

The Eggshell Audit Part I: A Primer

By Larry A. Campagna, Caroline D. Ciraolo, and Eric L. Green

Larry A. Campagna, Caroline D. Ciraolo, and Eric L. Green examine the issues raised at the beginning of an audit, the applicable privileges, how to deal with the client, how to conduct a shadow investigation and how to work with the agent.

Despite its well publicized efforts in the area of offshore disclosures and criminal tax prosecutions, the IRS has not lost its focus on traditional audits and collections. The IRS has hired hundreds of new revenue agents, tax compliance officers and revenue officers, and has seen a corresponding increase in its compliance efforts. The increased audit activity naturally results in more “eggshell” audits, and a need among practitioners to review the tools available to the IRS and the strategies that should be considered to best represent their clients.

An eggshell audit is one in which the client and the representative are aware of potential indicators of civil fraud or criminal tax violations that have not yet come to the attention of the revenue agent or other examining officer. The primary goal in these audits is to avoid a referral by the revenue agent to the IRS Criminal Investigation Division (CI). The avoidance of a deficiency and civil penalties take a back seat.

This article is the first of a three-part series on eggshell audits. Part I addresses the issues raised at the beginning of the audit, including the applicable privileges, dealing with the client, conducting the shadow investigation and working with the agent. Part II will discuss indicators of fraud as defined by the IRS and the fraud development procedures followed by IRS examination and collection function employees.

In Part III, we return to the *Tweel* case and discuss the impact of post-*Tweel* developments on the IRS’s approach to civil examinations, particularly those cases where a revenue agent has identified indicators of fraud.

Preserving Privileged Information

So how does a practitioner best deal with an eggshell audit? The first step is to identify and preserve the privilege. The client likely has possession of information and documents that could expose the client to substantial civil penalties or criminal prosecution. It is important that the client share such communications with an attorney, not with the preparer of the tax returns at issue, and not with an accountant whose privilege under Code Sec. 7525 or state law does not extend to criminal investigations. The attorney can engage an accountant or other professional to assist with the audit and extend the attorney-client privilege to those individuals pursuant to *L. Kovel*.¹ Under a *Kovel* agreement, the accountant works for, and all files remain property of, the attorney. Because the “*Kovel* accountant” is cloaked with the attorney’s privilege, the client can discuss the sensitive information and share the critical documents with the accountant without fear that the IRS can obtain those documents or the *Kovel* accountant’s testimony through an administrative summons or grand jury subpoena.

Not every accountant can be employed under a *Kovel* relationship. For example, the accountant who prepared the return under audit cannot shield information obtained during the preparation process by entering into a *Kovel* agreement with the client’s

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tax attorney. The preparer has no privilege with respect to items on a return filed with the IRS. In addition, an accountant who was not the preparer, but who has been discussing the return and related issues with the client prior to contacting the attorney, is not the best candidate for a *Kovel* agreement. The *Kovel* agreement is not retroactive and cannot protect communications prior to its effective date. This often presents a professional dilemma for the attorney, who has been brought in to the case by a referring accountant who now wants to serve as the *Kovel* accountant. It is important to remember that the client's interests outweigh any potential business development.

Accountants should contact an attorney as soon as there is even a hint of potential fraud with respect to a return to prevent communications that may be subject to disclosure down the road.

Developing the Facts

Having established the privilege, the practitioner should conduct a "shadow audit" to determine what risks the client faces. Unfortunately, that often means it is time to take the client to the woodshed. Clients tend to withhold information regarding tax violations from everyone, including their own representatives. A practitioner should start with the tax return, review all information reported carefully, and then assume the role of a forensic accountant. Obtain all bank statements and cancelled checks, prepare a deposit analysis, and confront the client about unusual deposits, wire transfers or checks written to or received from unidentified third parties. The practitioner should obtain and carefully review all documents supporting deductions claimed, use third party tools to confirm information provided, and search for items that the client may have withheld. For example, if a client ever filed for bankruptcy protection, practitioners should review the Schedules of Assets and Statement of Financial Affairs filed with the U.S. Bankruptcy Court. Internet searches should be conducted for real property, personal property, business entities, and other relevant information available. Most clients

do not reveal everything during the initial meetings and need to be pushed to fully disclose all of the landmines present in a case. A practitioner should trust but verify everything.

The attorney should also review Part 4 (Examining Process) of the Internal Revenue Manual (IRM) and in particular, IRM 4.10.3, Examination Techniques, the training guide for revenue agents preparing for and conducting examinations.

If applicable, the attorney should study any applicable Audit Technique Guides available on the IRS website,² which provide detailed information regarding specific issues and industries, as well as documents that should be

requested and questions that should be asked by the revenue agent during the exam.

The attorney should interview the client's return preparer as soon as possible. It is not uncommon for the revenue agent to interview and/or request the work papers of the return preparer. The attorney should carefully review the return with the preparer, obtain copies of their work papers, ask the preparer to identify any documents requested by the preparer and/or provided by the client during the return preparation process. The attorney should inquire about the preparer's training and experience, as well as the length and nature of the relationship between the preparer and the client. The attorney should ask if the preparer had any concerns during the preparation process or thereafter regarding the client or the returns, and if so, whether the preparer discussed these concerns or anything else related to the client with third parties, including anyone from the IRS or other government agency.

The goal here is to learn what the revenue agent could learn, before the revenue agent learns it. Sometimes, there is a single, dangerous issue. If so, focusing on that issue and developing a strategy for handling the item before the agent becomes aware of it is key. Often, however, the client only informs the attorney of one area of potential fraud and the attorney later uncovers other problematic items. Even so, better to have discovered the additional items during a thorough shadow examination of the returns than for the agent to surprise the attorney with the additional issues.

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Handling the Examining Agent

Meanwhile, the revenue agent will schedule an initial meeting at the outset of the examination, and to the extent applicable, the agent will request a tour of the client's business. It goes without saying that a client should not voluntarily meet with a revenue agent in an eggshell audit. That being said, the practitioner must decide who will be the face of the audit. If fees are not an issue, the ideal approach is for the attorney to engage an accountant, who will be the contact with the revenue agent. That accountant will not meet with the taxpayer; instead, the accountant will act as a conduit, acting at the direction of the attorney. Under this approach, the accountant can respond to inquiries and transmit documents based on information provided by the attorney, but when faced with sensitive questions, can honestly respond that those issues have not been discussed with the taxpayer and that the accountant is unable to provide the requested information. Of course, most clients are unable or unwilling to pay for several professionals; in those cases, the attorney will meet with the revenue agent and must be very careful to avoid misrepresentations or false statements.

So what does an attorney do when the revenue agent asks the questions that touch on the sensitive issues the client is hoping to avoid? For example, what if the revenue agent requests the client's books and records, and the client has two sets of books? Or the revenue agent asks the attorney if there is anything on the return that is incorrect? Or the attorney learns that before he or she was engaged, the client produced false invoices to the revenue agent? First and foremost, the attorney may not misrepresent the facts or mislead the revenue agent. Doing so constitutes obstruction and interference with the internal revenue laws under Code Sec. 7212, or other criminal tax offenses.³ With that said, the attorney may not disclose, without the client's permission, privileged communications that reveal false statements on the return.

The ultimate answer to these questions depends on the particular facts and circumstances of a given case. In some situations, the attorney can take a proactive approach, disclosing the problems

on the returns, producing a *pro forma* amended return (not signed by the client) reflecting what the attorney believes is the accurate tax due, and offering a check for the tax and interest due. In the face of this *mea culpa*, the revenue agent may appreciate the disclosure and the time and effort invested by the representative, and opt to simply include the issue in their proposed adjustments with an accuracy-related (or civil fraud) penalty. In other situations, such a disclosure will lead to a criminal referral. Where a criminal referral seems likely, the attorney may simply decline to provide the information and wait to see if the revenue agent issues

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an administrative summons to the taxpayer in accordance with Code Sec. 7521(c) and pursuant to Code Sec. 7602.

If a summons is issued pursuant to Code Sec. 7602(a), the taxpayer will be faced with a decision—submit to an interview and/or produce the documents requested, or invoke his or her right under the Fifth Amendment to decline to respond on the grounds that the response may incriminate him or her. If the taxpayer reaches a point where he or she is invoking the Fifth Amendment privilege, the chance of a referral to CI clearly increases. Still, having the client invoke the Fifth Amendment privilege is preferable to joining the prosecution team.

The revenue agent has a right to tour the business pursuant to Reg. §301.7605-1(d)(3)(iii), but not to do so in a manner that disrupts business operations or requires the presence of employees.⁴ If a revenue agent requests a tour of the business, a practitioner should schedule the tour before the business opens, or after a close of business, and the practitioner (not the client) should be present during the tour.

All requests from the revenue agent during the civil examination, and all responses from the client through his or her attorney, should be in writing. The attorney should presume that all responses will be reviewed by someone other than the revenue agent, so the responses should be clear and concise. The responses also should be reviewed and approved by the client before they are sent to the revenue agent. Do not leave it to the revenue agent to unilaterally summarize a response in his or her own words.

Potential Referral for Criminal Investigation

Finally, an attorney should remain vigilant throughout the audit. A revenue agent can be extremely professional, friendly and reassuring, all the while preparing a referral to CI. If an attorney suspects that the revenue agent has identified the sensitive issue and may be considering a referral, the approach to the case may change. The attorney could ask the revenue agent whether there has been any contact with the Fraud Technical Advisor (FTA). The FTA, formerly known as a Fraud Referral Specialist, is a civil agent who assists other revenue agents in examinations where the potential for a civil fraud penalty or a referral to CI exists. The risk of asking if the agent has been talking to the FTA is that doing so may initiate a fraud investigation or consideration of a referral to CI where no such intention existed.

Before the creation of the FTA position, much attention was given to whether a revenue agent violates the Manual by failing to refer a matter to Criminal Investigation once the agent finds a “firm indication of fraud.” This standard developed from *N.J. Tweel*,⁵ a case in which the revenue agent willfully misled the taxpayers into believing that the examination was strictly civil in nature when in fact the examination was being used as a stalking horse for a criminal investigation.

Over the last several decades, *Tweel* has stood for the principle that the IRS cannot conduct a criminal tax investigation under the guise of a civil audit without risking suppression of any evidence obtained during the civil process. The IRS still honors this policy, as evidenced by the guidelines set forth in the Internal Revenue Manual.⁶ These rules require the agent to refer the case to CI once the agent finds a “firm indication of fraud.” Access to FTAs eliminates the need for a revenue agent to engage in early or premature consultations with CI. The IRS contends that the use of FTAs does not violate the *Tweel* doctrine, and it certainly has resulted in increased

and improved criminal referrals.⁷ We will return to the continued viability of *Tweel* in Part III of this series.

Upon firm indications of fraud, revenue agents are directed to suspend a civil examination and not to disclose the reason for suspension to the taxpayer or representative.⁸ Following *Tweel* and its progeny, the agents may not give false or deceitful responses when asked directly whether a case is being referred. Under the IRM, a revenue agent:⁹

- may decline to answer questions about criminal potential,
- may not deceive taxpayers when asked specifically about the character or nature of an investigation,
- are not required to initiate disclosure about developing indicators of fraud or a potential referral to CI, or
- may simply advise that when indicators of fraud are present, a referral to CI is required.

So short of a direct inquiry, how does a taxpayer know that a case is headed in the wrong direction or has been suspended? There are some tell-tale signs. Is there undue interest in a particular transaction? Does the revenue agent bring his or her manager to meetings? Is the revenue agent contacting and interviewing third parties? Are there repeated questions regarding the taxpayer’s state of mind or intent with respect to specific items of income or deductions? After significant activity, has the revenue agent gone silent? If many of these questions are answered in the affirmative, you may have a criminal referral on your hands.

ENDNOTES

- ¹ *L. Kovel*, CA-2, 62-1 USTC ¶9111, 296 F2d 918.
- ² <http://www.irs.gov/businesses/small/article/0,,id=108149,00.html#L>.
- ³ See IRM 25.1.2.5(3) (Jan. 1, 2003).
- ⁴ See IRM 4.10.3.3.1 (Mar. 1, 2003).
- ⁵ *N.J. Tweel*, CA-5, 77-1 USTC ¶9330, 550 F2d 297.
- ⁶ See IRM 25.1.2.2(6) (Oct. 30, 2009).
- ⁷ See TIGTA Memorandum dated Sept. 18, 2007, *Management Has Emphasized the Fraud Program, but Opportunities Exist to Further Improve It* (Reference No. 2007-30-179).
- ⁸ IRM 25.1.3.2(1) (12-27-2011).
- ⁹ *Id.*; see also IRM 4.2.4.1(3) (10-01-2003).

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