



## TAX LITIGATION ISSUES

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### *When the IRS Violates Its Own Rules on Criminal Probes*

**T**he Internal Revenue Service (IRS) enforces the federal tax laws both civilly and criminally. Enforcement responsibility is divided between two IRS divisions, the examination or audit division and the criminal investigation division (CID).

It is inevitable, however, that certain civil audits grow into criminal investigations. Internal policies instruct revenue agents (civil auditors) to cease a civil audit when they become aware of criminal wrongdoing, and file a report with the CID.

Although the issue of what happens when the revenue agent fails to abide by these policies has been litigated numerous times, two recent cases demonstrate that the law is far from clear.

#### **The Internal Revenue Manual**

The IRS Internal Revenue Manual (IRM) “is the single official source for IRS policies, directives, guidelines, procedures and delegations of authority in the IRS” and serves IRS employees in the daily administration of their job.<sup>1</sup> In relevant part, §4565.21 of the IRM states that: “[i]f, during [a civil audit] examination, an examiner uncovers a potentially fraudulent situation caused by the taxpayer and or the preparer, the examiner shall discuss the case at the



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earliest possible convenience with his/her group manager.... Once there is a firm indication of criminal fraud all examination activity shall be suspended.”<sup>2</sup>

The Fraud Handbook of the IRM provides an exhaustive list of “badges of fraud” an auditor is to look for in determining whether there are firm indicators of fraud, including: i) the omission of income; ii) sudden substantial increases in net worth; iii) keeping two sets of books or no books; iv) claiming fictitious deductions; and v) false statements of material facts during the examination.<sup>3</sup>

#### **Significance of Internal Revenue Manual**

In 1979, the U.S. Supreme Court considered whether evidence obtained in violation of IRS regulations could be admitted at a taxpayer’s criminal trial. In *United States v. Caceres*,<sup>4</sup> the defendant was charged with bribing an IRS agent. In support of its case, the government sought the admission of tape-recorded conversations between the defendant and the agent obtained when the agent wore a concealed radio transmitter while meeting with the defendant. The defendant sought the suppression of the tapes on

the grounds that the agent had failed to obtain the authorizations required by IRS regulations.

Specifically, the defendant argued that the IRS incorrectly obtained “emergency approval” for the recorded conversations, thereby bypassing the need for additional approvals from the Justice Department, when the exigencies supporting the application were the result of “government-created scheduling conflicts.” The district court granted the defendant’s motion and the U.S. Court of Appeals for the Ninth Circuit affirmed the district court’s decision.<sup>5</sup>

The Supreme Court reversed, finding that the IRS was not required by the Constitution or by statute to adopt the regulations in question. Accordingly, the agent’s failure to abide by the more onerous regulations did not constitute a violation of the defendant’s constitutional rights. Rather, the majority said that the Fourth Amendment did not protect the privacy rights of individuals in the defendant’s position.<sup>6</sup>

The Court also rejected defendant’s argument that the exclusionary rule should apply when electronic eavesdropping regulations are violated, even if they are not required by the Constitution or statute, because of the importance of these regulations in “safeguarding the privacy of the citizenry.” Rather, taking a case-by-case approach, the Court noted that the defendant’s case exemplified those in which the exclusionary rule should not be applied.<sup>7</sup>

The dissent, authored by Justice Thurgood Marshall and joined by Justice William Brennan, noted that the Court “has consistently demanded governmental compliance with regulations designed

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to safeguard individual interests even when the rules were not mandated by the Constitution or federal statute" where the procedure afforded "significant procedural protections."<sup>8</sup> According to the dissent, the IRS regulations at issue in *Caceres* clearly were created to afford such protections.

Furthermore, the dissent said that the regulation at issue invoked the Due Process Clause of the Constitution and that the IRS's failure to abide by its procedures therefore constituted a constitutional violation, the fruits of which should have been suppressed.<sup>9</sup> The dissent concluded by observing that, under the majority's decision, "regulations largely unenforced by the IRS will be unenforceable by the courts."<sup>10</sup>

### Cases Involving IRS Violation of Its Rules

In applying *Caceres*, circuit courts of appeals have disagreed about a taxpayer's ability to challenge the IRS's violation of its own rules and procedures. Some courts have read the Supreme Court's opinion strictly, finding that all IRM provisions are merely internal guidelines and do not have the effect of law.<sup>11</sup> Other courts have read *Caceres* to allow taxpayers to challenge violations of IRM provisions that involve Constitutional safeguards.<sup>12</sup>

Disagreement over this issue applies to cases involving violations of §4565.21 of the IRM as well. Some courts have found that the provision does not confer any substantive rights, while others assert that it safeguards a taxpayer's Fourth Amendment right against unreasonable searches and seizures and Fifth Amendment right to Due Process. Two cases decided this year further the discussion.

### 'United States v. Greve'

In *United States v. Greve*,<sup>13</sup> the IRS began a civil audit of Mr. Greve's 1997 tax return in June 1999. In September, Mr. Greve met with the revenue agent, Ms. Luke, and admitted the omission of certain income in 1997. For the next 18 months, Mr. Greve continued to meet with Ms. Luke to discuss his case, documents to be produced, and how they should be organized.

Beginning in March 2000, Ms. Luke had informed her supervisor that Mr. Greve's case might involve fraud. While she was seeking and obtaining Mr. Greve's cooperation, Ms. Luke met frequently with a district fraud coordinator to discuss the case and obtain guidance on how to investigate the case for fraud. At one point, on July 20, 2000, Ms. Luke met with Mr. Greve and his attorney. During that meeting, the attorney asked Ms. Luke whether she would be able to "wrap up" the audit for the years in question after receiving the requested documents. Ms. Luke responded that the audit would be "wrapped up pretty quickly." Mr. Greve continued to cooperate with the audit investigation.

Ultimately, however, in March 2001, Ms. Luke referred the case to the CID and Mr. Greve subsequently was indicted on four counts of tax fraud.<sup>14</sup> Mr. Greve moved to dismiss the indictment and/or suppress evidence obtained during the civil audit, alleging that the IRS violated his Fourth and Fifth Amendment rights by conducting a criminal investigation under the guise of a civil audit. Thus, Mr. Greve argued that the evidence obtained by Ms. Luke should be suppressed because she improperly continued to conduct a civil audit after she had firm indications of fraud in violation of §4565.21.

The district court denied Mr. Greve's motion to dismiss, he appealed. On appeal, the U.S. Court of Appeals for the Seventh Circuit noted that although the IRM required civil investigators to cease investigation when firm indications of fraud were developed, "[a] failure to terminate a civil investigation when the revenue agent has obtained firm indications of fraud does not, without more, establish the inadmissibility of evidence obtained by [the agent] in continuing to pursue the investigation." Rather, the courts observed that precedent requires "[p]roof of deceit be linked up to the constitutional standard of threat or promise."<sup>15</sup> The court explained that such proof would exist if Mr. Greve could show that Ms. Luke induced his compliance through false promises.

Mr. Greve contended that Ms. Luke continually reassured him, leading him to believe that his case would be concluded with the civil audit. Furthermore, Mr.

Greve pointed to Ms. Luke's statement to his lawyer that the audit would be "wrapped up" after the production of the requested documents as a representation that his cooperation would result only in a civil tax assessment. The Seventh Circuit rejected both arguments, finding that Ms. Luke had made no affirmative promise to Mr. Greve. The court observed that an inappropriate promise is made where an agent pretends to be a prosecutor and assures the taxpayer that he will not be prosecuted if he cooperated. Finding that no such deceit occurred in this case, the court affirmed the district court's decision.<sup>16</sup>

### 'United States v. Rutherford'

In *United States v. Rutherford*,<sup>17</sup> the federal district court considered motions to suppress evidence and dismiss the indictment made by defendants charged with multiple counts of tax evasion, failure to pay and tax fraud. After reviewing the facts, the district court found that firm indicators of fraud existed and that the civil audit was improperly continued in violation of IRM §4565.21.

In May 2003, a revenue agent, Tagami, was assigned to conduct an audit of a company owned by the defendants after a news article suggested financial improprieties by the company. Tagami reviewed the company's documents and discovered that several required forms had not been filed. In a memo dated July 2003, it was noted that the case was "filled with very large and significant indicators of fraud."

The same month, a fraud referral specialist was called in to consult on the case to determine whether there were "first indicators of fraud." After reviewing the records and consulting with other agents, it was concluded that such indicators existed. Although the defendants expressed reluctance to meet with the IRS auditors individually, a meeting was held on Dec. 16, 2003. The defendants left before the interview was completed and refused to answer additional questions. Although further interview requests were rejected, the civil audit continued until a criminal referral was made in July 2004.

Following their indictment, the defendants moved to suppress evidence

obtained during the civil audit and dismiss the indictment. Noting its obligation to accord a great deal of deference to the revenue agent's decision, Judge Marianne Battani of the U.S. District Court for the Eastern District of Michigan nevertheless found that firm indications of fraud existed when the taxpayers refused to come in for a second interview. The court observed that "[w]ithout an alternative explanation for defendants' actions, the 'first' indicators of fraud morphed into 'firm' indicators" at that time.<sup>18</sup>

In making its finding, the court cited the U.S. Court of Appeals for the Sixth Circuit's opinion in *United States v. McKee*. In *McKee*, the court held that "[i]f the revenue agent continues [a] civil audit even after she has developed 'firm indicators of fraud,' then she is, in fact, making affirmative misrepresentations to the constitutional detriment of the taxpayer because she is gathering criminal evidence against the taxpayer under the guise of a civil proceeding."<sup>19</sup> The district court found that the revenue agent's decision to continue the civil audit against the defendants in *Rutherford* was "constitutionally infirm." The court, however, refrained from dismissing the indictment and instead referred the case to a "case manager" to "discuss the next step in these proceedings."<sup>20</sup>

The decisions in *Greve* and *Rutherford* demonstrate the unsettled nature of the law governing when civil examiners go too far. The Seventh Circuit found that a violation of §4565.21 alone did not implicate the Constitution. Rather, the agent must also have engaged in deceit that can be linked to the deprivation of constitutional guarantees.<sup>21</sup> As articulated by the Eighth Circuit in *United States v. Grunewald*, evidence obtained in violation of §4565.21 may be suppressed only if the defendant establishes that: 1) the IRS had firm indications of fraud by the defendant; 2) there is clear and convincing evidence that the IRS affirmatively and intentionally misled the defendant, something more than the mere failure to inform a defendant that a civil audit may result in a criminal case; and 3) the IRS's conduct resulted in prejudice to the defendant's constitutional rights.<sup>22</sup>

In contrast, the district court in *Rutherford* relied on that line of cases holding that the violation of §4565.21 is itself an affirmative misrepresentation sufficient to implicate the Constitution. In advocating this position in *McKee*, the Sixth Circuit found that §4565.21 is the "type of rule...designed to protect the taxpayer's constitutional rights," specifically, the taxpayer's Fourth and Fifth amendment rights. In these cases, the agent's violation of §4565.21 is sufficient to constitute an affirmative misrepresentation on behalf of the revenue agent. Therefore, incriminating evidence should be suppressed.<sup>23</sup> As written by Justice Marshall in his dissent in *Caceres*, "[r]estricting application of the exclusionary rule to instances of bad faith would invite law enforcement officials to gamble that the courts would grant absolution for all but the most egregious cases."<sup>24</sup>

### Policy Arguments

In cases arising outside of the tax context, the use of trickery, deceit, or impersonation is lawful, and will not result in suppression absent threats or promises by the government agents.<sup>25</sup> This is generally consistent with the position taken by courts requiring taxpayers to show affirmative deceit by the revenue agent in addition to the violation of §4565.21. Those courts argue that requiring proof of affirmative misconduct will protect against the premature termination of civil audits and unwarranted referrals for criminal action. "If IRS agents exercising sound discretion and good judgment fear suppression of evidence where no intentional, prejudicial misrepresentation is afoot, civil audits will prematurely and unnecessarily be referred to CID."<sup>26</sup>

By contrast, unlike other contexts, tax investigators are governed by specific rules set forth in the IRM. Those courts that suppress evidence have noted that any noncompliance with §4565.21 threatens the voluntary tax-reporting system, likely causing taxpayers to be more reluctant in cooperating in civil audit situations for fear they may reveal information that can be used against them in a

criminal proceeding.<sup>27</sup> This is particularly true where, as noted in *McKee*, "the government's evidence...was practically handed to the CID on a silver platter as a result of the civil investigation."<sup>28</sup>



1. Internal Revenue Service, "Information Quality Guidelines—Guidance: Information in the Internal Revenue Manual (IRM)" IRS Web site (available at <http://www.irs.gov/irs/article/0,,id=131183,00.html>).

2. IRM §4565.21 (1999) (emphasis added).

3. IRM §25.1.2.2 (2003).

4. 440 U.S. 741 (1979).

5. The Ninth Circuit reversed with respect to one tape, finding that the necessary authorizations had been obtained. Id. at 743.

6. Id. at 749-50 (citing *Lopez v. United States*, 373 U.S. 427 (1963)).

7. Id. at 756-57.

8. Id. at 759-60.

9. Id. at 765.

10. Id. at 768-69.

11. *United States v. Groder*, 816 F.2d 139 (4th Cir. 1987); *United States v. Mapp*, 561 F.2d 685 (7th Cir. 1977).

12. *United States v. McKee*, 192 F.3d 535 (6th Cir. 1999).

13. 490 F.3d 566 (2007).

14. Id. at 568-70.

15. Id. at 571 (citing *United States v. Kontny*, 238 F.3d 815, 820 (7th Cir. 2001)).

16. Id. 571-72.

17. 2007 WL 1703521 (E.D.Mich. June 12, 2007).

18. Id. at \*14.

19. 192 F.3d 535, 542 (6th Cir. 1999).

20. 2007 WL 1703521 at \*14.

21. See also, *United States v. Kontny*, 238 F.3d 815, 819-20 (7th Cir. 2001) ("failure to terminate a civil investigation when the revenue agent has obtained firm indications of fraud does not without more establish the inadmissibility of evidence obtained by him in continuing to pursue the investigation"); *Groder v. United States*, 816 F.2d 139, 142 (4th Cir. 1987) (the violation of IRM §4565.21 is, by itself, "without legal effect;" taxpayer must also show that the government proceeded against him in bad faith).

22. 987 F.2d 531, 534 (8th Cir. 1993).

23. 192 F.3d at 542.

24. 440 U.S. at 766. Justice Marshall further noted that evidence submitted before a House Subcommittee Hearing revealed that the IRS was less than exemplary in self-policing their agents' compliance with IRS internal regulations. Id. at 767.

25. *Kolney*, 238 F.3d at 817.

26. 987 F.2d at 534; *Groder* 816 F.2d at 144.

27. Amanda A. Cochran, "Evidence Handed to the IRS Criminal Division on a 'Civil' Platter: Constitutional Infringements on Taxpayers," *Journal of Criminal Law and Criminology* (Spring 2001).

28. 192 F.3d at 544.