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TAX LITIGATION ISSUES

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IRS: Quick, Simultaneous Enforcement Over Long-Time Practices

During the past year, the Internal Revenue Service (IRS) repeatedly has trumpeted the results of its stepped-up enforcement plan and the resulting increase in civil and criminal tax cases.

The new plan includes a policy shift with respect to the government's sim ultaneous pursuit of civil and criminal cases against taxpayers. This shift puts taxpayers under investigation by the government in the difficult position of having to defend both cases without compromising their position in either.

Frequently, criminal investigations arise out of civil audits conducted by revenue agents. Historically, the civil investigators would stop their efforts once a criminal referral was made, and the civil audit would remain dormant through the course of the criminal investigation and subsequent prosecution. The practice of halting the civil investigation was designed to protect against the taxpayer seeking to avoid criminal prosecution—or reducing the jury appeal of the criminal case—by settling the civil dispute or allowing the defendant to argue that the criminal charges were brought in order to enforce the civil tax laws.

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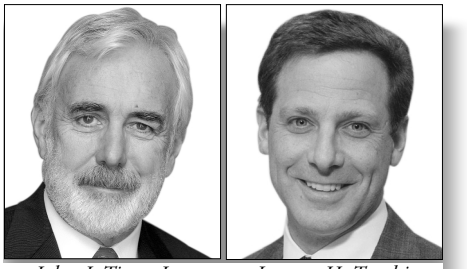

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Both Remedies at the Same Time

Now, however, the IRS, in conjunction with the Department of Justice, has broadly announced its intention to seek both remedies at the same time. Over the past two years, in its annual pre-April 15 press release, the Department of Justice has announced an increase in both civil and criminal enforcement efforts. On April 6, 2004, the Justice Department issued a press release entitled "Civil and Criminal Enforcement Against Tax Cheats on the Rise,"[1] which noted increased efforts by the Department of Justice and the IRS to enhance criminal and civil enforcement of the tax laws. Specifically, the assistant attorney general for the tax division, Eileen J. O'Connor, stated, "People who engage in, facilitate or promote tax fraud are increasingly likely to be on the receiving end not only of civil enforcement actions, but also of criminal prosecution. If you participate in a scheme to defraud the IRS, you can wind up in federal prison, and you will still have to pay taxes, along with interest and penalties."

In its April 2005 press release, the Justice Department again touted its continued success in its "vigorous and effective criminal tax enforcement and civil injunction efforts" against taxpayers who engage in fraud or otherwise are non-compliant.[2] The press release noted that in 2004, the Justice Department's tax division increased criminal prosecutions by more than 57 percent over those authorized in 2001. Further, in 2004, civil injunction suits were brought against 57 defendants, 49 of whom were barred from promoting their tax schemes by the federal courts. Finally, the press release noted, "The government brings both its civil and criminal tools to bear in the fight against tax fraud. An ongoing tax scheme represents a continuing harm to the federal Treasury and puts the people who engage in it on the wrong side of the law. Rather than waiting until a criminal case has been developed to take action to stop the scam, the Justice Department brings civil injunction suits to stop the promotion of tax scams and the preparation of false or fraudulent tax returns."

In his remarks to the National Press Club on March 15, 2005, IRS Commissioner Mark Everson spoke at length about the IRS's renewed focus on enforcement, stating that the "centerpiece of our enforcement strategy is combating abusive tax shelters."[3] He noted that in 2004, the IRS referred more than 3,000 cases to the Department of Justice for possible criminal prosecution, a 20 percent increase from the previous year.

Furthermore, Commissioner Everson touted the IRS's new policy of pursuing civil and criminal action simultaneously. He observed that the IRS's historic stance of halting civil activity during a criminal proceeding had resulted in reluctance on the part of the IRS staff to refer matters for criminal investigation "lest they lose their traditional turf." As a result, he stated, "we are now moving forward on parallel tracks with the Department of Justice."

Meaning for Taxpayers?

The question is: What does this shift mean for taxpayers being investigated for tax-related misconduct? In most cases in which the government pursues parallel investigations, the target faces something of a Hobson's choice—choosing between the vigorous defense of the civil action at the risk of previewing his defense to a developing criminal case (thereby enabling the government to prepare to rebut that defense) or taking a position before he has an opportunity to fully review the relevant documents and interview witnesses.

This choice is rendered all the more unpalatable by the reality that assertion of the Fifth Amendment privilege against self-incrimination often gives rise to an adverse inference, thereby handicapping the defense of the civil action. While the decision between asserting privilege in the civil investigation and harming the client's chances in the criminal case may seem obvious to criminal counsel, the pressures of an imminent civil action and collateral consequences of asserting privilege will often lead the target to draw the opposite conclusion.

Viewed from the other perspective, by pursuing parallel enforcement, the government can use the threat of a criminal case either to obtain a better result in the civil case or to gather information that will be helpful in establishing a criminal case.

Courts frequently have considered the extent to which the government can use information obtained in its civil investigations in parallel criminal proceedings. Well-established case law states that "the prosecution may use evidence acquired in a civil action in a subsequent criminal proceeding unless the defendant demonstrates that such use would violate his constitutional rights or depart from the proper administration of justice."[4] With respect to the protection of constitutional rights, courts have held that "[t]rickery, deceit, even impersonation" by an investigating agent would not render confessions made during the course of a civil investigation inadmissible in a criminal setting as long as the statements were made voluntarily and without coercion.[5] In these cases, a taxpayer can only hope to suppress evidence by showing that it was obtained by conduct constituting a departure from the proper administration of justice.

Circumstances involving such a departure were found recently in *United States v. Scrushy*.[6] In *Scrushy*, the Securities and Exchange Commission (SEC) was investigating the defendant's role in accounting fraud at HealthSouth. Unknown to Mr. Scrushy, the FBI and U.S. attorney's office were conducting a criminal investigation of events at HealthSouth, including Mr. Scrushy's role in the alleged wrongdoing. Shortly before Mr. Scrushy was scheduled to be deposed in the SEC action, the SEC accountant in charge of the administrative investigation was contacted by the U.S. attorney's office. The U.S. attorney's office requested that Mr. Scrushy's deposition be moved to the district in which the criminal investigation was being conducted and that the SEC accountant "participate" in the interviews of two cooperating witnesses in the criminal investigation.[7] Ultimately, the government sought to submit Mr. Scrushy's SEC deposition testimony in the criminal case to substantiate three counts of perjury.

In refusing to admit this evidence, the district court found that the SEC civil investigation had "merged" with the Justice Department's criminal investigation when the U.S. attorney's office sought to control the place of the SEC deposition and have the SEC accountant participate in the criminal investigation. The court noted the "special danger that the government can effectively undermine rights that would exist in a criminal investigation by conducting a de facto criminal investigation using normally civil means" through the manipulation of simultaneous civil and criminal proceedings, both of which it controls. Moreover, this intersection constituted a departure from the proper administration of justice because the defendant, Mr. Scrushy, had no knowledge that there was a criminal investigation of his activities and, therefore, could not take actions to prevent "the providing of information in an administrative or civil proceeding that could later be used against him in the criminal case."[8]

Under *Scrushy*, a taxpayer who is unaware of a criminal referral during the course of a civil investigation may seek to limit the use of discovery obtained in an administrative or civil tax case in which he is involved. However, where a taxpayer has knowledge of a pending or parallel criminal case and where the civil investigation has ripened to a judicial proceeding, the sole remedy is to seek a stay of the civil proceeding pending the outcome of the criminal case. While such stays are "extraordinary remed[ies], not to be granted lightly," it is within a court's discretion to grant a stay where the interest of justice requires.

Many courts have developed balancing tests to determine whether to grant a stay, including the consideration of factors such as: (i) the extent to which the issues in the criminal case overlap with those presented in the civil case; (ii) the status of the criminal case; (iii) the interests of both parties, as well as prejudice to both parties; (iv) interests of the courts; and (v) the public interest.[9]

Significantly, it is frequently the government that seeks a stay to prevent a putative criminal defendant from utilizing

the more-relaxed civil discovery rules to prepare her defense to criminal charges. An old, but oft-cited case, *Campbell v. Eastland,* discusses such a stay in the context of concurrent civil and criminal tax cases. In *Campbell,* the taxpayer brought a civil action for a tax refund while a criminal prosecution of the taxpayer for tax fraud was being considered. The criminal investigation had not yet gone to the grand jury, but the IRS moved to stay the civil suit pending the outcome of the criminal case. The district court denied the motion; the U.S. Court of Appeals for the Fifth Circuit reversed, noting the dangers of allowing a civil case to proceed where it is closely related to an ongoing criminal investigation. Specifically, the court wrote:

> There is a clearcut distinction between private interests in civil litigation and the public interest in a criminal prosecution, between a civil trial and a criminal trial…. The very fact that there is a clear distinction between civil and criminal actions requires a government policy determination of priority: which case should be tried first. Administrative policy gives priority to the public interest in law enforcement. This seems so necessary and wise that a trial judge should give substantial weight to it in balancing the policy against the right of a civil litigant to a reasonably prompt determination of his civil claims or liabilities…. [A] litigant should not be allowed to make use of the liberal discovery procedures applicable to a civil suit as a dodge to avoid the restrictions on criminal discovery and thereby obtain documents he would not otherwise be entitled to for use in his criminal suit.[10]

Although the government was seeking the stay in *Campbell* to protect its criminal case, a taxpayer who decides that the costs of proceeding with the civil case do not justify the benefits of obtaining discovery can rely on the Fifth Circuit's strong language in seeking a stay of civil proceedings during the pendency of a criminal tax case. Like public litigants, the government should not be permitted to use civil discovery and the threat of civil sanctions to further its position in a criminal case. Moreover, the articulated public interest in resolving criminal cases over civil claims should apply to government initiated civil suits as well.

The strong language in *Scrushy* admonishing the government for its manipulation of parallel civil and criminal cases and the availability of a stay in a civil case offers little comfort to those taxpayers who are aware of the criminal investigation, but against whom the government has not initiated judicial proceedings. Where the actions remain in the investigative phase, a taxpayer is limited in his ability to stop the government from using information gained on the civil side to develop a criminal case. For this reason, the IRS's increased focus on enforcement and simultaneous pursuit of civil and criminal actions may cause concern.

According to Kevin Brown, the commissioner of the IRS's small business/self-employed division, there is no reason for concern. He notes that the IRS's policy of simultaneous enforcement has been in place for the past couple of years and is focused primarily in the area of abusive tax shelters. Specifically, he noted that in instances where a civil investigation is halted pending the resolution of a criminal case, the promoter of an abusive tax shelter would be permitted to continue selling what the IRS believes to be a fraudulent product. Thus, according to Mr. Brown, the simultaneous enforcement efforts of the IRS and the Justice Department allow the government to seek the injunction of such wrongdoing while the criminal case is being developed.

Furthermore, Mr. Brown stated that a number of safeguards are in place to protect the public from overaggressive agents seeking to use the criminal case as a bargaining chip in settling the civil action. In particular, he noted that once a case is referred for criminal prosecution, civil investigators are prevented from issuing summons in the civil case. He added that, as a further precaution against wrongdoing, civil and criminal investigators will only share information pursuant to the formal process outlined in the Internal Revenue Manual.[11]

Conclusion

In any event, it remains to be seen the extent to which the new policy of simultaneous civil and criminal investigations will apply outside the tax shelter area. For instance, will garden-variety audits proceed while criminal investigators pursue their investigations?

1. Press Release, Department of Justice, Justice Department Notes Increase in Tax Enforcement (April 6, 2004) (available at 2004 WL 741260 (DOJ)).

2. Press Release, Department of Justice, Justice Department Notes Increase in Tax Enforcement (April 6, 2005) (available at http://www.usdoj.gov/tax/txdv05167.htm).

3. Mark W. Everson, Remarks at National Press Club (March 15, 2005) (transcript available at http://www.irs.gov/newsroom/article/0,,id=136835,00.html).

4. *United States v. Teyibo,* 877 FSupp 846, 855 (SDNY 1995), aff'd, 101 F.3d 681 (2d Cir. 1996).

5. See *United States v. Boykoff,* 186 FSupp2d 347, 352-53 (SDNY 2002), aff'd, 2003 WL 21191002 (2nd Cir. May 21, 2003) (relying on *United States v. Kotny,* 238 F.3d 815, 817-20 (7th Cir.), cert. denied, 532 U.S. 1022 (2001), allowing admission of statements made to civil tax agent in criminal tax case after finding that exclusionary rule did not extend to violation of an IRS regulation requiring a civil agent to refer the case to the criminal investigation division once firm indications of tax fraud are found).

6. 2005 WL 901010 (N.D. Ala. April 15, 2005).

7. Id. at **1-3.

8. Id. at *5 (citing *United States v. Parrott,* 248 FSupp 196, 200 (D.D.C. 1965) ("the danger of prejudice flowing from testimony out of a defendant's mouth at a civil proceeding is even more acute when he is unaware of the pending criminal charge")).

9. *In re Who's Who Worldwide Registry, Inc.,* 197 B.R. 193, 195-96 (E.D.N.Y. 1996) (citations omitted).

10. *Campbell v. Eastland,* 307 F.2d 478, 487 (5th Cir. 1962), cert. denied, 371 U.S. 955 (1963).

11. See IRM §25.1.3.