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Tax Crimes: Has the Bright Line Moved?

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We are longtime members of the ABA Section of Taxation Civil and Criminal Tax Penalties Committee. Our thrice-annual Saturday morning meetings used to involve continuing education only among lawyers joined by the common bond of representing clients who were not just aggressive in their tax affairs but who *really* cheated (or at least were thought to have by the government). Often, our civil tax colleagues would rib us about laboring in the dark underworld of tax practice. For the past few years, though, our sessions have been packed with practitioners who never before cared much about developments in the world of criminal tax law.

The reason for our overcrowded gatherings is the 2005 indictment of 19 former tax practitioners, most of them ex-senior employees of the accounting giant KPMG, in *U.S. v. Stein,* S1 05 Cr. 888 (LAK) (SDNY). White-collar practitioners know the case as a result of Judge Lewis Kaplan's dismissal of charges in July 2007 against 13 of the defendants based on a finding that prosecutors unconstitutionally interfered with KPMG's decisions regarding payment of legal fees to its current and former employees. The case is far from over, though — there have been five guilty pleas, other defendants await trial, other involved entities are still in play, and the Second Circuit is considering Judge Kaplan's original dismissal order. Federal prosecutors in New York also recently indicted four present and former partners at Ernst & Young on similar charges in a case styled *U.S. v. Coplan*, 07 Cr. 0453 (SHS) (SDNY). Comparable investigations are cropping up across the country.

The *Stein* and *Coplan* cases entail multiple counts of conspiracy to defraud the United States and tax evasion lodged against accountants, lawyers and investment advisers, charging that they knowingly and intentionally devised transactions designed to look like they had a real business purpose when in fact they were designed only to produce huge tax savings for the wealthy individuals who paid substantial fees for their implementation.

Traditional tax lawyers are paying rapt attention. Some are alarmed, seeing what they believe is the criminalization of transactions that in a prior day may have resulted in only civil adjustments and penalties. They argue that tax practitioners engage in tax avoidance transactions differing only in degree from those charged. The IRS does not recommend prosecution in such cases, but generally will disallow tax benefits and seek to impose civil monetary penalties for negligent or reckless tax avoidance or misconduct by taxpayers or tax professionals.

'Sham Transactions' and the Business Purpose

Somewhat more specifically, critics of the *Stein* and *Coplan* indictments assert that the government has blurred the line between two variants of the sham transaction doctrine, "sham in substance" and "sham in fact." A "sham in substance" occurs, *inter alia,* when a transaction actually occurs but has no legitimate purpose. A "sham in fact" is when a transaction is represented to have happened when in fact it did not. To date, a "sham in substance" generally has not been deemed criminal, while "shams in fact" are prosecuted.

To illustrate, the *Stein* indictment describes a tax shelter named "BLIPS," which generated tax losses through a series of transactions, including the formation of a LLC, a loan from a cooperating bank, and the use of funds in purported foreign exchange swap transactions. With minor exceptions, the indictment does not allege a sham in fact, *i.e.*, that the LLC was never created, that loan documents were never signed, or that the foreign exchange transactions never occurred. Rather, the charge is largely that the transactions were shams in substance — deals lacking in profit motive, producing billions in tax losses, structured to appear as if they had a business purpose, and made criminal by the bad faith and false representations about business purpose by the professionals and parties involved.

In broad terms, critics assert, this theory differs only slightly from claims made by the government in civil corporate tax shelter cases, where the IRS has disallowed tax benefits on the ground that a transaction was a sham in substance and imposed only civil penalties. In such cases, ranging from simple computer sale-leaseback transactions to complex hedging and swap strategies, the IRS has largely prevailed. For example, in one such civil case, the Fourth Circuit noted that a transaction is a "sham" if the "taxpayer was motivated by no business purposes other than obtaining tax benefits" and the transaction had "no economic substance because no reasonable possibility of a profit" existed. *Rice's Toyota World, Inc. v. Commissioner*, 752 F2d 89 (4^{th} Cir. 1985).

In a similar and recent case, *Jade Trading LLC v. U.S.*, No. 03-2164T (12/21/07), the U.S. Court of Federal Claims disallowed tax losses from a tax shelter similar to those at issue in *Stein* and *Coplan*; only civil penalties were imposed. These findings that a transaction lacks a business purpose are not far off from allegations such as those in ¶ 38 of the *Stein* indictment alleging that opinion letters or other documents falsely described a legitimate investment motivation. How, it is asked, can a corporate tax shelter held to lack a business purpose be pursued civilly, and the shelters at issue in *Stein* and *Coplan* be criminal? It cannot be simply because the indicted parties falsely represented the existence of a business purpose. In the civil tax cases, court records are full of documents in which professionals and taxpayers recited the existence of a business purpose and rife with references to their sworn testimony to the same effect. If in the civil cases the government followed the approach in *Stein*, each person who so opined or testified might have been prosecuted for conspiracy and perjury. Instead, the taxpayers simply lost their tax benefits and the IRS's civil penalties, if any, were upheld..

Badges of Fraud

The government argues that comparing the civil and criminal cases in this manner is incorrect, pointing to the core thesis of the two indictments — that irrespective of whether formalities were observed, the transactions at issue were designed entirely around a fixed tax loss sought by a client, with the professionals creating false documents purporting to describe the transactions as legitimate investments when no professional believed that in good faith. Thus, to the government, the false representations of a non-tax purpose, intentionally throwing sand in the eyes of the IRS about the details of and intentions behind these transactions, are the essence of a conspiracy to defraud the United States, 18 U.S.C § 371, as construed in *U.S. v. Klein*, 247 F.2d 908 (2d Cir. 1957).

Explicit and Traditional Badges of Fraud

The government also points to allegations in *Stein* and *Coplan* of explicit and traditional badges of fraud apart from the issue of business purpose — that individuals involved interposed sham privilege claims, drafted documents containing other statements they knew to be false, destroyed or concealed materials during IRS examinations, intentionally failed to comply with registration requirements, and lied to IRS and congressional investigators, while making lucrative fees and sometimes cheating on their own taxes. Whatever one might believe about whether the charges at issue blur the line between “shams in substance” or “shams in fact,” proof that sophisticated professionals undertook such steps would make their conduct more likely the subject of criminal tax charges.

Criminal Evasion or Civil Deficiency?

One can wonder whether the individuals in *Stein* and *Coplan* would have pushed forward with the tax strategies if they thought their conduct was criminal. Some may have believed that there was a chance, however remote, that a transaction might produce a real profit. Others, mindful that their actions were nearly identical to transactions in litigated civil corporate tax shelter cases, may have assumed that at most the IRS might disallow tax benefits and impose civil penalties. The government, obviously, would take issue, arguing that these highly sophisticated tax practitioners knew they were trying to smoke one by the IRS.

Indeed, the issue largely comes down to intent. Criminal tax prosecutions require proof of willfulness, *i.e.*, a showing that a defendant voluntarily and intentionally violated a known legal duty and did not hold a good faith belief in the legality of his or her actions. *U.S. v. Cheek*, 498 U.S. 192 (1991); *U.S. v. Pomponio*, 429 U.S. 10 (1976). The government usually proves intent by pointing to a pattern of obviously fraudulent acts. Typical is conduct such as diverting business income before it hits the company books, skimming cash, using assumed names or foreign accounts to disguise ownership of funds, making false statements on tax returns, or engaging in a cover-up once the IRS starts looking.

At bottom, the government’s theory in *Stein* and *Coplan* is that a professional’s knowing and intentional misrepresentation that a transaction has a business purpose is in the same category as more traditional badges of fraud. Prosecutors surely will seek to prove bad faith by pointing to evidence purporting to show that the professionals privately knew that these transactions had no valid business purpose and that they committed more traditional fraudulent acts.

However, the government also appears to be using the criminal process to attack the details of the underlying transactions. In addition to conspiracy, *Stein* and *Coplan* indictments charge tax evasion, 26 U.S.C. § 7201, which requires proof of a tax deficiency. Prosecutors presumably will have to demonstrate that the underlying losses or tax deductions at issue were improperly taken. Will prosecutors then attack the deals by arguing that they lacked economic substance? Will they seek to call expert witnesses to opine as to the implications of the tax law?

Conclusion

We and our civil tax colleagues will watch these cases closely, because while proof of intentional lying, cheating and concealment will make these cases more like traditional criminal tax cases, arguments that a transaction was novel, “too good to be true,” or lacked a profit motive or economic substance, will sound like the province of civil tax cases It will take one or more criminal trials and perhaps appeals to clarify whether the government has moved the fences in the field of tax planning, or whether these cases, though more complex, still rest on core allegations of criminal tax evasion. So stay tuned.

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