IRS Reorganization and Tax Prosecutions

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Louis De Falaise
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Managing Editor
Jim Donovan

Assistant Editor
Nancy Bowman

Law Clerk
Brian Burke

Internet Address
www.usdoj.gov/usao/eousa/foia/foiamanuals.html

Send article submissions to Managing Editor, United States Attorneys' Bulletin, National Advocacy Center Office of Legal Education 1620 Pendleton Street Columbia, SC 29201

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What Has Changed for IRS Criminal Investigation and Our Relationship with the Department of Justice?

By: Mark E. Matthews
Chief, IRS Criminal Investigation

In July 2000, the Internal Revenue Service Criminal Investigation ("CI") finalized an historic reorganization. We achieved numerous long-sought goals, including line authority over all CI special agents and employees, referral authority to the Department of Justice for our investigations and a direct reporting relationship to the Commissioner. Until last July, CI Special Agents reported most directly to multifunctional (i.e., civil and criminal) IRS district directors, a relationship mirrored at IRS headquarters with an Assistant Commissioner for CI reporting to a multifunctional executive subordinate to the Commissioner. Commissioner Charles O. Rossotti has now placed all criminal enforcement resources under the Chief, Criminal Investigation, who, in turn, reports directly to him. Two significant reasons for the reorganization were:

1. The Restructuring and Reform Act of 1998 (RRA 98) set the groundwork for the IRS to redesign to serve taxpayers and tax practitioners more effectively and efficiently. RRA 98 included redesign for the Criminal Investigation Division.
2. The 1999 Webster Report, written by Judge William Webster, made dozens of detailed recommendations, including the major structural changes described above.

Some of the most significant changes to IRS Criminal Investigation were virtually invisible to the field special agents and our key constituents: the Department of Justice Tax Division and the Offices of the United States Attorneys. However, numerous internal changes have occurred that will ensure a more focused tax compliance strategy, a streamlined approach to case management within CI, and a much more coordinated and effective media strategy. (See article "IRS Publicity Strategy" by Mark Matthews in this issue of the USA Bulletin) The revised CI mission statement reflects that focus:

I. Mission of IRS Criminal Investigation

Criminal Investigation (CI) serves the American public 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 tax law.

A. Line Authority

The IRS CI has line authority through the Chief CI who reports directly to the Commissioner. The local CI Special Agent-In-Charge (SAC) reports directly to the National Office through his or her Director of Field Operations (DFO), who is located in the IRS areas. This ensures that case management is now the responsibility of professional law enforcement officials within the IRS.

B. IRS Lead Development Centers

A new concept for the IRS CI was the establishment of Lead Development Centers (LDC). These centers, which are being implemented as this article is published, will assist CI special agents in developing and assigning investigative leads. LDCs will be a part of the Director, Field Operation's staff. They will perform database analysis, develop leads to the level required for Primary Investigation (PI) assignment, and review leads for consistency with the IRS Compliance Strategy. The LDC will process all fraud referrals from the four newly-created IRS Operating Divisions and send them to the field offices. Further, the LDCs will interface with CI Field Offices, Operating Divisions, task forces, and FinCEN (Financial Crimes Enforcement Network) to select, develop,

and assign leads. As of May 2001, the Baltimore LDC is staffed and operating. During the next year, LDCs will be opened in Atlanta, St. Petersburg, Garden City, Philadelphia, Cincinnati, Indianapolis, Kansas City, Austin, Denver, Fresno and Portland. (See appendix A – Case Management Process)

C. Fraud Referrals

Both structural and process changes are being established in the Operating Divisions to revive the referral program so that CI can focus on tax investigations. Both CI and Operating Division resources will be dedicated to fraud detection and investigation at key organizational levels. Formal educational, referral, and feedback processes will be established. The Operating Divisions have hired Fraud Area Managers for their four area offices. These managers will supervise over sixty fraud referral program specialists who will be spread across the country. These specialists will work directly with Revenue Agents and Officers to develop quality fraud referrals to CI.

D. Fraud Detection Centers

The newly named Fraud Detection Centers (FDCs) replace the Criminal Investigative Branches (formerly known as CIBs) located in the Customer Service Centers. The FDCs have been incorporated into the CI organization under the Office of Refund Crimes. They work closely with CI field offices to develop criminal cases as well as to stop fraudulent refunds. In addition, the FDCs work with the other Operating Divisions within the Service Center and in the field offices.

E. Focus of Tax

Legal source tax cases are and will be the top priority for CI, followed by money laundering and illegal source income cases. As the Webster Report concluded, it is CI and CI alone that is charged with enforcement of tax crimes. Anti-drug enforcement is, of course, a national concern, and CI special agents will still be utilized in those efforts. The Webster Report made clear, however, that CI should be reimbursed by other agencies that utilize its agents and resources in narcotics cases, and that is, in fact, happening now. CI is now focusing on those cases of significance where CI specifically brings its unique skills to the table and on cases with an impact on tax administration.

CI has developed an interim compliance strategy which identified three separate segments of CI's investigative efforts; Legal Source Tax Cases (commonly referred to as Title 26 cases although this segment also includes Title 18 violations such as 286, 287 and 371); Illegal Source Financial Crimes (which includes Title 18 and Title 26 violations as well as money laundering violations); and Narcotics-Related Financial Crimes (which includes both tax and money laundering violations.)

F. IRS Compliance Council

CI is a key member of the IRS Compliance Council that will implement an IRS National Compliance Strategy. The council includes CI, the IRS operating divisions, the Commissioner's Representative and external compliance stakeholders - such as the Department of Justice. The council will play an essential role in the IRS' strategic, coordinated approach to compliance issues throughout the pre-filing, filing and post-filing efforts. CI will use the National Compliance Strategy to manage the mix of cases to ensure the appropriate investigations are being conducted in order to foster compliance.

G. Partnership with Operating Divisions

CI works closely with the four operating divisions, and this relationship is reinforced through the IRS Compliance Council. The relationships with Small Business and Self Employed (SB/SE), Wage and Investment (W & I), Large and Mid-Sized Business (LMSB) and Tax-Exempt and Government Entities (TE/GE) is geared toward specific market-segment taxpayers for purposes of providing anti-fraud education and identifying appropriate fraud cases for referral.

H. IRS Counsel's Role in the new CI (See "IRS Creates Counsel/Special Agent Team" by Nancy Jardini and Mark Matthews in this issue of the USA Bulletin)

Counsel is now involved in CI cases from the very beginning to provide guidance to the case agent and management officials. Counsel is available to discuss all types of case related issues

regarding both Title 26 and money laundering. They are involved in the review of Special Investigative Techniques, handle summons enforcement, review CI cases upon completion, and prepare an evaluation memorandum for the referring official. (See appendix A -- Case Management Process.)

One of the recommendations in the Webster Report was to restructure the way legal service was provided to CI. Judge Webster's recommendations, along with the design changes brought about as a result of the more general IRS restructuring, resulted in the reorganization of Criminal Tax counsel. In July, 2000, immediately after CI was restructured, the Treasury Secretary, with the endorsement of Commissioner Rossotti, transferred referral authority of a criminal case from Counsel to CI Special Agents-in-Charge. The laws regulating the disclosure of taxpayer and tax return information from the IRS to outside agencies require that there be one centralized authority to refer criminal tax investigations to the Justice Department for prosecution.

I. Public Information Officers (PIOs) (See IRS Publicity Strategy by Mark Matthews in this issue of the USA Bulletin)

Criminal Investigation has established collateral duty positions for IRS special agents to serve as Public Information Officers (PIO). Each of the thirty-five Special Agents-in-Charge now has a PIO. They serve as the contact point for all internal and external CI communication initiatives, including issuing press releases and coordinating with the U.S. Attorneys' Offices and other law enforcement media events. One of the key responsibilities of the PIO is to establish a close working relationship with the U.S. Attorneys' Offices in their judicial districts to assist in ensuring that CI cases receive appropriate publicity. The PIOs have received disclosure training (as it relates to the disclosure of tax return information under Internal Revenue Code Section 6103) and media training with their SACs.

J. Recruiting New Special Agents

Criminal Investigations is taking aggressive steps to increase the special agent workforce. Some efforts include increased recruiting activities, obtaining additional hiring authority and the reestablishment of the student COOP program. During the next two years, 2001- 2002, CI will hire almost 600 additional special agents.

II. Geographic Structure

Headquarters: Washington, DC (See appendix B – Organizational Charts)

A. Field Structure (See appendix C – Map)

1. Six Area Director, Field Operations Offices: Atlanta, GA; Baltimore, MD; Chicago, IL; Dallas TX; Philadelphia, PA; Laguna Niguel, CA.
2. Thirty-five Special Agent-in-Charge Offices: CI territory offices will be aligned with the boundaries of the Federal judicial districts to enable each U.S. Attorney's Office to have contact with only one CI office.
3. Ten Fraud Detection Centers: Formerly called Criminal Investigative Branches in the ten IRS service centers, the Fraud Detection Centers will remain located in the same centers across the United States; however, they report to the Headquarters Director, Refund Fraud. These centers detect fraudulent returns and prevent issuance of related false refunds. They work closely with CI field offices to develop criminal cases.
4. Criminal Investigation Foreign Liaison Offices: CI special agents are in foreign posts-of-duty located in Canada, Mexico, Colombia, Germany, and Hong Kong, as well as at INTERPOL in Lyon, France.
5. CI Special Agents and support staff: The majority of CI's front line field employees are at the same location doing the same job.

B. Changes in Field Operations

1. CI Offices are aligned with IRS area boundaries and U.S. Judicial Districts to improve stakeholder interfaces and to meet our responsibilities in the area of tax administration and law enforcement.
2. CI has increased operational focus and accountability by linking more directly

with the IRS operating divisions to develop leads and investigate tax fraud.

3. Centralized management increases consistency in the application of the CI compliance strategy.
4. Responsibility is delegated to the Special Agents-in-Charge (SACs) and Assistant Special Agents-in-Charge (ASACs) in order to increase the efficient use of resources and eliminate duplicity in case review and approval.
5. Centralized management as well as increased presence by IRS Chief Counsel ensures that the best cases are pursued through a collaborative effort between CI, Chief Counsel, Department of Justice and the Executive Office for U.S. Attorneys.
6. The new configuration more closely resembles other law enforcement agencies.

C. What Does this Mean to the U.S. Attorney?

1. Criminal Investigation's involvement with the U.S. Attorney's office is essentially "business as usual."
2. CI in each field operation is under the direct authority of the Special Agent-in-Charge.
3. Field offices have been realigned to be consistent with the boundaries of U.S. Judicial Districts. Therefore, U.S. Attorneys work with one IRS SAC; however, in some areas, a SAC may have authority over more than one Judicial District (see map - Appendix C).
4. The SAC and ASAC and Supervisory Special Agent continue to establish and maintain liaison with the U.S. Attorney's office.

ABOUT THE AUTHOR

❑**Mark E. Matthews** is the Chief, IRS Criminal Investigation (CI), responsible for investigating criminal violations of the tax code. Headquartered in Washington, D.C., Mr. Matthews oversees a nationwide staff of approximately 4,500 CI employees as they investigate and assist in the prosecution of criminal tax, money laundering, and narcotics-related financial crime cases. Mr. Matthews came to the IRS from private law practice. His most recent public service was as Deputy Assistant Attorney General, responsible for criminal tax prosecutions at the Justice Department's Tax Division. He also served as an Assistant United States Attorney and as Deputy Chief of the Criminal Division in the United States Attorney's Office in the Southern District of New York. He has served in other governmental positions as Special Assistant to Director William H. Webster at the Federal Bureau of Investigation and the Central Intelligence Agency. ✠

IRS Creates Counsel/Special Agent Team

Nancy Jardini
Division Counsel/Associate Chief Counsel (Criminal Tax)

Mark E. Matthews
Chief, Criminal Investigation

The role of the criminal tax attorney within the Internal Revenue Service's Office of Chief Counsel changed dramatically in July, 2000. Both the organizational structure of Chief Counsel's Criminal Tax Division, also known as CT, as well as its procedural responsibilities have been altered to promote a stronger, more integrated and constructive relationship between CT attorneys and the Criminal Investigation Special Agents. Assistant United States Attorneys and trial attorneys from both the Criminal Division and the Tax Division should understand the redesign of the Counsel role, and how they can take maximum advantage of the CT resources available to assist them in IRS investigations.

In response to Senate Finance Committee hearings in 1998, IRS Commissioner Charles Rossotti asked Judge William Webster, former director of the FBI and CIA, to conduct a comprehensive review of the operations of IRS Criminal Investigation (CI). In a report issued in April 1999, see http://www.treas.gov/irs/ci/ci_structure/index.htm, Judge Webster made numerous recommendations to improve the efficiency of CI operations. One of those recommendations was to restructure the way legal service was provided to CI. Judge Webster's recommendations were based on two fundamental findings. First, a structural change to CT would ensure accessible legal advice in the complicated area of criminal tax to the Special Agents in the field. Another equally important reason, however, was to ensure that the very sensitive enforcement concerns of the IRS, which differ from every other federal law enforcement agency, are consistently considered in every case. The restructuring of CT has allowed CT to effectively accomplish the goals set forth by Judge Webster.

Before the reorganization, the criminal tax services provided by the Office of Chief Counsel were fractured. National policy was developed by a small cadre of lawyers in the national office who had no authority to enforce it. In the field, criminal tax work was handled by multi-functional district counsel attorneys who were responsible for supporting and reviewing CI investigations, as well as for a broad range of civil tax issues such as tax court and bankruptcy proceedings. They were not full-time practitioners in the complicated criminal tax arena.

This fractured structure presented a number of difficulties in providing effective legal advice to CI. The field attorneys who were expected to provide expert legal advice on complicated aspects of criminal tax to the agents in the field also shouldered diverse responsibilities for civil tax matters. Consequently, these attorneys were expected to develop a depth of expertise while at the same time fulfilling their responsibilities in tax court and in U.S. District Court on bankruptcy matters. As a result, despite the dedicated efforts of Counsel attorneys, the criminal tax work often became a low priority because it had less urgent deadlines. Finally, because the national office had no direct authority over the field attorneys, national criminal tax policy guidance and training was not always effectively implemented in the field.

The new structure of CT not only addresses those shortcomings but also reflects the IRS' commitment to support the criminal enforcement component. Every attorney nationwide who is assigned to CT is a dedicated expert in criminal tax law and does not have any civil tax responsibilities. CT has a direct line of authority

from the national office through the field to establish consistent policy and to provide uniform review, guidance, and training. CT attorneys' mandate is not only to foster criminal tax expertise, but to be accessible and integrated members of the criminal investigative team. These features of a stronger national office with direct supervisory control over field operations is mirrored in the CI organization as well.

The CT National Office is now directed by the Division Counsel/Associate Chief Counsel (Criminal Tax), who reports directly to the Chief Counsel of the IRS. Although there is no direct reporting authority to CI, the Division Counsel and the Chief of CI work closely together to ensure consistent policy development and implementation. The Division Counsel is responsible for directing the entire Criminal Tax program, which includes a national office staff and docket attorneys located in thirty-five field offices throughout the country. The National Office mandates all CT policy and procedure, coordinates multidistrict investigations, develops and coordinates all CT training, reviews sensitive investigations from the field and generally ensures that the CT program is implemented effectively.

The CT field structure is designed to mirror the structure of the client, CI. Thus, CT field operations are coordinated by six regionally deployed Area Counsel who are co-located with CI's six directors of field operations (DFOs). CT docket attorneys are assigned to each of the thirty-five CI field offices where the CI Special-Agents-In-Charge (SACs) are located. Most CT field attorneys have a primary office location with other attorneys from the Office of Chief Counsel, but have secondary space in the CI offices. This allows the CT attorneys to maintain professional contact with their peers from other field divisions of Counsel and also to develop a new, closer and more integrated relationship with the investigating Special Agents.

In addition to the structural changes, CT has effected numerous procedural changes to accomplish the mission of partnership with CI. The most significant procedural change has been the transfer of "referral authority" of a criminal case from Counsel to CI Special-Agents-In-Charge. The laws regulating the disclosure of taxpayer and tax return information from IRS to outside agencies require that there be one centralized authority to refer criminal tax investigations to the Justice Department for prosecution. That responsibility, known as referral authority, has traditionally been held by Counsel because it was thought to ensure that the criminal tax laws were applied uniformly throughout the country. It was also designed to ensure that both the civil and criminal tax implications were evaluated during the criminal referral process.

The practical impact of Counsel's possession of the referral authority was to create a significant impediment in the relationship between Counsel and CI. It created a dynamic under the old Counsel structure whereby multifunctional Counsel attorneys, who may not have had any significant expertise in criminal tax, wielded the authority to prevent an investigation from being referred for prosecution. Those attorneys, who were often consumed with tax court responsibilities, only got involved in the criminal investigation once it was completed and were responsible for conducting a thorough legal review and deciding whether the case warranted prosecution. If that attorney referred the case, then a second review was conducted by the Justice Department's Tax Division. From the CI special agents' point of view, the CT attorney, in most instances, got involved at the end of an investigation and was perceived only as someone who could hurt, not help, the case. Counsel's power to decline cases, combined with their inability to dedicate significant time to assisting in perfecting the cases, created strained relationships on occasion between Counsel and CI.

In July, immediately after CT and CI were restructured, the Treasury secretary, with the endorsement of Commissioner Rossotti, Counsel and CI, transferred referral authority to CI. CT attorneys are no longer the gate through which criminal investigations must pass in order to be prosecuted, but are vehicles to assist in developing quality cases at every stage, not just once the investigation has been completed. The CT attorney is still responsible to ensure that both the civil and criminal implications of an investigation are considered. National consistency in criminal

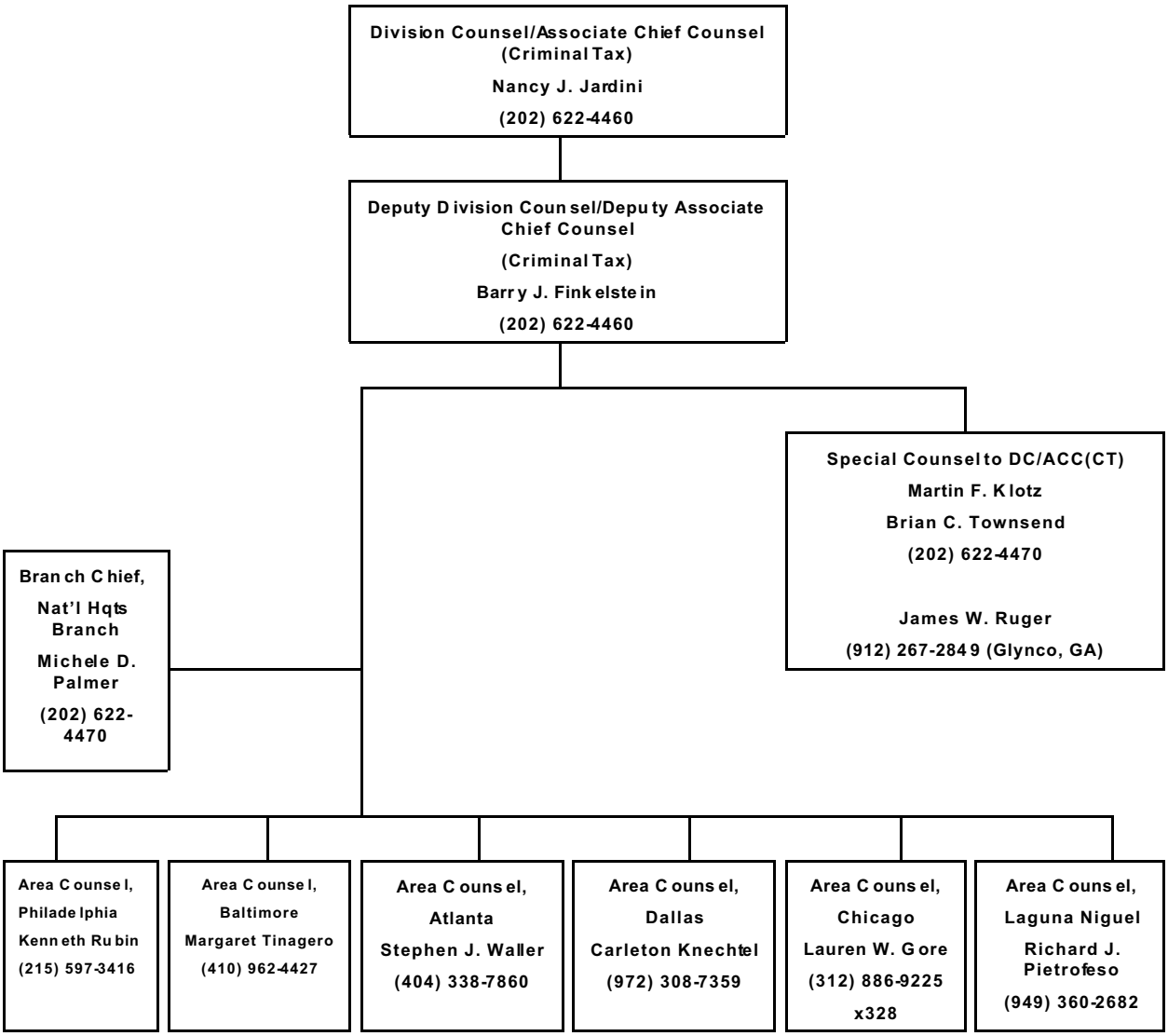
tax enforcement is accomplished by both CT attorneys' intimate involvement in the case at every stage and the Justice Department's review after the investigation is referred.

Although CT attorneys no longer have referral authority, they have taken on a broad range of responsibilities to assist CI in the development of quality investigations. CT attorneys are the sole legal advisors to CI in administrative tax investigations, but work in partnership with CI special agents in both administrative and grand jury investigations. Their role in grand jury investigations is to assist both the case agents and the supervising prosecutor by providing technical criminal tax expertise and helping to ensure that the investigative means conform to both legal standards and IRS policy requirements. An example is the use of search warrants in tax cases. IRS CI policy is to subject such warrants to a careful review, involving CT attorneys, to ensure that a variety of factors are considered, including whether less intrusive means of gathering the necessary evidence are available. By having CT attorneys assist CI agents in drafting search warrants, it is hoped that a better product will result and that CT's involvement will aid in reducing the burdens on the prosecutor. CT attorneys and federal prosecutors have worked cooperatively in numerous districts on search warrants and a variety of other issues to the benefit of federal tax prosecutions.

CT attorneys continue to conduct in-depth legal analysis of all completed investigations, but also become involved in the preparation of the Special Agent report long before it is finalized. This document is not only relied on in determining whether a case is referred, but also by the Justice Department in determining whether they will accept a case for prosecution. The Justice Department's Tax Division attorneys consider the CT review a highly important aid in evaluating cases. CT attorneys arrange and participate in taxpayer and taxpayer representative conferences in administratively investigated cases. They review undercover operation requests and participate in the strategic planning of those activities. They assist in the preparation of grants of immunity, search warrants, summons enforcement actions, and requests for the use of special investigative techniques such as wiretaps. CT attorneys are also active in CI training at both the local and national level, and have two attorneys who train new Special Agents, deployed to the Federal Law Enforcement Training Center in Glynco, Georgia.

In sum, CT attorneys are involved at every stage of the criminal investigation to cooperatively assist Special Agents and prosecutors in the development of quality cases. From CI Special Agents' perspective, the CT attorney is now seen as someone who will help, rather than hinder an investigation. This should assist in avoiding missteps in investigations and rectifying promptly any case deficiencies. Although too soon to evaluate, our early experience indicates that this new process will result in a more efficient and prompt review process, without sacrificing existing standards.❖

Division Counsel/Associate Chief Counsel (Criminal Tax)



ABOUT THE AUTHORS

❑**Nancy J. Jardini** is the Division Counsel/Associate Chief Counsel for Criminal Tax within the Internal Revenue Service. She, directs a nationwide staff of approximately eighty attorneys deployed in thirty-five locations nationwide and in the national headquarters in Washington, D.C. These criminal tax specialists work closely with the Special Agents and managers of IRS' Criminal Investigation during all stages of criminal investigations relating to criminal violations of the Internal Revenue laws and other statutes for which the Internal Revenue Service has enforcement responsibility. Ms. Jardini, who has been a criminal law practitioner for over thirteen years, came to the IRS in July 2000, from the Criminal Division of the Justice Department. In addition to her experience as both a federal prosecutor and as a defense attorney she

has written and lectured extensively on a variety of topics related to criminal law and procedure.

Mark E. Matthews, as the Chief, IRS Criminal Investigation (CI), heads the Internal Revenue Service function responsible for investigating criminal violations of the tax code. Headquartered in Washington, DC, Mr. Matthews oversees a nationwide staff of approximately 4,500 CI employees as they investigate and assist in the prosecution of criminal tax, money laundering, and narcotics-related financial crime cases. With fourteen years experience in the investigation and prosecution of financial crimes, Mr. Matthews came to the IRS from private law practice. His most recent public service was as Deputy Assistant Attorney General, responsible for criminal tax prosecutions at the Justice Department's Tax Division. He also served as an Assistant U.S. Attorney and as Deputy Chief of the Criminal Division in the U.S. Attorney's Office in the Southern District of New York. He has served in other governmental positions as Senior Advisor to the Assistant Secretary of Enforcement at the Treasury Department and as Special Assistant to Director William H. Webster at the Federal Bureau of Investigation and the Central Intelligence Agency.✠

New IRS Publicity Strategy

Mark E. Matthews
Chief, Criminal Investigation

I. Introduction

Before becoming Chief of Criminal Investigation, I spent over ten years as a federal prosecutor, both as an AUSA and then as the Deputy Assistant Attorney General responsible for criminal tax matters in the Tax Division. In both of those positions, I was frustrated by the fact that dollar for dollar, tax cases did not seem to garner the same media attention (and hence deterrence value) as similar white collar fraud cases. As a result of: (a) the IRS reorganization effort last year; (b) additional resources devoted to our publicity efforts; and (c) a major overhaul of our media strategy, I am pleased to report that we have developed the tools that are already dramatically improving the length, placement and targeting of media stories about criminal tax cases. The key elements are the creation and training of thirty-five Special Agent Public Information Officers ("PIOs"), the dramatic expansion of our website, our institutional commitment to become more open and to provide more comprehensive information about our enforcement efforts and, lastly, a press strategy that links individual cases in a systematic way to larger compliance issues and enforcement programs. The website allows us to "recycle" tax cases — generate multiple press stories nationwide about particular cases — and to target our enforcement efforts to particular media outlets or other specialized websites that reach key audiences. This entire effort is accomplished with maximum fidelity to taxpayer disclosure laws and in cooperation with United States Attorneys' Offices and the Tax Division.

II. Background

As part of modernization, the Internal Revenue Service commissioned Roper Starch Worldwide, Inc. to conduct a study among the general public to determine their attitudes toward income tax and the IRS, in particular. The results showed that the majority of taxpayers make an honest effort to file accurate and timely tax returns. The survey also showed that those honest taxpayers wanted to know that everyone else pays his/her fair share of taxes — in fact, the survey said that taxpayers believe that they end up paying the “tax” bill for those who cheat.

Some of the other findings included the belief by 88% of those polled that major tax indiscretions should be punished. The survey also asked "From the following list of people, how likely would you be to read a newspaper or magazine article or watch a TV news story about their indictment or conviction for tax evasion?"

	Very Likely	**Some-what Likely**	**Not at all Likely**
National celebrity	21%	33%	23%
Local business person such as your local gas station owner	28%	39%	15%
A neighbor or person in your town	44%	35%	10%
A neighbor or person in your town who is also indicted or convicted of money laundering	47%	34%	9%
A political figure, such as your congress-person	56%	28%	9%
Someone who has the same occupation or works in your industry or profession	49%	30%	10%

These results told us several important things. First, we need to focus our publicity on specific audiences – or market segments, because the respondents said they wanted to know about someone in their local area or someone who had a similar occupation. Second, we learned that in order to enhance compliance (reach those who are tempted to cheat or evade their tax obligations) and to instill public confidence in the integrity of the tax system (reach those who believe that THEY pay the price for others who cheat), we needed to do a better job of publicizing our enforcement efforts.

Historically, when we work a case in IRS Criminal Investigation, we put 99% of our effort into the lengthy, complex investigation, from initiation to sentencing, yet we don't even spend 1% of our time obtaining publicity on that case. We realized that we needed to reallocate resources given the fact that IRS CI faces the largest general deterrence mission in all of federal law enforcement. We have to reach over 200 million Americans who encounter the tax system each year — both to deter the potential cheaters and assure the vast majority who are honest that the IRS is investigating those who intentionally evade their obligations.

When I came on the job last year, many practitioners, members of the American Bar Association and industry leaders kept asking me, "Mark, when is CI going to do something about abusive trusts? When are you going to bring some criminal cases in this area?" My reply was, "Did you know that we had thirty-five indictments last year and that we have 130 open criminal investigations in the area of abusive trusts?" Of course, the common answer was, "No, and why are you keeping it a secret? That information would have been useful to us in our practice." Consequently, we started looking at what we did

with those cases. We found that we were taking standard press items from Criminal Investigation indictments and/or convictions, writing up a short press release and dropping it in the court house regular press box for courthouse reporters. We did not pay attention to whether those reporters or their readers were interested in tax stories. Our stories got viewed in isolation, focused only on the individual defendants, and often wound up being buried in the Metro or Business section of the papers.

III. Compliance Strategy Linked to Media Strategy

Several features of the modernized IRS are helping us solve our problems. One is that we are actually developing a comprehensive compliance strategy throughout the IRS. That strategy will be combined with a more comprehensive and more sophisticated media strategy. The goal is to allow us to provide reporters with more comprehensive information about our enforcement efforts and to place an individual prosecution in the context of a larger compliance problem. The idea is that an individual case then becomes the fresh, newsworthy element in a story that focuses on a national compliance problem and the IRS and Justice Departments' responsive efforts. Using our related web pages and the efforts of the local Public Information Officer, we are beginning to provide reporters with information about similar convictions around the country, "recycling" those convictions and sentences and allowing the media to provide a more comprehensive "trending" story. Of course, we are doing all of this within the confines of Internal Revenue Code Section 6103 (Disclosure of Tax Information).

IV. IRS CI Website and U.S. Attorney Press Releases

A significant part of our media strategy was the development of a website, http://www.treas.gov/irs/ci, that provides compliance-related enforcement activity information to the public. Our website includes fraud alerts in areas involving Employment Tax Fraud, Non-filers, and Abusive Trusts. We will be expanding the fraud alerts in the future to include Return Preparers and other key areas of non-compliance and other programs such as money laundering and narcotics related cases. By doing this, the media is able to obtain the most current, factual information about legal actions taken by the Department of Justice on CI investigations. To use abusive trusts as an example, we provide a description of the foreign and domestic schemes that are occurring in the abusive trust area. We also provide information about the number of indictments, the number of open investigations, and the number of sentences and the average sentence. Toward the end of the website material on trusts, we list the five or six biggest, most significant cases (we call it "bundled" news). We also provide the text from the IRS brochure, *Should your financial portfolio contain Too Good To be True Trusts*, a really good example of things that the public should be looking for when considering a trust.

This is a new approach for the IRS, but it does a very effective job of reaching various market segments and certainly gives the media a wealth of information that was previously not available to them from the IRS. Now, every time we get a new conviction in a particular program, we steer the reporters to the relevant webpage. We tell the reporter, "Here's a press release on a conviction regarding an abusive trust, and if you want more information for your story, here is the website for additional background information and cases." We are extremely pleased that several U.S. Attorneys' Offices have begun to include our web address in press releases on our cases, giving both the public and the media access to this comprehensive enforcement data. It is particularly useful in a press release involving a guilty plea when the vast majority of the case-specific information may still be protected by disclosure laws.

In addition to the website, our national press office has a very active program in marketing Justice Department convictions and sentencings to the professional tax preparation community and their national periodicals. This audience is a particularly important audience for tax-related prosecutions. Not only are they our partners in our compliance efforts, they have an economic interest in spreading information about con artists and their tax scams. I have even been told by one practitioner that he keeps copies of the

convictions from our abusive trust webpage to hand to clients who ask him about such schemes.

V. Public Information Officers

CI now has thirty-five special agents serving as full or part-time Public Information Officers, one for each field office. The PIOs work directly for the Special Agent-in-Charge and in cooperation with public information officers in U.S. Attorneys' offices. They have received IRS disclosure training, which can be a valuable resource to the United States Attorneys as they draft their press releases. Both the Special Agent-in-Charge and the PIOs have received media training as well. One of the key responsibilities for the PIOs is to work with the Offices of the United States Attorneys to ensure that key information is provided for press releases and press conferences regarding CI's investigative and enforcement efforts. Since October 2000, when the PIOs were selected, the publicity on CI enforcement activity has increased significantly. I am confident that the primary reason for this increase is a result of the positive support they have received from the Offices of the United States Attorney.

With the support of Department of Justice Tax Division, the United States Attorneys and the newly trained special agent PIOs, this new media strategy is going to have a significant impact on compliance with the tax laws. By leveraging the general deterrence impact of our enforcement actions, it also provides the taxpayers with a better return on their investment in our enforcement program.❖

ABOUT THE AUTHOR

❑**Mark E. Matthews** is the Chief, IRS Criminal Investigation (CI), responsible for investigating criminal violations of the tax code. Headquartered in Washington, D.C., Mr. Matthews oversees a nationwide staff of approximately 4,500 CI employees as they investigate and assist in the prosecution of criminal tax, money laundering, and narcotics-related financial crime cases. Mr. Matthews came to the IRS from private law practice. His most recent public service was as Deputy Assistant Attorney General, responsible for criminal tax prosecutions at the Justice Department's Tax Division. He also served as an Assistant United States Attorney and as Deputy Chief of the Criminal Division in the United States Attorney's Office in the Southern District of New York. He has served in other governmental positions as Special Assistant to Director William H. Webster at the Federal Bureau of Investigation and the Central Intelligence Agency.✠

Prosecution of Abusive Trust Cases

Martin E. Needle
Attorney, National Headquarters Branch
Office of Division Counsel/Associate Chief Counsel (Criminal Tax)
Internal Revenue Service

Dora S. Welsh
Senior Trial Attorney
Southern Criminal Enforcement Section
Tax Division
Department of Justice

Beth Elfrey
Trial Attorney
Southern Criminal Enforcement Section
Tax Division
Department of Justice

I. Introduction

At the outset, it is important to recognize that not all trusts are abusive. Legal trusts are frequently used in estate planning, to facilitate charitable transfers of property, and/or to hold property for minors and incompetents. No legal trust arrangement, however, reduces or eliminates all income tax except for certain trusts whose income is specifically exempted from tax by statute. Either the trust, the beneficiary, or the grantor, as applicable, must pay the tax on the income realized by the trust, including the income generated by property held in trust. Abusive trust arrangements typically are promoted by the promise of tax benefits while there is no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets. It is in these situations where commonly accepted trust and income tax principles are being ignored that the Internal Revenue Service is focusing its enforcement efforts.

In recent years the Internal Revenue Service has detected a proliferation of promotions involving abusive trust schemes aimed at fraudulently reducing a taxpayer's tax liability. Multi-layered trusts, in combination with other business forms, are used to conceal the taxpayer's control over the trusts and his/her assets. The goal of this layered distribution of income is to gradually reduce or eliminate taxable income through the use of bogus deductions and offshore diversions of income. When looking at the validity of a trust set-up, one must determine who is spending and controlling the income and assets. In many abusive trust schemes, the income and assets are controlled no differently than if the taxpayer had never formed a trust. In situations like these, the trusts are disregarded and the income attributed to the true owners.

While a number of prosecution strategies are available to attack these abusive trust schemes, experience has demonstrated one of the most successful approaches is proving who controlled and spent the money rather than attacking the actual trust structure. Prosecutors have focused on tracing the flow of money and attributing it to the individuals who earned and controlled it under a lack of economic substance or sham theory. In these abusive trust schemes, the government has directed its prosecution efforts towards promoters and their clients who have willfully taken advantage of these schemes to evade taxes.

II. Abusive Trust Schemes

Typically abusive trust arrangements promise benefits which may include: (1) the reduction or elimination of income subject to tax; (2) deductions for personal expenses paid by the trust; (3) depreciation deductions of an owner's personal residence and furnishings; (4) a stepped-up basis for property transferred to the trust; (5) the reduction or elimination of self-employment taxes; and (6) the reduction or elimination of gift and/or estate taxes.

These abusive arrangements often use trusts to hide the true ownership of assets and income in order to disguise the actual substance of the transactions. These arrangements frequently involve multi-tiered or layered trusts, each holding different assets of the taxpayer, as well as interests in other trusts. A typical abusive trust scheme may involve any number of the following

trusts: business trust, equipment or service trust, family residence trust, charitable trust, and foreign trust.

A **business trust** is created when the owner of a business, typically a sole proprietorship, transfers the business to a trust in exchange for shares of ownership. Through nominee trustees or other controlled entities, the owner is still able to not only run the business's day-to-day activities but also control its income stream. The business trust makes payments to the trust unit holders or to other downstream trusts created by the owner which are characterized as either deductible business expenses or deductible distributions. These payments purport to reduce the taxable income of the business trust to a point where little or no tax is due. In addition, the owner claims the arrangement reduces or eliminates the owner's self-employment taxes on the theory that the owner is receiving reduced income or no income from the operation of the business.

An **equipment trust** is formed to hold equipment that is rented or leased to the business trust, often at inflated rates. A **service trust** is formed to provide services to the business trust, often for inflated fees. Under these abusive arrangements, the business trust may purport to reduce its income by making allegedly deductible payments to the equipment or service trust. Further, as to the equipment trust, the equipment owner may claim that the transfer of equipment to the equipment trust in exchange for trust units is a taxable exchange. The trust takes the position that it purchased the equipment for its fair market value and that this value is the new tax basis for purposes of calculating depreciation. The owner, on the other hand, takes the inconsistent position that the value of the trust units received in the exchange cannot be determined, resulting in no taxable gain to the owner from the exchange. The equipment or service trust also may attempt to reduce or eliminate its income through distributions to other trusts.

A **family residence trust** is formed when an owner of the family residence transfers the residence, including its furnishings, to a trust. The trust claims the exchange results in a stepped-up basis for the property, while the owner reports no gain from the transfer. The trust claims to be in the rental business and purports to rent the residence back to the owner, however, little or no rent is actually paid. Rather, the owner contends the family members are caretakers or provide services to the trust and live in the residence for the benefit of the trust. The family residence trust often receives distributions from other trusts which are treated as income. To reduce this income, the trust may attempt to deduct depreciation expenses and other expenses associated with maintaining and operating the residence, such as utilities, gardening service, pool service and food expenditures.

A **charitable trust** is created when a taxpayer transfers assets or income to a purported charitable trust and claims either that the payments to the trust are deductible or that the payments made by the trust are deductible charitable contributions. The trust pays for personal, educational, and recreational expenses on behalf of the taxpayer or family member. The trust then improperly claims the payments as charitable deductions on its tax returns to reduce or offset taxable income.

Foreign trusts are integral to most abusive trust arrangements. They are often located in tax haven countries that impose little or no tax on trusts and have strict bank secrecy laws. Typically, funds are transferred between the various layers of trusts and are ultimately routed offshore to the foreign trust. The funds are then repatriated to the taxpayer in the United States, often in the form of sham gifts or loans or through the use of debit/credit cards issued by an offshore bank. Some trust arrangements may include multiple layers of foreign trusts or an International Business Corporation (IBC) that acts as the nominee donor or lender for the purported gift or loan.

III. Theories of Prosecution

In determining the validity of trust arrangements, courts look at a taxpayer's control over his/her assets and sources of income. Courts have routinely invalidated abusive trust arrangements and found the income taxable to the individual taxpayer, and not the trust, by using one or more of the following legal theories: lack

of economic substance (sham theory), unlawful assignment of income or the grantor trust rules.

A. Lack of Economic Substance or Sham Theory

In cases where the trust structure has no economic purpose and the taxpayer retains complete control over the trust assets, courts have ignored the trust arrangement under a lack of economic substance or sham theory. It is long-settled that transactions motivated solely by tax avoidance are disregarded for tax purposes. If, after considering all the facts and circumstances surrounding a particular transaction, the finder of fact determines that there is no real economic effect to the transaction other than the creation of tax benefits, and the form of the transaction affects no cognizable economic relationship, the substance of the transaction will control over its form. *Gregory v. Helvering*, 293 U.S. 465 (1935); *Furman v. Commissioner*, 45 T.C. 360, 364 (1966), *aff'd per curiam*, 381 F.2d 22 (5th Cir. 1967). If a trust has no economic substance apart from tax considerations, the trust entity is considered a "sham" and is not recognized for federal tax purposes. *Zmuda v. Commissioner*, 731 F.2d 1417, 1421 (9th Cir. 1984), *aff'g,* 79 T.C. 714 (1982); *Markosian v. Commissioner*, 73 T.C. 1235, 1245 (1980); *Christal v. Commissioner*, T.C. Memo. 1998-255. This principle applies even though the trust may have been properly formed and has a separate existence under applicable local law. Several criminal cases have endorsed the lack of economic substance or sham theory including *United States v. Noske*, 117 F.3d 1053, 1059 (8th Cir. 1997); *United States v. Tranakos*, 911 F.2d 1422, 1431 (10th Cir. 1990); and *United States v. Krall*, 835 F.2d 711, 714 (8th Cir. 1987).

The lack of economic substance rule prohibits the taxpayer from structuring a paper entity for the sole purpose of avoiding tax. Whether a particular trust entity lacks economic substance or is a sham for tax purposes is a question of fact. *Paulson v. Commissioner*, T.C. Memo 1991-508, *aff'd per curiam*, 992 F.2d 789 (8th Cir. 1993) (citing *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950)). In making this determination, the trier of fact is guided by the following considerations: (1) whether the taxpayer's relationship, as grantor, to the property differed materially before and after the trust's formation; (2) whether the trust had a bona fide trustee; (3) whether an economic interest passed to other beneficiaries of the trust; and (4) whether the taxpayer felt bound by any restrictions imposed by the trust or the law of trusts. *See Zmuda*, 79 T.C. at 720-722; *Markosian*, 73 T.C. at 1243-45; *Hanson v. Commissioner*, T.C. Memo 1981-675; *aff'd per curiam*, 696 F.2d 1232 (9th Cir. 1983); *Buckmaster v. Commissioner*, T.C. Memo 1997-236.

To evaluate the first factor, the trier of fact must look behind the trust documents to determine the identity of the true grantor. Sham trust arrangements typically use nominee or straw grantors to conceal the identity of the true grantor. The true grantor is the individual who furnishes the trust with funds/assets, not the individual who nominally acts as grantor. *Buhl v. Kavanagh*, 118 F.2d 315 (6th Cir. 1941). It is also helpful to look at before-and-after snapshots to see if any economic change occurred as a result of the formation of the trust, other than the creation of tax benefits. There is a lack of economic substance to a trust if the taxpayer continues to treat the income and assets as his/her own after purportedly transferring them to the trust.

With regard to the second factor, sham trust arrangements typically involve nominee trustees who have no authority or responsibility in managing the trust's income and assets. Instead, the taxpayer/grantor retains control through various means. The taxpayer may control the funds in the trust bank account by maintaining custody of the checkbook, exercising signature authority over the trust bank account, or using a rubber stamp with the nominee trustee's signature to issue checks from the trust bank account. The taxpayer may also exercise control over the trustee, and hence the trust assets, by filing a secret wish list with the nominee trustee. Alternatively, the taxpayer may be appointed the trust manager to handle the day-to-day activities of the trust, or the nominee trustee may give the taxpayer blank signed trust minutes that the taxpayer may use any time to justify use of the assets.

The third factor to consider when determining if a trust arrangement is a sham is whether an economic interest passed to other beneficiaries of the trust. The original owner of the trust assets, rather than the named third-party beneficiary, is usually the true beneficiary of an abusive trust arrangement. It is essential to trace the flow of funds through the multiple layers of trusts to determine who is the real beneficiary. In most instances, the funds flow in a circular pattern back to the taxpayer. Attempts are made to conceal that the taxpayer is the true beneficiary by routing the funds through offshore banks and disguising the return of funds as sham loans or gifts. A common indicia of fraud occurs when the taxpayer transfers on paper his/her beneficial interest in a valuable asset for little or no consideration.

Lastly, if it is apparent from the taxpayer's conduct that he/she did not feel bound by the restrictions imposed by the trust itself or the law of trusts, then the trust is probably a sham. This is the case when the taxpayer exercises unfettered control over the income and assets of the trust. For example, the taxpayer uses trust assets and income to pay personal expenditures (such as payments on a personal residence, vacation expenses, educational expenses, etc.) and claims deductions for such payments on the trust tax returns. This theory has been the most widely used and accepted in the abusive trust area.

B. Unlawful Assignment of Income

Another possible legal theory involves the assignment of income doctrine. It is a long-standing principle that gross income includes all income from whatever source derived. I.R.C. § 61(a). This includes compensation an individual receives for services. Fundamental to this principle is that income is taxable to the person who earned it. *Commissioner v. Culbertson*, 337 U.S. 733, 739-40 (1949). The person who earns the income cannot deflect the tax on it by attempting to assign or transfer the income to another person or entity. *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930). The test of taxability is not who is the ultimate recipient of the income, but rather, who controlled the earning of the income. *American Savings Bank v. Commissioner*, 56 T.C. 828, 839 (1971).

Courts routinely invalidate trust arrangements that are designed to allow a taxpayer to unlawfully assign income which he/she earns from personal services. *See Vnuk v. Commissioner*, 621 F.2d 1318, 1321 (8th Cir. 1980)(medical doctor cannot assign income to trust when trust did not supervise doctor's employment, did not determine doctor's compensation, and doctor was under no legal duty to earn money for or perform services for trust); *Holman v. United States*, 728 F.2d 462 (10th Cir. 1984) (same); *United States v. Russell*, 804 F.2d 571 (9th Cir. 1986)("personal services contract" through which taxpayers attempted to sell life services to a trust was an unlawful anticipatory assignment of income); *United States v. Krall*, 835 F.2d 711 (8th Cir. 1987)(optometrist unlawfully attempted to assign business receipts to foreign trusts); *Estrada v. Commissioner*, T.C. Memo. 1997-180 (nurse anesthetist who administered anesthesia and received compensation for services cannot assign such income to trust), *aff'd*, 156 F.3d 1236 (9th Cir. 1998); and *Leonard v. Commissioner*, T.C. Memo. 1998-290 (taxpayer, who earned income as firefighter, welder and contractor, unlawfully assigned income to trust).

C. Grantor Trust Rules

A third theory courts use to find income taxable to the individual grantor, rather than the trust, is based on the grantor trust provisions found in sections 671-679 of the Internal Revenue Code. Generally, "if the grantor of a trust retains certain rights or powers, then for income tax purposes he is treated as the owner of the portion of the trust over which the rights or powers extend." *Hanson v. Commissioner*, T.C. Memo. 1981-675.

Under I.R.C. § 671, a grantor or other person is required to include in his/her taxable income all items of income which are included in the trust's income if he or she is treated as the trust's owner. Sections 673 through 678 define the circumstances under which a grantor or other person is treated as the "owner" of a trust. *See Wesenburg v. Commissioner*, 69 T.C. 1005 (1978), for an explanation of how the grantor trust provisions are applied to a specific trust arrangement. The Tax Court commonly uses the

grantor trust rules to resolve civil disputes about trusts. The grantor trust theory, however, is not typically used in the context of criminal prosecutions.

IV. Criminal Violations in Abusive Trust Cases

As discussed above, many schemes utilizing domestic and foreign trusts have been used by taxpayers to evade taxes. Some schemes not only seek to conceal or misidentify the responsible parties, but also attempt to structure transactions in a manner that places the taxable event at a point where liability cannot be imposed. Others attempt to disguise false deductions or to conceal sources of income. A taxpayer utilizing an abusive trust scheme could violate a number of criminal statutes. For example, he or she may engage in tax evasion by knowingly omitting taxable income from the trust tax return, or commit tax perjury by claiming false deductions for personal expenses or charitable contributions that were never made or by failing to disclose the existence of a foreign bank account over which he or she has signature authority. Additionally, a trust has independent reporting requirements for which the fiduciary has responsibility. Ignoring these requirements could result in prosecution. Finally, any actions undertaken in concert with any other person or entity may amount to a conspiracy.

As the Service increases its focus on prosecuting those involved in sophisticated tax schemes, tax advisors may become likely targets of investigations. In most abusive trust schemes, a lawyer or accountant rendered advice concerning the underlying transactions. The Service will scrutinize the practitioner's role in any transactions under investigation and will recommend prosecution if it believes a professional has violated the law.

The Tax Division's criminal tax enforcement program includes prosecuting both the promoters of abusive trust schemes and the taxpayers who use the schemes. The criminal violations usually charged against promoters include *Klein*-type conspiracies (18 U.S.C. § 371), aiding and abetting income tax evasion (I.R.C. §7201 and 18 U.S.C. § 2), aiding and assisting in the preparation of false tax returns (I.R.C. § 7206(2)), and possibly violations of the omnibus clause of I.R.C. § 7212(a). For guidance in prosecuting promoters of abusive trust schemes, *see United States v. Schmidt*, 935 F.2d 1440 (4th Cir. 1991), and *United States v. Scott*, 37 F.3d 1564 (10th Cir. 1994).

In *Schmidt*, the defendants promoted the use of unincorporated business organizations (UBOs) as a means to conceal taxpayers' income and assets from the IRS. Most of the trust purchasers were Form W-2 wage earners who assigned their wages to UBOs, yet retained control over the income and assets ostensibly transferred to the UBO. The government's theory of tax fraud focused on the use of the trust entities in the scheme of evasion and did not challenge the entities as "shams."

In *Scott*, the defendants were promoters who marketed a multi-tiered trust scheme as a device to eliminate taxpayers' income tax liabilities while allowing them to maintain control over their income and assets. The scheme involved four layers of trust: a domestic trust and three foreign trusts. The goal of the scheme was to funnel the income to the third foreign trust and repatriate the money to the taxpayer tax-free in one of the following ways: in the form of a sham gift under $10,000; through the use of debit or credit cards at an offshore bank; or in the form of sham loans. The government's theory of prosecution focused on the manner in which the trusts were operated, not on their form. The indictment alleged that the promoters had engaged in sham transactions which had no economic substance or business purpose and created the illusion that the purchasers had relinquished control of their income and assets, when in reality, the taxpayers had continued to exercise control over their income and assets.

V. Indicia of Fraud

When investigating a trust structure, the presence of several factors is suggestive of possible fraudulent activity warranting further investigation. While no single characteristic is determinative, these factors can be used to identify the existence of criminal activity. The factors include the deduction of personal living expenses, such as, school tuition, home mortgage payments, auto payments, home utility bills and

home repairs and maintenance expenses by the trust. These otherwise nondeductible expenses are improperly deducted as disguised trust expenses against wages or income.

A claim that a significant portion of a trust's income is being distributed to a charity or other nontaxable entity is often an indication of fraudulent activity. The existence of a charitable remainder trust from which the taxpayer makes interest free loans at his discretion could be viewed as an indicia of fraud. Also, when there is no evidence of charitable activity on behalf of a so-called "charitable" beneficiary, the trust could be facilitating the grantor's evasion of taxes. Payments to an organization that purports to be a qualified charity under the Internal Revenue Code, when in fact it is not, is one of the most common vehicles used to unlawfully transfer otherwise taxable income out of a trust tax free.

Fraudulent trusts generally lack trustees who are either professional or have a personal relation to the grantor. Legitimate trusts will usually have a professional trust company acting as trustee, or one of the grantor's intended beneficiaries will be named as trustee. Named trustees that are not related to the grantor and appear unqualified to act as a trustee can be a sign that they are merely nominees. Additionally, fraudulent trustees commonly do not adhere to generally acceptable business practices. When an unrelated individual controls both the trustees and the beneficiaries, the trust may be a sham.

The control of assets and income by an unrelated "promoter" can be indicative of an abusive trust. Co-mingling of assets also is frequently found in these situations. A legitimate trustee will keep the assets of the various trusts separate. With the assets co-mingled, the promoter hopes to make particular assets untraceable, thus thwarting tax collection efforts.

Promises of tax reduction by trust marketers are often signs that the trusts are going to be used illegally. A legitimate trust is used for inheritance and probate reasons, among others, and there usually is no appreciable change in the amount of income tax paid by a business owner by virtue of placing his/her business in a trust. Claims to the contrary should be treated as suspicious. Additionally, promises of protection from tax collection should raise a red flag.

Although legitimate trustees frequently make loans to trust beneficiaries and/or trust grantors, a pattern of loans to a large number of trust grantors, or frequent loans to a single grantor, may be evidence of an attempt to return trust income to the grantor tax free. Additionally, the use of anonymous post office boxes to communicate between the taxpayer and the trustees is indicative of an abusive arrangement.

Fraudulent trusts often create a paper trail of financial transactions supporting the alleged flow of money through the various trusts. Often the flow of funds is on paper only, as no actual money is transferred between the various entities. This happens with the use of foreign entities and bank accounts as well, where the financial transactions never occur. Similarly, upon the creation of the various trusts, the title to property is never legally deeded or assigned to the newly formed entity.

Other indicia of fraud which may be present in abusive trust arrangements include: backdating of documents; the layering of trusts such that one trust is made the beneficiary of another trust; the use of units of beneficial interest rather than simply naming the beneficiaries in the trust document; the deduction of “management fees” or “consulting fees” in lieu of payment of wages; promoters advising taxpayers not to talk to the IRS about the trusts; and promoters steering taxpayers to attorneys and accountants affiliated with the promoter.

VI. Conclusion

Schemes involving abusive trusts, both foreign and domestic, have become a favorite tool of unscrupulous promoters trying to assist taxpayers in fraudulently reducing or eliminating their tax liabilities. It is not the trust entity itself that is abusive, but rather the manner in which the trusts are being used by taxpayers to reduce or eliminate taxes. When looking at the validity of a trust set-up, one must determine who is controlling the income and assets. In many abusive trust schemes, the income and assets are controlled no differently than if the taxpayer had never formed a trust. In situations like these, the

trusts are disregarded and the income is attributed to the true owners.

A number of prosecution strategies are available to attack these abusive trust schemes. Past experience has shown that one of the most successful approaches in combating these schemes is proving who controlled and spent the money rather than attacking the actual trust structure. Juries are often left confused in situations where it becomes a battle of the experts on the question of the validity of the trusts. Therefore, prosecutors have focused on tracing the flow of money and attributing it to the individuals who earned and controlled it. The government has directed its prosecution efforts primarily against promoters and their clients who have willfully taken advantage of these egregious schemes to evade their taxes. In such cases, the government has experienced a high degree of success.❖

ABOUT THE AUTHORS

❑**Martin E. Needle** has served as an attorney in the Criminal Tax Division of the Internal Revenue Service since 1992. Before that, Mr. Needle was a senior associate with the accounting firm Coopers & Lybrand. Mr. Needle has done extensive work in the abusive trust area including lectures before IRS Criminal Investigation, Counsel, and Assistant United States Attorneys. Along with these speaking engagements, Mr. Needle has prepared the underlying course materials and participated in training activities.

Dora S. Welsh has been a trial attorney in the Tax Division of the Department of Justice for over twenty-one years. During that time she has tried a number of complex tax cases, several of which involved offshore trust issues. During the last eleven years she has been a senior trial attorney for the Southern Criminal Enforcement Section of the Tax Division and, in that capacity, she has worked on the 1994 Criminal Tax Manual and its previous editions, participated in training activities in the abusive trust area, and served as coordinator of abusive trust cases and issues.

Beth Elfrey has been a trial attorney in the Criminal Enforcement Section of the Tax Division since October, 1992. Ms. Elfrey has litigated numerous criminal tax cases, including abusive trust prosecutions. During the last year, she served as the Criminal Enforcement Section's Abusive Trust Coordinator. She has participated in speaking engagements on abusive trust matters and developed an expert witness training program for IRS revenue agents.✠

Recycled "Redemption": The Latest Illegal Tax Protester Scheme

Jennifer E. Ihlo
Senior Trial Attorney
Special Counsel for Tax Protest Matters (Criminal)
Southern Criminal Enforcement Section
Tax Division
Department of Justice

Melissa E. Schraibman
Senior Trial Attorney
Western Criminal Enforcement Section
Tax Division
Department of Justice

The latest illegal tax protester scheme to sweep the nation is a hybrid of the "redemption" scheme popular in the 1980s and the fictitious financial instrument schemes popular in the 1990s. The 1980s redemption scheme promoted the use of federal income tax forms, usually

Forms 1099, to retaliate against government employees or private citizens for perceived wrongs to the illegal tax protester. The scheme was designed to trigger an Internal Revenue Service (IRS) audit, during which the Form 1099 recipient would have to explain the discrepancy between the income reported on his or her return and that reported on the Form 1099. *See United States v. Van Krieken*, 39 F.3d 227 (9th Cir. 1994); *see also United States v. Lorenzo*, 995 F.2d 1448 (9th Cir. 1993).

The most popular scheme of the 1990s used fictitious financial instruments to "pay" tax liabilities and obtain erroneous IRS refunds, as well as to "pay" private creditors. These instruments – often entitled "Certified Money Order," "Certified Bankers Check," "Public Office Money Certificate," or "Comptroller Warrant" – were designed to deceive the IRS and financial institutions into treating them as authentic checks or real money orders.

The recycled "Redemption" scheme combines the use of fictitious financial instruments with the use of IRS forms for harassment purposes. The scheme was uncovered in 1999 during the prosecution of Veral R.H. Smith and his wife, Judy, in the District of Idaho. Both had been indicted for failing to file federal income tax returns for the years 1992 through 1994. The defendants had earned gross receipts totaling over $435,000 during the prosecution period from their business, Lead Bullet Technologies (LBT). LBT manufactured and sold bullet molds and other ammunition-related products. Smith operated LBT out of his Moyie Springs, Idaho, home, a fairly isolated forty-acre property near the Montana-Canada border.

Early in the prosecution, Smith canceled a court-ordered doctor's appointment for his wife to assess her physical competency to stand trial. He also wrote to the United States Attorney "canceling the [criminal] proceedings." Despite notification to both defendants that the proceedings were not canceled, neither defendant appeared in court. As a result, the court issued a bench warrant for the arrest of defendant Veral Smith. Hoping to avoid execution of the bench warrant, the United States Marshals drove to Smith's property in northern Idaho. They spoke with Smith across the fence that lined his property and encouraged him to come to court. Smith refused and told the Marshals that he had sent a letter to the court to resolve the matter.

Subsequently, the clerk of the court received a "Sight Draft," dated July 20, 1999, payable to the IRS in the amount of $1.5 million, signed by Veral R.H. Smith. The draft was purportedly issued by the U.S. Treasury. It was later learned that Smith had also attempted to use a "sight draft" for over $106,000 to purchase two brand new automobiles, a Toyota Tundra pickup truck and a Lexus LS400 sedan. On August 3, after a scuffle with two Deputy Marshals, Smith was arrested as he left the Moyie Springs Post Office.

A superseding indictment returned on October 7, 1999 charged Smith with three counts of failure to file income tax returns (26 U.S.C. § 7203), two counts of presenting fictitious obligations (18 U.S.C. § 514), one count of resisting arrest (18 U.S.C. § 111), and one count of failure to appear (28 U.S.C. § 3146(a)(1)). During the trial, Smith admitted filing false IRS Forms 8300 (Report of Cash Payments Over $10,000 Received in a Trade or Business) against one of the prosecutors and the judge, alleging that each had been paid $200 trillion dollars in foreign currency. Prosecutors used these documents as justification for an obstruction enhancement at sentencing. *See United States v. Veral Smith*, 3:99-CR-00025 (D. Idaho 2000) <http://www.id.uscourts.gov> (district court considered false Forms 8300 filed against prosecutors and judge as evidence supporting obstruction enhancement). Smith was sentenced to fifty-one months in prison.

Within months of learning about the sight drafts presented in the Smith case, the Treasury Department received hundreds of sight drafts with face values ranging from as little as $1,200 to amounts in the trillions of dollars. The Office of the Comptroller of Currency and the Office of the Fiscal Assistant Secretary of the Department of Treasury issued Alerts to the banking industry in August 1999. *See* <http://www.occ.treas.gov/altlst99.htm>. Simultaneously, participants in the new

"Redemption" scheme were sending false Forms 8300 by the hundreds to the Detroit Data Center.

The theory behind the "Redemption" scheme is based on the erroneous premise that when the United States went off the gold standard in 1933, the government began to be funded with debt instruments secured with "the energy of current and future inhabitants." A fictitious identity or "straw man" was created for each American, and the value of a person's birth certificate became the collateral for our currency. The value of an individual's birth certificate is determined by the number of times it is traded on the world futures market and the amount is purportedly maintained in a Treasury Direct Account under that person's social security number.

A participant in the scheme attempts to reclaim his or her straw man, and therefore the value of the fictitious identity, by redeeming his or her birth certificate. The participant first files a Form UCC-1 with the Secretary of State in any state that accepts such filings, claiming title and security interest in his or her social security, driver's license, and birth certificate numbers. The individual then writes "acceptance for value," "non-negotiable charge back," or other prescribed language diagonally on some government document and returns it to the government official who issued it. The types of documents used for redemption include anything from a traffic ticket to a federal indictment. The "charge back" allegedly creates a Treasury Direct Account with the U.S. Treasury that contains the amount assigned to the charge back, which the participant can then draw upon by writing "sight drafts." "Sight drafts" are then written for varying amounts, some as high as trillions of dollars. A Form UCC-3 indicating the partial release of collateral in the amount of each sight draft is usually filed with the Secretary of State for the state in which the UCC-1 was filed.

The "sight drafts" look like checks, are of very high print quality, and usually contain some reference to HJR 192, the House Joint Resolution that took the United States off the gold standard in 1933. These "sight drafts" purport to be drawn on the United States Treasury Department. Since the prosecution of individuals who have attempted to pass these fictitious "sight drafts" began, the scheme has continued to evolve: "sight drafts" are now sometimes called "bills of exchange," or "trade acceptances." All reference HJR 192.

The harassment component of the scheme usually involves filing a false Form 8300, although some Forms 4789 (Currency Transaction Reports) and Suspicious Activity Reports (SARs) have also been filed. These documents report that a large amount of cash, sometimes foreign currency, was paid to the named recipient. IRS agents, federal and state prosecutors and judges, state troopers, and private creditors are the common targets. Typically, the protester will send his or her victim an IRS Form W-9, requesting a social security number. Even without the target's social security number, the protester files a Form 8300. Unless the document has already been identified as fraudulent, the IRS sends a letter to the named recipient requesting additional information and warning of possible penalties for incomplete information. A "fraud" indicator is attached to the computerized record of those documents identified as part of this scheme. The fraudulent Forms 8300 are then sent to the appropriate IRS Criminal Investigation Division (CID) office or to the Treasury Inspector General for Tax Administration (TIGTA) for investigation. Those who receive one of these false forms should contact the local CID office. CID investigates all non-IRS employee filings, while TIGTA has jurisdiction over filings against IRS personnel. All of these cases, whether investigated by CID or TIGTA and regardless of the statutes charged, require authorization from the Tax Division before conducting a grand jury investigation and/or prosecuting.

Historically, bogus financial instrument cases involving private creditors were prosecuted under a variety of statutes: conspiracy (18 U.S.C. § 371); mail fraud (18 U.S.C. § 1341); uttering a false security (18 U.S.C. § 472); bank fraud (18 U.S.C. § 1344), and possessing and uttering a counterfeit security (18 U.S.C. § 513). *See, United States v. Pullman*, 187 F.3d 816 (8th Cir. 1999); *United States v. Hanzlicek*, 187 F.3d 1228, 1230 (10th Cir. 1999); *United States v. Wells,* 163 F.3d 889 (4th Cir. 1998); *United States v. Stockheimer*, 157 F.3d 1082 (7th Cir. 1998).

In 1996, Congress passed a new statute, 18 U.S.C. § 514, specifically in reaction to the notorious Schweitzer/Broderick comptroller warrants. Noting that anti-government groups use fictitious financial instruments to commit economic terrorism against government agencies, private businesses, and individuals, Congress enacted Section 514 as a Class B felony, which carries a maximum prison sentence of 25 years. 142 Cong. Rec. S10155-02 (Sept. 10, 1996), pp. 196-197. Section 514 provides, in pertinent part, that:

> (a) Whoever, with the intent to defraud–
>
> > (1) draws, prints, processes, produces, publishes, or otherwise makes, or attempts or causes the same, within the United States;
> >
> > (2) passes, utters, presents, offers, brokers, issues, sells, or attempts or causes the same, or with like intent possesses, within the United States; or
> >
> > (3) utilizes interstate or foreign commerce, including the use of the mails or wire, radio, or other electronic communication, to transmit, transport, ship, move, transfer, or attempts or causes the same, to, from, or through the United States,
>
> any false or fictitious instrument, document, or other item appearing, representing, purporting, or contriving through scheme or artifice, to be an actual security or other financial instrument issued under the authority of the United States, a foreign government, a State or other political subdivision of the United States, or an organization, shall be guilty of a class B felony.

When prosecuting a case involving the "Redemption" scheme, the prosecutor should first determine if the protester has attempted to pass any fraudulent sight drafts or other financial instruments. This will require coordination with the U.S. Secret Service (USSS), Federal Bureau of Investigation (FBI), IRS and TIGTA. Title 18, U.S.C. § 514 is the obvious charge when prosecuting a case involving a sight draft. To date, four trials in the District of Idaho have had successful results: *United States v. Boone*, 1:99-CR-00119; *United States v. Clapier*, 1:99-CR-00120; *United States v. Pahl,* 1:99-CR-00121; *United States v. Smith*, 3:99-CR-0025. For filings relating to these cases, see the Idaho federal courts web page at <http://www.id.uscourts.gov>.

If the protester has filed only a few false Forms 8300 *and* used sight drafts, the prosecutor might consider charging the sight drafts pursuant to 18 U.S.C. § 514 and using the false Forms 8300 as evidence of intent. Filing a large number of false Forms 8300 may warrant charges pursuant to 26 U.S.C. § 7212(a) (omnibus clause). Section 7212(a) cases require Tax Division authorization at the Deputy Assistant Attorney General level, unlike other charges in these cases that require only Section Chief authorization. Because the Forms 8300 are signed under penalties of perjury, filing a false return in violation of 26 U.S.C. § 7206(1) may also be a viable charge. Neither Forms 4789 nor SARs contain jurats, so they cannot form the basis for a Section 7206(1) charge.

Sentencing for violations of 18 U.S.C. § 514 is governed by § 2F1.1 of the United States Sentencing Guidelines (USSG), and is based on the intended loss that the defendant was attempting to inflict. One common concern in the prosecution of this scheme involves the sometimes great difference between "intended loss" and "actual loss." Often, little or no actual loss results from the use of a fictitious financial instrument. In *United States v. Ensminger*, 174 F.3d 1143 (10th Cir. 1999), the court was faced with a scheme to obtain ownership in real

property through submission of bogus financial instruments. The district court enhanced Ensminger's sentence under 18 U.S.C. § 1001, based on an intended loss of $540,700, the uncontested value of the property. The facts in *Ensminger*, however, showed that there was no way the scheme could have succeeded, because the properties Ensminger attempted to obtain had already been sold to third parties. Based on these facts and two previous decisions (*United States v. Galbraith*, 20 F.3d 1054 (10th Cir. 1994); *United States v. Santiago*, 977 F.2d 517 (10th Cir. 1992)), the Tenth Circuit held that a ten-level enhancement for the intended loss was clearly erroneous. The *Ensminger* court noted that the Fifth, Seventh, Ninth, Eleventh, and District of Columbia Circuits disagree with this analysis, in reliance on application note 10 to section 2F1.1 of the guidelines. *Ensminger*, 174 F.3d at 1146-47. Furthermore, in cases specifically involving the use of bogus financial instruments, the Fifth Circuit upheld sentencing based on the face value of the Certified Money Orders even though there was no actual loss. *See United States v. Moser,* 123 F.3d 813, 830 (5th Cir. 1997). *See also United States v. Switzer*, 162 F.3d 1171, Nos. 97-50265, 97-50293, 97-50442, 1998 WL 750914 (9th Cir. Oct. 19, 1998) (upholding sentence based on intended loss); *United States v. Lorenzo,* 995 F.2d 1448, 1460 (9th Cir. 1993).

Sentencing for violations of the omnibus clause of 26 U.S.C. § 7212(a) is governed by either USSG § 2J1.2 or § 2T1.1. USSG App. A. Because the filing of the false Forms 8300 is designed to harass targeted individuals, rather than generate fraudulent refunds or reduce the perpetrators' tax liabilities, there is an argument that USSG § 2J1.2 (base offense level 12) should be applied. In addition, the application of § 2T1.1 requires a calculation of the tax loss that was the object of the offense. Although it can be argued that the targeted individual would have sustained a loss if the false Form 8300 was accepted at face value by the IRS, the absurdly high amounts on the forms could discourage courts from finding that the defendants actually intended a tax loss. *See United States v. Krause*, 786 F. Supp. 1151 (E.D.N.Y. 1992) (court held there was no tax loss from Forms 1096 falsely stating payments of huge fictitious salaries to various individuals and tax return claiming entitlement to a refund in excess of $23 million because the documents were specious on their face and did not represent an actual attempt to obtain something of value from the government), *aff'd*, 978 F.2d 706 (2d Cir. 1992); *see also United States v. Telemaque*, 934 F.2d 169 (8th Cir. 1992). *But see United States v. Dentice*, 202 F.3d 279, No. 99-50101, 1999 WL 1038003 (9th Cir. Nov. 15, 1999) (Ninth Circuit declined to follow *Krause* because "it was decided under a different guidelines scheme and unlike Dentice, Krause was a tax protestor who was acknowledged as such by the government and who did not actually intend to claim a refund, like Dentice").

Sentencing for violations of 26 U.S.C. § 7206(1) based on the filing of false Forms 8300 is governed by USSG § 2S1.3. Section 2S1.3 provides for a base offense level of six plus the number of offense levels from the fraud loss table (§ 2F1.1) corresponding to the amount of funds involved in the false report.

The "Redemption" scheme continues to evolve. Consequently, the best prosecutions require coordination of investigations by all involved agencies: IRS, TIGTA, FBI and USSS. The Tax Division has sample indictments and is available to help however possible. Any questions concerning these schemes or requests for assistance should be directed to Jennifer E. Ihlo, Special Counsel for Tax Protest Matters (Criminal), at 202-514-5171.❖

ABOUT THE AUTHORS

❑**Jennifer E. Ihlo** is Special Counsel for Tax Protest Matters (Criminal) in the Tax Division of the Department of Justice. She has been a trial attorney with the Tax Division since July, 1989. She is a two-time recipient of the Tax Division's Outstanding Attorney Award. On July 8, 1998, she received the Attorney General's John Marshall Award. She regularly lectures on the subject of prosecuting illegal tax protesters. Ms. Ihlo is the author of *The Gold Fringed Flag: Prosecuting Illegal Tax Protesters*, United States Attorneys' Bulletin, April 1998, and co-author of

The Pro Se Defendant, United States Attorneys' Bulletin, July 1998.

Melissa Schraibman has been a trial attorney with the Western Criminal Enforcement Section of the Tax Division, Department of Justice, since October of 1994. She received the Tax Division's Outstanding Attorney Award in 1997 and 2000. In December of 1999 she was named an "honorary special agent" by the IRS Criminal Investigation Division for the successful prosecution of Veral Smith.✠

The Internal Revenue Service's Voluntary Disclosure Policy

Stanley J. Okula, Jr.
Assistant United States Attorney
Southern District of New York

You receive a telephone call from a criminal defense attorney you know and trust who tells you the following: he represents two partners in a three–partner business concern that is in the midst of a nasty dissolution. The rift between the partners stems from the partners' discovery that the third partner had apparently diverted hundreds of thousands of dollars of partnership funds over a five-year period for personal use, and that the diverted funds were booked as partnership expenses on the partnership tax returns and thus not picked up as income on the third partner's personal returns. (The attorney knows this because the partnership's accountant also prepares the partners' personal returns.) The defense attorney wishes to present this case to you, in the hopes that you will commence a criminal tax investigation of the third partner. There's a hitch, though – the two partners represented by the attorney have their own tax problems, in that they each improperly deducted, as business expenses, approximately $100,000 of personal expenses, through the use of a partnership credit card. The attorney explains, however, that his clients had already voluntarily disclosed their improper deductions by filing amended (and completely truthful) returns, which spanned a three-year period, and that they had paid their back taxes with interest and penalties. The attorney concludes by suggesting that, given his clients' voluntary disclosures, he expects that their cases will not be referred for criminal prosecution.

Do you give the two partners a pass because they made a "voluntary disclosure"? What are the factors you consider when making that decision?

I. Overview

Given the number of tax returns filed each year, and the inherent limitations of law enforcement to police our self-reporting tax system, it stands to reason that many tax crimes go undetected. In order to encourage taxpayers to remedy past failures to file tax returns, or previously filed false returns, the Internal Revenue Service created what has come to be known as the "Voluntary Disclosure Policy."

The IRS' voluntary disclosure policy provides that the IRS will generally take into account the fact that a taxpayer came forward voluntarily, to file delinquent returns or correct false returns, in determining whether to recommend criminal prosecution. Both the IRS's Internal Revenue Manual and the Department of Justice Tax Division's Criminal Tax Manual have provisions discussing the policy and set out in detail the requirements that a taxpayer must satisfy in order for the IRS to consider the taxpayer's filings to be a "timely," and thus truly "voluntary", disclosure.

It must be emphasized at the outset that the IRS and DOJ guidelines regarding voluntary disclosures are simply that –- guidelines. Both the IRS and DOJ have made clear that those

guidelines do not have the force of law and thus may not be invoked to bind the IRS or DOJ. Indeed, the guidelines also make clear that IRS and DOJ may decide to prosecute even if a voluntary disclosure has been made. In sum, as one prominent commentator has noted, "making or attempting to make a voluntary disclosure is a matter of judgment, not law. No formula exists, and a taxpayer must endure the certainty of the risk that a voluntary disclosure will not be considered truly voluntary by the Service . . . " M. Saltzman, *IRS Practice and Procedure*, ¶ 12.03[3][c], at 12-40 (2nd ed. 1991) (hereinafter "Saltzman").

II. The History Of The IRS Policy

Prior to 1952, the Treasury Department declined to refer tax evasion cases to the Justice Department when the taxpayer had made a "clean breast of things" to the IRS before it had initiated an investigation. *United States v. Shotwell Manufacturing Co.*, 355 U.S. 233, 235 n.2 (1957). This policy was never formalized in regulations, but was set forth in "various informal announcements by Treasury officials." *Id. See* M. Saltzman, ¶ 12.03[3][c], at 12-35 (noting that early IRS voluntary disclosure policy was not rooted in any statutory authority). The Supreme Court construed this early version of the voluntary disclosure policy as an "offer of immunity." *Shotwell Manufacturing Co. v. United States*, 371 U.S. 341, 349 (1963) ("*Shotwell* II").

On January 10, 1952, the Treasury Department announced that it was abandoning this policy. Treasury Declaration S-2930 (Jan. 10, 1952). The Treasury explained:

> Litigation in the courts in recent years has illustrated the controversial nature of the question as to what constitutes a true voluntary disclosure in fact. In the administration of the policy it has been difficult and at times impossible to ascertain whether the disclosure was made because the taxpayer realized he was under investigation or whether the disclosure was in fact voluntary and in reliance on the immunity held out by the policy.

Rather than continue to litigate this question, the Treasury abandoned the immunity policy, and announced that "[i]t is the policy of the Treasury Department to recommend criminal prosecution in every case where the facts and circumstances warrant that action." *Id.*

In 1961, the IRS issued a statement which "reaffirm[ed]" the existing IRS policy: "even true voluntary disclosure of a willful violation will not, of itself, guarantee prosecution immunity. At the same time, the Service will carefully consider and weigh it, along with all other facts and circumstances, in deciding whether or not to recommend prosecution." IRS News Rel. No. 432 (Dec. 13, 1961).

The IRS put this policy into the Internal Revenue Manual ("IRM") in 1973. The Manual provision stated that a voluntary disclosure may be "significant" in the IRS' decision whether to recommend prosecution, but "does not necessarily preclude prosecution." IRM § P-9-2 (eff. Jan. 19, 1973). From the 1970's through the early 1990's, the IRS policy was essentially the same as described in 1961 and 1973. The Manual provision in effect in 1992 began by explaining that the IRS' former immunity policy "was abandoned" in 1952. IRM § 342.141 (eff. April 10, 1990). The Manual provision then stated the basic policy: "It is the practice of the Internal Revenue Service that a voluntary disclosure will be considered along with all other factors in the case in determining whether criminal prosecution will be recommended." *Id.* § 342.142(1). The Manual emphasized that "[a] voluntary disclosure will not of itself guarantee immunity from prosecution." *Id.* § 342.142(2); *see also id.* § 342.142(5) (stating, in bold type, that "a voluntary disclosure does not bar criminal prosecution"). The Manual also explained that "[t]he IRS's voluntary disclosure practice creates no substantive or procedural rights for taxpayers, but rather is a matter of internal IRS practice, provided solely for guidance to IRS personnel." *Id.* § 342.142(7).

The policy provided — and provides today — that to qualify as a voluntary disclosure, the

communication must be truthful, timely and complete, and the taxpayer must cooperate with the IRS in determining his correct tax liability. *Id.* § 342.142(3); *see also* IRM 9.5.3.3.1.2.1 (04/09/99) and CCDM 31.3.3 (01/17/1996). The policy defined a disclosure as timely if it was received before:

> a) The IRS has initiated an inquiry that is likely to lead to the taxpayer, and the taxpayer is reasonably thought to be aware of that investigative activity;
>
> or
>
> b) Some event known by the taxpayer occurred, which event is likely to cause an audit into the taxpayer's liabilities, e.g., a newspaper article highlighting commercial bribery in a particular industry or corruption in a government office.

Id. § 342.142(4). *See generally* Saltzman, ¶ 12.03[03][c], at 12-35-37 (discussing timeliness issue). In another part of the Internal Revenue Manual, the IRS Chief Counsel's Directives Manual ("CCDM") provided that to make a voluntary disclosure, "[t]he taxpayer must make bona fide arrangements to pay the applicable taxes and penalties to the extent of the taxpayer's actual ability to pay." CCDM Part (31)330, § (4)(d) (eff. 12/12/91).

Starting in June 1992, the IRS under Commissioner Shirley Peterson issued a series of speeches, press releases, and memoranda publicizing its voluntary disclosure policy, as part of a program called "Compliance 2000." To encourage individuals who had stopped filing returns to rejoin the tax system, IRS statements publicized the policy and emphasized the IRS' usual practice of not prosecuting taxpayers who voluntarily file delinquent returns. However, the IRS was generally careful to make clear that its voluntary disclosure policy was not a blanket offer of immunity to taxpayers and that voluntary disclosure remained only one factor the IRS would consider in deciding whether to recommend prosecution. *See* IRS News Rel. No. 92-71 (June 18, 1992) (reserving option of "criminal prosecution in appropriate cases"); IRS Fact Sheet No. 92-5 (September 1992) ("[i]n egregious cases, IRS will recommend criminal prosecution to the Department of Justice"); IRS News Rel. No. 92-94 (Sept. 30, 1992) (IRS policy not "a blanket exoneration"); IRS News Rel. No. 92-114 (Dec. 7, 1992) ("voluntary disclosure practice is not an amnesty or a grant of immunity from prosecution").

In an IRS press release issued December 7, 1992, the IRS for the first time signaled a change in the timeliness requirement for making a voluntary disclosure. The IRS explained that a voluntary disclosure would henceforth be deemed timely if it was filed before "notification by the IRS by a telephone call, letter or personal visit that the taxpayer is under *criminal investigation*." IRS News Rel. No. 92-114 (Dec. 7, 1992) (emphasis added). In April 1993, the IRS amended the Internal Revenue Manual provisions on the voluntary disclosure policy. IRM § 342.142 (eff. Apr. 5, 1993). The principal change effected by the amendment was to formally adopt this changed definition of timeliness. *Id.* § 342.142(3)(c). The 1993 amendment also added to this section of the IRM a provision requiring that the taxpayer seeking voluntary disclosure treatment must have "made full payment of the amounts due or in those situations where the taxpayer was unable to make full payment, made bona fide arrangements to pay," *id.* § 342.142(3)(e), which had previously been set out only in the Chief Counsel's Directives Manual.

The 1993 amendment explained that the IRS "has a long-standing practice of not recommending criminal prosecution arising from an individual's failure to file one or more returns" when the taxpayer made a timely voluntary disclosure. *Id.* § 342.142(3). However, the 1993 amendment also made clear that a voluntary disclosure was not a guarantee of immunity from prosecution. The policy retained the IRM section explaining that the IRS policy of granting immunity had been "abandoned" in 1952. *Id.* § 342.141. The IRM continued to direct agents to warn taxpayers that "a voluntary disclosure does not bar criminal prosecution," but "will be

considered with all other factors in the investigation when deciding whether to recommend prosecution." *Id.* § 342.142(1). The IRS also retained the Manual provision making clear that "the IRS's voluntary disclosure practice creates no substantive or procedural rights for taxpayers, but rather is a matter of internal IRS practice, provided solely for guidance to IRS personnel." *Id.* § 342.142(5).

Thus, the April 1993 amendment, while it modified the definition of a voluntary disclosure, did not change the nature of the policy. As explained in a memorandum signed by former Acting Assistant Attorney General for the Tax Division, James Bruton, "At bottom, the Service's voluntary disclosure policy remains, as it has since 1952, an exercise of prosecutorial discretion that does not, and legally could not, confer any legal rights on taxpayers." Criminal Tax Manual § 3.00, at 3-43

Effective August 25, 1995, the IRS amended the voluntary disclosure section of the IRM once again. The 1995 revision, which was put in place without fanfare, Saltzman, ¶ 12.03[03][c], at S12-20 (2000 Supplement), abandoned the "Peterson" rule on timeliness adopted in 1993, and restored in large part the language previously in place. Thus, the policy in place today requires that:

> [i]n order for the disclosure to be considered a "true" voluntary disclosure, the communication must be truthful, timely, and complete, and the taxpayer must show a willingness to cooperate with the Service (and actually cooperate) in the determination of the taxpayer's tax liability. The taxpayer's disclosure will not be timely if the taxpayer communicates with the Service only after an event that the Service believes would have eventually led to the discovery of the taxpayer's fraud. If a so-called triggering event has occurred, the disclosure is motivated by a fear of detection and is inconsistent with a voluntary act of accepting responsibility for prior misconduct. Accordingly, the Service must receive the disclosure before either the Service has "initiated an inquiry that is likely to lead to the taxpayer, and the taxpayer is reasonably thought to be aware of that investigative activity," or some event has occurred about which the taxpayer knows and that event is likely to cause an audit into the taxpayer's liabilities.

Id. (citing IRM § 342.142).

As noted above, the Tax Division of the Justice Department also has a practice concerning voluntary disclosure, which is discussed in the Department's Criminal Tax Manual ("CTM"). At all relevant times, the Justice Department's practice has followed the IRS' pre-1993 policy. When the IRS amended its policy in 1993, the Justice Department declined to adopt the IRS' revisions, announcing that it "has not changed its policy concerning voluntary disclosure, and cases should be evaluated as they have in the past." CTM § 3.00, at 3-43.

Thus, the Justice Department's practice at all times was to "give[ ] consideration to a 'voluntary disclosure' on a case-by-case basis in determining whether to prosecute." CTM § 4.01[1]. The Manual explained that the Department's practice was "an exercise of prosecutorial discretion that does not, and legally could not, confer any legal rights on taxpayers," and that "even if there has been a voluntary disclosure, prosecution and conviction may still result." CTM § 4.01[3]. The Manual provided that a voluntary disclosure must be timely, and "the taxpayer must thereafter fully cooperate with the government." CTM § 4.01[2]. The Justice Department's practice at all times followed the IRS' pre-1993 definition of timeliness. CTM § 4.01[2].

III. Cases

A. General

Courts have been unanimous for more than forty years in holding that the IRS policy does not give any taxpayer immunity from prosecution. *See United States v. Hebel*, 668 F.2d 995, 997-99 (8th Cir. 1982) (voluntary disclosure "does not insulate the taxpayer from prosecution"); *United States v. Choate*, 619 F.2d 21, 23 (9th Cir. 1980) (there is "no longer a policy affording immunity for voluntary disclosure," and the fact that taxpayer made a voluntary disclosure "is not conclusive" on whether prosecution will be authorized); *Plunkett v. Commissioner*, 465 F.2d 299, 303 (7th Cir. 1972) (rejecting argument that "United States Attorney was foreclosed from prosecuting Plunkett" because he had voluntarily disclosed and amended his false returns); *see also Crystal v. United States*, 172 F.3d 1141, 1151 (9th Cir. 1999) ("if completing a voluntary disclosure does not immunize taxpayers from prosecution, a fortiori initiating a voluntary disclosure cannot immunize them from investigation"); *United States v. Knottnerus*, 139 F.3d 558, 560-61 n.5 (7th Cir. 1998) (concluding that defendant seeking to preclude tax evasion prosecution failed to make a timely voluntary disclosure, but noting that even if he had, "his due process claim would be highly dubious"); *Bateman v. United States*, 212 F.2d 61, 65 n.2 (9th Cir. 1954) ("In 1952 the Treasury Department announced that voluntary disclosure would no longer prevent recommendation for prosecution"); *United States v. J.R. Watkins Co.*, 127 F. Supp. 97, 105 (D. Minn. 1954) (taxpayers who make voluntary disclosure after 1952 act at their own risk, since "prosecution might well be recommended"). Thus, a taxpayer may be prosecuted even if he or she makes a voluntary disclosure. Some highly experienced commentators have noted that, when a truly voluntary disclosure is made, a taxpayer is seldom prosecuted. *E.g.*, S. Michel, L. Feld & R. Fink, *Representing A Tax Criminal Prior To The Criminal Tax Investigation*, at C-6 (reprinted in ABA's Criminal Tax Fraud Seminar, Fall 2000). The reason for this is plain:

> Where a taxpayer makes a true voluntary disclosure before the Service has made any investigation into his returns, the case simply does not have the deterrent impact desired by the Service. Rather than encouraging compliance with the tax laws, such prosecution might well encourage other taxpayers to continue to conceal whatever omissions they may already have been guilty of in the hope that they will avoid detection. Not only do taxpayers who make voluntary disclosures make poor examples for deterrent purposes, but prosecution of such taxpayers can present significant trial hazards, since a disclosure is evidence from which a finder of fact may determine that the original act was not "willful" in a criminal sense.

Saltzman, ¶ 12.03[3][c], at 12-37.

B. Timeliness

As noted above, a disclosure will not be deemed truly voluntary if it was made in response to a "triggering" event. The classic triggering event is an investigation or inquiry by the IRS. Accordingly, "once a taxpayer has been contacted by any Service function (whether it be the Service center, office examiner, revenue agent, or a special agent), the taxpayer cannot make a qualifying voluntary disclosure under IRS practice." Saltzman, ¶ 12.03[3][c], at 12-37. In addition, a triggering event may consist of a governmental investigation of others that may lead to an audit of the taxpayer's liabilities, *e.g.*, *United States v. McCormick*, 67 F.2d 867 (2d Cir. 1933) (disclosure not timely where taxpayer knew that others were under investigation, and filed and paid his taxes to put himself in a safer position), or even a private dispute, such as a bitter business dissolution or a divorce proceeding, Saltzman, ¶ 12.03[3][c], at 12-37. *See also United States v. Zukerman*, 88 F. Supp.2d 9, 14 (E.D.N.Y. 2000) (disclosure untimely where taxpayer disclosed failure to file after being contacted by IRS special agent who sought to interview taxpayer about his

employer, but was aware of taxpayer's failure to file); *United States v. Levy*, 99 F. Supp. 529, 534 (D. Conn. 1951) (IRS inquiry relating to corporate executive's purchase of insurance policy "almost certain" to disclose that insurance policy had been purchased with cash, which would lead to evidence of cash transactions and tax evasion involving three co-workers); *United States v. Knottnerus*, 139 F.3d at 560 (disclosure untimely because it was made in response to special agent's visit).

C. Cooperation with the IRS

The 1993 "Peterson Policy" required the taxpayer to pay, or make a bona fide arrangement to pay, any outstanding tax liabilities. (The current policy requires the taxpayer to "cooperate" with the IRS in determination of the outstanding tax liabilities. While paying, or making an arrangement to pay, is likely to lead the IRS to conclude that the taxpayer has "cooperated," there is no firm payment requirement in the current policy. *see* IRM 9.5.3.3.1.2.1 (04/09/99).) In *United States v. Tenzer*, 127 F.3d 222 (2d Cir. 1999)("*Tenzer* I"), the court held that the taxpayer did not meet all of the requirements of the voluntary disclosure policy because he had failed to pay, or make an arrangement to pay, tax liabilities of almost $1,300,000. The court found it significant that, although a civil IRS agent advised that any offer-in-compromise filed by the taxpayer should be in the $600,000 range, the taxpayer, with the assistance of tax counsel, offered only $250,000, which offer the district court deemed "laughable." (Despite this finding, the District Court had concluded that Tenzer had made a bona fide arrangement to pay, and ultimately dismissed the information charging Tenzer with four counts of failure to file. 950 F. Supp. 554 (S.D.N.Y. 1996). The District Court also had held that Tenzer's disclosure was timely, despite the fact that the IRS was investigating the clients of Tenzer's accounting firm and had served Tenzer with a grand jury subpoena for client documents, which had led Tenzer to question whether he himself was under investigation. The Government appealed this ruling, which led to the Second Circuit's reversal in *Tenzer* I.) Moreover, after the IRS returned the inadequate offer, rather than offer more, Tenzer indicated that "he planned to resubmit the same offer with a more detailed explanation attached." 127 F.3d at 228. In addition, although the IRS revenue officer advised Tenzer that, if he wished the IRS to consider his offer-in-compromise he would have to become current on his accruing taxes and make all estimated payments, Tenzer failed to make estimated payments or pay any of his current year's taxes. Finally, Tenzer disregarded the revenue officer's advice that he divest certain assets and begin making monthly tax payments of $7,000. Given the foregoing, the Second Circuit concluded that Tenzer "had ample opportunity" to comply with the policy's requirement to make an arrangement to pay, but failed to do so.

D. Sentencing

Following *Tenzer* I, the District Court sentenced Tenzer to a year and a day in prison, rejecting Tenzer's request for a departure based on the IRS's conduct in the case. Judge Brieant's holding in this regard was premised on his belief that the mandate in *Tenzer* I precluded him from considering Tenzer's attempts to qualify for the voluntary disclosure policy, or the IRS's alleged improper conduct, as a basis to depart. *United States v. Tenzer*, 213 F.3d 34, 41 (2d Cir. 2000) ("*Tenzer* II"). On appeal, the Second Circuit remanded for resentencing, finding that its opinion in *Tenzer* I did not preclude the District Court, in the first instance, from considering whether Tenzer's attempts to qualify for the voluntary disclosure program, and the IRS's conduct, were sufficiently exceptional factors to take Tenzer's case out of the heartland and justify a downward departure. *Id.* at 43-44. The *Tenzer* II panel emphasized, however, that it was not deciding whether those factors, individually or together, constitute an appropriate basis for departure; rather, it held that such a consideration was not precluded by the mandate of *Tenzer* I, and the District Court was in the best position to make such an assessment in the first instance.

Following *Tenzer* II, the case was reassigned to a different District Judge, who rejected Tenzer's departure motion and sentenced Tenzer to the same year-and-a-day sentence that had been imposed previously. In so doing, the Court cited, among other factors, Tenzer's position as a tax

attorney and advisor, and his de minimus offers of back tax payments.

IV. Procedure

There is no formalized procedure for making a voluntary disclosure, there is no specific office within the IRS to which to direct such matters, and there is no requirement that a taxpayer contact the IRS to put the Service on notice of his or her intention to make a voluntary disclosure. In fact, in its simplest form, a taxpayer could file amended returns and pay the additional taxes owed prior to any triggering event and come within the policy. It should be noted, however, that a voluntary disclosure cannot be made anonymously through a taxpayer's attorney. For a discussion of how attorneys should go about making a voluntary disclosure, *see*, *e.g.*, Saltzman, ¶ 12.03[3][c], at 12-38-39, and S. Michel, L. Feld & R. Fink, *Representing A Tax Criminal Prior To The Criminal Tax Investigation*, at C-7 - C-9. *See also* testimony of IRS Attorney Robert Marino in *United States v. Tenzer*, 95 Cr. 1016 (CLB), explaining the practice of one IRS District Counsel in handling voluntary disclosures. (As a witness in the *Tenzer* case, Marino testified that he would occasionally have meetings while at IRS District Counsel with attorneys who would present a "hypothetical" case to him and ask whether, assuming the facts in the hypothetical, the taxpayer would be considered by the IRS to have made a voluntary disclosure. After hearing the hypothetical, Marino would caucus briefly with others at District Counsel while counsel waited, and thereafter give the attorney an answer. If the conclusion was that the hypothetical facts did constitute a voluntary disclosure, Marino would emphasize that the client's ability to avoid prosecution was conditioned on the IRS's not having previously commenced any investigation of the taxpayer, either civil or criminal.)

V. Conclusion

Based on the facts set out at the outset, it appears that the attorney's clients would be good candidates for the voluntary disclosure program. First, they have already filed correct amended returns and paid all of their back taxes, with interest and penalties. Next, although the amount of tax loss attributable to their false returns was probably sufficient to warrant prosecution, the numbers involved were not so egregious (as in *Tenzer*, for instance) to override the other policy considerations. Moreover, the tax losses for the disclosing partners are significantly lower than those of the third partner. In addition, although it might be argued that the business dispute was a "triggering event" that prompted the disclosures (thus negating the timeliness factor), it could also be argued that the simple business dispute was not "likely" to cause an IRS audit of the partners' tax returns. (After all, any partner informing on the others would have to disclose the existence of his or her own tax crimes. Thus, there are built-in incentives not to refer the matter to the authorities, no matter how bitter the dispute.) In sum, consideration of the various factors suggests that giving a pass to the attorney's clients would not be inappropriate.❖

ABOUT THE AUTHOR

❑**Stanley J. Okula, Jr.** has been an Assistant United States Attorney in the Southern District of New York since 1995. Prior to that time, he served as an Assistant United States Attorney in the Eastern District of New York from 1990 to 1995. He is the author of *The Voluntary Disclosure Policy*, Association of the Bar of the City of New York, Representing Defendants in Criminal Tax Investigations (January 2001); *Venue and Federalizing Crime: Will The Supreme Court Tell Prosecutors Where To Go?*, Criminal Justice (Winter 1999); *Third-Party Cooperation: Proceed With Caution*, Criminal Justice (Summer 1997); *Tracking Developments on Guideline Dealing With Skill And Abuse of Trust*, New York Law Journal, Feb. 9, 1999.✠

Missing in Action: The Absent Witness Instruction in Tax Prosecutions [1]

Thomas E. Zehnle
Counsel to the Assistant Attorney General
Tax Division
Department of Justice

Courts generally do not like to give "missing witness" instructions, even if the evidence presented at trial supports the charge. Judges will find all sorts of reasons to avoid doing so, especially in criminal cases. Usually, this entails a ruling from the bench that the witness was equally available to both sides, or that he or she was not peculiarly within the power of one of the parties to produce. Judges also refuse to give the instruction by holding that the witness's testimony would have been cumulative or immaterial–that the evidence would not have illuminated any matter at issue.

The courts' reluctance to instruct juries about the adverse inference that they may draw from a missing witness is not hard to fathom. To many, the instruction encourages the fact finder to speculate about "nonevidence," that is, evidence that was never presented at trial. *See, e.g., United States v. Simpson*, 974 F.2d 845, 848 (7th Cir. 1992). Judges are not alone in this belief. Many prosecutors might agree that, once released, this genie is difficult to get back in the bottle.

But here is the twist: I believe that the *government* should more frequently seek the missing witness instruction in white-collar prosecutions, particularly tax cases. Obviously, when this instruction is sought *against* a defendant, it raises concerns about potential violations of the Fifth Amendment privilege and impermissibly shifting the burden of proof to the accused. Before addressing these issues, however, it is important to explore the instruction's theoretical basis.

Missing Witnesses and the Adverse Inference Rule

The foundation for the missing witness instruction in this country dates back well over a century. In *Graves v. United States,* 150 U.S. 118 (1893), the Supreme Court declared that such a charge is warranted "if a party has it peculiarly within his power to produce witnesses whose testimony would elucidate the transaction." *Id.* at 121. Essentially, the instruction advises jurors that they may draw a negative inference against a party who controls important information but who chooses not to share it at trial. (Of course, nothing prevents that side from explaining during summation why particular witnesses were not called to the stand.)

A more modern formulation of the rule is found in the case of *United States v. Caccia,* 122 F.3d 136, 138-39 (2d Cir. 1997), which explains:

> The most appropriate version of a "missing witness" instruction, where the facts warrant it, permits the jury to draw an adverse inference against a party failing to call a witness when the witness's testimony would be material and the witness is peculiarly within the control of that party. In such circumstances, it is more likely than not that the testimony of an uncalled witness would have been unfavorable to the party with such control, and a jury may reasonably draw such an inference. The

[1]This article has been modified from its original version, *Genie in a Bottle: Using the Missing Witness Instruction*, that was published in Criminal Justice, Volume 13, No. 3 (Fall 1998). It is reprinted with permission from the American Bar Association. The views expressed here are solely those of the author and do not necessarily reflect the position of the Department of Justice.

> requirement that the witness be "peculiarly within the control" of the party ensures that the inference is not available to be drawn against a party who, in comparison with an adversary, lacks meaningful or pragmatic access to the witness.

A number of points are worth noting. First and foremost, the missing witness instruction is available against *any* party. Still, it may surprise some attorneys that this includes criminal defendants. Thus, it is an option that prosecutors may consider. *See, e.g., United States v. Dahdah,* 864 F.2d 55 (7th Cir. 1988). Indeed, the gist of this article is that there are particular white-collar cases (*e.g.,* tax prosecutions) where the government should press for such an instruction in order to level the evidentiary playing field.

Next, the proponent must show that the witness's testimony would have been *material* to an issue at trial. In this context, some courts have defined "material" by using language similar to that employed by the Supreme Court in *Graves*; – *i.e.,* the testimony must "elucidate the transaction." *See United States v. Glenn,* 64 F.3d 706, 709 (D.C. Cir. 1995). Interestingly, that same circuit probably gave a better definition when it opined that there "are some persons . . . who potentially have so much to offer that one would expect them to take the stand." *United States v. Pitts,* 918 F.2d 197, 199 (D.C. Cir. 1990). In any event, it seems fair to say that the testimony is "material" and will "elucidate the transaction" when it is relevant and noncumulative.

Finally, the absent witness instruction is generally restricted to those situations where one party has some *peculiar control* over the witness. It is the unequal access to important testimony that justifies the adverse inference. *Accord* 1 Devitt, Blackmar, Wolff & O'Malley, *Federal Jury Practice and Instructions,* § 14.15, at 458-59 (4th ed. 1990). However, the availability of the witness is to be determined based upon the facts and circumstances of that witness's "relation[ship] to the parties, rather than merely on physical presence or accessibility." *United States v. Torres,* 845 F.2d 1165, 1170 (2d Cir. 1988)(quoting *United States v. Rollins*, 487 F.2d 409, 412 (2d Cir. 1973)); *see also United States v. Romo,* 914 F.2d 889, 893-94 (7th Cir. 1990) (witness's relationship with a party may make his testimony "in pragmatic terms" only available to that side); *but see United States v. Sorrentino,* 72 F.3d 294, 298 (2d Cir. 1995) (confidential informant was not peculiarly within the control of government because government produced witness and defense could have called him to testify). In fact, one court has opined that a witness may be peculiarly available to the other side "if the witness would be hostile to or biased against the calling party." *United States v. Hoenscheidt,* 7 F.3d 1528, 1531 (10th Cir. 1993); *see also United States v. Addo,* 989 F.2d 238 (7th Cir. 1993) (witness who is available to both parties but has bias towards one side may be deemed in control of that party).

It should be noted here that some believe that a modified version of the instruction is appropriate where the witness is equally available to both parties, but neither side calls her. Under these circumstances, it is argued that the court should instruct the jury that an adverse inference may be drawn against either or both parties. *See generally United States v. Bahna*, 68 F.3d 19, 22 (2d Cir. 1995) (discussing trial court's charging options). Frankly, permitting a negative inference to be drawn in such cases does not make much sense, Professor Wigmore's views notwithstanding. *Compare* 2 Wigmore, Evidence § 288, at 208 (Chadbourn Rev. 1979) *with United States v. Adeniji,* 31 F.3d 58, 65 (2d Cir. 1994). Simply put, if a witness has important testimony to offer and is available to both sides, it does not seem wise to encourage the jury to speculate about it when the real thing could have been presented. *See Bahna*, 68 F.3d at 22 (noting that if any instruction is to be given in such situations, the majority of circuits favor advising the jury that *no* inference may be drawn against either side).

Apprehension about the Instruction

Many defense attorneys, and some judges, are uneasy about an argument that seeks to expand the prosecution's use of the missing witness instruction. The anxiety stems primarily from two sources: concern regarding potential violations of

the defendant's Fifth Amendment privilege to remain silent; and the related issue of the government's burden of proof *vis-a-vis* the defendant's right not to produce any evidence. A third reason – that the missing witness instruction allows jurors to speculate – may also be a concern, but courts frequently allow fact finders to draw adverse inferences in analogous situations without similar worry.

The Fifth Amendment "forbids either comment by the prosecution on the accused's silence or instructions by the court that such silence is evidence of guilt." *Griffin v. California,* 380 U.S. 609, 615 (1965). Accordingly, a constitutional violation occurs only where the prosecutor's comment (or, *a fortiori*, the court's instruction) "was manifestly intended or was of such character that the jury would necessarily construe it as a comment on the failure of the accused to testify." *See United States v. Chirinos,* 112 F.3d 1089, 1099 (11th Cir. 1997) (quotation marks omitted). Care must be taken, therefore, to distinguish between a comment or an instruction which relates to the failure of the *defense*–as opposed to the failure of the *defendant*–to counter or explain the evidence. An adverse inference based on the former is permissible; on the latter, it is not. *Chirinos*, 112 F.3d at 1100; *see also United States v. Castillo,* 866 F.2d 1071, 1083 (9th Cir. 1988) (comment on failure of defense is not an infringement of the accused's Fifth Amendment privilege).

Accordingly, a judge may instruct jurors that a negative inference may be drawn against the defense for its failure to produce a material witness within its control. The decision to so charge the jury lies within the sound discretion of the trial court. *United States v. Mittelstaedt,* 31 F.3d 1208, 1215 (2d Cir. 1994). It is only where the witness and the accused are one and the same – where the explanatory evidence would naturally and necessarily have to come from the defendant himself – that the instruction is forbidden. *Accord United States v. Gomez-Olivas,* 897 F.2d 500, 503 (10th Cir. 1990) ("[a]s long as evidence can be solicited other than from the mouth of the accused, it is proper to comment upon the failure of the defense to produce it").

Understandably, some will have trouble with the missing witness charge being used against an accused because it is difficult to reconcile the government's burden of proof with the defendant's right not to present a case. *See*, *e.g.*, *Gomez-Olivas*, 897 F.2d at 503-04. At first blush, the situation presents an apparent paradox. The answer lies in the fact that the jury is free to accept or reject the adverse inference. That is to say, the *permissive* nature of the inference undercuts any argument that the burden has been unconstitutionally shifted to the defendant. *Niziolek v. Ashe*, 694 F.2d 282, 292 (1st Cir. 1982). The burden of proof always remains with the prosecution. The inference is simply a way of allowing the government to carry that burden "and no more changes it than does damning evidence." *United States v. Sblendorio,* 830 F.2d 1382, 1391 (7th Cir. 1987). The Supreme Court has held that permissive inferences in general place no obligation of any kind on the defendant. *County Court of Ulster County v. Allen,* 442 U.S. 140, 157 (1979).

Although he has no burden of proof, the accused does run the risk of an adverse inference being drawn against him based upon the nonproduction of a material witness if the government establishes that the defendant had the peculiar power to produce the individual in question. *See* 8 Wigmore, Evidence § 2273, at 450 (Chadbourn Rev. 1979). The difficulty in distinguishing between these concepts probably accounts for the view of some courts that the instruction should not be given if the defense has not presented any evidence. *See* Manual of Model Criminal Jury Instructions for the District Courts of the Eighth Circuit, Instruction No. 4.16 (1996). It goes without saying that where the defense seeks to employ a missing witness argument against the government, the Fifth Amendment and related burden-shifting concerns are not present.

Finally, many attorneys, prosecutors, and defense lawyers alike, are squeamish about this instruction because they believe that it allows jurors to speculate about "nonevidence." No one actually testifies, but the fact finder may nevertheless infer what the missing witness would have said on the stand. However, upon closer inspection, this is really nothing new. Courts have

long permitted jurors to make such adverse inferences when the surrounding circumstances warrant it. For example, when an accused will not provide handwriting exemplars so that they may be compared against a questioned document, it is permissible to instruct the jury that they may draw a negative inference regarding the defendant's refusal. *United States v. Stone,* 9 F.3d 934, 942 (11th Cir. 1993). In such a case, no expert has in fact testified that the defendant drafted the document, yet the jury may conclude this based on his refusal to give the writing samples. Likewise, where a defendant declines to speak for identification purposes at a police line-up, evidence of this refusal does not violate the accused's constitutional rights. *Higgins v. Wainwright,* 424 F.2d 177 (5th Cir. 1970); *see also United States v. Franks,* 511 F.2d 25, 35-36 (6th Cir. 1975) (appropriate to instruct jury that defendant's refusal to provide voice exemplar may be viewed as consciousness of guilt). The Supreme Court has stated that evidence of a defendant's refusal to submit to a blood-alcohol test does not violate his Fifth Amendment privilege. *South Dakota v. Neville,* 459 U.S. 553, 562-63 (1983).

Indeed, even though the government may benefit from permissive inferences such as these, the prosecutors would almost certainly prefer the actual evidence. As noted in *Neville*, a positive test result would be far stronger evidence of intoxication than any adverse conclusion which *might* be drawn from the defendant's refusal to take the test. *Neville*, 459 U.S. at 563-64. Similarly, in a missing witness situation, the government's lawyers would certainly prefer to cross-examine the material witness under oath rather than simply argue an inference in summation.

Missing Foreign Witnesses in Tax Cases

In what type of white-collar cases should prosecutors consider seeking a missing witness instruction? Answer: Where the missing witness is a *foreign* nominee, bank official or executive who is transactionally associated with the defendant. The assistant U.S. attorney or Department of Justice trial attorney should not overlook this possible strategy where the accused's actions have otherwise stonewalled the government's case.

Let us start with the rather basic premise that people are more sophisticated today than in the past in the way they handle (and hide) their money. To this end, those up to no good have increasingly utilized foreign corporations as shells and deposited their funds in financial institutions where the host country maintains strict bank secrecy laws. Obviously, not everyone who has an offshore account or who has dealings with a foreign company is engaged in nefarious conduct. Indeed, most of these relationships are for legitimate business purposes. But, as always, there are those who use these services to violate federal and state criminal laws.

In true white-collar prosecutions, such as tax evasion, the use of overseas nominees and foreign banks can prove to be a substantial roadblock. (These cases should be distinguished from money laundering prosecutions, where there has been significant international cooperation, at least in combating narcotics trafficking.) Traditional techniques employed by criminal investigators to obtain testimony and documents are often futile in these circumstances. If the foreign jurisdiction is not cooperative, the chances of procuring the necessary evidence to successfully try the case is dramatically decreased.

An example of some of the hurdles that face the government may be enlightening here. Assume that a physician with a lucrative medical practice decides to skim profits from his business and evade paying taxes on this income. Or, assume that the case involves a politician who accepts bribes for his services. In either case, rather than placing the money in a domestic bank or brokerage house where the IRS or FBI could subpoena the records and the account executive, he sends it overseas. Just parking the money in the Caribbean, for example, does nothing to enhance the lifestyle of our ne'er-do-well defendant. So he forms, through nominee directors, a foreign corporation which purchases substantial assets (such as buildings) in the United States. He then "leases" these buildings, thus sending more of his money offshore to himself, since he *is* the foreign corporation.

Now let us assume that the government somehow gets wind of this scheme, either through a disgruntled former employee at the medical practice or a suspicious secretary at the politician's office. Not surprisingly, the defendant denies maintaining any foreign bank account and contends that the relationship with the offshore corporation is legitimate. Despite having a broad overview of the operation, incriminating records are lacking and the witnesses who have first-hand information are overseas and seemingly not subject to examination under oath. What options are available to the government?

More than likely, the prosecutor will first determine whether the foreign country has entered into a mutual legal assistance treaty (MLAT) with the United States. These treaties create formal contracts to provide legal assistance in criminal matters – assistance which includes, among other things, taking testimony and providing documents. The problem is that although MLATs often encompass a broad range of felonies, some foreign countries specifically exclude coverage in those matters that they consider to be purely "fiscal," such as tax evasion. It is no secret that many jurisdictions continue to serve as tax havens for U.S. citizens. In our hypothetical, then, there is no formal treaty by which the government can obtain this important evidence.

The trial attorney may next examine the possibility of employing a letter rogatory, which is nothing more than a formal request from the American court in which the case is pending to the foreign court seeking judicial assistance. (Prior to the expansion of MLATs, law enforcement officials and private parties often relied on this method to obtain evidence.) Here, we will assume that the prosecutor seeks to depose certain witnesses, such as a nominee corporate director and a bank account executive. In addition to having to secure the American court's permission, the real problem is that the foreign court has no obligation whatsoever to honor the request – especially if that country allows for no exceptions to its financial secrecy laws. Moreover, the letter rogatory procedure is uncoordinated and subject to serious time delays.

Both these channels appear futile. The prosecutor next considers using subpoenas to obtain the testimony of (and documents from) the foreign corporation and the defendant's suspected banker. There are, of course, major difficulties with this strategy as well. If the foreign witnesses cannot be located – even temporarily – within the jurisdiction of the United States, the subpoenas will not work. *See generally In re Grand Jury Proceedings (Field),* 532 F.2d 404, 407 (5th Cir. 1976). Further, issuing a grand jury or trial subpoena to the domestic branch of a foreign bank (assuming there is one) is very controversial and often creates serious jurisdictional disputes between countries. Furthermore, the unilateral approach can be ineffective even when permission to issue the subpoena on the branch is granted. *See, e.g., In re Grand Jury Proceedings (Bank of Nova Scotia),* 691 F.2d 1384 (11th Cir. 1982).

Not to be deterred, the trial attorney may seek a "compelled directive," where the court orders the alleged account holder (*i.e.,* the doctor or politician) to direct the foreign bank or other institution to disclose any information it has concerning the accused. These directives are sometimes referred to as "*Ghidoni* waivers." *See United States v. Ghidoni,* 732 F.2d 814 (11th Cir. 1984). The Supreme Court has held that an order directing the alleged foreign account holder to execute a hypothetically-framed disclosure does not violate his Fifth Amendment rights. *Doe v. United States,* 487 U.S. 201, 206-18 (1988). Without such a waiver, the information would be protected by the host country's financial secrecy laws. Unfortunately, some foreign jurisdictions hold that compelled directives are not voluntary and freely-given consent, therefore, *Ghidoni* waivers often fail to satisfy the relevant country's strict privacy laws.

Instruction, Not Just Argument

What can be done when legitimate investigative avenues are foreclosed or are impractical and the defendant will not voluntarily consent to having a foreign witness under his peculiar control release potentially relevant information? Assuming that it can otherwise make out a *prima facie* case, the government should seek, and the court should grant, the missing

witness instruction against the accused. Otherwise, the wrongdoer may prevail through a sophisticated handling of his financial affairs – conduct which at its very heart is designed to prevent disclosure of the incriminating evidence to the authorities. We should never countenance justice being dispensed according to such gamesmanship.

No doubt, some will contend that the defendant could not have subpoenaed the foreign witnesses and that, therefore, they were not under his control. However, this would be a disingenuous argument under circumstances similar to those set forth above. A witness's physical amenability to subpoena is only one of a number of factors to be analyzed in determining whether the absent witness is peculiarly within the power of one of the parties to produce. *See United States v. MMR Corp. (LA),* 907 F.2d 489, 502 (5th Cir. 1990) ("[t]hat the potential witness is physically present at trial or accessible to service of subpoena by the court does not make the witness equally available to both sides"); *see also United States v. Martin*, 696 F.2d 49, 52 (6th Cir. 1983). In our example, the business relationship between the accused and the director of the nominee corporation would certainly make that person more available to the defendant than to the prosecution. Similarly, a family tie or connection often makes a witness more likely to favor one party over the other and, thus, be within the peculiar power of that party to produce.

Others may grant that something should be done, but believe that a missing witness instruction is dangerous, even in our hypothetical. For these people, a middle ground may be possible; *i.e.,* simply permit the prosecutor to make the missing witness argument during his or her summation. The government has been allowed to do so in other cases. *See Nichols v. Scott,* 69 F.3d 1255 (5th Cir. 1995); *United States v. Santana,* 877 F.2d 709 (8th Cir. 1989); *United States v. Glantz,* 810 F.2d 316 (1st Cir. 1987).

As every experienced trial attorney knows, the lawyer's closing argument "does not bring to bear the same force as would a pronouncement on the issue from the bench. . . ." *Mittelstaedt*, 31 F.3d at 1215. In cases such as these, where an ingenious defendant can arrange his affairs so as to preclude the government from obtaining crucial foreign evidence, a court's instruction on the matter is warranted.

The argument presented herein is not made lightly. It is by no means intended to circumvent a defendant's right to remain silent or to require anything less than the government fully meeting its burden of proof beyond a reasonable doubt. Indeed, no prosecutor should ever seek to obtain a conviction "by artfully or unintentionally inducing a jury to find a defendant guilty on improper and unconstitutional grounds." *Castillo*, 866 F.2d at 1084. However, advising the jury that they may draw an adverse inference against the accused is not unconstitutional under these circumstances – it is just. As criminals become more sophisticated in their financial dealings and transactions, the government must become more resourceful, and the courts more open-minded.❖

ABOUT THE AUTHOR

❑**Thomas E. Zehnle** has been Counsel to the Assistant Attorney General for Criminal Matters at the U.S. Department of Justice, Tax Division, since January 2000. As such, he participates in the development and implementation of criminal tax policy on a national level. Prior to that, he served nine years as a senior trial attorney prosecuting tax violations and other financial crimes on behalf of the Department of Justice. Over the years, he has written numerous articles and has been published on topics such as criminal law, tax, and evidence. In addition, he has been a frequent lecturer at seminars presented by the Justice Department, the American Bar Association, and the Internal Revenue Service.✠

Obtaining Foreign Evidence and Other Types of Assistance for Criminal Tax Cases

James P. Springer
Senior Counsel for International Tax Matters
Tax Division
Department of Justice

I. Introduction

This article provides a detailed analysis of the means available to federal prosecutors for obtaining foreign evidence and other types of international assistance in criminal tax cases. The means analyzed here include mutual legal assistance treaties (MLATs) and similar processes, tax information exchange agreements (TIEAs) and tax treaties, court-sponsored procedures for taking foreign depositions, including letters rogatory, and the use of unilateral compulsory measures, such as subpoenas, for obtaining foreign evidence.

Obtaining foreign evidence and other types of international assistance usually requires considerable amounts of time and can cause significant delays in an investigation or trial proceeding. Thus, a prosecutor should initiate seeking such evidence or assistance through the appropriate process as soon as possible.

No United States investigator or prosecutor may contact foreign authorities or witnesses, whether by telephone or other means, or undertake foreign travel, without obtaining the proper clearances or authorizations. Prosecutors under the jurisdiction of the Department of Justice are required to coordinate and clear all such contacts and travel through the Office of International Affairs ((202) 514-0000).

II. Obtaining Foreign Evidence or Other Types of Assistance under Mutual Legal Assistance Treaties

A. Background

Mutual Legal Assistance Treaties create a routine channel for obtaining a broad range of legal assistance for criminal matters generally, including, *inter alia,* taking testimony or statements of persons, providing documents and other physical evidence in a form that would be admissible at trial, and executing searches and seizures. These treaties are concluded by the Department of Justice (primarily the Criminal Division) in conjunction with the Department of State. An MLAT creates a contractual obligation between the treaty partners to render to each other assistance in criminal matters in accordance with the terms of the treaty. It is designed to facilitate the exchange of information and evidence for use in criminal investigations and prosecutions. Unfortunately, while many of the MLATs currently in force cover most U.S. tax felonies, several others have only limited coverage, at best, for tax offenses.

B. MLATs Currently in Effect

As of March 10, 2001, the United States has MLATs with the following jurisdictions: Anguilla, Antigua & Barbuda, Argentina, Australia, Austria, the Bahamas, Barbados, Belgium, Brazil, the British Virgin Islands, Canada, the Cayman Islands, the Czech Republic, Dominica, Estonia, Grenada, Hong Kong, Hungary, Israel, Italy, Jamaica, Latvia, Lithuania, Luxembourg, Mexico, Montserrat, Morocco, the Netherlands (including the Netherlands Antilles and Aruba), Panama, the Philippines, Poland, South Korea, Spain, St. Christopher and Nevis, St. Lucia, St. Vincent & the Grenadines, Switzerland, Thailand, Trinidad & Tobago, Turkey, the Turks

and Caicos Islands, Ukraine, the United Kingdom, and Uruguay.

C. The Extent of Tax Coverage in MLATs

The MLATs with Antigua & Barbuda, Argentina, Australia, Austria, Barbados, Belgium, Brazil, Canada, the Czech Republic, Dominica, Estonia, Grenada, Hong Kong, Hungary, Israel, Italy, Jamaica, Latvia, Lithuania, Luxembourg, Mexico, Morocco, the Netherlands (excluding the Netherlands Antilles and Aruba), the Philippines, Poland, South Korea, Spain, St. Christopher and Nevis, St. Lucia, St. Vincent & the Grenadines, Thailand, Trinidad & Tobago, Turkey, Ukraine, and the United Kingdom cover all criminal tax felonies under the Internal Revenue Code. The remaining MLATs contain a variety of restrictions regarding assistance for tax offenses. Thus, the Swiss MLAT excludes tax and similar fiscal offenses from its scope except in cases involving organized crime. However, assistance is available from the Swiss under one of their domestic mutual assistance statutes (referred to as an "IMAC") in any tax matter where a foreign tax authority can establish "tax fraud" as the term is used under Swiss law. Historically, the Swiss had considered the conduct underlying most U.S. criminal tax felonies as civil in nature, and establishing "tax fraud" as the term is used under Swiss law had been a considerably difficult task. However, with the advent of the new Income Tax Treaty with Switzerland, the concept of tax fraud has been expanded and this expansion applies to requests made for mutual legal assistance under an IMAC. The Cayman and Bahamian MLATs generally exclude offenses relating to tax laws except for tax matters arising from unlawful activities otherwise covered by the MLATs. Furthermore, each of these three treaties contains specific limitations on the use of evidence obtained for covered offenses. Thus, evidence obtained for some other offense is generally not available for tax purposes in subsequent civil or criminal investigations or proceedings.

D. Designation of a Central Authority to Administer the MLAT for Each Treaty Partner

Every MLAT specifies central authorities to act on behalf of each treaty partner to make requests, to receive and execute requests, and to generally administer the treaty relationship. The central authority designated for the United States is the Director, Office of International Affairs (OIA), Criminal Division, U.S. Department of Justice. 28 C.F.R § 0.64-1. The central authority for the treaty partner is generally an entity located within the ministry of justice or its equivalent agency.

E. Matters for Which Assistance Is Available under MLATs

Assistance is available under the MLAT once an investigation or prosecution has been initiated by an appropriate law enforcement or judicial authority in the requesting state. Thus, the United States may initiate a request for assistance under an MLAT when a criminal matter is at the trial stage, or is under investigation by (1) a prosecutor, (2) a grand jury, (3) an agency with criminal law enforcement responsibilities, such as the Criminal Investigation Division of the Internal Revenue Service, or (4) an agency with regulatory responsibilities, such as the Securities and Exchange Commission.

F. Types of Assistance Available under MLATs

Generally, MLATs provide for the following types of assistance:

1. serving documents in the requested state;
2. locating or identifying persons or items in the requested state;
3. taking testimony or statements from persons in the requested state;
4. transferring persons in custody in either state to the other for testimony or other purposes deemed necessary or useful by the requesting state;

5. providing documents, records, and articles of evidence located in the requested state;
6. executing requests for searches and seizures in the requested state;
7. immobilizing assets located in the requested state;
8. assisting in proceedings related to forfeiture and restitution; and
9. any other form of assistance not prohibited by the laws of the requested state.

MLATs are designed to override local laws in the requested states pertaining to bank secrecy and to ensure the admissibility in proceedings in the requesting state of the evidence obtained. Thus, for example, MLATs typically contain provisions which, in conjunction with certain statutes, are directed at securing the admissibility of business records, or establishing chain of custody over an evidentiary item, without having to adduce the in-court testimony of a foreign witness.

G. Procedures for Making Requests for Assistance

To make a request for assistance under a particular MLAT, a prosecutor or investigator should contact OIA at (202) 514-0000, request to speak to the attorney in charge of the country from which assistance will be requested, and collaborate on preparation of the request. Once the Director of OIA signs a request, it must be translated into the official language of the requested state, unless the particular MLAT provides otherwise. The request will then be submitted in both language versions (English and the official language of the requested state) to the central authority of the requested state.

H. Limitations on Use of Evidence or Information Obtained

Generally, MLATs have provisions restricting the use of information or evidence furnished under their provisions, including conditions of confidentiality. Accordingly, the law enforcement authorities of the requesting state must comply with these restrictions in using the information or evidence in the course of an investigation or prosecution. Although some MLATs are more restrictive, generally, once the information or evidence properly used in the investigation or prosecution becomes a matter of public record in the requesting state, it may be used for any purpose.

III. Mutual Legal Assistance under Foreign Statutes Where No Formal Treaty Relationship Need Exist

New approaches have been recently developed for obtaining assistance from countries whether or not there is a treaty relationship. As a result, letters rogatory issued by a court are no longer the exclusive means of securing formal legal assistance outside an MLAT. Such requests typically follow a format similar to that employed under MLATs, and are sometimes referred to as "MLAT-Type" requests. Legal assistance in these circumstances is provided to the extent permitted by relevant domestic legislation. Countries in this category include Ireland, Japan, New Zealand, Channel Islands, Isle of Man, Liechtenstein, Switzerland, and the United Kingdom. Contact the appropriate OIA Team at (202) 514-0000 for further details.

IV. Obtaining Foreign Evidence under Tax Information Exchange Agreements and Tax Treaties

A. Background

Tax information exchange agreements (TIEAs) and income tax treaties are also means for obtaining foreign-based documents and testimony, often in admissible form, for criminal and civil tax cases, and investigations. These pacts are concluded by the United States Department of Treasury, with the assistance of the Internal Revenue Service and the Tax Division of the Department of Justice, and are administered by the Director, International, of the IRS. For the purposes of obtaining foreign evidence, TIEAs are more specialized and effective than tax treaties.

B. Tax Information Exchange Agreements (TIEAs)

TIEAs are agreements which specifically provide for mutual assistance in criminal and civil

tax investigations and proceedings. This assistance comprises obtaining foreign-based documents, including bank records, and testimony in admissible form. TIEAs are statutory creatures of the Internal Revenue Code. *See* 26 U.S.C. §§ 274(h)(6)(C) and 927(e). This statutory framework initially authorized the Secretary of the Treasury Department to conclude agreements with countries in the Caribbean Basin (thereby qualifying such countries for certain benefits under the Caribbean Basin Initiative), but later expanded this authority to conclude TIEAs with any country.

C. TIEAs Currently in Effect

As of March 10, 2001, the United States had TIEAs in effect with the following countries: Barbados, Bermuda, Costa Rica, Dominica, the Dominican Republic, Grenada, Guyana, Honduras, Jamaica, Marshall Islands, Mexico, Peru, St. Lucia, and Trinidad & Tobago.

D. Information Exchange under Tax Treaties

The United States has income tax treaties with more than fifty countries. There are two principal purposes of these treaties: (1) to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country; and (2) to prevent avoidance and evasion of the income taxes of the two countries to the treaty. To address the latter purpose, almost all U.S. income tax treaties contain a provision for exchanging information, similar in concept to TIEAs. The Treasury Department places great importance on information exchange in these tax treaties and will not enter into a treaty relationship with any country that cannot meet the minimum standards of information exchange.

E. Tax Treaties Currently in Effect

As of March10, 2001, the United States had income tax treaties in force — including exchange of information provisions — with the following countries: Australia, Austria, Barbados, Belgium, Bermuda, Canada, China, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kazakhstan, Korea, Latvia, Lithuania, Luxembourg, Mexico, Morocco, Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Portugal, Romania, Russia, Slovak Republic, South Africa, Spain, Sweden, Switzerland, Thailand, Trinidad & Tobago, Tunisia, Turkey, Ukraine, the United Kingdom, and Venezuela.

F. Scope of TIEAs and Income Tax Treaties

Under most of the TIEAs and tax treaties to which the United States is a party, requests for assistance may be made for any civil or criminal tax investigation or proceeding regarding any tax year not barred by the statute of limitations of the state seeking the information.

G. Designation of a Competent Authority to Administer TIEAs and Tax Treaties for Each Treaty Partner

Every TIEA and tax treaty specifies competent authorities to act on behalf of each treaty partner to make requests, to receive and execute requests, and to administer generally the treaty relationship. The Director, International (DI), Internal Revenue Service, has been designated to act as the competent authority for exchanging information under TIEAs and tax treaties under the authority of the Secretary of Treasury. The specific office acting under the direction of the DI to make and receive requests for information under TIEAs and income tax treaties is the Exchange of Information Team. The competent authority for the treaty partner is generally an entity located within the ministry of finance or its equivalent agency.

H. Procedures for Making Requests For Information

If you wish to explore making a request for evidence or information under a TIEA or tax treaty, call the general number for the Exchange of Information Team ((202) 874-1624) in the Office of the DI and ask to speak to the Exchange Analyst who is responsible for the country where the information is located. Usually, the investigator or prosecutor in charge of the case will draft the initial version of the request and forward this draft to the Exchange Analyst, or the Revenue Service Representative (RSR) in charge

of the country where the information is located, for review. Subsequently, the request is formalized and sent to the foreign competent authority for execution.

I. Confidentiality of Information Obtained

All of our TIEAs, and virtually all of our tax treaties, currently in effect contain language requiring that information obtained under such agreements be used only for tax purposes. Obviously, such language can raise troublesome issues for a prosecutor conducting a grand jury investigation directed at both tax and non-tax crimes. Indeed, recently certain treaty partners have resisted executing requests for information made in such cases based on their view that the obligation of confidentiality forbids use by a grand jury considering non-tax crimes. To address this situation, the Treasury Department and the Justice Department jointly decided to undertake using cautionary instructions to the grand and petit juries in such cases.

Under this approach, the prosecutor would caution the grand jury, as the trial judge would the petit jury, that the evidence obtained under the tax agreement could not be utilized to draw inferences of guilt regarding the non-tax offenses. This approach would also require the trial judge to ignore the evidence for the purposes of a defendant's motion to dismiss under Fed. R. Crim. P. 29.

J. Possible Problems with Exchanging Information under TIEAs and Income Tax Treaties

Although exchanging information under TIEAs and tax treaties has been relatively successful, there are a variety of problems which can arise. For example, officials of some countries having civil law systems balk at executing tax treaty requests in criminal tax cases, especially those arising from grand jury investigations. This hesitancy arises from the belief that tax treaties, which they consider to be part of an *administrative* governmental process, should not be used for *judicial* matters. This problem can be aggravated where non-tax offenses are also under investigation, given the ever-present provision in these agreements dealing with confidentiality. Also, certain countries will provide treaty partners only with information which currently exists in their tax files regarding a given taxpayer, and will not undertake to gather information from other sources, including third parties. Finally, some treaty partners, even if they will undertake to gather information from sources other than their tax files, will not obtain and provide financial information, such as bank records, because of bank secrecy laws.

V. Using Letters Rogatory and Other Judicial Procedures to Obtain Evidence in Criminal Tax Cases

A. Background

Before the advent of tax treaties, MLATs, TIEAs, and other types of mutual assistance agreements, law enforcement authorities (just as private litigants) primarily relied upon the letters rogatory, or letter request, procedure to obtain the assistance of foreign authorities. *See* Fed. R. Crim. P. 15.

A letter rogatory is a formal request from a court in which an action is pending, to a foreign court, to perform some judicial act. If the foreign court honors the request, it does so based on comity rather than any sort of strict obligation. As this definition suggests, a letter rogatory can usually only be used in a proceeding which has actually commenced, such as in the post-indictment stages of a criminal case or the post-complaint stages of a civil case. The route of a letter rogatory is quite circuitous and involves many diverse entities in an uncoordinated process. Typically, a litigant initiates the process by applying to the court before which the particular action is pending, for the issuance of a letter rogatory, supporting the application with a set of complicated and formalistic pleadings.

Upon signature by the court, the letter rogatory must be transmitted through diplomatic channels, which involves not only the U.S. State Department but also the foreign ministry of the country involved. The foreign ministry delivers the request to the country's ministry of justice, which in turn delivers it to the foreign court originally contemplated to execute the letter

request. If the request is successfully executed, the evidence must retrace the path of the request.

B. Procedures for Obtaining Assistance by Letters Rogatory

The procedures for utilizing the letters rogatory process, once a prosecutor has secured the court's leave to do so under Fed. R. Crim. P. 15, are not as well defined and standardized as those for obtaining assistance under MLATs, TIEAs, and tax treaties. For example, the channel for sending a "letter request" to certain countries is the State Department, as generally described above. However, for some countries, such as the United Kingdom and Hong Kong, OIA has developed an expedited channel for transmitting letter requests, thereby speeding up the overall process.

The form of the letter request can vary according to the country of destination. Thus, the best approach for initiating a letter request is to follow the initial phase of the MLAT procedure, namely, contact OIA (202-514-0000) and ask to speak to the attorney in charge of the country from which assistance is sought.

C. Problems with the Letters Rogatory Process When Used in Criminal Tax Cases

While the letter rogatory procedure is the traditional method of obtaining assistance abroad, it is not without its flaws. For example, there is no obligation on the foreign country to honor the request; the foreign country's enabling legislation, if any, may not provide any exceptions to that country's bank secrecy laws; there may be no mutually agreed upon procedures which ensure the obtaining of evidence in admissible form; the multiple stages of the process, involving diverse entities, generate serious time delays; and, the procedure may not be available at all crucial stages of a proceeding, *e.g.*, the investigation of a criminal offense, where it may be needed most. To address these critical problems, law enforcement authorities developed new methods to gather foreign evidence, such as the MLAT.

In addition to the problems which afflict the letters rogatory process generally, prosecutors seeking to obtain foreign evidence through this process for tax cases have faced problems in jurisdictions following the common law tradition of the United Kingdom (UK). The number of countries which follow British common law is quite large, since both the present and former dependencies of the United Kingdom fall into this category. For example, the Bahamas, Singapore, the Cayman Islands, and Hong Kong follow this legal precedent. The problems, which are occurring less frequently as a result of a decision of the UK House of Lords (see discussion immediately *infra*), are related to the international rule of comity that one nation will not directly or indirectly enforce the revenue laws of another nation.

In its most basic form, the rule is that the courts of one country will not enforce a judgment for taxes issued by the court of another country. *Her Majesty, Queen in Right, Etc. v. Gilbertson*, 597 F.2d 1161 (9th Cir. 1979). The rule seems to have originated in two opinions of Lord Mansfield in 1775 and 1779. *Gilbertson*, 597 F.2d at 1164. However, the modern basis of the rule seems to be the House of Lords' decision in *Government of India v. Taylor*, [1955] 2 W.L.R. 303 (cited in *In re State of Norway's Application*, [1987] 1 Q.B. 433, 445-46 (C.A.); *R. v. Chief Metropolitan Stipendiary Magistrate*, [1988] 1 W.L.R. at 1207, 1214-15; and *United States v. First National City Bank*, 379 U.S. 378, 395-96 & n.16 (1965)). While most common law jurisdictions, including the United States, seem to accept this basic form of the rule without dispute (See, e.g., *First Nat'l City Bank*, 379 U.S. at 396 (Harlan, J., dissenting on other grounds); *Gilbertson*, 597 F.2d at 1163-66), its application beyond this realm has varied.

In *R. v. Chief Metropolitan Stipendiary Magistrate*, [1988] 1 W.L.R. at 1207, 1214-15, the English Court distinguished permissible extradition of a Norwegian national for tax-related charges from impermissible assistance in the recovery of taxes for a foreign state. Whereas, in *In re State of Norway's Application*, [1987] 1 Q.B. at 448, the English Court of Appeal (which would later be reversed) applied the rule more broadly, stating that providing evidence to another state for its civil determination of a tax liability is the enforcement, albeit indirect, of that state's revenue laws. On the other hand, in *Re Request for*

International Judicial Assistance, [1979] 102 D.L.R.3d 18, 38, the Canadian Court rejected broader application of the rule and stated that granting assistance to the United States in a criminal tax case is not tantamount to the collection of taxes for that state.

Until the decision was overturned, there was serious fallout from the decision of the United Kingdom Court of Appeal in *In re State of Norway's Application*, where that Court construed the rule to operate in the broader sense. Thus, the United Kingdom and the common law countries which follow its legal precedent were rejecting the letter rogatory requests of U.S. tax authorities based on the dicta in that decision. Fortunately for U.S. prosecutors seeking foreign evidence in tax cases, the House of Lords, the highest court of the United Kingdom, reversed the Court of Appeal in *In re State of Norway's Application*, [1989] 1 A.C. 723 (consolidated appeals and cross appeals), holding that simply providing evidence to another state for that state to use to enforce its revenue laws does not constitute the direct or indirect enforcement of another state's revenue laws. This decision has dramatically enhanced mutual assistance from countries following English Common Law in civil and criminal tax cases, especially between governmental authorities.

VI. Using Compulsory Measures to Obtain Foreign Evidence

A. Background

The United States tax authorities do not always have an effective mutual assistance means available to them for obtaining evidence abroad. For example, in a "pure tax" case involving evidence in the Cayman Islands or the Bahamas, United States authorities cannot use a tax treaty (no such agreement is in effect with such jurisdictions), and the current MLATs with these countries exclude assistance for pure fiscal matters. Thus, the United States may have to resort to unilateral action, such as a subpoena, to obtain the needed evidence. While there are other unilateral measures, the two principal methods are the use of subpoenas or summonses to obtain the evidence directly, and the use of disclosure directives.

B. The Use of Subpoenas or Summonses to Obtain Foreign Evidence Directly

One form of process used by government attorneys to obtain evidence abroad is the subpoena power applied directly to a domestically-based entity having some relationship to the foreign-based entity holding the records. *See*, *e.g.*, *Matter of Marc Rich & Co. A.G. v. United States*, 707 F.2d 663 (2nd Cir. 1983), later proceeding, 731 F.2d 1032 (1984), later proceeding, 736 F.2d 864 (1984), later proceeding, 739 F.2d 834 (1984); *United States v. Vetco, Inc.*, 691 F.2d 1281 (1981); *United States v. Toyota Motor Corp.*, 561 F.Supp. 354, 355-56, 358 (C.D. Cal. 1983), later proceeding, 569 F. Supp. 1158 (1983); *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).

If a Department of Justice attorney or an Assistant United States Attorney wants to use a grand jury or criminal trial subpoena to obtain evidence located in a foreign country, the prosecutor must obtain the concurrence of the OIA, Criminal Division, before both issuing and enforcing such subpoena. United States Attorneys' Manual (USAM) 9-13.525. In determining whether to concur in such actions, OIA considers the following factors: (1) the availability of alternative methods for obtaining the records in a timely manner, such as use of mutual assistance treaties, tax treaties or letters rogatory; (2) the indispensability of the records to the success of the investigation or prosecution; and (3) the need to protect against the destruction of records located abroad and to protect the United States' ability to prosecute for contempt or obstruction of justice for such destruction. Once the concurrence of OIA to issue and enforce a subpoena for foreign records has been obtained, the prosecutor will then be required to plead a so-called comity analysis (assuming that there has not been compliance with the subpoena) and the enforcement court will be required to balance the comity factors in favor of the government before the subpoena can be properly enforced. *See* Section 442(1)(c) of the Restatement (Third) of

Foreign Relations Law of the United States (1987). *See also Societe Nationale Industrielle Aerospatiale v. United States District Court*, 482 U.S. 522, 543-44 & n. 28 (1987); *Richmark Corp. v. Timber Falling Consultants*, 959 F.2d 1468, 1474-79 (9th Cir. 1992).

C. The Use of Compelled Directives to Obtain Disclosure of Financial Matters Covered by Foreign Secrecy Laws

Prosecutors can obtain court orders compelling an account holder to direct a foreign bank or other institution to disclose to the prosecutor matters protected by foreign financial secrecy laws. *See*, *e.g.*, *Doe v. United States*, 487 U.S. 201 (1988); *United States v. Davis*, 767 F.2d 1025 (2d Cir. 1985); *In Re Grand Jury Proceedings, Western District of Louisiana (Juan A. Cid)*, 767 F.2d 1131 (5th Cir. 1985); *United States v. Ghidoni*, 732 F.2d 814 (11th Cir. 1984). *But see In Re Grand Jury Proceedings*, 814 F.2d 791 (1st Cir. 1987); *In Re ABC Ltd.*, 1984 CILR 130 (Grand Court of the Cayman Islands, 1984); *Garpeg, Ltd. v. United States*, 583 F. Supp. 789, 799 (S.D.N.Y. 1984). The Supreme Court has ruled that an order directing an account holder to sign a hypothetically-framed disclosure directive does not violate his Fifth Amendment privilege against self-incrimination. *Doe v. United States*, 487 U.S. at 206-18.

Foreign courts have had mixed reactions to these directives. A court of the Cayman Islands, a dependency of the United Kingdom, has held that such directives do not constitute voluntary and freely given consent for disclosure as required under the secrecy laws of that jurisdiction. *In Re ABC Ltd.*, 1984 CILR 130, 134-35 (Grand Court of the Cayman Islands, 1984). For other countries which do not have such stringent secrecy statutes and which follow the British common law, there is authority that such disclosure directives do constitute valid consent under the common law duty of a banker to keep the financial affairs of an account holder confidential. *Tournier v. National Provincial & Union Bank of England*, 1 K.B. 461 (C.A. 1924).

Prosecutors have enjoyed widespread success in using *compelled* disclosure directives to obtain financial records from most countries, and, indeed, have used *voluntary* disclosure directives to gather financial records from virtually every country. The use of disclosure directives is preferred over the use of compulsory process directed against U.S.-based branches or offices of financial institutions to obtain financial records located abroad, because using disclosure directives involves no real jurisdictional conflicts (except when seeking evidence in countries like the Cayman Islands) and lessens the inclination of most foreign countries to block production of the evidence.

D. Jurisdictional Conflicts Arising from the Use of Certain Unilateral Measures

The use of certain of these unilateral measures, especially the subpoenas on domestic financial institutions for foreign-based records, is controversial and often leads to protracted litigation which fails to secure the intended result. Indeed, these jurisdictional controversies led the Justice Department to adopt USAM 9-13.525, which requires the concurrence of OIA for both the issuance and enforcement of such subpoenas in Department criminal matters. When U.S. authorities resort to the enforcement of such measures, they often encounter strong opposition from many different quarters. For example, the financial institutions served with process typically resist strenuously and raise every possible issue, including the bedrock of their position, the jurisdictional conflict between the laws of the two countries involved. Even when these institutions suffer an adverse decision of the U.S. courts, they often choose to be subject to sizeable contempt sanctions rather than produce the subpoenaed or summonsed records. *See*, *e.g.*, *In re Grand Jury Proceedings (Bank of Nova Scotia)*, 691 F.2d 1384 (11th Cir. 1982). Officials of foreign jurisdictions also object to the use of these measures, by instructing their foreign ministries to complain to the U.S. State Department, entering *amicus* appearances in the protracted litigation, and sometimes directing their own law enforcement authorities to take blocking measures, which may include the seizure of the foreign-based records to thwart production. *See*, *e.g.*, *In re Marc Rich & Co., A.G. v. United States*, 707 F.2d 663 (2d Cir. 1983). Needless to say, production of the evidence sought by the use of

these unilateral measures is not a foregone conclusion.

At all events, as mentioned above, before a *Bank of Nova Scotia*-type subpoena can be authorized by the Criminal Division (*see* USAM 13.525) or enforced by a district court, a prosecutor will need to establish that no alternative methods exist for obtaining the foreign records sought.

VII. Conclusion

New law enforcement treaties and agreements are continually being negotiated and concluded by the various responsible authorities. Accordingly, new means for obtaining foreign evidence may appear on the horizon following publication of this analysis. For further details regarding the matters set forth herein, or for developments following publication, contact James P. Springer, Senior Counsel for International Tax Matters, Tax Division, Department of Justice, at (202) 514-2427.❖

ABOUT THE AUTHOR

❑**James P. Springer** has served as the Senior Counsel for International Tax Matters in the Tax Division of the Department of Justice since 1985. He previously served as a trial attorney in the Tax Division from 1975 to 1985, both as a prosecutor and as an appellate attorney. He is the author of *House of Lords Clears Way for Use of Letters Rogatory and Hague Evidence Convention in Tax Cases*, 5 I.E.L.R. 180 (1989), and *An Overview of International Evidence and Asset Gathering in Civil and Criminal Tax Cases*, 22 Geo. Wash. J. Int'l & Econ. 277 (1988).✠

Character Evidence in Tax (and Other) Cases

Robert Miskell
Assistant United States Attorney
District of Arizona

> "Much of this law [of character evidence] is archaic, paradoxical and full of compromises and compensations by which an irrational advantage to one side is offset by a poorly reasoned counter-privilege to the other."
>
> *Michelson v. United States*, 335 U.S. 469, 486 (1948).
>
> "The modern rules governing the admissibility of character evidence at trial are counterintuitive and enigmatic vestiges of an ancient time . . . ."
>
> *United States v. Monteleone*, 77 F.3d 1086, 1089 (8th Cir. 1996).

Tax cheats and other white collar criminals generally portray themselves as individuals of "good character." The prosecution of such individuals frequently involves the introduction, by the defense, of a parade of character witnesses. This article addresses what character evidence is admissible, as well as what actions may be taken by the prosecutor in response to such evidence.

I. Limitations on What Character Evidence a Defendant Can Introduce

A. Limitation on Type of Character Traits

Under Federal Rule of Evidence 404(a)(1), a defendant may elect to offer evidence of "a pertinent trait of character." If a defendant offers such evidence, the prosecution may offer evidence "to rebut the same." Fed. R. Evid. 404(a).

In attempting to limit a defendant's introduction of character evidence, the first issue to consider is

whether the proposed evidence is "pertinent" to the crimes charged in the indictment. In Rule 404(a)(1), "pertinent" is "read as synonymous with 'relevant.'" *United States v. Angelini*, 678 F.2d 380, 381 (1st Cir. 1982).

The pertinence of a particular character trait may depend on the crime charged. For example, when the defendant does not testify, the defendant's character for truthfulness would be pertinent in a prosecution for a crime involving deceit or falsification. *United States v. Darland*, 626 F.2d 1235, 1237 (5th Cir. 1980). Such character evidence would not be relevant, however, in a prosecution for a drug offense. *United States v. Jackson*, 588 F.2d 1046, 1055 (5th Cir. 1979). Of course, if the defendant testifies, his character for truthfulness would be pertinent regardless of the crime charged. *Darland*, 626 F.2d at 1237.

Frequently, defendants will attempt to introduce "good" character traits that are not relevant to the crimes charged. Generally, the courts have recognized that such evidence is not admissible. For example, the First Circuit has held that the traits of bravery, attention to duties as a police officer, and community spirit were not relevant in the prosecution of a police officer for conspiracy to commit mail fraud and perjury. *United States v. Nazzaro*, 889 F.2d 1158, 1168 (1st Cir. 1989). Similarly, the District of Columbia Circuit has held, in a drug prosecution of corrupt police officers, that a defendant's "dedication, aggressiveness and assertiveness" in investigating drug dealing and carjacking was not "pertinent" under Fed. R. Evid. 404(a)(1). *United States v. Washington*, 106 F.3d 983, 999 (D.C. Cir. 1997). *See United States v. Scholl*, 166 F.3d 964, 975 (9th Cir. 1999) (in a prosecution of state judge for filing false tax returns, defense counsel's question to a character witness about whether defendant was doing his job was irrelevant).

The First Circuit also has recognized that the trait of being a good family man was not relevant in a prosecution for criminal violations of the immigration laws. *United States v. Santana-Camacho*, 931 F.2d 966, 968 (1st Cir. 1991). Likewise, evidence that the defendant's son suffered from cerebral palsy and that the defendant would never do anything to risk disabling himself from caring for the boy properly was not relevant in a RICO prosecution. *United States v. Paccione*, 949 F.2d 1183, 1201 (2d Cir. 1991).

On the other hand, courts have held that evidence of the general character trait of "law abidingness" is pertinent no matter what crime is charged in the indictment. *Angelini*, 678 F.2d at 381-82; *United States v. Hewitt*, 634 F.2d 277, 279-80 (5th Cir. 1981); *United States v. Diaz*, 961 F.2d 1417, 1419 (9th Cir. 1992) (equating "proneness to criminal activity" with "law abidingness").

A defendant, however, is not allowed to narrowly define the pertinent character trait in a manner that would be misleading. For example, in *Diaz*, 961 F.2d at 1419, the defendant attempted to introduce evidence of his "propensity to engage in large scale drug dealing." The Ninth Circuit held that the district court did not err in excluding such evidence because "[s]uch an inquiry would be misleading if addressed to a defendant with a record of criminal offenses other than drug dealing: If answered in the negative, the impression may be given that the defendant is a law-abiding person even though he has a record of other crimes." *Id.*

B. Limitation on How a Defendant Can Prove Good Character

A second issue to consider in attempting to limit a defendant's introduction of character evidence is whether the defendant is using the proper method of proving character. The manner in which a defendant's character may be proved is controlled by Fed. R. Evid. 405. Under Rule 405, the defendant generally can prove character *only* by reputation and opinion evidence. A defendant may introduce specific instances of conduct *only* in cases where character or trait of character "is an essential element of a charge, claim, or defense." Fed. R. Evid. 405(b). As the Advisory Committee Notes explain (Fed. R. Evid. 405 Advisory Committee Notes (1972)):

> the rule confines the use of evidence of [specific instances of conduct] to cases in which character is, in the strict sense, in issue and hence deserving of a searching inquiry. When character is used circumstantially and hence

> occupies a lesser status in the case, proof may be only by reputation and opinion.

Rule 405(b)'s "permissive use of evidence of specific acts is regularly misinterpreted by trial lawyers. It is allowed only when character itself is an issue under substantive law." *United States v. Doyle*, 130 F.3d 523, 542 (2d Cir. 1997) (quoting J. Weinstein, M. Berger & J. McLaughlin, 2 *Weinstein's Federal Evidence* § 405.05[4] (1997)). An example of a case in which specific acts are admissible is where an employer is being sued for retaining, as a taxi driver, a known alcoholic with an extensive accident record. In such a case, the driver's character is directly at issue, and evidence of specific acts – the prior accidents – may be introduced. *Id.*

In a criminal case, the Ninth Circuit has concluded that when the defendant raises an entrapment defense, a defendant may introduce specific acts of good conduct to attempt to show that he was not predisposed to commit the crime. *United States v. Thomas*, 134 F.3d 975, 980 (9th Cir. 1998). The Court reasoned that to find predisposition beyond a reasonable doubt, the jury was required to consider the defendant's character, thus making his character an "essential element." *Id.*

In most cases, however, Rule 405 precludes a defendant from introducing specific acts to attempt to establish good character. Specific good deeds cannot be introduced by a defendant to disprove knowledge or intent elements of crimes. *Doyle*, 130 F.3d at 542; *United States v. Marrero*, 904 F.2d 251, 260 (5th Cir. 1990).

For example, in a drug prosecution, the defendant attempted to introduce, to negate criminal intent, evidence that he had turned down an offer to become involved in another drug smuggling venture and repeatedly advised the smuggler who made the offer of the damage the smuggler was doing to society. The Eleventh Circuit held that the district court properly excluded the evidence under Rule 405(b): "Evidence of good conduct is not admissible to negate criminal intent. . . . [The witness's] proffered testimony was merely an attempt to portray [the defendant] as a good character through the use of prior 'good acts.' The trial judge properly exercised his discretion in excluding this testimony as inadmissible character evidence." *United States v. Camejo*, 929 F.2d 610, 612-13 (11th Cir. 1991) (citations omitted). Similarly, in *United States v. Hill*, 40 F.3d 164, 169 (7th Cir. 1994), the court concluded, in a case involving theft of mail by a postal employee, that the defendant's failure to steal "test letters" was not admissible pursuant to Rule 405(b).

C. Limitation On the Number of Character Witnesses

The third issue to consider in attempting to limit character evidence is to attempt to limit the number of such witnesses. The trial court has discretion to limit the number of character witnesses. *Michelson v. United States*, 335 U.S. 469, 480 (1948). Appellate courts have found no error when a trial court has limited the number of a defendant's character witnesses. *United States v. Scholl*, 166 F.3d at 972 (three witnesses); *United States v. Johnson*, 730 F.2d 683, 688 (11th Cir. 1984) (three witnesses); *United States v. Koessel*, 706 F.2d 271, 275 (8th Cir. 1983) (three witnesses); *United States v. Henry*, 560 F.2d 963, 965 (9th Cir. 1977) (two witnesses). The factor to consider is the cumulative nature of the character evidence. *Scholl*, 166 F.3d at 972.

II. The Prosecutor's Response to Defendant's Introduction of Character Evidence

A. Cross Examination of Character Witnesses

1. Bias, Prejudice and Knowledge

One method of attacking character witnesses is to question them about their relationship with the defendant. If the witness is too close to the defendant, such as his mother, the suggestion is that the witness's opinion and testimony should be discounted because of the overly close relationship. On the other hand, if the witness is not particularly close to defendant, the suggestion is that the witness's opinion and testimony should be discounted because the witnesses do not really know the defendant. Moreover, you can usually get the character witness to admit that nobody can know everything about another individual's life.

2. "Guilt Assuming" Hypothetical Questions Are Not Allowed

A prosecutor should not ask a defense character witness whether, assuming the defendant had committed the act charged in the indictment, his testimony regarding the defendant's character would change. Virtually every court that has considered the issue has concluded that "guilt-assuming" hypothetical questions are improper. *United States v. Guzman*, 167 F.3d 1350, 1352 (11th Cir. 1999); *United States v. Mason*, 993 F.2d 406, 408-09 (4th Cir.1993); *United States v. Oshatz*, 912 F.2d 534, 539 (2d Cir.1990); *United States v. Barta*, 888 F.2d 1220, 1224-25 (8th Cir.1989); *United States v. Page*, 808 F.2d 723, 731 (10th Cir. 1987); *United States v. McGuire*, 744 F.2d 1197, 1204 (6th Cir.1984); *United States v. Williams*, 738 F.2d 172, 177 (7th Cir.1984); *United States v. Candelaria-Gonzalez*, 547 F.2d 291, 294-95 (5th Cir.1977). The primary reasoning of these cases is that such guilt-assuming hypothetical questions create too great a risk of impairing the presumption of innocence. *E.g., Oshatz*, 912 F.2d at 539.

The District of Columbia Circuit appears to allow guilt-assuming hypothetical questions to character witnesses who provided their *opinion* of a defendant's character. *United States v. White*, 887 F.2d 267, 274-75 (D.C. Cir. 1989). The Court stated that the "[c]ross-examination of witnesses who testify only to the defendant's community reputation with hypotheticals assuming guilt may be improper." *Id.* at 274. The Court concluded, however, that similar cross-examination of witnesses who give their opinion of the defendant's character is not error. *Id.* at 274-75.

Some courts have made a distinction between guilt-assuming hypothetical questions and questions that simply ask the character witness to interpret conduct of the defendant that the defendant concedes happened. In *United States v. Velasquez*, 980 F.2d 1275, 1277 (9th Cir. 1992), the defense counsel conceded that the defendant, charged with bank robbery, had entered a bank and displayed a hand grenade, but claimed the defendant did not intend to rob the bank. During the cross-examination of defendant's character witnesses, the prosecutor asked the character witnesses how their opinion that defendant was not violent would be effected by the fact that defendant had displayed a hand grenade in the bank. The Ninth Circuit concluded that the district court did not abuse its discretion in allowing those questions. The court reasoned that the prosecutor did not ask the witnesses to assume anything about the defendant's intent, but rather only asked the witnesses to interpret the acts that defense counsel had conceded in his opening statement had occurred. *Id.* Similarly, in *United States v. Wilson*, 983 F.2d 221, 223-24 (11th Cir. 1993), the defendant admitted selling credit card numbers to an undercover agent, but denied having any fraudulent intent. The Eleventh Circuit concluded that allowing questions of the character witnesses about this admitted transaction was not an abuse of discretion. The court concluded that the questions, which did not mention the defendant's intent, did nothing more than ask about an event that defendant had admitted. *Id.* at 224-25.

3. Cross-Examination about Specific Instances of Conduct

On the cross-examination of character witnesses, the prosecutor is allowed to ask about "relevant specific instances of conduct." Fed. R. Evid. 405(a). The Supreme Court has explained the basis for allowing such questioning:

> Another hazard is that [the defendant's] own [character] witness is subject to cross-examination as to the contents and extent of the hearsay on which he bases his conclusions, and he may be required to disclose rumors and reports that are current even if they do not affect his own conclusion. It may test the sufficiency of his knowledge by asking what stories were circulating concerning events, such as one's arrest, about which people normally comment and speculate. Thus, while the law gives defendant the option to show as a fact that his reputation reflects a life and habit incompatible with commission of the offense charged, it subjects his proof to tests of credibility designed to prevent him from profiting by a mere parade of partisans.

Michelson v. United States, 335 U.S. 469, 479 (1948) (footnote omitted).

In cross-examining a character witness regarding specific acts of misconduct, the prosecutor is attempting to attack the witness's credibility in two ways. First, to the extent the witness is not aware of the prior act, the suggestion can be made that the character witness's testimony is of little value because he is not familiar enough with the defendant's actions. Second, to the extent that the witness claims that knowledge of the prior act does not change his testimony regarding the defendant's character, the suggestion is that the criteria that the witness uses to judge an individual's character are not credible. The Supreme Court cites as a classic example of the latter the cross-examination of a character witness in a murder prosecution. *Michelson*, 335 U.S. at 479 n.16. The witness, who testified that the defendant had a reputation for peace and quiet, was asked on cross-examination if she had heard that the defendant had shot anybody. She replied that the defendant had shot three or four people, provided the names of two victims, and said she could not remember the names of the other victims. Despite this knowledge, she insisted that the defendant was of "good character." As the Supreme Court noted, the jury apparently "valued her information more highly than her judgment," and convicted the defendant. *Id.*

Thus, to achieve the goal of demonstrating that the character witness either lacks knowledge or has poor standards for judging credibility, the prosecutor is allowed to ask character witnesses about the defendant's prior arrests, even arrests that do not result in conviction. *E.g., Michelson*, 335 U.S. at 482 ("character witness may be cross-examined as to an arrest whether or not it culminated in a conviction, according to the overwhelming weight of authority"); *United States v. Wellon*, 32 F.3d 117, 120 n.3 (4th Cir. 1994); *United States v. Grady*, 665 F. 2d 831, 835 (8th Cir. 1981); *United States v. Bermudez*, 526 F.2d 89, 95 (2d Cir.1975); *United States v. Cummings*, 468 F.2d 274, 281 (9th Cir. 1972).

The specific acts of misconduct that a character witness may be cross-examined about are not limited to prior arrests. For example, in the prosecution of a state court judge for filing false tax returns, the Ninth Circuit decided that it was not improper for the prosecutor to ask the character witnesses about: (1) an undisclosed loan that the judge had accepted from an attorney who had a case pending before the judge, and (2) a complaint brought by the Commission on Judicial Conduct which alleged that the defendant had filed a false state financial disclosure form. *Scholl*, 166 F.3d at 974-75.

Often, material for the cross-examination of character witnesses can be found in civil lawsuits involving defendant; proceedings before administrative agencies, such as the Securities and Exchange Commission; and the files of state agencies that may regulate the defendant's business or profession. At least one court has indicated that a character witness should not be asked about other proceedings that involve the same alleged conduct as the criminal prosecution. In *United States v. Bush*, 58 F.3d 482, 489 (9th Cir. 1995), the prosecutor asked whether the character witness had heard that a civil RICO suit had been filed against the defendant. Although not clear from the phrasing of the prosecutor's question, the civil RICO action actually involved the same conduct for which defendant was on trial. *Id.* The Ninth Circuit concluded that the district court committed error, albeit harmless, in allowing the prosecutor's question, because the question suggested that the RICO charges represented a separate incident of misconduct somewhere in the defendant's past, which was a false inference. *Id.* at 489-90.

Another potential problem area with questioning a character witness about specific acts of conduct may arise when the character witness testifies only about the defendant's reputation. In *United States v. Monteleone*, 77 F.3d 1086, 1089 (8th Cir. 1996), the Eighth Circuit concluded that it was improper to question a character witness, who had testified only to the defendant's reputation, about alleged perjured statements the defendant had made before the grand jury. The court explained that the reasons for allowing a "reputation witness" to be questioned about specific acts is to test the reliability and credibility of the reputation witness. *Id.* at 1090. Accordingly, the court reasoned that the prosecutor must possess a good faith belief that the described events are of a type likely to have become a matter of general knowledge in the community. *Id.* The court noted that because of grand jury secrecy rules, it is unlikely that the defendant's alleged perjury would be known in the community. *Id.*

The Sixth Circuit has reached the opposite conclusion. In *United States v. Frost*, 914 F.2d 756, 772 (6th Cir. 1990), defendant argued that because he "presented character evidence by way of reputation evidence rather than opinion evidence, the only acts permitted to be mentioned in cross-examination questions are those acts likely to have been known in the community." *Id.* The Sixth Circuit rejected that argument, noting that such a cross-examination is "a textbook application of Fed. R. Evid. 405(a)." *Id.*

The cross-examination of character witnesses who testify as to their *opinion* about the defendant is not limited to specific acts of misconduct likely to be known in the community. That is, the act would be relevant to the witness's opinion, regardless of whether the act was well known in the community. *United States v. Bruguier*, 161 F.3d 1145, 1149-50 (8th Cir. 1998); *Scholl*, 166 F.3d at 975 ("knowledge in the community" was not a "material predicate" to cross-examination of character witness who testified to his opinion).

On occasion, a defendant may quibble with the phrasing of cross-examination questions, citing *Michelson*, 335 U.S. at 482. In that case, the Supreme Court stated that in cross-examining a character witness who testified as to reputation, "the form of inquiry, 'Have you heard?' has general approval, and 'Do you know?' is not allowed." *Id.* Courts have indicated, however, that either form of question is appropriate in light of Federal Rule of Evidence 405. *Government of the Virgin Islands v. Roldan*, 612 F.2d 775, 780 (3d Cir. 1979) (citing Fed. R. Evid. 405 Advisory Committee Notes (1972)); *Scholl*, 166 F.3d at 974 (same). The Advisory Committee Notes to Rule 405 state that "these distinctions [in the form of the questions] are of slight if any practical significance, and the second sentence of subdivision (a) eliminates them as a factor in formulating questions."

Prior to cross-examining a character witness about any specific acts, the prosecutor must establish that the acts are relevant to the character trait at issue and that he has a good faith basis for the question. *Monteleone*, 77 F.3d at 1089-90; *United States v. West*, 58 F.3d 133, 141 (5th Cir. 1995); *United States v. Smith*, 26 F.3d 739, 755 (7th Cir. 1994); *United States v. Adair*, 951 F.2d 316, 319 (11th Cir. 1992).

Moreover, when a character witness is cross-examined about specific instances of misconduct, the defendant is entitled to a limiting instruction to the jury. *Roldan*, 612 F.2d at 781; *see* O'Malley, Grenig, & Lee, *Federal Jury Practice and Instructions* § 11.15 (5th ed. 2000).

The specific acts of conduct which defendant's character witnesses are questioned about on cross-examination, however, cannot be proven by extrinsic evidence unless it is an essential element of the charge. Fed. R. Evid. 405(b); *United States v. Benedetto*, 571 F.2d 1246, 1250 (2nd Cir. 1978) ("while a character witness may be asked on *cross-examination* about 'specific instances of conduct,' such acts may not be proved by extrinsic evidence").

B. Rebuttal Witnesses

Once a defendant has produced character witnesses and placed his character in issue, the prosecutor also is entitled to call witnesses to testify about defendant's bad character. *United States v. Murphy*, 768 F.2d 1518, 1535 (7th Cir. 1985). Such witnesses generally are limited, by Rule 405(a), to opinion and reputation testimony. *United States v. Reese*, 568 F.2d 1246, 1251 (6th Cir. 1977).

III. Practical Aspects

One may ask, "what does all this have to do with tax prosecutions?" The answer is that in tax prosecutions, it is very likely that the defense will attempt to introduce character evidence. The prosecutor in a tax case should be as comfortable with the rules regarding character evidence as he or she is with the rules governing the admissibility of documentary evidence. Moreover, in the close case, being able to limit defendant's character evidence, or effectively attack such evidence through cross-examination, could make the difference between a guilty verdict and an acquittal.

One advantage that a prosecutor in a tax prosecution has is that the Special Agents of the Internal Revenue Service usually do a good job of discovering facts that may form the basis for cross-examination questions for character witnesses. This information generally is contained in the sections of

the Special Agent's Report entitled "Reputation in the Community, Criminal Actions, and Business History."

Once it appears that a defendant will introduce character evidence, motions *in limine* are useful both to limit the defense to introducing pertinent character traits, and to advise the court of possible areas of cross-examination. Such motions serve to remind the judge about the law regarding character evidence. ❖

ABOUT THE AUTHOR

❑**Bob Miskell** spent his formative years as a trial attorney (1984-1990) in the Criminal Section of the Tax Division, United States Department of Justice. Since 1990, he has been an Assistant United States Attorney in Tucson, Arizona.✠

Holding the Defendant Responsible for the Loss in a Criminal Tax Prosecution: Is Restitution the Answer?

Mitchell J. Ballweg
Assistant Chief
Western Criminal Enforcement Section
Tax Division
Department of Justice

Karen Quesnel
Senior Appellate Attorney
Criminal Appeals & Tax Enforcement Policy Section
Tax Division
Department of Justice

I. Introduction

Nearly every criminal tax prosecution relies on the basic premise that the Internal Revenue Service was harmed in its ability to perform a basic function - its ability to assess and collect the correct amount of taxes owed. This underlying concept invades nearly all aspects of our criminal prosecutions, including our selection of criminal tax cases for prosecution (which cases promote a general deterrent effect, thus enhancing voluntary compliance), our ability to establish the falsity of a tax return (the provisions of the Internal Revenue Code that require the transactions in issue to be reported), our proof that a defendant acted willfully (the primary motivation was greed, *i.e.*, the defendant decided not to pay taxes that were owed), and even, ultimately, the court's determination of the appropriate sentence after conviction (the base offense level is determined by the amount of the tax loss per United States Sentencing Guidelines (U.S.S.G.) § 2T1.1).

Given the considerable overlap between criminal tax prosecutions and the Internal Revenue Service's duty to collect income taxes, we, as prosecutors, may ask whether we can help ensure payment of some of the taxes due and owing by the defendants. At first, a seemingly simple solution would be to include a broad clause in a plea agreement requiring the defendant to pay a fixed dollar amount to resolve all of her or his tax liabilities. For the reasons discussed below, these so-called "global settlements" are rarely approved by the Tax Division.

A second common method is for a plea agreement to include a clause requiring the defendant to cooperate fully with the Internal Revenue Service to determine the correct amount of tax that is due and to pay that amount. A district court will sometimes include a similar provision as a special condition of probation or supervised release, either on its own or at the request of the government. Some courts, however, decline to include such a condition at sentencing, stating that the Internal Revenue Service already

is armed with a statutory scheme designed to ascertain and collect the correct amount of tax owed by the defendant.

Thus, it would seem that there is a need for a different solution, one that requires a defendant to pay some of the taxes owed, meets the approval of the Tax Division, and calls for minimal involvement by the court. Is restitution the answer? While not the perfect solution for resolving the defendant's tax liabilities as part of the criminal tax prosecution, an appropriate order of restitution to the Internal Revenue Service as part of the criminal sentence allows the Internal Revenue Service to recover at least some of the lost tax revenue, without jeopardizing its ability to pursue civil remedies of any matters that were not germane to the prosecution. In addition, seeking an order of restitution does not require Tax Division approval and, hopefully, will require only minimal involvement of the court after sentencing. This article briefly notes the problems with global settlements in tax cases, describes our current restitution scheme, and then addresses the specifics of restitution in criminal tax cases.

II. Global Settlements

It is not unusual for a defendant to approach the prosecutor, whether an Assistant United States Attorney or Tax Division trial attorney, and attempt to convince her or him that it is in everyone's best interest to wrap-up the criminal case and civil tax liability into one package deal with a guilty plea and payment of an agreed-upon amount to the Internal Revenue Service. An offer to pay a large amount of additional taxes is sometimes dangled as a carrot in the face of the prosecutor and the Internal Revenue Service as part of an attempt to negotiate a plea to lesser charges in the criminal case.

While such a defense proposal may sound appealing, the Tax Division will generally not approve a plea agreement containing a global settlement. United States Attorneys' Manual (USAM) 6-4.360. The reasons behind the long-standing policy prohibiting such agreements include the fact that criminal tax investigations typically involve the analysis of only a limited portion of a taxpayer's financial matters. For example, the investigation is likely to focus on only unreported gross receipts for a particular Schedule C business or false itemized deductions reported on Schedule A. None of the other items reported on the return are typically brought onto the criminal playing field. Thus, there may be a number of appropriate civil adjustments that a prosecutor is unaware of, ill-equipped to address, and unwittingly may deal away as part of the global settlement. In addition, a major concern attending global settlements is the potential public perception that a wealthier defendant is being allowed to buy his way out of jail time. *See* Paula M. Junghans and Thomas E. Zehnle, *Global Pacts in Criminal Tax Prosecutions: Why The DOJ 'Just Says No,'* BUS. CRIMES, Oct. 2000, at 1.

Some of these same concerns are also attendant to any plea agreement or sentence imposing an order of restitution in a tax case. To protect the overall interests of the government, prosecutors need to ensure that provisions for restitution do not, in any manner, affect the Internal Revenue Service's ability to pursue all civil remedies. After all, the "government's primary objective in criminal tax prosecutions is to get the maximum deterrent value from the cases prosecuted. To achieve this objective, the government's tax enforcement activities must reflect uniform enforcement of the tax laws." USAM 6-4.010. In light of the potential impact on criminal tax cases overall, we should not allow what may be beneficial in one isolated case to cause us to lose sight of the reason criminal tax charges are brought in the first instance.

III. Overview of Restitution

The ability of a court to impose an order of restitution as part of the sentence in a criminal case does not fall under the court's inherent authority. *United States v. Gottesman*, 122 F.3d 150, 151 (2d Cir. 1997); *United States v. Helmsley*, 941 F.2d 71, 101 (2d Cir. 1991). Rather, the authority to impose restitution must be conferred on the court by Congress. *Helmsley*, 941 F.2d at 101.

Generally, prior to the enactment of the Victim and Witness Protection Act (VWPA), 18 U.S.C. § 3663, in 1982, restitution could only be ordered as a condition of probation pursuant to the Federal Probation Act, formerly codified at

§§ 3651-3656 and repealed effective November 1, 1987. *Helmsley*, 941 F.2d at 101. With the enactment of the VWPA, a court was permitted to order the payment of restitution as part of the sentence for all violations under Title 18 of the United States Code, as well as certain other statutory violations. In 1996, Congress enacted the Mandatory Victim Restitution Act, 18 U.S.C. § 3663A, which made restitution mandatory for many of the offenses covered by 18 U.S.C. § 3663, specifically reaching any offense against property under Title 18, including any offense committed by fraud or deceit (18 U.S.C. § 3663A(c)1)(A)(ii)). Because there is no case law dealing with the application of section 3663A in the context of a tax case, however, this article will limit discussion of restitution as part of the sentence to restitution imposed under 18 U.S.C. § 3663. Discussion of concepts under 18 U.S.C. § 3663 seem equally applicable to restitution under 18 U.S.C. § 3663A, as both sections cover much the same ground. (For a history of restitution dating back to the Code of Hammurabi and the Old Testament, *see United States v. Vaknin*, 112 F.3d 579, 582-83 (1st Cir. 1997)).

The VWPA empowers courts, in certain cases, to impose restitution as part of a sentence rather than as a special condition of probation or supervised release. *See* 18 U.S.C. §§ 3663, 3664; *United States v. Minneman*, 143 F.3d 274, 284 (7th Cir. 1998); *United States v. Martin*, 128 F.3d 1188, 1190 (7th Cir. 1997); *Helmsley*, 941 F.2d at 101. The purpose of the VWPA is "to ensure that wrongdoers, to the degree possible, make their victims whole." *United States v. Patty*, 992 F.2d 1045, 1050 (10th Cir. 1993), quoting *United States v. Rochester*, 898 F.2d 971, 982-83 (5th Cir. 1990); *see Vaknin*, 112 F.3d at 582; *Virgin Islands v. Davis*, 43 F.3d 41, 46-47 (3d Cir. 1994); *see also United States v. Harris*, 7 F.3d 1537, 1539 (10th Cir. 1993) (purpose of VWPA is to compensate victims of crime). In enacting the VWPA, Congress "strove to encourage greater use of a restitutionary remedy." *Vaknin*, 112 F.3d at 587; *see Minneman*, 143 F.3d at 284-85; *Martin*, 128 F.3d at 1190 (VWPA designed to ensure that courts do not relegate victim restitution to "an occasional afterthought") (citations omitted). A "victim" under section 3663 is any person "directly and proximately harmed as a result of the commission of an offense." 18 U.S.C. § 3663(a)(2); *Martin*, 128 F.3d at 1190.

To evaluate whether a court has the authority to impose restitution in any given case, the analysis relies on one, or more, of the following factors: the offense of conviction; the type of sentence imposed; and the terms of any plea agreement. Depending on the offense of conviction, restitution may be imposed either directly or as a condition of supervised release or probation. The court is permitted to impose an additional direct sanction of restitution under 18 U.S.C. § 3556. Section 3556 states that the court, in imposing a sentence, may order restitution under 18 U.S.C. § 3663. This provision is the authority for a court to impose a direct order of restitution to any victim of the offense as part of the criminal sentence, similar to a court's imposition of a term of imprisonment. The VWPA authorizes a court to impose a direct order of restitution to victims of the offense, after considering several mandatory factors (*see* 18 U.S.C. § 3663(a)(1)(B)(i)), only when sentencing a defendant convicted of an offense under Title 18 U.S.C., certain sections of the Controlled Substances Act (21 U.S.C.), and certain sections of Title 49. 18 U.S.C. § 3663; *see Helmsley*, 941 F.2d at 101.

The court's authority to order restitution is also dependent on the sentence imposed. Under the Sentencing Guidelines, an individual convicted of a crime must be sentenced to a term of probation, a fine, or a term of imprisonment. 18 U.S.C. § 3551(b) (fine may be in addition to any other sentence). If the defendant is sentenced to a term of probation under 18 U.S.C. § 3561, the court is required to explicitly provide certain mandatory conditions of probation. 18 U.S.C. § 3563. Restitution in accordance with sections 3663 and 3664, among other provisions, is one of these mandatory conditions of probation. 18 U.S.C. § 3563(a)(6). In addition to the specified mandatory conditions of probation, a court may also provide discretionary conditions of probation after considering certain factors (*see* 18 U.S.C. § 3563(b)). As one of the permissible discretionary conditions, a court can require a defendant to make restitution to a victim of the

offense under 18 U.S.C. § 3556. Such an order of restitution as a further condition of probation is not subject to the provision (18 U.S.C.§ 3663(a)) limiting restitution to only certain offenses of conviction. 18 U.S.C. § 3563(b)(2).

Similarly, there are provisions for restitution if the defendant is sentenced to a term of imprisonment under 18 U.S.C. § 3581. As noted above, 18 U.S.C. § 3556 provides for restitution if the offense of conviction is specified in section 3663(a). If the offense of conviction is one that is not specified in section 3663(a), an order of restitution may piggyback on the court's order imposing a term of supervised release. A court sentencing a defendant to a term of imprisonment may include a requirement that the defendant be placed on a post-imprisonment term of supervised release. 18 U.S.C. § 3583(a). A court may impose as a discretionary condition of supervised release any of the conditions provided as discretionary conditions of probation "in section 3563(b)(1) through (b)(10) and (b)(12) through (b)(20), and any other condition it considers to be appropriate." 18 U.S.C. § 3583(d). As is the case with probation, these discretionary conditions are not limited by the nature of the offense of conviction. 18 U.S.C. § 3583(d).

Finally, different rules apply if the defendant has negotiated a guilty plea with the government. If the defendant has entered a guilty plea, the sentencing court may order restitution to the extent agreed to in the plea agreement. The court's authority to order agreed-upon restitution in a case resolved by plea agreement applies "in any criminal case" and is not restricted by the offense of conviction. 18 U.S.C. § 3663(a)(3). *See*, *United States v. Blake*, 81 F.3d 498, 506 (4th Cir. 1996); *United States v. Schrimsher*, 58 F.3d 608, 609 (11th Cir. 1995); *United States v. Silkowski*, 32 F.3d 682, 688-89 (2d Cir. 1994). Prosecutors in the Ninth Circuit should be aware of the decision in *United States v. Baker*, 25 F.3d 1452, 1457 (9th Cir. 1994), in which the court of appeals held that an agreement to pay "heightened restitution" must be in exchange for a promise by the government to drop or not pursue other offenses.

IV. Restitution in Tax Cases

A question frequently asked of the Tax Division is whether restitution is legally permissible in a tax case and, if so, how to do it correctly. Historically, it was a widely held belief that restitution was not available in criminal tax prosecutions. After conducting a cursory review of the restitution scheme, many people dismiss the possibility of restitution in a pure tax prosecution because 18 U.S.C. § 3663(a) does not authorize restitution for Title 26 offenses. *See Minneman*, 143 F.3d at 284; *United States v. Joseph*, 914 F.2d 780, 783-84 (6th Cir. 1990). The analysis, however, should not end with section 3663(a).

A. Title 26 Violations

Although Title 26 offenses are not included in the list of offenses in 18 U.S.C. § 3663(a)(1) with respect to which the court may sentence a defendant to pay direct restitution, section 3663(a) is not the only source of authority for an order of restitution. As noted previously, a court is authorized to impose any "discretionary condition of probation in section 3563(b)(1) through (b)(10)" as a condition of supervised release or probation. *See* 18 U.S.C. §§ 3556, 3563(b)(2), 3583(d); U.S.S.G. § 5E1.1(a), § 5E1.1, comment. (backg'd); *United States v. Daniel*, 956 F.2d 540, 543-44 (6th Cir. 1992); *Helmsley*, 941 F.2d at 101. Accordingly, as restitution is one of the listed discretionary conditions of probation (*see* 18 U.S.C. § 3563(b)(2)), a court is authorized to order restitution for violations of Title 26 as a condition of a term of supervised release following a term of imprisonment (*see, e.g.*, *United States v. Bok*, 156 F.3d 157, 166-67 (2d Cir. 1998)) or as a condition of probation when the court imposes a sentence of a term of probation.

B. Title 18 Violations

If the charged tax crimes are not brought under the offenses included in Title 26, a district court may order restitution as a sanction at sentencing. Consider a case in which the offense charged is a conspiracy to defraud the Internal Revenue Service in violation of 18 U.S.C. § 371 or the filing of a false claim in violation of 18 U.S.C. § 287 where the false claim is a fictitious

income tax return claiming a refund of purportedly overpaid taxes. Under the VWPA, section 3663 provides that restitution may be ordered to any victim of the offense. No limitations are placed on the term victim. A government agency, including the Internal Revenue Service, can be a victim for purposes of restitution. *Minneman*, 143 F.3d at 284; *Martin*, 128 F.3d at 1190-92 (collecting cases); *Helmsley*, 941 F.2d at 101; *United States v. Salcedo-Lopez*, 907 F.2d 97, 99 n.2 (9th Cir. 1990). The VWPA explicitly allows restitution for any violation of Title 18, including section 371. *Minneman*, 143 F.3d at 284 (section 371); *United States v. Woodley*, 9 F.3d 774, 780 (9th Cir. 1993) (mail fraud); *Helmsley*, 941 F.2d at 101 (section 371). Thus, a district court may impose restitution in a tax case involving Title 18 offenses, so long as the court complies with the requirements of the VWPA. *Minneman*, 143 F.3d at 284-85. Under the VWPA, the district court may order restitution so long as payment is made to an identified victim in a definite amount and the amount of restitution is limited by the actual losses of the victim. *See Virgin Islands v. Davis*, 43 F.3d at 45; *Woodley*, 9 F.3d at 780 (citations omitted).

C. Determining The Amount

Regardless of the provision under which the order of restitution is imposed, the amount of restitution ordered must be determined by the court pursuant to notice and a hearing. *See Minneman*,143 F.3d at 285-86; *Woodley*, 9 F.3d at 780-81; *United States v. Jordan*, 890 F.2d 247, 253 (10th Cir. 1989) (considering restitution ordered as a condition of supervised release). The court may not delegate the responsibility to the Internal Revenue Service or the Probation Office. *See United States v. Porter*, 41 F.3d 68, 71 (2d Cir. 1994) (district court's order that Probation Office would have the discretion to set schedule of repayment of restitution amount constituted improper delegation of judicial functions inherent in the grant of restitution). In the absence of a plea agreement, the amount of court-determined restitution is limited to the actual loss to the Internal Revenue Service resulting from the underlying offense of conviction. The VWPA provides guidance regarding the calculation of the amount of restitution to be ordered. *Hughey v. United States*, 495 U.S. 411, 418 (1990); *Minneman*, 143 F.3d at 285-86; *United States v. Mullins*, 971 F.2d 1138, 1146-47 (4th Cir. 1992). For purposes of determining the amount of restitution, section 3663(a)(1)(A) requires a showing of actual loss. *United States v. Germosen*, 139 F.3d 120, 130 (2d Cir. 1998). The loss must directly result from the offense of conviction. *See Hughey*, 495 U.S. at 420; *Germosen*, 139 F.3d at 131; *Daniel*, 956 F.2d at 543. Section 3663(b)(1) provides that "in the case of an offense resulting in damage to or loss or destruction of property of a victim of the offense," the restitution order may require return of the property or, if that is impossible or impractical, payment of an amount equal to "the value of the property on the date of sentencing." In a criminal tax case involving a conspiracy to defraud the United States, in violation of 18 U.S.C. § 371, the offense generally results in the loss of government property, that is, the money to which the government was entitled under the tax laws but which was not paid by the defendant. In the rare situation in which a tax case involves violations of 18 U.S.C. § 1341 (mail fraud) or 18 U.S.C. § 1343 (wire fraud), care should be exercised in determining the victim and the amount of the loss suffered.

The calculation of the amount of loss for purposes of restitution when the IRS is the victim is closely related to the calculation of the tax loss used to determine a defendant's base offense level. The district court may rely upon the same "quantity and quality of evidence" to determine the amount of loss in both contexts. *See Germosen*, 139 F.3d at 130; *United States v. Corpus*, 110 F.3d 1529, 1537 (10th Cir. 1997). The Government must establish the amount of loss for restitution by a preponderance of the evidence. *See McMillan v. Pennsylvania*, 477 U.S. 79 (1986); *Minneman*, 143 F.3d at 285; *Vaknin*, 112 F.3d at 587 (a restitution award "cannot be woven solely from the gossamer strands of speculation and surmise"); *United States v. Boney*, 977 F.2d 624, 636 (D.C. Cir. 1992); *United States v. Lowden*, 955 F.2d 128, 130 (1st Cir. 1992); *Mullins*, 971 F.2d at 1147 (government must establish amount of restitution by preponderance of evidence if amount is disputed).

In arriving at an order of restitution, depending on the circuit, the district court may need to set forth its findings concerning restitution in detail. In some circuits, it is sufficient if the record reflects that the court "has considered the statutorily mandated factors." *See Germosen*, 139 F.3d at 131 (citations omitted); *Minneman*, 143 F.3d at 285; *United States v. Broyde*, 22 F.3d 441, 442 (2d Cir. 1994); *United States v. Springer*, 28 F.3d 236, 239 (1st Cir. 1994). Those factors include the amount of loss, the defendant's financial resources, the financial needs and earning ability of the defendant and his or her dependents, and any other factors the court deems appropriate. 18 U.S.C. § 3663(a)(1)(B)(i). In other circuits, the district court must make explicit findings in areas including: (1) the amount of the loss actually sustained by the victim; (2) how the loss is connected to the offense of conviction; and (3) the defendant's financial needs and resources. *United States v. Seligsohn*, 981 F.2d 1418, 1421, 1423 (3d Cir. 1992); *Mullins*, 971 F.2d at 1148. If the district court does not provide detailed findings, the court runs the risk that the court of appeals may remand the restitution order as based on "inadequate explanation and insufficient reasoning." *United States v. Menza*, 137 F.3d 533, 538 (7th Cir. 1998).

Prosecutors should also be aware of an unpublished opinion of the Tenth Circuit, *United States v. Jacobs*, No. 99-2327, 2000 WL 1694300, at *4 (10th Cir. Nov. 13, 2000), in which the court concluded that if the government wishes restitution of back taxes in a criminal action for tax evasion without first civilly litigating the exact amounts due, it must give notice of its intent to establish (by a preponderance of the evidence) the amount due and obtain a special jury verdict as to the exact amount. (Unpublished judgments of the court of appeals are not binding precedent. 10th Cir. R. 36.3(a)). The Tax Division does not agree with the Tenth Circuit's conclusion. There is nothing about restitution in a tax case that requires that it be treated differently from restitution in any other kind of case.

Of course, the amount of restitution due may be agreed to by the parties. The parties to a plea agreement may authorize the imposition of restitution in an amount greater than the loss attributable to the offense of conviction. 18 U.S.C. § 3663(a)(3). *See, Blake*, 81 F.3d at 506; *Schrimsher*, 58 F.3d at 609; *Silkowski*, 32 F.3d at 688-89; *Baker*, 25 F.3d at 1457. The parties to the plea agreement may also agree that the court may order restitution to persons other than the victim of the offense. 18 U.S.C. § 3663(a)(1)(A). When a defendant agrees to pay heightened restitution, the government must still prove that the loss to be repaid resulted from the defendant's criminal conduct. *See Patty*, 992 F.2d at 1050 (heightened restitution agreed to by defendant included amounts and victims not charged in the indictment, but only to the extent that the defendant's fraudulent conduct caused the losses). The plea agreement must be specific as to both the agreement to pay restitution and the amount of restitution. *Gottesman*, 122 F.3d at 152-53 (court not empowered to impose restitution where the plea agreement merely provided the defendant "will pay past taxes due and owing ... on such terms and conditions as will be agreed upon between [defendant] and the IRS"). The district court may order a defendant to pay restitution only in an amount not to exceed that agreed upon by the parties. 18 U.S.C. § 3663(a)(3). *See United States v. Bartsh*, 985 F.2d 930, 933 (8th Cir. 1993) (district court may order defendant to pay amount of restitution within range agreed to in plea agreement). If the plea agreement does not provide for heightened restitution, the court may still order restitution to any victim to the extent of the loss caused by an offense of conviction. *See United States v. Broughton-Jones*, 71 F.3d 1143, 1148 (4th Cir. 1995). The general rules concerning restitution would then apply and the amount of the restitution would be limited by the losses caused by the offense or offenses of conviction. *See Hughey*, 495 U.S. at 418.

D. Preserving The Right to Collect Any Additional Civil Tax Liability

Any amount paid as restitution to the Internal Revenue Service must be used to offset the ultimate civil tax liability of the defendant. *Helmsley*, 941 F.2d at 102. Liability for restitution may be imposed jointly and severally by a court. Because of the possible civil implications resulting from an order of restitution, the

government must be careful to ensure that any order of restitution or plea agreement provision for restitution does not prohibit further civil activity by the Internal Revenue Service. Plea agreements, in particular, should include language specifically stating that the agreement to restitution is not a final determination of the defendant's civil tax liability and does not preclude the Internal Revenue Service from further efforts to determine and collect taxes from the defendant.

V. Other Methods to Collect Tax

Restitution is not the only means by which a defendant can be made to satisfy, in whole or in part, his or her tax liabilities. Whether the defendant pleads guilty or is convicted after a trial, a district court may order, as a condition of probation or supervised release, that the defendant pay all back taxes that have been conclusively established. District courts retain broad discretion in tailoring conditions of probation and supervised release. *See* U.S.S.G. §§ 5B1.3(b), 5D1.3(b); *United States v. Edgin*, 92 F.3d 1044, 1048 (10th Cir. 1996). Any conditions imposed, however, must take into consideration the factors spelled out in 18 U.S.C § 3553(a)(1) and (a)(2) (*see* 18 U.S.C. §§ 3563(b), 3583(d)(1), (d)(2), (d)(3)), generally relating to the nature and circumstances of the offense and the history and characteristics of the defendant, the need "to afford adequate deterrence to criminal conduct," "to protect the public from further crimes of the defendant," and "to provide the defendant with needed educational or vocational training, medical care, or other correctional treatment in the most effective manner." *See United States v. Coenen*, 135 F.3d 938, 940 (5th Cir. 1998); *United States v. Bass*, 121 F.3d 1218, 1223 (8th Cir. 1997); *United States v. Ritter*, 118 F.3d 502, 504 (6th Cir. 1997); *United States v. Abrar*, 58 F.3d 43, 46 (2d Cir. 1995).

An order to pay back taxes is essentially a requirement that a defendant obey the law. *See United States v. Hatchett*, 918 F.2d 631, 644 (6th Cir. 1990); *United States v. Schiff*, 876 F.2d 272, 275 (2d Cir. 1989); *United States v. Tonry*, 605 F.2d 144, 147 (5th Cir. 1979). A requirement that a defendant pay back taxes is directly related to a defendant's tax crimes. The payment of back taxes prevents a defendant from deriving any benefit from past tax crimes and protects the public coffers. Moreover, the obligation to pay back taxes may deter a defendant from evading or ignoring federal tax obligations in the future. The payment of back taxes does not jeopardize a defendant's liberty. Furthermore, the special condition of payment of back taxes does not conflict with any pertinent Sentencing Commission policy.

The order to pay back taxes as a condition of probation or supervised release need not be limited to amounts owed for the years for which the defendant was convicted, as is the case with restitution. *Hatchett*, 918 F.2d at 644. Nevertheless, the taxes ordered paid can only be for amounts due that the defendant has admitted or that have otherwise been conclusively determined. *See id.* (order to pay back taxes cannot be taken to require the payment of tax debts that are legitimately in contest). The payment of tax obligations for other years that have been reduced to judgment is appropriate since such debts represent definite legal obligations. *See id.* (collecting cases).

A court may include as a condition of probation or supervised release a direction that the defendant cooperate with the Internal Revenue Service in the determination of his or her tax liability and pay any amounts ultimately determined to be due and owing. *See United States v. Thomas*, 934 F.2d 840, 845 (7th Cir. 1991); *United States v. Taylor*, 305 F.2d 183, 187 (4th Cir. 1962). Such a condition, however, may not strip a defendant of his or her right to fairly question and litigate the amount of civil tax liability. *See United States v. Stafford*, 983 F.2d 25, 28 (5th Cir. 1993).

VI. Conclusion

Restitution does not provide the government with a vehicle to resolve all of a defendant's civil tax liabilities as part of a criminal prosecution. For policy reasons associated with the overall criminal tax enforcement program, any global resolution of civil and criminal tax liabilities is discouraged. A properly crafted order of restitution, however, does provide the government with a unique

opportunity to obtain at least a partial payment of a defendant's ultimate tax liability as part of a criminal tax prosecution. Prosecutors needing assistance in this area, including any questions concerning the applicability of 18 U.S.C. § 3663A, should contact the Criminal Appeals & Tax Enforcement Policy Section of the Tax Division at (202) 514-5396

Practice Note: Before you begin seeking restitution orders in these types of cases, you should consult with the IRS Criminal Investigation Special Agent-in-Charge office for your district as well as your Financial Litigation Unit. It is important that the restitution order not limit or restrict IRS' collection ability. ❖

ABOUT THE AUTHORS

❑**Mitchell J. Ballweg** is an Assistant Chief in the Tax Division's Western Criminal Enforcement Section. Mr. Ballweg served as Associate Special Counsel to the Criminal Investigation Division Review Task Force assembled by the Honorable William H. Webster at the request of the Commissioner of the Internal Revenue Service in 1998. He also served as an Assistant United States Attorney for the Western District of Wisconsin.

Karen Quesnel is a Senior Appellate Attorney with the Criminal Appeals and Tax Enforcement Policy Section of the Tax Division of the Department of Justice and has been with the Tax Division since 1989. Before she joined the Department of Justice, Ms. Quesnel worked for a year and a half for the Internal Revenue Service's District Counsel's office in Las Vegas Nevada.

As this special tax issue of the United States Attorneys' Bulletin goes to print, the Tax Division proudly announces the availability of a new edition of its *Criminal Tax Manual (Green Manual)*, the recognized "bible" in criminal tax prosecutions. Most chapters of the new *Green Manual,* including the chapters dealing with Title 26 offenses, Methods of Proof, and Foreign Evidence, are available. The remaining chapters and other materials, including certain Title 18 offenses, specialized chapters on Tax Protestors and 6103 tax confidentiality, and form indictments and jury instructions, will be made available as they are completed. A final completion date of October 1, 2001, is anticipated. Thereafter, an ongoing revision process is expected to highlight new developments as they occur. The *Green Manual* will be available on the Tax Division's internet web site at www.usdoj.gov. Anyone with questions about the new *Green Manual"* should contact Michael E. Karam, Senior Trial Attorney, CATEPS, Tax Division at 202-514-5166.

UPCOMING PUBLICATIONS

September 2001 Forensic Evidence Issue

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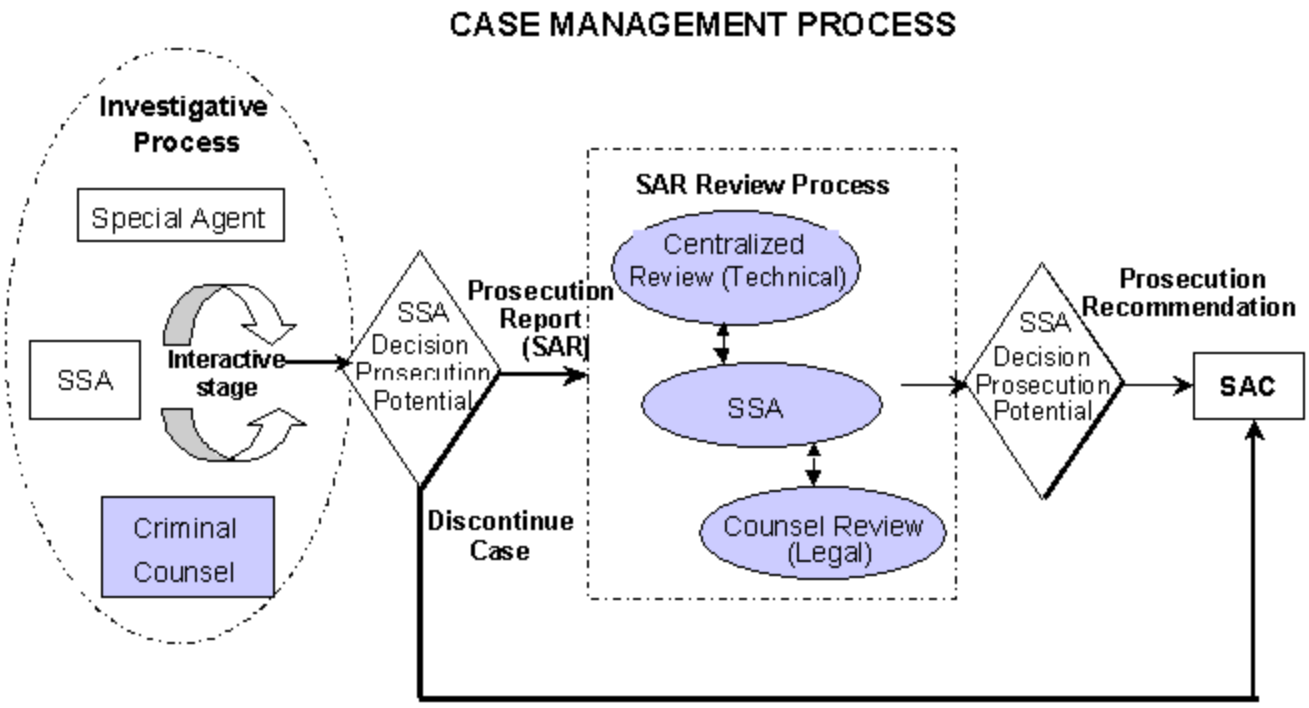

Case developed and Special Agent Report (SAR) is written recommending prosecution

SAR is reviewed for technical completeness and legal accuracy

Forwarded to U.S. Attorney's office or DOJ for prosecution