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Government Looks to Pin Down **Tax Evaders**

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Tax evasion, whether by individuals or businesses, is a serious problem in the United States. This is especially true for owners of nightclubs, bars, restaurants and other predominantly cash ventures, since cash is harder to trace. In trying to combat this offense, the federal government has established definite parameters to prosecute the different forms of illegal conduct that constitute this crime.

Under federal law, there are generally two forms of tax evasion pursuant to 26 U.S.C. §7201: the willful attempt to evade or defeat the assessment of a tax, and the willful attempt to evade or defeat the payment of a tax. Both offenses have three similar elements that the government must prove for conviction.

A classic example of a willful attempt to evade or defeat an assessment of tax was demonstrated by the infamous Studio 54 nightclub. Studio 54 was notorious for its hedonism and eccentric parties and actually paved the way for heightened investigations within the discotheque industry for tax evasion. The club's status was firmly established a week after its opening, when Bianca Jagger entered through the doors on a white horse to celebrate her 27th birthday. Thereafter, it became the choice venue for celebrities, including Michael Jackson, Elton John, Elizabeth Taylor and Dolly Parton, among others.

From 1977 to 1978, Studio 54 generated revenues in excess of $5 million, equivalent to over $18 million today. Suspecting unaccounted for monies, a search warrant was executed by federal authorities, who discovered that the nightclub had failed to declare $2.5 million in state and federal taxes.

On Jan. 18, 1980, the owners of Studio 54 pled guilty to tax evasion under 26 U.S.C. §7201, which is still the current law, amended therein to increase the fines:

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


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As in any other criminal case, the government maintains the burden of proving all of the elements of a federal tax offense beyond a reasonable doubt. For evasion of assessment, the three elements that must be proven are: (a) an attempt to evade or defeat a tax, (b) an additional tax due and owing, and (c) willfulness. Usually, the first two elements are easy to substantiate; however, the third element is extremely difficult, as it dabbles into the mens rea of a defendant.

To prove the first element of tax evasion—that there was an attempt to evade tax—the government must show that there was an actual affirmative act. Mere passive neglect is insufficient. The following conducts have been held as affirmative acts to evade or defeat a tax: filing a false return; filing a false W-4; diverting corporate funds to pay personal expenses; consistently overstating deductions; or concealing bank accounts. Structuring of false cash transactions is another typical affirmative act. Structuring occurs when the taxpayer systematically makes deposits, so as not to trigger the bank's mandatory cash transaction report for cash deposits exceeding $10,000.

In most tax evasion cases, a defendant's initial response is that the accountant prepared the returns and that there was no actual act by the taxpayer. Such a defense was used by the defendant in *U.S. v. Trevino*, 394 F.3d 771 (9th Cir. 2005), who owned and operated a flower shop. Trevino's business was audited, wherein the agents discovered that she was making much more profit than what was reported in her returns. Trevino in turn tried to blame the incorrect numbers on her accountant. The accountant testified that Trevino often complained of the high taxability and "instructed him to reduce it, and that he did so by increasing the cost of goods sold." Id. In an attempt to reduce her tax liability, Trevino directed her accountant to fabricate numbers that reduced her actual profits and generated a false return. There was no question that Trevino's behavior was an actual affirmative act that was done to evade tax, satisfying the first element of the crime.

The U.S. Supreme Court has also set out the following examples of other conduct that constitute affirmative acts of evasion, from *Spies v. United States*, 317 U.S. 492 (1943): keeping a double set of books, making false or altered entries, making false invoices, destroying records, concealing sources of income, handling transactions to avoid usual records and any other conduct likely to conceal or mislead.

To prove the second element of tax evasion—that an additional tax is due and owing—the government does not have to state an exact amount with mathematically certainty. Rather a mere tax deficiency is sufficient. As a general rule, the government has to use the taxpayer's method of accounting in computing income.[1] In the same manner, the taxpayer is bound by the method he used, and may not change from the cash method to an accrual method, or vice versa, even if the unreported income would be less than the government's final figures.

For the final element of tax evasion—willfulness—the government must show that the taxpayer had a "voluntary, intentional violation of a known legal duty."[2] Surprisingly, a defendant's good faith belief that he is not violating a tax law, no matter how unreasonable that belief may be, is a defense in tax prosecution. See *Cheek v. United States*, 498 U.S. 192 (1991).

In *Cheek*, the defendant was an American Airlines pilot who stopped filing federal income tax returns approximately six years after being employed. He also claimed an increasing number of withholding allowances, and indicated on his W-4 forms that he was exempt from federal

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income taxes when his income during all times far exceeded the minimum necessary to trigger the statutory filing requirement. As a result, Cheek, was charged with 10 violations under the federal law, including the willful failure to file federal tax returns and willful attempt to evade income taxes.

Cheek admitted that he did not file certain personal income tax returns; however, he argued that his conduct was not willful. To support his position, Cheek told the jury about the seminars he frequently attended, in which the group of attendees believed that federal taxes were unconstitutional. Some of the speakers at these seminars were lawyers, one of whom provided a letter to Cheek stating that the "Sixteenth Amendment did not authorize a tax on wages and salaries but only on gain or profit." Id. Cheek's defense was that "based on the indoctrination he received from this group and from his own study, he sincerely believed that the tax laws were being unconstitutionally enforced and that his actions were lawful." Id. In this regard, Cheek's main defense was that he acted without the willfulness required for conviction of the various offenses with which he was charged.

The U.S. Supreme Court held in *Cheek* that there is no willfulness if one fails to pay tax under a good-faith belief that it is not legally owing. On the contrary, willfulness may be inferred from "any conduct, the likely effect of which would be to mislead or conceal."[3] Willfulness has been inferred from a plethora of cases that demonstrate the following examples of conduct: signing a return knowing that the contents of that return understated income, prior and subsequent similar acts reasonably close to the prosecution years, failure to supply an accountant with accurate and complete information, making false exculpatory statements to agents, destroying or throwing away books and records, making or using false documents, entries in books, records or invoices, keeping a double set of books, placing property in the name of another, extensively using cash or cashier's checks, spending large amounts of cash that could not be reconciled and holding accounts in a fictitious name.

The government was able to prove willfulness in *U.S. v. Brooks*, 174 F.3d 950 (8th Cir. 1999), where the defendant had similarly obtained information from certain tax seminars as in *Cheek*. The difference with this defendant, however, was that Brooks was told several times by federal agents that he had an affirmative duty to pay his taxes. Brooks disregarded these instructions and instead established different trusts in an effort to disassociate himself from his personal property and income. He also cashed his paychecks, instead of depositing his wages into bank accounts.

In *Brooks*, the government further proved willfulness by providing evidence that Brooks had prepared and signed inaccurate IRS Form W-4s claiming false allowances and incorrect exempt status. Brooks also claimed "non-resident alien" status incorrectly, which the courts have construed as indicative of willfulness.

The government is also allowed to use factual evidence of a defendant's state of mind to prove willfulness. Hearsay rules of evidence may not be applicable, since certain forms of evidence may come from third parties contributing to a defendant's state of mind. For example, love letters from a mistresses' wealthy lover who gave her excessive amounts of money in *U.S. v. Harris*, 942 F.2d 1125 (7th Cir. 1991), were allowed as evidence to show the defendant's state of mind regarding those monies. The U.S. Court of Appeals held that these letters were correctly offered into evidence to prove the woman's lack of willfulness in evading a tax obligation. Accordingly, the mistress could not be convicted for willful failure to file tax returns, or willful failure to evade tax on the substantial monies that she received from her lover.

Affirmative acts of evasion include keeping a double set of books, making false or altered entries, making false invoices, destroying records, concealing sources of income, handling transactions to avoid usual records and any other conduct likely to conceal or mislead.

Generally, to prove willfulness, if the defendant does not make an admission, or if there was no confession or accomplice testimony, willfulness would be inferred from the circumstances of each particular case and is rarely subject to direct proof.

This leads to the other form of tax evasion under §7201: a willful attempt to evade or defeat the payment of a tax. In order for the government to establish that there was an attempt to evade or defeat the payment of a tax, a missed payment is required. Payments are ascertained by way of an assessment, which is the statutorily required recording of a tax liability. Once an assessment is made, if it is not challenged, the taxpayer must pay the monies due and owing therein.

Merely failing to pay an assessed tax, without more, does not demonstrate an attempt to evade payment. The government must prove that there was an affirmative act done by the taxpayer to avoid payment. Affirmative acts of evasion of payment typically involve schemes with currency, such as transferring assets to other countries or to someone else's name, or the like. A classic example of evasion of payment was demonstrated in *United States v. Shoppert*, 362 F.3d 451 (8th Cir. 2004), where defendant concealed assets by using his family's bank accounts. He made expenditures extensively by cash or through the use of third parties' credit cards. He placed assets in the names of others and made false statements to agents regarding his ownership of real property and assets.

Taxpayers may be saved from evasion crimes by the statute of limitations. The government has a six-year limitation period, which begins to run either six years from the date of the last affirmative act done, or from the statutory due date of the return, whichever is later. IRC §6531(2). However, if the taxpayers' offense is within the statutory period and is proved beyond a reasonable doubt, the taxpayer may be fined, imprisoned and even deported in certain cases.

In addition to tax evasion, there are many serious tax crimes that the government similarly enforces. The following are a brief synopsis of a few: Included in the other tax crimes are the willful failure to collect or pay tax pursuant to IRC §7202; the failure to file, supply information or pay tax pursuant to IRC §7203; fraudulent withholding exemption or failure to supply information pursuant to IRC §7205; fraud and false statements pursuant IRC §7206; fraudulent returns, statements or other documents pursuant to IRC §7207; attempts to interfere with administration of internal revenue laws pursuant to IRC §7212; aiding and abetting pursuant to 18 U.S.C. §2; conspiracy to defraud the government with respect to claims pursuant to 18 U.S.C. §286; false, fictitious or fraudulent claims pursuant to 18 U.S.C. §287; conspiracy to commit offense or to defraud the United States pursuant to 18 USC §371; fictitious obligation pursuant to 18 U.S.C. §514; and identity theft pursuant to 18 U.S.C. §1028(a)(7).

Needless to say, despite the creative efforts used by taxpayers to commit tax crimes, whether civil or criminal, the government is keen to the same and is always on the prowl for offenders.

1. *Fowler v. United States*, 352 F.2d 100 (8th Cir. 1965).
2. *Cheek v. United States*, 498 U.S. 192 (1991).
3. *Spies v. United States*, 317 U.S. 492 (1943).

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