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Tax Tips

IRS Cracks Down on Tax Fraud by Creating a New Enforcement Office

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Comparing recent annual statistics of criminal investigations and prosecutions by the Internal Revenue Service seems to suggest that the agency may be shifting resources away from criminal tax enforcement. In Fiscal Year 2019, the IRS Criminal Investigation Division initiated 2,485 investigations and recommended 1,893 prosecutions.¹ This continues a trend seen in recent years of declining criminal investigations by the IRS. In 2016, the division initiated 3,395 investigations,² and, in 2017, it initiated only 3,019 investigations.³ In 2018, that number had dropped to 2,886.⁴ This trend coincides with a continuing decline in criminal investigation special agents—in 2019, the division had the fewest special agents since the early 1970s.⁵

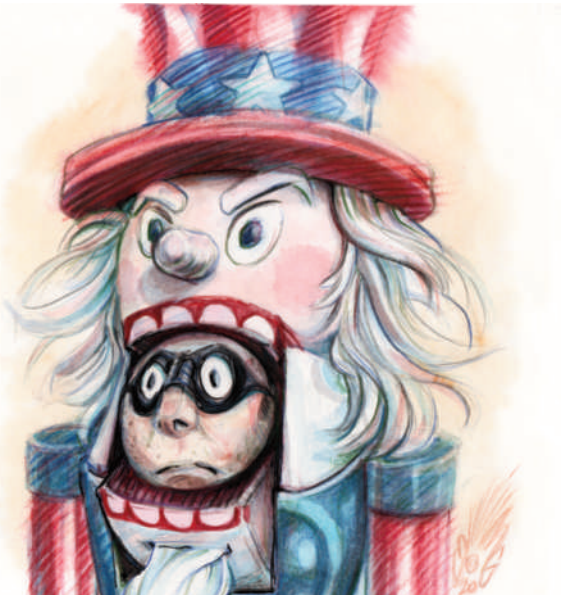
However, it would be a mistake to conclude that the focus at the IRS is shifting away from criminal tax enforcement. To the contrary, the IRS announced on March 5, 2020, the creation of the Fraud Enforcement Office, to be led by Damon Rowe, a veteran of the IRS Criminal Investigation Division.⁶ Prior

to appointment as the director of the new Fraud Enforcement Office, Rowe was the executive director of International Operations for the division. Previously, he had served as special agent in charge of the Los Angeles and Dallas field offices and as assistant special agent in charge of the New Orleans field office.

The new Fraud Enforcement Office was created to further efforts by the IRS to detect and deter fraud while strengthening the National Fraud Program. Through additional training, resources, and applied analytics, the IRS aims to thwart emerging threats in the area of fraudulent filings and related activities.⁷ The National Fraud Program is a program within the IRS's Small Business/Self Employed Division (SB/SE) responsible for coordinating the establishment of nationwide fraud strategies, policies,

and procedures to increase enforcement.⁸

An important part of the IRS's strategies to foster voluntary compliance with the tax laws is through the recommendation of criminal prosecutions and/or civil fraud penalties against taxpayers committing tax evasion. This includes the IRS's Fraud Referral Program under SB/SE, which requires the identification and development of potential criminal fraud and civil fraud penalty cases to be considered in all taxpayer examinations.⁹ If an examiner detects possible fraud, the IRS procedure is for the examiner to consult with his or her group manager and then contact a Fraud Referral Program advisor as soon as possible for technical guidance and advice. In Fiscal Year 2001, the IRS had created within the SB/SE fraud technical advisor groups to assist examiners with the



development of potential fraud cases.¹⁰

Despite these procedures under SB/SE for identifying potential fraud cases, referrals from the IRS's civil side was the source of only 7 percent of criminal cases in 2019.¹¹ Of these, fraud referrals from revenue officers handling collections cases accounted for most of the accepted referrals—an extraordinary statistic. The largest source of criminal cases was the U.S. Attorney's Office (28 percent), other federal agencies (26 percent), and investigations that originated with the criminal investigation division (15 percent).¹²

However, the IRS's continued commitment to SB/SE's role in enforcement is demonstrated by the July 2019 appointment of Eric Hylton as commissioner of SB/SE since he has extensive background and experience in criminal enforcement. Indeed, before being appointed to lead SB/SE, Hylton was the deputy chief of the Criminal Investigation Division as well as executive director of the division's Office of International Operations.¹³ Regarding his appointment, Hylton stated he is "excited to work with the SB/SE team to bring a laser focus on our enforcement strategies and initiatives."¹⁴

Data Analytics

Although employee numbers in the Criminal Investigation Division have been declining, it is focused on making up for that loss by increasing the use of data analytics, among other strategies.¹⁵ Don Fort, chief of the Criminal Investigation Division, stated that the division is "working smarter using data analytics to augment good old-fashioned police work and find those cases that have the biggest impact on tax administration."¹⁶ He has explained that the "future for CI [criminal investigations] must involve leveraging the vast amount of data we have to help drive case selection and make us more efficient in the critical work that we do."¹⁷ Deputy Chief of Criminal Investigation Division Jim Lee stated that in 2019 the division "solidified units designed to better use data to aid[] in finding and solving the best financial crime cases."¹⁸ This process included seizing 1.25 petabytes of digital data in 2019.¹⁹ As part of its cybercrimes program, the division's forensic analysis for electronic crimes includes dark web activity, encryption and password recovery, deduplication of large data sets, recovery of hidden and deleted data and damaged disk drives,

extraction of data from proprietary financial software (such as tax preparation software), internet activity and history analysis, and website preservation.²⁰ The criminal investigation division has been building its cybercrimes program since 2015.²¹

Noteworthy Trends

Two recent trends in IRS criminal enforcement are worth noting. The division classifies its investigations into the following program and emphasis areas of fraud: abusive return preparer enforcement, abusive tax schemes, bankruptcy fraud, corporate fraud, employment tax enforcement, financial institution fraud, gaming, general fraud investigations, healthcare fraud, identity theft schemes, international investigations, money laundering and bank secrecy act, narcotics-related investigations, non-filer enforcement, public corruption crimes, and questionable refund.²² Although the number of criminal investigations are down overall, the Criminal Investigation Division has been increasing the number of investigations initiated in two of these emphasis areas of fraud: 1) employment tax enforcement and 2) non-filer enforcement.²³

Employment tax enforcement includes a variety of employment tax evasion schemes, including pyramiding, in which a business withholds taxes from its employees but intentionally fails to remit them to the IRS; employee leasing, in which a business contracts with outside businesses to handle their staffing needs, but the employee-leasing company fails to pay over to the IRS the collected employment taxes; paying employees in cash, which also has implications for the taxpayer's entitlement to future social security or Medicare benefits; filing false payroll tax returns and failing to file payroll tax returns.²⁴ In 2019, initiated employment tax enforcement investigations increased by over 50 percent to 250 from 162 in 2017.²⁵

Non-filer enforcement is targeted at individuals who refuse to comply with their obligation to file required tax returns and pay any taxes due and owing, generally based on the long-rejected arguments that taxes are voluntary or illegal.²⁶ In 2019, investigations initiated of non-filers increased by almost 40 percent to 271 from 206 in 2017.²⁷

Enforcement Efforts Go Global

Beyond the IRS's local enforcement efforts, criminal tax evasion has been

receiving notable global attention in recent years. Two years ago, the Joint Chiefs of Global Tax Enforcement (J5) was formed with leaders of tax enforcement authorities from five countries: Australia, Canada, the Netherlands, the United Kingdom, and the United States. In late 2017, during closing arguments for the Organisation for Economic Co-operation and Development (OECD), a five-point action plan was announced.²⁸ Point one of that plan called for a focus on targeted responses to professional enablers of international tax evasion. Recognizing that professional advisors and intermediaries can play an important role in helping the financial system run smoothly (or not), recent big data leak stories, such as the "Panama Papers" of 2016, reflected that a number of professionals were enabling some of the most complex and global forms of tax crime. As a matter of priority, the OECD pledged to increase efforts in this area of international criminal tax enforcement.

The J5 was formed in response to the OECD's call for action by countries to do more to tackle the enablers of tax crime.²⁹ It was created as a platform for the five countries to work together to gather information, share intelligence, conduct operations, and build the capacity of tax crime enforcement officials. The ultimate and greater goal, however, is for the J5 to share its successes, new approaches, and findings from its joint efforts with the broader international tax enforcement community.

To increase the potential for more immediate success, as well as, arguably, to send a clear message that the J5 countries are invested in this venture, each J5 country's participation is being spearheaded by its respective top criminal tax leaders, viz. the heads of tax crime and senior officials from the Australian Criminal Intelligence Commission (ACIC) and Australian Taxation Office (ATO), the Canada Revenue Agency (CRA), the Dutch Fiscal Intelligence and Investigation Service (FIOD), Her Majesty's Revenue & Customs (HMRC), and Internal Revenue Service Criminal Investigation (IRS-CI).³⁰

On June 5, 2019, the first anniversary of formation of the J5, these respective criminal tax leaders met in Washington, D.C. After just one year of working together, it was publicly noted that they were all better equipped to conduct joint operations in the fight against those who
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commit, promote, and enable international tax crimes and money laundering. The J5 also announced the following collaborative results:³¹

- Collective work on more than 50 investigations involving sophisticated international enablers of tax evasion, including a global financial institution and its intermediaries who facilitate taxpayers to hide their income and assets.
- Cooperation on cases covering crimes from money laundering and the smuggling of illicit commodities to personal tax frauds and evasion.
- Hundreds of data exchanges between J5 partner agencies with more data being exchanged in the past year than the previous 10 years combined.

The first year of the J5 clearly signaled the emphasis on working together to leverage each country's capabilities and access to information, within existing treaties and laws, so as to enhance the overall effectiveness and success with one goal in mind: to combat cross-border financial tax crimes. Financial crime occurs on a global scale with proceeds of crime transferred among jurisdictions, or, stated another way, tax crime crosses international borders.

In a relatively short amount of time, the J5 leaders have been able to facilitate their respective countries' abilities not only to share information and open new cases but also to more rapidly develop existing cases. Working to reduce the time it takes to do one's job is good business. Facilitating international law enforcement's ability to avoid duplication of efforts and share information in real time to more efficiently and timely disrupt crime on a global level is better business.

To achieve this goal, the J5 partners have focused on building the domestic skillset of like-minded international tax administrations and law enforcement agency partners to collectively develop strategies to combat global tax cheats. The J5 has focused on platforms that enable each country both to share information and to do so in a more organized manner. One such platform is FCInet, which each country has invested in to further that goal.³²

A decentralized virtual computer network enabling agencies to compare, analyze, and exchange data anonymously, FCInet helps users to obtain the right information in real-time and enables

agencies from different jurisdictions to work together while respecting each other's local autonomy. Organizations can jointly connect information, without needing to surrender data or control to a central database. FCInet does not collect data; it connects data.³³

The J5 made clear it would focus on shared areas of concern and cross-national tax crime threats, including cybercrime and cryptocurrency as well as enablers of global tax evasion while working to share intelligence and data in near real time.

The Web Is Not All That Dark

As criminals continue to find new methods to commit tax fraud and launder illegal proceeds, the J5 also has committed to keep pace with investigating these egregious financial crimes. Tax fraud on any level, including international, is not a new crime. The sophistication with which criminals commit tax fraud has significantly increased through cyber-related activities in recent years. Data breaches, intrusions, takeovers, and compromises are the new tools that criminals use to commit tax crimes.

True to its word, in November 2019, the J5 publicly turned its focus to cryptocurrency as experts from each country gathered in Los Angeles with the mission of optimizing data from a variety of sources available to each country to identify and hold accountable tax cheats and other criminals who attempt to use the dark web and cryptocurrency to commit financial crimes.³⁴ Specific training was provided on virtual currency, blockchain, and the dark web, as well as advanced training concerning cryptocurrency tracing and open source intelligence.

Using various analytical tools, members of each country were put into teams tasked with generating leads and finding tax offenders using cryptocurrency based on the new data available to them to make connections when current individual efforts would take years to make those same connections, if ever.³⁵ Cutting through red tape and using the J5 as a force multiplier, this J5 gathering facilitated real investigators, using real data, finding real criminals through leads, trends, methodologies, and investigations that encouraged all the J5 countries to further current and future investigations under the J5 umbrella.

On January 23, 2020, the J5 announced that they had carried out a "day of action" targeting an unnamed

Central American financial institution suspected of facilitating money laundering and tax evasion for customers "across the globe" and collectively executing search warrants, interviews, and subpoenas expected to result in further criminal, civil, and regulatory action being taken by law enforcement in each country.³⁶

The investigation began with information obtained by the Netherlands.³⁷ The coordinated enforcement action garnered leads on hundreds of Australians who were identified as clients of the bank. The amount of tax evasion and money laundering involving the institution's clients was estimated at more than £200 million in the United Kingdom alone.³⁸

Offshore evasion is an international issue that calls for joint international solutions. In just two years, the collective actions of the J5 appear to be a significant and effective step in that direction. Taken together with the IRS's recent domestic fraud enforcement efforts, the IRS has demonstrated its commitment to combatting criminal tax evasion, both domestically and internationally. ■

¹ I.R.S., IRS: CRIMINAL INVESTIGATION ANNUAL REPORT 2019, 100 YEARS 1919-2019 73, available at https://www.irs.gov/pub/irsutl/2019_irs_criminal_investigation_annual_report.pdf [hereinafter CRIMINAL INVESTIGATION ANNUAL REPORT 2019].

² I.R.S. New Release IR-2017-47 (Feb. 27, 2017), available at <https://www.irs.gov/newsroom/irs-criminal-investigation-releases-fiscal-year-2016-annual-report>.

³ CRIMINAL INVESTIGATION ANNUAL REPORT 2019, *supra* note 1, at 73.

⁴ *Id.*

⁵ I.R.S. News Release IR-2019-199 (Dec. 5, 2019), available at <https://www.irs.gov/newsroom/irs-criminal-investigation-releases-fiscal-year-2019-annual-report-celebrates-100-years> [hereinafter IR-2019-199].

⁶ I.R.S. News Release IR-2020-49 (Mar. 5, 2020), available at <https://www.irs.gov/newsroom/irs-criminal-investigation-veteran-selected-as-new-fraud-enforcement-director>.

⁷ *Id.*

⁸ Memorandum from Michael R. Phillips, Deputy Inspector Gen'l for Audit, A Corporate Approach Is Needed to Provide for a More Effective Tax-Exempt Fraud Program (Audit #200810024) (Ref. no. 2009-10-096) to Comm'r, Tax Exempt & Gov't Div. (July 6, 2009), available at <https://www.treasury.gov/tigta/auditreports/2009reports/200910096fr.html>.

⁹ Memorandum from Michael R. Phillips, Deputy Inspector Gen'l for Audit, Management Has Emphasized the Fraud Program, but Opportunities Exist to Further Improve It (Audit #200630009) (Ref. no. 2007-30-179) to Comm'r, Small Business/Self-Employed Division (Sept. 18, 2007), available at <https://www.treasury.gov/tigta/auditreports/2007reports/200730179fr.html>.

¹⁰ *Id.*