New York Criminal Tax Investigations: Certified Public Accountant
Klein, Mark S;Trachtenberg, Jack
The CPA Journal; Oct 2009; 79, 10; ProQuest Central
pg. 48

New York Criminal Tax Investigations

Strategies Used by the Special Investigations Unit

By Mark S. Klein and Jack Trachtenberg

As many tax professionals are by now aware, the New York State Department of Taxation and Finance (DTF) has been reorganized to include a new bureau called the Office of Tax Enforcement. This new bureau is composed of the previously existing Audit Division, the Collections and Civil Enforcement Unit, as well as the new Special Investigations Unit (SIU). William Comiskey, formerly the chief prosecutor at New York State's Medicaid Fraud Control Unit, is the deputy commissioner in charge of the Office of Tax Enforcement.

Recently, the Office of Tax Enforcement has focused on implementing what it calls a "tax gap enforcement strategy." The goal of this strategy is to enhance voluntary compliance (by deterring unlawful taxpayer conduct) and in the process increase the collection of lawfully owed taxes in order to alleviate the negative impact of New York's budget shortfall. To this end, the Office of Tax Enforcement is seeking to use a "carrot and stick" approach to change taxpayer behavior. The carrot includes a new voluntary disclosure program, under which taxpayers may voluntarily approach the tax department to report past delinquencies and obtain a certain degree of amnesty. The stick has been a significant increase in criminal investigations, referrals, convictions, and plea bargains (Jack Trachtenberg and Michelle Merola, "New York's Less Kind and Gentle Tax Department: Preparing for Criminal Investigations," State Tax Notes, March 31, 2008). According to Comiskey, the DTF has quintupled the number of staff fighting fraud since the inception of this program. Indeed, there were more cases referred to SIU for criminal investigation in the first three months of 2008 then there had been in total for the prior four years combined (Jason Subik, "State getting tough on sales tax cheaters," *Daily Gazette*, August 12, 2008).

Because of the new emphasis on tax enforcement, the state has staffed SIU with a multidisciplinary cadre of new attorneys, auditors, investigators, forensic accountants, and others charged with the task of ferreting out fraud. SIU has also been charged with conducting comprehensive investigations across a broad range of tax (and non-tax) areas. As a result, many SIU cases that begin with a focus on one type of tax often will spill over into an investigation of other areas. For example, the authors have seen cases start with a focus on sales tax, but quickly evolve into an investigation of alleged fraud related to income tax, franchise tax, and withholding tax. Other cases have grown to include money laundering, embezzlement, and other fraud-related charges. More recently, SIU has targeted fraud that it believes is being committed by accountants and tax preparers.

How Does SIU Find Its Targets?

The Office of Tax Enforcement is becoming more sophisticated in identifying and investigating potential fraud and now has more resources to carry out its mission. It has adopted (or reinstituted) some enhanced tactics to bolster its fraud detection efforts. These include the following:

- Issuing more subpoenas to taxpayers and third parties for records and testimony;
- Subpoenaing accountants to take advantage of the fact that there is no accountant–client privilege;
- Establishing a new data resource unit for third-party records (e.g., data-mining);
- Increased coordination with other states and federal agencies; and
- Proposed legislation aimed at increased compliance and enforcement, including a new law that would require banks and financial institutions to annually report the amount of deposits into accounts of registered sales tax vendors; and a new whistleblower statute for tax evasion.

The Office of Tax Enforcement has also increased its use of undercover and covert operations. This has included enlisting and making deals with allegedly corrupt taxpayers or preparers. New York State has even begun sending in undercover agents acting as taxpayers to meet with accountants and other tax preparers. During these meetings, the undercover investigator will wear a wire or camera to record the suspects ("Accountant Arrested as Part of the Tax Department's Statewide Investigation of Corrupt Tax Preparers," press release, New York State Department of Taxation and Finance, September 29,

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

2008, available at www.tax.state.ny.us/press/2008/pordy092908.htm).

Identifying Potential Fraud Cases

Accountants, tax preparers, and other tax professionals should make a concerted effort to identify potential tax fraud cases. Doing so helps to inform the practitioner of his professional obligations in representing the client. For example, if a tax preparer suspects that a client is committing sales tax fraud and is not providing all relevant information regarding the amount of sales made, the preparer should decline representation and refuse to prepare or file a false sales tax return. The failure to terminate the relationship could lead to the tax department's conclusion that the tax preparer was, at the very least, an accomplice to the fraud.

There are other reasons for tax preparers to be on the lookout for potential fraud. First, taxpayers sometimes engage in conduct that is not fraudulent but may at first glance look like fraud. Indeed, cases are sometimes referred to SIU due to factors such as sloppy (or nonexistent) recordkeeping, a lack of internal controls, and inconsistent or unexplained tax filings, all of which may have an innocent explanation. In such cases, the preparer can advise the client on how to remedy these shortfalls before they even have an opportunity to become problems. Moreover, if a professional has identified a candidate for a potential criminal investigation, criminal prosecution can sometimes be avoided by quickly filing a voluntary disclosure application and bringing them into compliance on a going-forward basis. (It's important to note that, among other restrictions, the voluntary disclosure program is not available to taxpayers who are already under audit or investigation by the DTF.) Finally, identifying potential fraud cases will help the tax professional understand how to handle any civil audit that may arise, specifically in the appropriate way to respond to an auditor's request for information or documentation (i.e., do not voluntarily provide information in a civil examination that could later be used in a criminal prosecution).

How does one go about deciding whether a taxpayer could become the subject of a New York State or New York City criminal tax investigation? The first step is to understand that there are a multitude of tax crimes provided for in New York State tax law. Some of the most common (and most familiar) include the failure to file a return, filing a false return, disclosing false information, and failing to collect or pay tax. Professional preparers should be aware that there are a host of more obscure tax crimes, such as the selling of taxable items without a certificate of authority and the failure to charge state sales tax separately. Moreover, some tax crimes can be charged under penal law (as opposed to tax law). Examples here include the failure to keep records required by law, falsifying business records, and even larceny (e.g., theft of sales tax trust fund taxes).

Though this is not a complete list of New York's tax-related crimes, the discussion above should alert tax professionals to the fact that many types of conduct—not just the failure to file or the filing of a false return—may be subject to criminal sanctions. Preparers should broaden their radar and be on the lookout for any activity that a New York State tax agent may find suspicious. In this regard, it is important for practitioners to be familiar with some of the "badges of fraud" that auditors and investigators look for in deciding whether to refer a case for criminal investigation.

Badges of fraud are what auditors and investigators seek when direct evidence of a taxpayer's intent to commit fraud is unavailable. In other words, investigators frequently look to establish fraud from the surrounding circumstances, including the conduct of the taxpayer. Indeed, at a criminal trial, the government can seek to establish criminal fraud through the introduction of circumstantial evidence. Some of the badges of fraud that may become evidence of a deliberate attempt to commit tax fraud include the following:

- Omitting income or sales on a return where similar types of other income or sales are reported;
- Unexplained increases in reported income or sales (especially if substantial);
- Unexplained bank deposits in excess of reported income or sales;
- Substantial understatements of income or sales. This can include substantial understatements discovered by the investigator through the use of indirect audit methodologies (e.g., observation audits or markup audits for sales tax);
- Concealing bank accounts or assets;
- Concealing the existence of New York living quarters;
- Reporting income or sales in an amount that does not support one's standard of living or business expenditures;
- Dealing in cash only;
- Failing to follow normal business practices, such as not depositing revenues into an operating account;
- Employees working off the books;
- Selling items that do not appear on the business's purchase records;
- Failing to file a return (especially on a repeated basis);
- Failing to make estimated tax payments;
- Maintaining inadequate records or no records at all;
- Destroying records;
- Refusing to make records available;
- Keeping two sets of books;
- Falsifying books or business records;
- Inconsistencies between the sales figures recorded on a business's income, corporate, and sales tax returns;
- Other discrepancies between books and tax returns (e.g., amounts or treatment of items);
- Claiming fictitious deductions or exemptions for fictitious individuals (e.g., a dependency deduction for a deceased individual);
- Implausible or inconsistent explanations of behavior;
- Failing to follow the requirements of the law where the taxpayer knows his obligations (e.g., based on advice of counsel or experience in the business).

In addition to the above, certain types of conduct almost invariably increase one's chance of becoming the target of a criminal investigation. Failing to cooperate with the tax authorities, making false statements about relevant facts (especially if under oath), and hindering an audit or investigation (e.g., constantly cancelling appointments or failing to provide a power of attorney or other requested records) are notable examples and should be avoided. And, although it should go without saying, taxpayers should never threaten or attempt to bribe an auditor or investigator. Even an innocent gesture (e.g., offering an auditor tickets to a sporting event that would otherwise go unused) might be misconstrued.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The bottom line is that tax professionals must be alert to the existence of the badges of fraud. If a client has not yet come under audit or investigation, there may be steps that the taxpayer can take to come into compliance, reduce the potential tax exposure, and avoid criminal sanctions. Being attuned to possible fraud is also important for taxpayers who are already undergoing a civil examination, but who have not yet been referred to SIU. In these cases, the client can be monitored and encouraged to not dig deeper by stalling, misleading, or obstructing the auditor. More importantly, however, the client should be advised to engage an attorney so as to ensure that the auditor's requests for information and documentation are handled in way that does not do harm to the taxpayer should the civil examination at some later date turn into a criminal investigation.

Handling Requests for Information

DTF auditors and investigators will inevitably request that the taxpayer provide documentation regarding the transaction or tax filing at issue. They may also ask that the taxpayer offer testimony in response to specific questions. It is important, therefore, to remember the differences regarding the burden of proof in civil cases as opposed to criminal cases. In a civil audit, the taxpayer generally bears the burden of proving that an asserted tax liability is incorrect. Conversely, in a criminal case, the burden ultimately rests with the government to prove that there is a liability and that the taxpayer intended to commit fraud. Consequently, whether dealing with a civil audit that could turn criminal or a case that is already under criminal investigation, an advisor must carefully analyze whether and how to provide information requested by the state. A tax preparer does not want to voluntarily provide information to the investigator that could be used against the taxpayer in a criminal proceeding.

Whether and how information should be provided is often a function of how it is requested. If the taxpayer has not been subpoenaed, the tax practitioner should ask whether there is a way to satisfactorily answer the auditor's inquiry without hurting the taxpayer's position. Tax preparers should never, however, lie or make things up (or feel free to do so just because there is no subpoena), because anything said could later be used against the taxpayer, even if not stated by the taxpayer directly. If the preparer does not have the document requested or does not know the answer to the investigator's question, she should generally just say so.

The situation changes if a subpoena has been issued, whether for testimony or records. Generally, the taxpayer or other party must comply with the subpoena. Compliance can be withheld if, for example, a privilege can be asserted or a court order has been obtained to quash all or part of the subpoena. Some of the privileges that may apply include the attorney–client privilege, the doctor–patient privilege, the marital privilege, and the Fifth Amendment privilege against self-incrimination. Keep in mind, however, that because the failure to comply with a subpoena issued by the DTF is a crime, one's refusal, even if for good reason, should be handled carefully and according to proper procedure.

Tax professionals should also be on the lookout to determine whether a client should be taking steps to challenge or at least register an objection to a subpoena issued to a third party. This may be appropriate, for example, in the context of a subpoena issued to a former attorney. In that case, the taxpayer may wish, depending on the information requested, to ask that the former attorney not comply with the subpoena on the grounds that compliance could be treated as a waiver of the taxpayer's Fifth Amendment privilege.

One final consideration regarding information or document requests: At the federal level, IRS regulations require that a civil tax audit be suspended once the auditor has reason to believe that fraud has been committed. In other words, federal tax auditors cannot conduct a criminal investigation under the guise of a civil audit. Though it may be that the courts would enforce a similar set of rules against the DTF on the grounds that such rules are required by the Fifth Amendment to the U.S. Constitution [see *United States v. Tweel*, 550 F.2d 297 (5th Cir. 1977)], New York has not yet adopted specific regulations to address the issue. Consequently, it is unclear if and when an auditor in New York must suspend the civil examination in the face of suspected fraud. Even if New York were to follow (or be forced to follow) a similar policy, it is possible that the information provided during the civil phase of an audit, if it is provided before the auditor suspects fraud, could be used against the taxpayer after the case is referred for criminal investigation. This makes the above considerations regarding the proper handling of information or documentation requests all the more crucial.

Tax Preparer Obligations and Responsibilities

As noted above, the Office of Tax Enforcement is focusing much of its antifraud campaign against tax preparers. According to the state, this is because it believes that: 1) preparers are uniquely situated to influence compliance; 2) preparers are generally not regulated; and 3) the state's data mining has revealed a pattern of fraud tied to preparers. Indeed, the Office of Tax Enforcement has begun to rely on technology to snuff out credit and refund schemes and to identify fraud tied to specific preparers. The state has established a "questionable preparer" database and is looking to build cases against preparers on the basis that they are accomplices to fraud. This has resulted in the imposition of civil preparer penalties, criminal charges, and the publicizing of those preparers found guilty of fraud. In terms of penalties, New York's recently enacted 2009/2010 budget legislation provides for a $5,000 penalty to be assessed against any paid tax preparer who aids or assists in the preparation of fraudulent returns, reports, statements, or other documents, or who supplies false information to the DTF.

The DTF has also issued Publication 135, "Consumer Bill of Rights Regarding Tax Preparers." It describes the rights of taxpayers and how they can protect themselves from unfair practices by tax preparers. New York is also mailing taxpayer alerts notifying taxpayers that their preparer is under investigation or has admitted to filing fraudulent or inaccurate returns. These taxpayers are urged to act quickly (e.g., file a voluntary disclosure) to avoid penalties, criminal charges, or other compliance actions.

So what does all of this mean for tax preparers?

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

It means that preparers should ensure that they are performing the requisite amount of due diligence before preparing or filing a return. A tax preparer's lawful duty is to assist in the preparation and filing of correct and accurate returns. This should be the guiding rule, and all advice and conduct should be aimed toward this end. Tax preparers are not obligated to police or investigate their clients, but if there is reason to believe that a taxpayer is not providing complete or accurate information, a preparer should ask follow-up questions. Knowingly turning a blind eye to fraud may create the level of intent necessary for the state to charge the preparer as an accomplice, especially if they assist in the preparation or filing of a false return.

What to Do if a Case Goes Criminal

If a taxpayer has come under criminal investigation, SIU will generally issue a letter to the taxpayer and the taxpayer's representative informing them of this fact. If a taxpayer has not received such a letter but the preparer believes that the auditor or investigator suspects criminal activity, one should ask the question: Is there a pending criminal investigation? The response will help to inform many of the decisions a preparer will have to make regarding requests for documentation and other information. If the auditor or investigator misleads the taxpayer into believing that there is no suspicion of fraud, it may become a defense at a later date (i.e., because the auditor arguably was conducting a criminal investigation under the guise of a civil audit).

If a criminal investigation has been commenced, certain steps should be taken immediately. Most importantly, all direct communication between the taxpayer and the government should cease. In particular, taxpayers and their advisors should be cautious if government agents show up unannounced. In addition, the taxpayer should retain counsel and execute a power of attorney authorizing counsel's representation in the matter. An assessment should be undertaken to analyze the nature of the relationship between the taxpayer and the accountant or tax preparer. Depending on the circumstances, a new accountant may need to be retained to assist the attorney in connection with the criminal investigation. Finally, an effort should be made to gather, organize and analyze all relevant documents, especially if they are currently being held by third parties.

The Role of Voluntary Disclosure

Recently, the New York State legislature, at the urging of the Office of Tax Enforcement, adopted a statutory framework for voluntary disclosure, under which taxpayers can voluntarily approach the tax department to report past delinquencies and obtain a certain degree of amnesty. Eligible taxpayers who file a disclosure statement and execute a voluntary disclosure and compliance agreement will avoid incurring any civil penalties and will not be subject to any criminal proceedings for the period disclosed. Taxpayers will not, however, be able to enter into such an agreement if: 1) they are currently under audit or a party to a criminal investigation; 2) the tax department has already identified the disclosed deficiency; or 3) the taxpayer is disclosing participation in a tax avoidance transaction that is a federal or New York State reportable or "listed" transaction.

The voluntary disclosure program is available to taxpayers who wish to disclose a delinquent tax liability, even one that was deliberately or fraudulently evaded. In such cases, the taxpayer may be able to obtain immunity from prosecution, but it is crucial to remember that such immunity will apply only to those years disclosed and paid under the program. Because various statutes of limitation apply to the different tax crimes, and due to the potential application of prosecutorial theories such as the "ongoing crimes" doctrine (which may act to toll or extend these periods of limitation), taxpayers who wish to disclose a potentially fraudulent transaction should first consult with an attorney. Indeed, while there is an automated process available on the tax department's website, the voluntary disclosure program can be confusing for a host of reasons. Talking to legal counsel beforehand will help to ensure that disclosure is the best course of action and that the taxpayer ultimately receives the fullest protection possible from the program.

Incentive to Do the Right Thing

New York's current criminal tax compliance initiative should be viewed as good news for honest and diligent tax preparers who struggle to do the right thing. At the same time, unscrupulous taxpayers, and those who assist them, have plenty to fear. And while it is unusual for defendants indicted in tax crimes to serve any significant time in jail, the imposition of hefty fines, penalties, taxes, and interest has the potential of being devastating to all concerned. Moreover, when one of the participants is a licensed CPA, New York State may attempt to publicize the criminal charges and notify other clients of the accountant's misdeeds. The state is also likely to make every effort to revoke the CPA's license. Faced with such a downside, the DTF hopes that more taxpayers and professionals will do the right thing. Those who don't, act at their own peril. ❑

Mark S. Klein *is a partner at the Hodgson Russ law firm with offices in New York and Buffalo, N.Y.* ***Jack Trachtenberg*** *is an associate at Hodgson Russ who specializes in New York tax matters.*

RELIABLE STARTUP & INCORPORATION SERVICES

USA Corporate Services adds to your **PRODUCTIVITY** and **PROFITABILITY** by ensuring you **ACCURATE** information, **TIMELY** support and **EXCEPTIONAL** services.

Our startup services can be tailored to fit your clients' situation, available for all 50 States & D.C.

CALL : (800) 888-4360

www.usa-corporate.com

USA Corporate Services Inc.
19 W 34th St. #1018 NYC 10001
info@usa-corporate.com

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.