the following policies which afford various opportunities for companies to voluntarily disclose, cooperate and remediate so as to increase the possibility of earning a declination, non-prosecution agreement, or significant sentencing benefits. If counsel has any questions regarding the IRS's voluntary disclosure programs, they may contact the IRS Criminal Investigations Voluntary Disclosure hotline at (267) 466-1607.

IRS Voluntary Disclosure Programs

- Offshore Voluntary Disclosure ("OVDP").
- Streamlined Offshore Disclosure.

- Amended Returns.
- Delinquent FBAR submission procedures.
- Delinquent international information return submission procedures.
- IRM 9.5.11.9 Voluntary Disclosures.
 - IRS Domestic Voluntary Disclosure Coordinator may be contacted⁶ at: (267)466-1115 or the following address:
 - IRS Criminal Investigation
 - Attn: Domestic Voluntary Disclosure Coordinator
 - 1-D04-100
 - 2970 Market Street
 - Philadelphia, PA 19104

DOJ Voluntary Disclosure Programs

- USAM⁷ 9-28.900 Voluntary Disclosures
- USAM 9.28.300-1300 Ten Factors to Consider in Corporate Prosecutions
- USAM 9-28.1200 Civil or Regulatory Alternatives
- Criminal Tax Manual 4.01 Voluntary Disclosure, DOJ Tax Division Policies and Procedures

For corporations, even if a declination is not issued by DOJ, absent a history of recidivism, the benefit of such voluntary disclosure may also include a 50% reduction off the low end of the United States Sentencing Guideline ("USSG") range.

Conclusion

Ultimately, the internal investigation should create a record that sets forth, objectively and with as much substantiation as appropriate and available, what the issue is, how and why the issue occurred, and who took, or didn't take, action which resulted in the issue in the first place. Once counsel has completed that task, she/he will then be able to provide the client with the facts to enable it to best determine the appropriate course of action, be it remedial, preventive, self-reporting, cooperation, or the presentation of an effective defense.

ENDNOTES

¹ *Marinello*, 584 US __ (2018).

² *Upjohn Co.*, 544 U.S. 383, 101 S.Ct. 677 (1981).

³ 26 USC §7623 *et seq.*

⁴ Notice IR-2018-52, March 13, 2018.

⁵ Note, the IRS has placed a warning on IRM 9.5.11.9 noting that it may not reflect current law, policies or procedures. Further, the same notice has been placed on the IRS's Voluntary Disclosure: Questions & Answers, the IRS's 2009 Offshore Voluntary Disclosure Program, and various

other IRS.gov pages which relate to voluntary disclosure policies.

⁶ An executed power of attorney, Form 2848, must accompany such contact with the IRS.

⁷ United States Attorneys' Manual ("USAM").

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