



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

OFFICE OF  
CHIEF COUNSEL

JUL - 6 2000

CC:EL:CT-112385-00  
KDavidson/MFKlotz

MEMORANDUM FOR CHIEF, CRIMINAL INVESTIGATION  
(Attn: Mary Ann O'Donnell)

FROM: Nancy J. Jardini   
Acting Division Counsel/Associate Chief Counsel (Criminal Tax)

SUBJECT: Financial Audits and Reports Required By 26 U.S.C.  
§§ 7608(c)(4)(A) and (B)

The purpose of this memorandum is to respond to your request for guidance concerning which undercover investigative operations are subject to financial audits pursuant to 26 U.S.C. §§ 7608(c)(4)(A) and (B).

#### Background and Discussion

It is well established that undercover is a legitimate law enforcement device. See, Grimm v. United States, 156 U.S. 604 (1895) and Andrews v. United States, 162 U.S. 420 (1896). In United States v. Little, 753 F.2d 1420, 1436 (9<sup>th</sup> Cir. 1984), the Ninth Circuit set forth a statutory road map concluding the Service is authorized to conduct undercover operations. See also, Jones v. Berry, 722 F.2d 443 (9<sup>th</sup> Cir. 1983) and United States v. Walker, 760 F.2d 144, 147 (7<sup>th</sup> Cir. 1985). Adding to these judicial pronouncements is 26 U.S.C. § 7608(c), "Rules relating to undercover operations," which is legislative evidence of Congress' intent to permit the Service to use undercover as an investigatory tool. For purposes of this memorandum it is significant to mention that Criminal Investigation ("CI") special agents are financial investigators and, therefore, their undercover operations involve the use of appropriated and third party funds.

In regard to the use of funds in CI's undercover operations, CI is subject to the provisions of the Prompt Deposit Act, 31 U.S.C. § 3302. Under the Prompt Deposit Act CI is prohibited from lending, using, depositing, or exchanging "public money,"

PMTA : 00379

and must deposit the public money in the Treasury within three days of receipt. CI is also subject to the provisions of 18 U.S.C. § 648 which criminalizes the loaning, use, conversion, or exchange of public money.

As applied to undercover operations in general, these provisions prevent the use of profits received in an undercover operation, above and beyond original appropriations, to offset expenses, a procedure which is commonly referred to as "churning." Rather, these profits must be immediately deposited into Treasury.<sup>1</sup> Notwithstanding the mandate of the Prompt Deposit Act, the Comptroller General issued an opinion dated March 23, 1988, which stated "short term" operations might be considered single transactions for purposes of the Prompt Deposit Act's deposit requirement.<sup>2</sup> Thus, prior to the enactment of § 7608(c)(1), CI could use profits made in short term operations to offset expenses incurred in those operations and deposit the balance of the profits at the conclusion of the operation. The Comptroller General's opinion specifically mentioned gambling and short term money exchange operations as examples of "short term" operations, but also stated, "we do not think it prudent to set forth more specific guidelines on what operations would and would not conform with section 3302. We leave that to the administrative discretion of the IRS."<sup>3</sup> More distinctly these short term operations may be thought of as multiple transactions within an actual operation but without § 7608(c)(1), the profits would have to be deposited at the end of each gambling session, money exchange or similar transaction.

On November 18, 1988, the Anti-Drug Abuse Act of 1988<sup>4</sup> was approved. This act amended 26 U.S.C. § 7608 to include a new subsection, § 7608(c). The first part of this amendment is § 7608(c)(1) which provided:

(1) CERTIFICATION REQUIRED FOR EXEMPTION OF UNDERCOVER OPERATIONS FROM CERTAIN LAWS.—With respect to any undercover operation of the Internal Revenue Service ...

---

<sup>1</sup>See, 67 Comp. Gen. 647, 649 (1960); see also, 5 Comp. Gen. 289, 290 (1925) (money used to purchase evidence of violations of the narcotics and prohibition acts had to be deposited as miscellaneous receipts after serving its purpose as evidence).

<sup>2</sup>See 67 Comp. Gen. 353 (1988).

<sup>3</sup>*Id.* at 356.

<sup>4</sup>P.L. 100-690 § 7601(c)(2).

(A) sums authorized to be appropriated for the Service may be used—

...

(ii) to establish or to acquire proprietary corporations or business entities as part of the undercover operation, and to operate such corporations or business entities on a commercial basis, without regard to sections 9102 and 9103 of title 31, United States Code;

(B) sums authorized to be appropriated for the Service and the proceeds from the undercover operations, may be deposited in banks or other financial institutions without regard to the provisions of section 648 of title 18, United States Code, and section 3302 of title 31, United States Code, and

(C) the proceeds from the undercover operation may be used to offset necessary and reasonable expenses incurred in such operation without regard to the provisions of section 3302 of title 31, United States Code.<sup>5</sup> Emphasis added.

In essence, this section granted churning authority to CI and enabled CI to deposit appropriated funds and proceeds into banks and other financial institutions as well as permitting the establishment or acquisition of corporations or business entities without regard to 31 U.S.C. §§ 3302 and 9102, respectively. In regard to 31 U.S.C. § 9102, this provision prohibits government agencies from establishing or acquiring corporations to act as agencies without a specific law or act of Congress but this provision says nothing about establishing or acquiring business entities.

Section 7608(c)(3) compliments and completes § 7608(c)(1) by requiring CI, after using the proceeds of undercover operations to offset expenses, to deposit the balance of the proceeds into the Treasury at the conclusion of those undercover operations. Thus, the Anti-Drug Abuse Act of 1988's amendments to § 7608 exempted CI from the Prompt Deposit Act's deposit requirement and from criminality for misuse of funds as provided by 18 U.S.C. § 648 and allowed CI to churn funds and deposit the balance of the proceeds only at the conclusion of the operation.

---

<sup>5</sup>1.R.C. § 7608(c)(1), *emphasis added*.

The Anti-Drug Abuse Act of 1988 also added § 7608(c)(4) which provided:

**(4) AUDITS.--**

**(A) The Service shall conduct a detailed financial audit of each undercover investigative operation which is closed in each fiscal year; and**

**(i) submit the results of the audit in writing to the Secretary; and**

**(ii) not later than 180 days after such undercover operation is closed, submit a report to Congress concerning such audit.**

**(B) The Service shall also submit a report annually to Congress specifying as to its undercover investigative operations--**

**(i) the number, by programs, of undercover investigative operations pending as of the end of the 1-year period for which such report is submitted;**

**(ii) the number, by programs, of undercover investigative operations commenced in the 1-year period preceding the period for which such report is submitted; and**

**(iii) the number, by programs, of undercover investigative operations closed in the 1-year period preceding the period for which such report is submitted and, with respect to each such closed undercover operation, the results obtained and any civil claims made with respect thereto.<sup>6</sup>**

In addition, § 7608(c)(5) explained § 7608(c)(4) by defining "undercover investigative operation." Section 7608(c)(5) provided:

---

<sup>6</sup>I.R.C. § 7608(c)(4).

**(5) DEFINITIONS.**—For purposes of paragraph (4)—

...  
**(C) UNDERCOVER INVESTIGATIVE OPERATION.**—The terms “undercover investigative operation” and “undercover operation” mean any undercover investigative operation of the Service—

**(i) in which—**

**(I) the gross receipts (excluding interested [sic] earned) exceed \$50,000; or**

**(II) expenditures, both recoverable and nonrecoverable (other than expenditures for salaries of employees ), exceed \$150,000; and**

**(ii) which is exempt from section 3302 or 9102 of title 3 [sic], United States Code.**

Clauses (i) and (ii) shall not apply with respect to the report required under subparagraph (B) of paragraph (4).

Thus, the Anti-Drug Abuse Act of 1988's amendments to § 7608 mandated CI to audit and to submit reports on all undercover investigative operations relying on § 7608(c)(1)'s exemption from the Prompt Deposit Act's prohibition against churning where either gross receipts exceeded \$50,000 or expenditures exceeded \$150,000.<sup>7</sup>

For purposes of complying with the financial audit requirements of § 7608(c)(4)(A), in October, 1996, the Assistant Commissioner (Criminal Investigation) and the Assistant Chief Inspector (Internal Audit) entered into a Memorandum Of Understanding (“MOU”). This MOU remained in effect until November, 1998, when it was revoked by the Chief Inspector (Internal Audit) as a result of the Restructuring and Reform Act of 1998 which eliminated the Office of the Chief Inspector and created the new Office of the Treasury Inspector General for Tax Administration (“TIGTA”). Negotiations to create a new MOU for the purpose of auditing the undercover investigative operations mandated by § 7608(c)(4)(A) have been ongoing with TIGTA but have been unsuccessful and, thus, no audits have been done since the latter part of 1998.

---

<sup>7</sup>I.R.C. § 7608(c)(5).

Historically, the exemption from the Prompt Deposit Act's deposit requirement provided in § 7608(c)(1) by the Anti-Drug Abuse Act of 1988 was given a one year period of applicability which expired on December 31, 1989. The exemption was extended by the Crime Control Act of 1990<sup>8</sup> to December 31, 1991. After the expiration of this period of applicability, the period was not renewed until July 30, 1996 when the Taxpayer Bill of Rights 2<sup>9</sup> extended the period through December 31, 2000.<sup>10</sup>

On July 30, 1996, the Taxpayer Bill of Rights 2 became effective. This act, in addition to renewing the period of applicability of the § 7608(c)(1) exemption from the Prompt Deposit Act's deposit requirements, also amended § 7608(c)(5) to provide:

(5) DEFINITIONS.—For purposes of paragraph (4)—

...  
 (C) UNDERCOVER INVESTIGATIVE OPERATION.—The term “undercover investigative operation” means any undercover investigative operation of the Service; except that, for purposes of subparagraphs (A) and (C) of paragraph (4), such term only includes an operation which is exempt from section 3302 or 9102 of title 31, United States Code.<sup>11</sup>

The apparent significance of this amendment is the removal of the dollar amounts from the definition of undercover investigative operations. This amendment is remarkable in that § 7608(c)(4), which requires CI to audit and report on all undercover investigative operations, does not contain, and has never contained a subparagraph (C) since the Anti-Drug Abuse Act of 1988's November 18, 1988 introduction of § 7608(c).<sup>12</sup> Under these circumstances, it is reasonable to assume the referral to subparagraph (C) was a technical error. Comparing the Taxpayer Bill of Rights 2's amendment to § 7608(c)(5), to the Anti-Drug Abuse Act of 1988's version of § 7608(c)(5), it appears Congress intended only to eliminate the dollar figures which used to trigger § 7608(c)(4)'s audit and reporting requirements, and maintain exemption from 31 U.S.C. §§ 3302 and 9102 as triggers to the audit and reporting requirements.

---

<sup>8</sup>P.L. 191-647 § 3301.

<sup>9</sup>P.L. 104-168 § 1205.

<sup>10</sup>*Id.* at § 1205(b).

<sup>11</sup>*Id.* at § 1205(c)(2).

<sup>12</sup>P.L. 100-690 § 7601; P.L. 101-647 §§ 3301 and 3302; P.L. 101-508 § 11704; and P.L. 104-168 § 1205.

### Conclusion and Recommendations

The use of undercover as a judicially approved investigative tool is well documented in the annals of jurisprudence. See, Grimm v. United States, 156 U.S. 604 (1895) and Andrews v. United States, 162 U.S. 420 (1896). Likewise, undercover has been recognized by courts as an appropriate investigative tool to be used by the Service. See, Jones v. Berry, 722 F.2d 443 (9<sup>th</sup> Cir. 1983), United States v. Little, 753 F.2d 1420, 1436 (9<sup>th</sup> Cir. 1984) and United States v. Walker, 760 F.2d 144, 147 (7<sup>th</sup> Cir. 1985). In addition, Congress has impliedly approved the Service's use of undercover by legislating § 7608(c), which is titled "Rules relating to undercover operations."

Congress granted the Service authority to offset expenses of its undercover operations and to deposit commingled appropriated funds and undercover proceeds in banks and other financial institutions, thus exempting CI from the requirements of 31 U.S.C. § 3302, the Prompt Deposit Act. Congress also authorized the Service to establish or acquire and operate proprietary corporations or business entities without regard to 31 U.S.C. § 9102. This Congressional approval, however, did not come without oversight requirements. To this extent, CI is required by the provisions of § 7608(c)(4)(A) and (B) to conduct detailed financial audits and to submit to Congress reports of each undercover investigative operation which is exempt from the limitations of 31 U.S.C. §§ 3302 and 9102.



DP