

Parallel Investigations: The Unclear Present Danger of Getting Caught

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Martin A. Schainbaum and Bryant Smith examine the issues arising when a taxpayer comes under investigation by both the civil and criminal arms of the IRS.

Introduction

Parallel civil and criminal investigations have posed risks to taxpayers for many years, particularly as the IRS has become more aggressive in conducting parallel investigations. In a reverse eggshell audit, a criminal tax investigation is disguised as a civil audit, allowing the IRS to use the investigative tools of a civil audit, like administrative subpoenas and examinations of tax records, without presenting taxpayers with a clear opportunity to invoke their constitutional rights of due process, the right against unreasonable searches and seizures, the right against self-incrimination, and the right to counsel. During such an audit, unwary taxpayers may unintentionally waive the attorney-client privilege or some of their constitutional rights, including the right against self-incrimination if their counsel is not careful and courageous.

In these situations, the taxpayer comes under investigation by both the civil and criminal arms of the IRS without necessarily being notified of the criminal investigation. Administrative summonses are a powerful tool that the IRS can use for either civil or criminal investigations, so long as those investigations are carried out within the administrative examination process. Once a case has been referred to the Justice Department, the IRS may no longer issue or enforce administrative summonses against the taxpayer or third parties (banks, title companies, credit card issuers, etc.).¹ In a criminal investigation, the IRS is not required to notify a taxpayer of the issuance of third-

party summonses.² Thus, if a civil audit is referred to the IRS's criminal investigation division (CI) without the taxpayer's knowledge, third-party summonses may also be issued without the taxpayer's knowledge and the IRS has an incentive to keep the investigation in-house rather than refer it to the Justice Department and lose the administrative summons power.

These parallel investigations endanger taxpayers because information provided to an examiner, although ostensibly for determining civil tax liability, may be used as evidence to prove criminal violations. While a special agent is required to advise the taxpayer of his or her constitutional rights against incrimination and the availability of an attorney prior to an interview, such interview will often be delayed, to avoid giving notice while the examiner continues to collect information and conduct interviews with the taxpayer. In addition, in some parallel investigations certain entities or tax years are subject to a criminal investigation while related entities or other tax years are the subject of a simultaneous civil audit. Any information collected by the civil examiner in this circumstance may be used in a criminal referral, again without the taxpayer's knowledge.³ Thus, a taxpayer may be under criminal investigation while his or her closely held corporation is the subject of a civil audit, or he or may be under criminal investigation for certain tax years and be the subject of concurrent civil investigation for other tax years.

I. *Tweet*⁴

In an eggshell audit, the auditing revenue agent is unaware that the taxpayer has filed one or more fraudulent returns, and the practitioner's primary

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goal in such an audit is to contain the audit to a civil examination, without having the case referred to the criminal investigation unit of the IRS or the Department of Justice. In contrast, in a reverse eggshell audit (or joint investigation or *sub rosa* criminal proceeding) the information collected by the IRS under the guise of a civil audit is being used to construct a criminal case against the taxpayer. In this situation, the practitioner's primary objective is to discover the criminal proceeding and protect the taxpayer from prosecution and self incrimination.

The best protection for taxpayers is provided by *N.J. Tweel*, which held that while intentional deception of the taxpayer is implicit in a reverse eggshell audit, the deception can only be tacit and cannot be affirmative. In *Tweel*, the taxpayer's accountant asked the examining revenue agent whether a "special agent" was involved in the investigation. The revenue agent answered that no special agent was involved. While the agent answered truthfully that no special agent was involved, the audit was conducted to acquire evidence for a criminal prosecution. The revenue agent knew that the accountant's question was intended to discover whether or not his client was the subject of a criminal investigation. The revenue agent's response to the accountant's inquiry "materially deceived" the taxpayer into providing incriminating information to the IRS. Ultimately, the IRS could not sustain a successful criminal prosecution because of the revenue agent's deceptive conduct.

If an examiner fraudulently asserts that there is no parallel criminal investigation, or if he continues a civil investigation after the discovery of firm indicators of fraud, which is supposed to trigger a criminal referral, any documents subsequently produced by the taxpayer are suppressible in a criminal prosecution.⁵ This second situation can be difficult for the practitioner because it may be difficult to prove the exact moment at which an examiner becomes aware of firm indicators of fraud for purposes of suppression. Furthermore, if a rule violation does not rise to the level of a constitutional violation, or if the violation is unintentional and does not prejudice taxpayer, there will be no suppression.⁶

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Prior to answering a summons or turning over documents, the practitioner should ask the revenue agent the magic question, "Is there is a parallel or *sub rosa* criminal investigation?" Ancillary questions to ask: Has this matter been referred to the fraud coordinator? If so, what guidance has been given by the fraud coordinator? Further, what information has been provided to the fraud coordinator, and by the fraud coordinator? These questions serve different purposes depending

on whether the audit is eggshell or reverse eggshell. If the audit is eggshell, such questions serve to protect the taxpayer. If the audit is a reverse eggshell, the questions can rescue the taxpayer, because such questions will either expose the existence of the criminal investigation or, if the examiner denies the existence of a criminal investigation of which he is aware, any information produced thereafter is suppressible under *Tweel*.

Finally, DON'T BE AFRAID TO TAKE THE FIFTH. If a civil investigation has some telltale signs of a criminal investigation, or if you think the examiner has discovered some firm indicators of fraud but not revealed that discovery, the taxpayer can refuse to answer a summons, by exercising his or her constitutional privilege not to incriminate himself or herself. This is another area that might give rise to suspicion in the examiner, but failure to invoke taxpayer's Fifth Amendment privileges can be even more damaging to a taxpayer as information gathered by an examiner can be used against the taxpayer in a criminal prosecution. Further, turning that information over to a civil examiner might constitute waiver of the taxpayer's Fourth, as well as Fifth Amendment constitutional protections.

II. *Stringer*⁷

In 2008, the Ninth Circuit vacated the indictment dismissal of three individual charged with criminal securities violations in *Stringer*. The court held that the government may conduct simultaneous criminal and civil investigations, as long as it does not act deceitfully in so doing. In *Stringer*, the Oregon U.S. Attorney's Office decided to conduct a criminal

investigation of the subjects of an ongoing SEC civil securities fraud investigation. The U.S. Attorney's Office decided to keep its criminal investigation confidential, but the two investigations proceeded in tandem, with the SEC providing information and documents to the U.S. Attorney's Office as evidence for a criminal prosecution. Under the instruction of the U.S. Attorney's Office, the SEC conducted "interviews of the defendants so as to create 'the best record possible' in support of 'false statement cases' against them." During the investigation, the SEC sent subpoenas to each of the defendants, attached to which was a form that notified the defendants that the information they supplied to the SEC would be made available to the U.S. Attorney's Office where appropriate. None of the defendants, although all represented by counsel, invoked their Fifth Amendment rights.

Based on the notification attached to the subpoenas and the defendants' failure to invoke the Fifth Amendment, the court found that the SEC had acted properly in conducting the parallel investigations. Citing *Kordel*,⁸ however, the court reaffirmed that the SEC cannot conduct parallel investigations in bad faith. The Court described such "bad faith cases [as being] where 'the [g]overnment has brought a civil action solely to obtain evidence for its criminal prosecution or has failed to advise the defendant in its civil proceeding that it contemplates his criminal prosecution ...'"⁹ Absent these circumstances, the SEC is justified in conducting parallel investigations. The same would be true for IRS investigations.

III. *Stringer II*?

In a case currently pending before the Ninth Circuit, the appellant has alleged that the civil investigation being conducted by the IRS is actually a *sub rosa* criminal proceeding.¹⁰ The IRS issued administrative summonses to the appellant, but repeatedly refused to represent that it is not conducting a criminal investigation, so the appellant invoked his Fifth Amendment rights, rather than answer the subject summonses. During the contempt proceedings that followed, the U.S. District Court for the District of Hawaii rejected the appellant's Fifth Amendment claims and required the appellant to produce the information requested in the summonses. Notwithstanding, reasonable efforts by the appellant to comply with the summonses at that point, the District Court found the appellant in

contempt of court for failing to comply with the summonses, principally on the basis of failure to answer incriminatory questions.

The facts of the *Liddell* case appear to be the same scenario discussed in *Stringer* where bad faith actions by the IRS bar parallel criminal and civil investigations. The IRS's failure to advise the appellant of a contemplated criminal prosecution indicates that any criminal investigation would be in bad faith. In addition, the IRS has proceeded with the "civil" investigation, including summons enforcement and probing questions indicating a criminal investigation, despite the issuance of a Notice of Deficiency asserting the civil fraud penalty. The issuance of the Notice of Deficiency demonstrates that the IRS believes it has sufficient information to determine and assess a civil tax liability and prove it by clear and convincing evidence. The IRS's continued pursuit of summonsed information, allegedly to determine Liddell's civil tax liability, is alleged to be for some other purpose. If this other purpose is a criminal investigation, then the IRS allegedly has acted in bad faith and, if so determined, such evidence collected during the parallel investigations should be disqualified from use against the taxpayer.

IV. Conclusion

Parallel investigations are sensitive and require the practitioner to be ever vigilant to protect taxpayer rights. Failure to ask the right questions at the sensitive juncture in the process may result in loss of taxpayer constitutional rights and privileges. Therefore, know your case prior to embarking on the examination process, always be careful and attentive to the areas of IRS inquiry, and walk the courageous and careful line to protect your client and preserve his or her constitutional rights.

ENDNOTES

- ¹ Code Sec. 7602(c)(3)-(d).
- ² Code Sec. 7602(c)(3)(C).
- ³ IRM §25.1.4.3.4.
- ⁴ *N.J. Tweel*, CA-5, 77-1 USTC ¶9330, 550 F2d 297.
- ⁵ See *A. Tousaint*, DC-TX, 78-2 USTC ¶9793, 456 FSupp 1069.
- ⁶ *A.L. Caceres*, SCT, 79-1 USTC ¶9294, 440 US 741; *J. Crystal*, CA-9, 99-1 USTC ¶50,464, 172 F3d 1141 (where a civil examiner mistakenly told a taxpayer that there was no parallel criminal investigation because he didn't know about it).
- ⁷ *United States v. Stringer*, 521 F3d 1189 (9th Cir. Or. 2008).
- ⁸ *United States v. Kordel*, 397 US 1 (U.S. 1970).
- ⁹ *Stringer*, *supra* note 7, quoting *Kordel*, *id.*, at 12-13.
- ¹⁰ *United States v. Liddell*, No. 07-16617 (9th Cir.) (pending); *United States v. Liddell*, No. 08-16082 (9th Cir.) (pending).