

CHAPTER 7

Why Your Client’s Chances of Criminal Prosecution and Civil Fraud Penalties Have Dramatically Increased: The IRS’s New Office of Fraud Enforcement

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¶ 700 INTRODUCTION

The primary mission of the operating divisions of the Internal Revenue Service (“IRS”) is tax compliance and the collection of taxes. The IRS’s Mission Statement sets forth:

Provide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and enforce the laws with integrity and fairness to all.

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This mission statement describes our role and the public's expectation about how we should perform that role. In the United States, the Congress passes tax laws and requires taxpayers to comply. The taxpayer's role is to understand and meet his or her tax obligations. The IRS role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share.¹

It is the minority who are unwilling to comply with the tax laws and pay their fair share that the IRS is most interested in, particularly when it comes to referrals for criminal investigation or assessment of a civil fraud penalty. As has been well documented, the statistics in recent years have not reflected the kind of numbers that would arguably signal a focus on taxpayer fraud. The IRS is looking to reverse the trend in recent years of declining criminal investigations. While the IRS has not been shy about its "renewed focus" in pursuing taxpayers who intentionally and willfully fail to comply with their tax obligation, it has also sent a clear message that it is not simply interested in numbers; rather what it wants to see are "quality" fraud referrals.

The IRS's creation in 2020 of a new Office of Fraud Enforcement, notably headed by a former IRS Criminal Investigation Special Agent-in-Charge and assisted by an IRS National Fraud Counsel, shows that the IRS is serious about not only an increased focus on non-compliant taxpayers but placing resources in position to provide a further coordinated review process focused on the quality of cases referred for fraud enforcement.

So what can taxpayers and tax professionals expect from the IRS's addition of the new Office of Fraud Enforcement as part of its overall National Fraud Program?

¶ 701 WHAT IS OLD IS NEW AGAIN

¶ 1 Generally

The new Office of Fraud Enforcement was created to further efforts by the IRS to detect and deter fraud while strengthening the National Fraud Program. 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. While the Office of Fraud Enforcement is new to the IRS, the IRS's fraud referral process has been around for decades. The files of the IRS detail thousands of reports of investigations. The process of a criminal investigation can be tedious, frustrating and, of course, time consuming. On this later point, while most federal crimes carry a 5 year statute of limitations, Congress saw fit to provide CI with more time: a 6 year statute of limitations for tax crimes. Often these investigations involve voluminous records of financial dealings, such as bank records, business

¹ <https://www.irs.gov/about-irs/the-agency-its-mission-and-statutory-authority>.

ledgers and emails. It is rare that a criminal investigation uncovers what one might describe as a “smoking gun” in the sense of determining the key element to every tax crime, *e.g.*, willfulness. Getting into the mind of a taxpayer to determine if there is evidence of an intent to violate the tax laws versus negligence or a simple misunderstanding is more often than not the factor that determines whether a tax case is handled civilly versus criminally. Thus, absent firm indicia of fraud it simply makes no sense for CI to spend time or resources on what is more likely than not an appropriate case to be resolved in the hands of an IRS examination or collection employee.

¶ 2 The IRS Fraud Referral Program—Firm Indicia of Fraud

A criminal tax fraud referral occurs when an IRS business operating division (BOD) refers matter to the IRS Criminal Investigation (CI). A referring BOD, in layman’s terms, typically just means an IRS Revenue Agent or Revenue Officer (hereinafter “compliance employee”).

The primary factor that causes a compliance employee to consider a fraud referral to CI is when that employee obtains information during a civil examination or a collection proceeding that evidences firm indicia of fraud by the taxpayer. When it comes to pinning down exactly what constitutes firm indicators of fraud the old saying “beauty is in the eye of the beholder”² may not be completely out of place here as the factors considered by the IRS are neither all-inclusive nor one size fits all. Nonetheless, the Internal Revenue Manual (IRM) does provide a list of instructive factors that compliance employees are told to be on the lookout for when evaluating whether firm indications of fraud exist in an examination or collection proceeding.³ Here are a few notable examples:

- Indicators of fraud on the income side include actions such as concealing bank accounts, failing to deposit business receipts into a bank account, dealing in large sums of currency, falsifying the source of disclosed income, cashing checks where the taxpayer doesn’t maintain an account, false entries on the books and records.
- Indicators of fraud on the expense side include claiming fictitious deductions, claiming substantial personal expenses as business expenses and claiming dependency exemptions for nonexistent or deceased persons.
- Indicators of fraud as to the conduct of the taxpayer, such as false statements, destruction of books and records, backdated documents, or an attempt to hinder or obstruct an examination and methods of concealment of ownership of

² Margaret Wolfe Hungerford, *Molly Bawn* (1878).

³ IRM 25.1.2.3.

assets.⁴

¶ 3 The National Fraud Program—Quality Fraud Referrals

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. 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. Almost two decades ago, the IRS created, within the SB/SE, fraud technical advisor groups to assist examiners with the development of potential fraud cases.

Under the IRS’s Fraud Referral Program, once the compliance employee identifies firm indications of fraud and clearly documents the factors identified, a consultation with a fraud technical advisor (FTA) is required.⁵

While ultimately, it is CI’s responsibility to evaluate a fraud referral and decide whether it will accept the case for criminal investigation or return the matter back to the BOD,⁶ compliance employees and their group managers are cautioned to never seek direct advice from CI for a specific case under examination/collection activity. One might argue this prohibition has a historical connection to the finding of impropriety by CI in directing its criminal investigation under the guise of civil audit,⁷ as described by the Fifth Circuit as “sneaky deliberate deception” and a “flagrant disregard” of a taxpayer’s rights in the often cited case of *Tweel*.⁸ Since 2001, the practice of the compliance employee’s consultation with the FTA has been a cornerstone of the fraud referral program. However, by 2001, it was equally fair to note that the role of the FTA and the additional review process served the further purpose of facilitating a heightened level of “internal” IRS objectivity as well as the uniform goal of siphoning out what would not be viewed by CI as a quality fraud referral.

If, after consultation with the FTA, it is determined that the case meets the standards for a criminal referral, then the compliance employee will suspend the examination or collection efforts and a formal referral will be made to CI.⁹

⁴ IRM 25.1.2.3(1)–(7).

⁵ IRM 25.1.2.2(1).

⁶ IRM 25.1.3.4.

⁷ IRM 25.1.2.2(10)(B).

⁸ *United States v. Tweel*, 550 F2d 297 (5th Cir 1977).

⁹ IRM 25.1.3.2(1).

The formal referral to CI involves a detailed presentation of the facts that establish firm indications of fraud or willfulness including, but not limited to the following information:¹⁰

- A description of the firm indications/willfulness
- Taxpayer's explanation of the firm indications/willfulness
- Estimated criminal tax liability
- Method of proof used for income verification

At this point, while evidence of firm indicia of fraud is key to CI's review process; it is nonetheless only one factor that will be considered in CI's evaluation of what makes for a quality fraud referral. Additional information often addressed in the fraud referral will include:¹¹

- Returns were solicited
- Attempts were made to resolve the civil issues
- IRS took prior actions involving the alleged offense or similar/past offense
- Observations regarding Taxpayers
- Age and Health (mental and physical)
- Education and Occupation
- Availability of records (domestic and international)
- Other issues—flagrancy, significance, public interest, and deterrent effect

Despite these procedures, as discussed above, for identifying potential fraud cases, referrals from the IRS's civil side was the source of only 7 percent of criminal cases in 2019. Of this 7%, fraud referrals from revenue officers handling collections cases accounted for most of the accepted referrals—an extraordinary statistic in light of the fact that historically collection cases accounted for very few fraud referrals. 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

¹⁰ IRM 25.1.3.2(2).

¹¹ IRM 25.1.3.3(1).

¹² <https://taxlitigator.me/2019/09/27/your-small-business-irs-examination-might-take-a-criminal-turn-by-jonathan-kalinski/>.

¶ 4 The IRS Criminal Investigation's Role in the Fraud Referral Process

The primary objective of CI is the prosecution, conviction and incarceration of individuals who violate criminal tax laws and commit related offenses.¹³ CI's mission is to serve the American public by investigating potential criminal violations of the Internal Revenue Code (IRC) and related financial crimes in a manner that fosters confidence in the tax system and compliance with the law.¹⁴

CI's stated position on the importance of criminal tax prosecutions is asserted in almost every single Department of Justice sentencing brief filed in the federal courts in connection with a criminal tax prosecution,¹⁵ “[c]riminal [tax] prosecutions serve to enhance voluntary compliance” as well as deterrence of non-compliance, with our nation’s federal tax laws.¹⁶ What this means in practical terms is that when it comes to a fraud referral from a civil component of the IRS, quality is key. Neither CI as a division of the IRS, nor the IRS as a whole, want to spend criminal resources on a tax case that is better suited for a civil resolution, which could include a civil fraud penalty. The message has, arguably, become even more significant in the past decade for the following two reasons that one can fairly argue have directly impacted the need for quality criminal tax fraud referrals:

- *Decrease in resources of CI.* In 2018, the IRS-CI employed 2,019 agents versus 2,009 in 2019.¹⁷ In 2018, the IRS-CI reported initiating 1,714 tax investigations and 1,172 non-tax investigations. Respectively, these numbers dropped to 1,500 and 985 in 2019.¹⁸ In 2018, 1,052 tax offenders were sentenced while the number was 848 in 2019. This drop is probably more telling in the total tax fraud identified: \$1.8 billion in 2019 versus \$9.7 billion in 2018.
- *Supreme Court's 2005 decision in Booker.* In 2005, the Supreme Court held, in *United States v. Booker*,¹⁹ that the United States Sentencing Guidelines, which had for almost 20 years been viewed by the federal sentencing courts to be mandatory, was to henceforth be only advisory in nature. This change required the courts to consider factors other than simply criminal history and the amount of loss caused by the offense of conviction in determining a sentence that was

¹³ IRM 25.1.3.1(4).

¹⁴ IRM 25.1.3.1(3).

¹⁵ IRM 25.1.3.1(5).

¹⁶ IRM 25.1.3.1(5).

¹⁷ https://www.irs.gov/pub/irs-utl/2019_irs_criminal_investigation_annual_report.pdf; https://www.irs.gov/pub/irs-utl/2018_irs_criminal_investigation_annual_report.pdf.

¹⁸ *Id.*

¹⁹ *United States v. Booker*, 543 US 220 (2005).

“sufficient but not greater than necessary.”²⁰

Thus, it is with this focus on quality, and perhaps quantity, of fraud referrals where the new Office of Fraud Enforcement is intended to play a significant role in overall tax compliance.

¶ 702 THE NEW FRAUD ENFORCEMENT OFFICE

¶ 1 Generally

As part of the IRS’s continuing focus on compliance issues, on March 5, 2020, the IRS created, within SB/SE, the new Office of Fraud Enforcement.²¹ Damon Rowe, a veteran law enforcement agent for CI and a licensed attorney,²² was announced as the director of the new office, with the stated goals of providing agency-wide executive leadership and direction in the design, development and delivery of major activities within the Fraud Enforcement office in support of IRS efforts to detect and deter fraud while strengthening the National Fraud Program, a leadership decision publicly noted by both the IRS Commissioner and the SBSE Commissioner:²³

- “Our compliance and enforcement functions are working together to improve tax administration for everyone,” said IRS Commissioner Chuck Rettig. “Every compliance employee has a commitment for a general awareness of tax fraud related issues, which is a priority for the agency.” In addition to leveraging existing law enforcement relationships, Rowe will have a continued focus on unscrupulous activities of taxpayers and professional enablers that undermine our Federal Tax Laws in a manner that is consistent and fair to the American public. With additional training, resources and applied analytics, SB/SE will thwart emerging threats as it relates to fraudulent filings and related activities.
- “Damon’s selection to this new office will help strengthen our compliance work and is yet an additional opportunity to engineer partnerships with the tax professionals as well as strengthen our capacity and resolve across all business units with coordinated enforcement efforts,” Eric Hylton, SB/SE Commissioner, said. “Fraud Policy will be getting more attention this year to ensure it has the staff and resources it needs to expand detection and deterrence efforts of our campus and field employees across the IRS.”

²⁰ 18 USC § 3553(a).

²¹ IR-2020-49, March 5, 2020.

²² <https://www.irs.gov/newsroom/irs-criminal-investigation-veteran-selected-as-new-fraud-enforcement-director>.

²³ *Id.*

In May 2020, the IRS then named Carolyn Schenck, a senior level IRS division counsel,²⁴ as the National Fraud Counsel serving the agency's new Fraud Enforcement Program.²⁵

The message is clear—the IRS is bringing together diversely-experienced IRS personnel and providing additional training, resources, and applied analytics to thwart emerging threats in the area of fraudulent tax filings and related activities with increased focus on fraud referrals.

¶ 2 Data Analytics & the Fraud Enforcement Office

The IRS has not been shy about sharing its focus on making up for the loss in CI agents by increasing the use of data analytics, among other strategies. This process included seizing 1.25 petabytes of digital data in 2019.²⁶ 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. The Criminal Investigation division has been building its cybercrimes program since 2015. The new Fraud Enforcement Office has also made clear that data analytics will play a key role in helping the office better direct its resources and focus on analyzing trends and emerging threats to the U.S. Treasury.

¶ 3 Covid-19 and the Rollout of the Fraud Enforcement Office

The IRS's formation of a new Fraud Enforcement Office found itself, like the country, and the entire world, thrust into the midst of the COVID-19 crisis. Nonetheless, the new office worked to expand its workforce and promptly began providing revenue agents and officers within the SB/SE Division with advice from counsel attorneys, pushing resources into areas identified as agency-wide enforcement priorities.

In August 2020, the Fraud Enforcement Office announced plans to have a team of 42 fraud enforcement advisors, consisting of both revenue officers and revenue agents, hired and on board nationwide within 30 to 45 days.

Expect Priorities of the Fraud Enforcement Office to Align with the IRS's National Priorities

Microcaptive insurance transactions, syndicated conservation easements, virtual currency, and coronavirus-related fraud soon became household names in the world of

²⁴ <https://www.irs.gov/newsroom/irs-fraud-enforcement-program-adds-schenck-as-national-fraud-counsel>.

²⁵ IR-2020-102, May 26, 2020.

²⁶ 2019 IRS-CI Annual Report.

tax fraud enforcement, with a view toward the IRS's goal to increase the number of quality criminal fraud referrals and civil fraud penalties. More recently, the Fraud Enforcement Office has also included in its list of priorities cases involving high net worth non-filers, fraudulent Offers in Compromise (OIC) and employment tax non-compliance.

¶ 4 High-Net-Worth Non-Filer Focus of the Fraud Enforcement Office and Congress

The IRS has stated that SB/SE Revenue Agents and Revenue Officers are collaborating with the Fraud Enforcement Office to actively pursue Americans earning more than "\$100,000 a year" who are purposely not meeting their tax obligations.²⁷ With regard to "high income non-filer cases," Eric Hylton, the former IRS SB/SE Commissioner and a former Deputy Chief of IRS CI, noted that the Fraud Enforcement Office acts a bit like a computer's Central Processing Unit, or CPU, connecting "the dots across all IRS divisions" to pursue "failure to file, tax evasion and tax fraud."²⁸

Indicators are that Congress is willing to fund an IRS priority that is focused on finding high-income non-filers a priority. In October 2020, the House Committee on the Budget released a statement that budget cuts have "weakened the IRS's ability to ensure that . . . wealthy individuals pay their fair share . . ."²⁹ Subsequently, House Democrats requested more funding for the IRS, contending that its enforcement activities "must be a priority for Congress"³⁰ due to an increased amount of "identified-tax fraud"; specifically, they requested increased funding for the IRS to focus on "high-income tax evaders," noting that "increasing the IRS's budget to investigate high-income individuals would more than pay for itself by allowing the IRS to effectively collect unpaid taxes owed by the wealthiest individuals."³¹ The letter emphasized the Congressional Budget Office's conclusion that increased enforcement funding would increase revenues by a three-to-one margin.³²

²⁷ 2019 IRS-CI Annual Report.

²⁸ <https://www.irs.gov/about-irs/how-the-irs-prioritizes-compliance-work-on-high-income-non-filers-through-national-and-international-efforts>.

²⁹ https://budget.house.gov/sites/democrats.budget.house.gov/files/documents/IRS%20budget_FINAL.pdf.

³⁰ <https://taxaid.com/criminal-tax-law/house-democrats-call-for-irs-funding-to-pursue-wealthy-tax-evaders/>.

³¹ <https://www.forbes.com/sites/insider/2020/12/10/irs-cis-annual-report-and-the-state-of-enforcement/?sh=1d32152274cf>.

³² <https://www.forbes.com/sites/insider/2020/12/10/irs-cis-annual-report-and-the-state-of-enforcement/?sh=1d32152274cf>.

¶ 703 CONCLUSION

The Fraud Enforcement Office has made clear that the focus here is not taxpayers who make a mistake, act through inadvertence or rely on incorrect technical advice. To a lesser degree, one could fairly surmise that the Office of Fraud Enforcement focus is not even pursuing, through a lens of “fraud,” sincerely-held differences of opinion, negligence, or even carelessness. To that point, even taxpayers who knowingly take advantage of lawful tax avoidance measures should not find themselves in the crosshairs of this office either. After all, it is black letter law in the United States that tax avoidance, which is simply arranging one’s financial affairs in such a way as to minimize tax liability within the law, is not only acceptable but is legal. As famously stated by Judge Learned Hand:³³

Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.

That said, it is equally true that tax evasion is neither acceptable nor legal. The consequences of such illegal activity being detected, investigated and punished, whether criminally or by civil financial penalties, are significant. The message is quite clear that the IRS’s Fraud Enforcement Office can be expected to view with great skepticism and resource-focused interest actions that involve affirmative acts of fraud, willful violations of the tax laws, and obstruction of justice.

As the mission statement of the IRS sets forth in its conclusion, the IRS’s role includes *ensuring that the minority who are unwilling to comply pay their fair share*. That minority will, and should be, the focus of the Fraud Enforcement Office; a fraud focus that is criminal, civil or even both. One clear message being signaled by the creation of the Office of Fraud Enforcement is that the IRS’s Fraud Referral practice is no longer going to feel like a walk in the park. Instead, the clear message is more like “Back in Business.”

³³ *Gregory v. Helvering*, 69 F2d 809, 810 (2nd Cir 1934), *affd* 293 US 465 (1935). *See also, Commissioner v. Newman*, 159 F2d 848, 850–851 (2nd Cir 1947) (“Over and over again courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everyone does it, rich and poor; and all do right, for nobody owes any public duty to pay more than the law demands.”).