TAX OBSTRUCTION CRIMES: IS MAKING THE IRS'S JOB HARDER ENOUGH?

ONLINE APPENDIX*

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* This Appendix is an unpublished, online supplement referenced extensively in the following article: John A. Townsend, *Tax Obstruction Crimes: Is Making the IRS's Job Harder Enough?*, 9 HOUS. BUS. & TAX. L.J. __ (2009).

These examples illustrate anecdotally the range of audit avoidance conduct – i.e., the intent to lower the audit profile coupled with some legal – even morally neutral objective – conduct.

I. EXAMPLE 1: CHOOSING THE STANDARD DEDUCTION WHEN ITEMIZED DEDUCTIONS ARE LARGER.

A taxpayer is advised by his return preparer that returns with itemized deductions are more likely to be audited than returns claiming the standard deduction. Knowing that his client has had a bad experience with a "no-change" audit[1] that was a hassle and expensive, the preparer recommends that the taxpayer consider electing the standard deduction. Preferring to avoid an audit or at least lower the chances of an audit, the taxpayer accepts the recommendation and directs his return preparer to elect the standard deduction even though his deductions, if itemized, would produce a lesser tax liability. The return is prepared and filed with the standard deduction.

II. EXAMPLE 2: CLAIMING FEWER DEDUCTIONS THAN OTHERWISE AVAILABLE.

A taxpayer with large Schedules A and C deductions is advised by the return preparer that the amount of the deductions being relatively large and aberrational will almost certainly flag the return for audit. The return preparer advises that the IRS has a computer model called the Discriminate Index Function ("DIF") used to test for aberrational patterns that might justify an audit. The return preparer does not have the model behind the DIF but imagines that it would pick up this return because of the aberrational deductions which he thinks are proper, but an audit would be costly and distracting for this taxpayer. They accordingly cut back the

1. A no change audit is one that results in the IRS making no changes to the return.

quantum of the deductions in order to minimize the audit risk.[2] The return preparer finalizes and the taxpayer files the return with the reduced deductions.

III. EXAMPLE 3: VARIATION: CLAIMING FEWER CHARITABLE DEDUCTIONS.

This is a variation on Examples 1 and 2 of foregoing deductions. You are a business man – a generous business man – who prefers to do your own return. You made substantial charitable contributions during the year, all of which are deductible. You buy TurboTax. When you input your tax data into the TurboTax program, it raises an "audit flag" and provides data regarding averages which cautions that your contributions are substantially above the average for taxpayers with a comparable tax profile. TurboTax designs its audit flags and averages to caution taxpayers that they may be increasing their audit profile by claiming benefits in excess of the averages.[3] You also review the Turbo Tax publisher's web site on avoiding audits.[4] Indeed, in the 2007 iteration of TurboTax, the IRS has a feature called "Audit Risk Meter" advertised to "Help you reduce risk of audit."[5] Based on these various TurboTax offerings, you scale back your claims of charitable contributions.

IV. EXAMPLE 4: MAKING THE AMOUNT OF CHARITABLE DEDUCTIONS BASED ON AUDIT FACTORS.

Same facts as Example 3, but the taxpayer decides next year that he will make charitable contributions that are lower than TurboTax's flags and averages showed in preparing his return for last year. He clearly shapes his actions – less charitable contributions – and resulting return reporting position to lower his audit profile.

2. This example is inspired by James Edward Maule, *No Thanks, Uncle Sam, You Can Keep Your Tax Break*, 31 SETON HALL LEGIS. J. 81 (2006). The author explores the issue of whether the taxpayer can decline to take deductions the taxpayer is otherwise entitled to take on several grounds, including the perception that more deductions than claimed would higher the audit profile.

3. For similar mass distributed techniques to play the audit lottery by avoiding audit, one need only Google "avoid audit tax" or some such iteration of the key words. The results are a number of claims by tax whackos and marginally credible sources, but some are by recognized publications and tax experts. *See e.g.*, Tom Herman, *How to Avoid Getting Audited: IRS Ramps Up Scrutiny Of High-Income Groups; Red-Flag Deductions,* WALL ST. J.,, Apr. 7, 2007, (http://online.wsj.com/article/SB117589697192162590-search.html?KEYWORDS=avoid+audit&COLLECTION=wsjie/6month). Are they recommending criminal conduct, and more directly in point do they and the target persons who engage in audit avoidance engage in tax obstruction or a *Klein* conspiracy?

4. *See* http://www.quicken.com/cms/viewers/article/taxes/6206 (last visited Apr. 7, 2007).

5. *See* http://turbotax.intuit.com/personal-taxes/online/compare.jsp (last visited July 7, 2008).

V. EXAMPLE 5: CONFORMING DEDUCTIONS TO IRS AUDIT MODELS.

Professor Amir D. Aczel is a statistician with an intense interest in taxes as a result of suffering, he feels, an audit from hell. He built a statistical model that emulates the IRS's computer modeling score – referred to in the IRS and tax afficionados as the "DIF score" (or some variation) and has published a book about it titled Amir D. Aczel, *How to Beat the I.R.S. at Its Own Game: Strategies to Avoid - And Fight - An Audit* (Four Walls Eight Windows 1995).[6] And his statistical technique has been widely described – e.g. in the New York Times.[7] The book and the articles the book or the author has generated tell the author's techniques for avoiding audits. Some readers have shaped their planning and return reporting around the information provided by Dr. Aczel.

VI. EXAMPLE 6: FOLLOW THE FORMS STRATEGY.

The Wall Street Journal "Wealth Report" for January 30, 2008 published some simple strategies designed to help "a rich person duck an audit."[8] These, of course, are all facially legal strategies designed to lessen the risk of an audit. The strategies include (1) keep the tax landscape of artificial entities (S Corps, trusts and partnerships) relatively simple; complexity invites scrutiny; (2) avoid radical year to year changes which also invite scrutiny; and (3) "follow the forms" meaning that, even if you receive a Form 1099 or K1 that you "think may be wrong," just "suck it up" and report consistently rather than creating a ruckus that might invite broader scrutiny.[9]

VII. EXAMPLE 7: PLANNING RETURN POSITIONS BASED ON THE TAXPAYER CIVIL PENALTY RULES.

The taxpayer engaged in a transaction that is not a tax shelter. The tax preparer advises the taxpayer that the favorable return reporting position the taxpayer desires to take in reporting the transaction (i) has substantial authority[10] but and (ii) is not more likely than not to prevail. The preparer

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6. On Amazon at www.amazon.com/Beat-I-R-S-Game-Avoid-Fight/dp/1568580487. Professor Aczel may have an ax to grind because of his perception of inappropriate behavior from an IRS agent, but he is a credible statistician. See http://en.wikipedia.org/ wiki/Amir_Aczel.

7. David Cay Johnston, *Your Taxes: Some New Tricks to Help Filers Avoid an Old Audit Trap*, N.Y. TIMES (Feb. 25, 1996) (Apr. 7, 2009, http://query.nytimes.com/gst/ fullpage.html?res=9500E1D71039F936A15751C0A960958260).

8. *See* http://blogs.wsj.com/wealth/2008/01/30/the-taxman-targets-the-rich (last visited July 7, 2008),

9. Query whether this is consistent with the taxpayer's signing on the return that it is true, complete and correct even when, as posited, the taxpayer thinks the 1099 or K-1 is wrong. Does it matter whether the taxpayer thinks the error, if reported consistently, generates less tax?

10. Substantial authority is tax jargon from the civil accuracy related penalty rules. This and related jargon are the concepts that tell if return reporting positions are subject to civil penalties. The gradation of opinions has been described as: "non-frivolous = 10 percent or better; reasonable basis =

advises that the combination of these phenomena permit the taxpayer, in effect, to play a congressionally approved version of the audit lottery without disclosure and without penalty other than having to pay the tax and interest if the return is audited, if the agent spots the position, if the agent understands the position, if the agent is not dissuaded from making an adjustment, and if the taxpayer does not prevail in appeals or in litigation. After discussion of the risks and potential rewards, the taxpayer directs the tax preparer not to disclose the position, for Congress has directed that there be no penalty even if he does not increase the chance of audit by disclosing.

VIII. EXAMPLE 8: SAME EXAMPLE WITH PREPARER PENALTY RULES IN PLAY.

Use the same example, but now consider the preparer penalty in Section 6694(a), as amended in 2007,[11] which imposes a relatively light civil penalty (the greater of $1,000 or 50% of the income with respect to the return) for a preparer who prepares a return with a return reporting position that would impose the accuracy related penalty on the taxpayer. Since the penalties are parallel in their application, the promoter will not even be subject to this relatively light promoter penalty even though the taxpayer at the preparer's direction intended to and did play the audit lottery and certainly intended to impede the IRS's ability to detect the aggressive return reporting position. Yet, Congress did not even impose the relatively light civil penalty upon either the taxpayer or the preparer; it is incomprehensible that Congress intended a far more draconian criminal penalty to apply.

IX. EXAMPLE 9: FAILURE TO DISCLOSE WHERE EVEN A CIVIL PENALTY WOULD NOT APPLY.

A taxpayer consults with his tax lawyer and his tax accountant regarding how to report a non tax-shelter transaction on his return. They both advise the taxpayer that it is more likely than not (i.e., over a 50%

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20 to 25 percent; realistic possibility of success = 33 1/3 percent; substantial authority = something more than realistic possibility, perhaps 35 to 40 percent; more likely than not = something more than 50 percent; probable = 70 to 80 percent." Burgess J.W. Raby and William L. Raby, *Painting the Accounting Practitioner Into a Tax Practice Corner*, 2005 TNT 178-4 (citation omitted); see generally Jasper L. Cummings, Jr. *The Range of Legal Tax Opinions with Emphasis on the "Should" Opinion*, 98 TAX NOTES 1125 (2003). Tax crimes require the intentional violation of a known legal duty, so that, by analogy, a non-frivolous or stronger position (i.e., at least reasonable basis) should be relegated solely to the civil penalty regime.

11. The amendment has an effective date for returns filed after May 25, 2007, but because of administrative concerns, the IRS has granted transitional relief so that the less onerous prior version of § 6694(a) applies through 2007. Notice 2007-54, 2007-27 I.R.B. 1. Prior to the amendment, the statute imposed a $250 penalty for positions that had no realistic possibility of success and was either not disclosed or was frivolous.

chance) that the taxpayer will be taxed on the transaction and that there is not even substantial authority for that position. But, they both advise, there is a reasonable basis but nonfraudulent position that the taxpayer will not be taxed on the transaction. The tax lawyer and tax accountant advise further that, under the accuracy related penalty rules, the taxpayer would be subject to the substantial understatement accuracy penalty unless he discloses the transaction on his return. They advise the taxpayer that the penalty would be 20% if there is an audit and the position discovered and challenged. The taxpayer then asks what his chances of being audited are if he does not disclose. The tax lawyer and tax accountant advise that that is hard to quantify, but they believe the statistics indicate the audit rate is less than 1% overall and that almost certainly for his profile it is less than 2%. (The tax lawyer and the tax accountant did not take the audit rate into consideration in making their more likely than not and reasonable basis determinations.) The taxpayer then decides to forego disclosing the position, viewing his remote risk of having to pay a penalty as acceptable because of the substantial benefit if an audit is avoided. This decision not to disclose is solely a decision to influence the audit profile which they all imagine is increased if he discloses. With the blessings of the professionals, the tax accountant prepares the return, and the taxpayer signs it and files it. This type of conduct is not uncommon.[12] The implication from the fact that only a civil accuracy related penalty (and not a civil fraud penalty) would apply to this conduct is that the conduct itself is not fraudulent.

X. EXAMPLE 10: DRAFTING RETURN DISCLOSURE TO LOWER THE AUDIT PROFILE.

Same example, except that the taxpayer decides he is not willing to risk the penalty and therefore will make the disclosure. The tax lawyer then drafts the disclosure in a way that is not false but spins disclosure with the intent of lowering the risk that the IRS would audit the return. The spin is in effect a one-sided brief stating the case in the best light for the taxpayer and is intended to affect the audit profile. The tax accountant prepares the return (including the disclosure which incorporates the tax lawyer's "brief-type" disclosure on the issue). This type of conduct is not uncommon.[13]

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12. I dare say most practitioners have done some variation of this theme. Cf. *Richard C. Stark, A Principled Approach To Collection And Accuracy-Related Penalties*, 91 TAX NOTES 115, 122 (Apr. 2, 2001) ("There are taxpayers, and probably every tax practitioner has encountered them and most of us have represented them, who deliberately take advantage of ambiguities in the code and who carefully do their penalty algebra in evaluating whether to disclose positions and how aggressively they should act.").

13. *See supra* note 12.

XI. EXAMPLE 11: FILING A PAPER RETURN TO EXPLOIT IRS INEFFICIENCIES.

A tax preparer believes that the IRS is less capable of managing paper returns as efficiently as e-filed returns.[14] Accordingly, the preparer routinely recommends to his clients that they file paper returns rather than e-filed returns. All of his clients like the idea of using this technique to slow down or stop the IRS's ability to deal with their returns in any context, audit or otherwise.

XII. EXAMPLE 12: INCORPORATING.

What if a taxpayer prefers, if possible, to avoid an audit for his business activities? He or she consults with his tax adviser who advises that, based on his understanding of Government statistics and his own anecdotal experience, the IRS audits Form 1040 Schedule C business operations more than they audit C Corporation business activities at the activity level of the taxpayer's business. The taxpayer then decides to incorporate to achieve what he thinks will be a lower audit profile, and the tax adviser then implements the incorporation (e.g., by preparing and filing articles of incorporation, making the necessary tax elections, etc.).[15] They certainly are guilty of no substantive tax offense because this example has no tax that is underpaid.[16]

XIII. EXAMPLE 13: FILING A RETURN ON EXTENSION.

You and your tax return preparer have suffered through an expensive and time and energy consuming IRS audit of the taxpayer's year 1 return that resulted in "no change." The taxpayer and you believe the agent was inefficient and even abusive. The tax preparer has substantially completed your year 4 return for your signature on April 1 of year 5 and advises that, from the publications she has read as to the IRS's mechanisms for classifying returns for audit, she believes that taxpayers with your return

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14. There is some indication that this belief would be consistent with the facts, but for purposes of this paper it does not matter whether the preparer's belief is true. It just matters that he believes it is true. However, for a GAO study consistent with the truth of this hypothetical belief, see GAO Report GAO-07-1160 titled *The Internal Revenue Service Can Improve Its Management of Paper Case Files* (September 2007).

15. One web site touts this audit avoidance technique as follows: If you are self-employed and file a Schedule C you automatically increase your audit chances. If you are self-employed the best way to avoid scrutiny from the IRS is to Incorporate or form a Limited Liability Company. Corporations and LLCs are audited far less frequently than individuals. It's also a good idea to be incorporated to help protect your personal assets in the event of a lawsuit. Another benefit is the fact that corporations are allowed more deductions with fewer limitations, and officers of the corporation can borrow money as well as take a salary - the borrowed money being tax free to the officer until converted into salary. *See* http://www.totaltaxsolutions.com/avoid-audit.htm (last visited Apr. 9, 2007).

16. Ah, but you say, what about § 7212 which has similar language ("impedes, or endeavors to obstruct or impede, the due administration of this title")? I discuss that section in the text below.

profile are more likely to be audited if the return is filed timely than if the return is filed during the 6 month extension period that can be routinely obtained by filing a Form 4868.[17] The preparer recommends that, although you could file a substantially complete and accurate return on time, there are some things that will not be available by that time to make it more complete and accurate, so that you could obtain the extension and then file the return on September 1 of year 2, which she thinks is close to the "sweet spot" for lowering your audit profile. You ask the preparer if it is legal, for, although you are an aggressive sort, you certainly don't want to break the law. The preparer assures you it is legal – taxpayers are entitled to obtain an extension and are not required under the current form to state a reason for the extension. Preferring to lower the risk of audit any way you can legally, you direct the preparer to complete the return on September 1 of year 2 and you will come by her office to sign it on that date and have her mail it to the IRS. The return is then prepared, signed by both and mailed in on September 1 as planned. Can they be charged with tax obstruction or *Klein* conspiracy? Would it make any difference if a key deduction claimed on the return was an SEP deduction which may be claimed for SEP payments made prior to the filing of the return and you say that, although you are prepared to make the payment on April 1 if you were to file on April 1 you will just maintain the funds in an interest bearing account and make the SEP payment August 25, just before the return is prepared, signed and mailed to the IRS? If the preparer additionally advised you that she is giving her other important (translated high income, high fee) clients the same advice and most are following her advice, would that make you a co-conspirator with all the others who follow her advice?

XIV. EXAMPLE 14: FILING A RETURN THAT INCORRECTLY STATES THE ECONOMIC POSITION OF THE TAXPAYER.

This example is "inspired by" (in Hollywood language designed to alert you to the fact that it is not exactly the same as, but it close enough) a famous Supreme Court case where the Supreme Court famously asserted that form trumps economic substance for tax purposes. The case is *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). There a bank obtained its corporate headquarters building by complex financing arrangement in which the bank appeared nominally as a tenant for a period of time, a corporation (the Frank Lyon Co.) owned by one of the bank's directors

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17. One web site explains this audit avoidance technique:

> Due to budget constraints there is a limit to the number of returns selected for examination. Most returns are selected by the end of the summer, so file on the last extension possible (October 15th). By then it's likely that the IRS has already reached its yearly quota of audited returns so your chances of an audit is reduced.

See http://www.totaltaxsolutions.com/avoid-audit.htm (last visited Apr. 9, 2007).

(Frank Lyon) appeared nominally as the owner for a period of time, and a financial institution appeared as the lender (the financial institution's role was not nominal) which looked, for all practical purposes solely to the bank to repay the loan. As is common in complex financial arrangements, however, the nominal positions of some of the parties were not their real economic positions. In economic substance, although nominally a tenant, the bank had the material economic attributes of ownership and the Frank Lyon Co. had the material economic attributes of a lender (in this case a second mortgage lender, because the financing institution was in the first mortgage position and Frank Lyon Co. ultimately only got his advance money returned with an interest factor). Yet, because of how the parties and their counsel papered the transaction, Frank Lyon Co. reported the transaction as if it were the owner of the building, thus achieving depreciation deductions for depreciation Frank Lyon Co. would never suffer – achieving a tax shelter effect by deferring income sheltered by the depreciation and converting it ultimately to capital gains when the bank took nominal title to the building which it was entitled to do simply by paying Frank Lyon Co. its principal and interest thereon. This was tax shelter nirvana, if it worked. The Eighth Circuit easily saw through the paper fog, but, amazingly, the Supreme Court said the complicated tax engineering by financial wizards and papersmiths worked for artificial reasons, giving hope to even the most brazen of tax shelter promoters ever since.[18] But, let's say for analysis purposes that Supreme Court had not rendered from Mount Olympus the flawed *Frank Lyon* decision and the Government wanted to pursue the players in that case, including their respective professionals, who papered Frank Lyon Co. as owner when he was in fact a lender and reported the transaction that way. Could the Government charge tax obstruction or *Klein* conspiracy on the theory that the nominal ownership position was an intent to deceive the IRS into believing Frank Lyon Co. was really the owner in substance?[19] Or even if the parties could dodge the bullet on that point because, under the facts, the bank regulators required the bank not appear as owner (even though it really was), could the Government say that tax obstruction or *Klein* conspiracy is still present because, even though the bank regulators required the charade for its purposes, there was no requirement that the charade encouraged or even blessed by the bank regulators be carried

18. There are a number of scholarly publications discussing this case, so I cite here only a few: Charles I. Kingson, *How Tax Thinks*, 37 SUFFOLK U. L. REV. 1031 (2004); Bernard Wolfman, *The Supreme Court in the Lyon's Den: A Failure of Judicial Process*, 66 CORNELL L. REV. 1075 (1981) (discussed in Kingson's article).

19. Just for fun, I plugged in the *Frank Lyon* facts into the major allegations of the *Stein* indictment. Fit like a charm. Except, of course, the Supreme Court blessed the deal. For those interested, the result of this fun exercise can be downloaded from my web site at: www.tjtaxlaw.com/franklyon.pdf. Remember in reviewing the draft indictment that I am not alleging that anybody committed a crime; rather, what I am suggesting is that, given the Government's imagination, almost anybody can be charged with a crime.

forward into the tax return where, after all, substance and not form is said to prevail (sometimes)?[20] At least in this example, there is something false and deceptive really being done – papering Frank Lyon Co. or presenting Frank Lyon Co. on the return as owner when it is really a lender. But the Supreme Court blessed that false return presentation on the merits, so presumably the Government could not make any type of crime out of it unless tax obstruction or the *Klein* conspiracy is so expansive as to criminalize the mere intent to influence an audit with some act in furtherance thereof.

XV. EXAMPLE 15: RESISTING IN AN AUDIT.

A taxpayer is undergoing an audit. The taxpayer is represented by a lawyer. The IRS requests documents from the lawyer. The lawyer says that he does not respond to oral requests, hoping thereby to deflect the oral inquiry. (In the lawyer's experience, sometimes agents will not bother to follow through with a written request.) The agent thinks about it off and on for a couple of weeks and issues an Information Document Request (Form 4564) ("IDR") for the documents, asking that they be produced in 10 days. The lawyer advises the taxpayer that the IDR is not compulsory and that he need not respond. They agree to not respond, thinking that the agent might not pursue it further. The agent stews for a few days after the 10th day when the documents are not produced, consults with his division attorney. After careful attention to needs of the audit, the agent and attorney draft and issue a comprehensive summons. Now, the lawyer advises the taxpayer that they have what he views might be compulsory process and must respond. You will note that the taxpayer's and practitioner's inaction to the first two steps – refusing the oral request and not complying with the IDR – had as their purpose the intent to impede the agent in the audit.

XVI. EXAMPLE 16: NONCOMPLIANCE WITH SUMMONS.

Take the same example (Example 14) except that the taxpayer, with the advice of the lawyer, then do not comply with the summons. The taxpayer and the lawyer live in Manhattan where the IRS audit is being conducted (the venue for the *Stein* case). Your attorney is aware of a truly remarkable decision in the Second Circuit – *Schulz v. I.R.S.*, 395 F.3d 463 (2d Cir. 2005), revised opinion 413 F.3d 297, 298-299 (2d Cir. 2005) – holding that you need not even comply with the summons unless ordered to do so in a subsequent summons enforcement proceeding in district court initiated by the Government. The lawyer advises the taxpayer that, based on his experience, the IRS often does not do the extra work to engage DOJ to file such a proceeding, but that in any event the filing and obtaining of a

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20. *Cf. Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979) (financial accounting, even if demanded for regulatory purposes, does not control tax accounting and reporting.

court order would take several months. The taxpayer desires to at least delay, and thus, he and the lawyer agree that there will be no production pursuant to the summons.

XVII. EXAMPLE 17: NONCOMPLIANCE WITH SUMMONS (PART 2).

Assume that the taxpayer is in a Circuit that does not buy into the *Schulz* position that the summons itself is not compulsory without a court order. The summons itself is viewed as a compulsory process even without a subsequent judicial order to comply. The taxpayer nevertheless resists the summons, requiring the IRS to pursue a summons enforcement proceeding in the district court. Or, the taxpayer files a motion to quash the summons in the district court. In either case, as is typically the case in such judicial contests to IRS summonses, the taxpayer has no possibility of avoiding the summons under the familiar *Powell*[21] standards and thus has no legitimate purpose in not originally complying with the summons. By failing to comply originally, the taxpayer has delayed the IRS audit and caused the institution of unnecessary judicial proceedings.

XVIII. EXAMPLE 18: VARIATION ON RESISTING AN AUDIT.

This example, a variation of the same theme, is from Professor Goldstein's seminal article:

> Another class of problem is illustrated by A's direction to a bank official to keep A's bank records from an internal revenue agent who is trying to ascertain whether A owes additional taxes. Arguably, everyone has the right to keep his affairs private unless an affirmative duty of disclosure has been imposed through a valid exercise of governmental power. On the other hand, the tax authorities unquestionably are authorized to conduct investigations looking to the ascertainment of tax liability. If the "conspiracy to defraud" statute is said to guard that authority, the problem arises of how to draw a line between the area in which one may act with complete impunity in personal affairs and the area in which impunity ends and an obligation to act "honestly" begins. Is there "dishonest interference" with an internal revenue agent investigating tax liability when an individual refuses to make his bank records available to the agent? The response of one sensitive to a tradition that crimes must be clearly defined by the legislature in terms comprehensible to men of common intelligence is that such an act can constitute

21. *United States v. Powell*, 379 U.S. 48 (1964).

> "dishonest interference" only if a statute or a properly promulgated regulation imposes an obligation to disclose to the revenue agent. The existence of an elaborate investigative machinery, provided by statute and empowering the agent to obtain a subpoena, would seem to negate by implication the obligation to make disclosure outside the formal setting.[22]

In other words, merely because a taxpayer and his lawyer decline to produce documents in which the IRS on audit is interested in order to slow down the audit or, if the agent does not follow through with a summons, impede it altogether, that does not make them guilty of a *Klein* conspiracy because the law did not impose an obligation that the taxpayer and his lawyer produce without the compulsion of a summons.[23]

XIX. EXAMPLE 19: STRUCTURING TRANSACTIONS FOR LESS VISIBILITY ON AUDIT.

This example is "inspired by" fact patterns in *Stein*, a *Klein* conspiracy case. An accounting firm introduces taxpayers with large capital gains to a strategy where the taxpayers will obtain offsetting losses which are not real economic losses. The strategy is, in common tax parlance, a tax shelter. The economic cost to the taxpayer will be an amount that, although temporarily invested, will ultimately be used for fees to the accounting and law firm that will give the taxpayers written opinions that the tax benefits will more likely than not prevail and to an investment firm that will make the temporary investments purportedly supporting the strategy. A key assumption in this "inspired by" example as I posit it is that the opinions are given and received in good faith – the accounting firm and law firm, as well as the taxpayer (after getting independent advice), believe that the tax benefits will more likely than not be sustained. (In the real case, the Government contests this assumption, but make the assumption for purposes of this analysis.) The accounting firm also advises the taxpayers that they can implement the strategy either at their individual level or through a grantor trust where the tax law requires that the results be reported by the taxpayers on their personal returns. The accounting firm advises the taxpayers that the accounting firm believes that the risks of audit are less if the grantor trust alternative is used. The accounting firm and the taxpayers specifically discuss the benefits of the lower audit profile – (1) even though they both believe in good faith that the claimed benefits will more likely than not be sustained if audited, they know that there is

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22. Goldstein, *Conspiracy*, p. 432.

23. Indeed, it is unclear whether the mere issuance of a summons alone – without the enforcement of the summons – is itself a compulsory event. See *Schulz v. I.R.S.*, 395 F.3d 463 (2d Cir. 2005), clarified *Schulz v. IRS*, 413 F.3d 297, 298-299 (2d Cir. 2005).

some risk that the benefits will not be sustained if audited, so a lower audit profile gives them greater opportunity to sustain the benefits (the IRS would say that this gives them greater opportunity to play the audit lottery); and (2) even if ultimately sustained after audit and any resulting litigation, the transaction costs of responding to audit and litigation would be great and hence it is better to avoid such costs if possible. Based on this advice and with the intent to lower the audit profile, the taxpayers elect the grantor trust alternative. The taxpayers, with the assistance of the accounting firm, implement the grantor trust alternative and prepare and file trust and individual returns reporting the claimed results.

How is this fact pattern materially different from a prior one (Example 12) involving the incorporation to lower the audit profile? Have the accounting firm and taxpayers engaged in deceitful conduct within the intention of the defraud clause? At one level, they did take actions, otherwise clearly legal, which in their minds would lower the audit profile. Is it deceitful per se to take an action otherwise legal and not misleading if the parties intend thereby to lower the audit profile by exploiting the IRS's audit rates or audit priorities for varying types of taxpayers (in this case entities)?

In *Klein*, for example, the court catalogued acts of deceit including alteration of documents, false descriptions in accounting records as to the nature of payments, false statements on the income tax returns and the on and on.[24] The element of deceit was clearly present. But, it seems to me that in this Example 18 deceit is missing because the actions are legal, are reflected in clear and simple paper trail (not one needlessly complex to create a virtual fog via complexity alone), and there is no deceptive description of the legal steps taken. Should that be criminal? Does the *Klein* conspiracy fit?

XX. EXAMPLE 20: ACTION TO DELAY VIA U.S. BANK.

The taxpayer has an assessed unpaid tax liability. The taxpayer has given the IRS a financial statement identifying his two bank accounts. The taxpayer's accountant has advised that the IRS is likely to levy on those accounts. The taxpayer says that he will receive in a week a $10,000 check from a customer, which he needs for other purposes and does not want it to be seized by IRS levy. The accountant advises that the taxpayer can set up a new account that the IRS will not know about (until it asks) and use it without fear of levy at least for the time being. The taxpayer, with the accountant's assistance, sets up the account at the accountant's bank which is across the street from the accountant's office. The account is set up in the taxpayer's name and with his social security number, but the taxpayer chooses a non-interest bearing account so that, he and the accountant

24. *Klein* catalogs these at p. 915.

believe, 1099s will not be sent to him and the account reported to the IRS with his SSN. Let's assume that the facts are clear that both the taxpayer and the accountant fully intend to identify this account if the IRS ever asks about it; they just don't want to volunteer the information. They thus realize that the account is just an interim measure to avoid a levy until the IRS asks. The court in *United States v. McGill*, 964 F.2d 222 (3d Cir. 1992), cert. denied 500 U.S. 1023 (1992), held that these bare facts would not constitute an affirmative act of evasion of payment to allow prosecution under § 7201. Under *Spies*,[25] an act otherwise legal can constitute the required affirmative act for tax evasion if it is deceptive. But, *McGill* held that setting up an account in the taxpayer's own name with no deception is not the required *Spies* affirmative act of evasion.[26] Can the Government do through the *Klein* conspiracy (or § 7212) that which the *McGill* court denied under § 7201?

XXI. EXAMPLE 21: ACTION TO DELAY VIA FOREIGN BANK.

Take the same facts as Example 20 except that the bank rather than being in the U.S. is in a foreign, tax haven jurisdiction. At the time the account is established, the facts are clear that the taxpayer intends to put the account beyond the IRS's ability to levy. Assume that the taxpayer intends to identify and properly report the account for all purposes, including the foreign bank account question on Schedule B of his 1040, the FBAR report, and any question or financial statement with the IRS. He is not hiding the account; he just imagines it is beyond the IRS's ability to levy. He has thus no reason to disguise the ownership of the bank account, so he puts in his own name and provides the foreign bank for its associated records his U.S. TIN (SSN) and passport number. Nothing about the titling or existence of the bank account is deceptive. It is, however, outside the U.S. jurisdiction so that the IRS is impaired in its ability to identify easily (short of asking the taxpayer) and levying the account. Would that be sufficient to support a *Klein* conspiracy? I think it would, both as to evasion and conspiracy. Keep in mind that, unlike *McGill*, the taxpayer has not put the asset beyond the IRS's ability to levy and thus enforce collection. Even without deception, an offshore deposit would still be evasion of payment and conspiracy to defeat the lawful functioning if done with the purpose of preventing the IRS practical ability to collect the tax

25. *Spies v. United States*, 317 U.S. 492 (1943).

26. Despite the thrust of the holding in *McGill,* a recent indictment in the Northern District of Texas charges tax evasion with one of the *Spies* required affirmative acts of evasion as "directing a person known to the Grand Jury not to deposit money into one of Hill's bank accounts because the deposited monies would be seized by the IRS." Indictment in *United States v. Hill, et al.* (N.D. TX - No. 3:07CR289-R (filed Sept. 27, 2007), at Count 26, subparagraph d. It is not clear from the allegation quoted whether the deposit was directed away from one account into another, so it is not clear that this indictment deals with the *McGill* situation. However, just reading the bare fact alleged, there is nothing to distinguish it from *McGill*.

due. The key difference is, of course, that it has been put beyond the power of the IRS. Perhaps this analysis would explain the bond iteration in the *Klein* litany discussed above (so that, if, in *Klein*, the conspirators had just moved the bonds from New York to Cleveland rather than to Canada, it would not be considered conspiracy).

XXII. EXAMPLE 22: TAKING A DEDUCTION AS SCHEDULE C RATHER THAN SCHEDULE A.

The taxpayer, a criminal defense lawyer, is a generous person. He regularly makes contributions to public charities equaling 10% of his substantial income. In year 5, however, he made public charity contributions equaling 40% of his income, 25% of which was a special contribution to his law school to help fund a criminal defense institute that will be named after the lawyer. In making the decision to contribute, the taxpayer was motivated both by his charitable instincts and by the public recognition that will permit his practice to grow and his hourly rate and nonrefundable retainer rate to grow. His accountant, who prepares his return, advises him that claiming a charitable deduction of 40% of his income will likely result in an audit, because as he understands the IRS computer based review, it will kick out such a large and statistically aberrational charitable contribution. The accountant advises that they can put a special disclosure on the return and the disclosure may give the IRS enough information to forego a full audit. But, he is not sure that will work. The accountant then advises that, given the relationship of that contribution to the taxpayer's business, the taxpayer can claim the deduction as a business expense, thus, while not exactly burying it among other large expenses on his Schedule C, still giving it less surface visibility in the IRS scoring models. In short, the accountant says that that return position, totally legal, will result in a lower audit profile. The taxpayer agrees, the accountant prepares the return accordingly, and the taxpayer signs and mails it in. Are they guilty of a *Klein* conspiracy?

XXIII. EXAMPLE 23: TAKING AN NOL CARRYOVER TO A LATER YEAR.

With his lawyer's and his CPA practitioner's advice, the taxpayer takes an aggressive position on the return. The position results in a net operating loss ("NOL") from the taxpayer's Schedule C activity. The taxpayer is a sophisticated businessman and has learned from his regular reading of the Wall Street Journal tax column that IRS audit rates are low. The taxpayer thus believes that the odds of an audit are low and confirms that with his lawyer and CPA, both of whom cautioned him that he should not consider the audit odds in taking the position and specifically advise him that the audit odds had not entered into their advice to take the position resulting in a net operating loss. The lawyer and the CPA do, however, then proceed to advise the taxpayer that he can take the NOL to an earlier year, which would require a refund claim for the earlier year or carry it forward to a later year. Upon the taxpayer's request to be advised as to the risks of audit in each alternative, the lawyer and CPA advise that, although they do not know for sure, they believe that carrying the NOL back and the filing of a claim for refund is substantially more likely to generate an audit than carrying it forward and claiming a deduction on future original returns. They therefore recommend that the NOL be carried forward. Based on this advice, the taxpayer decides to carry the NOL forward and, pursuant to that decision, the lawyer directs the CPA to elect to carry the NOL forward.

XXIV. EXAMPLE 24: DECLINING TO AMEND A TAX RETURN.

The taxpayer has filed a nonfraudulent original year 1 return on April 15 of year 2 reporting $500,000 gross income and tax of $100,000. Among the gross income reported was $9,500 of rental income. On February 1 of year 3, the taxpayer advises his return preparer that he omitted rental income of $500 from the return, explaining that he recently discovered that this rental income has been improperly totaled because he had failed to cash one of the rent checks and was $10,000 rather than $9,500. The tax preparer dutifully prepares an amended return which reports that additional tax due with respect to the omitted income is about $190. From an abundance of caution, the tax preparer advises the taxpayer that, although he is only generally aware of practitioner shop talk as to the IRS's scoring techniques for deciding whether to audit, he does believe that the IRS generally is more likely to audit amended returns than original returns. The taxpayer has not taken positions on the return other than this $500 rental item that are, in the final analysis, subject to any adjustment, but the taxpayer does have audit phobia. The taxpayer therefore asks whether he is required to file the amended return. The tax preparer advises correctly that the Code and interpretations of the Code, including the Regulations, do not require an amended return. Often an amended return might be advisable to invoke the voluntary disclosure policy, but under the facts indicated the policy is irrelevant because there is no fraud and no likelihood that the IRS would even consider conducting a fraud investigation. The tax preparer therefore suggests the taxpayer not file an amended return since (1) he is not required to and (2) the audit exposure is increased if he does. The taxpayer then decides that he will not file an amended return and instructs his preparer to destroy the draft amended return. Are the taxpayer and the preparer guilty of the *Klein* conspiracy? (Set aside in answering the question whether there is an overt act of the conspiracy; focus just on whether they have the prohibited agreement.)

XXV. EXAMPLE 25: MANIPULATING THE SYSTEM.

This example is a variation of this theme of manipulating the system to impair the IRS's ability to deal effectively with aggressive tax positions. The facts are taken from a recent case.[27] A decedent's estate had taken an extremely aggressive valuation position for a minority interest in a closely held corporation on an estate tax return. The estate's return position was that the value was $1.75 million; the Tax Court ultimately found a value of $13.5 million and the finding was sustained on appeal. The true valuation, thus determined, was almost 8 times what the estate reported on the return; stated another way, the estate reported a value of around 13% of the correct value as determined by the Tax Court. In originally filing the return, the estate clearly knew that the valuation position was aggressive, and took steps that it believed would make the position less visible to the IRS upon audit. The center of gravity for the estate and the corporation were in the New York City metropolitan area – the corporation was headquartered there, the estate was probated there, the executors lived there. Notwithstanding that center of gravity, the estate engaged a lawyer and an accountant, both living and practicing in Alaska, to value the company and to represent the estate for filing and for audit. The lawyer and accountant were marginally qualified, if qualified at all, to render a valuation on the corporation. The sole purpose of the estate's engagement of the Alaska lawyer and accountant was to try to smoke the marginal valuation past the IRS by moving the audit to the IRS Alaska office, having far less experience in such valuations than the IRS New York office. Although, as noted, the estate reported a value of about 13% of the correct value as determined by the Tax Court, the Tax Court nevertheless rejected the IRS attempt to apply the valuation misstatement penalty,[28] which imposes a penalty if the reported value is 25% or less of the correct value unless due to reasonable cause and good faith. The Second Circuit reversed the Tax Court on both aspects. First, the Court of Appeals remanded for a correction of a double counting issue in reaching the valuation. The IRS estimated that correcting the valuation calculation for the double counting would require a downward adjustment to value of $1.2 million, so that the correct value after recalculation would be $12.3 million. On that basis, the estate's initial reporting was about 14% of the corrected value. Second, since, even with a revaluation on remand, the value reported would still be less than 25% of the correct value, the Court of Appeals remanded for the Tax Court to determine specifically whether the estate reasonably and in good faith relied upon the Alaska lawyer and accountant for the valuation. Technically, although the manipulation of the audit process does not relate to the valuation itself, the Court of Appeals recited it prominently in

27. *Estate of Thompson v. Commissioner*, 499 F.3d 129 (2d Cir. 2007).

28. § 6662(a), g(1), (h)(1), (h)(2)(C) (2006).

determining to remand for reconsideration of the reasonableness and good faith issue. What is clear from this recitation of the facts is that the estate's executors and the lawyer attempted to manipulate the processing of the audit to achieve a result for an aggressive position that they might not otherwise have been able to obtain. They never stated a false fact (except as one might infer that such an aggressive valuation position is false, a step that neither court was asked to take); all they did was attempt to manipulate the system through a type of administrative arbitrage to move the audit to a more favorable forum within the IRS.[29] It is relevant that neither the Tax Court nor the Court of Appeals indicated any perception of illegality in the conduct, however much both of them disliked it. Nevertheless, was this a *Klein* conspiracy simply because, through the commonly agreed gambit, they attempted to impede or impair the normal functioning of the IRS?

XXVI. EXAMPLE 26: STAGING A VOLUNTARY DISCLOSURE.

The taxpayer filed fraudulent original returns for years 1, 2, 3 and 4 understating gross receipts and overstating deductions for his schedule C business. The IRS has not begun any audit or investigation of the returns. Unprompted by any external influence, he develops pangs of conscience and comes to you on January 15 of year 6 to help him clean up the mess. His principal concern is that he could go to jail. You confirm that, indeed, he could go to jail and advise that the criminal statute of limitations is 6 years, so that each of the years is still in play for criminal purposes.[30] You reach into your bag of tricks and come up with the venerable voluntary disclosure policy. The voluntary disclosure policy, generally, says that, if the taxpayer makes a voluntary disclosure the taxpayer will not be prosecuted.[31] Voluntary disclosure is usually made by filing nonfraudulent amended returns.[32] You advise him to file nonfraudulent amended returns

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29. Practitioners use variations of this theme of forum shopping within the IRS and then in resulting litigation as routine components of the bag of tricks used to produce value for clients and thus fees for themselves.

30. Whether the Government could, in fact, charge 6 years is a different issue. The normal lead time it needs for the investigation of a tax crime might cause one or more of the early years to be barred by the statute of limitations.

31. The IRS policy is set forth in IRM 9.5.3.3.1.2.1 which has been recently revised and will be discussed later in this section. A good recent discussion of the policy may be found in Allen D. Madison, *An Analysis of the IRS's Voluntary Disclosure Policy*, 54 TAX LAW. 729 (2001). DOJ Tax has a parallel voluntary disclosure policy at CTM 2.00 (2001 ed.), quoting memorandum titled "Tax Division Voluntary Disclosure Policy," dated Feb. 17, 1993.

32. In the case of returns that have not been timely filed, the voluntary disclosure is often made by filing nonfraudulent delinquent returns.

Voluntary disclosure is sometimes pursued by first having a discussion with IRS's Criminal Investigation ("CI") to determine whether, if the facts presented (with taxpayer identity anonymous) are as disclosed, the IRS will treat the disclosure under the voluntary disclosure policy. There might be circumstances where this avenue is pursued but, in most cases that I have observed, voluntary disclosure is pursued by filing nonfraudulent amended or delinquent returns.

for the years 1, 2, 3 and 4.[33] You advise that this policy solves only the criminal issue; the taxpayer could still be subject to a civil penalty. The two relevant civil penalties are the 75% civil fraud penalty and the 20% accuracy related penalty. The additional principal tax dollars and any penalty applied will bear interest from the date of the return. So, the "cost" of coming clean is going to be significant. However, you advise that a civil penalty parallel to the voluntary disclosure policy might avoid the civil tax penalties. That civil penalty parallel is the qualified amended return.[34] That concept, you advise, is not applicable with respect to fraudulent original returns.[35] Of course, the qualified amended return relief would not technically apply here because the original returns were in fact fraudulent.[36] However, you know that the Code is clear that the taxpayer does not self-assess any of the civil penalties; further, your experience is that, in qualifying for the voluntary disclosure policy, the taxpayer need do no more than file a true, correct and complete amended return without red-flagging to the IRS that it should assert the civil fraud penalty with respect to the return and be prepared to cooperate fully by opening the kimono in any resulting IRS audit or investigation. Your experience tells you, however, that the IRS is unlikely to follow through with any audit or investigation. The taxpayer decides to pursue voluntary disclosure by filing amended returns for these years. You then advise the taxpayer that some practitioners believe that, if the amended returns are not filed at one time, but the filings are spread out over some period (such as, say, one

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33. Some practitioners might advise filing less than 4 years amended returns. The advice is related to the normal lead time required for criminal tax investigations. I won't get into the factors that enter such advice here, but just note it in case the reader wants to follow through on that thread outside this article. I will say, however, that the Government lawyer who claims that, while a ranking official with the IRS, he authorized the *Stein* indictments also stated earlier while he was in private practice that he rarely recommended going beyond three past years, because the IRS will not be inclined to go back further either for civil or criminal purposes. That lawyer is a friend – at least I count him as a friend. Let me see how I can state this delicately – could an attorney making that type of advice and participating in its implementation be guilty of a *Klein* conspiracy or § 7212 and perhaps even an offense conspiracy? I see no principled basis for saying that this conduct is noncriminal but the other conduct discussed in the outline is. The conclusion I draw obviously is that none of this conduct is criminal, simply because it is not false or deceptive, although clearly the goal is to influence in the taxpayer's favor how the IRS goes about its business.

34. This concept is a creature of the Regulations. Treas. Reg. § 1.6664-2(c)(2) & (3). The taxpayer-friendly concept although not in the Code is likely the law under *Chevron* concepts (*Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984)) or, as a fallback, estoppel. The IRS is unlikely to disavow its own regulations. And, as with the voluntary disclosure policy, is unlikely to apply it too strictly because the qualified amended return is an overall net winner, so applying it too strictly would be self-defeating.

35. Treas. Reg. § 1.6664-2(c)(2).

36. For this reason, it would be inadvisable to do anything that would affirmatively claim that the taxpayer is entitled to qualified amended return treatment. The Regulations do not appear to require anything other than an amended return. So, on the return, the taxpayer does not have to waive the fraud red-flag and, in any ensuing investigation, the taxpayer and the practitioner have to be careful that any claims of the absence of fraud are consistent within tolerable ranges as to the truth, as permitted to be claimed in an adversarial context.

every week), the amended returns are less likely to draw service center attention and thus less likely (1) to generate an audit or investigation and (2) to generate assessment of a penalty (the thinking is that, since the return appears on its face to be a qualified amended return, the IRS will not assert a fraud penalty or an accuracy related penalty because it will be unlikely to expend resources auditing a return of that nature.[37] Obviously, the second leg (number (2) is dependent upon there not being an audit. So the planning to send in the amended returns is designed to affect the audit profile – at least in the imagination of the tax community – and lower the risk of the IRS asserting the civil fraud penalty that is otherwise due. You advise the taxpayer that this last gambit of stretching out the filing of returns is a bit troubling to you, but that it seems so prevalent in the tax community that you feel you must offer it as an option. He decides to do that. You therefore direct the accountant engaged to prepare the amended returns to complete the returns one year at a time one week apart and deliver each year's returns immediately upon completion so that it can be executed and filed.

XXVII. CONCLUSION.

These examples illustrate the dangers of the Government's expansive imagination of the tax obstruction crimes in § 7212 and the *Klein* conspiracy. Most practitioners have engaged in some patterns of conduct that would be deemed not dissimilar to many of the examples. While as among the examples, there are differences in nuance, there is no principled difference between or among them that would provide guidance as to which of the transactions should be subject to a Government *Klein* conspiracy or tax obstruction charge and which ones would not. I hope that those of you who are in the trenches in the real world of tax practice will instinctively recoil at the notion that the legal conduct of the type described, even where the tax rules are clearly manipulated without falsity or misrepresentation, could be criminalized. But, more importantly for all of us, I hope also that the courts will recoil when the prosecutors exercise indiscretion in this area.

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37. One practitioner advises that he advises clients to send in the amended returns in separate envelopes, even if filed the same day, because of experiences he has had where multiple returns sent in a single envelope got stapled together or even the bottom returns got thrown out by service center personnel not handling the enclosures properly. His concern is that, because of sloppy service center processing, the voluntary disclosure policy might not apply or, at a minimum a criminal investigation might kick in that gets diverted after the error is established. So, he thinks he assures better processing by separate envelopes for the returns. And, he did add that, oh, by the way, he imagines it is less likely that the IRS will put together the returns filed in separate envelopes than if they were in a single envelope, so there might be some favorable by-product of separate filing in that respect.