

# New York Law Journal



Web address: <http://www.law.com/ny>

VOLUME 230—NO. 100

THURSDAY, NOVEMBER 20, 2003

## TAX LITIGATION ISSUES

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### *Federal-State Cooperation in Tax Investigations*

**A**LTHOUGH FEDERAL, state and local law enforcement agencies do not always operate in perfect harmony, they have, over the years, formed a number of highly effective alliances. Joint task forces have long operated to combat street crime and narcotics trafficking and, more recently, the federal and state governments have stressed the importance of increased cooperation within and between the federal and local law enforcement agencies in the fight against terrorism.

Garnering far less publicity is the increasing frequency with which the Internal Revenue Service is joining forces with state and local governments in pursuit of tax evaders and purveyors of fraudulent tax schemes. These efforts, extolled by the IRS as good for the taxpayers as well as the investigators, raise difficult issues regarding the confidentiality of returns and further blur the already fuzzy lines between state and federal tax enforcement.

#### **Overlap Between State, Federal Conduct**

There is a wide, and growing, range of conduct that can be prosecuted at either a federal or state level. Not only has federal law encroached upon a number of crimes traditionally thought of as local, but local law enforcement officials have recently become actively involved in white-collar law enforcement. In many cases, such as narcotics, domestic violence or securities fraud, the same, exact conduct constitutes a violation of both federal and state law. Ostensibly federal



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and state tax fraud are distinct crimes, involving separate acts of criminal conduct (i.e., the filing of separate fraudulent returns). But this distinction is often illusory, because a misstatement or omission on a federal return is almost always reflected on the state return, and vice versa.

The Double Jeopardy Clause offers no protection to taxpayers facing state and federal tax evasion charges based on a single misstatement repeated on two different sets of returns. The unitary nature of tax filing is also reflected in the federal sentencing guidelines, which permit inclusion of state and local tax loss in calculating the sentence for federal tax crimes.<sup>1</sup> Although the U.S. Sentencing Commission (for the guidelines) briefly considered an amendment to the guidelines that would have excluded state and local taxes from the definition of tax loss under the guidelines, that amendment has not been adopted, leaving defendants vulnerable to harsher sentences based on inclusion of those amounts.

#### **Joint Enforcement Initiatives**

This overlap between federal and state tax crimes provides fertile ground for joint enforcement initiatives, and the enthusiastic cooperation between federal and local tax investigators stands in stark contrast to the often-competitive relationship between federal, state and local law enforcement agencies investigating securities violations. In some instances, the federal prosecutors join forces

with their local counterparts on a case-by-case basis, as with the high-profile prosecution of Leona Helmsley.<sup>2</sup> But often, agencies charged with enforcing local and state tax laws partner with the IRS on a broader initiative, pooling their investigative resources without ceding enforcement authority. This spirit of cooperation in tax cases may be attributable to the fact that state and local tax authorities have limited resources and can each derive concrete benefits from pooling their energies. Such collaborative efforts are quite common between federal, state and local tax agencies in New York.

In the past year alone, the IRS has commenced three different joint initiatives with New York City or New York State or both. Last fall, it began a program with both the state and the city to conduct joint audits of foreign banks doing business in New York City. This endeavor apparently marks the first time that the three agencies have worked together on examinations.<sup>3</sup> Describing this three-way partnership as a “less-intrusive and more-effective audit process,” the tax officials claimed that “[e]veryone wins when the federal, state and city governments work together” because the agencies benefit from each others’ expertise and the taxpayers are subject to a single audit.

The New York district of the IRS announced two more joint projects this past January. In one, the IRS criminal investigation entered into a memorandum of understanding with the New York State Department of Finance designed to facilitate information sharing to promote identification of taxpayers filing false refund claims. Describing their agreement as the “first formal agreement of its kind” between the two agencies, they explained that it would permit them to conduct cooperative investigations and pursue both civil and criminal remedies where appropriate. Some of the schemes specifically targeted by this joint effort are identity theft, filing false Schedule C forms and purchasing dependents for purposes of filing false

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claims for earned income credits.

This cooperation extends beyond the enforcement realm and into collection matters. Thus, in January, the IRS also partnered with the city and the state in a public information campaign warning taxpayers to avoid unscrupulous tax preparers. In a joint press release, the three agencies counseled taxpayers to review their tax returns carefully, paying particular attention to earned income and child and dependent care tax credits. The agencies also provided advice on how to select a tax preparer and how to avoid problems with inaccurately prepared returns. Finally, the press release contained the details of several recent prosecutions of dishonest tax preparers.

While many initiatives depend on cooperation at the local level, some are directed more centrally at a national level between the IRS and the states. The most recent such joint enforcement venture was launched in September, when the IRS and tax enforcement officials from 40 states (including New York, New Jersey and Connecticut) formed a partnership aimed at combating abusive tax avoidance schemes. Such schemes have been the focus of recent federal tax enforcement initiatives, and, in remarks issued at the announcement of this partnership, IRS Commissioner Mark W. Everson referred to abusive tax avoidance transactions as a "cancer" that "mock[s] honest taxpayers" and erodes confidence in the fairness of our tax system. He noted that abusive schemes "are not just the IRS's problem," but also plague the states. Touting the initiative as a "milestone in state and federal cooperation," Mr. Everson declared that the states and the federal government were "fighting as allies" and "closing in ... from all sides."<sup>4</sup> Arthur J. Roth, the New York State Commissioner of Taxation and Finance, issued a statement expressing pleasure at the fact that "New York was the first state to sign the [memorandum of understanding]." Mr. Roth noted that, under the agreement, "we will no longer have to discuss the 'growing' area of tax schemes and scams," and that he was "look[ing] forward to referring to the 'shrinking' or 'once thriving, but now dying' area of tax schemes and scams."<sup>5</sup>

Participating states will each execute a memorandum of understanding with the IRS under which both sides will share information and coordinate case management. The Abusive Tax Avoidance Transactions (ATAT) Memorandum of Understanding<sup>6</sup> has as its stated purpose the presentation of "a united compliance front to taxpayers and their representatives, increas[ing] audit coverage, and leverag[ing] federal and state resources in the ATAT area." To that end, the agreement states that the ATAT program office

will provide each signatory state with a list of participants in a particular scheme who the state may investigate. Under the agreement, these lists will be provided after the IRS identifies the participants in a given scheme and "determines a compliance strategy for the promotion." In addition, the IRS will share with state agencies audit results from ATAT cases as well as audit technique guides and information on the types of schemes identified at the federal level. For their part, the states will inform the IRS as to which scheme participants on the lists provided by the IRS they intend to examine and will work with the IRS to use their databases to further refine participant lists. Under the agreement, the states will forward audit results to the IRS, exchange audit strategies and procedures with the IRS and provide it with information about the types of ATAT schemes discovered at the state level.

According to the IRS, the cooperation envisioned by this federal-state partnership differs from other joint enforcement efforts in that it provides for the up-front exchange of information and the sharing of leads, permitting both the state and federal agencies to leverage and focus their limited resources and avoid duplication of each others' efforts.

### Taxpayer Privacy

One issue restricting federal-state cooperation is the IRS's need to strike a balance between enhancing effective law enforcement through cooperation with the states and protecting taxpayer privacy, as mandated by IRC §6103. Section 6103 authorizes the IRS to share federal taxpayer information with local authorities for the purposes of tax administration, but imposes on receiving agencies the obligation to maintain the confidentiality of that information. In its press release announcing the ATAT partnership, the IRS explained that its agreement with the states "focuses solely on abusive avoidance transactions," leaving unchanged communication relating to "more routine taxpayer compliance efforts" in deference to the "important separation of federal and state tax authority and protection of taxpayer privacy." Commissioner Everson stressed that the IRS "treat[s] taxpayer privacy as a top priority."<sup>7</sup>

### Problems Identified

The IRS appears to have ample cause for concern with confidentiality. Earlier this year, the Treasury Inspector General for Tax Administration issued a report identifying security weaknesses affecting sensitive, computerized

federal tax information maintained by state governments.<sup>8</sup> The report noted that consistent with its obligations under IRC §6103, the IRS provides tax information to more than 250 state and federal agencies, which are required to protect the security and confidentiality of that data. The inspector general further noted that weaknesses at the states' Internet gateways are subject to exploitation by hackers and disgruntled employees and found that the states did not consistently employ controls adequate to authenticate users, track activity or proactively monitor their systems to identify inappropriate browsing of taxpayer accounts. The report concluded that computerized federal tax information "is at risk while in the possession of state agencies."

In its response to these findings, the IRS pointed to the considerable resources it had devoted to improving the protection of federal taxpayer information at the state level, but acknowledged that it was nevertheless "struggling with the proliferation of increasingly sophisticated computer systems coupled with the lack of adequate staff expertise." It noted in particular, that its ability to review the safeguards put in place by the states was impaired by the proliferation of varying computer systems among the states.

Undoubtedly, partnerships between the IRS and state and local tax agencies offer valuable efficiencies to the government. However, despite claims that taxpayers also benefit from such collaboration, it is difficult to imagine individuals caught up in a joint investigation will consider themselves fortunate. Not only will these taxpayers have to defend against enforcers who have combined their investigative powers, but their privacy may also be put at risk by the increased exchange of information.

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(1) See *United States v. Fitzgerald*, 232 F3d 315 (2d Cir 2000).  
 (2) See *United States v. Helmsley*, 941 F2d 71 (2d Cir. 1991); see also *United States v. Guerrero*, 670 FSupp 1215 (SDNY 1987).  
 (3) New York City Department of Finance News Release, Oct. 22, 2002.  
 (4) Remarks of Commissioner of Internal Revenue Mark W. Everson, Sept. 16, 2003, available at [www.irs.gov/newsroom/article/0,,id=112875,00.html](http://www.irs.gov/newsroom/article/0,,id=112875,00.html).  
 (5) [www.irs.gov/newsroom/article/0,,id=112864,00.html](http://www.irs.gov/newsroom/article/0,,id=112864,00.html).  
 (6) [www.irs.gov/newsroom/article/0,,id=112870,00.html](http://www.irs.gov/newsroom/article/0,,id=112870,00.html).  
 (7) [www.irs.gov/newsroom/article/0,,id=112866,00.html](http://www.irs.gov/newsroom/article/0,,id=112866,00.html).  
 (8) Department of Treasury, Audit Report, Feb. 21, 2003 "Computer Security Weaknesses at State Agencies Put Federal Tax Information at Risk," available at [www.treas.gov/tigta/2003reports/200320064fr.pdf](http://www.treas.gov/tigta/2003reports/200320064fr.pdf).