

The Eggshell Audit, Part II: Indicators of Fraud and IRS Fraud Development Procedures

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

Larry A. Campagna, Caroline D. Ciraolo and Eric L. Green review the indicators of fraud that often lead to criminal referrals and examine the fraud development procedures followed by the IRS.

In Part I of our series, we offered a primer on the eggshell audit, addressing the issues raised at the beginning of the audit, the applicable privileges, dealing with the client, conducting the shadow investigation and working with the agent.¹ Here, we review the indicators of fraud that often lead to criminal referrals and take a closer look at the fraud development procedures followed by the IRS. This article focuses on the eggshell audit, but much of the discussion applies equally to collection function employees.² Part III of our series will address the IRS's Special Enforcement Program (SEP) and the increasing use of SEP agents in sensitive and complex examinations.³

Under its National Fraud Program, the IRS seeks to encourage voluntary compliance through the imposition of civil penalties and, where warranted, the recommendation of a criminal investigation of taxpayers who willfully and intentionally evade the reporting or payment of tax. IRS examiners are trained to identify signs, also referred to as "first indicators"

or "badges," of fraud.⁴ The IRS offers an extensive, but not exclusive, list of examples by category as illustrated in Exhibit 1.⁵

In recognizing and developing fraud cases, the IRS views the first contact with the taxpayer as a valuable opportunity to obtain information that may not be readily available later in the examination. This may be because the taxpayer is not yet represented, is not prepared for the questions, has not had time to get his story straight, or has not yet disclosed to his or her representative the problem areas on the return. As noted in Part I, a representative should not permit the taxpayer to be interviewed unless and until the representative has carefully and thoroughly interviewed the client and verified the positions taken. Following any contacts, the agent should prepare a Memorandum of Interview that outlines the information obtained and statements made by the taxpayer.

Typical Sensitive Audits

Fraud cases often involve sole proprietors and small businesses with one or two people in charge and poor or inadequate internal controls. This environment allows for greater opportunity to understate income or inflate expenses. During their examination, agents are instructed to identify the individuals who prepared the information used

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Exhibit 1.

Indicators of Fraud—Income

- Omissions of specific items where similar items are included
- Omissions of entire sources of income
- Unexplained failure to report substantial amounts of income identified as received
- Substantial unexplained increases in net worth, especially over a period of years
- Substantial personal expenditures exceeding reported available resources
- Bank deposits from unexplained sources substantially exceeding reported income
- Concealment of bank accounts, brokerage accounts, and other property
- Inadequate explanation for dealing in large sums of currency, or the unexplained expenditure of currency
- Consistent concealment of unexplained currency, especially in a business not routinely requiring large cash transactions
- Failure to deposit receipts in a business account, contrary to established practices
- Failure to file a tax return, especially for a period of several years, despite substantial amounts of taxable income were received
- Cashing checks, representing income, at check cashing services and at banks where the taxpayer does not maintain an account
- Concealing sources of receipts by false description of the source(s) of disclosed income, and/or nontaxable receipts

Indicators of Fraud—Expenses or Deductions

- Substantial overstatement of deductions
- Substantial amounts of personal expenditures deducted as business expenses
- Claiming fictitious deductions
- Dependency exemption claimed for nonexistent, deceased or self-supporting persons.
- Providing false or altered documents, such as birth certificates, lease documents, school/medical records, for the purpose of claiming the education credit, additional child tax credit, earned income tax credit (EITC) or other refundable credits
- Trust fund loans disguised as expenses or deductions

Indicators of Fraud—Books and Records

- Maintaining multiple sets of books or no records
- False entries, or alterations made on the books and records; back-dated or post-dated documents; false invoices, false applications, false statements or other false documents or applications
- Invoices are irregularly numbered, unnumbered or altered
- Checks made payable to third parties that are endorsed back to the taxpayer; checks made payable to vendors and other business payees that are cashed by the taxpayer
- Failure to keep adequate records, concealment of records or refusal to make records available
- Variances between treatment of questionable items as reflected on the tax return, and representations within the books
- Intentional under- or over-footing of columns in journal or ledger
- Amounts on tax return not in agreement with amounts in books
- Amounts posted to ledger accounts not in agreement with source books or records
- Journalizing of questionable items out of correct account
- Recording income items in suspense or asset accounts
- False receipts to donors by exempt organizations

Indicators of Fraud—Allocations of Income

- Distribution of profits to fictitious partners
- Inclusion of income or deductions in the tax return of a related taxpayer, when difference in tax rates is a factor

Indicators of Fraud—Conduct of Taxpayer

- False statement about a material fact pertaining to the examination
- Attempts to hinder or obstruct the examination; e.g., failure to answer questions; repeated cancelled or rescheduled appointments; refusal to provide records; threatening potential witnesses, including the examiner; or assaulting the examiner
- Failure to follow the advice of accountant, attorney or return preparer
- Failure to make full disclosure of relevant facts to the accountant, attorney or return preparer

- The taxpayer's knowledge of taxes and business practices where numerous questionable items appear on the tax returns
- Testimony of employees concerning irregular business practices by the taxpayer
- Destruction of books and records, especially if just after examination was started
- Transfer of assets for purposes of concealment, or diversion of funds and/or assets by officials or trustees
- Patterns of consistent failure over several years to report income fully
- Proof that the tax return was incorrect to such an extent and in respect to items of such magnitude and character as to compel the conclusion that the falsity was known and deliberate
- Payment of improper expenses by or for officials or trustees
- Willful and intentional failure to execute pension plan amendments
- Backdating applications and related documents
- Making false statements on Tax Exempt/Government Entity (TE/GE) determination letter applications
- Use of false Social Security numbers
- Submission of false Form W-4
- Submitting a false affidavit
- Attempts to bribe the examiner
- Submission of tax returns with false claims of withholding (Form 1099-OID, Form W-2) or

refundable credits (Form 4136, Form 2439) resulting in a substantial refund

- Intentional submission of a bad check resulting in erroneous refunds and releases of liens
- Submission of false Form W-7 information to secure Individual Taxpayer Identification Number (ITIN) for self and dependants

Indicators of Fraud—Methods of Concealment

- Inadequacy of consideration
- Insolvency of transferor
- Asset ownership placed in other names
- Transfer of all or nearly all of debtor's property
- Close relationship between parties to the transfer
- Transfer made in anticipation of a tax assessment or while the investigation of a deficiency is pending
- Reservation of any interest in the property transferred
- Transaction not in the usual course of business
- Retention of possession or continued use of asset
- Transactions surrounded by secrecy
- False entries in books of transferor or transferee
- Unusual disposition of the consideration received for the property
- Use of secret bank accounts for income
- Deposits into bank accounts under nominee names
- Conduct of business transactions in false names

to complete the returns, approved and classified expenses, were responsible for the bank deposits and ultimately determined the gross receipts of the business.⁶ The MANUAL goes into further detail with respect to specific types of offenses, providing insight into various areas and describing ways a taxpayer might engage in affirmative acts of fraud.

For example, the IRS will investigate potential bankruptcy offenses under Title 18 of the U.S. Code where there is a corresponding offense of the Internal Revenue Code. An agent will carefully review the Petition and Statement of Financial Affairs (SOFA) and often attend the first meeting of creditors, where the debtor is required to answer questions regarding their financial affairs under oath. Indications of fraud in bankruptcy cases include, but are not limited to, failure to disclose

assets or income on the SOFA; transfers of assets for little or no consideration within two years of filing bankruptcy; maintaining a lifestyle that does not match reported income; lack of accounts in the debtor's name; failure to file personal or business tax returns; and the presence of a trust holding assets previously owned by or purchased with funds belonging to the debtor.⁷

The MANUAL also address employment tax fraud.⁸ The IRS recognizes that employers will often misclassify workers in an effort to avoid paying employment tax, and fail to account for, collect and deposit trust fund liabilities and file employment tax returns, resulting in violations of Code Secs. 7202, 7203, 7206, 7212 and 7215. Revenue agents and revenue officers are trained to look for "pyramiding," where a taxpayer

collects and withholds tax from its employees, fails to remit those taxes to the government, and when the liabilities accumulate or the business fails to generate a profit, shuts the business down and creates a new entity under a new name and employer identification number, but with the same fraudulent pattern.

The IRS is also interested in employee leasing companies that hire some or all of their client's employees, and lease those employees back to the client. Employee leasing companies are often shell entities with little or no assets. Many have failed to deposit employment tax, running up large liabilities in a short period of time. Agents are advised to consider a referral if the evidence suggests that the leasing company was established or used by the client with the intent to evade employment tax.⁹

Another indicator of fraud in the employment tax arena is the payment of cash wages, often evidenced by the taxpayer issuing checks to "cash" in large amounts to cover payroll. The IRS is aware that some companies pay workers in part or entirely in cash to avoid employment tax obligations. These companies also use cash payments to circumvent overtime requirements. Cash payrolls also frequently result in income tax evasion by the payees' workers. The MANUAL notes the prevalence of this practice in the construction and landscaping industries.¹⁰

A variation of the foregoing schemes is the use of fictitious subcontractors, whereby the taxpayer will issue checks to a shell corporation set up by the taxpayer or a third party (also known as a "five percenter") and claim those amounts as payments to a legitimate contractor. The corporation will cash the checks, retain a percentage if operated by a third party, and return the cash to the taxpayer, who uses the funds to pay its workers off the books. The IRS notes that the shell corporations frequently shut down, and new corporations are formed to avoid detection.¹¹

Another area of interest for the IRS is excise tax fraud, a broad category that includes fuel taxes, communication tax, air transportation tax, wagering tax, retailer schemes and heavy highway vehicle use tax.¹² Taxpayers may seek to evade the payment of excise tax, fail to file required returns or file false claims for refund. In these cases, the examining agent takes particular note of the destruction of records, sales at tax-included prices where tax is not reported

or paid to the government, multiple refund claims for the same tax, and false invoices omitting collected tax or falsely characterizing a customer as exempt.

If Fraud Is Discovered

When fraud indicators are uncovered, the examining agent will document the indicators and initiate a discussion with the group manager. At the IRS's Small Business/Self-Employed (SB/SE) Campuses—Brookhaven, Cincinnati, Memphis, Ogden and Philadelphia, Functional Fraud Coordinators (FFC) serve as fraud liaisons and are responsible for reviewing Forms 13549 (Campus Fraud Lead Sheets). The Wage & Income (W&I) division has corresponding AUR ("Automated Under Reporter") FFCs at its Campuses in Andover, Atlanta, Fresno and Kansas City. In addition, each SB/SE Campus has a Campus Fraud Coordinator (CFC), and each W&I exam function has an Exam Fraud Coordinator (EFC). A CFC or EFC has 21 days to accept or decline a fraud lead submitted on a Form 13549.

In a field audit, if the group manager agrees that the fraud indicators warrant further development, they will contact a Fraud Technical Advisor (FTA).¹³ If the revenue agent, group manager and FTA concur that affirmative acts of fraud may be present, the revenue agent will prepare a Form 11661, *Fraud Development Recommendation—Examination* (or for a collection case, a Form 11661-A, *Fraud Development Recommendation—Collection*) and submit for manager approval. If the group manager agrees, the form is sent to the FTA for final approval. The Campuses follow similar procedures, with the CFC/EFC preparing the Form 11661 and submitting it to the FTA for concurrence.

A Form 11661 documents the presence of an FTA in the case and places the case in fraud development status. For examinations, the revenue agent will update the Audit Information Management System (AIMS) to status code 17. For collections, the revenue officer will request the input of ICS sub-code 910, or TC 971 AC 281. If a case is placed in fraud development status, the revenue agent or CFC/EFC must form an initial Plan of Action that includes, at a minimum, following up on all leads, securing copies of all documents and noting the source of the documents, and attempting to interview the taxpayer to explain, among other things, any discrepancies.¹⁴

In fraud development cases, original returns must be requested and reviewed.¹⁵ On the other hand, where fraud is suspected and a return has not been filed, the revenue agent is advised *not* to ask for the return, and if returns are offered by the taxpayer, they should be accepted. This is in line with the IRS's Non-Solicitation Policy, found in IRM § 38.3.1.6, which notes that solicitation of a return or "a summons for information by which a return can be prepared if the taxpayer understands that a return could be filed in lieu of specific compliance with the summons" can be "detrimental to a criminal case in that the defense can be expected to argue that the prosecution was instituted because of the unsuccessful attempt to dispose of the matter civilly and as a substitute for unsuccessful collection." The revenue agent should still request the books and records for the years at issue. To avoid an argument that the IRS is using the civil examination process to build a criminal case, revenue agents are expressly advised not to consult with Criminal Investigation regarding a specific case under examination.¹⁶

As noted in Part I of this series, if affirmative acts of fraud are established, the revenue agent must suspend the examination and immediately notify the group manager and the FTA without disclosing the findings to the taxpayer.¹⁷ If the taxpayer or the representative asks if a fraud referral is being considered or if Criminal Investigation is involved in the case, the revenue agent is not permitted to give false or misleading information. Instead, the MANUAL offers the following guidance:

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

Referral to Criminal Investigation

At this point, the revenue agent will complete a Form 2797 (*Referral Report of Potential Criminal Fraud Cases*), which will include a description of the firm indications of fraud, the taxpayer's explanations to the

extent obtained, the estimated criminal tax liability, and the method of proof use to verify income. The group manager will review the Form 2797 and, upon approval, forward it to the FTA, who will recommend referral to Criminal Investigation if the criminal referral criteria have been met.¹⁸

Within 10 days of Criminal Investigation receiving the file, the special agent assigned to the case will identify the subject as the primary investigation and set up the initial conference with the revenue agent, group manager, supervisory special agent and the FTA to discuss the referral and review the tax returns, evidence gathered and criminal tax computations. Other matters addressed at the initial meeting include whether returns were solicited, attempts made to resolve the civil issues, prior actions by the IRS involving a similar alleged offense, characteristics of the taxpayer such as age, health, education and occupation, and the public interest and deterrent effect of any investigation and prosecution.¹⁹ Within 30 days of the referral, the same individuals will meet again for a disposition conference to discuss Criminal Investigation's decision to accept or decline the referral. The 30-day period may be extended by written agreement.

If the referral is accepted, the primary investigation is elevated as a Subject Criminal Investigation, a TC 914 control is added to the master file and the AIMS status is revised to code 18. If Criminal Investigation declines the referral, the file is returned to the FTA group manager with a memorandum explaining the reasons for denial. The FTA will consider recommending the civil fraud penalty and, if appropriate, the 10-year ban on the Earned Income Tax Credit (EITC) under Code Sec. 32(k). Upon receipt of the file, the revenue agent will resume the examination and may refer the case again if additional firm indications of fraud are developed. If no further actions related to criminal or civil fraud development are anticipated, the agent should remove the case from fraud development status.²⁰

As the foregoing suggests, the IRS has established a very structured and comprehensive review process and procedures for determining whether taxpayers are referred for a criminal investigation. Representatives need to be aware of the fraud indicators identified by the IRS, thoroughly investigate their client's returns and financial affairs, and carefully prepare for any conversations and meetings with the IRS to avoid conduct that will aggravate an already sensitive audit.

ENDNOTES

- ¹ Larry A. Campagna, Caroline D. Ciraolo and Eric B. Green, *The Eggshell Audit Part I: A Primer*, J. TAX PRACTICE & PROCEDURE, June-July 2012, at 21.
- ² See Internal Revenue Manual (“the MANUAL” or “IRM”) §25.1.8 (Feb. 14, 2013), *Fraud Handbook, Field Collection*, and §25.1.11 (Dec. 27, 2011), *Fraud Handbook, Campus Collection Fraud Procedures*.
- ³ For a wonderful analysis of *N.J. Tweel*, CA-5, 77-1 USTC ¶9330, 550 F2d 297 (1977), the creation of the Fraud Technical Advisor (FTA) and the constitutionality of the FTA position in the civil division, as opposed to the criminal division, we recommend Andrew D. Allen and Martin A. Schainbaum, *Substance over Form: The IRS Fraud Technical Advisor, Civil or Criminal Agent?* J. TAX PRACTICE & PROCEDURE, Dec. 2012–Jan. 2013.
- ⁴ See IRM §25.1.2 (Jan. 11, 2013), *Fraud Handbook, Recognizing and Developing Fraud*; §25.1.14 (09-07-2010), *Fraud Handbook, Campus Examination Fraud Procedures*.
- ⁵ IRM §25.1.2.3 (Jan. 11, 2013).
- ⁶ IRM §25.1.2.4(6) (Jan. 11, 2013).
- ⁷ IRM §25.1.2.6 (Jan. 11, 2013).
- ⁸ IRM §25.1.2.7 (Jan. 11, 2013); see also IRM 1.2.13.1.2, *Policy Statement 4-4*.
- ⁹ IRM §25.1.2.7(3) (Jan. 11, 2013).
- ¹⁰ IRM §25.1.2.7(4) (Jan. 11, 2013).
- ¹¹ IRM §25.1.2.7(5) (Jan. 11, 2013).
- ¹² IRM §25.1.2.8 (Jan. 11, 2013).
- ¹³ IRM §25.1.2.2 (Jan. 11, 2013).
- ¹⁴ IRM §25.1.2.4 (Jan. 11, 2013).
- ¹⁵ IRM §25.1.2.2(6) (Jan. 11, 2013).
- ¹⁶ IRM §25.1.2.2(6) (Jan. 11, 2013).
- ¹⁷ IRM §25.1.3.2 (Dec. 27, 2011).
- ¹⁸ See IRM 25.1.3, *Criminal Referrals*.
- ¹⁹ IRM §25.1.3.3 (Dec. 27, 2011).
- ²⁰ IRM §25.1.3.5 (Dec. 27, 2011).

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