

Client Criminal Matters and the CPA:

Practice Guide

AICPA Tax Division

January 2011



Copyright © 2011
American Institute of Certified Public Accountants, Inc.
New York, NY 10036-8775

All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please visit www.copyright.com or call (978) 750-8400.

Notice to Readers

Often a CPA is a taxpayer's representative during the early phases of an IRS investigation that ultimately results in a criminal investigation. This practice guide provides practical insights concerning issues of which the CPA should be aware and procedures the CPA should follow in providing advice to a taxpayer if the CPA believes that the taxpayer may face possible exposure to allegations of fraud or other criminal misconduct. The information set forth in this practice guide is not to replace the CPA's need to consult with legal counsel regarding the appropriate steps to follow upon learning of the existence of a potential criminal matter.

This practice guide is designed to provide illustrative information with respect to the subject matter covered. It does not establish standards or preferred practices. The AICPA's Statements on Standards for Tax Services ("SSTs") are the enforceable tax practice standards for members of the AICPA.

This material was prepared by AICPA committee members and staff; it has not been adopted by the AICPA Tax Executive Committee or the AICPA Board of Directors and does not represent an official opinion or position of the AICPA. It is provided with the understanding that the individuals who worked on its development and the publisher are not engaged in rendering legal, accounting, or other professional service as a result of this practice guide. If legal advice or other expert assistance is required, the services of a competent professional should be sought. The individuals who worked on this publication and the publisher make no representations, warranties, or guarantees about and assume no responsibility for the content or application of the material contained herein and expressly disclaim all liability for any damages arising out of the use of, reference to, or reliance on such material.

Although much thought and effort have gone into the development of this guide, the matters discussed herein are subject to change. You need to consider the impact of developments occurring after this practice guide was written. In addition, the law itself is subject to varying interpretations. Accordingly, you retain responsibility for the final use of this guide's content. Please review the material carefully and make any changes necessary for your specific purposes.

The AICPA thanks James H. Schlessler, Washington, DC, for developing this practice guide and the other members of the Tax Practice Responsibilities Committee for their assistance in the review process.

Table of Contents

	Page
Overview.....	1
Criminal Authority of the IRS	1
Crimes Arising Under the Internal Revenue Code	2
Criminal vs. Civil Penalties	2
IRS’s Handling of Criminal Matters.....	3
Sources of Criminal Investigations.....	4
The Civil Examination and Firm Indications of Fraud.....	4
Referral to the Criminal Investigation Division.....	5
Special Agent Activities	5
Evidentiary Considerations for the CPA.....	6
Constitutional Privileges.....	7
Attorney-Client Privilege.....	8
Work Product Doctrine	8
Accountant-Client Privilege.....	8
Kovel Arrangements.....	9
Other Areas of Focus for the CPA.....	9
File Maintenance and Retention	9
New Client Acceptance.....	10
Providing Advice to a Client.....	10
During Return Preparation-Knowledge of a Client’s Past Errors.....	10
During an Examination-Knowledge of a Client’s Past Errors (“Eggshell Audits”).....	11
Interaction with the IRS	11
Need for Representation for the CPA	11
Appendix A: Summary of Internal Revenue Code Criminal Provisions.....	13
Bibliography.....	16

Client Criminal Matters and the CPA

Overview

Occasionally, a taxpayer may become the possible subject of a criminal investigation or criminal proceeding about a specific tax matter or a set of tax matters (referred to as a *potential criminal matter*). This may be the result of a questionable filing the taxpayer made or may result from a failure to file on the part of the taxpayer. If convicted in a criminal tax matter, a taxpayer generally faces imprisonment.

As a result, in such situations, it is important that the CPA be aware of pertinent issues (including consideration of the potential privileges available to the client in the attorney-client relationship) and appropriate actions to take. Statement on Standards for Tax Services (SSTS) No. 6, *Knowledge of Error: Return Preparation and Administrative Proceedings* (AICPA, *Professional Standards*, vol. 2, TS sec. 600), states that if a member believes a taxpayer may face possible exposure to allegations of fraud or other criminal misconduct, the CPA should advise the taxpayer to consult with an attorney before the taxpayer takes any action. As the language of SSTS No. 6 indicates, this advice should be given to the client or prospective client as early as possible to best protect that client and the CPA.

A taxpayer may need to engage the services of a CPA for assistance regarding a tax matter that may become or is already a potential criminal matter. In these cases, the CPA may be replacing another CPA who has previously provided services to the taxpayer or may be the initial CPA who will be providing services to the taxpayer regarding the potential criminal matter. In either case, it is important that the new CPA take precautionary measures in order to best serve the interests of the client and the CPA.

This practice guide is designed to provide the CPA with relevant background regarding potential criminal matters in general and practical guidance with respect to handling such situations with respect to existing and prospective clients. The first two sections of this practice guide, “Criminal Authority of the IRS” and “IRS’s Handling of Criminal Matters,” summarize the jurisdiction of the IRS in criminal matters and the procedures it follows in criminal investigations. The last two sections of this practice guide, “Evidentiary Considerations for the CPA” and “Other Areas of Focus for the CPA,” summarize various matters of potential interest to the CPA, including the importance of client privileges and how they can be established and maintained, as well as providing ongoing advice to a client when the CPA becomes aware that a current client is, or may become, the possible subject of an investigation regarding a potential criminal matter.

Criminal Authority of the IRS

The IRS has 3 primary areas of authority to enforce criminal statutes. It has the authority to investigate crimes arising under: the Internal Revenue Code (IRC); Title 18 *U.S. Code* (USC) Sections 1956 and 1957, which deal with money laundering; and Title 31 USC section 5311 et seq., *The Bank Secrecy Act*. In addition to these criminal offenses, the IRS also has enforcement authority for certain provisions in Title 18 regarding criminal penalties applicable to fraud and miscellaneous investigations. IRS’s enforcement authority under Title 18 includes provisions

relating to conspiracy, perjury, mail and wire fraud, racketeering, aiding and abetting, and false claims against the government. The Department of Justice (DOJ) *Criminal Tax Manual* provides great detail about the basic elements of the various tax crimes and the DOJ's policies regarding prosecution of such crimes. It is available on the DOJ Web site.

This guide will address the IRS's activities with respect to crimes arising under the IRC, since those are the IRS's main enforcement priority and also the areas of criminal law that CPAs and other tax practitioners are most likely to encounter.

Crimes Arising Under the Internal Revenue Code

Chapter 75 of the IRC contains the criminal offenses under the federal tax laws. The most familiar tax offense is tax evasion under IRC section 7201. Tax evasion is a felony, with a maximum sentence of 5 years in prison. The elements of tax evasion are (1) a deficiency in tax, (2) an affirmative act or attempted act of evasion, and (3) willfulness.¹ An affirmative act of evasion means something more than a failure to perform a duty, such as file a return. An affirmative act of evasion is conduct that has the likely effect of misleading or concealing wrongdoing.² Willfulness requires the intentional violation of a known legal duty as opposed to a careless disregard for the truth or negligence.³ The test for willfulness in tax evasion is subjective rather than objective, and good faith reliance on the advice of a tax practitioner (after complete factual disclosure to the practitioner) is a defense to the crime.⁴

Although tax evasion may be the most commonly known tax crime, in situations where it may be difficult to prove the element of a tax deficiency beyond a reasonable doubt, the government will often bring charges under IRC section 7206(1), for willfully making and subscribing to a false return, statement, or other document, which also is a felony.⁵ Section 7206(1) sets forth the following elements for this offense: (1) the willful making and subscribing to a return, statement, or other document under penalties of perjury and (2) not believing it to be true and correct with respect to every material matter.

Appendix A, "Summary of Internal Revenue Code Criminal Provisions," describes most of the other criminal offenses contained in Chapter 75 of the IRC.

Criminal vs. Civil Penalties

For many violations of the IRC, the IRS has the choice of whether to pursue civil penalties or a criminal prosecution. Perhaps the most obvious factor in making that decision would be the burden of proof that the government must satisfy. To successfully prosecute a criminal tax case, the government must prove its case beyond a reasonable doubt, whereas, in a civil case, the IRS has to prove the case only by clear and convincing evidence.⁶ From a factual proof standpoint,

¹ Robert S. Fink, *Tax Controversies—Audits, Investigations, Trials* (Newark, N.J.: Matthew Bender, 2002), 16.01.

² *Ibid.*

³ *Ibid.*

⁴ *Ibid.*

⁵ *Ibid.*, 16.02.

⁶ *Ibid.*, 5.01.

the element of willfulness can be the hardest to establish. Because the IRS cannot criminally prosecute every taxpayer suspected of having a willful intent to violate the IRC, other factors are often evaluated in deciding whether to pursue a criminal prosecution. Generally, single instances of wrongdoing will not result in a criminal prosecution; rather, the government looks for multiple years of ongoing wrongful behavior before it charges a taxpayer with a crime as opposed to civil penalties.⁷ The government is unlikely to pursue a criminal tax case where the monetary amounts involved are insufficient to guarantee a period of incarceration under the sentencing guidelines.⁸ In 1980, the IRS acknowledged that specific monetary guidelines existed for determining whether or not to prosecute a criminal case, but any current guidelines are not available to the public.⁹ In addition, commentators have suggested other factors as playing a role in deciding between civil penalties and criminal prosecution:

- Omissions of income versus false deductions. The IRS is likely to be more interested in criminal prosecutions in the case of omissions of income rather than incorrectly taken deductions, because it is harder to prove that a wrongful deduction was taken willfully.¹⁰
- The taxpayer's reputation, health and age, intelligence, and education.¹¹

IRS's Handling of Criminal Matters

The investigation of potential criminal violations of the IRC is handled by the IRS's Criminal Investigation Division (CI). CI conducts general investigations, which are surveys or canvasses relating to a group or activity that are designed to identify particular groups of taxpayers that may be involved in criminal violations of the IRC.¹² It also conducts "primary" and "subject" criminal investigations, which are investigations of specific taxpayers that have allegedly violated the tax laws.¹³ The primary investigation is for cases that may have prosecution potential; if the case is found to definitely have prosecution potential, it is upgraded to a subject criminal investigation. Special agents work with CI counsel's criminal tax attorneys, who provide advice during investigations and may review cases before they are recommended for prosecution. If a case is recommended for prosecution by CI, the case is then reviewed by the Tax Division of the DOJ. If the Tax Division authorizes prosecution, the prosecution will usually be handled by the local U.S. Attorney's office. Once the case is referred to the Tax Division, the IRS may not issue or enforce an administrative summons with respect to the taxpayer for the same tax and the same taxable period.¹⁴ In circumstances where CI either cannot complete its investigation or otherwise determines that it cannot effectively gather information through the administrative process, it may request that the Tax Division authorize a grand jury investigation.¹⁵

⁷ Ibid, 5.01[1].

⁸ IRS, *Internal Revenue Manual* (IRM), 25.1.3.1.1.

⁹ Fink, *Tax Controversies*, 5.01[2].

¹⁰ Ibid, 5.01[3].

¹¹ Ibid, 5.01[6].

¹² Ibid, 5.02.

¹³ IRS, IRM, 9.4.1.4.

¹⁴ Department of Justice (DOJ), *United States Attorneys' Manual*, 6-4.110.

¹⁵ Ibid, 6-4.121.

Sources of Criminal Investigations

The investigations conducted by CI are generated from various sources. Investigations may result from a newspaper article; an informant's tip (for example, a corporate whistleblower); a referral from a federal, state, or local law enforcement or regulatory agency; or examination of the numerous financial reporting forms required to be filed by banks, businesses, and individuals (for example, currency transaction reports, suspicious activity reports, or foreign bank account reports).¹⁶ However, referrals from the civil side of the IRS constitute the single largest source of criminal investigation cases.¹⁷

The Civil Examination and Firm Indications of Fraud

The referral of a civil case to CI stems from the examining agent uncovering indicators of potential fraud by the taxpayer during the course of a civil examination. Tax fraud is defined in the *Internal Revenue Manual (IRM)* as “an intentional wrongdoing on the part of a taxpayer with the specific purpose of evading a tax known or believed to be owing.”¹⁸ The indicators of potential fraud by a taxpayer generally are identified in the ordinary performance of the field agent's examination procedures and can come from any number of sources, including taxpayer records, discussion with taxpayer personnel, and other related or unrelated materials. When initial indicators of fraud are discovered, the field agent consults with a fraud technical advisor, who will work with the agent to develop the case and determine whether firm indications of fraud exist.¹⁹

The IRM lists numerous indicators of fraud in the “Fraud Handbook,” which is found in Part 25, *Special Topics*, of the IRM. The IRM notes that most fraud cases involve individuals and businesses with poor or nonexistent internal controls. However, there must be affirmative acts of fraud present in order to sustain the civil fraud penalty or make a criminal referral. The IRM refers to these affirmative acts as *firm indications of fraud*. Examples of indicators of fraud that often trigger the initiation of a criminal investigation include the following:

- Omissions of entire sources of income
- Substantial unexplained increases in net worth, especially over a period of years
- Substantial amounts of personal expenditures claimed as business expenses
- Keeping two sets of books or no books
- Amounts on return not in agreement with amounts in books
- Backdating of applications and related documents
- Assets placed in others' names.²⁰

Once the field agent has developed the firm indications of fraud, and the case meets other criminal criteria, a referral to the CI can be made. The CPA representing a taxpayer during a civil

¹⁶ Fink, *Tax Controversies*, 5.03.

¹⁷ *Ibid*, 5.03[1].

¹⁸ IRS, IRM, 25.1.1.2.

¹⁹ IRS, IRM, 25.1.2.1.

²⁰ IRS, IRM, 25.1.2.3.

audit should be familiar with the indicators of fraud in the IRM, and be alert for signs that the examining agent is looking to develop evidence to support the existence of these indications.

Referral to the Criminal Investigation Division

The IRM outlines the formal process that agents must follow in order to initiate a criminal investigation. A case cannot be referred for formal criminal investigation until firm indications of fraud exist and it is likely that the individual would be incarcerated if convicted.²¹ If it is determined that a potential fraud case is suitable for criminal referral, the examining agent is to suspend the civil examination without disclosing to the taxpayer or his representative the reason for the suspension.²² A referral to CI is made using Form 2797, “Referral Report for Potential Criminal Fraud Cases.” The referral goes through several levels of review, and if it is accepted, the existing primary investigation will be logged as a subject criminal investigation and assigned to a special agent.²³ CI can request assistance from a field agent in the referring field office. This means that often the field agent that was conducting the civil examination will continue working on the case even after the matter has been officially accepted for criminal investigation. If CI determines that the referral does not meet the criminal criteria (for example, no likelihood of incarceration in the case of a conviction) or if an obvious barrier to prosecution exists, the referral will be declined.²⁴

Special Agent Activities

Criminal tax investigations (and investigations of most financial crimes) differ from other types of criminal investigations in that they generally begin with a known person, and the investigator tries to determine whether that person has committed a crime. In nonfinancial crimes, the investigator usually begins with a known crime and then tries to determine who committed it.²⁵ If an IRS investigation is assigned to a special agent, that special agent’s purpose is to obtain facts and evidence to determine if the subject of the investigation has committed a criminal violation.

Therefore, upon becoming aware that a special agent is or may be assigned to an investigation, the CPA should immediately advise the taxpayer to obtain the counsel of a criminal tax defense attorney if the taxpayer does not already have such counsel. The CPA should cease representation of the taxpayer at this point. Representing a taxpayer in a criminal tax investigation requires specific knowledge and expertise that most tax advisors do not possess. Moreover, the tax advisor may be considered a witness in the criminal investigation and be subpoenaed to testify against the taxpayer, so having the tax advisor gain greater knowledge about the alleged criminal activity can work to the disadvantage of the taxpayer.

Special agents have the authority to investigate tax crimes much like any other law enforcement officer.²⁶ They have at their disposal various investigative and financial computer databases not

²¹ IRS, IRM, 25.1.3.1.1.

²² IRS, IRM, 25.1.3.2.

²³ IRS, IRM, 25.1.3.4.

²⁴ IRS, IRM, 25.1.3.3.

²⁵ IRS, IRM, 9.5.1.2.1.

²⁶ Special agents also have the same authority to issue summonses as the field agents on the civil side of the IRS. See IRS, IRM, 9.1.2.3.2.

available to the public-at-large, and they may also request information from the taxpayer and others potentially related to the alleged crime. They can also conduct surveillance and undercover operations. However, perhaps their most potent investigative tool is the interview of the taxpayer.

Because a field agent conducting a civil examination is under no obligation to inform a taxpayer when a case has been referred for criminal investigation, the first indication that a taxpayer is under criminal investigation may come from a special agent requesting an interview with the taxpayer. A taxpayer who is interviewed before he or she has obtained representation by a criminal attorney may make incriminating statements that can later be used against him or her in a criminal prosecution.

The special agent is required by IRS policy to inform the subject of a criminal investigation of his or her constitutional rights before conducting an interview.²⁷ The special agent must identify himself or herself, describe the agent's criminal function, and advise the taxpayer that (1) any statement the taxpayer makes or documents the taxpayer provides can be used against the taxpayer; (2) the taxpayer does not have to respond to questions or requests for information that might tend to incriminate the taxpayer; and (3) the taxpayer has the right to consult with legal counsel before consenting to the interview.²⁸ If the taxpayer initially consents to the interview, but during its course wishes to end the interview or consult counsel, the special agent must terminate the interview.

After the interview, the special agent prepares a memorandum summarizing the information gathered and statements made by the taxpayer. The memorandum is generally not admissible as evidence at trial, but it may be used to impeach a witness or the defendant on the stand when testimony is inconsistent with statements made during the interview, or to refresh the memory of a witness or to discourage him or her from changing his or her testimony from that which was offered during the interview. Importantly, if the interview memorandum contains a statement that can be considered a confession or an admission against interest, that statement may be admissible at trial.²⁹

Evidentiary Considerations for the CPA

Because most criminal investigations stem from routine civil examinations, it is important for the CPA to be alert to the taxpayer's possible exposure to allegations of fraud or other criminal misconduct. Although the IRM presents the process of a criminal referral as one having a clear demarcation between the termination of the civil examination and the initiation of the criminal investigation, case law shows that the boundaries between the two are sometimes blurry.

For example, in *U.S. v. Rutherford*, 99 A.F.T.R.2d (RIA) 3223 (June 12, 2007, E.D. Mich.), *reversed and remanded by* 555 F.3d 190 (6th Cir. 2009), a civil examination into a nonprofit's tax-exempt status quickly turned into an investigation of potential tax fraud by the nonprofit's officers. In *Rutherford*, the subjects of the investigation were interviewed once by a field agent

²⁷ IRS, IRM, 9.4.5.11.3.1.

²⁸ IRS, IRM, 9.4.5.11.3.1.1.

²⁹ IRS, IRM, 9.4.5.10.4.

and twice by a Special Enforcement Program (SEP) agent before a criminal referral was made. Some of these interviews occurred after there were *firm indications of fraud* and a referral to the CI was appropriate. Although the court agreed that the IRS civil agents probably should have made the criminal referral sooner (putting defendants on notice that the investigation was criminal in nature), it did not bar the use of the interview statements against the defendants during the criminal trial. The defendants were represented by an accountant at the time the interviews were conducted.

Rutherford is an excellent example of how a CPA representing a taxpayer in a civil examination can become involved in a criminal prosecution of that taxpayer. Evidence gathered during the civil examination is often used during the criminal prosecution, so CPAs should be aware of the following evidentiary concerns regarding privileges.

Constitutional Privileges

The Fourth, Fifth, and Sixth Amendments to the U.S. Constitution afford certain protections during a criminal investigation. The Fourth Amendment protects against unreasonable searches and seizures, the Fifth Amendment provides a right to not be compelled to incriminate oneself, and the Sixth Amendment provides a right to counsel. The warning that the special agent gives to a taxpayer upon first contact is meant to inform the taxpayer of these rights. The manner in which these issues are raised in the criminal tax context is often in the form of a motion to suppress evidence that was gathered during a civil examination, on the theory that the government committed acts or omissions that misrepresented the criminal nature of the investigation, causing defendants to involuntarily consent to providing documents and incriminating statements to revenue agents.

In extreme cases, courts have suppressed evidence in a criminal case gathered under the guise of a civil investigation. In *U.S. v. Tweel*, 550 F.2d 297 (5th Cir. 1977), the taxpayer had previously been under investigation by CI. At the start of a subsequent civil examination, the taxpayer's accountant asked the field agent whether a special agent was involved in the examination. The field agent responded that there was no special agent involved, which was true at the time, but the field agent did not disclose that the examination was being conducted at the specific request of the Organized Crime and Racketeering Section of the DOJ. The court found that the field agent's failure to inform the defendant of the obvious criminal nature of the investigation was a deliberate deception that nullified the defendant's consent to inspect his records, and suppressed the use of them at trial. However, *Tweel* is the rare case in that such an argument has succeeded. The more typical result is what happened in the *Rutherford* case previously mentioned; even though there was a finding that the IRS had violated its own policies regarding the point at which a criminal referral should be made, the court found that the violation did not affect the voluntariness of the defendants' incriminating statements and those statements were admissible at trial.

From a practical standpoint, the CPA should be aware that, generally, any statements made or documents provided during the course of a civil examination can be offered against the taxpayer in a criminal prosecution. Any inconsistent or less-than-truthful statements made during the civil examination may come back to haunt the taxpayer during a criminal investigation.

Attorney-Client Privilege

The purpose of the attorney-client privilege is to allow full and frank exchange of information between an attorney and his or her client to ensure effective legal representation. This attorney-client privilege is especially crucial in the criminal arena, where a client may make incriminating statements to his or her attorney. If such facts were able to be discovered by the government, it would serve as a deterrent to the client making a full disclosure to his or her attorney, thus impeding the attorney's ability to vigorously defend the client. For this reason, the attorney-client privilege is viewed as an integral part of the justice system.

Work-Product Doctrine

An additional protection is the work-product doctrine, which restricts the discovery of documents prepared in anticipation of litigation.³⁰ Note, however, that there continues to be controversy concerning the application of this doctrine with respect to certain tax matters. Therefore, in considering the possible application of this doctrine, reference should be made to the current status of the doctrine as it applies to tax issues.

Accountant-Client Privilege

Given the importance of the attorney-client privilege in a criminal case, perhaps the best reason that a CPA should not represent a taxpayer in a potential criminal matter is that no confidentiality privilege exists between accountants and clients when it comes to criminal matters. Congress enacted IRC section 7525, the so-called "accountant privilege," in 1998, which extended the common law attorney-client privilege to tax advice furnished by a federally authorized tax practitioner; however, that confidentiality privilege for accountants may only be asserted in noncriminal tax matters.³¹ Therefore, no protection exists for the taxpayer who tells his or her CPA incriminating facts during a civil examination—that CPA can later be called as a witness against the taxpayer during a criminal prosecution.

Despite IRC section 7525's rather plain statement that the accountant privilege does not apply to criminal matters, a gray area still exists with respect to its applicability to communications made during a civil examination that later results in a criminal prosecution. Clearly, communications made with respect to tax return preparation are never protected by the accountant privilege, because such communications would not be privileged under the common-law attorney-client privilege either. However, if a client sought tax advice from a CPA with respect to a tax planning matter or civil tax examination, are those communications still protected pursuant to the accountant privilege if the taxpayer later becomes the subject of a criminal prosecution? The IRS takes the position that the accountant privilege is not applicable in any criminal matter, even if the communications at issue took place in the context of a civil proceeding.³² There does not appear to be case law addressing this issue.

³⁰ *Federal Rules of Civil Procedure*, 26(b)(3).

³¹ *Internal Revenue Code*, section 7525(a)(2).

³² IRS, *Chief Counsel Advice 200008006* (February 25, 2000).

Kovel Arrangements

A taxpayer with a potential criminal matter often requires both legal and accounting assistance to defend his or her case. The taxpayer's usual CPA generally is not a suitable choice for assistance on a potential criminal matter because of the possibility that the CPA who has advised the taxpayer during tax return preparation, or even through the civil examination, may be called as a witness against that taxpayer during a criminal trial. In such a circumstance, the taxpayer may need to engage the services of a different CPA for assistance regarding the potential criminal matter. The best way for the CPA to assist in defending the taxpayer is for the taxpayer's attorney to engage the CPA through a *Kovel* arrangement so that communications between the taxpayer and the CPA could be protected by the attorney-client privilege.

The *Kovel* arrangement derives its name from the Second Circuit case that established the precedent.³³ In a *Kovel* arrangement, an accountant works directly for an attorney, assisting the attorney as an interpreter of the technical tax issues in the matter, to enable the attorney to render legal advice. In working directly for an attorney, the CPA should address the requirements under IRC section 7216 with respect to the disclosure of tax return information and obtain a written consent from the taxpayer as required. Because the CPA has been engaged to assist the attorney in providing legal advice, the attorney-client privilege extends to communications made between the client, attorney, and accountant. A *Kovel* arrangement should be documented in writing, preferably through an engagement letter prepared by the attorney that evidences the accountant is working directly for the attorney.

Other Areas of Focus for the CPA

File Maintenance and Retention

A CPA should take necessary steps to protect any materials that are related to services rendered with respect to a client with a potential criminal matter. The taxpayer's attorney will find it helpful to know what documents have already been provided to the IRS, as well as any interviews that have taken place and the content of those interviews. If the CPA has a document retention policy in place that would call for disposal of materials related to the matter, the CPA should consider extending the retention period for the materials.

To the extent the CPA is performing services on behalf of the client through a *Kovel* arrangement, the CPA should look to the attorney who has engaged the CPA for direction with respect to the maintenance and retention of any materials that are related to the potential criminal matter. The attorney can provide guidance regarding the best manner in which to retain and file documents in order to preserve the attorney-client privilege. To the extent the attorney does not provide the CPA with such direction, the CPA should consider taking measures to adequately label the materials, segregate the materials from other client-related materials, and adopt access restrictions as appropriate.

³³ *U.S. v. Kovel*, 296 F.2d 918 (2nd Cir. 1961).

New Client Acceptance

Having effective client acceptance policies and procedures in place is an important part of the CPA's management of his or her practice. When the CPA screens or performs investigative procedures regarding a new client, the issue of potential criminal matters may come to light. In these cases, the CPA should take precautions to ascertain whether the potential criminal matters are indicative of the nature of the client and other potential risks that may be associated with the business relationship.

The prospective client may need to engage the services of a different CPA for assistance regarding a tax matter that may become or is already a potential criminal matter. In these cases, that CPA may be replacing another CPA who has previously provided services to the taxpayer or may be the initial CPA who will be providing services to the taxpayer regarding the potential criminal matter. In either case, the CPA should request that the prospective client engage the services of appropriate legal counsel before commencing the engagement. To the extent the prospective client is not willing to engage the services of legal counsel, the CPA should consider whether establishing the new business relationship is appropriate.

Providing Advice to a Client

When a CPA becomes aware that a current or former client could be exposed to allegations of fraud or other criminal misconduct, the CPA should advise the taxpayer to consult with an attorney before the taxpayer takes any action. Additionally, the CPA should consider whether to withdraw from the performance of further tax (or other) services for the client and whether to continue a professional or employment relationship with the client. When the CPA advises the client of the need to engage legal counsel, the CPA should be aware that any communication made between the CPA and the client could be subject to an investigative summons or grand jury subpoena. In some instances, for example, based on the nature of the services the CPA previously performed for the client, it may be advisable for the CPA also to engage separate legal counsel.

During Return Preparation - Knowledge of a Client's Past Errors

While performing services for a client, a CPA may become aware of circumstances such as an error on a previously filed tax return of the client or of the client's failure to file a required tax return. Such circumstances can arouse the suspicion of examining agents (see the indicators of fraud in the IRM). Under SSTS No. 6, in these circumstances, a CPA should inform his or her client of the error or failure to file and recommend that corrective measures be taken. If the CPA believes the client could face possible exposure to allegations of fraud or other criminal misconduct, the CPA should advise the client to consult legal counsel before taking any other action. The CPA may not inform the taxing authority of the error or failure to file without the taxpayer's permission, except when required by law. If the client does not correct the error, the CPA should consider whether to continue a professional relationship with that client. If the CPA decides to maintain the client relationship and prepare a return for a year subsequent to that in which the error occurred, the CPA should take reasonable steps to ensure the error is not

repeated. If the subsequent year's return cannot be prepared without perpetuating the error, the CPA should consider withdrawal from the return preparation.

During an Examination - Knowledge of a Client's Past Errors ("Eggshell Audits")

An "eggshell audit" is a civil examination in which the taxpayer has previously engaged in conduct, such as errors on a past return or the failure to file a return, as previously described, which, if known by the field agent, might result in a criminal investigation. These examinations are fraught with complications for the taxpayer and the practitioner (in other words, they are "walking on eggshells") as they balance cooperating with the field agent in order to avoid a criminal referral and remaining silent to protect the taxpayer from self-incrimination or consenting to a search. If the IRS selects a fraudulent return for audit, the taxpayer may be faced with a choice between admitting the fraud and committing further crimes to conceal it.

Similar to the standard previously noted with respect to return preparation, SSTS No. 6 states that a CPA representing a taxpayer in an administrative proceeding with respect to a return that contains an error should request the taxpayer to disclose the error to the taxing authority. However, if the CPA believes the taxpayer may face possible exposure to allegations of fraud or other criminal misconduct, the CPA should advise the taxpayer to consult legal counsel before taking any action. This is especially important because voluntary disclosure should be approached with caution if potential criminal charges are at stake. For example, a client who has committed tax fraud may be able to avoid criminal liability by making a voluntary disclosure before the IRS has discovered the fraud.³⁴ However, such a disclosure can backfire and lead to criminal prosecution. Voluntary disclosures in potential criminal matters should be approached with caution and only by a practitioner with appropriate experience.

Interaction with the IRS

If a client has obtained legal counsel for a potential criminal matter, in order to best protect the client's rights, it is essential that the CPA work in consultation with the client's attorney. In this regard, the CPA should avoid any unsupervised communication with IRS personnel. The nature and content of any and all information that is to be shared with the IRS once the investigation has commenced should be approved in its entirety by the client's legal counsel.

Need for Representation for the CPA

Generally speaking, when a CPA is providing advice to a client or a client's attorney with respect to a potential criminal matter, the CPA does not necessarily need his or her own legal representation. In certain circumstances, however, the CPA may consider it appropriate or necessary to obtain legal representation based on the nature of the services that were performed for the client, the questions that are being asked, or other concerns the CPA may have. At some point, the CPA's interest may be adverse to those of the taxpayer. In such instances, the CPA should evaluate whether a potential conflict of interest exists with respect to performing ongoing

³⁴ DOJ, *Criminal Tax Manual*, 4.01[1].

services for the client.³⁵ To the extent the CPA considers it necessary to obtain legal representation, the CPA should consider engaging legal counsel who is experienced in the specific issue of concern with respect to the potential criminal matter.

³⁵ See AICPA, Code of Professional Conduct, Rule 102, *Integrity and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 102).

Appendix A: Summary of Internal Revenue Code Criminal Provisions

<i>Internal Revenue Code Section</i>	<i>Name of Offense</i>	<i>Elements</i>	<i>Criminal Charge</i>	<i>Penalty</i> ³⁶
7201	Attempt to Evade or Defeat Tax	(1) A deficiency in tax (2) An affirmative act or attempted act of evasion (3) Willfulness	Felony	Imprisonment up to 5 years; Fine of up to \$100,000 (\$500,000 for a corporation)
7202 ³⁷	Willful Failure to Collect or Pay Over Tax	(1) Defendant had a duty to collect or pay over tax. (2) Defendant failed to do so. (3) Willfulness	Felony	Imprisonment up to 5 years; Fine of up to \$10,000
7203	Willful Failure to File Return, Supply Information or Pay Tax	(1) Defendant had a duty to pay a tax, make a return, or supply information. (2) Defendant failed to do so. (3) Willfulness	Misdemeanor ³⁸	Imprisonment up to 1 year; Fine of up to \$25,000 (\$100,000 for a corporation)
7204	Fraudulent Statement or Failure to Make Statement to Employees	(1) Defendant was required under the provisions of Internal Revenue Code (IRC) section 6051 to furnish a statement. (2) Defendant furnished a false or fraudulent statement or failed to furnish a statement in the manner, at the time, and showing the information required. (3) Willfulness	Misdemeanor	Imprisonment up to 1 year; Fine of up to \$1,000
7205	Fraudulent Withholding Exemption Certificate or Failure to Supply Information	(1) Defendant was required to furnish an employer with a signed withholding exemption certificate (Form W-4). (2) Defendant supplied his or her employer with a signed withholding statement that contained false or fraudulent information, or failed to provide information. (3) Defendant acted willfully.	Misdemeanor	Imprisonment up to 1 year; Fine of up to \$1,000

³⁶ The penalties noted in this table are those found in Chapter 75 of the Internal Revenue Code (IRC). However, certain other sections of the *U.S. Code* may operate to change or override the penalty provisions found in Chapter 75. Counsel from a competent criminal tax attorney should be sought to better understand the penalty provisions related to criminal offenses under the IRC.

³⁷ This penalty is most commonly found in situations where an employer, who is required to withhold and pay over payroll taxes, fails to do so as required.

³⁸ In the case of a willful violation of IRC section 6051, the offense under IRC section 7203 becomes a felony, and the maximum term of imprisonment is increased to 5 years.

7206 ³⁹	Fraud and False Statements			
7206(1)	False Return, Statement, or Other Document	(1) Defendant made and subscribed to a return, statement, or other document under penalties of perjury. (2) Defendant did not believe it to be true and correct with respect to every material matter. (3) Defendant acted willfully.	Felony	Imprisonment up to 3 years; Fine of up to \$100,000 (\$500,000 for a corporation)
7206(2)	Aid or Assistance in Preparation or Presentation of False or Fraudulent Document	(1) Defendant aided, assisted, or advised in the preparation or presentation of a document in connection with a matter before the IRS. (2) The document is fraudulent or false. (3) Defendant acted willfully.	Felony	Imprisonment up to 3 years; Fine of up to \$100,000 (\$500,000 for a corporation)
7206(3)	Fraudulent Bonds , Permits, and Entries	(1) Defendant (a) simulates or falsely or fraudulently executes or signs any bond, permit, entry or other document (“document”); (b) procures such document to be falsely or fraudulently executed; or (c) advises, aids in, or connives at such execution. (2) The document is required by the internal revenue laws or regulations thereunder.	Felony	Imprisonment up to 3 years; Fine of up to \$100,000 (\$500,000 for a corporation)
7206(4)	Removal or Concealment with Intent to Defraud	(1) Defendant removed or concealed property. (2) The property was subject to tax or levy. (3) Defendant intended to defeat or evade tax.	Felony	Imprisonment up to 3 years; Fine of up to \$100,000 (\$500,000 for a corporation)
7206(5)	Compromises and Closing Agreements	In connection with any compromise, closing agreement, or offer with respect to either: (1) Defendant: concealed property; withheld, falsified, or destroyed records; or made false statements relating to the financial condition of person liable for tax. (2) Defendant acted willfully.	Felony	Imprisonment up to 3 years; Fine of up to \$100,000 (\$500,000 for a corporation)
7207	Fraudulent Returns, Statements or Other Documents	(1) Defendant submitted a return, statement, or other document to the IRS. (2) The return, statement, or other document was false or fraudulent concerning a material matter. (3) Defendant acted willfully.	Misdemeanor	Imprisonment up to 1 year; Fine of up to \$10,000 (\$50,000 for a corporation)

³⁹ Section 7206 can apply to taxpayers and tax return preparers.

7210	Failure to Obey Summons	<p>(1) Defendant was duly summoned to appear to testify or to appear and produce certain records.</p> <p>(2) Defendant did not appear or produce such records.</p> <p>(3) At least some of the records called for by summons were in existence and in the defendant's control.</p> <p>(4) Defendant willfully and knowingly neglected to appear and produce them.</p>	Misdemeanor	Imprisonment up to 1 year; Fine of up to \$1,000
7212	Attempts to Interfere with Administration of Internal Revenue Laws	<p>(1) Defendant endeavored to obstruct or impede the administration of the IRC.</p> <p>(2) Defendant acted corruptly or by force or threat of force.</p>	Misdemeanor or Felony, depending on nature of violation	Misdemeanor: Imprisonment up to 1 year; Fine of up to \$3,000 Felony: Imprisonment up to 3 years; Fine of up to \$5,000
7215	Offenses with Respect to Collected Taxes	<p>(1) Defendant was a person required to collect, account for, and pay over Federal Insurance Contributions Act (FICA) taxes and withheld income taxes</p> <p>(2) Defendant was served with the statutory notice prescribed by IRC section 7512(a)</p> <p>(3) Defendant failed to comply with the notice, while not entertaining a reasonable doubt concerning whether the law required the defendant to do so, and the failure was not due to circumstances beyond the defendant's control</p>	Misdemeanor	Imprisonment up to 1 year; Fine of up to \$5,000
7216	Disclosure or Use of Information by Preparers of Returns	<p>(1) Defendant disclosed any information furnished for, or in connection with, the preparation of a tax return; or uses the tax preparation information for any purpose other than to prepare or assist in preparing a return, without the consent of the taxpayer</p> <p>(2) Defendant acted knowingly or recklessly in so doing.</p> <p>(3) Defendant is a tax return preparer</p>	Misdemeanor	Imprisonment up to 1 year; Fine of up to \$1,000

Bibliography

This practice guide is intended to provide only a summary of some of the issues and procedures to be considered if the CPA believes that the taxpayer may face possible exposure to allegations of fraud or other criminal misconduct. A more extensive discussion of this subject matter can be found in the documents listed below.

AICPA, [Statement on Standards for Tax Services No. 6, Knowledge of Error: Return Preparation and Administrative Proceedings](#) (AICPA, *Professional Standards*, vol. 2, TS sec. 600).

Fink, Robert S., *Tax Controversies – Audits, Investigations, Trials* (Matthew Bender, 2002).

[Internal Revenue Code of 1986 as amended](#), Title 26 U.S.C. Subpart F, Procedure and Administration.

[Internal Revenue Service, Internal Revenue Manual, Part 9](#), Criminal Investigation. Available at <http://www.irs.gov/irm/part9/index.html>

[Internal Revenue Service, Internal Revenue Manual, Part 25, section 25.1](#), Fraud Handbook. Available at <http://www.irs.gov/irm/part25/index.html>

U.S. Department of Justice, *Criminal Tax Manual*. Available at <http://www.justice.gov/tax/readingroom/2008ctm/CTM%20TOC.htm>

U. S. Department of Justice, *United States Attorneys' Manual*, Title 6, Tax. Available at http://www.justice.gov/usao/eousa/foia_reading_room/usam/title6/title6.htm