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JUSTIN A. THORNTON

Law Offices of Justin Thornton
One Thomas Circle, NW   Suite 1100
Washington, DC 20005
(202) 626-8224 Direct
(202) 478-0427 Fax
JAT@ThorntonLaw.com
http://www.ThorntonLaw.com

FEDERAL CRIMINAL TAX ENFORCEMENT IN THE USA*

Justin A. Thornton**

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** A former federal prosecutor, **Justin A. Thornton** of Washington, DC is a white collar criminal defense attorney specializing in criminal tax matters. *See* www.ThorntonLaw.com.

FEDERAL CRIMINAL TAX ENFORCEMENT IN THE USA

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I. OVERVIEW OF THE FEDERAL TAX ENFORCEMENT SYSTEM

A. General Observations

1. The federal revenue system in the United States is based upon voluntary compliance and self-assessment by its taxpayers. The United States Government purportedly seeks to preserve the integrity of its tax system through vigorous and uniform enforcement of its tax laws, thereby exposing tax cheaters and deterring other potential tax violators.

2. The Internal Revenue Service Criminal Investigation (IRS-CI) is responsible for investigating tax fraud cases. As stated by a former IRS Assistant Commissioner for Criminal Investigations, "The primary mission of the Internal Revenue Service Criminal Investigation Division is to put people in jail who cheat on their taxes."

3. The Tax Division of the United States Department of Justice in Washington, DC ultimately determines which criminal tax cases will be authorized for prosecution. A centralized review process and prosecution oversight by "Main Justice" is intended to ensure uniformity in the enforcement of the tax laws.

4. Criminal tax investigations are lengthy and burdensome, and can easily last for several years, with extensive questioning of taxpayer's friends, business associates, and other third party witnesses, as well as the gathering of voluminous records from financial institutions and other sources, public and private, domestic and foreign.

5. With few exceptions, six years is the statute of limitations for criminal tax violations. *See* 26 U.S.C. § 6531. The limitations period generally commences from the due date of the tax return or, if later, when the return was filed. In the case of a "Klein" conspiracy (*see* § I.H.5., *infra*), the statute of limitations expires six years following the last overt act of the conspiracy.

6. Tax fraud cases are subject to multiple levels of review within the IRS and the Department of Justice before prosecution is initiated. Marginal cases involving insubstantial tax losses or fewer than three tax years generally are not prosecuted.

7. The two-pronged standard of review applied by both IRS and DOJ in evaluating whether to prosecute tax crimes is the existence of: (1) evidence sufficient to prove guilt beyond a reasonable doubt, and (2) a reasonable probability of conviction.

8. For the taxpayer under investigation, early legal representation by defense counsel is crucial because cases may be won or lost prior to indictment. Effective defense counsel will know how and when to: monitor the progress of the federal investigation; engage the legally-privileged services of a forensic accountant; counsel the client against self-incrimination and obstruction of justice; control the flow of information; and timely pursue conferences with the IRS and Department of Justice Tax Division in Washington in an effort to persuade the Government to decline prosecution.

9. The defense's chances of prevailing at trial in a tax fraud prosecution are lower than for any other type of case, civil or criminal. The Government enjoys a conviction rate (including guilty pleas) of greater than 90% in criminal tax cases authorized for prosecution.

10. The collateral civil tax case involving taxes due, interest, and penalties, is separate and generally has been held in abeyance pending the conclusion of the criminal tax case. In recent years, however, there has been an increase in the number of parallel civil and criminal tax proceedings and an increasing trend towards "global settlements" of both the criminal and civil aspects of the case.

11. Generally, communications between taxpayers and accountants are not privileged. For example, *see* discussion of *Kovel* agreement, § II,E, *infra*.

12. Although advisory and no longer mandatory, federal sentencing guidelines nevertheless usually assure a sentence of incarceration will be imposed upon the convicted tax cheater. [Although foreign bank account cases, *infra*, have been a notable recent exception.]

B. **Origins of IRS Criminal Investigations**

1. IRS civil examinations and audits historically account for 15-20% of the criminal cases that IRS-CI investigates.

2. IRS-CI special programs that target individuals and businesses with financial accounts in offshore tax havens, illegal tax protestors, etc.

3. Informants such as disgruntled employees, former spouses, and jealous or resentful neighbors or friends.

4. Information gathered during investigation of taxpayer that pertains to a third party witness.

5. Review of various reports required to be filed by law, such as:

   a. Currency Transaction Reports (CTRs), Forms 4789. *See* 31 U.S.C. § 5313(a) (domestic financial institution involved in a transaction for the payment, receipt or transfer of U.S. coins or currency [over $10,000] must file a report on the transaction).

   b. Reports of International Transportation of Currency or Monetary Instruments (CMIRs), Forms 4790. *See* 31 U.S.C. § 5316 (person shall file a report if transports, is about to transport, or has transported, monetary instruments of more than $10,000 at one time out of or into the U.S.A.).

   c. Reports of Foreign Bank & Financial Accounts (FBARs), Forms TD F 90-22.1. [recently re-named FinCEN Form 114] *See* 31 U.S.C. § 5314(a) (a United States person with a financial interest in or signature authority over foreign financial accounts with an aggregate value exceeding $10,000 at any time during the calendar year must file an FBAR with the Treasury Department in Detroit on or before June 30th of the year immediately following the calendar year being reported, and the filing date may not be extended). Effective July 1, 2013, FBARs must be filed electronically with FinCEN (Financial Crimes Enforcement Network) using its BSA E-Filing System and the new online Form 114. *See* http://bsaefiling.fincen.treas.gov/NoRegFBARFiler.html.

      Note: Willful violations of the FBAR regulations may be charged under 31 U.S.C. § 5322, which provides for penalties of up to 10 years' imprisonment and a $500,000 fine. Civil penalties may be onerous, amounting to the greater of $100,000 or 50% of the account balance at the time of each willful violation.

   d. Reports of Cash Payments Over $10,000 Received in a Trade or Business, Forms 8300. *See* 26 U.S.C. § 6050I (must file a report within 15 days after the cash is received).

6. Case referrals from other federal law enforcement agencies (*e.g.*, FinCEN, FBI, DEA, SEC, ICE, Postal Service, etc.).

C. Enforcement Priorities

Note: The Website of IRS-CI includes information regarding its current enforcement priorities, tax scams, consumer alerts, and recent tax fraud cases. *See* http://www.irs.gov/uac/Tax-Scams-Consumer-Alerts.

1. Abusive foreign and domestic trust schemes. In recent years, prosecutions, grand jury investigations, and Congressional hearings have focused on abusive offshore tax havens. IRS-CI has continued to combat tax schemes that attempt fraudulently to reduce or eliminate taxable income through multiple, vertical layers of income distribution through trusts formed within and outside the United States.

2. Offshore compliance initiative. IRS and DOJ in recent years have aggressively pursued taxpayers with unreported foreign financial accounts. The DOJ Tax Division describes its offshore compliance initiative at http://www.justice.gov/tax/offshore_compliance_intiative.htm where numerous details concerning recent indictments, pleas, sentencings, and other developments are available on an ongoing basis. For a full discussion and criticism of IRS and DOJ efforts to combat offshore tax evasion, see the 176-page report "Offshore Tax Evasion: The Effort to Collect Unpaid Taxes on Billions in Hidden Offshore Accounts," issued by the U.S. Senate Permanent Subcommittee on Investigations (PSI) on February 26, 2014. As to the magnitude of U.S. taxes evaded through offshore schemes, PSI Chairman Carl Levin noted estimates that U.S. persons hold more than one trillion dollars in offshore assets and evade annual U.S. taxes of between $40 billion to $70 billion, and that U.S. corporations account for another $30 billion in taxes evaded through such offshore tax schemes.

3. Non-Filer Initiative. The IRS estimates that 10 million individuals and businesses fail to file returns, resulting in an annual "tax gap" in excess of $7 billion. The IRS reportedly is pursuing vigorous enforcement of those non-filers who fail to come forward voluntarily.

4. Identity theft. Scam artists have fraudulently used the IRS name and logo to gain access to taxpayer's financial information in order to steal their identities and financial.

5. Employment tax enforcement program. IRS enforcement efforts against employers who fail to pay over to the government employment taxes (e.g., Social Security and Medicare taxes) withheld from their employees' wages are vigorously pursued.

6. Return preparer enforcement program. Accountants, lawyers, and others who assist in the preparation of false and fraudulent tax returns often are targets of IRS criminal investigations.

7. Illegal narcotics enforcement. IRS-CI is regularly called upon to assist in narcotics investigations by tracing the flow of illegal income derived from drug trafficking.

8. Fraudulent refund cases stemming from the electronic filing ("ELF") of tax returns. Victims of identity theft also may be subjected to fraudsters using their stolen identities to file false tax returns claiming refunds.

9. Illegal tax protestors (or "tax defiers"). Individuals who refuse to file returns or pay income taxes based upon ill-founded beliefs and frivolous arguments that the U.S. income tax system is unconstitutional, that wages are not taxable as income, that filing a tax return necessarily violates the protection of the Fifth Amendment, etc., are continuously subject to investigation and prosecution.

10. Other forms of abusive activity, such as bankruptcy fraud and healthcare fraud.

D. **Domestic Investigative Techniques**

1. IRS increasingly utilizes undercover operations, search warrants and electronic surveillance techniques (*e.g.*, money laundering projects, tax haven/offshore banks projects, business opportunities projects, fraudulent tax shelter projects, and illegal tax protestors projects).

2. IRS also frequently refers matters to the Department of Justice for grand jury investigation, as opposed to handling the case administratively, thereby obtaining the power to subpoena witnesses and documents before grand jury in lieu of issuing summonses that may be contested in lengthy enforcement proceedings. Approximately 50% of all criminal tax investigations now utilize the power of a grand jury.

E. **Obtaining Evidence Abroad**

1. IRS and DOJ are gaining increased access to foreign financial records, and tax fraud investigations are becoming more offshore in nature. The well-publicized investigation and prosecution of UBS essentially has led to the end of bank secrecy in Switzerland, and has resulted in the prosecution of numerous individuals with undisclosed offshore bank accounts, as well as numerous bankers and professionals who assisted them. As mentioned above, those efforts were subjected to severe criticism during the Senate PSI hearing on February 26, 2014, concerning Credit Suisse and offshore tax evasion. IRS and DOJ continue to investigate tax evasion schemes involving other offshore financial institutions located in numerous foreign jurisdictions (*e.g.*, HSBC of India).

2. The investigative tools now available to investigators and prosecutors to gather evidence abroad are varied and increasingly plentiful as cross-border tax crimes become more sophisticated and prevalent. Among the arrows in the Government's quiver are:

a. Mutual Legal Assistance Treaties. Approximately 60 MLATs are in force between the U.S. and other countries, with several more that have been negotiated but not yet ratified. MLAT requests are handled by DOJ's Office of International Affairs. Of particular note, MLATs can provide for the taking of testimony, as well as searches and seizures of evidence.

b. Tax Information Exchange Agreements (TIEAs) & Tax Treaties.

i. TIEAs specifically provide for mutual assistance in obtaining records and testimony for use in criminal and civil tax investigations and proceedings. TIEAs are administered by the Director, International, IRS, and currently are in effect with at least two dozen countries, including Aruba, Antigua & Barbuda, the Bahamas, Barbados, Bermuda, Brazil, the British Virgin Islands, the Cayman Islands, Colombia, Costa Rica, Dominica, the Dominican Republic, Grenada, Guernsey, Guyana, Honduras, the Isle of Man, Jamaica, Jersey, Liechtenstein, Marshall Islands, Mexico, Panama, the Netherland Antilles, Peru, St. Lucia (*see* Rev. Rul. 2007-28), and Trinidad & Tobago.

ii. Tax treaties, while similar in concept to TIEAs, are more general and less effective with regard to the exchange of information. The U.S. currently is party to tax treaties with approximately 50 nations. *See* http://www.irs.gov/Individuals/International-Taxpayers/Tax-Treaties

c. Letters Rogatory. Also known as letters of request, this traditional means of obtaining evidence is handled through diplomatic channels and often involves a lengthy process.

d. Compulsory measures.

i. Subpoenas & summonses to financial institutions. U.S. prosecutors may obtain foreign records by issuing a subpoena to a U.S.-based financial institution with a relationship to the foreign-based company that possesses the desired information. *See, e.g., In Re Grand Jury Proceedings (Bank of Nova Scotia),* 722 F.2d 657 (11th Cir. 1983), *appeal following remand*, 740 F.2d 817 (1984); *In Re Grand Jury Proceedings (Bank of Nova Scotia*), 691 F.2d 1384 (11th Cir. 1982).

ii. Title 31 subpoenas to U.S. persons with offshore accounts. In recent years, federal prosecutors increasingly and successfully have obtained foreign financial records pursuant to 31 U.S.C. § 5314 over targets' Fifth Amendment objections by relying on the "required records doctrine."

iii. Summons enforcement & compulsion orders. U.S. prosecutors have obtained court orders compelling holders of foreign accounts to direct foreign financial institutions to disclose information otherwise protected by its country's bank secrecy laws. *See, e.g., Doe v. United States*, 487 U.S. 201 (1988). The well-publicized issuance of a "John Doe" summons by the IRS to UBS in 2008 essentially initiated the process that would lead to the demise of bank secrecy in Switzerland.

e. Multilateral initiatives (G-7 declarations, Financial Action Task Force, and OECD Forum on Harmful Tax Practices). Numerous declarations have been issued by cooperating countries attempting to coordinate their efforts to combat money laundering and tax evasion.

f. Foreign Account Tax Compliance Act (FATCA). Enacted in 2010, FATCA requires foreign financial institutions (FFIs) to report account information for their U.S. customers to the IRS beginning July 1, 2014. FFIs may choose not to subject themselves to FATCA by not doing business in the U.S. or with U.S. persons, or to comply with FATCA through a streamlined process by having their home governments enter into intergovernmental agreements (IGAs) with the U.S. Government.

F. Conferences, Case Review Procedures, and Prosecutions

1. IRS-CI conference. After the IRS criminal investigation is completed, the special agents and their supervisor will set forth to the taxpayer's counsel the proposed offenses, the amount of taxes due for criminal purposes, the years involved, and the method of proof. This is usually the first opportunity for the taxpayer and defense counsel to learn of the proposed charges.

2. Department of Justice Tax Division conference.

a. DOJ applies the same standard of review as does the IRS in its evaluation of the evidence. Notably, however, trial attorneys will review the case from a prosecution perspective.

b. DOJ Tax Division, which has the sole responsibility for authorizing prosecution of virtually all criminal tax cases, can decline the case, send it back to IRS for further investigation, or forward it to the appropriate U.S. Attorney's Office for prosecution or, if necessary, for further investigation by a grand jury.

c. If DOJ Tax Division authorizes prosecution, charges to be brought may not necessarily be the same as those recommended by IRS; the years involved and method of proof to be utilized also may be subject to change.

d. DOJ Tax Division, at the request of the U.S. Attorney, may assign one or more of its trial attorneys from Washington to assist the U.S. Attorney's Office with the prosecution of a tax fraud case or to take total control of the case if the U.S. Attorney's Office lacks expertise or manpower, has a conflict, or disagrees with the Tax Division's recommendation to prosecute.

3. U.S. Attorney's Office conference. The U.S. Attorney's Office is not authorized to decline the prosecution of a case, but can send it back to the Tax Division for reconsideration with a recommendation to decline prosecution or to authorize different charges.

G. General Policy Considerations

1. "Major count policy" -- Under Tax Division rules, the U.S. Attorney cannot accept a plea agreement unless it includes a guilty plea to the major count. Also, *see* U.S. Attorney's Manual "bluesheet" of December 17, 1990, regarding application of Tax Division major count policy in sentencing guideline cases, U.S.A.M. § 6-4.310.

2. "Successive prosecution policy" -- Justice Department will not prosecute a tax case if it arises out of same facts as a prior federal prosecution where defendant received a substantial sentence unless there is a compelling federal interest to support such a prosecution. *See* U.S.A.M. § 9-2.142.

3. "Dual prosecution policy" -- Justice Department will not prosecute a case following a state prosecution based on same acts unless compelling interest to the contrary. Individual states, on the other hand, may still decide to prosecute. *See* U.S.A.M. § 9-2.142.

4. Use of RICO charges in tax cases -- Only in exceptional circumstances will RICO charges be authorized in tax fraud prosecutions. *See* U.S.A.M. § 6-4.211(1), and Tax Division Directive No. 128 of October 29, 2004.

5. Tax Division review of 18 U.S.C. § 1956(a)(1)(A)(ii) money laundering cases -- Required where intent is to commit tax fraud. *See* U.S.A.M. § 9-105.300, and Tax Division Directive No. 128 of October 29, 2004.

H. **Federal Tax Crimes: Principal Statutes Involved**

Willfulness is an element of proof in all criminal tax offenses. As defined in *United States v. Pomponio*, 429 U.S. 10 (1976), willfulness simply means "a voluntary, intentional violation of a known legal duty." In *Cheek v. United States*, 498 U.S. 192 (1991), the Supreme Court held that a good-faith misunderstanding of the law, even if not objectively reasonable, negates willfulness.

As in all federal criminal cases, the burden is on the U.S. Government to prove guilt beyond a reasonable doubt in a criminal tax case. The principal statutes utilized are set forth below.

[Note: Notwithstanding the fine provisions enumerated below, 18 U.S.C. § 3571 generally provides for the imposition of fines up to $100,000 for individuals and $200,000 for corporations convicted of a misdemeanor, and up to $250,000 for individuals and $500,000 for corporations convicted of a felony; alternative fines of twice the amount of gain or loss caused by the defendant also may be imposed.]

1. Attempted income tax evasion: 26 U.S.C. § 7201.

   Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.

   Elements of the offense are: (1) affirmative act to evade (*e.g.*, filing of false return); (2) a substantial tax deficiency; and (3) willfulness.

2. Filing a false return: 26 U.S.C. § 7206(1).

   Any person who willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter, shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 3 years or both, together with the costs of the prosecution.

   Elements are: (1) false material statement; (2) written declaration made under the penalties of perjury; and (3) willfulness.

   Note: The government is not required to prove a tax deficiency under 26 U.S.C. § 7206(1). Accordingly, this statute often is used in cases where taxpayers failed to disclose on their returns their interest in or control over a foreign financial account.

3. Aiding and assisting in the preparation of a false return: 26 U.S.C. § 7206(2).

   Any person who willfully aids or assists in, or procures, counsels or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim or document, shall be guilty of a felony and fined up to $100,000 ($500,000 in the case of a corporation), or incarcerated for up to 3 years, or both, together with the costs of the prosecution.

   Note: As one might correctly assume, this is the statute of choice for prosecutions of lawyers and accountants involved in the business of tax return preparation.

4. Willful failure to file a return, supply information, or pay tax: 26 U.S.C. § 7203.

   Any person required under this title to pay any estimated tax or tax, required by this title or by regulations made under authority thereof to make a return, keep any records, or supply any information, who willfully fails to pay such estimated tax or tax, make such return, keep such records, or supply such information, at the time or times required by law or regulations, shall, in addition to other penalties provided by law, be guilty of a misdemeanor and, upon conviction thereof, shall be fined not more than $25,000 ($100,000 in the case of a corporation) or imprisoned not more than one year, or both, together with the costs of prosecution. [...] In the case of a willful violation of any provision of section 6050I, the first sentence of this section shall be applied by substituting "felony" for "misdemeanor" and "5 years" for "1 year". [*see supra* regarding failure to file Reports of Cash Payments Over $10,000 Received in a Trade or Business, Forms 8300]

   Note: The penalty is less for one who fails to file a return (a misdemeanor) than for the taxpayer who files a false return (a felony).

5. Conspiracy to impede and impair the IRS: 18 U.S.C. § 371.

   If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined under this title or imprisoned not more than five years, or both.

Note: A conspiracy to defraud the United States is called a "*Klein* conspiracy." *See United States v. Klein,* 247 F.2d 908 (2d Cir. 1957), *cert. denied*, 355 U.S. 924 (1958) (conspiracy to impede and impair the IRS violates 18 U.S.C. § 371).

6. Willful failure to collect or pay over tax: 26 U.S.C. § 7202.

Any person required under this title to collect, account for, and pay over any tax imposed by this title who willfully fails to collect or truthfully account for and pay over such tax shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, be fined . . . or imprisoned not more than five years, or both, together with the costs of prosecution.

Note: This statute often is used in cases where employment taxes have been withheld but have not been paid over to the government. Unlike a prosecution under § 7201 for attempted income tax evasion, § 7202 does not require the government to prove an affirmative act. Also see the misdemeanor statute concerning offenses with respect to collected taxes, 26 U.S.C. § 7215.

7. Interference with administration of the internal revenue laws: 26 U.S.C. § 7212(a).

Whoever...endeavors to obstruct or impede, the due administration of this title, shall, upon conviction thereof, be fined not more than $5,000, or imprisoned not more than 3 years, or both, ... [.]

Note: This statute, the so-called "one-person *Klein* conspiracy," has been employed by tax prosecutors with increasing frequency in recent years. *See United States v. Popkin*, 943 F.2d 1535 (11th Cir. 1991).

8. False statements: 18 U.S.C. § 1001.

...whoever, in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States, knowingly and willfully (1) falsifies, conceals or covers up by any trick, scheme, or device a material fact; (2) makes any materially false, fictitious or fraudulent statement or representation; or (3) makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined under this title or imprisoned not more than five years, or both.

Note: Generally, 18 U.S.C. § 1001 is not used for prosecution of a taxpayer who made a false <u>oral</u> statement but rather where false or altered documents have been submitted to the IRS.

9. Mail and wire fraud: 18 U.S.C. §§ 1341 and 1343.

a. § 1341. Frauds and swindles.

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting to do so, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or deposits or causes to be deposited any matter or thing whatever to be sent or delivered by any private or commercial interstate carrier, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail or such carrier according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined under this title or imprisoned not more than five years, or both. If the violation affects a financial institution, such person shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.

b. § 1343. Fraud by wire, radio, or television.

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio or television communication in interstate or foreign commerce, any writings, signs, signals, pictures or sounds for the purpose of executing such scheme or artifice, shall be fined under this title or imprisoned not more than five years, or both. If the violation affects a financial institution, such person shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.

Note: For a violation of the mail fraud statute, intrastate mailing is sufficient; to violate wire fraud statute, use of the wires must be interstate or involve a foreign country.

Note: “The Tax Division may approve mail fraud, wire fraud or bank fraud charges in tax-related cases involving schemes to defraud the government or other persons if there was a large fraud loss or a substantial pattern of conduct and there is a significant benefit to bringing the charges instead of or in addition to Title 26 violations." *See* USDOJ Tax Division Directive No. 128 of October 29, 2004.

Note: For a significant case involving application of the wire fraud statute in a fraudulent scheme to evade foreign taxes (*i.e.*, Canadian excise taxes), *see Pasquantino v. United States*, 544 U.S. 349 (2005).

10. Conspiracy/Making False Claim: 18 U.S.C. §§ 286 and 287.

    a. § 286. Conspiracy to defraud the Government with respect to claims.

       Whoever enters into any agreement, combination, or conspiracy to defraud the United States, or any department of agency thereof, by obtaining or aiding to obtain the payment or allowance of any false, fictitious or fraudulent claim, shall be fined under this title or imprisoned not more than ten years, or both.

    b. § 287. False, fictitious or fraudulent claims.

       Whoever makes or presents to any person or officer in the civil, military, or naval service of the United States, or to any department or agency of the United States, or to any department or agency thereof, any claim upon or against the United States, or any department or agency thereof, knowing such claim to be false, fictitious, or fraudulent, shall be imprisoned not more than five years and shall be subject to a fine in the amount provided in this title.

    Note: Prosecutions of fraudulent claims for refund through the electronic filing ("ELF") of tax returns are usually brought under 18 U.S.C. §§ 286 or 287.

11. Money Laundering: 18 U.S.C. § 1956.

    Whoever, knowing that the property involved in a financial transaction represents the proceeds of some form of unlawful activity, conducts or attempts to conduct such a financial transaction which in fact involves the proceeds of specified unlawful activity

    (A)(ii) with intent to engage in conduct constituting a violation of Section 7201 or 7206 of the Internal Revenue Code of 1986

    shall be sentenced to a fine of not more than $500,000 or twice the value of the property involved in the transaction, whichever is greater, or imprisonment for not more than twenty years, or both.

Note: Money laundering has been described as "the crime of the 1990's" (as RICO was "the crime of the 1980's."). The statute applies to crimes committed after November 18, 1988. Federal agents and prosecutors especially prefer its enhanced criminal penalties (20 years and $500,000 fine) and related provisions for asset forfeiture.

I. Methods of Proof

1. Direct method -- "specific items" – is the simplest method. Government offers direct evidence that taxpayer reported income to be smaller or did not report income at all.

   a. Direct evidence includes testimonial or documentary evidence, such as cancelled payroll checks, payroll records, Forms W-2 and 1099, cancelled personal checks and receipts.

   b. Specific items cases generally involve unreported income where: (1) there is a difference between amounts received and amounts reported; (2) certain items of income are not reported; (3) a source of income is omitted; (4) a false source of income is reported; or, (5) deductions or expenses are overstated.

2. Indirect methods.

   a. Net worth.

      i. *Prima facie* case of a tax deficiency by net worth method where government "establishes the defendant's opening net worth (computed as assets at cost basis less liabilities) with reasonable certainty and then shows increases in his net worth for each year in question which, added to his nondeductible expenditures and excluding his known nontaxable receipts for the year, exceed his reported taxable income by a substantial amount." *United States v. Sorrentino*, 726 F.2d 876, 879, 880 (1st Cir. 1984).

      ii. Generally used where taxpayer has kept inadequate books and records.

   b. Expenditures -- similar to net worth.

      i. Used for taxpayers who "expend" their income on consumer goods and services, as opposed to tangible assets, such as stocks, bonds or real estate.

      ii. For an expenditures case, government must establish a likely source of income from which the expenditures sprang; show that expenditures did not result from cash on hand or the conversion of assets on hand; establish through independent evidence that expenditures were nondeductible; and investigate all relevant leads.

c. Bank deposits -- can be combined with other methods.

i. *Prima facie* tax deficiency established if government can show taxpayer engaged in activity from which unreported income arose; regular deposits were made in taxpayer's bank accounts or accounts over which he had control; accounts were investigated to distinguish between deposits of income and non-income; and unidentified deposits appear to be income.

ii. Always important for government to establish a beginning figure for taxpayer's "cash on hand," otherwise taxpayer may have "cash hoard" defense.

II. PRACTICAL CONSIDERATIONS AND OBSERVATIONS

A. Early Representation by Defense Counsel: "Damage Control"

1. From the defense perspective, it is important to ascertain whether the IRS is conducting an ordinary audit or a criminal investigation, as defense counsel should control the amount of information to be given to the IRS on behalf of the taxpayer. If the government's inquiry is a criminal investigation, then the information given to the IRS may be limited to protect the client's Fifth Amendment privilege against self-incrimination.

2. Experienced defense counsel usually will conduct an independent or "shadow" investigation with the assistance of a forensic accountant.

3. Well-advised taxpayers generally will not meet with the revenue agent or special agent because of Fifth Amendment self-incrimination problems.

4. Any attempts to mislead or conceal are considered attempts to evade. *United States v. Beacon Brass Co.*, 344 U.S. 43 (1952). It is imperative to ensure that the client does not submit false documentation to the IRS.

a. The Supreme Court in *Spies v. United States*, 317 U.S. 492,499 (1943), lists illustrative acts of evasion, such as "keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal."

b. "*Spies* evasion" -- Where one willfully fails to file and also engages in affirmative acts of evasion as listed in *Spies*, the prosecution may upgrade the failure to file misdemeanor charge to felony tax evasion. *See Spies*, 317 U.S. at 500.

c. If the government faces a statute of limitations problem in a case involving the filing of a false tax return, then it may use a later affirmative act of evasion (as discussed in *Spies*) to extend the statute of limitations. *See Beacon Brass*.

B. **Voluntary Disclosures**

1. The Department of Justice and IRS each have a voluntary disclosure policy that allows qualified individuals with unreported, legal source income to come into compliance with their tax obligations and avoid criminal prosecution. According to DOJ, its voluntary disclosure policy is an exercise of prosecutorial discretion that confers no legal rights upon taxpayers or non-filers. *See* Tax Division Memorandum of February 17, 1993. The IRS states that "a voluntary disclosure will be considered along with all other factors in the investigation in determining whether criminal prosecution will be recommended." *See* IRM 9.5.11.9.

2. To qualify as a voluntary disclosure, the disclosure must be timely and the taxpayer must fully cooperate with the IRS. Timeliness generally is recognized as being prior to the initiation of an IRS civil examination or criminal tax investigation, or notification to the taxpayer of the government's intention to initiate such an examination or investigation; and prior to the receipt by the government of information from a third party concerning the taxpayer's non-compliance. Further, the voluntary disclosure practice does not apply to individuals with illegal source income.

3. For voluntary disclosures relating to U.S. persons with unreported foreign financial accounts, the IRS initially established in 2009 a formal Offshore Voluntary Disclosure Program (OVDP) that subsequently was revised in 2011 and again in 2012. In order to avoid criminal prosecution, qualified participants generally were required (depending upon which of the three OVDPs they entered) to cooperate with the IRS, file delinquent or amended returns for six to eight prior tax years, pay applicable civil penalties and interest, pay an FBAR penalty of 20% to 27.5% of their highest account balance of the foreign account in a given year. According to the IRS, those three OVDPs have resulted in 43,000 voluntary disclosures and the collection of approximately $6 billion in taxes, interest and penalties.

4. On August 29, 2013, DOJ announced its "Swiss Bank Program" pertaining to Swiss banks not already under criminal investigation by the U.S. Under this voluntary disclosure program, qualified and cooperative Swiss banks avoid criminal prosecution and pay civil penalties ranging from 20% to 50% of the value of accounts not disclosed to the IRS, depending upon the date the applicable accounts were opened. *See* http://www.justice.gov/opa/pr/2013/August/13-tax-975.html. Of approximately 300 Swiss banks, 106 ("Category 2") banks applied by the December 31, 2013, deadline for acceptance into the program. Fourteen Swiss ("Category 1") banks already under investigation were ineligible. *See* http://www.bloomberg.com/news/2013-09-08/secret-swiss-accounts-said-no-longer-safe-for-tax-dodging.html. For ongoing information about the Swiss Bank Program, including a list of non-prosecution agreements executed under the program, *see* http://www.justice.gov/tax/swiss-bank-program.

C. **Monitoring the Civil Audit**

1. Indication of a referral to IRS-CI is the transfer of the case from a revenue agent to a special agent. If revenue agents had merely conducted a civil audit, upon completion they would approach taxpayer with a settlement figure. Otherwise, audit may be suspended for three or four weeks pending the referral to IRS-CI.

2. Revenue agent who finds indications of fraud should complete Form 2797, fraud referral, and submit it to IRS-CI. The information in the fraud referral form should reflect omitted income, impermissible deductions and evidence of willfulness. The revenue agent is prohibited from telling the taxpayer when a referral is made to IRS-CI.

D. **Cooperation or Resistance by the Taxpayer under Investigation?**

1. Defense counsel and the client must understand that cooperation or lack of cooperation will not affect whether the case is prosecuted or not. The decision to prosecute or not depends solely on the evidence against the taxpayer. The admitted tax cheater who cooperates with the IRS simply makes the special agent's job easier and shortens the length of time before he or she goes to prison. To cooperate or not must be considered on a case-by-case basis.

2. Well-advised taxpayers should not meet with CI agents without counsel present. Special agents will be seeking admissions later to be used against the taxpayer in a prosecution.

3. Statements of attorney to IRS agent may be admissible under agency exception to hearsay rule, and can be admitted in evidence as vicarious admissions of taxpayer. However, defense attorney's statements during a

Tax Division conference will not be used as vicarious admissions, except where attorney authenticates a written instrument. *See* Tax Division Directive No. 86-58 of May 14, 1986.

E. **Accountant's Role in Assisting Defense Counsel**

1. During the course of the government's tax fraud investigation, experienced defense counsel often will hire a forensic accountant to conduct a shadow investigation and to assist counsel in identifying technical tax issues and other matters that may be helpful in defending the case.

2. The attorney-client privilege will apply if a defense attorney hires the accountant to assist him or her in providing legal advice to the client. Counsel and the accountant should enter into a *Kovel* agreement. *See United States v. Kovel,* 296 F.2d 918 (2d Cir. 1961). For a more recent case that points out potential pitfalls in the attempt to establish a privileged and confidential relationship amongst counsel, accountant, and client, *see United States v. Cavallaro*, 284 F.3d 236 (1st Cir. 2002).

F. **Cautionary Checklist for Tax Advisors**

1. Defense counsel could be considered to have aided or assisted in tax fraud if they advise the client of a fraudulent means to avoid tax liability. *See* 26 U.S.C. § 7206(2).

2. *Klein* conspiracies (18 U.S.C. § 371) are very broad, and a tax advisor can be implicated if involved in impeding the functions of the IRS.

3. Tax advisors should avoid even the appearance of wrongdoing, lest they be considered to have obstructed justice. For example, if a taxpayer wants to destroy documents in the normal course of business, the ethical tax practitioner will advise them to do so only on a regular basis and in a consistent manner, and <u>not</u> to destroy any documents that are under subpoena or that may be the subject of an ongoing investigation.

4. A potential new "client" may be an undercover IRS agent.

5. When advising all clients, tax advisors should conduct themselves as if their words and actions are being recorded. They may be.

G. **Federal Sentencing Guidelines**

1. The United States Sentencing Guidelines became effective as of November 1, 1987 for individuals (November 1, 1991 for organizations), and apply to offenses committed on or after that date.

2. The stated purpose of the guidelines is to achieve in sentencing: honesty (*i.e.,* what you get is what you serve - no parole), uniformity (*i.e.*, treat similar cases alike), and proportionality (*i.e.*, treat different cases differently).

3. In *United States v. Booker*, 543 U.S. 220 (2005), the Supreme Court held that the federal sentencing guidelines are advisory, not mandatory. Later, in *Gall v. United* States, 552 U.S. 38 (2007), the Supreme Court provided federal district judges with greater discretion in sentencing than previously provided by the guidelines.

4. Under the current sentencing guidelines, jail time in the amount of 15-21 months is called for in a criminal tax case involving a total tax loss of $30,000 to $80,000 (exclusive of adjustments and departures). The amount of "tax loss" essentially "drives" the sentence that will be imposed. Recent statistics from the U.S. Sentencing Commission indicate an average sentence of 23 months imprisonment for tax crimes, generally.

5. Recent sentences in offshore tax evasion cases have varied widely from the norm, however. *See United States v. H. Ty Warner*, No. 13-cr-731 (N.D. Ill. 2013), where the creator of "Beanie Babies" paid an FBAR penalty in excess of $55 million and received a sentence of two years probation and 500 hours of community service although the tax loss exceeded $5 million. Although prosecutors may offer the opportunity for a "downward departure" from the sentencing guidelines in exchange for the defendant's substantial assistance in the investigation or prosecution of another offender under USSG § 5K1.1, Bradley C. Birkenfeld received a 40-month sentence after divulging to IRS and DOJ the vast tax evasion transgressions of UBS that led to its investigation and prosecution by DOJ. The IRS subsequently awarded Mr. Birkenfeld $104 million for blowing the whistle on UBS. *See* http://www.nytimes.com/2012/09/12/business/whistle-blower-awarded-104-million-by-irs.html?_r=0.

III. CONCLUSION

This paper was prepared in hopes of providing an overview of federal criminal tax enforcement in the United States. Of particular note, the investigations and prosecutions in recent years of lawyers and accountants who have rendered advice in tax strategies involving foreign trusts, offshore banks, and mass-marketed tax shelters, are unprecedented. And, as tax crimes continue to involve international financial transactions, enforcement efforts by U.S. authorities to detect and deter tax fraud are continuingly enhanced by the negotiation, conclusion, and application of international treaties and agreements. Significantly, those taxpayers and their professional advisers who previously - and often, successfully – asserted the defense of good faith reliance on professional advice, or attorney-client privilege in the giving and receipt of that advice, are now more likely than ever to find themselves charged as defendants in a *Klein* conspiracy. In short, a new world has developed in which federal tax enforcement authorities in the U.S. have acquired many more arrows for their quivers and an increased willingness to use them.