

The Use of Forensic Accounting Experts in Tax Cases as Identified in Court Opinions

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INTRODUCTION

Forensic accounting has gained prominence in recent years. When speaking about the fight on terrorism, Chancellor of the Exchequer Gordon Brown (2006), former Prime Minister of the United Kingdom stated, "What the use of fingerprints was to the 19th century, and DNA analysis was to the 20th century, so financial information and forensic accounting has come to be one of today's most powerful investigative and intelligence tools available." Factors that increased the need for forensic accounting emanated from the governments' and banks' efforts to crack down on international money laundering and on tax evasion. There is little existing research in the area of forensic accounting because it is such a new field (McMullen & Sanchez 2010).

This paper takes a comprehensive look at the use of forensic accounting experts in tax litigation based on what judges have written about the experts in their court opinions. The findings extend the insights into this area from experiments and surveys into the empirical domain of case opinions. Understanding how forensic accounting experts have been used in tax litigation in the past will assist taxpayers and their legal counsel when considering whether to engage forensic accounting experts in the future. Identification of the backgrounds and

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credentials that are shared by experts whose testimony was found to be either effective or weak will also be useful. This research will help forensic accountants understand opportunities and risks as well as what judges find to be effective testimony.

Researchers have sought to identify the most important qualifications of forensic accountants in their roles as expert witnesses. An effective forensic accounting expert can have a significant influence on the trier of fact (Rasmussen and Lauanae 2004, 166). From surveys (Champagne et al. 1991; DiGabriele 2008) and experiments (Ponemon 1995; Cohen et al. 1996; Crumbley 2005; Davis et al. 2009) the research to date provides insights into the roles of expert witnesses (Beatty et al. 1999), but does not explore their actual use or the effectiveness of their testimony in tax cases.

The following is an empirical analysis of federal and state tax court opinions from 1982, when the involvement of a forensic accountant as an expert witness was first disclosed, to December 31, 2010. In addition to the frequency of the use of forensic accountants in the different trial venues, this paper analyzes: for whom they performed their services; whether their identities were disclosed; what the primary reason for their involvement was; which kinds of tax and issues were underlying the disputes; what the experts' assignments were; how their performance was appraised; and for which party the case was decided.

The following section first defines forensic accounting and then provides selected results from prior studies that define the role of a forensic accountant. It then reviews the qualifications needed by a forensic accountant to serve as an expert witness. Then there is a review of the *Frye* and *Daubert* standards judges use to determine if the witness is an expert and if the expert testimony is relevant and reliable. It concludes by outlining the roles forensic accountants can

have in a tax dispute. The next sections present the research questions and the research methodology. The final sections of the paper discuss the results and conclusions.

LITERATURE REVIEW

Forensic Accountants' Role

The role of expert witnesses in litigation is to assist the trier of fact in resolving issues in dispute by contributing their specialized knowledge. When litigation revolves around facts that require understanding and application of accounting issues, forensic accountants are able to assist the parties in resolving disputes between taxpayers and revenue authorities. Crumbley *et al.* (2009) define forensic accounting engagements as the specialty practice area that results from actual or anticipated disputes or litigation. They state that forensic means suitable for use in a court of law, where the law is the standard within which forensic accountants generally have to work and give expert evidence at trial. Their detailed definition states that, “*Forensic Accounting* is the action of identifying, recording, settling, extracting, sorting, reporting and verifying past financial data or other accounting activities for settling current or prospective legal disputes or using such past financial data for projecting future financial data to settle legal disputes.”

The American Institute of Certified Public Accountants (AICPA) Business Valuation/Forensic Litigation Services Executive Committee's definition (2006) includes, “...to collect, analyze, and evaluate evidential matter and to interpret and communicate findings, and may involve either an attest or consulting engagement.” Examples of forensic accounting engagements include assistance with business termination, bankruptcy, loss of earnings, accounting for assets, antitrust price fixing, water utility rate disputes, trademark infringement profits, independent contractor or employee determination, breach of contract, business valuations, shareholder disputes, estate distribution among beneficiaries, divorce disputes,

malpractice litigation against CPAs as well as tax-related matters such as tax fraud, various tax assessment disputes and disallowance of exempt status (Telpner & Mostek 2002, 8-10). Prior to 1993, the courts also used the term investigative accountant. For simplicity, throughout this paper the term forensic accountant is used.

Prior Research

Champagne et al. (1991) surveyed jurors, judges, lawyers and experts that participated in civil trials in which expert witnesses testified. They found that most expert witnesses spent a small part of their professional time as witnesses even though many of them frequently testified. The results of the study indicate that lawyers want personable, attractive experts who have integrity, are articulate, have strong credentials, are willing to be coached and draw firm conclusions that support the lawyer's position. The authors conclude that it is therefore unlikely that the most accomplished or the most objective experts in a field are often chosen as witnesses.

Ponemon (1995) examined accountants' objectivity when serving as a litigation specialist and expert witness on legal cases in an experiment. He had 207 usable responses from two accounting firms to an experiment that required respondents to estimate inventory lost in a fire. Of the test subjects, 101 were from litigation support and 106 were in auditing. Ponemon concludes that the accountants in litigation support services are sensitive to the legal positions of the client while neither the auditors' experience nor ethical reasoning levels seem to influence the objectivity of their evidence.

DiGabriele (2008) surveyed accounting academics, forensic accounting practitioners and users of forensic accounting services asking them to rank competency factors for forensic accountants. The competencies needed by forensic accountants based on 252 responses were

ranked from most to least: critical thinking, deductive analysis, investigative flexibility, written communication, oral communication, analytical proficiency, unstructured problem solving, composure, and specific legal knowledge. The AICPA (Davis et al. 2009) sought to identify the essential traits, characteristics and skills in a survey of the same three groups. CPAs provided 77.4% of the 779 responses. In their opinion, the most essential traits and characteristics are to be analytical, inquisitive, detail-oriented, ethical, skeptical and intuitive. They ranked the following as the most important core skills in descending order: critical/strategic thinkers, effective writers and oral communicators, and skilled and intuitive investigators.

While these researchers used surveys or experiments to gain information about forensic accountants, this analysis will explore their actual use in court and the effectiveness assessment of their testimony in tax opinions. The following sections introduce the tests applied by the courts to determine whether expert testimony is admissible. It is important to understand the Frye and Daubert Standards as the judge will apply them to determine if an individual can be considered an expert witness and opposing council can use them to try to disqualify an individual from being called as an expert witness.

The *Frye* Standard

As science advanced in the twentieth century, the legal system began to develop tests for the admissibility of scientific evidence. The landmark District of Columbia Circuit federal case decision in 1923, *Frye v. United States*, considered the admissibility of testimony based on the systolic blood pressure test, a precursor of the modern polygraph. The court announced that a novel scientific technique must have gained general acceptance in the particular field in which it belongs and that it is not enough that a qualified individual expert testifies that a particular technique is valid (Henry 2010, 2).

In 1975, more than a half-century after Frye was decided; the Federal Rules of Evidence (FRE) were promulgated to guide criminal and civil litigation in federal courts. The original FRE Rule 702 allowing expert witness was as follows (Henry 2010, 3):

If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise.

Although some state courts continue to use the Frye standard, after almost 70 years the Frye standard was replaced with a new standard for federal court cases and many state courts.

The *Daubert* Standard

In 1993, the United States Supreme Court decision in *Daubert v. Merrill Dow Pharmaceuticals, Inc.* created a new test, known as the *Daubert* standard, requiring federal court trial judges to ensure that scientific testimony is relevant and reliable (Crumbley 2005, 49). FRE Rule 702 was updated to the following (Federal Rules of Evidence 2009, 14):

If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.

Crumbley (2005, 51) notes that in *Daubert v. Merrill Dow Pharmaceuticals, Inc.* (1993) the United States Supreme Court suggested that the following factors be considered by judges to determine that an expert's testimony is reliable and pertains to the facts: the theory or technique has been tested; the technique has been subjected to peer review; the potential error rate is known; there is widespread acceptance of the theory or technique; and the theory or technique existed before the litigation began. Subsequently, the *Joiner* and *Kumho Tire* cases clarified the application of the *Daubert* standard. Per *General Electric Company et al. v. Joiner et ux*, (1997),

appeals courts may review a trial court judge's admission or rejection of expert testimony for an abuse of discretion. *Kumho Tire Co. v. Carmichael* (1999) established that a judge's basic gate keeping obligation applies to all expert testimony whether it provides scientific, technical or other specialized knowledge. Part of the role of forensic accountants who pass the challenges of admittance as expert witnesses is to ensure that their testimony cannot be challenged. The next section discusses the roles that forensic accountants can play in tax disputes.

Roles Forensic Accountants Can Play in Tax Disputes

Michaelson (2005) notes that forensic accounting experts may be classified into three groups; testifying expert, consulting expert and fact witness. When accountants are called to testify as fact witnesses, they are expected to offer only factual first-hand information, without rendering an opinion. The second role described by Michaelson is that of consulting expert where an accountant may consult on an attorney's work product by formulating strategy, reviewing documents and providing additional support in resolving a case. Consulting experts owe objectivity to the client rather than the trier of fact and may advocate their position on a client's behalf.

The third group is the testifying expert. Michaelson notes that testifying experts generally appear before a trier of fact (a judge and/or jury) to provide an opinion either by deposition or by testimony before the court. They must be able to pass the Daubert standard described above or the Frye standard where it still applies. DiGabriele (2011) points out that these standards create an environment where an expert's opinion should maintain a character of transparent objectivity. Although accountants can serve as consultants to an attorney, those that act as expert witnesses should appear to be independent from the client (Crumbley 2005). The relationship should not lead jurors or judges to question if they are impartial and fair in reaching their conclusions.

The next section introduces the research questions for the study and explains their importance. The following analysis provides insights about the use of forensic accounting experts in tax litigation.

RESEARCH QUESTIONS

Through high-profile cases of fraud schemes and the introduction of professional certifications, forensic accounting has become more prevalent as a profession (Solomon 2008, C16-C19) over the past years. The first professional designation in the field was the Certified Fraud Examiner (CFE) issued by the Association of Certified Fraud Examiners. Other credentials such as the Certified Forensic Accountant (Cr.FA), the Forensic Certified Accountant (FCPA), and the Certified Forensic Financial Analyst (CFFA) as well as a number of international certifications followed. Most recently in 2008, the American Institute of Certified Public Accountants (AICPA) added the Certified in Financial Forensics (CFF) credential to its portfolio of designations. In the same year the AICPA released the results of a survey that indicated acceleration in the demand for CPAs providing forensic accounting services (AICPA 2008).

The following six research questions looked at various aspects of the use of forensic accounting experts in tax cases:

RQ 1: How often have forensic accounting experts been mentioned in tax cases by judges over time and by court venue?

RQ 2: Who presented the forensic accounting experts in the cases and were they identified in the opinions?

RQ3: Was the tax owed the primary motivation for the involvement of a forensic accountant?

RQ4: What were the underlying issues in the tax cases that used forensic accounting experts?

RQ5: What assignments did the forensic accountants perform?

RQ6: Did having an effective forensic accounting expert affect the case outcome?

The next section of the paper presents the research design.

RESEARCH DESIGN

This analysis utilized an archival research methodology that consisted of several steps. The first steps were to search, select and retrieve electronic tax research platforms for tax cases that indicated the involvement of a forensic accountant. The next step entailed a detailed review of each case to identify whether a forensic accounting expert was involved. This resulted in the final case list. The case opinions were then surveyed to extract the information needed to answer the research questions. The selected case data was then analyzed.

The court opinions were retrieved from four specialized tax case databases using the search strings “forensic accountant” and “forensic accounting.” As a sub-set of the services that forensic accountants provide was sometimes referred to as investigative accounting, another targeted search was performed using the terms “investigative accountant” and “investigative accounting.” Each of the databases contains a different collection of cases. The databases used were the Bureau of National Affairs (BNA) Tax and Accounting Center, Commerce Clearing House (CCH) IntelliConnect, RIA ThomsonReuters Checkpoint and Tax Analysts (also TaxAnalysts) Research Libraries. U.S. Tax Court opinions were also retrieved from the court’s official website using the same search strings. The coverage of historical court opinions varies by database. Cases covered in these databases date back as far as the year 1860 (Pratt et al. 2008, 989-990). Reporting of regular decisions of the U.S. Tax Court and its predecessor, the U.S. Board of Tax Appeals, started in 1924. In 2001, the latest addition was the publication of U.S. Tax Court Summary Opinions containing the simplified small case procedures. A master case list was created from the retrieval results. As expert testimony takes place at the trial court level,

appeals court decisions were consolidated with the related trial court opinions. Serial lawsuits that related to the same case were consolidated into one count on the master list.

The data has some limitations. There is no single complete source of all court opinions that have been issued by all U.S. courts over time. While all court decisions were published in the early years, a resolution was passed in 1964 due to the rapidly growing number of issued opinions. Since 1964, the criteria for the publication of a decision at most trial and appeals courts have been either laid out in the rules of the court or deferred to the decisions of judges. The precedential value of an opinion is by far the most prevalent criterion used for court decisions to be published. A case is selected for publication when the opinion is believed to be of precedential value as opposed to a case that simply reiterates established legal principles (Gerken 2004, 478-479).

In addition to the opinions that courts designate for inclusion in the official reporter, editors at commercial publishers select “unpublished” opinions for inclusion in their databases which courts consider to be of lesser precedential value. Although they are in fact published, these opinions are referred to as unpublished. Their citation allows the user to distinguish them from published opinions. Thus, the case collection in each of the tax subject matter research databases includes “published-published” and “published-unpublished” opinions. As a result, the case collection in each database varies. All available opinions were used in this analysis. In all opinions, it is at the judge’s discretion how much information to include about the involvement of an expert in a case. The following section describes the data retrieval process and discusses the findings for each of the six research questions.

RESULTS

Tax Cases Located

The databases were accessed multiple times through December 31, 2010 using the search strings “forensic accountant,” “forensic accounting,” “investigative accountant” and “investigative accounting.” The data retrieval yielded 50 federal tax cases in BNA, 65 cases in CCH, 78 cases in RIA and 69 cases in the Tax Analysts database. No additional cases were identified in the U.S. Tax Court’s database. The gross state tax case results were three cases in BNA, 11 cases in CCH, 28 cases in RIA and five cases in the Tax Analysts Research Library. After elimination of multiple counts and consolidation of appeals court with trial court decisions and serial cases on the same issue, there were 84 federal and 28 state tax cases for a total count of 112 cases on the master list. There were only four opinions that used “investigative accountant or accounting.” This term was not used in cases after 1993.

The net was cast wide by the search strings as expert witnesses are frequently presented in a supporting role that is described in no particular place in a legal opinion. They are rarely mentioned in a case summary or head note. A detailed review of the opinions on the master list led to numerous eliminations because the forensic expert was from a field other than accounting, or because the case had no expert witness. The final list consisted of 30 federal and 10 state tax cases. Due to the limited number of published tax court decisions in which forensic accountants were used, while this paper provides the first comprehensive analysis of the topic, it cannot offer a statistically rigorous assessment of the success factors of forensic accounting experts in tax cases. The analysis of the tax case opinions provided insights to the research questions as discussed in the following sections.

Results of the Analysis

Forensic Accounting Experts Mentioned in Tax Cases by Judges over Time and by Venue (RQ1)

From a chief judge's perspective, the reader of an opinion should first consider whether a case involves expert witnesses (Cohen 2001, 9). The judges determine how much information about a forensic accounting expert is included in the opinions. Although there is no standardized requirement for judges to include certain information about the background, assignment and performance of an expert, potential elements of available information include the expert's name, education, credentials, work experience and deficiencies in an expert's background.

Different courts may hear tax cases. For Federal tax disputes, the choices of trial courts are the U.S. Tax Court, U.S. District Courts, the U.S. Court of Federal Claims, and the U.S. Bankruptcy Courts. The U.S. Court of Federal Claims shares jurisdiction for tax refund suits with the U.S. District Courts. Judges at the district courts and the U.S. Court of Federal Claims deal with a broad range of cases. Judges at the U.S. Tax Court are tax specialists and judges at the bankruptcy courts are specialists in their area, but not tax. In the case of state tax disputes, the respective state's system provides the guidance. It is plausible that the use of forensic accountants may vary based on court venue due to the differing levels of specialization of the trier of fact.

From databases containing cases as far back as the year 1860, Table 1 shows the earliest tax opinion that cites a forensic accountant was issued by a district court in 1982, followed by U.S Tax court opinions in 1988 and 1992. These are the only three opinions in this study that predate the *Daubert* Standard. A total of just nine cases in the master list (22.5%) occurred during the time frame 1982 – 2000. Three cases took place in District Courts, three in the U.S. Tax Court, one in the U.S. Bankruptcy Court and two in the state courts. In the last decade between 2001 and 2010, there were 31 citations representing 77.5% of the data set. Although most tax cases are litigated in the Tax Court (Greenaway 2009, 316), eighteen of these cases

were tried in District Courts, eight in state tax cases, four in the U.S. Tax Court and one in the Bankruptcy Court (1). The only venue without a single case that mentions a forensic accountant as an expert witness is the U.S. Court of Federal Claims.

Parties Presenting Forensic Accounting Experts in Tax Cases (RQ2)

In the U.S., either party to a case, the government or the taxpayer, may present experts. Court-appointed experts are rare in tax cases. The party that presents an expert witness typically funds the expert's fees. As tax cases are about government revenue, one would expect that forensic accountants be presented by the government in order to secure its revenue and by the taxpayer to prove that the methods used to determine their tax payments were within the law. The identification of a forensic accountant bears reputation risk for the expert. The disclosure of the name together with the assessment of the effectiveness of the testimony has the potential to enhance the expert's reputation, diminish or destroy it.

As shown in Table 2, eighty-four percent of taxpayers or third parties, such as a bankruptcy trustee or a taxpayer's employer, presented forensic accounting experts. These parties also funded the experts' services. With the exception of one federal and one state tax case, only one forensic accountant was involved in each case. In the federal *King* case, one forensic accountant represented the taxpayer and one the government. In one state tax opinion, the *Marquez* case, multiple forensic accounting experts were presented. The government presented three and the taxpayer one. With the exception of one expert who is mentioned in four different cases, none of the forensic accounting experts appeared in more than one case.

The judge who is responsible for writing a case opinion decides not only whether to mention an expert, but also whether to identify an expert by name or to make a generic reference. In the data set, any forensic accountant that was involved for the government was mentioned in

the case by name. The results for experts that were presented by the taxpayer or a third party are mixed. The bankruptcy courts named the experts, the U.S. Tax Court identified six out of seven, the district courts named ten out of 20 and state tax courts identified six out of eight.

Primary Reason for the Involvement of a Forensic Accountant (RQ3)

This research question explored whether it was a tax or another issue that brought the forensic accountant onto a case. As shown in Table 3, a tax issue was the primary reason for the involvement of a forensic accounting expert in 77.5% of the cases (31 out of 40), followed by employee embezzlement (8.8%), bankruptcy or temporary receivership (7.5%), financial fraud (3.7%) and divorce in a single case. There was one primary reason for the expert testimony in all but the Levinson case, in which fraudulent financial reporting practices and employee embezzlement were presented as equal reasons. Viewing the results by court venue, four of the ten state tax cases indicated primary non-tax reasons compared to only two district court decisions and one U.S. Tax Court decision. The bankruptcy trustees appointed forensic accountants for non-tax reasons in the bankruptcy court cases.

Tax Types and Issues Underlying the Disputes (RQ4)

Forensic accounting experts possess specialized knowledge, which they can apply to assist a judge or jury to understand the evidence or to determine a fact in question. Different taxes are levied by the federal and state governments. These include taxes on income and property, employment taxes, sales and use taxes as well as excise taxes such as the motor fuel tax. The cases were reviewed to learn what types of taxes and issues were in dispute that called for the testimony of a forensic accountant.

There was both civil and criminal tax fraud. The preponderance of the court proceedings (34 of 40) was civil in nature. Two of the cases dealt with ancillary disputes after a criminal

conviction of the taxpayer. The remaining six cases were criminal proceedings. A total of 13 cases dealt with allegations of fraud. Two of the cases dealt with cross-border issues involving bank accounts in the Bahamas and in Germany.

Table 4 shows the results regarding the types of taxes underlying the disputes in court. Most of the tax disputes (87.5%) related to income taxes. With one exception that related to the non-payment of federal employment taxes tried in a district court, across court venues the issues that led to the legal disputes in the federal tax cases concerned income tax issues. Income taxes also led to the majority of state tax cases. The remaining disputes were made up of sales and use tax, property taxes and motor fuel tax.

As shown in table 5, the tax issues underlying the disputes concerned tax administration and procedure in 35 cases and substantive tax provisions in the remaining five cases. The federal tax issues on trial addressed income tax provisions in Subtitle A of the Internal Revenue Code in five cases. In 27 cases, the issues related to tax procedure and administration in Subtitle F. Among the federal cases, six dealt with tax fraud or evasion, three with sentencing, and two each with counsel, damages, dismissal and IRS summonses. In one case each, embezzlement, recusal of a judge, liens, litigation costs, meritless claims, refund of a penalty, recovery of costs, restitution, tax collection and transfers were the issues on trial. The substantive tax provisions related to the research and development credit, the dividends received deduction and the consolidated tax return rules.

Tax procedure and administration disputes were tried in eight of the ten state cases and substantive provisions in the other two. Taxes owed or paid were in question in four opinions. Three were for sales and use tax and one was a motor fuel tax case. The proof of the non-existence of assets and the right to challenge the assessed value were the issues in two property

tax cases. Tax fraud was considered in two cases. The two substantive issue cases dealt with the deduction of alimony paid and the establishment of statutory residence in a state.

Assignments of Forensic Accountants (RQ5)

Although the cases studied in this research were related to tax litigation, it is expected that the specific assignments performed by the forensic accountants varied. In general, forensic accountants collect and preserve evidence, analyze the evidence, perform calculations, arrive at opinions and report on their findings. The specific nature of their assignments depends on the requirements of each case. In tax litigation, the use of forensic accountants and their roles in testifying before the court are still emerging. They are considered financial experts. The issues that they typically address “assist the trier of facts.” Traditionally, the three common types of financial experts were accountants, economists, and appraisers and valuation experts. There are no minimal standards for financial expert testimony and therefore the lines between them are blurred (Adroque and Ratliff 2000).

Over time forensic accountants have expanded their field from strictly accounting-based assignments (Rasmussen and Leauanae 2004, 165), to damage calculations and valuations. In this study, examples of potential types of assignments performed by forensic accountants are roughly categorized as follows:

1. **Fraud Investigations:** Tax fraud, financial statement fraud, asset misappropriation and bankruptcy fraud
2. **Regulatory/Governmental Compliance:** Tax cases and environmental compliance
3. **Commercial Damages:** Breach of contract, negligence, anti-trust and insurance claim disputes
4. **Personal Economic Damages:** Marital dissolution, estate disputes, wrongful discharge, personal injury and wrongful death
5. **Business Valuations:** Shareholder disputes, partnership dissolution, and merger and acquisition disputes

The tax cases used in this investigation were reviewed to identify the assignments and tasks performed by the forensic accounting experts using the five categories above.

As shown in Table 6, three types of the assignments were found in the tax cases: regulatory/governmental compliance, fraud investigation and determination of commercial damages. Although it might be expected that the majority of the assignments would be related to fraud investigations, they were the second most frequent assignment types with 15 instances in 13 cases. Of the 42 tasks, 25 were regulatory or governmental compliance assignments. Forensic accountants determined commercial damages in two of the cases. The reason for more than 40 tasks, as mentioned above, was that two or more forensic accounting experts were presented in some of the cases.

Information about the specific tasks that the identified forensic accounting experts performed was available in all but three cases of the regulatory/governmental compliance assignments. In each case, forensic accountants performed one specific task with the exception of two fraud investigation cases, in which they performed two tasks. In 12 cases, the most frequently assigned task to forensic accountants was to evaluate the legitimacy of specific tax claims. In ten cases experts verified the accuracy of books and records. In seven cases an estimation of the extent of fraud was the assignment and in three cases locating and/or identifying assets was the problem. In two cases, locating and/or identifying income and calculating damages were the assigned work. In one case each, the tasks of collecting lifestyle evidence, locating evidence and calculating the amount of tax claims were determined by forensic accountants.

Effectiveness of Forensic Accounting Experts (RQ6)

Taxpayers and the government present forensic accountants in their cases because they expect that their investment in experts will help make their cases more convincing to the judge and result in a favorable outcome. This question seeks to identify whether taxpayers, third parties or the government are more likely to present an expert that a judge evaluates as effective and whether the effectiveness of a given party's expert translates into a favorable outcome for that party.

Table 7 shows who won the case, which party presented the forensic accountant and if the judge noted that the forensic accounting expert testimony was effective. Cases were decided for the taxpayer or for the government, or in part for either or both parties. Even if the party lost a case, the judge still may have noted that the forensic accountant's testimony was effective and ruled a lower amount of tax owed or lesser penalties. Of the forensic accountants' testimonies, 23 of 42 were found to be effective. The forensic accountants' success ratios varied by court venue. Their success ratios were 100% at Bankruptcy Courts, 72.7% in state tax decisions, 45.5% at U.S. District Courts and 42.8% at the U.S. Tax Court.

The largest number of decisions was for the government with 25 out of 40 (62.5%) cases found in their favor. This was followed by nine decisions for the taxpayer (22.5%) and the remaining six decisions (15%) with partial outcomes for either or both parties. Out of the nine decisions in which the taxpayer prevailed, the taxpayer presented a forensic accounting expert in seven of the cases. In all seven cases, the judge either found those experts to be effective or they approved the accountant's fees without commenting on effectiveness. In the *Marquez* case where both the taxpayer and the government presented a forensic accounting expert, the taxpayer's expert was evaluated as effective, but the government's was not. Although the Robertson case

was settled in the taxpayer's favor, only the government presented an expert that the judge noted provided effective testimony.

Of the 25 cases that were decided for the government, only three experts were presented by the government. The judges found all three to be effective. When the taxpayer presented a forensic accountant but the government prevailed, the expert's work was evaluated as effective by the judge in four cases and ineffective in 15 cases. There was no evaluation rendered by judges in two cases.

In some instances, the court opinions provide detailed evaluations of the performance of the forensic accounting experts' work. When the forensic accountant's testimony was not accepted by the judge it was noted that: the work was beside the relevant issue; the expert had insufficient time available to complete an assignment; and the expert performed bank deposit analyses incorrectly. Other comments related to the expert's background information. Positive comments made by the judges noted that: experts had prior IRS experience; held the CPA, CFE, CVA and/or CMC credentials; completed undergraduate and graduate degrees and advanced specialty coursework; authored publications; enjoyed recognition as experts in the field; and had previous expert witness experience. Negative comments by the judges included: the lack of the CPA credential; not being an enrolled agent or otherwise authorized to practice before the IRS; absence of a state license to practice accounting; no prior IRS experience; and being a self-proclaimed forensic accountant.

In the three cases that were decided for the taxpayer in part, the taxpayers' experts helped the taxpayer's credibility in one case and in another case the judge accepted the testimony, but made adjustments. In the third case, the bankruptcy court judge noted that the expert's work carried substantial weight. Taxpayers presented experts in the two cases that were decided for

both the taxpayer and the government in part, of which one forensic accountant was found to be effective and the other one was not. In the sole opinion that was decided in part for the government, the taxpayer presented an ineffective forensic accounting expert.

SUMMARY AND CONCLUSION

The use of forensic accounting experts in tax litigation is an emerging field. This research is the first to actually review court cases. Forty cases were found in which forensic accounting expert witnesses passed the *Frye* and *Daubert* Standards and for which court opinions were published. They represent only a tiny portion of all tax dispositions. As the prospect of litigation must be considered in almost all cases (Greenaway 2009) the results of the analysis of the court opinions have implications for many more tax cases.

The findings of this analysis may be summarized as “80-80-80-80-80.” In both federal and state tax litigation, roughly 80% of reported cases with forensic accountant involvement were decided in the last decade from 2001 to 2010. This shows a large increase in forensic accountant’s expert testimony in tax litigation. The results are consistent with an exponential overall growth in the forensic accounting profession (Crumbley and Apostolou 2002, Stimpson 2007). Taxpayers or third parties presented more than 80% of the forensic accountants. This is not surprising as the taxpayers hired the forensic accountants to help explain their cases. In nearly 80% of the cases, a tax issue was the primary reason for involving a forensic accounting expert and 80% of the identified cases related to income tax disputes. As the analysis targeted tax courts this is to be expected. Finally, more than 80% of the issues tried concerned tax administration and procedure. Tax fraud and taxes owed were the two most frequent issues.

It was the forensic accounting experts’ role to assist the triers of fact to understand the evidence. Three types of assignments for forensic accountants were found in the tax cases: fraud

investigation, regulatory/governmental compliance and commercial damage determination. Although testimony on business valuations for tax purposes by forensic accountants was absent in the cases reviewed for this research, such valuation issues have been resolved with the assistance of expert witnesses in tax litigation (Beatty et al. 1999). Forensic accountants have expanded their domain into this area in general in the past decade, but this type of assignment has not been presented in tax cases.

Judges frequently provide an evaluation of the effectiveness of the expert testimony in the written opinion that is separate from the outcome of the case. Further analysis of the cases in which taxpayers presented forensic accounting experts shows that expert testimony was effective in all the cases that were decided for the taxpayers, but only in 26% of the cases that were decided for the government and in 60% of the cases with partial outcomes for the taxpayer, the government or both. In total, the performance of about half of the forensic accountants was evaluated to be effective by the judges. The result is consistent for the cases that were decided in the last decade in which roughly 54% of the testimonies presented were evaluated as effective by the judges. This indicates a potential for substantial improvement of expert witness testimony by forensic accountants.

Finally, a distillation of the success factors of effective experts as noted by judges in their opinions expands the research literature from surveys of forensic accountants, lawyers and academicians to an analysis of how judges perceive their value. Some of the reasons the judges found the experts' testimony to be ineffective included: work performed was not relevant; insufficient time for the expert to complete the assignment; and work was not performed properly. The judges looked favorably on the forensic accounting experts that had backgrounds with the proper credentials and experience. Watters et al. (2007) found that the volume of

forensic accounting services provided by CPA firms did not significantly change over the period of their study from 1998 through 2003. Each of the forensic experts that held the CPA credential was found to give effective testimony. The results of this study indicate a business opportunity for these individuals in the area of tax litigation. The same applies to holders of the CFE, CVA and/or other credentials.

The results presented in this paper will assist taxpayers and their legal counsel to pick a forensic accounting expert who is more likely to be perceived well by the court. The summary of the tax disputes in which forensic accountant testimony was presented and what assignments forensic accountants performed provide a start of a library for forensic testimony in tax disputes. The findings educate taxpayers and their legal counsel about judges' concerns regarding the backgrounds and credentials of the experts that they valued and the weaknesses that judges identified.

Further research could explore the reasons why taxpayers chose to use forensic expert testimony in the U.S. District Courts and the U.S. Tax Court but not in the U.S. Court of Federal Claims. Other areas for research include: the reasons for the absence of forensic accountant testimony in business valuation cases; expansion of the scope of this analysis to tax cases that engage expert witnesses for authentication of documents or information technology; and comparisons with cases in other areas of the law that engage forensic accountants such as securities and intellectual property. It would also be helpful to understand whether accounting experts specialize in forensic accounting or whether they provide a broader range of expert witness services. Educators could crosscheck the areas of identified weaknesses with their learning objectives to ascertain coverage in their curricula. They could review the cases to create instructional resources to be used to teach forensic accounting.

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TABLE 1

**Number of Tax Cases
by Decade and Court**

Decade	U.S. District Courts	U.S. Tax Court	Bankruptcy Courts	State Tax Decisions	Total (%), by Decade
1981-1990	1	1	-	-	2 (5.0%)
1991-2000	2	2	1	2	7 (17.5%)
2001-2010	18	4	1	8	31 (77.5%)
Total, by courts	21	7	2	10	40 (100.0%)

TABLE 2
Number of Forensic Accountants
by Court, Appointing Party and Name or Affiliation of Forensic Accountant
Disclosed

Forensic Accountants Appointed By	U.S. District Courts	U.S. Tax Court	Bankruptcy Courts	State Tax Decisions	Total (%), by Appointing Party
<u>Taxpayer or third party</u>					
Name or affiliation disclosed	10	6	2	6	24 (54.5%)
Name or affiliation not disclosed	10	1	-	2	13 (29.5%)
Sub-total	20	7	2	8	37 (84.0%)
<u>Government</u>					
Name or affiliation disclosed	2*	-	-	5*	7 (16.0%)
Total, by Courts	22	7	2	13	44 (100.0%)

* Multiple experts in two cases: In the King federal income tax case, one forensic accountant represented the taxpayer and one the government. In the Marquez state income tax case, forensic accounting experts were presented by both parties: the government presented three and the taxpayer one.

TABLE 3

Number of Tax Cases
for each Primary Reason for Forensic Accountant Involvement

Primary Reason	U.S. District Courts	U.S. Tax Court	Bankruptcy Courts	State Tax decisions	Total (%), by primary reason
Tax	18	7		6	31.0 (77.5%)
Employee embezzlement	1/2*	1		2	3.5 (8.8%)
Bankruptcy/receivership	1		2		3.0 (7.5%)
Financial fraud	1/2*			1	1.5 (3.7%)
Divorce				1	1.0 (2.5%)
	20	8	2	10	40.0 (100.0%)

* Equal reasons in the Levinson case, in which the assignment was to conduct a forensic audit in order to determine fraudulent reporting practices and the amount the taxpayer used for his own benefit.

TABLE 4

**Number of Tax Cases
by Court and Type of Tax Underlying Dispute**

Type of Tax	U.S. District Courts	U.S. Tax Court	Bankruptcy Courts	State Tax Decisions	Total (%), by Type of Tax
Income	20	7	2	6	35 (87.5%)
Employment	1	-	-	-	1 (2.5%)
Sales and use	-	-	-	1	1 (2.5%)
Property	-	-	-	2	2 (5.0%)
Motor fuel	-	-	-	1	1 (2.5%)
Total, by courts	21	7	2	10	40 (100.0%)

TABLE 5

**Case Issues by Jurisdiction Level and Type of Tax:
Income Tax (I), Employment Tax (E), Sales and Use Tax (S), Property Tax (P)
and Motor Fuel Tax (M)**

Type of Issue	Federal	State
<u>Substantive provisions (5)</u>		
<u>Research and development credit (1)</u> Whether the taxpayer was entitled to additional research credits.	I	
<u>Dividends received deduction (1)</u> Whether the taxpayer was entitled to the dividends received deduction.	I	
<u>Consolidated tax return (1)</u> Whether the bankruptcy trustee was entitled to recover inter-company loan funds and interest payments.	I	
<u>Alimony (1)</u> Whether to disallow the taxpayer's deductions for alimony paid.		I
<u>State residency (1)</u> Whether the taxpayers were properly subject to personal income tax as statutory residents.		I
<u>Tax procedure and administration (35)</u>		
<u>Tax fraud (8)</u> Whether to enjoin the promotion of a tax fraud scheme.	I	
Whether the taxpayer was responsible for willful failure to pay withholding taxes.		I
Whether the taxpayers were guilty of tax fraud and failure to file returns.	I	
Whether the taxpayers willfully filed false tax returns.		I
Whether the reconstruction of income supports the finding of fraud.	I	
Whether to convict and sentence the taxpayer for tax evasion.	I	
Whether a taxpayer met the burden of proof that no income was underreported.	I	
Whether to convict a taxpayer for filing false tax returns.	I	
<u>Tax owed/paid (4)</u>		
Whether the taxpayer owed sales tax, interest and penalties.		S
Whether to re-determine the taxpayer's personal income tax deficiency.		S
Whether the owner of a business was entitled to a revised determination or a refund of taxes.		S
Whether an individual failed to remit motor fuel tax.		M
<u>Sentencing (3)</u>		
Whether to grant a business owner the motion to vacate a sentence that was imposed pursuant to his guilty plea to making and subscribing false tax returns.	I	
Whether to impose a sentence of probation on an individual who was convicted of wire fraud and filing a false income tax return.	I	
Whether the taxpayer is entitled to some downward departures under the sentencing guidelines with respect to his conviction on tax and nontax crimes relating to the fraud.	I	

Type of Issue	Federal	State
<u>Counsel (2)</u>		
Whether to grant the taxpayer's claim that his counsel was ineffective.	I	
Whether to sanction an attorney in a taxpayer's deficiency case.	I	
<u>Damages (2)</u>		
Whether to award damages to the taxpayer for unlawful tax liens.	I	
Whether the government had to pay disclosure damages.	I	
<u>Dismissal (2)</u>		
Whether to grant the defendant's motion to dismiss.	I	
Whether to dismiss four suits an individual filed to challenge the IRS's collection efforts and to obtain a tax refund and damages.	I	
<u>IRS Summonses (2)</u>		
Whether to reconsider an order enforcing IRS summonses.	I	
Whether IRS summonses to ascertain tax preparer's civil liability were enforceable.	I	
<u>Property (2)</u>		
Whether to grant the taxpayer's challenges to the value of a self-storage facility for property tax purposes.		P
Whether the taxpayer has sufficiently established that the assets in question never existed.		P
<u>Embezzlement (1)</u>		
Whether a fraudulent company also suffered from embezzlement.	I	
<u>Judge (1)</u>		
Whether to grant the taxpayer his motion to recuse the district judge from the case.	I	
<u>Liens (1)</u>		
Whether the government was entitled to proceed with the foreclosure of tax liens.	I	
<u>Litigation costs (1)</u>		
Whether to award litigation costs after IRS concession.	I	
<u>Meritless claims (1)</u>		
Whether to impose penalties against the taxpayer for advancing meritless claims.	I	
<u>Penalty refund (1)</u>		
Whether to grant a refund of penalties arising from failure to pay employment taxes.	E	
<u>Recovery of costs (1)</u>		
Whether a temporary receiver was entitled to recover costs of receivership from the government.	I	
<u>Restitution (1)</u>		
Whether to deny restitution for false statements made to the IRS.	I	
<u>Tax collection (1)</u>		
Whether to grant the taxpayers' action for refund and unlawful collection.	I	

Transfers (1)

Whether to grant the bankruptcy trustee's motion whether to avoid fraudulent transfers from the taxpayers.

I

TABLE 6
Number of Tax Cases
by Assignment Type and Specific Task

Specific Task*	Assignment Type			Total (%), by Specific Task
	Fraud Investigations	Regulatory/ Governmental Compliance	Commercial Damages	
Evaluate legitimacy of specific tax claims		12		12 (28.6%)
Verify accuracy of books and records	2	8		10 (23.8%)
Estimate extent of fraud	7			7 (16.6%)
Locate/identify assets	2	1		3 (7.1%)
Locate/identify income	2			2 (4.8%)
Calculate damages			2	2 (4.8%)
Locate evidence		1		1 (2.4%)
Collect lifestyle evidence	1			1 (2.4%)
Calculate tax claims	1			1 (2.4%)
Unknown		3		3 (7.1%)
Total, by Assignment Type	15**	25	2	42 (100.0%)

* A case assignment may consist of one or more specific tasks.

** These tasks were performed in 13 cases.

TABLE 7

Who Won versus Who Had the Forensic Accounting Expert

Winning Party	Number of Cases Won (%)	Who had Expert in Winning Case: Government/Taxpayer/ Third Party*	Judge Found Expert Effective: Government/Taxpayer/ Third Party**	Of cases Won, Who Had Effective Expert (%): Government/Taxpayer/ Third Party***
Government	25 (62.5%)	3/19/3	3/5/2	100%/26%/67%
Taxpayer	9 (22.5%)	1/7/1	1/7/1	100%/100%/100%
Government, in part, and/ or taxpayer, in part	6 (15%)	- /5/1	- /3/1	- /60%/100%
Total	40	4/31/5	4/15/4	100%/48%/80%

* In the two cases in which both the government and the taxpayer presented forensic experts, only the expert that the judge considered effective is included.

** Tax opinions provide positive or negative comments or remain silent about a forensic accountant's effectiveness. Sometimes they provide statements about the approval of a forensic accountant's fees as a proxy. This column only includes those experts on whose performance a comment is available explicitly or by proxy. The court may have found testimony effective, but made adjustments before arriving at a conclusion.

*** The performance of a taxpayer's forensic accountant may have been effective although a case was decided for the government, but it may have had an impact on the amount a taxpayer owed the government or any penalties that were imposed on a taxpayer.