

FEDERAL CRIMINAL TAX ENFORCEMENT*

Justin A. Thornton**

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FEDERAL CRIMINAL TAX ENFORCEMENT

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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 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 Division (IRS-CID) 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.
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 the Government in evaluating whether to prosecute is the existence of: (1) evidence sufficient

to prove guilt beyond a reasonable doubt, and (2) a reasonable probability of conviction.

8. 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 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 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 virtually assure a sentence of incarceration will be imposed upon the convicted tax cheater.

B. Origins of IRS Criminal Investigations

1. IRS civil examinations and audits historically account for 15-20% of the criminal cases that IRS-CID investigates.
2. IRS-CID 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 (CTR's), 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 (CMIR's), 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 (FBAR's), Forms TD F 90-22.1. *See* 31 U.S.C. § 5314(a) (person in U.S. making a transaction or maintaining a relation for any person with a foreign financial agency with respect to foreign financial accounts exceeding \$10,000 must file a report). Note that a revised Form TD F 90-22.1 issued in October 2008 must be used as of January 1, 2009.
 - 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-CID includes information about its current enforcement priorities and about recent tax fraud cases. *See* <http://www.irs.gov/compliance/enforcement/article/0,,id=98205,00.html>.

1. Abusive foreign and domestic trust schemes. Ongoing prosecutions, grand jury investigations, and Congressional hearings by the Senate Finance Committee have focused on abusive offshore tax havens. IRS-CID is combating 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. *See* Attachments A, B, C & D from the IRS Website concerning Abusive Tax Schemes.
2. 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.
3. 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.

4. 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.
5. Illegal narcotics enforcement. IRS-CID is regularly called upon to assist in narcotics investigations by tracing the flow of illegal income derived from drug trafficking.
6. Fraudulent refund cases stemming from the electronic filing ("ELF") of tax returns.
7. Tax defiers. Individuals who refuse to file returns or pay income taxes based upon ill-founded beliefs 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 subject to investigation and prosecution.
8. Other forms of abusive compliance, such as bankruptcy fraud and healthcare fraud.

D. Domestic Investigative Techniques

1. IRS increasingly is using 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 is also increasingly referring 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-CID, in conjunction with the Department of Justice, is gaining increased access to foreign financial records, and tax fraud investigations are becoming more offshore in nature. The recent and well-publicized investigation 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 those who assisted them. Quite notably, IRS and DOJ are actively investigating tax evasion schemes involving other offshore financial institutions located in numerous foreign jurisdictions.

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 sixty (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 Aruba, Antigua & Barbuda, the Bahamas, Barbados, Bermuda, the British Virgin Islands, the Cayman Islands, Costa Rica, Dominica, the Dominican Republic, Grenada, Guernsey, Guyana, Honduras, the Isle of Man, Jamaica, Jersey, Marshall Islands, Mexico, the Netherland Antilles, Peru, St. Lucia (*see* Rev. Rul. 2007-28), and Trinidad & Tobago. TIEAs with Colombia and Brazil had been signed but were not in effect as of late 2007. In October 2008, the United States and the government of Liechtenstein entered into a TIEA that is prospective only, beginning with calendar year 2009, in terms of coverage, and taking effect, in terms of the process for making a request, beginning January 1, 2009.
 - 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 more than 50 nations.
 - 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. 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. 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). Likewise, upon motion by the government, courts have issued orders to require taxpayers to produce account information from offshore financial institutions or face the imposition of contempt charges. *See, e.g., United States v. Berlin*, Misc. Case No. 06-0170 (D.D.C. 2006).
- 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. U.S.A. Patriot Act of 2001. Within 45 days following the tragic events of September 11, 2001, Congress enacted powerful legislation to fight the war on terrorism. Although the Patriot Act does not directly pertain to tax prosecutions, it does give U.S. prosecutors additional resources and investigative powers to combat financial crimes that correspondingly may result in the gathering of evidence for use in criminal tax cases. Among the pertinent provisions of the Patriot Act:
 - i. Section 315 expands the scope of money laundering offenses to include transactions involving the proceeds of foreign tax crimes. Thus, while tax fraud is not a "specified unlawful activity" under the money laundering statute, foreign tax crimes may be charged as money laundering offenses pursuant to the Patriot Act.
 - ii. Section 319 allows prosecutors to obtain foreign bank records by issuing a subpoena to the correspondent bank located in the United States.
 - iii. Forfeiture provisions of the Patriot Act permit prosecutors to attach and seize funds from the correspondent bank even if the "dirty money" was deposited into the foreign account.

Note: Needless to say, many private practitioners have been concerned that the U.S. Government's application of the Patriot Act has transcended the scope of the problem it was enacted to address (e.g., as with the RICO and money laundering statutes).

- g. EU-USA Agreements on Extradition and Mutual Legal Assistance.
 - i. As of June 2006, the U.S. has signed agreements with all EU member states. The agreements and all implementing instruments are awaiting action by the Senate. These agreements supplement rather than supplant the bilateral treaties between the U.S. and EU member states, with the stated intent of streamlining the procedures for extradition and mutual legal assistance by alleviating legalization and certification requirements, simplifying pertinent documentation, and providing for the designation of administrative authorities for making and executing requests.
 - ii. The Agreements broaden the range of extraditable offenses by allowing extradition for every offense punishable by more than one year imprisonment. Grounds of refusal to extradite or provide mutual assistance by EU member states may still be asserted based upon bilateral treaties or principles of domestic law. Additionally, the Agreements provide for the formation of joint investigative teams, the use of video-technology for taking testimony, and, importantly, the exchange of information regarding suspect bank accounts

F. Conferences, Case Review Procedures, and Prosecutions

- 1. IRS-CID 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 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".

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. 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).

7. 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 oral statement but rather where false or altered documents have been submitted to the IRS.

8. 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: For a significant, recent 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).

9. 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.

10. 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 FOR THE PRACTITIONER

A. Early Representation -- "Damage Control"

- 1. Important to ascertain whether the IRS is conducting an ordinary audit or a criminal investigation as 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. Counsel ideally should conduct an independent or "shadow" investigation with the assistance of a forensic accountant.
3. Taxpayer generally should 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 Disclosure

1. The Department of Justice and IRS each have a voluntary disclosure policy. 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.

C. Monitoring the Civil Audit

1. Indication of a referral to IRS-CID 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-CID.
2. Revenue agent who finds indications of fraud should complete Form 2797, fraud referral, and submit it to IRS-CID. 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-CID.

D. Cooperation or Resistance?

1. 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. Taxpayers should not meet with CID 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

1. During the course of the government's tax fraud investigation, often it is useful for counsel to 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 an 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 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. 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 tax advisor can be implicated if involved in impeding the functions of the IRS.
3. Avoid even the appearance of wrongdoing, lest you be considered to have obstructed justice. For example, if client wants to destroy documents in the normal course of business, advise them to do so only on a regular basis and in a consistent manner; however, advise client not to destroy any documents that are under subpoena or that may be the subject of an ongoing investigation.
4. Always remember that a potential new "client" may be an undercover IRS agent.
5. When advising all clients, conduct yourself as if your 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. And in its recent *Kimbrough* and *Gall* opinions, the Supreme Court has given federal district judges greater discretion in sentencing which may lead to lower sentences. *See Kimbrough v. United States*, No. 06-6330 (Dec. 10, 2007) and *Gall v. United States*, No. 06-7949 (Dec. 10, 2007). In recent years, however, more convicted tax cheaters have been going to jail rather than receiving probationary sentences which otherwise may have been imposed prior to the implementation of the sentencing guidelines. For

example, under the current guidelines, jail time in the amount of 15-21 months is called for in a tax case involving a total loss of \$30,000 to \$80,000 (exclusive of adjustments and departures).

4. 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. *See* USSG § 5K1.1.

[An example of an exceptionally extreme downward departure involves the case of John M. Mathewson, former President of Guardian Bank & Trust Ltd. of the Cayman Islands. Mathewson purloined computer tapes that contained the secret account information and identities of about 1,800 of the bank’s depositors. After the Cayman Islands government took control of his bank in 1995, Mathewson moved to the United States where he subsequently was indicted on money laundering charges. Facing a possible 20-year sentence of imprisonment and a \$600 million fine, Mathewson entered into a plea bargain, turned over the stolen computer tapes, and cooperated with U.S. law enforcement authorities in their investigation and prosecution of others. On August 2, 1999, Mathewson was sentenced in the U.S. District Court for the District of New Jersey. In exchange for his substantial assistance, Mathewson received a sentence of six months home detention, five years probation, and a \$30,000 fine.]

5. In the face of federal sentencing guidelines that in recent years have provided for increasingly harsh punishments for tax offenders, the government regularly has sought maximum publicity of the sentences imposed in hopes of deterring other would-be offenders from violating the tax laws of the United States. In short, the sentencing guidelines have exposed the convicted tax cheater to a new and tougher sentencing system that essentially proclaims “pay the tax, or do the max” (or render substantial assistance to the government as did John Mathewson). It remains to be seen whether the sentences imposed by federal judges will be shorter in tax cases now that those sentencing judges have enhanced discretion under the *Kimbrough* and *Gall* decisions.

III. CONCLUSION

This paper was prepared in hopes of providing counsel with an overview of federal criminal tax enforcement, and with various practical considerations for representing the client who is subject to investigation or prosecution by the federal government for criminal tax fraud. Of particular note, the recent investigations and prosecutions 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 federal authorities to detect and deter tax fraud are continually 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, it's a whole new world out there in which federal tax enforcement authorities have acquired many more arrows for their quivers and an increased willingness to use them. Be careful out there, and don't become their target.

Overview – Abusive Tax Schemes

Abusive tax schemes have evolved from simple structuring of abusive domestic and foreign trust arrangements into sophisticated strategies that take advantage of the financial secrecy laws of some foreign jurisdictions and the availability of credit/debit cards issued from offshore financial institutions.

IRS Criminal Investigation (CI) has developed a nationally coordinated program to combat these abusive tax schemes. CI's primary focus is on the identification and investigation of the tax scheme promoters as well as those who play a substantial or integral role in facilitating, aiding, assisting, or furthering the abusive tax scheme (e.g., accountants, lawyers). Secondly, but equally important, is the investigation of investors who knowingly participate in abusive tax schemes.

What is an Abusive Tax Scheme?

The Abusive Tax Schemes program encompasses violations of the Internal Revenue Code (IRC) and related statutes where multiple flow-through entities are used as an integral part of the taxpayer's scheme to evade taxes. These schemes are characterized by the use of trusts, Limited Liability Companies (LLCs), Limited Liability Partnerships (LLPs), International Business Companies (IBCs), foreign financial accounts, offshore credit/debit cards and other similar instruments. The schemes are usually complex involving multi-layer transactions for the purpose of concealing the true nature and ownership of the taxable income and/or assets.

Form over substance are the most important words to remember before buying into any arrangements that promise to "eliminate" or "substantially reduce" your tax liability. The promoters of abusive tax schemes often employ financial instruments such as trusts in their schemes. However, the instruments are used for improper purposes including the facilitation of tax evasion.

ATTACHMENT A

What are some of the Most Common Abusive Tax Schemes?

Tax evasion using foreign jurisdictions is accomplished using many different methods. Some can be as simple as taking unreported cash receipts and personally traveling to a tax haven country and depositing the cash into a bank account. Others are more elaborate involving numerous domestic and foreign trusts, partnerships, nominees, etc. The following schemes are not all-inclusive, but just a sample of abusive tax schemes.

Abusive Foreign Trust Schemes: The foreign trust schemes usually start off as a series of domestic trusts layered upon one another. This set up is used to give the appearance that the taxpayer has turned his/her business and assets over to a trust and is no longer in control of the business or its assets. Once transferred to the domestic trust, the income and expenses are passed to one or more foreign trusts, typically in tax haven countries.

As an example, a taxpayer's business is split into two trusts. One trust would be the business trust that is in charge of the daily operations. The other trust is an equipment trust formed to hold the business's equipment that is leased back to the business trust at inflated rates to nullify any income reported on the business trust tax return (Form 1041). Next the income from the equipment trust is distributed to foreign trust-one, again, which nullifies any tax due on the equipment trust tax return. Foreign trust-one then distributes all or most of its income to foreign trust-two. Since all of foreign trust-two's income is foreign based there is no filing requirement.

Once the assets are in foreign trust-two, a bank account is opened either under the trust name or an International Business Corporation (IBC). The trust documentation and business records of this scheme all make it appear that the taxpayer is no longer in control of his/her business or its assets. The reality is that nothing ever changed. The taxpayer still exercises full control over his/her business and assets. There can be many different variations to the scheme.

International Business Corporations (IBC): The taxpayer establishes an IBC with the exact name as that of his/her business. The IBC also has a bank account in the foreign country. As the taxpayer receives checks from customers, he sends them to the bank in the foreign country. The foreign bank then uses its correspondent account in the to process the checks so that it never would appear to the customer, upon reviewing the canceled check that the payment was sent offshore. Once the checks clear, the taxpayer's IBC account is credited for the check payments. Here the taxpayer has, again, transferred the unreported income offshore to a tax haven jurisdiction.

False Billing Schemes: A taxpayer sets up an International Business Corporation (IBC) in a tax haven country with a nominee as the owner (usually the promoter). A bank account is then opened under the IBC. On the bank's records the taxpayer would be listed as a signatory on the account. The promoter then issues invoices to the taxpayer's business for goods allegedly purchased by the taxpayer. The taxpayer then sends payment to the IBC that gets deposited into the joint account held by the IBC and taxpayer. The taxpayer takes a business deduction for the payment to the IBC thereby reducing his/her taxable income and has safely placed the unreported income into the foreign bank account.

ATTACHMENT B

How Does the Taxpayer Access the Funds in Offshore Accounts? – Abusive Tax Schemes

Although the unreported funds sitting in the offshore bank account are earning interest or being used for investment purposes, most of the time the taxpayer wants to have access to the money. There are several methods used to get the funds back to the taxpayer, but the following are the most common.

Fraudulent Loans: The taxpayer's International Business Corporation (IBC) will make a loan to the taxpayer. The funds are wire transferred back to the taxpayer's U.S. bank account. Since these wired funds are allegedly loans they are not taxable. Many times ownership of the IBC is through bearer shares so it is very difficult to prove that the loan is a complete sham. Further adding to the difficulty is the fact that the promoters provide their clients with loan documents to make the transaction appear legitimate.

Credit/Debit Card: One of the most popular methods in recent years has been use of the bankcard to access offshore funds. Once the foreign bank account is established, the taxpayer is issued a bank card. The taxpayer can use the bankcard in the to withdraw cash and to pay for everyday expenses.

In Partnership – IRS Criminal and Civil Enforcement and Department of Justice – Abusive Tax Schemes

The IRS criminal and civil enforcement divisions work with the Department of Justice, Tax Division to shut down these abusive schemes as quickly as possible in an effort to protect taxpayers from potential additional financial harm. Parallel civil and criminal investigations are an effective and aggressive IRS approach that halts these schemes quickly and permanently. A civil injunction against the promoter stops the scheme and prevents additional 'clients' from investing. In addition, CI shares abusive tax scheme investor lists with the civil operating divisions to ensure investor tax returns are considered for examination (audit).

The IRS civil enforcement divisions have developed [tools to educate the public about abusive tax avoidance transactions](#) and have issued several [consumer alerts](#).