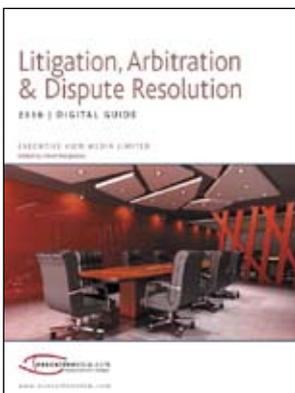


PREPARE NOW FOR THE KNOCK ON THE DOOR:

AS TAX ENFORCEMENT ACCELERATES, LEGAL COUNSEL MUST BE PREPARED FOR MANY LAYERS OF CLIENT NEED

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Is your client a target of federal tax authorities?

The odds that you answered “yes” are higher today than they have been at any time in recent memory. The federal government is on a drive to increase tax revenue, and part of their effort involves a much higher level of tax enforcement – up to and including the dreaded “knock on the door” – a full-scale visit to the taxpayer’s home, often after hours, by multiple law-enforcement agencies, not just the IRS but also the FBI, as well as local and state law enforcement agencies.

Taxpayers are typically unprepared for sudden, intensive scrutiny – which might even involve arrest and attendant publicity. In a state of distress, they will typically turn to legal counsel. Counsel, in turn, must be prepared to meet the demands of the investigation or of multiple overlapping investigations by different agencies.

Budget Shortfalls and a Fraud Epidemic Have Lead to an Aggressive Enforcement Campaign

There are multiple reasons for the heightened level of enforcement. The first and most obvious is that authorities are under pressure to generate revenue. As a result of the massive economic downturn, tax revenue has declined as a direct result of the drop in individual and corporate incomes. This has happened just as increased government spending on recovery programs increased the pressure on the shrinking revenue pool. Any additional revenue that can be found can help close the gap. They are targeting any and all revenue that will help close the “tax gap” – the gap between what taxpayers actually pay, and what the U.S. Internal Revenue Service believes they should pay. This is a recipe for heightened enforcement – enforcement that in particular targets individual taxpayers, who have the greatest discretion over how much tax to pay.

At the same time, fraud is on the increase, as it always is in difficult economic times. Individuals want to make up their portfolio losses, and fall prey to “too good to be true” schemes (the Madoff case is only the most famous of many examples). This is especially true of high-net-worth individuals, who have more losses to make up. Businesses desperate to maintain cash flow begin to cut corners as well.

The result is a “perfect storm” of enforcement – intensive demand for revenue just as instances of taxpayer fraud hit peak levels.

High-Net-Worth Individuals are the Primary Enforcement Targets

As noted, individual taxpayers are the primary enforcement targets.

Among individual taxpayers, the IRS is in particular targeting high-net-worth individuals. Of those, highest on the list are those who have high income and/or net worth, and who in addition

are responsible for reporting their own income and expenses. Included as well are officers of businesses – family-owned, S-corporations or partnerships – that are not subject to reporting requirements. Finally, there are a limited number of wage-earners, very senior and highly compensated, whose complex investments open them to attention.

The reason these individuals are targeted is due first of all to the fact that their discretionary control over income reporting and declaration of expenses is much greater than that of large corporations, which are tightly regulated and are effectively subject to constant audit. Wealthy individuals are attractive to the IRS most obviously because of simple return on investment. A successful enforcement action against a wealthy taxpayer means more tax revenue for each enforcement dollar spent. Under new tax rates – the top bracket in the Obama Administration’s tax plan is now 39.6 percent. This means a \$1 million judgment produces nearly \$400,000 in tax revenue.

Then there is the deterrent effect. An enforcement against a prominent person will have a chilling effect on many others. A senior surgeon or a CFO is a far more valuable target than a factory worker who claimed a questionable expense.

An additional risk affecting certain high-net-worth individuals is the holding of undisclosed overseas accounts. The federal government recently closed its window for voluntary foreign account disclosure. There are likely to be stringent enforcement efforts and strict penalties for those taxpayers who did not take advantage of the disclosure period and who continue to hold these accounts.

Enforcements Are Complex, Aggressive, and Spill Over into Business and Personal Finances

What does a tax enforcement action entail?

The answer is as complex and individual as the taxpayers involved. The IRS can and often does limit itself to civil enforcement actions. But it also has the power to bring criminal charges, and often does this too, both on the merits and for the sake of deterrent effect. In a civil action, consequences involve the recovery of unpaid taxes and the imposition of penalties. A criminal action adds the possibility of conviction and sentencing, perhaps to a prison term.

In addition, when a criminal action includes the participation of multiple agencies, such as federal, state and local law enforcement, multiple charges in multiple jurisdictions are a likely outcome. The U.S. attorney might bring an action alongside the IRS, and state or local charges might follow depending on the nature of the activity. A multi-jurisdiction criminal enforcement action can quickly spiral to levels of extreme complexity.

A criminal action typically includes all the usual techniques in the enforcer’s toolkit, techniques

designed to persuade him or her to disclose more information, and disclose it sooner, than necessary. The knock on the door during dinner is typical, and the knock on the door at 6 a.m. is not unheard of. The accused finds his home suddenly occupied by tax officials, FBI agents and/or police. Officers fan out to seize documents and computers. The accused often begins to talk, rather than remaining silent and requesting counsel, as he or she has a right to do.

The records seized often cover years of financial activity, and the investigation often looks back years as well. Fraud is not a sudden crime. It takes years to develop. Investigators know this, and will generally want to review tax, investment and business documents stretching back three years or longer.

Accounting Expertise is Needed, but Using the Individual's Current Accountant Means Waiving Attorney-Client Privilege

Therefore, the client who arrives in your office is often in a state of extreme distress, is facing scrutiny for an extended period of financial activity, and has sometimes shared information that need not have been shared. As counsel, you are immediately in challenging circumstances having to deal with a frightened client and very possibly with multiple investigations by multiple agencies in multiple jurisdictions.

The essential step for counsel is to put the right support team in place. Attorneys will know how to deploy their own firm's resources to support the defence. But when it comes to adding additional skill sets, in particular accounting, there are pitfalls to be avoided.

One of the most common mistakes is to engage the client's current accountant. Sometimes counsel does this. More often, it is the client who seeks out the familiar tax professional who has worked on the account for years. This can be catastrophic. The problem is that if the accountant has been involved in the client's affairs on an ongoing basis, attorney-client privilege does not apply. The accountant can and will be questioned, not just about the matter at hand, but about the full range of the client's business and financial activity. The effects of the greatly expanded scope of the investigation can be devastating. Do not engage the current accountant as part of a fraud defence. Instead, it is essential that counsel hire a new accountant or, preferably, an accounting team that comes fresh to the case and will be protected by privilege.

A Full-Service Accounting Firm Brings Multiple Capabilities to Bear – Capabilities that Match All the Complexities of the Client's Situation

As to the merits of an accounting team, the ideal support for counsel in a tax enforcement action is a full-service accountancy that can offer multiple disciplines and skill sets. The reason is simple.

The investigation will typically range across all of the client’s business, investment and personal financial activity. The accountants at the table need to be deeply familiar with all of that activity as well. That way, they can play their most valuable role – serving as investigators of fact, while the legal team develops its defence, negotiation and/or trial strategy.

Among the accounting skill sets that ought to be represented are:

- *Tax litigation/IRS experience:* Many accounting firms hire IRS veterans to play key roles in their tax litigation practices. These former IRS officials know what motivates the IRS, and how the agency will develop its investigative strategy. They can develop and run the parallel investigation that is essential to the defence team. They also understand what kind of outcome will be acceptable to IRS investigators, and can thus guide negotiations should the case develop in that direction.
- *High-net-worth experience:* A firm with a specialised practice advising high-net-worth individuals will be better able to understand, review and track the complex tax filings and investment instruments that are at the heart of the federal enforcement action.
- *Small and family-owned business experience:* As noted, small and family-owned businesses are a particular target for tax enforcement, overlapping with the high-net-worth category. Again, experienced accounting professionals can better understand the client’s business actions and how they generated tax consequences. In addition, accountants versed in small business issues can add value by helping guide the client through the current effects of the investigation, which typically put severe demands on the business and may require its reorganisation.
- *Bankruptcy experience:* Bankruptcy may be an outcome of litigation for both businesses and individuals, and may be an advisable strategy in advance of any outcome. The accounting team can add value by being able to manage the tax aspects of the bankruptcy filing.
- *Matrimonial experience:* Just as the financial impact of tax litigation can affect business structures, it can also affect personal and household finances and tax strategies. Experienced accountants can manage a range of outcomes, including the restructuring of household accounts, and the financial effects of separation and divorce.

Overall, accountants with some combination of these skills will be the best partners for legal counsel, best able to plan and manage the needed parallel investigation and add value by helping counsel advise the client. Note that many of the events at issue such as bankruptcy and other business consequences might happen even if no investigation occurs.

It would be sensational but not inaccurate to say that it is now “open season” on those who

have committed tax fraud, and on those who are suspected of having done it. The stress on at-risk individuals will be high, and that stress will spill over to their counsel. At the same time, tax litigation defence is bound to be a growing area for law firms for the foreseeable future. Counsel will have an easier time, and will be more effective, if it can assemble a multidisciplinary team to meet the government's effort. An accounting firm with diverse, specialised skills should be a part of it. This extended team is best qualified to defend, and create value for, the client.

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