

Eggshell Audits

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What is an “eggshell” audit?

An eggshell audit is a civil audit in which the return(s) under examination contain a material understatement of income, material overstatement of deductions or credits were claimed that the taxpayer was not entitled to, the result of which was that the taxpayer showed less tax liability than they would have owed had an accurate return had been filed. These errors can be caused by mere negligence or via willful intent which would indicate underlying criminal issues with the tax filing under audit.

What is a reverse “eggshell” Audit?

Reverse eggshell audits are parallel and simultaneous civil and criminal investigations where essentially a criminal tax investigation is disguised as a civil audit.

Because of recent changes in IRS internal policy, parallel investigations are on the rise and are rapidly becoming a favorite tool of the IRS. The advantages to the government in utilizing reverse eggshell audits is that the ample investigatory tools available to the average civil auditor such as third party subpoenas to banks and witnesses can be utilized without the taxpayer having the opportunity to utilize the constitutional protections of the due process clause, the fourth amendment privilege against unreasonable searches and seizures, and the fifth amendment right not to self-incriminate which are the most powerful tools available to criminal defense counsel.

Consequently, reverse eggshell audits present grave danger to taxpayers faced with them where they employ less sophisticated tax representatives that mistakenly operate under the misconception that the taxpayer is merely complying with a standard civil audit and thus unwittingly waive the taxpayer’s constitutional rights that criminal tax defense counsel would have exercised if they knew for certain their client was facing a criminal investigation.

Reverse eggshell audits and parallel investigations often involve cooperating federal agencies (such as the SEC, FBI, DEA, ABC and the DOJ) and the civil and criminal investigation functions of the IRS. This flavor of eggshell audits additionally carries the risk that the examination conducted by the IRS will further the criminal investigation of the cooperating federal agency.

It is often assumed that a taxpayer's IRS master file is flagged if the taxpayer is involved in a criminal investigation, and thus could theoretically respond to an inquiry by a taxpayer’s representative whether there is an open criminal investigation, grand jury investigation, associated technical fraud advisor or associated special agent of the criminal investigation division. While the civil revenue agent will almost certainly be aware of the coding in the file, when queried, they will have to either answer honestly or more likely refuse to respond at all, in either event the criminal tax defense attorney will have learned something. In my opinion a refusal to deny a parallel tax criminal investigation is underway is as good as an admission that one is.

Questioning the auditor regarding whether there is an open criminal investigation, grand jury investigation, associated technical fraud advisor or associated special agent of the criminal investigation division achieves different objectives in an eggshell or reverse eggshell. In an

eggshell audit, this line of questioning may become necessary to protect the taxpayer but must be asked in such a manner as not to raise the auditor's suspicion that tax fraud exists in the client's fact pattern. If a reverse eggshell audit is underway, this line of questioning can help protect the taxpayer, because it will alert counsel to the existence of a clandestine criminal investigation or, if the revenue agent provides more than a tacit denial of the existence of a parallel criminal investigation, subsequent information and statements may be suppressible under *Tweel*.

Ordinarily an IRS civil revenue agent's primary concern is supposed to be determining the correct civil tax liability for the tax years at issue, while an IRS Special Agent from the Criminal Investigation Division is primarily concerned with gathering evidence to prove criminal violations have occurred and to prove it at trial if need be.

Special agents are required to advise taxpayers of their constitutional rights against self-incrimination and of the taxpayer's right to have an attorney present during an interview via a non-custodial reading of their rights which states that anything they say may be used in a subsequent criminal prosecution for tax crimes. Because of this requirement, the initial interview with the special agent will often be delayed while the investigated taxpayer obtains legal counsel. To avoid granting the investigated taxpayer this tactical advantage, initial contact is often made via a civil revenue agent to avoid putting the investigated taxpayer on notice that they are under criminal investigation while the civil examiner continues to collect information and conduct interviews with the taxpayer who is none the wiser.

Exposure to a client facing a parallel investigation can exponentially increase where certain entities owned, or tax years filed, by the taxpayer are under clandestine criminal investigation while related entities or tax years are the subject of an open, obvious and simultaneous civil audit. Information that is collected by the civil examiner in this scenario is fully available to the special agent without the taxpayer or his or her representative's knowledge or consent.

Reverse eggshell audits can follow a referral from a civil examiner (revenue agent) to a Fraud Referral Specialist whose sole job it is to work up the case for a handoff to a special agent in the criminal investigation (CI) division or upon a request by CI that a civil audit be assigned to an ongoing criminal investigation.

A civil audit may be suspended before completion and referred to CI for criminal investigation without the knowledge of the taxpayer.

Ordinarily an examiner operating is not on notice at the outset of an audit about a taxpayer's potentially criminal conduct, in a reverse egg audit it the taxpayer and potentially their representative who is not on notice about the auditor's true intentions.

In the typical eggshell audit, the criminal tax defense attorney seeks to avert the emergence of a criminal investigation, by attempting to prevent a client from making any criminal admissions.

The typical eggshell audit is said to reverse where a temporary suspension of a civil audit occurs which is often indicated where a civil auditor cancels a subsequent appointment and then fails to

contact or return the taxpayer's calls for several weeks while the referral process to CI progresses.

In a reverse eggshell audit, they endeavor to discover any ongoing clandestine criminal tax proceeding and possibly limit the taxpayer's cooperation in order to protect the taxpayer from criminal prosecution by protecting their constitutional rights against self-incrimination and unreasonable search and seizures.

What are the warning signs to look for in determining if there has been a criminal referral and therefor an eggshell audit has reversed into a reverse eggshell audit?

A criminal referral is likely to follow a civil audit if firm indications of fraud exist in the mind of the civil auditor.

Common indications of fraud, often called "badges of fraud" include:

- omissions of income,
- inability to explain large items,
- substantial overstatements,
- two sets of books,
- fictitious items,
- etc.

Note: An omission of income greater than \$10,000 in a single year will result in an automatic referral to a technical fraud advisor for possible development of the case for a hand off to the criminal investigation division.

Commonly recognized warning signs that precede a criminal referral include:

- The Revenue Agent becomes unexplainably unreachable.
- The Revenue Agent focuses heavily on the "intent" of the client in taking positions on a return or worse yet mentions a pattern of noncompliance on several tax returns.
- The Revenue Agent focuses prepares a net worth analysis or subpoena's bank records.
- The Revenue Agent gathers an excessive amount of documentation or makes excessive copy requests.
- The Revenue Agent makes undisclosed contact with third parties.
- You receive a summons for records or for an appearance.
- More than one revenue agent, the agent and their manager or worse yet two revenue agents, an attorney from chief counsel's office and a court reporter attend a client interview.
- An officer of the IRS wearing a gun and a badge approaches you and reads you something similar to a Miranda warning (this is an IRS special agent from the criminal investigation division of the IRS). If you are ever faced with one, demand that counsel be present for your questioning and remain silent.

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