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

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR ASSISTANT CHIEF COUNSEL (CRIMINAL TAX)

FROM: Gary D. Gray
Assistant Chief Counsel (General Litigation)

SUBJECT: Application of Section 7602(c) to Questionable Refund Detection Teams

This memorandum responds to your March 17, 2000, memorandum requesting our advice on whether and to what extent section 7602(c) applies to third-party contacts made by Service employees who work in each Service Center's Questionable Refund Detection Team (QRDT). For the reasons given below, we conclude that third-party contacts made by the QRDT are not subject to section 7602(c). We caution, however, that this conclusion—as for almost all section 7602(c) questions—is highly sensitive to the specific facts presented. Therefore, our conclusion may be affected to the extent that our understanding of the facts is incorrect or incomplete in any respect.

Background Facts

Our understanding of the facts of what the QRDT does and how it operates derives from the March 13, 2000, memo from Johnny C. Rose to your office regarding "Legal Opinion on Third-Party Contacts," from our meeting on April 17, 2000, with you, Brian Townsend, Gary Bell, John Fowler, and Dennis Crawford, and from our review of material provided by Gary Bell.

Based on these sources, we understand that each QRDT is made up of employees working under the supervision of a special agent in charge of each Service Center's Criminal Investigation Branch (CIB). Although the number of employees working on each QRDT varies during the year—more work on the team during the filing season than otherwise—each employee who works on the QRDT is a full-time employee of CIB at all times during his or her employment with the Service. Currently, only CIB employees are allowed to work on each QRDT, unlike past practice where employees from other Service Center functions worked on each QRDT during the filing season.

We understand that the mission of the QRDT is to identify and investigate potential crimes committed by taxpayers who may be attempting to defraud the United States by making false claims for refunds of taxes. The teams review approximately 5.5 to 6 million returns each year, searching for fraudulent refund claims. The team attempts to identify and prevent erroneous refunds from being issued and tries to do so without delaying legitimate refunds. The number and variety of fraudulent refund schemes makes it impossible to detect such schemes without making some third-party inquiries to determine the validity of the claimed earnings and withholdings, to determine the true identity of an individual who has submitted potentially false returns and to verify the legitimacy of addresses used by individuals suspected of falsely claiming refunds. We understand that such inquiries are made regarding approximately 70,000 to 100,000 of the returns reviewed each year. Because of the high volume of returns reviewed and the short time frames with which the QRDT operates, once the team identifies a false return, it refers the case to the local Criminal Investigative District (CID) where a special agent investigates the case for its criminal prosecution potential. We understand that approximately 2,000 to 3,000 such referrals are made per year.

Analysis

Section 7602(c)(1) requires that before any Service employee contacts any person other than the taxpayer with respect to the determination or collection of the taxpayer's tax liabilities, the Service must notify the taxpayer that third parties may be contacted. Section 7602(c)(2) requires the Service to keep a list of third parties contacted and to provide that list to taxpayers periodically and upon taxpayer request. Section 7602(c)(3)(B) exempts from these requirements any contacts made "with respect to a pending criminal investigation."

As we have noted many times before, in enacting this statute Congress attempted to balance the privacy and reputational interests of taxpayers, the privacy interests of third parties, and the tax administration responsibilities of the Service. Specifically, Congress was concerned that third-party contacts "may have a chilling effect on the taxpayer's business and could damage the taxpayer's reputation in the community," and that taxpayers "should have the opportunity to resolve issues and volunteer information before the IRS contacts third parties." S. Rep. No. 105-174, at 77 (1998).

The fact that Congress chose to exempt pending criminal investigations from the statute demonstrates the Congressional conclusion that the importance of identifying and prosecuting tax crimes outweighs the privacy and reputational interest of taxpayers.

Turning to the specific language of the exception, the term "criminal investigation" assumes that the Service conducts discrete investigations to detect criminal activity and that criminal investigations can be distinguished from civil ones. The term "pending" assumes that a discrete criminal investigation had been opened and is ongoing. Neither assumption is completely accurate. As has been amply discussed by the courts and commentators, there is no inherently "criminal" activity to detect. Under the Code the exact same behavior may give rise to either civil or criminal liability. For example, the failure to account for or pay over trust fund taxes may lead to either a civil penalty under section 6672, or a criminal conviction under sections 7201 or 7202. Exactly the same predicate acts may result in the civil penalty or the criminal prosecution. Since any and all acts of noncompliance may or may not be criminal, it has historically been difficult to label any pending investigation as being "civil" or "criminal" and it can fairly be said that rarely are investigations solely criminal in nature before the matter has been referred to the Department of Justice for criminal prosecution. See generally United States v. LaSalle National Bank, 437 U.S. 298, 316-317 (1978).

For these reasons, we do not interpret "pending criminal investigation" as meaning an investigation whose sole purpose is to uncover criminal activity. Instead, we interpret the phrase to include those investigations where the Service as an institution focuses more on the criminal prosecution potential of a case than on the simple determination of how much tax the taxpayer owes. This shift in focus typically occurs when the Service opens a formal, numbered investigation on a taxpayer and assigns the investigation to an employee whose primary function is to identify and investigate the criminal prosecution potential of cases.

To leave the definition there, however, creates a problem. Criminal investigators may contact third parties not only as part of an investigation but also as part of the process of deciding whether to open an investigation against a taxpayer. That is, sometimes CI opens an investigation against a class of taxpayers—called a General Investigation (GI)—all or some or none of whom may ever become the subject of a formal numbered investigation. So long as the criminal investigator is contacting third parties without disclosing the identity of any particular taxpayer, then the statute does not apply because there can be no reputational harm in such contacts. Likewise, once a taxpayer is identified and placed under a formal numbered investigation, then it can fairly be said that the taxpayer is under a pending criminal investigation and so the statute does not apply. However, between the time the criminal investigator isolates identified individuals from the general class being investigated and the time a formal numbered investigation is opened, the investigator may need to contact third parties as part of the process of deciding whether to open a formal criminal investigation or whether to refer the taxpayer to another function. Requiring the criminal investigator to disclose this activity to the taxpayer would defeat the purpose of the criminal investigation

exception. Therefore, we interpret the term "investigation" to include "inquiries" made by a criminal investigator to decide whether to open a formal numbered criminal investigation of an identified individual.

Applying this analysis to the QRDT activities, we conclude that third-party contacts made by the teams are not subject to section 7602(c). Various automatic and manual fraud filters are used to select approximately 5.5 to 6 million returns per year for review. Of this, some 70,000 to 100,000 require third-party contacts to determine whether there is a basis for a more extensive investigation to decide whether to recommend the offense be prosecuted. If a fraud scheme is detected and the scheme meets certain criteria, it is referred to the Criminal Investigation Division of the district and that office opens a formal numbered investigation against the individuals identified. It would defeat the purpose of section 7602(c)'s criminal investigation exception if the QRDT had to notify the 70,000 to 100,000 taxpayers that third parties were being contacted about a potential fraudulent refund scheme investigation.

If you have any questions or comments, please do not hesitate to call Bryan T. Camp of this office at 202-622-3835.