

Criminal Tax Cases

By Caroline D. Ciraolo, Esq.

During the fiscal year ending (FYE) September 30, 2006, approximately 228,145,000 federal tax returns were filed (2006 *IRS Data Book*—Table 2). During this same period, the Internal Revenue Service (IRS or the “Service”) Criminal Investigation Division (CID) initiated 3,907 criminal investigations, an increase of almost 20 percent over the number of investigations initiated five years ago. During the 2006 fiscal year, the Service also recommended prosecution of 2,720 cases, filed information or indictments in 2,319 cases, and obtained 2,019 convictions (2006 *IRS Data Book*—Table 18).

Criminal tax cases are remarkable in that the conviction rate is above 90 percent and incarceration is likely. Of defendants sentenced for tax crimes in FYE 2006, 81.7 percent were incarcerated. There are many reasons for the government’s success in this area. Following are the basics of a federal criminal tax investigation which may shed some light on this success.

History

The Criminal Investigation Division began as the Intelligence Unit in 1919 to investigate allegations of tax fraud. The first special agents were six US Post Office Inspectors. The Intelligence Unit gained national recognition in the 1930s for its role in the conviction of Al Capone and the investigation of the Lindbergh kidnapping.

In 1978, the Intelligence Unit was renamed Criminal Investigation, and today has approximately 4,400 employees around the world, including approximately 2,800 special agents. The IRS, through CID, is the only federal agency authorized to investigate potential criminal violations of the Internal Revenue Code.

The CID divides investigations into three interdependent programs: 1) Legal Source Tax Crimes, 2) Illegal Source Financial Crimes, and 3) Narcotics Related Financial Crimes. Legal source tax crimes encompass a wide range of offenses, including tax evasion, non-filers, employment tax fraud, abusive tax schemes and shelters, corporate and accounting fraud, bankruptcy fraud, insurance and Medicare fraud, and pension fund fraud.

Current Priorities

The mission of CID is to assist in the enforcement of tax law by “investigating potential criminal violations of the *Internal Revenue Code* and related financial crimes in a manner that fosters confidence in the tax system and compliance with the law.” To achieve this mission, CID has identified priorities and areas of emphasis, including, but not limited to:

Abusive Tax Schemes—These cases involve simple structuring of abusive trusts as well as sophisticated tax evasion strategies, including offshore credit and debit cards, foreign financial institutions, and complex shelters. The IRS is aggressively seeking to identify and investigate the promoters of such schemes, those individuals who aid or assist in furthering the schemes, and the investors.

Nonfilers—CID assigns a high investigative priority to taxpayers who fail to file income tax returns. Of particular interest are accountants, lawyers, public officials, high-income wage earners, and nonfilers who advocate militant, anti-government or tax protestor viewpoints.

Corporate Fraud—Corporate fraud encompasses complex tax and other financial crimes committed by large corporations and/or their executives. CID began prioritizing corporate fraud in FYE 2004, during which 107 such investigations were initiated. Examples of such cases include the investigations of World Com, Enron and Tyco.

Refund Crimes—CID continues to investigate questionable refund schemes that involve high dollars and numerous participants, often focusing on unscrupulous tax return preparers who promote the preparation and filing of fraudulent returns. These cases often involve false Forms W2, earned income tax credit fraud, false itemized deductions, fraudulent credits, and false refund claims on prisoner returns.

Employment Tax Crimes—CID investigates a wide variety of employment tax schemes, including:

- a. Paying employees in cash to avoid reporting requirements
- b. Failing to file employment tax returns
- c. Filing false returns
- d. Closing a business to avoid mounting payroll tax liabilities only to reopen a new business under a new name to incur new liabilities (known as “pyramiding”)
- e. Employee leasing companies that fail to pay over to the IRS employment taxes due.

Counter Terrorism—CID works with the FBI’s Joint Terrorism Task Forces and the US Attorney Offices’ Anti-Terrorism Task Forces to pursue counterterrorism leads, using its financial expertise and resources to track the money. CID Special Agents work with the Treasury Office of Terrorism and Financial Intelligence, and the Office of Foreign Assets Control to investigate and freeze accounts controlled by individuals and organizations suspected of raising or facilitating the movement of funds to support terrorism.

Organized Crime Drug Enforcement Task Force (OCDETF)—Joining with OCDETF and High Intensity Drug Trafficking Area (HIDTA) investigations, CID uses its financial expertise and resources to investigate narcotics trafficking and money laundering organizations.

Bank Secrecy Act—CID coordinates with IRS Fraud Technical Advisors, *Bank Secrecy Act* (BSA) Examiners, and the Financial Crimes Enforcement Network (FinCEN) to investigate BSA criminal violations and identify potential significant legal and illegal source tax cases, as well as money laundering, asset forfeiture, terrorist financing and narcotics investigations.

Initiating an Investigation

Criminal investigations are initiated in a variety of ways. Some of the most common criminal referrals arise from pending civil audits, where a revenue agent examining a return discovers firm

indications of fraud. Similar referrals can arise from other areas of the IRS, like the Collection Division, where a revenue officer attempting to collect a federal tax liability finds that false statements have been made or false documents submitted during the collection process, or that a taxpayer is willfully evading payment. The IRS coordinates these efforts through its Fraud Referral Program. Fraud technical advisors work with the various IRS divisions to promote fraud awareness and fraud training.

Other state or federal agencies make referrals to CID based on documents filed with, or representations made to such agencies or their representatives. Referrals may also arise from non-tax criminal grand jury investigations, or from a bankruptcy proceeding, during which it is discovered that a taxpayer filed fraudulent returns, hid assets to hinder or prevent the collection of tax, or committed other violations of the *Internal Revenue Code*.

It is important to note that the IRS encourages individuals to report suspected tax fraud. As a result, many referrals come from third parties and secondary sources, including disgruntled former or current employees, business associates, business competitors, former spouses, former friends, neighbors, newspaper articles, etc.

These referrals are processed by the IRS Whistleblower Office, which was established by the *Tax Relief and Health Care Act of 2006*. Information from individuals is often prompted by the prospect of a reward equal to 15 to 30 percent of the total amount the IRS collects based on the information provided.

From Civil to Criminal

Taking the common example of a pending civil audit, revenue agents are required to consult with their respective group managers and a local fraud technical advisor (FTA) at the first indication that a taxpayer willfully attempted to defeat or evade the assessment or payment of tax. In this context, “willfulness” is defined as “the voluntary, intentional violation of a known legal duty.” (*Cheek v. United States*, 498 US 192, 201 (1991)).

In criminal cases, the government bears the burden of proving willfulness beyond a reasonable doubt and of negating a defendant’s claim that they were ignorant of or misunderstood the law, or held a good-faith belief that their conduct did not violate the law (*Id. at 201-202*). To satisfy its burden, the government is permitted to offer circumstantial evidence, often referred to as the “badges of fraud.”

In *Spies v. United States*, 317 US 492 (1943), the Supreme Court identified examples of such conduct: “keeping a double set of books, making false entries of 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.” (*Id. at 499*).

After identifying the first indication of fraud, the revenue agent continues to work with the manager and the FTA to document affirmative acts of fraud. When the revenue agent makes a “firm indication of fraud,” the civil examination must be suspended, a detailed report must be prepared detailing potential adjustments, tax loss and badges of fraud, and the case must be prepared for referral to CID.

The IRS is not permitted to use its broad powers to gather evidence in a civil examination to investigate a criminal case (*United States v. Tweel*, 550 F.2d 297 (5th Cir. 1977)). It is important

to note, however, that this prohibition does not bar the government from simultaneously pursuing a criminal investigation and civil enforcement actions, otherwise referred to as “parallel proceedings.”

The referral of a case to CID is generally not disclosed to the taxpayers or their representatives. Accordingly, a long period of silence from a revenue agent in the midst of a civil audit may be an indication that the case is being referred to CID. A taxpayer often learns that the case has been referred to CID when two or more special agents visit them.

In determining whether to accept a criminal referral, CID looks for significant egregious conduct. Simple understatement of income is generally not sufficient to convert a civil audit to a criminal prosecution. Instead, CID looks for patterns of substantial understatement or nonfiling, resulting in an aggregate tax loss to the government sufficient to warrant incarceration under the US Sentencing Guidelines (USSG).

CID also considers the deterrent value of the potential conviction and seeks to get the biggest “bang for its buck” by publicizing high-profile convictions. CID considers factors such as the taxpayer’s occupation and industry, position and standing in the community, criminal history and nature of the offense.

An example of this is the recent indictment of Joseph R. Francis for tax evasion. The indictment alleges that Francis, whose Mantra Films, Inc. and Sands Media, Inc. produce and sell the *Girls Gone Wild* movies, deducted more than \$20 million in false business expenses on his corporations’ income tax returns, and used offshore accounts and entities to hide millions of dollars in unreported income.

If CID accepts a criminal referral, it strives to make a timely decision on whether charges are warranted. Ten years ago, criminal investigations often lasted for years, and if taxpayers were ultimately charged and convicted, they often dissipated any assets that could be used to pay any resulting civil liabilities. In 2003, under the new administration of Commissioner Mark W. Everson, CID established a goal of completing investigations within 425 days.

CID conducts criminal investigations through a variety of methods. Special agents will visit the taxpayer and attempt to conduct an interview, subpoena financial and business records, interview third parties, seek and execute search warrants and access information through a variety of databases. Special agents work closely with IRS computer investigative specialists who use specialized equipment and software to obtain and preserve electronic evidence.

If CID believes that criminal prosecution is warranted, the IRS Special Agent in Charge notifies the taxpayer of potential charges and offers an opportunity to present any defenses before the matter is referred to the Department of Justice. A taxpayer may present defenses in person at what is referred to as a “conference,” or submit defenses in writing. At this point, CID will not discuss or consider potential pleas, civil settlements or compromises of the tax liabilities. If CID is not persuaded by the defenses raised, it will refer the matter to the Department of Justice, Tax Division (Criminal Section).

When the Tax Division receives a case from CID, it will review the files and offer the taxpayer a final conference to present reasons why charges should not be pursued. This conference may be conducted in person, by phone, or in writing. This is the taxpayer’s final opportunity to present any defenses before the matter is referred to the local US Attorney’s Office for indictment and prosecution in the US District Court.

Potential Charges

The most common criminal tax offenses are:

1. Willful attempt to evade or defeat any tax (evasion) under 26 USC § 7201
2. Willful failure to collect or pay over any tax (employment tax fraud) under 26 U.S.C. § 7202
3. Willful failure to file a return, supply information or pay tax due under 26 USC § 7203
4. Fraud and false statements (including aiding or assisting in preparation of false returns or refund claims) under 26 USC § 7206
5. Willful attempts to interfere with administration of internal revenue laws (obstruction) under 26 USC § 7212
6. Conspiring to defraud the government with respect to claims (*i.e.*, refund claims) under 18 USC § 286
7. False, fictitious, or fraudulent claims under 18 USC § 287
8. Conspiring to commit offenses or to defraud the United States under 18 USC § 371

Criminal tax prosecutions will often involve multiple counts, multiple years and, if appropriate, conspiracy charges. Most offenses are felonies, subject to a six-year statute of limitations with statutory maximum imprisonment ranges of three, five or ten years. Failure to file returns, in violation of 26 USC § 7203, is a misdemeanor subject to imprisonment up to one year. However, the government rarely seeks to prosecute a single count misdemeanor tax case.

Voluntary Disclosures

To encourage taxpayers to “come clean” with past offenses and get back into compliance, the IRS offers a voluntary disclosure policy for “legal source” tax offenders. The policy offers no substantive or procedural rights for the taxpayers, but a true voluntary disclosure will generally result in the IRS not recommending a case for criminal prosecution to the DOJ Tax Division, in part due to the lack of jury appeal of a repentant taxpayer who has come clean and cooperated in the investigation.

Moreover, there is case law supporting the position that a bad faith prosecution of a taxpayer after a true voluntary disclosure is subject to increased scrutiny (See *Groder v. United States*, 816 F.2d 139, 142 (4th Cir. 1987)). It is important to recognize, however, that the government has prosecuted taxpayers notwithstanding voluntary disclosures (See *United States v. Hebel*, 668 F.2d 995 (8th Cir. 1982); *United States v. Choate*, 619 F.2d 21 (9th Cir. 1980); *United States v. Adams*, 832 F. Supp. 1138 (W.D. Tenn. 1993)).

A voluntary disclosure must be truthful, complete, and timely—factors that are determined by CID. A taxpayer must fully cooperate with the Service to determine the accurate tax liability, make good faith arrangements to pay the full amount of tax, interest and penalties due, and be in full compliance with the tax laws.

To be timely, the disclosure must precede any “triggering” event. Such as:

1. The initiation of a civil audit or criminal investigation of the taxpayer, or directly related to the

taxpayer

2. The receipt of information from a third party regarding the specific taxpayer's noncompliance
3. The acquisition of information regarding the specific taxpayer from a criminal enforcement action such as a search warrant or grand jury subpoena

An IRS announcement of a civil compliance project, such as the pursuit of taxpayers using offshore credit cards to hide income, will not prevent a taxpayer in that category from making a true voluntary disclosure so long as the IRS has not initiated an examination or investigation of, or received information directly related to, the specific taxpayer.

Going to trial

In deciding to go to trial, a defendant must fully understand the elements of each offense charged and the chances of success as well as the ramifications of failure based on the theories of defense (see *Plea Agreements* and *Sentencing* infra). While each criminal tax case will have its own distinctive elements, most cases involve common defenses, including:

1. The taxpayer relied in good faith on a professional advisor (attorney, accountant, financial consultant or return preparer).
2. The bookkeeper did it.
3. The taxpayer had a good faith misunderstanding of the law.
4. The complexity of the tax law simply prevents a finding of willfulness.
5. The taxpayer lacks the mental capacity to commit the crime.
6. The offensive conduct was so obvious and so likely to be detected that it could not have been planned as part of a scheme to defraud or conceal.
7. The government's conduct was so offensive that the defendant should be acquitted.

As noted, the government has an extremely high conviction rate in criminal tax prosecutions. While there are acquittals and vacated convictions based on procedural errors at trial, most taxpayers indicted in a criminal tax case are well advised to consider the option of plea bargaining.

Plea Agreements and Sentencing

When the Tax Division refers a case for prosecution, the US Attorney may accept a plea of guilty to the major count(s) of the indictment or information without prior approval of the Tax Division. Most criminal tax cases are disposed of by entry of a guilty plea, due in no small part to the high conviction rate following trials and the harsh impact of the *US Sentencing Guidelines*, even though the *Guidelines* are advisory, not mandatory following *United States v. Booker*, 543 U.S. 220 (2005).

The *Guidelines* calculate an advisory sentencing range based on the "tax loss," which includes the loss caused by the offense for which the taxpayer is convicted, as well as any other "relevant conduct." Relevant conduct includes "all conduct violating the tax laws should be considered as part of the same course of conduct or common scheme or plan unless the evidence demonstrates that the conduct is clearly unrelated." (*USSG § 2T1.1 cmt. n.2*).

A defendant's sentence may be based on tax loss associated with years that are not charged, or even for which the defendant is acquitted (*USSG § 1B1.3(a)*). The 2006 edition of the

Guidelines provides the following tax table:

| TaxAggregate Loss (Apply the Greatest) | Offense Level | [Sentence Range] |
|---|----------------------|-------------------------|
| (A) \$2,000 or less | 6 | 0-6 months |
| (B) More than \$2,000 | 8 | 0-6 months |
| (C) More than \$5,000 | 10 | 6-12 months |
| (D) More than \$12,500 | 12 | 10-16 months |
| (E) More than \$30,000 | 14 | 15-21 months |
| (F) More than \$80,000 | 16 | 21-27 months |
| (G) More than \$200,000 | 18 | 27-33 months |
| (H) More than \$400,000 | 20 | 33-41 months |
| (I) More than \$1,000,000 | 22 | 41-51 months |
| (J) More than \$2,500,000 | 24 | 51-63 months |
| (K) More than \$7,000,000 | 26 | 63-78 months |
| (L) More than \$20,000,000 | 28 | 78-97 months |
| (M) More than \$50,000,000 | 30 | 97-121 months |
| (N) More than \$100,000,000 | 32 | 121-151 months |
| (O) More than \$200,000,000 | 34 | 151-188 months |
| (P) More than \$400,000,000 | 36 | 188-235 months |

(USSG § 2T4.1)

The *Guidelines* provide for reduced sentences for defendants who plead guilty and accept responsibility for their conduct. In addition, trial courts may consider a variety of factors set forth in 18 USC § 3553(a) to arrive at a reasonable sentence. In criminal tax prosecutions resulting in a guilty plea or conviction, a crucial role of defense counsel is to minimize the tax loss and maximize the favorable § 3553(a) factors to arrive at the lowest sentence possible.

Conclusion

Benjamin Franklin is often quoted as saying, “In this world, nothing is certain but death and taxes.” The world of tax law, however, goes well beyond Ben’s pithy statement and this short overview of criminal tax law. There are many treatises, manuals and other publications that delve into the evolving and growing number of nooks and crannies of this area of practice. Taxpayers should be cautious in their tax planning because the IRS has recovered from the public beating it took in Congressional hearings during the mid-1990s. Aggressive enforcement is again a top IRS priority.

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