Managing Expectations in Criminal Tax Defense – Yours and Your Client's

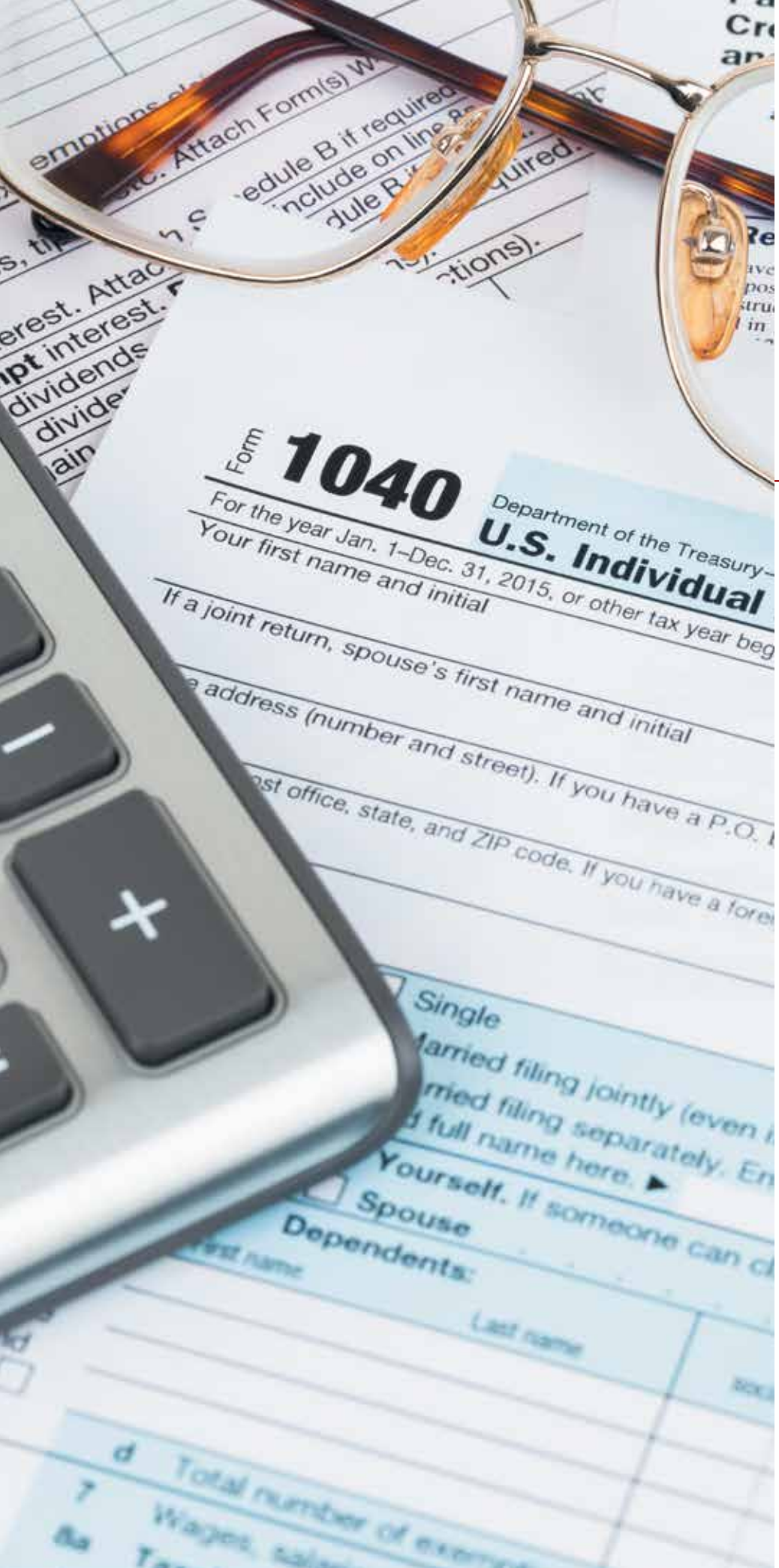
By John D. Russell and Andrew J. Hofland

AS A CRIMINAL DEFENSE ATTORNEY, the prospect of squaring off with the Internal Revenue Service and the Department of Justice may seem daunting. An accounting-heavy case is outside your bailiwick, or at least the cases you usually defend. The opposition is formidable. The imbalance of litigation resources is especially pronounced. After all, in this world nothing can be said to be certain, except death and taxes. Despite those concerns, a criminal tax case is, at its core, just another criminal case – albeit with a few distinctive facets. It has a familiar plaintiff with a familiar burden to provide evidence in accordance with familiar rules. Taking the time to learn the unfamiliar particularities of criminal tax enforcement cases can give you the confidence to competently and tactfully represent future taxpayer clients.

For the sake of background, the IRS Criminal Investigation Division conducted over 3,000 investigations and brought indictments in about 2,300 federal criminal cases in fiscal year 2017.[1] Those numbers, which include tax evasion cases, represent a meteoric fall from 2012's 5,125 investigations and 3,390 indictments,[2] largely due to continuing budgetary shortfalls and reduced manpower. Because of the decreases, the IRS prioritizes certain types of cases. Amidst more high-profile offenses, including abusive return preparation and offshore tax evasion, the IRS remains focused on bread-and-butter violations more likely to confront Oklahomans: 1) for individuals, failure to report legitimately earned income; and 2) for business associations, employment tax evasion. Becoming familiar with these common forms of tax fraud will give you a base to operate with in advance of your next criminal tax enforcement case.

UNDERSTAND THE CIVIL-CRIMINAL DIVIDE

Unlike other criminal cases, many criminal tax enforcement cases spin off from parallel civil proceedings. Parallel proceedings or parallel investigations can involve either the same agency or cooperating agencies, and most commonly occur with matters involving the SEC, EPA and IRS. In many tax cases, the IRS simultaneously conducts a civil audit and criminal investigation. While the investigations are technically separate, civil and criminal agents, consistent with IRS policy, coordinate their efforts and share information.[3] It is unsurprising then that the IRS makes the civil nature of an investigation apparent and the criminal aspect less so. With the possibility of parallel proceedings, taxpayers can find themselves faced with a difficult decision in an audit – 1) generously cooperate, potentially incriminating themselves, in the hopes they satisfy the auditor's concerns; or 2) refuse to cooperate, receive unfavorable adjustments stemming from "lack of substantiation" and face an uphill battle on appeal based on adverse inferences drawn from the refusal to cooperate. Thus it is exceedingly important to evaluate the likelihood of whether a criminal investigation will follow or has already begun.



Although the taxpayer may not know what signs to look for, there are telltale indications that a criminal investigation is underway. First, it's important to note a revenue agent cannot mislead a taxpayer about the exclusively civil nature of an investigation.[4] If a revenue agent states no other agencies are involved in the case or the agent is unaware of a criminal investigation, the taxpayer can take those statements at face value. Unfortunately, it's usually not that easy. To avoid any suppression issues related to the misinformation of a taxpayer, IRS policy now states, "[u]nder no circumstances should the revenue officer inform the taxpayer that the case has been referred to CI."[5] Regardless, interactions with auditors have been known to provide both overt and subtle indications that there's a hidden criminal investigation under the surface.

Second, the players involved in the process can provide a dead giveaway. During a strictly civil matter, a taxpayer will encounter revenue officers and revenue agents. Revenue officers are tasked with collection. They deal with tax already assessed and may work to file notices of tax liens and levy wages or bank

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accounts. Revenue agents conduct audits. They investigate unreported income and scrutinize the propriety of deductions, credits and exemptions claimed on tax returns. Because of the coordination of efforts discussed above, the fact that the taxpayer and the taxpayer's accountant are solely interacting with these IRS representatives does not guarantee the absence of a criminal investigation. However, the involvement of an IRS special agent guarantees the existence of one. Special agents are the criminal investigators of the IRS, typically assigned to a separate division known as the Internal Revenue Service Criminal Investigation Division (IRS CI).

Third, and in a similar vein, revenue agents and revenue officers do not read taxpayers their rights. As a matter of policy, special agents do.[6] If the taxpayer is read his or her rights or gets wind that an IRS special agent is involved with the audit – whether in-person, on a telephone conference or carbon-copied on correspondence – begin planning and preparing for a criminal case.

GET A *KOVEL* FORENSIC ACCOUNTANT ON BOARD EARLY

Once a criminal investigation is imminent, the first thing the taxpayer should do is engage a qualified criminal defense attorney. In turn, the first thing the attorney should do is engage an accountant. Criminal tax enforcement cases boil down to numbers. For the reasons stated in the section below, those numbers will drive your client's sentencing exposure; and therefore, the case. To exert maximal influence on the outcome of the case and shape it along the way, you and your client need to understand those numbers as early as possible. You can't do it alone. As the 2nd Circuit put it in *United States v. Kovel*, "[a]ccounting concepts are a foreign language to some lawyers in almost all cases, and to almost all lawyers in some cases."[7] A retained accountant will help you interpret your client's financial records and figure out the potential tax liability based upon nuances within the Internal Revenue Code.

To get the full and confidential benefit of your accountant's services, you, as the criminal defense attorney, should be the party to retain the accountant and should do so through a *Kovel* agreement. A *Kovel* agreement between the attorney and accountant extends the attorney-client privilege to the accountant as "outside help" to promote "effective communication between the client and the lawyer."[8] Further, the agreement can establish the accountant is being retained to help the taxpayer client in anticipation of, or during, litigation, thereby protecting the accountant's assistance under the work-product doctrine.

Resist the temptation to use your client's existing accountants. You want a bright line between the individual's or business' regular financial advice and advice necessary for the provision of legal services. When an accountant has performed both, the court may more closely scrutinize the distinction between roles and require you to put on additional evidence to avoid an order compelling disclosure of the accountant's communications and work product. While 12 O.S. §2502.1 provides a level of protection for accountant-client communications, you're better off hiring a previously uninvolved independent consultant without fear of unwanted disclosure. Further, a *Kovel* accountant will provide you not only with an unvarnished opinion of the taxpayer's conduct, but also of the existing accountant's work.

You may find your client relied on faulty accounting when the challenged return was prepared, and the existing accountant may not be willing to accept responsibility for errors on the return. For these reasons, you need an independent examination of the existing record to advise your client.[9]

MASTER THE RELEVANT SENTENCING ISSUES

It's all about the money. Calculations of tax loss and restitution will determine the outcome of your case, most prominently at sentencing. The unfortunate reality for your client is that there is often no defense to the merits of the government's charge. Either income was reported and taxes were paid, or they weren't. While there are exceptions,[10] it is uncommon for there to be an absolute defense or for the IRS to flat out get it wrong. More likely, the open questions relate to how much should have been paid and how much is currently owed. This is where your independent *Kovel* accountant becomes an indispensable part of the defense team.

As early as possible, once the client engages you and your accountant, you need to conduct a deep dive into tax loss and restitution, along with other ancillary factors that determine advisory sentencing ranges under the United States Sentencing Commission's Sentencing Guidelines.[11] In federal court, nearly half of all sentences fall squarely within the range established by the guidelines.[12] The sentencing range for tax crimes is driven primarily by the dollar amount involved, or the "tax loss." The guidelines manual defines "tax loss" as the "total amount of loss that was the object of the offense."[13] For instance, in terms of failure to report legitimate earned income, the tax loss corresponds to the amount of tax the individual failed to pay on the unreported income; for employment tax evasion, the amount of evaded employment taxes the business entity failed to pay to the IRS.

As a criminal defense attorney, the greatest impact you can have on your client's case is to closely examine the government's tax loss calculation. Unabashedly, the government calculates tax loss in the light most favorable to the government with little consideration of the credits, deductions and exemptions that went unasserted by the taxpayer. Often the IRS's numbers are based on gross receipts and the total amount deposited into bank accounts without regard for expenses and other figures that would reduce your client's tax liability for the relevant periods. Working closely with your *Kovel* accountant, you can contest the IRS's calculations and even counter with credits, deductions and exemptions 1) that relate to the tax offense and could have been claimed at the time of the offense, 2) that are reasonably and practicable ascertainable and 3) that are sufficiently supported by information in advance of sentencing to support their probable accuracy.[14] In an ideal world, the client would have perfect records covering the entire relevant period and proving unclaimed credits, deductions and exemptions would be as simple as filing a record-supported amended return, but rarely is it that simple. More likely, you and your *Kovel* accountant will have to don a green eyeshade and investigate how your client's business operated on a granular level to create an effective defense strategy. The key takeaway is: there are several ways to calculate tax loss – do not take the government's calculation as a given.

In federal court, you can't lose sight of potential sources of relevant conduct. Relevant conduct permits the court to consider the defendant's actions outside the counts of conviction, if proven merely by a preponderance of the evidence, to increase the tax loss calculation. For example, the court may add to the loss amount based on uncharged state and federal tax offenses, conduct outside the statute of limitations and even charged conduct of which the defendant was acquitted. When the alleged conduct of the taxpayer reveals

a common pattern or scheme, you can anticipate the sentencing calculation, regardless of the counts of conviction, will include the aggregate amount of each instance of the scheme. The additional loss from the relevant conduct can cause the overall tax loss to jump into a greater loss category, increasing the defendant's base offense level and yielding a higher advisory sentencing guidelines range.

In addition to tax loss, you need to focus on restitution; your client certainly will. Restitution is the harm to the victim of the crime, which in tax cases is the IRS. Restitution is not the same as the tax loss amount. While ultimately the figures may be closely related, tax loss reflects the intended loss when the offense was committed, whereas restitution reflects, and is limited to, the IRS's actual losses suffered as a result of the defendant's conduct. For instance, previous payments on the tax liability would decrease the harm to the victim at the time of sentencing, but interest can serve to increase the restitution amount as the tax loss calculation remains static. Also, unclaimed deductions and credits affect the real amount the taxpayer owes to the IRS and therefore restitution.

Your grasp of the concepts of tax loss and restitution will determine your sentencing strategy and whether your client pleads with a written plea agreement or without. Typically, in a plea agreement, the government will require your client to waive a panoply of rights in exchange for some certainty as to sentence, tax loss calculations and restitution amounts. Your evaluation of the facts and how good the deal is relative to those facts will determine, as with other plea negotiations, whether to plead pursuant to an agreement. Be forewarned, however, that tax crime idiosyncrasies affect the value of certain plea agreement terms, including, for example, the potential to charge bargain, the form of restitution and presentencing advocacy.

You should not anticipate you'll be able to meaningfully charge bargain with government counsel due to the DOJ Tax Division's major count policy. The policy, promulgated in DOJ's Justice Manual (formerly known as the United States Attorneys' Manual or USAM), authorizes the prosecuting attorney to accept a plea only if it includes the charge designated by the Tax Division as "the major count," unless the prosecutor obtains exceptional approval from the Tax Division.[15] The major count is typically the tax evasion count that carries the most severe penalties involving the greatest financial loss to the United States.[16] As a result, your ability to drastically improve your client's position through charge bargaining is limited.

For offenses under Title 26 of the United States code, the government can only achieve a restitution order through a plea agreement. Title 26 does not contain the same restitution provisions as Title 18, but if the defendant agrees to restitution as a bargained-for provision of a plea agreement, the court is permitted to order restitution as an independent part of the sentence.[17] Otherwise, in the absence of a plea agreement, a court desiring to award restitution must make payment of restitution a condition of supervised release or probation.[18] What's the difference between an agreed-up restitution order and a condition to make restitution on supervised release or probation? A restitution order is a money judgment that will last 20 years, whereas a requirement to pay taxes owed under Title 26 is limited to a 10-year statute of limitations and confined to collection by the IRS. Restitution orders are subject to the government's broader collection tools.

Finally, as may be self-evident, once you agree on the appropriate amount of tax loss and restitution, you forfeit the ability during the presentencing phase to challenge those amounts. In the absence of a plea agreement, you retain the ability to present evidence in support of a reduced tax loss, which, if successful, will reduce the sentencing guideline and the restitution amount. One danger of agreeing on tax loss and restitution amounts is that your client can be locked in at those amounts, even if it is subsequently shown they are in excess of what the taxpayer was obligated to pay.[19] In the absence of an agreement, you retain plenary rights to prove the accuracy of contested figures, appeal tax loss determinations and restitution awards and receive a *de facto* restitution cap of the amount lost *for the count of conviction* as opposed to an amount that includes relevant conduct.

It's not over when the taxpayer receives his or her sentence. The IRS may have follow-on action since criminal restitution and civil tax liability are separate and distinct. In 2010, Congress amended the tax code to include a provision for assessing restitution. Section 6201 of Title 26 authorizes the IRS to assess as a tax the amount awarded as restitution in a criminal tax case.[20] Prior to the enactment of Section 6201, the IRS couldn't assess or take administrative action to collect an assessed or assessable amount of restitution. The IRS can also assess interest from the date the return was or should have been filed, not the date the IRS assessed the restitution. In the case of a tax return preparer convicted of aiding and assisting the preparation of false or fraudulent returns under 26 U.S.C. §7206(2), your client could be assessed the amounts owed by every client for which the preparer

prepared a false return. The return preparer would never have been individually liable for the client's taxes, but with a restitution assessment, it is possible, including interest that wouldn't be recoverable under the restitution order. You should become familiar with each facet of the potential financial impact of a tax conviction and sentence on your client.

CONCLUSION

Criminal tax cases are different from a criminal defense attorney's average case, but getting involved early – hopefully long before the case is ever charged – and spending the requisite time to get familiar with the nuances of defending tax cases is essential to effectively representing your client. Practitioners need to educate themselves with the indispensable outside help of a *Kovel* accountant, regarding tax-specific defenses, charging alternatives favorable to the client and the case in mitigation. There is often no viable defense to a criminal tax charge; IRS special agents are good at what they do.[21] The key to effectively defending your client is to stay outcome-focused and lay the groundwork to reduce the consequences of your client's conduct. Armed with a little understanding of the criminal tax landscape and a thoughtful approach, you can begin to generate favorable outcomes for taxpayers in these cases.

ABOUT THE AUTHORS

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ENDNOTES

1. IRS-CI Fiscal Year 2017 Annual Report, www.irs.gov/pub/foia/ig/ci/2017_criminal_investigation_annual_report.pdf.
2. IRS-CI Fiscal Year 2012 Annual Report, www.irs.gov/pub/foia/ig/ci/REPORT-fy2012-ci-annual-report-05-09-2013.pdf
3. Internal Revenue Manual §5.1.5.5.
4. *United States v. Tweel*, 550 F.2d 297 (5th Cir. 1977).
5. IRM §5.1.5.7.
6. IRM §9.4.5.11.3.1.
7. *United States v. Kovel*, 296 F.2d 918, 922 (2d Cir. 1961).
8. *Id.*
9. The relevant defenses to a criminal tax case are beyond the scope of this article, but practitioners should note that good faith reliance upon a professional or return preparer is a defense to a charge under 26 U.S.C. §7206(1).
10. The most common defense is lack of scienter. The government must prove beyond a reasonable doubt that the taxpayer willfully committed the offense. *Cheek v. United States*, 498 U.S. 192, 201 (1991).
11. United States Sentencing Commission, *Guidelines Manual* (November 2016).
12. U.S. Sentencing Comm'n, Interactive Sourcebook, Fiscal Year 2017, Table N, isb.ussc.gov.
13. USSG §2T1.1(c).
14. USSG §2T1.1(c), comment. (n.3).
15. U.S. Dep't of Justice, Justice Manual 6-4.310 (2018), www.justice.com/jm/jm-6-4000-criminal-tax-case-procedures#6-4.310.
16. *Id.*
17. 18 U.S.C. §3663(a)(3); *see United States v. Anderson*, 545 F.3d 1072, 1077-78 (D.C. Cir. 2008); *United States v. Firth*, 461 F.3d 914, 920 (7th Cir. 2006); *see also United States v. Gottesman*, 122 F.3d 150, 151-52 (2d Cir. 1997) (for the district court to order restitution pursuant to a plea agreement, the plea agreement must clearly contemplate such an order).
18. *See* 18 U.S.C. §3583(d); 18 U.S.C. §3563(b); 18 U.S.C. §3556; *see also* USSG §5E1.1(a)(2); *Gall v. United States*, 21 F.3d 107, 109-10 (6th Cir. 1994) (recognizing the propriety of plea agreement-based restitution orders in the sentencing guidelines and case law).
19. *See e.g. Choi v. United States*, 2018 WL 620454 (D. Md. 2018) (argument that restitution amount in plea agreement was more than what was owed was unavailing, in part, due to defendant's agreement).
20. This does not affect the restitution order, upon which the government can seek collection.
21. We leave for another day a discussion of the best way to defend a criminal tax trial, primarily because they're nearly as extinct as the black-footed ferret.