Fox Rothschild Podcast

The Presumption of Innocence Podcast Series: Episode 17

The IRS Annual Dirty Dozen List: Avoiding Tax Scams and Schemes

Featuring Matthew Adams and Matthew Lee of Fox Rothschild LLP

Adams: Hi everyone, and welcome to "The Presumption of Innocence," a podcast brought to you by the White-Collar Criminal Defense & Regulatory Compliance Practice at Fox Rothschild.

I'm your host, Matt Adams. I'm joined today by my co-chair in the practice, Matt Lee, and we're here today to do our annual review of the IRS's Dirty Dozen Tax Scams for 2022. About this time last year, we reviewed the Dirty Dozen of 2021, Matt.

And just to remind our audience, the IRS views these Dirty Dozen as the sort of hot button issues that they think are ripe for discussion about potentially abusive scams targeting taxpayers. And from our perspective, where we sit, that is often a good sign of what the IRS is going to target when it comes to its enforcement activities. Isn't that right?

Lee: Yeah, that's right, Matt. The IRS has been releasing an annual list, this annual Dirty Dozen list, for some time. This is certainly not anything new. But it really does illustrate, I believe, the areas that the IRS see that present the greatest risk to taxpayers and to tax administration. And it really does provide a roadmap to where the IRS is likely to devote its enforcement resources in the coming year.

The Dirty Dozen is not always the same 12 or so items, and it's often updated. And as we'll talk about over the course of today's podcast, there are some new entries on this year's Dirty Dozen list. There are some entries that you've seen in years past, and many of the entries are focused specifically on pandemic- related fraud, which of course is relatively new in the last two to three years.

But again, these are what the IRS sees as presenting the greatest risk and certainly indicative of where we think the IRS is going to devote its resources over the course of the next 12 months or so.

Adams: We start from the proposition, don't we, Matt, that the IRS has limited resources. But is that dynamic itself changing at all? As we come into the fourth quarter of 2022, are we seeing more resources being directed at the IRS or less these days?

Lee: Yeah, this is a big year for the IRS in terms of resources. For the last, at least decade, the IRS's annual budget appropriation from Congress has really taken a hit. There's been tremendous cuts to the IRS's budget for the last decade. Tremendous attrition among the workforce at the IRS. There have been limited resources to improve the IRS's systems, its computer systems, its databases and so forth. And it really has affected tax enforcement in a real serious way over the last 10 years.

But there's two things that have happened recently that I think are starting to reverse that course. The first relates to data. And one of the things that the IRS has gotten, I believe, very good at is using artificial intelligence, data analytics and other software tools to review tremendously large sets of data and to use that type of artificial intelligence review to do things like follow the money, to find investigative leads, to identify taxpayers that may be potentially under reporting their income, things like that. To detect anomalies on tax returns that would likely never be found if you just had a set of human eyes reviewing the paper.

That's one thing I think the IRS has started to get very good at, is using data to help it further its mission. And then of course, much more recently, Congress has just passed legislation, and the president has signed, that is going to give the IRS the biggest infusion of budgetary resources perhaps in its history.

Over the course of the next 10 years, billions of additional dollars are going to the IRS to really help the IRS catch up in these areas where it's really deficient by hiring additional agents, improving its hardware and its computer software, improving customer service. As simple as hiring people to answer the phone at the IRS, which is something that has really been a problem for the last couple of years.

So, this really has been a good year, I think, for the IRS. And we will see over the course of the coming years significantly more resources at the IRS to carry out its enforcement role.

Adams: The IRS rolled out its first of its series in the Dirty Dozen tax scams for 2022, categorizing four discrete, what they call, "potentially abusive arrangements." And those are the use of CRATs, or Charitable Remainder Annuity Trusts, to eliminate taxable gain, foreign pension arrangements that misuse certain treaties, captive insurance either in Puerto Rico or elsewhere offshore, and the use of monetized installment sales. Now those four things, those four potentially abusive arrangements that the IRS refers to in its first of its series on this year's Dirty Dozen, what do they all have in common, Matt?

What's the common thread that flows through each of the four that I mentioned?

Lee: The IRS calls each of these four or describes them as potentially abusive arrangements. That's the -- I guess the terminology that the IRS likes to use to describe these, but really, what they are they're tax shelters. That's the more traditional and what many of our listeners might be used to hearing as a way to describe these things.

They're really tax shelters, and each of them has this sort of different setup and a different mechanism. But at the end of the day, they're designed to allow someone who has a valuable asset-- it could be real estate, it could be stock, whatever the case may be, something valuable, something that's appreciated in value-- it allows you to essentially sell that piece of property. And, if you were following the rules, you'd have to report that as a gain on your tax return and pay tax on, essentially, your profit, what you've earned on that transaction over and above your basis.

These arrangements allow an unscrupulous taxpayer to dispose of a valuable asset, get paid for it and avoid paying tax on the transaction. So, they're all different. They have different ways of going about the end goal, but at the end of the day, they do have this common goal of allowing someone to sell something valuable and shield the gain on that transaction from tax.

The other thing that each of these four arrangements or tax shelters has in common is that they all involve a promoter. And a promoter is the term of art that the IRS likes to use. It essentially refers to a third party who is actually selling these products. Each one of these is a product that is being sold to an individual or a business that wants to take advantage of the transaction, of the strategy, for a fee. And so, in each one of these instances, the IRS will be looking not only at the taxpayer who engages in the actual transaction and avoids the resulting tax consequences, but they're also looking at the promoter.

Who is the third party, who's the professional? Could be an attorney, could be an accountant. Who's selling this product for a fee?

Each of these tax shelters has that two- part investigative component too. One focused on the taxpayer/investor. A second track is focused on the promoter who's selling and oftentimes making a lot of money on these arrangements.

Adams: Yeah, I recently had an opportunity to speak on a panel about pandemic- related fraud and even talked about it somewhat on this podcast in prior episodes. And I spoke with an IRS Criminal Investigations Division agent who really was laser- focused on promoter liability. It seems to me that if you have the classic criminal investigative dynamic where the government, its agents, are trying to flip up to get the big fish, the promoter is really the big fish in some of these white-collar frauds, isn't it?

The taxpayer is the low- hanging fruit filing the potentially fraudulent return, for example, but the promoter that told them the way to do it and tried to rationalize its legitimacy really is the big fish in these investigations. Right?

Lee: Yeah, that's absolutely right. And it's really, oftentimes it's the promoter that's got the criminal liability. And what we've seen time and time again, I mean I really think this is sort of classic IRS and Justice Department strategy when you're dealing with these tax shelters is that the government will go after the promoter with an eye on potentially filing criminal charges and seeking to hold the promoter criminally liable. Whereas the taxpayer, essentially the customers who bought this strategy and implemented the strategy, are often going to face civil liability in the form of a tax audit.

They're going to get audited and ultimately if the IRS concludes that they did something improper, they'll have to pay the taxes that they avoided with interest and penalties. But that's a pretty standard playbook for the IRS we're seeing in this area is go after the promoters who as you say, Matt, really are the big fish. They're the kingpins. It's a traditional drug investigation where --

Adams: I was just going to say, or La Cosa Nostra.

Lee: Yeah, yeah or right, exactly, organized crime. Is that you're going to go for the top. The investigative agency's going to target the drug kingpin or the mafia boss, so to speak, and look to, essentially, aim for the head and stop the continuing promoting of this illegal product.

And if you, do it that way, you stop. And you don't have taxpayers who are continuing to purchase this product and take advantage of it on their tax returns. So, it's not a new law enforcement strategy. In fact, it's a pretty standard one that goes back for many years. It's just being used in a different context here, which happens to be a criminal tax context.

Adams: Many a movie made out of that particular plot line, I might add. It's really the perfect segue because the next group of IRS Dirty Dozen scams that made the list for 2022 really involve pandemic- related scams, as you mentioned. And it really truly focuses on the theft of benefits and certain bogus use of social media that the IRS is keying into. And this concept of the promoter is alive and well in these four scams, including economic impact payment and tax refund scams, unemployment fraud, leading to inaccurate 1099s, fake employment offers posted on social media and fake charities that steal your money.

Let's unpack. I know that you and I for the last couple of years have really been out in front talking about the COVID-19 stimulus- related fraud. Tell our audience a little bit about the IRS's role in that. Because I know at least as it relates to the ERTC credit, the refundable tax credit, that was passed by Congress to put money back into some of the coffers of businesses that were decimated by pandemic- related restrictions, it's intuitive that the IRS would be the lead investigative agency when it came to those type of schemes, but what role is the IRS playing as it relates to other schemes like PPP fraud?

Lee: Yeah, it's an interesting question. And it's not, I guess, it's not intuitive. You know, the Paycheck Protection Program, that's not a tax program. It's not administered by the IRS. That's a COVID relief program, maybe the centerpiece COVID relief program, from the original CARES Act that was designed to help small businesses that were suffering economic hardships to weather the pandemic storm.

But what we have seen is that the IRS has joined with numerous other federal agencies in what I think we often refer to as an all- hands- on- deck approach to combating pandemic- related fraud. So, the IRS has jumped in with the FBI, the Small Business Administration, the numerous federal banking regulatory agencies, to investigate fraud related to PPP, the idle program and other pandemic relief programs. Not because they're tax programs or because there is some tax element, but really, I think, it's because the IRS has very sophisticated financial investigators who are used to doing things like combing through tax returns and bank records and looking for tax fraud and tax evasion.

Here, they're not looking for tax evasion or tax fraud, so to speak, but they're looking for fraud. And so we've seen what I think is a tremendous diversion of resources from the IRS's traditional mission to root out tax fraud and tax evasion to focus on pandemic- related fraud. And I think that's going to continue for a while.

And I think it really, it's going to be interesting to see how that impacts the traditional IRS enforcement agenda. When you have this tremendous diversion of IRS resources, and it doesn't show any sign of abating, I think that we're going to be talking about pandemic fraud for quite a long time.

Adams: Even Congress has taken action to extend certain statute of limitations and the ERTC credit, as it's been called, the Economic Recovery Tax Credit, which I think is most directly implicating the IRS's jurisdiction because of the need to file amended 941s, really is only just beginning. Because you're filing amended tax returns outside the normal sequence of events, you're availing yourself of those credits through an amendment process for which you have a significant period of additional time to file amended returns.

The role of promoters is perhaps equal or greater than in the same context as you just mentioned, with these tax shelters, isn't it?

Lee: Yeah, so that ERC, that Employee Retention Credit you mentioned, is an interesting one. It's not on the list. You won't find it on the Dirty Dozen for 2022. But I'm willing to bet that when we do this podcast a year from now, you're going to see fraud related to the Employee Retention Tax Credit front and center on this list.

And why is that? It's because the Employee Retention Tax Credit was, again, part of the CARES Act, and it is a refundable credit for employers. And if you're eligible to claim it, it provides tremendous economic benefits. But what we have seen is that many employers claimed it who weren't eligible, and many promoters were out in the market selling their services to employers saying that, "We will do an analysis of whether you're eligible, for a fee of course, and then you can use that eligibility analysis to file amended employment tax returns and claim the credit."

So, I think we're just scratching the surface on fraud related to that particular credit, and we're going to hear a whole lot more about that in the years to come. And the promoters that have been marketing and selling in the ERC to perhaps unsuspecting employers.

Adams: Yeah, and when you round out this Dirty Dozen list of four categorized as pandemic-related scams, you can't help but think that the remainder-- other than these economic impact payment and tax refund scams-- the remainder all really do revolve around unemployment fraud, employment offers being posted on social media that are fake and charities that might be fake and giving taxpayers fake deductions thereby.

The reality of this is that anytime you're talking about payments to either employees or independent contractors, there's a significant tax consequence about how that payment is both recorded and structured, isn't there?

Lee: Well, for sure. And you're talking about the age- old distinction between independent contractors and salaried W2 employees, of course, are subject to withholding.

The employer and the employee have withholding obligations. Taxes are paid over. In the case of an independent contrary, that's not the case. Independent contractor gets the gross amount of whatever the compensation is. It's reported on a 1099. And it's the independent contractor then who has the duty to report that on his or her tax return and pay the associated tax.

So, sure, that's nothing new. The IRS oftentimes fights that battle with employers of whether someone should be properly classified as an independent contractor or an employee, and that battle has been raging for a long time and will continue to in the future.

Adams: The next list or series of Dirty Dozen tax scams that the IRS has published involves what they call OIC or Offer In Compromise Mills. What's that all about, Matt?

Lee: Yeah. So, this next set of entries into the Dirty Dozen really revolve around, again you could call 'em promoters essentially, but they're third parties that are offering services to taxpayers to help them deal with taxes they owe, back taxes.

So, an OIC is an offer in compromise. It is a very traditional and well recognized, totally legal way to work out an arrangement with the IRS. If you owe back taxes, an Offer In Compromise is actually a very valuable tool for many taxpayers to come back into compliance. And it allows you to offer to pay the IRS some amount less than the full amount you owe.

Essentially, you can pay the IRS cents on the proverbial dollar. And in exchange, if the IRS accepts your offer, the IRS will accept your partial payment in full satisfaction of all your debts. So, many, many taxpayers use OICs, individuals and businesses, and the IRS is glad to accept them.

Where you can run into trouble is with what the IRS is referring to in this Dirty Dozen list as OIC mills. These are unscrupulous firms that make wild promises. You can see these sometimes on TV or hear them on the radio. They make wild promises that they can handle anyone's tax debts. They can settle your tax liabilities with the IRS. Oftentimes, they make ridiculous guarantees of success.

That's why these companies, these firms, are referred to as OIC mills. They're unscrupulous. They make promises to taxpayers for a fee. They don't deliver. And they're really frauds. It's really a word to the wise that taxpayers who are looking to negotiate some sort of tax resolution with the IRS really need to be careful about who they use, what professional firm they hire, to help them do that. There are plenty of very reputable accounting firms, law firms, that do this work and do it well.

But there are also plenty of unscrupulous ones that will steal your money and not ever deliver on the wild promises that they make to you. So, it's buyer beware.

Adams: Yeah, and I've seen the term used "ghost preparer," meaning that if somebody is offering to prepare a tax return or any document that's going to be submitted under penalty of perjury, there's a method by which that preparer can sign the return and attest to its accuracy because they are licensed to do so. But I've seen this phenomenon, I think develop, Matt, with increasing frequency. And I guess I've seen it going back to the ERC context, where these preparers are saying, "We'll do your quote unquote calculation, but we won't sign the return that attests to its veracity. And oh, by the way, we're going to make you sign this draconian multi-page contract that disclaims all liability for everything that goes into that filed return. Because, essentially, they're acknowledging that they don't want that level of responsibility.

Isn't that a red flag unto itself? If a preparer is suggesting that they can provide you this sort of "secret sauce" for maximizing either a tax credit or a tax return and then not be willing to sign it?

Lee: It's a huge red flag. And anyone who's in that situation, anyone who's dealing with someone who's prepared a tax return and then refuses to sign it, you should walk away. Because that is a huge red flag. The law is actually very clear in this area that if you pay someone to prepare your income tax return, that person has to not only sign the return, essentially put their name on the tax return, saying, I, Matt Lee or Matt Adams, prepared this tax return, so the IRS knows who prepared it. But they also have to have a unique identifier, it's called a PTIN, stands for preparer tax identification number, they have to have that PTIN and they have to put that on their return as well, and it's a way for the IRS to keep track of who's preparing tax returns.

Any legitimate preparer is going to say, "Of course, I'll sign your return. Of course, I'll put my name on your return. Of course, I'll put my PTIN on your return. That's what the law requires." It's when someone says they won't do that, or they say they can't do that, or they don't have a PTIN and therefore they don't want to put their name down 'cause they'll get into trouble. Those are all huge red flags, and that is not somebody that you should be doing business with and is not somebody that should be preparing federal income tax returns.

Adams: Yeah. And that, that extends to 941s for employment tax as well, because they are so intricately linked in the environment that we're coming out of here with the pandemic to these refundable tax credits. I know for a fact there are shops out there that have advertised all over the place, and unsuspecting companies have availed themselves to their service, because their offer is almost too good to be true. It's, you can maximize your ERC credit for example, by we have this secret proprietary formula that does the calculation.

There's no secret or nothing proprietary to the formula to maximize some of these credit programs. It's prescribed by Congress. And frankly, the first red flag that should have you running for the hills, in my view, is these preparers who want nothing to do with what ultimately gets submitted to the government. If they're not willing to put some skin in the game and put the risk of their professional license and malpractice carrier in connection with the submittal, then you shouldn't be making it either.

The next set of scams that makes the Dirty Dozen list this year, which is a repeat once again from what we saw last year, is scams aimed at stealing personal identities and financial information. I know, for example, when you read the local police blotter in the community where I live, which is a very low crime area, time and time again examples of these types of identity theft scams.

Why does the IRS get involved in these, Matt? I would beg to say that from my vantage point, I've probably, in just the last month seen like 10 or 15 of these in just the local community, greater area, regional area where I live, be reported in sort of a high-profile way. Because local authorities are trying to put this on people's radar that there's really an uptick in these types of scams. But how does the IRS's mission and jurisdiction come into play when it comes to these types of scams?

Lee: So, these scams, Matt, you said it, these are not new. These phishing scams have been on the IRS Dirty Dozen list for years. So, this is nothing new.

What I think is new though, what I know is new, is that the fraudsters that are running these schemes have gotten a lot more sophisticated. But what are they trying to accomplish? It's actually pretty simple, I think. What they're trying to accomplish is to trick you, either by sending you a text message or an email, or making a phone call to you. They're trying to trick you into revealing your personal information, most notably your Social Security number. That's really the game here. The fraudsters want your Social Security number. Once they have your Social Security number, they can do a lot of things with it.

But in the tax context, what they can do is file a tax return. And we see this time and time again. I mean this type of identity theft has been going on for years. The IRS has, I think, gotten much better at combating identity theft. But it's ultimately pretty simple. If someone has your Social Security number, they can prepare a bogus tax return that shows a large refund is due, and then they file that return.

And of course, they use a different address. They don't use your own home address. They use a different address. The IRS gets the tax return, processes the return. Sees you're entitled to a refund, instructs the Treasury Department to cut a check. Check goes in an envelope with the address of the fraudster on it, and the check goes out into the mail.

The fraudster gets the check, cashes it, and then the fraudster is in the wind and never heard from again. This is very common, very common, and probably everyone that's listening knows someone who's been the victim of identity theft or has had a tax return filed on their behalf without their permission. Or it's happened to themselves because it is so common.

But that's why this is a tax issue because this type of personal information, primarily the Social Security number, can be used on a tax return to get money out of the Treasury.

Adams: Yeah, just like creating an alternative identity with that basic set of identity features.

The next scam that the IRS reports is related, but takes it from the individual to institutional and it's really these types of IT infrastructure attacks.

They call them spear phishing, and it's a play on words, certainly, but at its core, what role does the infiltration of IT systems have to play in the IRS's mission?

Lee: Again, the goal is the same. It's to get personal identifying information about individuals, including their Social Security numbers.

So, you think about a law firm like ours or an accounting firm, a hospital, a bank. All of these organizations have tremendous amounts of personal information. Highly confidential, highly sensitive information. And these spear phishing arrangements, these scams that the IRS is describing, are what they refer to is oftentimes highly sophisticated attempts by fraudsters to get into the IT infrastructure of an organization like a bank or a hospital.

Once they get in, they can then move around inside on the servers and get at the information they're looking at: Names, addresses, dates of birth, Social Security numbers.

Adams: It's a bigger trove. It's a bigger treasure for that fraudster, then.

Lee: It absolutely is. We were talking earlier about going after one person's Social Security number. Here, we're talking about thousands of Social Security numbers or hundreds of thousands of Social Security numbers. It is a much bigger trove. It's a lot more valuable. And it's why law firms like ours and accounting firms and banks and health care institutions have to have such stringent security measures to prevent this from happening. Because these fraudsters, many of whom are operating abroad, they're not in the United States, but they're launching sophisticated cyber-attacks against these organizations to get that information, to get at that treasure trove of secret sensitive, confidential, personal information.

And once they have it, it's incredibly valuable. And obviously once it's out, if it gets out, it's hard to get it back.

Adams: Yeah, for sure, once that genie is out of the bottle, it's usually gone forever. And probably the reason why the federal government at all levels and through all of its agencies, the IRS included, has placed such an emphasis on the cyber threat.

To wrap up the 2022 Dirty Dozen scams list, the IRS outlined what it called its tax avoidance strategies. I think the moniker given to this final list of avoidance strategies clearly it gives away what the ultimate objective is for these illegal schemes. But Matt, tell us a little bit about the difference, the age-old difference between tax avoidance and tax evasion.

Lee: Yeah, good question. So, tax avoidance is not illegal. Tax avoidance is arranging your financial affairs in such a way to minimize the amount of tax you have to pay.

And I guess it's a thin line between tax avoidance and tax evasion. But avoidance is the legal way to do it. You do it within the bounds of the law. You arrange your affairs in such a way to minimize your tax, and we see that happen all the time in the United States with large corporations. They have teams of lawyers and accountants advising them on the best way to minimize their tax liability at the end of the year within the bounds of the Internal Revenue Code.

Tax evasion on the other hand is when you cross the line, and the hallmark of tax of evasion is intent. Like any criminal activity, intent is critical. You've got to prove that someone intended to break the law. It wasn't negligence. It wasn't a mistake. But rather, it was intentional evasion of your tax-paying obligations.

And that's really the difference between when the IRS decides that it's going to conduct a civil audit of someone versus a criminal investigation: It comes down to intent.

And this last list of items on the Dirty Dozen list for 2022, often these are the criminal arrangements, where there is oftentimes intent., and that the IRS has the ability and oftentimes, not always, but oftentimes in these arrangements to make a criminal case out of taxpayer participation in one of these arrangements.

Adams: Yeah, and the traditional, I think, tax evasion scheme was the use of foreign accounts to conceal assets. The way that assets are concealed offshore has really morphed, hasn't it, Matt? Because of stepped-up law enforcement and enhanced international cooperation with nations like Switzerland that had historically been a tax haven. Hasn't a lot of that clamped down such that people who are looking to-- and promoters who are looking to promote --an offshore tax evasion strategy are looking to new technologies like crypto. Isn't that really what's happening at this point?

Lee: Yeah, that's exactly right. The days of having a numbered Swiss bank account to hide your ill-gotten gains or your business profits or whatever you want to hide those days are over. They're long since over.

It's a lot harder, I would say almost perhaps impossible, to hide money in an offshore bank account these days because the traditional tax havens like Switzerland and other countries, they've decided that it's not worth being international pariahs. They want to be part of international economies, and they've changed their laws and they've cracked down internally.

So, you can't really have a secret Swiss bank account anymore. Now, there are certainly places in the world where you can go and have a secret bank account, but those places are few and far between and they're nowhere near what they used to be. So, the age of having an offshore bank account that you could take comfort in knowing that the IRS would never find out about it, it simply doesn't exist.

That just doesn't exist. We're in an era of tax transparency, and by that, countries are exchanging information about taxes on a routine basis, Switzerland's providing information to the United States. The United States is providing information to lots of other countries. It's very hard now to hide your money in a traditional bank account.

And you're right, so what has that done? It means that if you really are in the business of trying to hide your assets, what we're seeing is that people that are so inclined to do that are exploring new technologies, and that's really primarily cryptocurrency. That's the new frontier I think that the IRS is trying to tackle. And I think the jury's out on how well the IRS is doing on cracking down on tax evasion by those that are using cryptocurrency. But the IRS has put a lot of resources into this. The IRS has invested in technology to try to uncover who are the real persons behind cryptocurrency investments.

It's a work in progress. But it's something that, when you hear the IRS enforcement personnel talk at conferences and seminars, they never failed to mention cryptocurrency as an area of great, great focus for law enforcement, particularly at the IRS.

Adams: Yeah, it always fascinates me, and I think this goes hand in glove with the government's effort to try to thwart cyber threats, that cryptocurrencies are built off of blockchain, which is supposed to be the most bonafide of blockchain as a viable technology are that you can trace it and track it back through the chain. But the government has to stay up with that technology in order to do so, and I think you've captured properly the struggle as the crypto wallet has really replaced the Swiss bank account as an effort in concealing offshore assets for purposes of evading tax.

There's the obvious that's in this final portion of the Dirty Dozen list about high income individuals who don't file tax returns. The legion of famous folks from Hollywood and professional sports that just brazenly don't file. That's sort of the obvious.

Perhaps less so is another item on this last list of tax evasion strategies, the syndicated conservation easement. And I know that this one's been hanging out on the Dirty Dozen for a couple of years now. But once again, Matt, explain to us what that is.

Lee: Yeah, this one's a little complicated and as you say, not new to the Dirty Dozen. But I would say that the media attention around conservation easements has really ticked upward in the last year.

And why is that? It is because, I think, the IRS has really gone public in talking about how these transactions can be abusive. They can be criminal in certain circumstances. And we have seen the first handful of criminal cases have been announced publicly against promoters.

Back to the promoters that we've talked about throughout this podcast: accountants, appraisers and other professionals. There's been a handful of criminal charges and a couple of guilty pleas already, and I think there'll be a whole lot more. So that's why we're seeing a lot more attention around conservation easements.

So, what are we talking about here, though? Again, complicated transaction, but let me try to simplify it. Essentially, what these transactions are, you start with a large piece of real estate. Oftentimes undeveloped, valuable, undeveloped land. If the owner of the property donates a portion of that property to a 501(c)(3) nonprofit organization who is going to conserve that property, i.e., not develop it, you can get a charitable contribution from, essentially, it's a charitable contribution to a 501(c)(3). These charitable contributions actually can be quite valuable if you're talking about donating large tracts of land.

They're not illegal. Congress has expressly made clear in the Internal Revenue Code that this type of land donation to a 501(c)(3) conservancy organization is legal, and you can claim a charitable contribution for doing that on your tax return.

Where we see trouble arise is around the valuation of the property that's donated. And what the IRS and the Justice Department are laser-like focused on is the valuation of these donations and whether they have been artificially inflated. And the IRS has been quite clear that in some, not all, but in some or many of these transactions, the appraisers and appraisals are artificially inflated two, three, four times to provide an artificially high charitable contribution, which in turn provides tremendous tax benefits.

The IRS has gone after this particular type of transaction in two ways, and it goes back to what we said a moment ago. Again, very traditional approach. The IRS has opened civil audits of many taxpayers who claim the contribution. Those are typically being handled civilly. You know where at the end of the day you're going to pay back taxes, interest and penalties.

It's the promoters, and in this case it's often accountants and it's the appraisers themselves in some instances, who are the subjects of criminal investigations. And as I said, so far we've seen a couple of criminal cases filed. There's a lot of pending criminal investigations. I expect to see a whole lot more in the next year.

And there's also literally hundreds of these cases that are pending in the United States Tax Court. Now that's civil litigation, not criminal. But there are hundreds of these cases that are currently being litigated, and the IRS has had pretty good success. They're not winning every case, but they're winning a lot of these cases.

So, this is an area where there's a tremendous amount of resources that have been devoted at the IRS level, and there's no sign of this letting up anytime soon.

Adams: Is that a regional phenomenon, Matt? Is this in areas where there's lots of vast open space that can be donated in the manner that you've discussed? Or is that happening in New York City, for example?

Lee: Yeah, no, good question. It really is geographically limited, where I think the vast majority of these transactions took place is in the southeastern part of the United States, and that's where the investigations really seem to be focused.

You're talking about the Carolinas, Georgia, Florida, that's where we're talking about. And it makes sense because you've got to start with a large piece of valuable, undeveloped real estate, hundreds of acres, if not thousands of acres. And then you donate a portion of that, often hundreds of acres that gets donated to a charitable organization.

So yeah, this is not taking place in Manhattan, for example.

Adams: Exactly.

Lee: There's not enough land there to make it valuable.

Adams: I've seen it out West as well, and I suppose that the government will get its feet under them at the civil phase. And then if they're successful there, I think they might start to bring more of these criminal cases.

I know that our firm in particular is very active as it relates to civil litigation that has spun off from this arrangement. And I can just think that it's only going to be a matter of time before the government has scratched the surface to its satisfaction and decides to move further into the more nefarious schemes and begin bringing criminal charges.

Lee: Yeah, I think that's right. And one of the things just to mention about the statute of limitations: At least civilly, if there's fraud involved, the IRS has no statute of limitations for a civil audit. If the IRS can establish fraud, and in many of these transactions, that's not that difficult to establish, so the IRS at least civilly, not criminally, but at least civilly, the IRS has unlimited time to go after participants in these transactions for civil liability taxes and penalties.

Adams: So, let's just make our final hard pivot away from conservation easements, because I think we could probably sit here and talk all day about them. They're pretty fascinating in the way that the valuation in particular gets litigated.

But let's just talk about the last of these schemes that the IRS has highlighted as an enforcement priority, and that's the abusive micro captive insurance arrangement. What's that, Matt?

Lee: This is not new. This is a tax shelter, abusive arrangement, whatever you want to call it, that has been on the Dirty Dozen list for many years, so nothing new here.

Essentially this is an insurance transaction or an insurance investment that the IRS says is phony. It's not real. Again, these are pretty complicated, but to try to simplify things, you're a business owner. You can invest in what is called a micro captive insurance company that will provide you insurance for your business.

The tax benefit is that the business can claim a deduction on its tax return for the value of the premiums that it pays for insurance. All of that is legit. It's consistent with the Internal Revenue Code. Nothing wrong with that as long as it's real insurance.

What the IRS is focused on in these micro captive arrangements is that this is really not insurance. These are not real insurance companies. They're not really insuring legitimate risks that a business might face. It's just a phony way to claim a deduction for insurance premiums for something that really isn't insurance.

And so, when the IRS looks at these types of arrangements, that's what they look at. Does this really look like an insurance arrangement? Is this really a legitimate insurance company? Is it ensuring risks that this business actually could face in the operation of its businesses or are the risks that are being insured so remote that you would never have a claim and therefore never submit a claim to reimburse for this insurance?

That's what the focus is here. This is primarily a civil issue. The enforcement activity we see by the IRS is focused on civil audits of businesses that have entered into these micro captive arrangements and have claimed deductions on their tax returns for insurance premiums, as well as investigations of the promoters that are selling these micro captive insurance arrangements.

But really, for the most part, while the IRS has been focused on this for a long time, this is really primarily a civil issue and not a criminal issue, but still one that the IRS has put a lot of resources into on the civil side.

Adams: Matt, that's all the time that we have, and we've made it through the 2022 Dirty Dozen list.

A lot of repeats. Some newly emerging threats, at least if you take the IRS's word for it. And since they're the ones dedicating their resources to enforcement here, we'll have to do so.

As we look towards what might come in the 2023 list, when we engage in the third installment of this very podcast on this very subject, I can't help but think we're going to get a renewed emphasis on that ERTC and some other pandemic-related matters.

What in 30 seconds or less that we have here remaining today, can you think of that might come to bear in the next installment?

Lee: Yeah, I don't have any sort of new things that I can think of that will show up on next year's list. I do think there will be a continued focus on pandemic-related fraud and in particular, what you just mentioned, the Employee Retention Credit.

I think all of these will continue, all the ones that are on the list will continue to be of interest. But, you know we'll just have to see. I mean, a lot of this depends on, where do the fraudsters turn when one particular tax shelter gets shut down? They pop up somewhere else with a different idea.

And that's what is always the hurdle that investigators have to confront is, what is the next micro captive insurance fraud issue, or what's the next conservation easement? That remains to be seen? And we'll look forward to talking about all of this, and probably some new stuff a year from now.

Adams: That's all the time we have for today on "The Presumption of Innocence." Until next time, I'm Matt Adams, and it's been great. Thank you for joining us.