CCTP Updates—Important Developments: Criminal

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1. Number of Criminal Prosecutions Keeps Shrinking; IRS Focuses on Pure Tax Cases of Higher Severity

IRS CI Chief Don Fort released his annual report on November 14, 2018. Available at https://www.irs.gov/pub/irs-utl/2018_irs_criminal_investigation_annual_report.pdf. The bottom-line numbers reflect that government does less, not more, with less resources. In the past five years, the number of investigations has dropped by nearly 50%, while the number of Special Agents dropped about 20%. However, the recent numbers also reflect significant shifts in resources away from high-volume ID Theft and Questionable Refund cases, in favor of higher-resource cases such as Abusive Tax Schemes and Employment Tax cases.

- Key takeaways from the Annual Report:
  - Numbers
    - Overall
      - Total number of investigations initiated dropped from 3,395 to 2,886 (down 15%) from 2016 to 2018 (a review of the 2016 annual report paints an even more dire picture, as between 2013 to 2018 investigations dropped 46% during which time the number of Special Agents dropped 20%)
      - Prosecutions recommended dropped 22% in the same period, to 2,130
      - Indictments dropped even more precipitously (25%), to just 2,011
      - However, the incarceration rate increased from 80 to 82 percent, and average months to serve increased 10%, from 41 to 45 months
      - The conviction rate remains above 90 percent

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1 Evan Davis has been a principal at Hochman Salkin Toscher Perez, P.C. since October 2016. He litigated civil tax matters for the DOJ Tax Division for 7.5 years, then litigated civil and criminal tax matters for the USAO C.D. Cal. for three years, and white-collar cases for the Major Frauds Section of the CD Cal. Criminal Division for eight years.
The mix of cases changed from 2016 to 2018. The most-pronounced changes:

- Abusive Tax Schemes saw a 43% increase in investigations initiated, so we should expect to see an increase in prosecutions and indictments in the next two years as these work through the system
- Employment Tax increased 50%, and average months to serve increased 50% as well, from 14 to 21 months
- There were small rises in Public Corruption, Non-filer, and International Operations (which presumably include FBAR cases)
- Financial Institution Fraud dropped 30%, and there were smaller drops in Money Laundering, Healthcare Fraud, Narcotics, and Terrorism cases
- The largest decreases were in the Identity Theft (71%) and Questionable Refund Program investigations initiated (70%)

Beyond the Numbers

- CI Chief Don Fort highlights that CI takes its exclusive responsibility to investigate federal tax crimes seriously and points to the continuing decline in white-collar prosecutions as a concern given the proliferation of white-collar crime.
  - All CI employees are now trained on cyber issues, which issues are prevalent in white-collar crime.
- CI is using various data analytics to identify and select the highest-value investigations.
  - CI set up the Nationally Coordinated Investigations Unit (NCIU) to use the data analytics to select cases and to train special agents and professional staff.
    - Data from 2018 reflects that NCIU referred 55 cases for evaluation, and the majority were employment tax cases with microcap stock making up most of the remainder
    - Although CI’s senior leadership identified virtual currency as a high priority, no VC cases were referred

Foreign accounts remain a focus

- In 2018, the IRS set up a new international tax and financial crime group in the Washington, DC field office.
• After the Annual Report
  o Don Fort spoke at the ABA Criminal/Civil Tax Conference in Las Vegas in December 2018.
    ▪ He highlighted the shift away from ID Theft and QRP cases and toward “core” tax cases such as Employment Tax
    ▪ He touted the use of data analytics and said that CI views the program as successful already
    ▪ Finally, he mentioned the “J-5” group recently created by the tax enforcers for the United States, the United Kingdom, Australia, Netherlands, and Canada.
  • In particular, he discussed each country recently having sent a data expert to the Netherlands to brainstorm how to identify tax criminals, and within 24 hours they had developed cases in addition to exchanging best practice ideas.
  • Finally, he and other IRS employees mentioned that new Commissioner Chuck Rettig is emphasizing fraud referrals from IRS Civil
    o The Annual Report shows that only 7% of cases came from IRS Civil, just above 6% from the Public and 5% from state and local government, but well below from IRS CI itself at 14%, U.S. Attorney’s Offices at 26%, and other federal agencies at 29%.

2. Kovel And Lawyers’ Tax Advice Under Attack – Civil and Criminal Cases

Those of us who represent criminal targets or taxpayers in civil eggshell audits routinely use Kovel accountants to assist us in representing our clients. They help us decide the amount of tax loss, for example, which attorneys use to advise clients regarding how to respond to the government investigation and whether to file amended returns to address previous errors.

Once Kovel accountants file tax returns, however, the Kovel accountants become tempting witnesses for IRS Special Agents. In decades past, the government tended to handle Kovel accountants with kid gloves, and reported cases involving forcing Kovel accountants to produce documents or testify were few and far between. This light touch perhaps reflected the government’s reticence to tamper with the attorney-client privilege along with a pragmatic view that parsing the difference between legal advice and return preparation is easier said than done.
Now, it looks like the gloves are off. Anecdotally (including in the author’s 18+ years’ experience with DOJ and 2+ years with a tax litigation boutique) the number of cases appears to be on the rise in the past few years, and two recent cases reflect a more-aggressive approach by the government concerning both Kovel as well as legal advice that may have shaped a filed tax return.

a. United States v. Edward Adams, No. 0:17-cr-00064 (D. Minn.)

In United States v. Adams, 2018 WL 5311410 (D. Minn. October 27, 2018), a Magistrate Judge partially granted and partially denied the government’s challenge to a criminal defendant’s assertion that attorney-client privilege and work product protection applied to communications with a Kovel accountant.

In Adams, the defendant asserted that his communications with his Kovel accountant were privileged. The government disagreed, arguing the communications were not protected, any protection was waived by the filing of amended returns, and the crime-fraud exception trumps any protection. The Magistrate Judge sided with the defendant.

The court’s reasoning reflects precisely how aggressive the government was being. The government argued that communications between the defendant’s lawyer and the Kovel accountant were not privileged, despite that the lawyer explained in his declaration how the Kovel accountant was assisting the lawyer to provide advice to the defendant regarding tax-related matters.

The government also tried to assert that the mere filing of an amended return waived privilege as to communications between the lawyer and Kovel accountant. The Magistrate Judge distinguished between underlying details of data conveyed in filed tax returns, which weren’t privileged, and other communications including “unpublished expressions” that were not later revealed on the amended tax returns.

Finally, the Magistrate Judge rejected the government’s crime-fraud assertion. After finding that the government had met its lower burden to show that the court should conduct an in camera review of the purported crime-fraud documents, the Magistrate Judge found that the government failed to meet this burden. The government’s argument was merely circumstantial – that the favorable tax treatment on the return was inconsistent with “several documents” that would have yielded unfavorable tax treatment, and, therefore, the client must have either lied to or conspired with his Kovel accountant and lawyer. That argument was the government’s third strike in its effort to pierce the Kovel relationship.
Seeking a second bite at the *Kovel* apple, the government objected to the Magistrate Judge’s R&R as it related to communications between the defendant and the *Kovel* accountant. That order was upheld on December 10, 2018, when the district court found that, under either the “clearly erroneous” or “de novo” standard of review, the R&R was neither contrary to law nor clearly erroneous. 2018 WL 6446387.


In a civil examination with implications on criminal investigations, the IRS set its sights on legal advice given to an accountant.

This is a long-running IRS summons case (note the 2015 case number), in which the IRS seeks two memoranda written by lawyers for Sanmina regarding a $503 million deduction in 2008. In May 2015, the district court ruled that the two memoranda were privileged and denied enforcement. Thirty months later, the Ninth Circuit remanded for the district court to determine whether the memoranda were privileged in the first instance and whether the privilege was waived. Nearly a year later in October 2018, the district court affirmed they were privileged and protected by attorney work product, but found all protections waived; it stayed enforcement of the summons pending yet another appeal to the Ninth Circuit. It’s unclear whether the IRS could assess taxes or penalties absent a fraud finding nearly ten years after the return was filed, but the IRS continues to pursue the two memoranda.

The October 2018 order is one step forward, two steps back for attorneys who give tax advice. The district court found that the memoranda were protected by both attorney client privilege and work product protection, which is a contentious issue because the government asserted that memoranda regarding what positions to take on a tax return were neither privileged (accounting, not legal, advice) nor work product (not prepared in anticipation of litigation).

However, the district court found attorney-client privilege was waived by disclosing the memoranda to the valuation expert, which expert referenced the memoranda in its final report and which report the accountants relied on when they filed the return. The district court relied on a fairness analysis, namely, that the taxpayer can’t disclose to the IRS the valuation report that relies on the legal memoranda and then prevent the IRS from reviewing the legal memoranda to determine the validity of the valuation report. However, the district court failed to conduct the separate waiver analysis for work product, which is not so easily waived. Had the district court conducted this analysis, it might have determined that work product was not waived, because waiver depends on whether disclosure to the third party (the valuation expert) substantially increased the risk
that the IRS might obtain the documents. As the valuation expert was aligned with the taxpayer, disclosure to the valuation expert likely did not increase the likelihood of disclosure to the IRS.

The last appeal took more than two years to complete, so look for an update in 2020 or 2021.

3. Other Criminal Developments

Finally, a short synopsis of other notables in criminal tax cases:

a. Panama Papers Indictment

In United States v. Ramses Owens, et al., the SDNY USAO charged four defendants related to the Panama Papers leak, including an attorney with Mossack Fonseca, the Panama-based law firm whose files were leaked. The allegations are centered around an alleged conspiracy by Owens and others to hide U.S. citizens’ assets in overseas bank accounts held in the names of sham foundations and shell companies. https://www.justice.gov/opa/press-release/file/1117191/download.

b. Criminal Employment Tax Cases

As reflected in the increased number of employment tax cases, including from the IRS’s new data-mining group, the IRS appears serious about bringing criminal employment tax cases. In the ABA meeting in Las Vegas in December 2018, practitioners noted the fine (if any) line between persons liable for a civil Section 6672 penalty for failing to pay over employment taxes, and criminal liability for the same conduct. An IRS representative pointed to the fact that the IRS focuses on the most-egregious cases due to its limited resources, but the defense bar pointed out that an individual client can take cold comfort in the chance that the IRS will chose someone else as a target. At least one practitioner stated that attorneys should consider advising all persons under Section 6672 examination to assert their Fifth Amendment rights.

c. Supposed Cryptocurrency Cases Coming Down the Pike

Additionally, at the Las Vegas ABA conference, the IRS repeatedly claimed that cryptocurrency cases are in the works. Beyond this blanket statement, officials remained tight-lipped about what type of cases we will see, and whether they are true crypto cases involving using anonymous crypto transactions to evade detection by the IRS, versus
issues such as failing to list crypto gains on a tax return where all of the transactions were on an exchange such as Coinbase.

d. **OVDP is Dead, Long Live Generic Voluntary Disclosure**

Finally, at the Las Vegas ABA conference, an IRS official was on the hot seat regarding the IRS arguably stacking the deck in its negotiations with taxpayers after they have filed a voluntary disclosure under new guidance that applies to all types of voluntary disclosures, including offshore accounts. The guidance, which may be subject to revision, limits fraud penalties to a single year if all years at issue are agreed with the IRS. The deck-stacking issue arises in the rare case where the taxpayer and the IRS cannot agree about an issue involved in the six-year lookback period, including an issue for which there is no criminal exposure but that had to be fixed as part of the program. The IRS said it would impose fraud penalties for each unagreed year, even if the year was unagreed solely because of a legitimate dispute over an unrelated matter. Needless to say, this approach was not warmly received by the defense bar. The IRS has indicated that its voluntary disclosure program is not set in stone, so perhaps the IRS will revisit this approach.