

**Improvements Are Needed to Ensure
Information Developed During Criminal
Investigations Is Referred for Civil Action**

September 2004

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 29, 2004

MEMORANDUM FOR CHIEF, CRIMINAL INVESTIGATION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Improvements Are Needed to Ensure
Information Developed During Criminal Investigations Is
Referred for Civil Action (Audit # 200310041)

This report presents the results of our review to determine whether the Criminal Investigation (CI) function ensured information identified during its investigations was properly referred for civil action.

Upon the closing of a criminal investigation, the CI function makes a determination as to whether the taxpayer's account should be referred to one of the civil functions to ensure any civil tax liabilities are assessed and delinquent taxes collected. During Fiscal Years 2002 and 2003, the CI function made a civil determination on 2,393 tax or tax-related¹ investigations with criminal deficiencies totaling approximately \$5.6 billion.² The pursuit of civil sanctions, in addition to criminal enforcement, contributes to maintaining voluntary compliance and public confidence in the fairness of the tax system.

In summary, the CI function's existing procedures did not ensure the Internal Revenue Service (IRS) civil functions were notified that civil action was required upon completion

¹ The CI function defines tax-related investigations as those investigations citing criminal violations of Title 26 (Internal Revenue Code) or Title 18 code sections 286, 287, 371(b), or 371(k).

² A prior Treasury Inspector General for Tax Administration report, *Courts Are Not Always Notified When Criminals Fail to Comply With Their Sentences to Settle Civil Tax Liabilities* (Reference Number 2004-10-060, dated March 2004) identified inaccurate criminal deficiency amounts in the CI Management Information System (CIMIS). The CIMIS is a database that tracks the status and progress of criminal investigations and the time expended by special agents. It is also used as a management tool that provides the basis for decisions of both local and national scope. We used the criminal deficiency amounts shown in the CIMIS and did not independently validate the information. Accordingly, we do not express an opinion on, and caution readers as to the reliability of, the amounts shown.

of a criminal investigation. We identified 13 cases for which civil action was needed, but the CI function either did not properly notify the civil functions or did not monitor the cases to ensure the information was received. As a result, taxpayers investigated, and in some cases convicted, for tax crimes were not pursued civilly, thereby potentially foregoing millions of dollars in tax assessments. In addition, our limited reviews, discussions, and analysis of the CI Management Information System (CIMIS) data underscore our concern that existing procedures within the CI function may not ensure information in grand jury³ cases was properly referred for civil action. The CI function does not have local guidance for determining what constitutes grand jury information, and CI function personnel may not be taking the necessary steps to identify information that could be referred. Also, the CI function did not appoint a management official within each field office to provide guidance on civil matters.

We recommended the Chief, CI, incorporate procedures to ensure a closing report is sent to the civil functions on all cases for which civil action is needed and to require field offices to confirm that the Small Business/Self-Employed (SB/SE) Division received information from all referred closed cases. The Chief, CI, should also consider issuing supplemental guidance to the field offices to improve the processes for properly classifying, segregating, and using grand jury information.

Management's Response: In general, the Chief, CI, agreed with the findings of the report and has already taken steps to address the issues identified. The Chief, CI, agreed to clarify case closing procedures pertaining to the referral of information to the SB/SE Division for civil action and to include instructions in the case closing report for the Technical Services function to notify the CI function upon receipt of the closing report and related attachments. The Chief, CI, also agreed to issue supplemental guidance to the field offices to improve the processes for properly classifying, segregating, and using grand jury information. We adjusted the wording in footnote 2 on page 1 and added footnote 16 on page 11 of the report to address the general comments provided by the Chief, CI (see page 22 for more details). Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

³ A grand jury is established to hear testimony to determine whether there is probable cause to believe the person to be indicted committed the crime in question. The grand jury adheres to the strictest of secrecy, and violators of the secrecy requirements are subject to severe penalties.

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Improvements Are Needed to Ensure Information Developed During Criminal Investigations Is Referred for Civil Action

Background

The mission of the Internal Revenue Service (IRS) Criminal Investigation (CI) function is to serve the American public by investigating potential criminal violations of the Internal Revenue Code (I.R.C.) and related financial crimes in a manner that fosters confidence in the tax system and compliance with the laws.

The I.R.C. provides civil and criminal sanctions for violations of the Internal Revenue laws. Both civil and criminal¹ sanctions may be imposed for the same offense. Typically, civil actions such as making assessments and proceeding with collection activity are not conducted until the criminal aspects of an investigation have been formally closed. The Small Business/Self-Employed (SB/SE) Division of the IRS generally pursues any civil sanctions.

Upon the closing of a criminal investigation, the CI function will make a determination as to whether the taxpayer's account should be referred to one of the civil functions to ensure any civil tax liabilities are assessed and delinquent taxes are collected. The pursuit of civil sanctions, in addition to criminal enforcement, contributes to maintaining voluntary compliance and public confidence in the fairness of the tax system.

The CI function categorizes investigations as either administrative² or grand jury.³ Administrative investigations are those worked outside of the grand jury process. All information developed during this type of investigation may

¹ The criminal violations are charged only against the tax deficiency that results from fraud. The civil tax deficiency is much broader and includes all tax due on a return. For example, a taxpayer may be charged criminally for evading taxes because of skimmed cash from a business. The criminal tax deficiency would be the tax resulting only from the income skimmed; the civil tax deficiency includes the entire tax liability.

² Most administrative investigations involve only Title 26 (I.R.C.) violations, although it is possible to investigate Title 31 (Currency Transaction Reporting) violations and some Title 18 violations administratively. Administrative investigations may be worked whenever the special agent anticipates working without the cooperation of other agencies.

³ A grand jury is established to hear testimony to determine whether there is probable cause to believe the person to be indicted committed the crime in question. The grand jury adheres to the strictest of secrecy, and violators of the secrecy requirements are subject to severe penalties.

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be used for civil purposes. Grand jury investigations involve the use of a grand jury before, while, or after the CI function conducts its investigation. Information presented to the grand jury may not be used for civil purposes unless the IRS obtains the information independent of the grand jury or in accordance with Rule 6(e) of the Federal Rules of Criminal Procedure.⁴ Grand jury information included in the indictment or plea agreement filed with the court and any information presented during any court proceeding that becomes public information can also be used for civil purposes. Otherwise, to use grand jury information that is not part of the public record to pursue civil tax remedies requires a Rule 6(e) order granted by the courts.

During Fiscal Years (FY) 2002 and 2003, the CI function closed and subsequently made a civil determination on 2,393 investigations containing tax or tax-related violations⁵ for which prosecution had been recommended. These 2,393 investigations had criminal deficiency amounts totaling approximately \$5.6 billion.⁶ Of these 2,393 investigations, 1,573 (66 percent) were categorized as grand jury; the remaining 820 cases (34 percent) were categorized as administrative investigations.

We conducted this audit during the period February through August 2004 in the National Headquarters CI function in Washington, D.C., and the Chicago, Illinois; Newark, New Jersey; Oakland, California; and Tampa, Florida, CI function field offices. We also

⁴ 18 U.S.C. Appendix, Rule 6 (2003).

⁵ The CI function defines tax-related investigations as those investigations citing criminal violations of Title 26 (I.R.C.) or Title 18 code sections 286, 287, 371(b), or 371(k).

⁶ A prior Treasury Inspector General for Tax Administration report, *Courts Are Not Always Notified When Criminals Fail to Comply With Their Sentences to Settle Civil Tax Liabilities* (Reference Number 2004-10-060, dated March 2004) identified inaccurate criminal deficiency amounts in the CI Management Information System (CIMIS). The CIMIS is a database that tracks the status and progress of criminal investigations and the time expended by special agents. It is also used as a management tool that provides the basis for decisions of both local and national scope. We used the criminal deficiency amounts shown in the CIMIS and did not independently validate the information. Accordingly, we do not express an opinion on, and caution readers as to the reliability of, the amounts shown.

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contacted SB/SE Division personnel in the Baltimore, Maryland; Chicago, Illinois; Oakland, California; and Philadelphia, Pennsylvania, offices. In addition, we contacted IRS Criminal Tax (CT) Division personnel⁷ in Washington, D.C., and the Chicago, Illinois; Jacksonville, Florida; Newark, New Jersey; and Oakland, California, offices.

We encountered a significant scope limitation that precluded us from fully addressing our overall audit objective, which was to determine whether the CI function was ensuring information identified during its investigations was properly referred for civil action. Our review of administrative cases did not entail direct access to entire investigative case files; rather, the CI function provided, at our request, specific case information necessary to accomplish our objective. However, and more importantly, we did not receive sufficient, competent, relevant, and timely information on a significant number of grand jury investigations that we selected to review. As part of the grand jury procedures governing disclosure of information, the CI function engaged local IRS CT Division attorneys and the Assistant United States Attorneys (AUSA) to determine what information, if any, from the cases we requested was considered grand jury material and, thus, was restricted from being provided to us. Ultimately, the AUSAs were the final authority on what we could review.

CI function and Treasury Inspector General for Tax Administration management cooperated to the fullest extent possible on this matter; however, due to the aforementioned process and circumstances beyond either party's control, we received either no information, or only partial and incomplete information, on a majority of the grand jury cases. Since an overwhelming majority of prosecution cases are categorized as grand jury, without access to certain information from those cases we can not reach conclusions with a sufficient degree of confidence on the appropriateness of the CI function's actions relative to the handling of civil matters. We can comment only on what we reviewed. Therefore, our review results, which are

⁷ A function within the IRS Office of Chief Counsel responsible for providing legal guidance to the CI function.

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based on limited observations and analyses, may not be representative of the population.

With the exception of the scope limitation described above, the audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

**Procedures for Transmitting
Information for Civil Action
Are Ineffective, Resulting in
Unassessed Taxes**

The CI function's existing procedures are ineffective in ensuring the IRS civil functions are properly notified that civil action is required upon completion of a criminal investigation. This occurred because the CI function did not ensure required closing letters notifying the civil functions to proceed with civil action were sent and/or received. Also, inadequate monitoring procedures to ensure the civil functions were properly notified contributed to the ineffectiveness. As a result, taxpayers investigated, and in some cases convicted, for tax crimes were not pursued civilly, thereby potentially foregoing millions of dollars in tax assessments.

We reviewed 34⁸ cases (from the 4 field offices) closed during FYs 2002 and 2003 to determine if the civil functions were properly notified when the CI function indicated that civil action was needed. In 12 of the 34 cases, the CI function either did not properly notify the civil functions of the need for any action (7 cases) or did not follow up to ensure the civil function received the information (5 cases). As a result, civil action was not initiated and pursued. According to case information, these 12 cases had total tax deficiencies of approximately \$3.9 million. We provided information on these cases to the CI function to allow it to take necessary actions.

In addition, 3d-----

⁸ We were unable to review one additional case due to the grand jury restrictions.

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-----⁹ This occurred because the CI function did not notify the civil function of the need to make the required assessment(s).

The Internal Revenue Manual (IRM) requires that the CI function notify the appropriate civil function of the need to take action upon completion of a criminal investigation and provide it with a copy of the Special Agent's Report if it is not prohibited by the grand jury secrecy rules. In addition, our discussions with CI function personnel indicated the CI function does not monitor the cases to ensure the civil functions were properly notified of the need for civil action. At a minimum, the CI function needs to ensure the information referred was received by the civil functions.

In April 2004, the CI function and the SB/SE Division issued interim procedures in response to the findings outlined in our report on monitoring conditions of probation.¹⁰ The procedures outlined the following steps to ensure tax cases on sentenced taxpayers are properly referred:

- The revised CI function closing report should identify the potential for the collection of a significant amount of tax.
- The revised closing report should be sent to the Territory manager of the Technical Services function, an SB/SE Division position.
- Special agents should contact the Territory manager to confirm that the information referred for civil action was received.

While we agree these procedures will help to ensure the civil functions are properly notified of the need for civil action on cases in which a taxpayer was sentenced for a tax violation, the procedures do not address tax investigations that were not prosecuted. We believe procedures are needed to ensure the civil functions are notified when action is

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¹⁰ *Courts Are Not Always Notified When Criminals Fail to Comply With Their Sentences to Settle Civil Tax Liabilities* (Reference Number 2004-10-060, dated March 2004).

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needed on all case closures, not just those in which the taxpayer was sentenced.

Recommendations

The Chief, CI, should:

1. Incorporate procedures to ensure a closing report is sent to the SB/SE Division on all cases for which civil action is needed.

Management's Response: The Chief, CI, agreed with the recommendation. The CI function revised its investigative closing documents to clarify procedures pertaining to the referral of information for civil action. Also, guidance was previously issued to the field specifically addressing the importance of proper case closing procedures for subjects who received conditions of probation as part of their sentences and addressing the civil closing requirements for sentenced taxpayers. Additionally, a comprehensive document is being prepared that provides instruction on a number of items of mutual interest to the CI function and other operating divisions; it will reiterate the instructions for case closing, including discontinued investigations.

2. Establish procedures requiring CI function field offices to confirm that the SB/SE Division received the information referred from all closed cases.

Management's Response: The Chief, CI, agreed with the recommendation. The case closing report has been revised to include instructions to the Technical Services function to notify the special agent upon receipt of the report. Further, guidance recently issued to CI function special agents instructs them to contact the Technical Services function to confirm receipt of CI closing reports and related attachments.

The Process for Classifying Grand Jury Information Can Be Improved

According to data in the CI Management Information System (CIMIS), the CI function referred for civil action about 50 percent of all closed investigations that contained tax violations. These data also show that information from administrative investigations was referred more frequently than information from grand jury investigations (59 percent compared to 46 percent). Similar patterns exist regardless

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of whether the taxpayer was successfully prosecuted. Table 1 summarizes the referral of closed tax investigations (for which the CI function recommended prosecution) during FYs 2002 and 2003.

Table 1: Referral of Closed Investigations - FYs 2002 and 2003

Type of Case	Results of Prosecution Recommendation	Total Cases	Total Referred	Percent Referred
Administrative	Sentenced	647	405	63%
	Not Sentenced	<u>173</u>	<u>82</u>	47
	Subtotal	820	487	59
Grand Jury	Sentenced	1,311	677	52%
	Not Sentenced	<u>262</u>	<u>41</u>	16
	Subtotal	1,573	718	46
All Cases	Sentenced	1,958	1,082	55%
	Not Sentenced	<u>435</u>	<u>123</u>	28
	Total	2,393	1,205	50

Source: The CIMIS.

Together with the information obtained during our limited review, these data underscore our concern that the CI function is not always properly referring information in grand jury investigations for civil action. As previously noted, we were unable to review case files of grand jury investigations for which the CI function did not forward the case for civil action. However, we discussed the procedures for referring both administrative and grand jury investigations with CI function and CT Division personnel. From these discussions, we identified several factors affecting the CI function's ability to refer information from grand jury investigations for civil action.

- The CI function's procedures for identifying information in grand jury cases that could be referred may be ineffective.
- The CI function may not have properly segregated information in grand jury cases.
- The CI function did not appoint officials within each field office to provide guidance on civil matters.

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The Government Accountability Office (GAO)¹¹ similarly concluded in a report issued in 1988¹² that better guidance on what constitutes grand jury information could increase case referrals for possible assessment. The GAO also concluded that special agents should consult with the IRS Office of Chief Counsel or the United States Attorney's Office (USAO) to help determine what information could be forwarded for civil action.

The CI function's procedures for identifying information in grand jury cases that could be referred may be ineffective

The general rule of grand jury secrecy is set forth in Rule 6(e)(2) of the Federal Rules of Criminal Procedure. It provides that grand jurors, Federal Government attorneys and their assistants, and other personnel associated with the grand jury are forbidden to disclose "matters occurring before the grand jury." The question of what constitutes a matter occurring before a grand jury has not been expressly addressed by the Supreme Court nor is it defined anywhere in the Federal Rules of Criminal Procedure.

In determining if something is a matter occurring before the grand jury, the courts have considered factors such as:

- Whether the evidence was ever presented to the grand jury.
- The type of evidence at issue.
- Whether the disclosure would reveal what transpired before the grand jury.

The issue of what constitutes grand jury material has been the subject of numerous and often conflicting circuit court opinions.¹³ The grand jury secrecy rules are a broad concept that results in each judicial district having its own interpretation of information subject to the grand jury secrecy rules. For instance, some courts have ruled the IRS

¹¹ Formerly the General Accounting Office.

¹² *Tax Administration: Investigating Illegal Income – Success Uncertain, Improvements Needed* (Reference Number GAO/GGD-88-61, dated April 1988).

¹³ *Litigation Guideline Memorandum CT-3, Grand Jury Evidence – Matters Occurring Before a Grand Jury*, dated September 6, 1994.

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may rely upon documentation that does not disclose matters occurring before the grand jury for its civil investigations. This can include tax calculations, back-up documentation, and work products created for purposes independent of the grand jury.

According to the IRM and CI function internal memoranda, after all criminal matters have been concluded, the CI function will confer with an attorney for the Federal Government for the purpose of pursuing any civil action. The ultimate decision to release evidence acquired during a grand jury investigation for civil action falls within the purview of the local USAO. If the attorney for the Federal Government agrees civil action should be pursued, the CI function will seek the assistance of the CT Division in reviewing the information gathered for the purpose of pursuing civil action.

According to CI function field office personnel, there is no local guidance for determining what constitutes grand jury information within their judicial districts. In addition, there is no uniformity in the steps taken for determining if information obtained during an investigation should be classified as grand jury. When asked to describe the process for classifying grand jury information, CI function field office personnel provided one or more of the following responses:

- Rely on past experience.
- Contact other CI function personnel.
- Contact Disclosure function personnel.
- Contact CT Division attorneys.
- Contact the USAO.

In describing the process for actually referring information in grand jury investigations, several CI function personnel indicated that only information that has been made public through the indictment, plea agreement, or the judgment and commitment order could be shared. While this may ensure the referral of case information when a taxpayer is sentenced and ordered to cooperate with the IRS, this may not ensure the referral of information from cases that were

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not successfully prosecuted. This is underscored by the fact that, during FYs 2002 and 2003, the CI function referred for civil action only 115 (18.2 percent) of 632¹⁴ grand jury investigations that were discontinued before the prosecution recommendation. Public information, such as an indictment or plea agreement, would not be applicable for these cases. Table 2 summarizes this information.

Table 2: Tax Cases Discontinued Prior to Prosecution Recommendation – Percentage Referred for Civil Action – FYs 2002 and 2003

Type of Case	Total Cases	Total Referred	Percent Referred
Administrative	983	570	58%
Grand Jury	632	115	18%
Total	1,615	685	42%

Source: The CIMIS.

Not having local guidance, along with CI function personnel not consulting with the USAO to identify information subject to the grand jury restrictions in each case, can result in referable cases not being forwarded for civil action. The USAO has the ultimate responsibility for determining if information in its grand jury investigations can be used for civil purposes. The CI function needs to emphasize to its field personnel that the USAO is the authority and should be consulted for determining what constitutes grand jury information during each case.

The CI function may not have properly segregated information in grand jury cases

To prevent doubt about the origins of information available for civil use, the IRM requires that the supervisory special agent ensure the segregation of information prior to the receipt of any grand jury information and have such material clearly marked as nongrand jury. After the grand jury investigation begins, any information obtained

¹⁴ According to the CIMIS, these 632 subject investigations contained tax or tax-related violations and were discontinued prior to a prosecution recommendation.

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independently of the grand jury should be kept separate and clearly identified as an independent source. In addition, CI function procedures require that its field personnel consult with CT Division attorneys and the USAO when questions arise in the segregation process.

The IRM further requires that special care be taken to document sources of information, since the IRS may have to prove evidence used for civil purposes was properly obtained under a Rule 6(e) order or was obtained independently of the grand jury process. The nongrand jury information, even if the same as the grand jury information, is not governed by Rule 6(e) and may be disclosed in accordance with I.R.C. § 6103.¹⁵

We started fieldwork at the beginning of February 2004 and requested to review information from 50 closed grand jury investigations. We agreed with the CI function that we would not be able to review grand jury information included in those investigations due to the grand jury secrecy rules. However, we were expecting some of the information to be readily available because the information would have been properly segregated and identifiable as nongrand jury material. Because several months lapsed between the time of our initial request and when we received limited information, this raises concerns that the CI function may not have properly segregated the nongrand jury material.¹⁶

The proper segregation of information within each grand jury investigation is essential to ensure all nongrand jury information is made available for civil assessment.

¹⁵ 26 U.S.C. § 6103 (2003), Confidentiality and disclosure of returns and return information.

¹⁶ The Chief, CI's, response stated that this was a speculative conclusion and that there was no information to establish how many of the grand jury cases were initiated as administrative investigations. We raised this issue based on the limited information available to us and believe that, regardless of how a grand jury case is initiated or investigated, certain information may not fall under the grand jury restrictions and thus should be segregated and readily available, as provided by the CI function's existing procedures. We also believe the underlying premise of our observation is further supported by the Chief, CI's, commitment to advise special agents in charge of the importance of segregating grand jury material, as provided on page 13.

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The CI function did not appoint officials within each field office to provide guidance on civil matters

According to the IRM, the CI Director, Field Operations, will appoint a management official in each field office to be responsible for making determinations on civil matters involving the subjects of grand jury investigations. The official will not have access to any grand jury information.

Several CI function managers advised they were unaware of this requirement and affirmed they do not have an official responsible for providing guidance on civil matters.

A management official fluent in the interpretation of the grand jury rules within his or her judicial district can be an asset in providing guidance on civil matters. The official could also assist in ensuring the proper segregation of information in grand jury investigations.

Because of the scope limitations previously described, we could not review a sufficient number of grand jury cases to conclusively determine whether the CI function is properly classifying and referring grand jury information for civil action. However, our limited reviews, discussions, and analysis of CIMIS data suggest that the following actions may improve this critically important process:

- Each field office should coordinate with the CT Division and the applicable USAO(s) to develop local guidance on what constitutes grand jury information.
- Field office personnel, in collaboration with the CT Division, should seek the USAO's guidance in determining what information from grand jury investigations can be provided to the civil functions, recognizing that the USAO is the final authority on such matters.
- Local CI function field office management should periodically review case files to verify whether information obtained during grand jury investigations is properly segregated.
- Each field office should appoint a management official responsible for making determinations on civil matters involving grand jury investigations.

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Without these improvements, taxpayers may not be pursued civilly, which could result in potential tax assessments not being made and negatively affect the public's confidence in the fairness of the tax system.

Recommendation

3. The Chief, CI, should consider issuing supplemental guidance to the field offices to improve the processes for properly classifying, segregating, and using grand jury information, thereby maximizing its use for civil tax administration purposes.

Management's Response: The Chief, CI, agreed with the recommendation. A memorandum will be issued to the special agents in charge nationwide that will include a reference to the IRM section on the importance of the segregation of grand jury material. Additionally, the IRM will be amended to remove the requirement that the Director, Field Operations, appoint a management official to be responsible for making determinations on civil matters involving the subjects of grand jury investigations, as this determination will still be made by the local USAOs. The CI function will instruct the field to maintain close liaison with the local AUSAs to keep them informed of potential civil issues and to seek their guidance in determining what material can be provided to the IRS civil functions.

The Criminal Investigation Function Has Implemented Procedures Emphasizing Coordination With Civil Functions on Investigations Involving Abusive Trust Promoters and Preparers of Fraudulent Returns

We selected 12 investigations involving abusive trust promoters and preparers of potentially fraudulent tax returns to determine if client information in these cases was referred for civil action, since the clients could have received an unwarranted tax benefit from the potentially fraudulent scheme. We reviewed only seven cases because of the grand jury restrictions previously described. As a result, we could not state an overall conclusion on the CI function's efforts to ensure client information is properly referred for civil action. The following are examples of the cases we reviewed to determine if the client information was referred:

- The clients of a tax preparer who pled guilty to aiding and assisting in the preparation of false and fraudulent returns were not referred because it was determined there was little potential for collection.

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The indictment charged that 85 false and fraudulent returns were prepared.

- The clients of a tax preparer convicted of preparing false and fraudulent returns were not referred for civil action because the assessment statutes had expired on the clients' returns. The investigation summary indicated 245 fraudulent tax returns were prepared.
- The investigation of a tax preparer was discontinued. The scheme was originally identified by the SB/SE Division; it was notified by the CI function upon closure of the criminal investigation that it was free to proceed civilly against the clients.

In response to a report issued by a joint IRS and Department of Justice task force,¹⁷ the CI function issued interim procedures on the use of parallel civil and criminal proceedings to stop promoters of abusive tax schemes. The procedures emphasize the importance of exploring the benefits of working civil injunctive investigations while the criminal investigations continue. The goal of the process is for the CI and civil functions to work together to ensure business decisions about investigations are in the best interest of the IRS' efforts to stop the promotion of abusive schemes.

The IRS estimates the potential revenue loss from abusive tax schemes to be in the tens of billions of dollars annually. Historically, the IRS has waited for criminal investigations to be completed before pursuing any civil actions. The task force concluded that the most effective method of stopping the abusive schemes and scams would be to pursue parallel civil and criminal actions.

According to task force members, the benefit of proceeding civilly against an abusive scheme promoter is the use of civil injunctions to stop the abusive scheme much earlier than is possible through criminal enforcement alone. This expedites the IRS' task of bringing investors (clients) into

¹⁷ *Using Parallel Civil and Criminal Proceedings to Stop Abusive Tax Schemes*, dated July 2003.

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compliance and recovering lost taxes by requiring the promoter to turn over complete client lists.

In addition, the CI function recently entered into a Memorandum of Understanding (MOU) with the Wage and Investment (W&I) Division for the referral of clients identified during its investigation of refund preparer schemes. This MOU established procedures for an efficient, timely, and cost-effective transition of work between the CI function and the W&I Division. During FY 2003, the initial year of the MOU, the CI function referred approximately 37,000 tax returns to the W&I Division. About 44,235 tax returns have been referred in FY 2004, and the CI function expects to refer about 23,000 tax returns to the W&I Division in FY 2005. In addition, in FYs 2003 and 2004, the CI function referred to the SB/SE Division approximately 11,000 and 27,000 tax returns, respectively. Approximately 43,000 tax returns are expected to be referred to the SB/SE Division in FY 2005, even though a formal agreement with the SB/SE Division is not in place.

We believe the successful implementation of these procedures should help ensure more clients of abusive trust promoters and preparers of fraudulent returns are addressed civilly.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Criminal Investigation (CI) function ensured information identified during its investigations was properly referred for civil action. To accomplish our objective, we obtained an extract from the CI Management Information System (CIMIS)¹ as of September 30, 2003. We validated the data received from the CIMIS by comparing the results of various queries to the CI function's management information reports. However, we did not verify the accuracy of the data entered in the CIMIS. Specifically, we:

- I. Determined whether the CI function's policies and procedures ensure cases are forwarded for civil action where appropriate.
 - A. Evaluated and discussed the procedures for ensuring the clients identified during investigations of abusive trust promoters and preparers of fraudulent tax returns are referred for civil action.
 - B. Evaluated whether the CI function had established procedures to monitor the civil actions taken by the Examination and Collection functions on closed criminal cases referred for civil action.
 - C. Reviewed and discussed policies and procedures pertaining to grand jury² information.
- II. Determined whether the tax implications resulting from closed criminal investigations of subjects and related clients (if applicable) are properly and timely referred to the appropriate Compliance function.
 - A. Analyzed the CIMIS and identified 2,393 tax-related³ subject investigations that were closed during Fiscal Years 2002 and 2003 and for which the CI function made a determination either to forward the case for civil action or that no civil action was necessary. This information was further subdivided between administrative and grand jury investigations. The Chicago, Illinois; Newark, New Jersey; Oakland, California; and Tampa, Florida, field offices were judgmentally selected

¹ The CIMIS is a database that tracks the status and progress of criminal investigations and the time expended by special agents. It is also used as a management tool that provides the basis for decisions of both local and national scope.

² A grand jury is established to hear testimony to determine whether there is probable cause to believe the person to be indicted committed the crime in question. The grand jury adheres to the strictest of secrecy, and violators of the secrecy requirements are subject to severe penalties.

³ The CI function defines tax-related investigations as those investigations citing criminal violations of Title 26 (Internal Revenue Code) or Title 18 code sections 286, 287, 371(b), or 371(k).

Improvements Are Needed to Ensure Information Developed During Criminal Investigations Is Referred for Civil Action

based on factors such as the number of cases closed for which a civil action determination was made, the number of abusive trust and return preparer cases closed for which a civil determination was made, the percentage of all cases forwarded for civil action, the percentage of grand jury cases forwarded for civil action, and the percentage of tax or tax-related cases forwarded for civil action. We also considered the geographic location of the offices.

- B. Randomly selected 78 of 417 tax or tax-related subject investigations that were closed during the same period from the 4 judgmentally selected CI function field offices. Of these, 35 cases were categorized as forwarded for civil action, and 43 cases were categorized as no civil action necessary. We included 12 cases involving abusive trust promoters and tax return preparers as part of our selection of 78 cases. We used this sampling methodology because we did not intend to project our results to the entire universe.
- C. For the 35 cases categorized as forwarded for civil action:
 - 1. Reviewed documents from the CI function's investigative case files for 34 cases. We were unable to review 1 of the 35 cases because the Assistant United States Attorney (AUSA) deemed the entire case as grand jury information.
 - 2. Reviewed the subjects' tax account data.
 - 3. For the cases involving abusive tax promoters and tax return preparers, assessed the reasons for not forwarding the clients for civil action, if applicable.
 - 4. Interviewed CI function and Small Business/Self-Employed Division personnel.
- D. For the 43 cases categorized as no civil action necessary:
 - 1. Reviewed documents from the CI function's investigative case files for 18 cases. We were unable to review 25 of the 43 cases because the AUSA deemed all or portions of these cases as grand jury information.
 - 2. For the cases involving abusive tax promoters and tax return preparers, assessed the reasons for not forwarding the clients for civil action, if applicable.
 - 3. Interviewed CI function personnel.

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Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)

John R. Wright, Director

Diana M. Tengesdal, Audit Manager

Jeffrey K. Jones, Lead Auditor

Todd M. Anderson, Senior Auditor

Michael J. Hillenbrand, Senior Auditor

Ahmed M. Tobaa, Senior Auditor

**Improvements Are Needed to Ensure Information Developed
During Criminal Investigations Is Referred for Civil Action**

Appendix III

Report Distribution List

Commissioner C
Office of Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Commissioner, Small Business/Self-Employed Division SE:S
Director, Operations Policy and Support, Criminal Investigation SE:CI:OPS
Division Counsel/Associate Chief Counsel (Criminal Tax) CC:CT
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaisons:
 Commissioner, Small Business/Self-Employed Division SE:S
 Director, Planning and Strategy, Criminal Investigation SE:CI:S:PS

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Increased Tax Revenue – Potential; approximately \$3.9 million (see page 4).
- Increased Tax Revenue – Actual; 3d----- (see page 4).

Methodology Used to Measure the Reported Benefit:

We reviewed 34 cases closed (from the 4 field offices reviewed) during Fiscal Years (FY) 2002 and 2003 for which the Criminal Investigation (CI) function indicated that civil action was needed to determine if the civil functions were properly notified. In 12 of these 34 cases, the CI function either did not properly notify the civil functions of the need for any action or did not follow up to ensure the civil function received the information. As a result, civil action was not initiated and pursued. According to the CI function’s case file information, these 12 cases had a total tax deficiency amount of about \$3.9 million.¹ The potential increased tax revenue portion of the Outcome Measure (\$3.9 million) recognizes the potential assessment and collection of tax revenues upon referral to the civil functions.

We also reviewed 12 administrative cases closed (from the 4 field offices reviewed) during FYs 2002 and 2003 for which the CI function indicated that civil action was not required. In one case, 3d-----

-----²

¹ A prior Treasury Inspector General for Tax Administration report, *Courts Are Not Always Notified When Criminals Fail to Comply With Their Sentences to Settle Civil Tax Liabilities* (Reference Number 2004-10-060, dated March 2004) identified inaccurate criminal deficiency amounts in the CI Management Information System (CIMIS). The CIMIS is a database that tracks the status and progress of criminal investigations and the time expended by special agents. It is also used as a management tool that provides the basis for decisions of both local and national scope. We used the criminal deficiency amounts shown in the CIMIS and did not independently validate the information. Accordingly, we do not express an opinion on the amounts shown.

² 3d-----

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Appendix V



Criminal Investigation

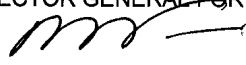
Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

RECEIVED
SEP 22 2004

September 22, 2004

MEMORANDUM FOR GORDON C. MILBOURN III
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Nancy J. Jardini 
Chief, Criminal Investigation

SUBJECT: Response To Draft Audit Report: Improvements Are Needed to
Ensure That Information Developed During Criminal
Investigations is Referred for Civil Action
(Audit #200310041)

Criminal Investigation (CI) reviewed the Treasury Inspector General for Tax Administration (TIGTA) Draft Audit Report concerning improvements to ensure that information developed during criminal investigations is referred to the civil function when appropriate. Your review and recommendations will help guide CI in improving this process.

Overall, CI management does not take exception to the validity of the findings of the report, gauged in its fullest context, and has already taken steps to address the issues identified. Management shares the frustration expressed in the report related to the release of Grand Jury information—a matter outside CI's control. Criminal Investigation provided its full cooperation in attempting to obtain authorization from the Assistant United States Attorneys (AUSAs) to provide Grand Jury case documentation.

Criminal Investigation management will continue to enhance internal procedures to ensure that information identified during criminal investigations is properly referred for civil action when appropriate. Additionally, CI management will reinforce to its field offices CI's existing policies and procedures related to this issue, and the Review and Program Evaluation section will be including these topics in its field office reviews.

Criminal Investigation personnel previously discussed many of your report's findings with your auditors and provided written responses to some of your conclusions and concerns. We have already taken corrective action on some issues that you noted and will continue to work with the field offices to address all the findings. For example, the auditors suggested that additional procedures be developed to ensure CI's closing reports are sent to the Small Business/Self Employed (SB/SE) function when appropriate. Criminal Investigation implemented the suggestion immediately by updating the case closing documents to clarify these procedures.

Criminal Investigation management feels some general commentary on a few sections of the report is needed to ensure the reader is properly informed of the issues involved in this matter.

Improvements Are Needed to Ensure Information Developed During Criminal Investigations Is Referred for Civil Action

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General Comments

Page 1, Footnote 2:

"Administrative investigations may be worked whenever the special agent anticipates working without the cooperation of other agencies and whenever time is not of the essence."

The last portion of this statement implies that time considerations are less important in administrative investigations as compared to those under the auspices of the Grand Jury. To the contrary, CI management stresses that time is of the essence in all criminal investigations and time considerations are a limited factor in making the determination of whether a case is investigated administratively or via the Grand Jury.

Page 11, 2nd paragraph:

"Because several months lapsed between the time of our initial request and when we received limited information, this raises concerns that the CI function may not have properly segregated the non-grand jury material."

This statement relays a speculative conclusion. There is no information to establish how many of the 50 closed Grand Jury investigations were initiated as administrative investigations, requiring the segregation of Grand Jury material. Part of the delay in delivering available case files to TIGTA was caused by the establishment of procedures by CI and Criminal Tax Counsel to work with the United States Attorney's Offices to determine what items did contain Grand Jury material. As such, TIGTA and CI management agreed that administrative case files would be submitted to the audit team first, pending the resolution of the Grand Jury files submission issue. This was the direct result of the delay.

Recommendation Comments

Recommendation 1:

The Chief, CI should incorporate procedures to ensure a closing report is sent to the SB/SE Division on all cases where civil action is needed.

In light of this finding, CI reviewed and revised investigative closing documents to clarify procedures pertaining to the referral of information for civil action. These updated documents will be posted to CI Document Manager, an application used to create and maintain investigative documents and other materials. Also, guidance was issued to the field on March 19, 2004 specifically addressing the importance of proper case closing procedures for subjects who received conditions of probation as part of their sentence. This memorandum also discussed the requirement that every tax case be referred for civil action and the importance of assisting in the civil process on both administrative and Grand Jury investigations. On April 13, 2004, a joint memorandum was issued by CI and SB/SE addressing civil closing

Improvements Are Needed to Ensure Information Developed During Criminal Investigations Is Referred for Civil Action

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requirements for sentenced taxpayers. The memorandum included attachments from both functions outlining their respective civil closing procedures. Additionally, a comprehensive document is being prepared that provides instruction on a number of items of mutual interest to CI and other operating divisions. This document, which will be issued to the Special Agents in Charge nationwide before the end of November 2004, will reiterate the instructions for case closing, including discontinued investigations.

Recommendation 2:

The Chief, CI should establish procedures requiring CI function field offices to confirm that the SB/SE Division received the information referred from all closed cases.

The CI case closing report has been revised to include instructions to Technical Services to notify the special agent upon receipt of the report. Further, guidance issued to CI personnel on April 13, 2004, instructs special agents to contact Technical Services to confirm their receipt of Criminal Investigation closing reports and related attachments. This revised closing document will be included in the CI Document Manager application.

Recommendation 3:

The Chief, CI should consider issuing supplemental guidance to the field offices to improve the processes for properly classifying, segregating, and using grand jury information, thereby maximizing its use for civil tax administration purposes.

A memorandum will be issued to the Special Agents in Charge nationwide (before the end of November 2004) that will include a section on Grand Jury investigations that will reference Internal Revenue Manual (IRM) section 9.5.2, which discusses the importance of the segregation of Grand Jury material. Additionally, the IRM will be amended to remove the requirement that the Director of Field Operations appoint a management official in each field office to be responsible for making determinations on civil matters involving the subjects of Grand Jury investigations, as this determination will still be made by the local United States Attorney's Offices. However, we will instruct the field to maintain close liaison with the local AUSAs to keep them informed of potential civil issues and seek their guidance in determining what material in a Grand Jury investigation can be turned over to our civil counterparts.

Other Comments

Criminal Investigation agrees with TIGTA that the draft audit report and CI's response should be available to the public.

Improvements Are Needed to Ensure Information Developed During Criminal Investigations Is Referred for Civil Action

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Criminal Investigation's responses to the specific recommendations in the report are as follows:

Recommendation 1

The Chief, CI should incorporate procedures to ensure a closing report is sent to the SB/SE Division on all cases where civil action is needed.

Corrective Action(s):

Criminal Investigation has already reviewed and revised investigative closing documents to clarify procedures pertaining to the referral of information for civil action. These updated documents will be posted to the CI Document Manager application. Additionally, a comprehensive document will be prepared that provides instruction on a number of items of mutual interest to CI and other operating divisions. This document, which will be issued to the Special Agents in Charge nationwide before the end of November 2004, will reiterate the instructions for case closing, including discontinued investigations.

Implementation Date:

Completed _____ N/A _____ Proposed November 30, 2004 N/A _____

Responsible Official(s):

Director, Operations, Policy and Support

Corrective Action(s) Monitoring Plan:

The Director, Operations Policy and Support will ensure that the implementation of the required documents is completed within the prescribed timeframe.

Recommendation 2

The Chief, CI should establish procedures requiring CI function field offices to confirm that the SB/SE Division received the information referred from all closed cases.

Corrective Action(s):

The CI case closing report has been revised to include instructions to Technical Services to notify the special agent upon receipt of the report. Further, guidance issued to CI personnel on April 13, 2004, instructs special agents to contact Technical Services to confirm their receipt of Criminal Investigation closing reports and related attachments. This revised closing document will be included in the CI Document Manager application.

Implementation Date:

Completed _____ N/A _____ Proposed November 30, 2004 N/A _____

Responsible Official(s):

Director, Operations Policy and Support

Improvements Are Needed to Ensure Information Developed During Criminal Investigations Is Referred for Civil Action

5

Corrective Action(s) Monitoring Plan:

The Director, Operations Policy and Support will ensure that the implementation of the required documents is completed within the prescribed timeframe.

Recommendation 3

The Chief, CI should consider issuing supplemental guidance to the field offices to improve the processes for properly classifying, segregating, and using grand jury information, thereby maximizing its use for civil tax administration purposes.

Corrective Action(s):

A memorandum will be issued to the Special Agents in Charge nationwide that will include a section on Grand Jury investigations that will reference IRM section 9.5.2, which discusses the importance of the segregation of Grand Jury material.

Implementation Date:

Completed _____ N/A _____ Proposed November 30, 2004 N/A _____

Responsible Official(s):

Director, Operations Policy and Support

Corrective Action(s) Monitoring Plan:

The Director, Operations Policy and Support will ensure that the memorandum is prepared and forwarded to the field within the prescribed timeframe.

If you have any questions, please call me at (202) 622-3200, or a member of your staff may contact Pota E. Coston, Director, Office of Strategy, at (202) 622-5876.