# Taxing Terrorism from Al Capone to Al Qaida: Fighting Violence Through Financial Regulation

by Jeff Breinholt

**TABLE OF CONTENTS**

<table>
<thead>
<tr>
<th>Introduction</th>
</tr>
</thead>
</table>

## Chapter 1 - Terrorist Financing

1.1 The Laws and Their Rationale
1.2 Criminalizing Terrorism
1.3 The Narcotics Analogy
1.4 The Counterterrorism Crime Challenge: An Illustration
1.5 The U.S. Crimes of Terrorism
1.6 What is Terrorist Financing?
1.8 The U.S. Terrorist Financing Enforcement Program
1.9 The Terrorist Designation Process
1.10 The Overinclusiveness Argument in the Context of § 2339B
1.11 Conclusion

## Chapter 2: Tax Collection and the Ten Scenarios

2.1 The American Taxpayer: The Wage Earner
2.2 The American Taxpayer: The Self-Employed
2.3 Aggressive Efforts to Impede Tax Administration
2.4 Illegal Income
2.5 The Criminal Tax Statutes
2.6 Proving Income
2.7 Example: Funds from the Wealthy Widower
2.8 Conclusion

## Chapter 3: The Tax Cheating Criminal

3.1 Al Capone and Spiro Agnew
3.2 The Strange Case of Eugene Tafoya
3.3 A Question of Fairness
3.4 Conclusion

## Chapter 4: The Embezzlers

4.1 Eugene James and the Taxability of Embezzlement
4.2 Some Crooked Accountants
4.3 The Occurrence of Embezzlement: The Sinking Ship
4.4 Corporate Skimming
4.5 Leona Helmsley and William Aramony
4.6 Some Unscrupulous Doctors
4.7 Conclusion

Chapter 5: Embezzlement (Part 2): A Question of Motive

5.1 Tax Conspiracy (Klein)
5.2 Tax Motive in Embezzlement Cases
5.3 A Limiting Principle?
5.4 Horace Ingram: Running Numbers in Georgia
5.5 Conclusion

Chapter 6: Drug Dealers and Their Lawyers

6.1 The Basics: Alfredo Garcilaso and John Paul Jones
6.2 Piercing the Drug Dealer’s Veil
6.3 Bencs, Pritchett and a Question of Fairness, Reprised
6.4 Tax Motive in Drug Cases
6.5 Money Laundering
6.6 The Intersection of Tax Crimes, Drugs and Money Laundering
6.7 Lawyers Gone Bad
6.8 Conclusion

Chapter 7: Public Servants Gone Astray

7.1 William Hart and the Detroit Police Special Fund
7.2 Fraud at the Illinois Governor’s Office
7.3 The Sunrise City Council in the Early 1980s
7.4 Bribes vs. Campaign Contributions
7.5 Undercover Sting: Operation Vespine in Atlanta
7.6 Help of Insiders: The Corrupt Border Agent, His Uncle, and His Outraged Wife
7.7 Fleecing the Unions
7.8 Distinction Between Bribery and Embezzlement
7.9 Conclusion

Chapter 8: Prejudice in Illegal Income Tax Cases

8.1 The Strange Case of Eugene Tafoya (continued)
8.2 Jerry Whitworth: The Tax Cheating Spy
8.3 The Indiana Barber Shop That Fixed DUI Citations
8.4 When Is Relevant Evidence of Unreported Income Too Prejudicial?
8.5 Conclusion

Chapter 9 - Privilege Against Self-Incrimination

9.1 The Fifth Amendment: The Basics
9.2 Income Tax Returns and the Fifth Amendment
9.3 The Modern Example: Gambling
9.4 Mechanics of Reporting Legal Gambling Activities
9.5 Tax Fraud Arising from Legal Gambling
9.6 Illegal Bookmaking
9.7 Phil Pinelli and Friends (Colorado)
Chapter 10: Investigative Methods in Tax Cases

10.1 The Two Faces of the IRS
10.2 The Origin of the Stalking Horse Claim
10.3 Further Refinements of the Stalking Horse Claim
10.4 Alfredo Caceres and the Remedy for IRS Guideline Violations
10.5 Constitutional Underpinnings of Stalking Horse Claim
10.6 More Recent Stalking Horse Claims
10.7 Stalking Horse Principles
10.8 The IRS Voluntary Disclosure Policy
10.9 The Use of Informants
10.10 The Crooked Professor and the *Massiah* Issue
10.11 The Saga of Shorttt Accountancy
10.12 Conclusion

Chapter 11: Aggressive Efforts to Thwart IRS

11.1 Threatening IRS Personnel
11.2 Schemes Involving IRS Forms 1099
11.3 Using Forms 1099 as a Weapon
11.4 Other False Instruments
11.5 Use of § 7212 in More Typical Tax Fraud Scenarios
11.6 Attempted Evasion of Payment: Hiding Assets
11.7 False Churches
11.8 Conclusion

Chapter 12: Criminal Intent

12.1 John Cheek and the Meaning of Willfulness
12.2 The Impact of *Cheek*
12.3 Mechanics of the “Good Faith” Defense
12.4 Did *Cheek* Actually Strengthen Law Enforcement?
12.5 Uncertainty: The *Critzer/Dahlstrom* Doctrine
12.6 What is the Interplay between *Cheek* and *Dahlstrom*?
12.7 Willful Blindness
12.8 Advice of Professionals
12.9 Medical Defense
12.10 Conclusion

Chapter 13: Taxing Terrorism
Introduction

This book aims to give readers an understanding of what I believe is a largely overlooked aspect of U.S. federal criminal law enforcement. My secondary goal is to foster an appreciation for an under-rated skill: telling a story with documents. These issues are vitally important to national security, and to the current challenge of keeping innocent people safe from political violence. In the war on terror, we cannot ignore financial investigative techniques and the value of documentary storytelling.

The focus of this volume is criminal tax. Lawyers and investigators who understand how to litigate tax cases necessarily become comfortable with large amounts of paper and know how to weave documents into a narrative that compels a certain legal result. I believe the world needs more of them. Tax specialists should be a welcome additional to any litigation team.

Why are tax specialists vital to U.S. national security? It is not because the they help collect the revenues that make a national defense possible, although that is part of it. Rather, it is because of the way their minds work, and the skills they possess. Those who understand the mechanics of tax litigation - how to follow the money, how to organize and categorize financial transactions and make sense of them, to make them come to life - are key players in the civilized world's efforts to prevent the loss of innocent life in acts of ideological violence. Their skills are directly applicable to the application of the rule of law to organized criminal plots. If one understands how to prove a criminal tax case in the U.S. - essentially, how to establish, through admissible evidence, unreported income - one will be able to prove legal nature of any financial transaction. This is the skill that will dry up the U.S.-based sources of the international terrorist group’s sources of financial support.

This book aims to promote the development of these skills. If it makes students more interested in tax law, or tax practitioners more interested in counterterrorism, or our counterterrorism community more aware of the value of financial techniques and expertise that is already out there, I will have succeeded.

In the United States, we have a long history of creatively applying criminal tax laws to lethal organizations. Al Capone, the most infamous criminal of the early 20th Century, was brought down by courageous United States Treasury agents. It was not his bootlegging, loan
sharking, bookmaking or strong-armed collection tactics (which included several murders) that took him off of the streets. Rather, it was his decision not to report his illegal income on his federal tax returns.

Today, as American law enforcement resources are being applied against Al Qaida and other international terrorist groups, the same skills are needed. If there is any doubt about that, take a look at the background of the prosecutors involved in some of the most celebrated post-9/11 American terrorism prosecutions brought to date (a point I will take up later in this volume).

This book is a labor of love. I began my public service career in 1990 as a federal tax prosecutor. Seven years later, tired of air travel and looking for a change, I moved over to another Department of Justice unit specializing in national security, where I have been ever since. In the course of my career, I discovered something rather surprising: when it comes to fighting international terrorism, the skills one develops as a tax lawyer are more valuable than any classified CIA or Pentagon threat briefing. While terrorism cases differ from tax prosecutions, the prosecutorial concepts are very much the same. If anything, prosecuting a criminal tax case may be the more difficult of the two. Those who understand criminal tax will be in good stead to prosecute any federal crime, including national security cases. As a nation, we are remiss if we do not take advantage of these skills, and promote their development.

Chapter 1 focuses what is perhaps the hottest topic in federal law enforcement today - terrorist financing. What does this mean? How is it discovered and redressed? What is the proper role of the white-collar fraud specialist have in the war against al Qaida, Usama Bin Laden the other radical Islamic groups engaged in violent jihad? Chapter 1 will show that proving the legal nature of a particular financial transaction is the essence of terrorist financing enforcement. It is a process that is no different from what is undertaken in every tax case.

From there, I turn to criminal tax. In the cases I have chosen for discussion, criminal tax tools were used as a powerful hammer to redress criminal conduct that goes well beyond trying to save a few dollars on your federal tax bill. This strategy has a fascinating history. Criminal tax laws have been applied against drug dealers, embezzlers, mobsters, crooked politicians, assassins and spies. Forty years after the Al Capone case, for example, criminal tax was used to convict Vice President Spiro Agnew in a Baltimore courtroom, a few minutes after his resignation. Otherwise, Agnew would have become the 38th President of the United States. The statutes, and the concepts underlying their enforcement, are remarkably robust and flexible.

Although this book should be of interest to tax practitioners and students, my hope is that it will be of interest to a wider audience. No familiarity with tax law is assumed. Chapter 2 seeks to provide an overview of the U.S. income tax collection system, to allow the reader a better understanding of the cases that follow in the succeeding chapters. My apologies in advance to those for whom Chapter 2 is too elementary. The hypothetical scenarios described in it are reincorporated in later parts of the book. This means Chapter 2 can be skipped by readers
already acquainted with the federal income tax system.

The succeeding chapters draws from cases in which the defendants - like Capone and Agnew - went far beyond tax fraud, or where the tax evasion schemes that are particularly audacious. This is by design. In addition to making for more interesting reading, this decision results (I hope) in a volume that addresses some of the most important issues in federal criminal law enforcement in an entertaining and intellectually satisfying way. My point is that criminal tax - the statutes, the concepts underlying them, and their means of enforcement - can be applied to the counterterrorism challenges we face today, and that is it logical to extend the lessons of Al Capone to the Al Qaida. In the final chapter, I turn once again to how financial skills can be applied in fighting terrorism.

This book is dedicated to Ronald A. Cimino, the long-time chief of the Western Criminal Enforcement Section, Tax Division, U.S. Department of Justice, who helped a generation of young lawyers appreciate the role of tax law in criminal justice. My thanks as well to Joe Wheatley of the University of Pennsylvania for his editing help.
Chapter 1 - Terrorist Financing

To understand terrorist financing as a law enforcement issue (sometimes referred to as “terrorist financing enforcement”), it is necessary to understand how the United States has sought to redress terrorism through criminal prosecutions. This type of counterterrorism is distinct from other tools available to American operational decision-makers, such as military strikes, diplomatic initiatives, economic sanctions and perpetual intelligence collection. When we talk about “counterterrorism enforcement,” we are referring to fighting political violence through legal proceedings and the rule of law.

This chapter describes the philosophical underpinnings of American counterterrorism and terrorist financing enforcement, and how this field of law has evolved over the last few decades. As will be shown, terrorist financing prosecutions - a key aspect of the government’s effort to prevent terrorists before they strike - depend on the process of proving that one or more financial transactions meet certain legal definition. This process is no different from what is undertaken in criminal tax cases every day.

1.1 The Laws and Their Rationale

Although the U.S. has been fighting terrorism since President Thomas Jefferson dealt with the Barbary Pirates in the late 1700s, the treatment of terrorism as a law enforcement issue is a relatively new development. This is due in part to the fact that the U.S., until the last quarter century, was not the target of choice of international terrorists. In fact, from 1960s to the 1990s, most acts of terrorism against U.S. interests occurred abroad or in the air. Americans who remained on U.S. soil could feel relatively safe from terrorist threats; empirically, injuries from household accidents represented a far greater risk to persons within the U.S.

Nevertheless, the U.S. Criminal Code has included terrorism as a law enforcement matter, well before the 1990s. The evolution of the U.S. terrorism criminal statutes was driven by the establishment of principles of international law, generally through multilateral treaties negotiated under the auspices of the United Nations. These treaties include what are known as “extradite or prosecute” instruments, whereby signatory nations are required to create certain terrorism-related crimes and the means of enforcing them.

In addition to the obligations imposed by international law, U.S. terrorism crimes have evolved within the limitations of the United States Constitution. In fact, constitutional limitations, more than those of international law, have been more influential in the development of the American approach to criminalizing terrorism.

1.2 Criminalizing Terrorism

The U.S. Constitution recognizes the inviolable right to free expression and free association, and the right to be free from deprivations of liberty or property without “due process
of law.” As interpreted by criminal courts, persons in the U.S. cannot be prosecuted for their thoughts alone, nor can the U.S. criminalize conduct that is protected by the First Amendment. As a result, our criminal jurisprudence stresses definable acts, rather than thoughts or speech unattached to particular conduct.

The structure of U.S. terrorism crimes follows this tradition. There is no crime of “being a terrorist” or “thinking terrorist thoughts.” While the U.S. Code defines the “federal crime of terrorism” (18 U.S.C. § 2332b(g)(5)), this terms simply lists all the terrorism-related crimes for ease of reference, and for such purposes as sentencing. Persons cannot be convicted of the “federal crime of terrorism,” because there is no such crime.

Instead, terrorism crimes have developed in the same manner as other law enforcement areas: policymakers determine what mischief should be prevented, and then craft criminal laws that take into account how such mischief is generally achieved. On occasion, acts that are criminalized are not ones that should necessarily be discouraged, if committed by persons not otherwise involved in the offensive conduct sought to be prevented. In these situations, laws are crafted to criminalize such conduct only when committed in particular circumstances.

1.3 The Narcotics Analogy

The best illustration of this concept comes from the U.S. anti-narcotics program. To combat the growing scourge of illicit drugs on the streets of urban America, the U.S. aggressively enforced the crimes of importing, distributing and possessing certain controlled substances. From there, we determined how drug dealers typically operate, and then made it a crime to engage in those operations.

Drug dealers, for example, could not enjoy the proceeds of their crime unless they could find a way of spending it without drawing attention to themselves. To do this, they had to rely on financial institutions to store and transfer their illegal proceeds, and find a way to make their proceeds appear legitimately derived. Recognition of this conduct led to the creation of the crime of money laundering: engaging in financial transactions for purpose of making dirty money appear clean.

Part of the U.S. money laundering program involved establishing required reports that must be generated and provided to the Treasury Department upon the occurrence of an act that conforms with the what we know about drug dealers’ operations. For example, because illegal drugs are generally purchased with cash, drug dealers will typical make large cash deposits into their bank accounts. After 1986, banks were required to generate a report, known as a Currency Transaction Report (CTR), anytime a customer deposits more than $10,000 in cash.

Is this requirement fair to the person in a legitimate cash business who happens to deposit cash in excess of $10,000? The 1986 law merely required the submission of a report. It properly recognized that there may be legitimate reasons to make large currency deposits.
Persons who fall into that category should have no reason to fear the issuance of a report, assuming that they are paying taxes on their cash earnings. The same was not true for drug dealers, of whom the required reports would draw unwanted scrutiny.

To accomplish their necessary financial goals after the imposition of this new requirement, drug dealers began dividing their currency deposits into smaller increments, each of which would be under the $10,000 triggering amount for a CTR. To redress this phenomenon, Congress created the crime of “structuring currency transactions” to avoid the reporting requirement. Where bank records show that someone made several $9,900 deposits at several different banks in the same day, prosecutors can ask the jury to infer that the person had a large corpus of cash and intentionally structured it to avoid the CTR requirement, thereby committing a federal felony.

The structuring offense (31 U.S.C. § 5324) is an example of a carefully crafted statute that prohibits conduct that is not inherently offensive (making several large cash deposits in a single day) in those circumstances that separate the innocent from the guilty. It effectively closed a loophole available to drug dealers who aspired to use the U.S. financial system to wash their illegal proceeds, forcing them to rely on other means. If persons other than drug dealers were ensnared in the process, these people are limited to those who had reason to fear (sometime unknown to the prosecutors, even after conviction) the generation of a CTR.

1.4 The Counterterrorism Crime Challenge: An Illustration

The best illustration of this challenge of criminalizing terrorism borrows from a construct used to illustrate the doctrine of “overinclusiveness” and “underinclusiveness,” within the meaning of the Equal Protection Clause of the Constitution. That clause, which appears in the Fourteenth Amendment prohibits state classifications that deprive persons of “equal protection under the law.” The government frequently make distinctions in classes of persons for purposes of determining such things as eligibility for benefits. The constitutionality of such distinction depends on the nature of the classification (racial, gender, alienage, income level, etc.), the government interest, and how closely the classification is drawn to achieve such interest.

In formulating criminal laws, governments are creating a classification. Upon its enactment, a crime creates two classes of people: (a) those who are prosecutable under the statute and (b) those who are not. Persons in the first category, when charged with the crime, sometimes claim that the crime they are charged with makes an unconstitutional distinction between what they are accused of doing and the conduct of other people that is not criminalized. Sometimes, they advance another constitutional argument: the enactment of the crime unconstitutionally infringes on their right to express themselves freely or associate with whomever they choose. Each of these arguments are depicted by the following charts:
In the case of overinclusive targeting, the person charged claims that his conduct, while perhaps within the larger circle, is outside of the “mischief circle.” His argument:

_The crime I am charged with committing arbitrarily ensnares me in something that should not be prohibited, because my conduct is outside the realm of “mischief” and is no more offensive that the type of conduct other people who are not charged with this crime._

Note that this is the type of argument that would be made by the non-drug dealer charged with structuring. It is, essentially, “I may be a lot of things – tax cheat, bad husband who want to hide assets from my wife – but I am certainly not a drug dealer, which is what the structuring offense is designed to capture.”

In the case of underinclusive targeting, the person is charged with conduct that fits
within the interior “crime” circle. Her argument:

While I may have done something that I should not have done, look at all of the other people who did the same sort of mischief but who conduct lies outside of the inner circle of “crime.” If you are serious about stopping the mischief in which you are accusing me of engaging, the crime I am charged with should include them as well, and is unfair as applied only to me.

Neither of these two arguments, cloaked as they are in notions of fairness, are likely to can much traction with the courts. Motions to dismiss, after all, are generally not granted on fairness arguments by criminal defendants. These two pleas, in their current form, are essentially public policy arguments, by self-interested persons who find themselves ensnared in the crimes. These persons and their legal advisors would be better served by finding a constitutional argument.

In the first example, the person claiming to be aggrieved by the overinclusive targeting should refine his argument, as follows:

I am charged with the crime of doing something that is protected by the First Amendment. While I do not contest the government’s right to punish those people who actually detonated the bomb, you should not lump me into their scheme simply because I believed in their cause and was present in the room when they were planning the attack. By doing so, you are seeking to punish me for my legitimate exercise of First Amendment rights, while chilling the exercise of such rights by other people who will notice what you are doing to me and be deterred from expressing themselves.

The second person, complaining about the underinclusive targeting, should say:

Your prosecution of me for committing an act of terrorism overlooks other acts of terrorism committed by people motivated by things other than the right to Palestinian freedom and self-determination. You are selectively prosecuting me because of my race, while consciously overlooking the terrorism committed by radical Jews and Irish nationalists.

Irrespective of whether these constitutional arguments would work, they come closer to the type of successfully constitutionally-based motions to dismiss, and illustrate the legitimate limits of policymaking through the enactment of criminal statutes. They also illustrate what would the ideal in crime-related policymaking, which is depicted here:
This ideal, which is rarely achievable, criminalizes virtually all of the mischief sought to be prevented, leaving few opening for criminal defendants to attack the enforcement program, either on constitutional or fairness grounds. In reality, criminal statutes and their enforcement are overinclusive or underinclusive, which does not present a problem if they do not infringe on constitutionally-protected conduct.

1.5 The U.S. Crimes of Terrorism

The various “federal crimes of terrorism” reflect a determination of what terrorists are known to do, rather than what they say or believe. It is a crime, for example, to commit the following types of acts:

- destruction of aircraft (18 U.S.C. § 32)
- bombing government property (18 U.S.C. § 844(f)(2)
- killing officer and employees of the United States (18 U.S.C. § 1114)
- hostage taking (18 U.S.C. § 1203)
- Presidential assassination (18 U.S.C. § 1751)
- weapons of mass destruction (18 U.S.C. § 2332a)

The existence and enforcement of these crimes do not present an obvious constitutional issue. Most people charged with these types of offenses would have a difficult time arguing that their prosecution will chill constitutionally-protected conduct. After all, one does not have a First Amendment right to take someone hostage or to destroy government buildings. On occasion, accused terrorists have tried these arguments, but they inevitably fail. See United States v. Whitehorn, 710 F. Supp. 803, 811 (D.D.C. 1989); United States v. Rahman, 1994 WL 388927 (S.D.N.Y. 1994). Perhaps someone charged under 18 U.S.C. § 871 with threatening the
life of the President could argue that the threat was merely a form of political expression, but this claim too has been rejected by the courts. See United States v. Watts, 394 U.S. 705 (1969).

As crimes are created in an effort reach conduct that is further removed from terrorist activity, we gain the ability to strike at the terrorist infrastructure at an early stage, well before their violence actions are set in motion. This is a salutory objective. At the same time, however, we begin to see clams that the enforcement of these crimes is unfair or unconstitutional. This is what makes terrorist financing enforcement such a hot topic today.

1.6 What is Terrorist Financing?

Terrorist financing has traditionally referred to the act of knowingly providing something of value to persons and groups engaged in terrorist activity. Although experts were studying this phenomenon of terrorist financing and ways to address it before 9/11, it has since became a more concerted global effort.

The crime of terrorist financing has been officially recognized in the United States since 1994, with the enactment of the first material support crime, 18 U.S.C. § 2339A. Prior to that time, such conduct could only be redressed through money laundering prosecutions.

Terrorist financing is similar to money laundering, and plays the same role in terrorism as money laundering did in the war on drugs. Money laundering is the process whereby money that is the product of some specified unlawful activity is cleaned, its source disguised, and it is placed inside the banking or other mainstream financial system. While terrorist financing can involve dirty money, it differs in that its focus is on the application – rather than the illegal source – of funds. With terrorist financing, it does not matter whether the transmitted funds come from a legal or illegal source. Indeed, terrorist financing frequently involves funds that, prior to being remitted, are unconnected to any illegal activity. A common example occurs when legitimate dollars are donated to charities that, sometimes to the chagrin of the donor, are actually fronts for terrorist organizations.

The current worldwide strategy against terrorist financing aims to disrupt the ability of state sponsors of terrorism and subnational terrorist organizations to provide funding and logistical support for terrorist acts. As a result of international treaties, countries establish appropriate mechanisms to disrupt terrorists' source of financial support, consistent with their legal traditions and the particular terrorist activity that occurs within their territories. This is the essence of the International Convention for the Suppression of Financing of Terrorism, negotiated under the auspices of the United Nations (1999).

Terrorist financing enforcement within the United States is directed at the type of activity that takes place here: international terrorist organizations raising funds from donors located within the U.S. To be constitutional, American terrorist financing enforcement be must consistent with our legal tradition; it must not infringe on constitutionally-protected activity, like
speech or association. It must meet the standards of acceptable overinclusive targeting, elucidated above.

The reasoning goes like this: we want to prevent the United States from being used as a fundraising location by international terrorist organizations, because we are obligated by international obligations to do our part in preventing the mischief they cause (terrorist attacks anywhere in the world). To fulfill this obligation, we criminalize precursor conduct (raising funds for terrorist organizations), but in a way that the criminal prohibitions do not extend to conduct that we do not want to discourage (raising funds for charity). This is a tricky proposition. How is it accomplished?

1.8 The U.S. Terrorist Financing Enforcement Program

Three major assumptions underlie American terrorist financing enforcement.

First, the United States Constitution, as interpreted by the Supreme Court, recognizes certain financial transactions as protected by the First Amendment, in particular the guaranteed freedoms of speech and association. The act of providing funds is a form of speech and association. Accordingly, any legal restrictions on such conduct must be tailored to conform with the First Amendment. This is not to say that financial transactions cannot be regulated or restricted. The constitutionality of monetary limits on political contributions and of embargoes which prohibit United States citizens from engaging in certain foreign transactions, for example, is well-established.

Second, some of the most lethal international terrorist organizations engage in legitimate philanthropic and humanitarian activity for people suffering within the regions in which they operate. This activity is considered the benevolent counterpart to their violent activities, and is designed to win the hearts and minds of people in such regions while simultaneously killing innocent people through indiscriminate violence elsewhere. Given the hybrid nature of many terrorist organizations, it would be an almost insurmountable law enforcement challenge to be required to trace the dollars coming from United States sources, through the shadowy Third World financial sector, to their ultimate use in purchasing bombs and bullets. Perhaps more importantly, even if such law enforcement efforts succeeded, it would be even more difficult to establish that the U.S.-based providers specifically knew that the funds were going to the malevolent, rather than humanitarian, purposes of the group.

Third, money is fungible. The benevolent intent of the United States donors cannot wash what is inherently a dangerous act – funding overseas groups that kill innocent persons. The funds provided by the humanitarian-minded donor are just as useful to the terrorist organization as the funds provided by persons who intend such funds to be used for violence.

These assumptions have led to an approach to terrorist financing enforcement that is unique to the United States, but which is increasingly being adopted by other countries. This
approach involves list-making. The government establishes which groups around the world qualify as “terrorist organizations.” Upon that announcement, it becomes a crime for anyone subject to United States jurisdiction to provide something of value to these entities, irrespective of the donors philanthropic intent.

This framework recognizes the fungibility of money. Even terrorist groups that have a undertake humanitarian work must be deprived of U.S.-based sources of support, lest the donations intended for good works be intermingled with funds destined for terrorist attacks. It is also consistent with the rules that limit American’s ability to engage in financial transactions with certain foreign actors. The enforcement of American sanctions against embargoed countries, such as Cuba and Libya, is constitutional.

Section 2339B prohibits anyone "within the United States or subject to the jurisdiction of the United States" from providing "material support or resources" to a designated foreign terrorist organization (FTO). The offense portion of the statute reads:

§ 2339B. Providing material support or resources to designated foreign terrorist organizations
(a) Prohibited activities.--

(1) Unlawful conduct.--Whoever, within the United States or subject to the jurisdiction of the United States, knowingly provides material support or resources to a foreign terrorist organization, or attempts or conspires to do so, shall be fined under this title or imprisoned not more than 15 years, or both, and, if the death of any person results, shall be imprisoned for any term of years or for life.¹

This crime, enacted in April 1996, did not become fully operational until the Secretary of State issued the first list of "Designated Foreign Terrorist Organizations" (FTOs) on October 7, 1997.

1.9 The Terrorist Designation Process

The Secretary of State designates FTO's, in consultation with the Attorney General and the Secretary of the Treasury. These designations are based on definitions contained within the Immigration and Nationality Act. The first FTO list, announced by Secretary of State Madeleine Albright in October 1997, consisted of twenty-nine organizations. Certain groups have been added and removed, and the current FTO list contains 40 groups. They are:

1. Abu Nidal Organization (ANO)

¹The language of this offense was changed slightly with the Intelligence Reform and Terrorism Prevention Act (December 17, 2004). The above language is included because it will still apply to pre-December, 2004 conduct.
2. Abu Sayyaf Group
3. Al-Aqsa Martyrs Brigade
4. Al-Jihad (Egyptian Islamic Jihad)
5. Al-Qaida
6. Ansar al-Islam
7. Armed Islamic Group (GIA)
8. Asbat al-Ansar
9. Aum Shinrikyo
10. Basque Fatherland and Liberty (ETA)
11. Communist Party of the Philippines/New People's Army
12. Continuity Irish Republican Army (CIRA)
13. Gama'a al-Islamiyya (Islamic Group)
14. HAMAS (Islamic Resistance Movement)
15. Harakat ul-Mujahidin (HUM)
16. Hizbullah (Party of God)
17. Islamic Movement of Uzbekistan (IMU)
18. Jaish-e-Mohammed (JEM) (Army of Mohammed)
19. Jama’at al-Tawhid wa’al-Jihad
20. Jemaah Islamiya (JI)
21. Kahane Chai (Kach)
22. Kurdistan Workers' Party (PKK)
23. Lashkar-e Tayyiba (LT) (Army of the Righteous)
24. Lashkar I Jhangvi (LJ) (Army of Jhangvi)
25. Liberation Tigers of Tamil Eelam (LTTE)
26. Libyan Islamic Fighting Group (LIFG)
27. Mujahedin-e Khalq Organization (MEK)
28. National Liberation Army (ELN)
29. Palestinian Islamic Jihad (PIJ)
30. Palestine Liberation Front (PLF)
31. Popular Front for the Liberation of Palestine (PFLP)
32. PFLP-General Command (PFLP-GC)
33. Real IRA
34. Revolutionary Armed Forces of Colombia (FARC)
35. Revolutionary Nuclei (formerly ELA)
36. Revolutionary Organization 17 November
37. Revolutionary People's Liberation Army/Front (DHKP/C)
38. Salafist Group for Call and Combat (GSPC)
39. Shining Path (Sendero Luminoso, SL)
40. United Self-Defense Forces of Colombia (AUC)

The Secretary of State's FTO designations are the culmination of an exhaustive interagency review process in which information about a group's activity, taken both from classified and open sources, is scrutinized. The State Department, working closely with the
Justice and Treasury Departments and the intelligence community, prepares a detailed administrative record which documents the terrorist activity of the proposed designee. Seven days before publishing an FTO designation in the Federal Register, the Department of State provides classified notification to Congress. Under their announcement, designations are subject to judicial review, triggered by a challenge from the group itself. This has occurred a few times since the publication of the original FTO list. In addition, one lawsuit was filed independently by the prospective donors of two FTOs, arguing that the designation infringes on their First Amendment freedoms of speech and association, and seeking a declaratory judgment that the statutory scheme was unconstitutional. The constitutionality of the FTO designation process has been thoroughly upheld. See, *Humanitarian Law Project v. Reno*, 205 F.3d 1130 (9th Cir. 2000); *People’s Mojahedin Org. of Iran v. Dep’t of State*, 182 F.3d 17 (D.C. Cir. 1999) (rejecting challenges by two designated groups); *National Council of Resistance of Iran v. Dep’t of State*, 2001 WL 629300 (D.C. Cir. June 8, 2001) (groups that have sufficient United States presence are entitled to procedural due process).

Section 2339B is designed to criminalize conduct of “non-bomb throwers:” persons who themselves may not be involved in any violence beyond the act of providing funds to terrorist groups, but who nonetheless play an important role in the terrorist groups’ division of responsibility. By permitting the prosecution of persons several steps removed from the actual violence without ensnaring persons who engage in otherwise legitimate conduct that we do not necessarily want to discourage – like charitable giving - American counterterrorism officials are able to strike a major blow at the international terrorist infrastructure. Section 2339B has proven to be a powerful tool in achieving this goal. It is the probably the closest thing American prosecutors have to the crime of being a terrorist.

1.10 The Overinclusiveness Argument in the Context of § 2339B

Earlier in this chapter, we saw a description of the arguments that would by persons who challenge an overinclusive criminal enforcement strategy, in the particular context of a currency structuring prosecution (18 U.S.C. § 5324). The same type of analysis illustrates the effectiveness and natural limitations of § 2339B enforcement, using the FTO Hamas as an example.

**Conduct Criminalized by § 2339B**

![Diagram](image)
In an effort to prevent mischief represented by the smallest circle, the U.S. makes it a crime to provide material support or resources to Hamas, which is an FTO. A federal prosecutor obtains indictments against three different persons: (1) the Hamas leader within the smallest circle; (2) the Hamas operative in the middle circle; and (3) the person who knowingly provided funds to the Hamas operative, in the outer circle.

The third of these defendants, indicted under § 2339B, might make the following argument in his motion to dismiss:

_I am charged with doing something that is not inherently dangerous–providing funds to the charity of my choice. In making this donation to Hamas, I intended my funds to be used for philanthropic goals, never violence. The United States government, if anything, should encourage charitable gift-giving. My decision to give to Hamas is protected by my First Amendment rights to express myself however I want, and to associate with whomever I choose. Moreover, people looking at what you are doing to me will naturally be deterred from giving funds to Hamas, and their First Amendment-protected activities will be chilled._

The prosecutor responds:

_Section 2339B represents Congress’ clear intent to dry up the United States source of funds for international terrorists. Under this statute, the United States announces the groups we view as designated foreign terrorist organizations. That action marks groups that use violence to achieve their political goals, and the fact that they may also engage in philanthropy does not change the terrorist nature of that organization. As a person within the United States, the defendant is prohibited by § 2339B from providing any funds to certain groups, including Hamas, no matter how the defendant intends Hamas to use his donated funds. This is a reasonably-tailored prohibition, supported by clear legislative history, which comports with First Amendment jurisprudence, just as the laws that prohibit United States citizens from purchasing items produced with embargoed countries have been upheld. In addition, the statutory scheme has been upheld when challenged on these same grounds, by persons who are alleged to have engaged in the same type of conduct as the defendant._

Note that this prosecutor's argument responds to the arguments of the defendant situated in the outer-most ring, the one furthest removed from the violent activity depicted in the inner circle. With regard to the constitutionality of § 2339B as applied to particular facts, the conduct of the other two defendants is an even easier argument. That is, these two defendants would have a more difficult time arguing that their alleged conduct is protected by the First Amendment.
1.11 Conclusion

This list-making approach to terrorist financing effectively alters the enforcement landscape. Instead of tracing monies from the United States to their ultimate use in terrorist acts, the enforcement challenge now is to establish that persons here engaged in financial transactions with persons they knew were acting on behalf of designated terrorist groups and individuals.

To add to its efficacy, § 2339B contains at an attempt and conspiracy provision. In other words, § 2339B can reach persons within the United States who form the intent to provide something of value to an FTO and take an affirmative step towards that goal.

The question for law enforcement thus becomes: how can one prove that a particular financial transaction (reflected in bank records) reflects an attempt to provide material support to an FTO? Mechanically, this is no different from the challenge faced by tax prosecutors: how to prove that a particular financial transaction meets the definition of “income.” If one understands the latter, one can easily prosecute terrorist financiers.

The relationship between terrorist financing enforcement and tax and other financial techniques will be taken up again in the last chapter. We now turn to criminal tax.
Chapter 2 - Tax Collection and the Ten Scenarios

Because this book assumes no familiarity with the U.S. tax system, this chapter is devoted to a brief description of the federal income tax structure, how tax is assessed and collected, and what is meant by “criminal tax fraud.” To achieve this goal, it uses ten scenarios, which will be referred to throughout this book. This chapter also includes a description of the main criminal tax statutes.

2.1 The American Taxpayer: The Wage Earner

As of this writing, any person in the United States who earns more than $7,950 in any calendar year is required to file an individual U.S. tax return, known as an IRS Form 1040. On those returns, which are signed under penalties of perjury and due on April 15 of every year, individual taxpayers are required to provide their names, addresses, social security numbers, and their adjusted gross income. This is the essence of the tax returns. Most criminal tax cases are brought on the basis of information contained on the first page of the Form 1040.

Here is a very simple example:

Kevin Downing lives in Ocean City, New Jersey and works for a small company known as ShoreCraft, for whom he repairs motorboats. His salary is $36,000 per year. Assume that this is the only income he receives. The front page of his IRS Form 1040 would look like this:

[Picture]

The United States government assesses income tax on the basis of the income Kevin reports on his return. It is Kevin’s obligation, however, to calculate the amount he owes. The fact that Kevin computes his own tax bill is sometimes referred to as the American system of “self-assessment.” He accomplishes this by following the instructions and completing page 2 of the Form 1040:

[Picture]

Note that the top line of page 2 is the same as the bottom line of page 1 of the Form 1040. This figure, defined as “adjusted gross income,” is the first step in computing Kevin’s income tax liability.

In addition to the IRS Form 1040, there are two other documents relevant to Kevin’s tax liability. The first is an IRS Form W-4, which he submitted to ShoreCraft soon after he was hired. The second is the IRS Form W-2 ShoreCraft issued to Kevin and copied to the IRS at the
end of the calendar year. These forms look like this:

(Picture)

A salaried employee, Kevin gets a paycheck every two weeks from ShoreCraft. Based on the information he provided to ShoreCraft on his Form W-4, ShoreCraft’s payroll clerk withholds a portion of Kevin’s paycheck and remits it to the IRS in approximate satisfaction of Kevin’s federal tax liability. Kevin is relieved of the obligation to report his income and income tax liability to the IRS as frequently as every pay period. Instead, his employer does it for him. At the end of the year, ShoreCraft summaries his wages payments and tax withholdings on the Form W-2.

Thus, by the end of the year, through Shorecraft’s actions, Kevin has already fulfilled most of his federal obligations. His total tax liability had been taken out in installments from his bimonthly paychecks. The only thing left for him to do is file his return on April 15. On it, he simply reports the information provided to him by Shorecraft on his Form W-2, which Kevin attaches to the return.

On his Form 1040, Kevin does the arithmetic on his Form 1040, by reporting his income (Line 22), and his exemptions and deductions (Lines 37 and 39). He then computes his tax liability (Line 60). From this amount, he subtract the taxes he has already paid during the year (Line 68), and either claims a refund (Line 70a) or pays any tax deficiency (Line 72). In terms of his tax liability, Line 60 is really the bottom line.

Note that, with the way in which Kevin earns a living, his tax liability is the result of three factors, as follows.

\[
\begin{align*}
\text{Wages (Line 22)} & \quad XXX \\
\text{less: Exemptions (Line 37)} & \quad XXX \\
\text{less: Deductions (Line 39)} & \quad XXX \\
\text{Taxable Income} & \quad XXX \\
\text{Tax Liability} & \quad XXX
\end{align*}
\]

Now let’s assume that Kevin wants to cheat on his taxes. His goal is to shave the dollar figure that appears on Line 60. Given his employment situation and how the IRS collection process works for him, how would he go about doing this through fraud and trickery? There are a number of distinct possibilities:

**Scenario 1:** Kevin files a Form W-4 with ShoreCraft which instructs it not to withhold any amount of his paychecks. He then neglects to file an Form 1040.

**Scenario 2:** Kevin files a Form 1040 which falsely reports that he did not receive any
income, and which claims a refund on the taxes ShoreCraft withheld and remitted to the IRS during the year.

**Scenario 3:** Kevin files a Form W-4 with ShoreCraft which instructs it not to withhold any amount of his paycheck. He then files a Form 1040 which reports zero income.

Each of these three scenarios actually occur in the real world, with amazing frequency. Of the three, **Scenario 1** is probably the most naive, and the one most likely to get Kevin prosecuted for tax fraud. In this scenario, he is seeking to impact Line 60 by not filing a return at all.

Before entering into **Scenario 1**, Kevin should realize what most people know – that the IRS Form W-2 he receives from ShoreCraft at the end of the year is simultaneously provided to the IRS. Accordingly, the IRS will know the Kevin received a salary from ShoreCraft, from which taxes were withheld. From the ShoreCraft-submitted Form W-2 alone, the IRS has enough information to start asking questions. Why did Kevin not file the required Form 1040, since he obviously received income in excess of $7,950? Why were no federal taxes taken out of his paychecks during the year? The IRS can approach ShoreCraft and Kevin with these questions. When it learns the truth, Kevin is sunk. He tried to cheat on his taxes. His scheme was discovered, and he will be punished.

**Scenario 2** and **Scenario 3** will also likely result in Kevin’s punishment. Why? It is for the same reason as **Scenario 1**: from the Form W-2 submitted by ShoreCraft, the IRS will know how much salary Kevin received from during the year. It can simply compare that amount to what Kevin reports on his Form 1040. If there is a discrepancy, the IRS can start asking questions. Specifically:

In **Scenario 2**, the IRS could inquire into why Kevin claimed a refund, given that he received income that was properly the subject of biweekly withholdings.

In **Scenario 3**, the IRS could inquire into the propriety of Kevin’s claiming no withholdings on the Form W-4 he gave to ShoreCraft.

Knowing that the IRS will receive a Form W-2 detailing his income, Kevin’s better course is to assume that the IRS knows about his earnings from the reports it receives from ShoreCraft. If he still wants to cheat, he should figure out another trick to throw it off track and minimize his chances of getting away with it. He may arrive at a more sneaky alternative:

**Scenario 4:** Kevin files a Form 1040 which reports the salary he receives from Shorecraft, but on page 2 he reports a false charitable deduction in an amount equal to his salary (Line 37).

When compared to his accurate tax return, this scenario would result in a tax return that
Scenario 4 is far more crafty than the other three scenarios. The tax return has the effect of driving Kevin’s tax liability (Line 60) to zero, while assuming that the IRS will know about his ShoreCraft salary. Perhaps the IRS will note the oddity of someone donating 100 percent of his income to charity, and begin asking questions about this transaction to determine its legitimacy. At the very least, however, Kevin has at least taken himself out of the Scenario 1, Scenario 2 and Scenario 3 categories of naive tax cheats. He has properly recognized that reporting that he received no salary from ShoreCraft will pave the way for an approach by the IRS. In Scenario 4, Kevin is reacting to his knowledge of how the U.S. federal income tax collection system works. He is rolling the dice and hoping that the IRS take his Form 1040 at face value. If he is not audited, he may well get away with it.

2.2 The American Taxpayer: The Self-Employed

Further gloss of how people cheat on their taxes comes from considering those who make a living in ways other than Kevin Downing. A good number of people own their own business, or support themselves in ways other that earning a biweekly paycheck from their employer. Consider the circumstances of Moni SenGupta, who owns her own flower shop in Los Angeles. Like Kevin, Moni must file a Form 1040 on April 15 of every year. Unlike Kevin, Moni is self-employed. She does not have an employer like ShoreCraft to withhold and remits to the IRS a portion of her earnings, and to provide her with a Form W-2 at the end of every calendar year. Instead, she makes quarterly estimated tax payments herself.

Even though her income and tax liability is about the same as Kevin’s, Moni’s tax return looks slightly different:

Note that Moni’s tax return contains more pages than Kevin’s, even though their tax liability is the same. This merely reflects her circumstances, and the way she chooses to make a living. As a self-employed businessowner, Moni has what is referred to as “business income,” based on a form known as an IRS Schedule C that sole proprietors are required attach to their tax returns. Like Kevin, she reports her income on Line 12 of her Form 1040, rather than on Line 7. In the end, it does not matter, since both entries lead to the “total income” figure (Line 22). In Kevin and Moni’s case, it is about the same.

How does Moni arrive at this figure that she reports on Line 12? On the Schedule C she attaches to her return, she is required to describe her business and, in particular, how much it earned – referred to as “Gross Receipts” on Line ___ of the schedule. She is also expected to
report how much the flower shop paid out as business expenses. The figure Moni places on Line 12 of her Form 1040 is the difference between these two figures on the Schedule C, i.e., the amount by which the flower shop’s gross receipts exceeded her expenses. In this example, it happens to be approximately the same salary as Kevin received from ShoreCraft. The second page of Moni’s Form 1040 is exactly like Kevin’s. Her ultimate tax liability is computed in the same way.

This slightly different income source opens up new avenues, if Moni wants to cheat on her taxes. She could perhaps rest easier than Kevin if she were to adopt the Scenarios 1, Scenario 2 and Scenario 3, since she is self-employed and has no employer and no Form W-2 with which to contend. As a result, she has more control than Kevin over what information is provided to the IRS. By the same token, she could just as easily follow Kevin’s lead and try the scheme described in Scenario 4 - accurately report her income but falsely claim that she donated all of her income to charity, as follows:

**Scenario 5:** Moni files a Form 1040 which reports her net income from the flower shop, but on page 2 she reports a charitable deduction in amount equal to her salary (Line 37).

Other tax cheating scenarios, however, are available to Moni:

**Scenario 6:** Moni systematically omits a portion of the gross receipts she reports on her Schedule C, by taking cash out of the cash register before it is recorded on the flower shop’s books and records.

**Scenario 7:** Moni records some of her personal living expenses (such as her apartment payment and grocery sales) as business expenses of the flower shop.

What is the impact of Scenario 5 and Scenario 6 on Moni’s bottom line - Line 60 of her Form 1040? In either case, her reported income -- upon which her tax liability is based – is understated by the amount of the fraud on the Schedule C. Line 60 is thereby impacted.

For Scenario 6, assume that Moni pocketed $10,000 of the flower shop’s gross receipts during the year while keeping it off its books and records. The following chart depicts how this would impact her reported tax liability, when compared to the accurate return shown above:

<table>
<thead>
<tr>
<th>Gross Receipts</th>
<th>Expenses</th>
<th>Sch. C Income</th>
<th>Gross Income</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Accurate Return</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Scenario 6 Return</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
In Scenario 7, assume that Moni listed $10,000 of her personal expenses as business expenses on the flower shop’s books. The resulting fraud would impact her tax liability as follows:

<table>
<thead>
<tr>
<th></th>
<th>Accurate Return</th>
<th>Scenario 7 Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Receipts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sch. C Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Income</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Scenario 6 and Scenario 7, while slightly different types of fraud, have the exact same impact on her bottom line. When compared to a return that accurately reflected her income, each scenario allows Moni to evade $________ in taxes.

Within these two scenarios, can it be said that Moni embezzled from the flower shop? In a sense she has, since she has used it for her own personal purposes. Then again, she is the sole owner of the flower shop, its sole proprietor. Given that she is responsible for the shop’s taxes by reporting them on her own tax return, it is probably not fair to say that she has defrauded the flower shop. Moni, after all, is the flower shop. Has she embezzled from the store. She does not have any partners, nor any shareholders, to whom she has a fiduciary obligation. She treats the flower shop as her own because it is. Apart from the IRS, who was victimized by her actions in Scenario 6 and Scenario 7?

2.3 Aggressive Efforts to Impede Tax Administration

Let’s say that Moni opts for Scenario 7, and is notified that she will be audited. Like some actual taxpayers of modern times, she may decide that the best defense is a good offense, and actively try to frustrate the IRS’ efforts to ascertain her actual tax liability. These efforts frequently mark the distinction between a civil tax matter and criminal prosecution. Consider this Scenario

Scenario 8: Moni records some of her personal living expenses (such her apartment payment and grocery sales) as business expenses of the flower shop. When she is chosen for an audit, she refuses to cooperate with the IRS and makes a series of phone calls to the revenue agents, threatening him with personal reprisal if he does not leave her alone.

These audacious steps to frustrate the IRS tax administration efforts are the subject of many recent court decisions, discussed in later chapters.

2.4 Illegal Income
Because this book seeks to demonstrate the efficacy of criminal tax prosecutions in redressing conduct that goes beyond tax fraud, these seven scenarios do not reach my ultimate conceptual goal. In these seven scenarios, Kevin and Moni are “merely” trying to cheat on their taxes. Their motive is no more diabolical than that. These scenarios represent the most common type of criminal tax prosecution, but they are not illustrative of the larger issue of how criminal tax tools fits into federal criminal law enforcement generally. For the majority of cases in this book, the framework for considering them can be established though an additional scenario each about Moni and Kevin. Let’s start with Moni.

**Scenario 9:** In addition to flowers, Moni sells marijuana out of her store and home. She does not report her marijuana sales, nor the fact of this illegal business, on her tax returns.

This seems like a logical choice for Moni, given her unfortunate decision to enter into a criminal enterprise. Unlike the payments she makes for her flower inventory, she cannot report her purchases of marijuana on her Schedule C. She also cannot report the profit she receives from the marijuana sale. Because it is illegal to sell marijuana, Moni does not want to list her business as “flowers and marijuana sales” on the Schedule C. Otherwise, she will suffer the interminable fear that the IRS will bring their friends from the FBI and DEA around to question how she supplements her flower shop income. To avoid this, she needs to keep her marijuana business separate from her flower business, and not commingle the two.

In addition to the $36,000 in net flower store income she reports on her Form 1040, Moni’s marijuana dealing nets her a $45,000 profit. She chooses not to report this illegal income on her tax return.

How does Scenario 9 differ from the previous scenarios? For sure, it is more interesting, and has more jury appeal. The government lawyer assigned to prosecute Moni for her Scenario 9 will have more fun than his colleagues handling the prosecution arising out of Scenarios 1 through 8.

For the Scenario 9 prosecution, what are the charges following the IRS-initiated DEA investigation? In addition to prosecuting Moni for her illicit drug dealing, can she also be charged with tax fraud? Is that fair to Moni? Was her motive for filing a false tax return to cheat on her taxes, to conceal her illegal activity, or both?

Before considering her motive, consider the impact of Moni’s omission of $45,000 on her tax liability. When compared to an accurate return, her tax liability would differ, as follows:

<table>
<thead>
<tr>
<th>Gross Receipts</th>
<th>Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Accurate Return</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Scenario 7 Return</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Taxing Terrorism**  
J. Breinholt Aug. 2005
Clearly, her omission of her income from marijuana sales had an impact on her bottom-line tax liability.

Let’s assume that, in Scenario 9, Moni is audited by the IRS, and that her bank accounts are obtained. The IRS discovers far more bank deposits than explained by the flower shop’s books and records. They do some digging and discover enough information to bring in the DEA. Jointly, the two agencies uncover Moni’s marijuana business and the fact that she failed to report her $45,000 profit from it on her tax returns. She is indicted on both narcotics and tax charges.

Moni’s defense attorney thinks her motive is relevant. Surely, the judge will realize that the tax charges are just piling on by the government. We cannot actually expect drug dealers to pay taxes on their illegal income, can we? He tries to get the tax charges thrown out, filing a motion to dismiss. His argument:

*Your honor, this case is absurd. It reflects government overreaching at its worst. If my client was dealing marijuana – a fact we plan to vigorously contest at trial – we cannot actually expect her to report this fact on her tax return. To charge her with tax fraud in addition to the drug counts is unfair. We move to dismiss the tax charges. The government is simply piling on, and we as a people should not tolerate it.*

The prosecutor responds:

*The grand jury has indicted the defendant on separate charges, which are properly joinable under the Federal Rules of Criminal Procedure. Both the tax charges and the drug charges arise out of the same transactions. Defense counsel has failed to articulate a valid reason for dismissing any of the charges. Judicial economy suggests that we should proceed with the entire indictment to the same jury.*

Who prevails? As shown in this book, the prosecutor will win this particular argument, and the motion to dismiss will be denied. The case against Moni goes forward with both the narcotics and the tax charges. Her lawyer may succeed in getting the charges severed, based on an argument that the jury will not be able to ignore her drug dealing activities in deciding on the tax charge and that the joining of the charges will result in undue prejudice. That attempt, even if successful, would mean that she will have to stand trial twice. The tax charges will go forward, because illegal income is taxable, and criminals are required to report their illegal activity on their tax returns. Failing to do so is a separate crime.
Now, consider a scenario in which Kevin, like Moni in Scenario 10, decides to go further into a life of crime.

**Scenario 10:** Kevin realizes that, in the course of his work at ShoreCraft, he can secretly pocket some of the customer payments for his services. Meanwhile, he can prepare paperwork reflecting that the customer has paid only that amount that ShoreCraft receives, which is recorded as gross business receipts by the company bookkeepers, and which omits the monies Kevin pockets. ShoreCraft, which is oblivious to Kevin’s scheme, does not include the pocketed customer payments on Kevin’s Form W-2. On his tax return, Kevin reports only his salary and withholdings from the W-2 and does not include the customer receipts he secretly pocketed.

In this scenario, Kevin has received illegal income in addition to what he legitimately earned from ShoreCraft. The illegal income is proceeds from his embezzlement scheme. Because it is not going onto Shorecraft’s books, it is escaping taxation altogether. Both ShoreCraft and the IRS are victims. Kevin’s lawyer may try to same argument as Moni’s from above. He will have no more luck, and will instead need to resort to some more crafty arguments, perhaps one that deals specifically with the taxability of embezzlement proceeds, the subject of the next chapter.

Let’s review the ten scenarios:

<table>
<thead>
<tr>
<th>Kevin Downing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee, ShoreCraft, Ocean City, NJ</td>
</tr>
</tbody>
</table>

**Scenario 1:** Kevin files a Form W-4 with ShoreCraft which instructs it not to withhold any amount of his paychecks. He then neglects to file a Form 1040.

**Scenario 2:** Kevin files a Form 1040 which falsely reports that he did not receive any income, and which claims a refund on the taxes ShoreCraft withheld and remitted to the IRS during the year.

**Scenario 3:** Kevin files a Form W-4 with ShoreCraft which instructs it not to withhold any amount of his paycheck. He then files a Form 1040 which reports zero income.

<table>
<thead>
<tr>
<th>Moni SenGupta</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner of Flower Shop, Los Angeles, CA</td>
</tr>
</tbody>
</table>

**Scenario 5:** Moni files a Form 1040 which reports her net income from the flower shop, but on page 2 she reports a charitable deduction in an amount equal to her salary (Line 37).

**Scenario 6:** Moni systematically omits a portion of the gross receipts she reports on her Schedule C, by taking cash out of the cash register before it is recorded on the flower shop’s books and records.

**Scenario 7:** Moni records some of her personal living expenses (like her apartment payment and grocery sales) as business expenses of the flower shop.
**Scenario 4**: Kevin files a Form 1040 which reports the salary he receives from Shorecraft, but on page 2 he reports a charitable deduction in amount equal to his salary (Line 37).

**Scenario 8**: Moni records some of her personal living expenses (such as her apartment payment and grocery sales) as business expenses of the flower shop. When she is chosen for an audit, she refuses to cooperate with the IRS and makes a series of phone call to the revenue agents, threatening him with personal reprisal if he does not leave her alone.

**Scenario 10**: Kevin realizes that, in the course of his work at ShoreCraft, he can secretly pocket some of the customer payments for his services. Meanwhile, he can prepare paperwork reflecting that the customer has paid only that amount that ShoreCraft receives, which is recorded as gross business receipts by the company bookkeepers, and which omit the monies he pockets. ShoreCraft, which is oblivious to Kevin’s theft, does not include the pocketed customer payments on Kevin’s Form W-2. On his tax return, Kevin reports only his salary and withholdings and does not include the customer receipts he secretly pocketed.

**Scenario 9**: In addition to flowers, Moni sells marijuana out of her store and home. She does not report her marijuana sales, nor the fact of this illegal business, on her tax returns.

These are factual scenarios that are common in criminal tax prosecutions. Although the particular case will vary in terms of the facts and the defendant’s conduct, many of the actual cases discussed in this book fall approximately into these ten scenarios. They will be used throughout this book.

### 2.5 The Criminal Tax Statutes

What about the law? What is meant by criminal tax fraud? There are a half-dozen criminal statutes that are used against tax cheats. Most of them are contained in the Internal Revenue Code, which Title 26 of the United States Code. They start with what is considered the most serious tax offense - the crime of attempting to evade the assessment of taxes, 26 U.S.C. § 7201. The statute provides:

**§ 7201. Attempt to evade or defeat tax**

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.

When people talk about “tax evasion,” this is a misnomer. What they are really referring to is the crime of “attempted evasion” under § 7201.

There is a logic to this. Everyone who is caught evading their taxes has, by definition, failed. They tried to cheat, but got caught by the IRS and were indicted. Because their scheme never came to fruition, they never successfully completed the act of evasion. To prosecute them, we have to rely on the inchoate crime of attempt, which does not depend on a completed crime. The crime of attempted tax evasion allows for the prosecution of those who formed the requisite criminal intent and took some affirmative act in furtherance of their illegal goal, even without fully achieving it.

Most § 7201 prosecution cases are “evasion of assessment” matters. As noted above, the U.S. income tax collection system is based on self-assessment. That is, American taxpayers self-report the income they have received during the year, and then calculate their ultimate tax liability. To the extent that what they owe differs from what they have already paid in federal income taxes during the year, they must pay or be refunded the difference. They report their income and tax liability. Their filed return reflects a self-assessment.

Although there are many examples of “affirmative acts” that qualify as sufficient in proving someone’s attempt to evade taxes, the most common one is the filing of a false return. A false return means a false assessment. If the prosecution can show that her conduct would have resulted in a tax loss to the U.S. Treasury, she will be convicted under § 7201.

What if the taxpayer never files a return, such as Kevin in Scenario 1? The mere failure to file, without any other acts of concealment, is a misdemeanor. Section 7203 of Title 26 provides:

§ 7203. Willful failure to file return, supply information, or pay tax

Any person required under this title to pay any estimated tax or tax, or required by this title or by regulations made under authority thereof to make a return, keep any records, or supply any information, who willfully fails to pay such estimated tax or tax, make such return, keep such records, or supply such information, at the time or times required by law or regulations, shall, in addition to other penalties provided by law, be guilty of a misdemeanor and, upon conviction thereof, shall be fined not more than $25,000
($100,000 in the case of a corporation), or imprisoned not more than 1 year, or both, together with the costs of prosecution. In the case of any person with respect to whom there is a failure to pay any estimated tax, this section shall not apply to such person with respect to such failure if there is no addition to tax under section 6654 or 6655 with respect to such failure. In the case of a willful violation of any provision of section 6050I, the first sentence of this section shall be applied by substituting "felony" for "misdemeanor" and "5 years" for "1 year".

There are tax experts who suggest that because § 7203 is a misdemeanor, it creates incentive for tax cheats not to file returns, as required by law. Can people avoid the more serious penalties of § 7201 by choosing not to file a false return, and limit their liability to that of a misdemeanor? It turns out that a failure to file, combined with some other act of concealment, constitutes attempted evasion under § 7201. This type of evasion, which was established by the Supreme Court case of Spies v. United States, 63 S.Ct. 364, 317 U.S. 492 (1943), would apply to Scenario 1:

Scenario 1: Kevin files a Form W-4 with ShoreCraft which instructs it not to withhold any amount of his paychecks. He then neglects to file an Form 1040.

Here, Kevin’s affirmative act of submitting the Form W-4 to his employer exposes him to the § 7201 felony charge. It is the difference between an act of omission and an act of commission. His conduct was not limited to an act of omission - the “mere” failure to file a return, which would have opened him up to § 7203 liability. He could be charged with what is known as a “Spies evasion:” a failure to file a return, coupled with one of more affirmative acts of concealment.

In terms of seriousness, between § 7201 (a five-year felony) and § 7203 (a one-year crime) lies another felony statute, referred to as “tax fraud,” or “tax perjury.” It is 26 U.S.C. § 7206, which criminalized the act of filing a false tax return.

Note that in all of the nine scenarios except for Scenario 1, the criminal conduct comes down to the act of filing a false tax return. We can pinpoint the culmination of the tax fraud scheme to the individual’s decision to sign one's name under that part of the return that describes how it is being subscribed under penalties of perjury. Because most American workers are required to file a federal income tax return, they must make at least one attestation per year that, under criminal penalties, they are telling the truth. To the extent their returns are false, they have committed the crime of perjury. Section 7206 provides, in relevant part:

§ 7206. Fraud and false statements

Any person who--
(1) Declaration under penalties of perjury.--Willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter; or

(2) Aid or assistance.--Willfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document; or

shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.

The difference between the two subsections of § 7206 boils down to a rather simple fact: whether or not the false return was signed. Section 7206(1) is used to prosecute persons who sign their false returns. Section 7206(2) is applied either against people who file unsigned false returns, or people who return other people’s returns. These crimes are three-year felonies.

When compared to the crime of attempted evasion (§ 7201), these crime are easier to prove, for the government need not show that the falsehood resulted in a tax loss to the United States. In other words, a return can be false and fraudulent even if the falsehood does not impact the bottom-line tax liability. This fact makes § 7206 a favorite of tax prosecutors.

Section 7206 is also a major problem for criminals. Scenario 8 and Scenario 9 illustrate that, for criminals - those people who earn their living illegally - our tax system is a whipsaw. Like other Americans, criminals are required to file a tax return. On it, they must report both the amount of their income and its source, and sign it under penalties of perjury. If the income is illegal, the criminals are not relieved of their legal obligation to report it. If they report it, American law enforcement may become privy to their illegal activities, and come after them for more than just their tax fraud. Illegal conduct gives rise to a Catch 22.

This point tends to surprise most people who are not involved in the criminal justice process. From a law enforcement perspective, it may seem too good to be true. Is there a hitch? The following chapters address that issue. The answer - controversial to some, surprising to many - gives voice to my thesis: that criminal tax is an incredibly powerful tool to federal law enforcement, one which has not yet been used to its full potential.

Taxing Terrorism
J. Breinholt Aug. 2005
2.6 Proving Income

Proving income is the bread and butter of tax litigation. Whether a particular transaction represents an incidence of income is a question of fact. The mere fact of money changing hands is not necessarily a taxable event, for there are plenty of monetary transfers that do not give rise to income. For example, if you receive a gift from a relative, you are not taxed on its value. If you receive a loan from someone, that monetary transfer is not income. If you made a loan to another person and then are repaid, the repayment is not income to you. These are some examples of non-taxable transfers. In tax litigation, the party with the burden of proof must establish, through admissible evidence, the income-nature of a financial transaction. Proving the fact of a transaction is easy – simply offering into evidence bank records through the business records exception of the hearsay rule.

Understanding how to prove income makes tax lawyers such good litigators. It is typically a two-step process: (1) establishing, through documents, that a financial transaction occurred, and (2) showing, through testimony, the motive for the transaction.

The first of these steps will involve the introduction of evidence under the business records exception to the hearsay rule, Rule 803(6) of the Federal Rules of Evidence, which provides:

The following are not excluded by the hearsay rule, even though the declarant is available as a witness.

. . . .

(6) Records of Regularly Conducted Activity.—A memorandum, report, record, or data compilation, in any form, or acts, events, conditions, opinions, or diagnoses, made at or near the time by, or from information transmitted by, a person with knowledge, if kept in the course of a regularly conducted business activity, and if it was the regular practice of that business activity to make the memorandum, report, record or data compilation, all as shown by testimony of the custodian or other qualified witness . . .

The second step will involve calling a witness with personal knowledge of the transaction to describe the circumstances of its occurrence. If the evidence is a check written to the defendant, the prosecutor will typically call the person who actually wrote the check to describe why she did so. This person need not be an expert in tax law, nor be asked whether the check represented income to the defendant. She merely needs to describe the reason the check was written.

This principle is illustrated by a pivotal criminal tax case from over 40 years ago which still guides the mechanics of how the income-nature of financial transactions is proved at trial.
Max Greenberg was charged with attempting to cause Star Pharmacy, Inc., a small Rhode Island drugstore corporation of which he was president, treasurer and sole stockholder, to file false and fraudulent income tax returns for the years 1952, 1953 and 1954, and two counts of willfully failing to file personal returns for the first two of those years. He was convicted on all counts. *Greenberg v. United States*, 280 F.2d 472 (1st Cir. 1960). He obtained a new trial by successfully attacking the way the prosecution proved his unreported income, claiming that it was dependent on hearsay evidence that should have been excluded.

The government’s case was premised on the theory that pharmacy checks were applied to Greenberg’s personal expenses, resulting in his receiving income (which he did not report) and the corporate listing business expenses to which it was not entitled. To establish the nature of these payments, the prosecution relied solely on the testimony of an IRS agent, who stated the totals of the checks that represented income and non-income in his opinion, and which were personal and which were for corporate purposes. How did the agent make this determination? He claimed it was on the basis of “monthly statements provided by the bank, and from independent corroboration from witnesses,” a determination “based on inquiries made of the payees of the checks, the taxpayer, Mr. Greenberg, or his representative.” For example, on finding that there were corporate checks payable to the telephone company and the light company, the agent went to these companies and concluded that the checks were to pay bills incurred by the defendant at this residence, and were not charges at his place of business. The problem was that the agent’s conclusions were based on out-of-court statements by the payee of the checks of other third-parties, none of whom testified at the trial.

The government argued, unsuccessfully, that the out-of-court statements of the persons interviewed by the agent were not offered for the truthfulness of their assertions as to the nature of the transactions for which these checks were issued, and were solely for the purpose of showing as a fact the reaction of the agent in his determination of the purposes for which the checks issued. This did not fly. According to the court,

Encouraged by this flight from reality the government moves into orbit, if we may use the vernacular . . . The government, however, seems not to realize where it has landed . . . Both in his opening and in his final argument to the jury, the United States attorney discussed the actual purpose of the checks, and nothing else. Of course nothing else was material. It is elementary that this purpose could not be established by what third parties told the witness out of court, or by testimony of what he concluded therefrom.

*United States v. Greenberg*, 280 F.2d 472, 476-7 (1st Cir. 1960).

The lesson of *Greenberg*: to prove the income nature of a financial transaction, litigants must rely on a live witness knowledgeable about the transaction. The mere fact that a particular payment was made, without more, does not suffice to prove income. A witness with personal knowledge of the purpose of the payment must appear in court, or the income nature of the
payment must be established through some other form of admissible evidence.

2.7 Example: Funds from the Wealthy Widower

Criminal tax cases sometimes turn on a jury’s resolution of a controversy regarding the nature of a particular financial transaction. In these cases, the defendant disputes whether the financial transaction that was omitted from their tax returns was “taxable,” or represented an incidence of income. If they succeed, there is no tax fraud, since they had no obligation to report it on their Forms 1040. This type of case is illustrated by the case of Leigh Ann Conley and Lynnette Harris.

Conley and Harris were twin sisters living in Wisconsin during the 1970s. They struck an acquaintance with David Kritzik, a wealthy widower who was partial to the company of young women. Over the course of the next several years, Kritzik gave them funds and items valued at more than half a million dollars, which they failed to report on their federal tax returns. They were charged with tax fraud. In separate criminal trials, Harris and Conley were convicted of willfully evading their income tax obligations regarding the money, and received a 10 month and five month prison sentence, respectively. They appealed, arguing that the transfers they received from Kritzik were non-taxable gifts.

By statute, gifts are not taxable. They are excluded from the definition of “gross income.” 26 U.S.C. § 61. What is meant by a “gift?” A definition was offered by the Supreme Court over forty years ago. In Commissioner v. Duberstein, 363 U.S. 278, 285, 80 S.Ct. 1190, 1196-97, 4 L.Ed.2d 1218 (1960), the Court stated that in distinguishing between income and gifts the "critical consideration . . . is the transferor's intention." A transfer of property is a gift if the transferor acted out of a "detached and disinterested generosity, . . . out of affection, respect, admiration, charity, or like impulses." Id. By contrast, a transfer of property is income if it is the result of ‘the constraining force of any moral or legal duty, constitutes a reward for services rendered, or proceeds from the incentive of anticipated benefit of an economic nature.”

The key issue in the twin sister’s appeal was Kritzik’s intent when he made the transfers, and whether they qualified as gift. The key factual issue, then, was the intent of the donor. Unfortunately, by the time of the trial, Kritzik was dead. He spoke, however, through the letters he had written to Harris before he died, which she kept. The trial court rejected her attempt to introduce them at trial.

The letters were arguably probative of Kritzik’s intent. In them, he wrote that he loved and trusted Harris and that, "so far as the things I give you are concerned - let me say that I get as great if not even greater pleasure in giving than you get in receiving;” that, "I love giving things to you and to see you happy and enjoying them” and "I . . . love you very much and will do all that I can to make you happy.” The trial court nonetheless excluded them as hearsay, reasoning that the letters were out-of-court statements offered to establish the truth of the matters asserted therein.
Finding error in this ruling, Judge Eschback of the Seventh Circuit accepted Harris’ argument that the Kritzik’s letters were offered not for the truth of the matter asserted, but rather to show the effect they had on her – and thereby justify her decision not to report the transfers as income on her return. As a result, they were not hearsay and should have been admitted. *United States v. Harris*, 942 F.2d 1125 (7th Cir 1991).

The *Harris* opinion addressed the important distinction between civil and criminal tax enforcement. An underlying theme of criminal tax jurisprudence is that prosecutions must rest on a violation of a clear rule of law, not on conflict over controversial civil tax treatment of particular transactions. If defendants in a criminal tax case could not have ascertained the legal standards applicable to their conduct, criminal proceedings may not be used to define and punish an alleged failure to conform to those standards."* United States v. Mallas*, 762 F.2d 361, 361 (4th Cir.1985). This rule is based on the Constitution's requirement of due process and its prohibition on *ex post facto* laws; the government must provide reasonable notice of what conduct is subject to criminal punishment. *See id.*, at 363; *see also* Kucharek v. Hanaway, 902 F.2d 513, 518 (7th Cir.1990), *cert. denied*, 498 U.S. 1041, 111 S.Ct. 713, 112 L.Ed.2d 702 (1991).

This rule is also based on the need, in criminal tax cases, to prove that the defendant’s cheating was “willful.” If someone fails to report the receipt of funds that arguably does not meet the definition of “income,” one can argue that their fraud was not willful, but instead a good faith decision about the taxability of certain payments. Consider these criminal tax prosecutions:

- Shortly after his discharge from the U.S. Army in the 1990s, William Irvin had gone to a lonely road in Missouri and prayed that he would become self sufficient and be able to take care of others. A few days later, due to a clerical error, he received a a United States Treasury check for $836,939.19. He deposited the check in a personal savings account at Boatman's Bank and used the proceeds to pay off the mortgage on his father's home, to purchase Jeeps for himself and his wife, to undertake home renovations, make charitable contributions, and for gifts to relatives. He did not report the check as income on his returns, and he spent over $340,000 of the proceeds of the check before the government discovered its error. *United States v. Irvin*, 67 F.3d 670 (8th Cir. 1995).

- Some time in the late 1960's after the birth of her third child, a Florida resident named Dorothy Garber was told that her blood contained a rare antibody useful in the production of blood group typing serum. By a technique called plasmapheresis, a pint of whole blood could be extracted from her arm, the plasma was centrifugally separated, and the red cells were returned to her body. The process could then be repeated. The two bleeds produced one pint of plasma from two pints of blood, and took a total of from one and a half to two and a half hours. By selling her blood between 1971 and 1973 to various biomedical
companies, she received over $70,000 per year and did not report it on her returns. *United States v. Garber*, 607 F.2d 92 (5th Cir. 1979).

- Amy Critzer, an Eastern Cherokee Indian, failed to report a portion of her income derived from the operation of a motel and restaurant, and from the lease of two gift shops and some apartments. Because all of her businesses were located on land in which the defendant had a "possessory holding," and within the Eastern Cherokee Reservation in North Carolina, she claimed it was not clear whether it fit the federal definition of taxable income. *United States v. Critzer*, 498 F.2d 1160 (4th Cir. 1974).

In each of these cases, the defendants argued on appeal that they lacked the requisite intent to cheat on their taxes, since the taxability of the payments was an open question and not sufficiently certain. This argument was successful for Dorothy Garber and Amy Critzer, but not for William Irvin, who had failed to mention the mysterious government check to his accountant. The *Garber* case, which involved the trial court excluding her expert witness who would have opined that the sale of her blood did not result in a net gain, is the origin of the famous phrase that criminal prosecutions are no place for the government to try out "pioneering interpretations of tax law." 607 F.2d at 100. This is a theme that resonates in many of the cases described in this book. In criminal tax cases, the issue is generally not whether a particular financial transaction is taxable, for this is a questions that is easily soluble in civil litigation. Rather, the question is what the defendant believed about the unreported payments when she signed and filed her tax return.

### 2.8 Conclusion

The ten scenarios and the statutes described above will be referred to throughout this book. The same is true of the concept of income, and how litigators go about proving the taxable nature of certain financial transactions. It is important to recognize that proving income – that is, establishing the legal nature of a particular set of transactions – is a powerful skill that is easily transferred to other legal fields, and is really no different than what is done in other law enforcement and national security contexts. In money laundering cases, for example, the prosecutor must prove that the funds involved in a financial transaction were, as a factual matter, the proceeds of some specified unlawful activity. In terrorist financing cases, prosecutors must prove that the intended beneficiary is an particular entity. In civil and criminal cases, fraud is demonstrated the same way. In criminal tax cases, however, prosecutors must avoid the urge to use the prosecutorial tools to pioneer novel tax interpretations, as those cases are best resolved in the civil context. The notion that "dirty money" – proceeds of crime – qualifies as income is well established and hardly novel. However, it is not without limitations.

*Taxing Terrorism*  
J. Breinholt Aug. 2005
Chapter 3 - The Tax Cheating Criminal

If dirty money is taxable, it means that every criminal is a tax cheat, unless they make the rather remarkable decision to report their illegal gains on their tax returns. Is that fair? American policymakers who have considered this question have ultimately been brought around to the thinking that being “fair” to the persons who makes a conscious decision to enter into a life of crime by excusing them from paying tax on their criminal proceeds is not a worthy goal. To do so would be to treat the criminal better than the honest American taxpayer. Besides, crime is a big business. Why should the government not tax illegal revenues?

3.1 Al Capone and Spiro Agnew

On October 10, 1973, Spiro T. Agnew, just minutes after resigning as Vice President of the United States, stood before a visiting judge in a Baltimore courtroom and pleaded nolo contendere to evading his federal income taxes, in violation of 26 U.S.C. § 7201. The judge, Walter E. Hoffman, had been brought up from Alexandria, Virginia to handle the case because Agnew, formerly the Governor of Maryland, was personally acquainted with the state’s federal bench. Judge Hoffman accepted Agnew’s plea and imposed a sentence of a $10,000 fine and three years unsupervised probation. As part of an agreement leading to that resignation, Attorney General Elliot Richardson recommended to Judge Hoffman in open court that no prison sentence be imposed. United States v. Agnew, 428 F.Supp. 1293 (D. Md. 1977). Richardson had incentive to offer this generous term to seal Agnew’s deal, for resignation and plea occurred during the height of the Watergate scandal, when he was a heartbeat away from ascending to the Presidency himself as Richard Nixon got further into trouble -- in part on the basis of allegations that Nixon cheated on his taxes! Had he not got into tax trouble, Spiro Agnew, rather than Gerald Ford, would have become the 38th President of the United States when Nixon resigned less than a year later.

The plea to a tax charge involved a factual stipulation in which Agnew acknowledged receiving over $29,000 in bribery payments. Why the tax charge? In addition to taking the bribes, Agnew failed to report them on his tax returns. It seems that even illegal income – bribes and kickbacks – should have been reported on Agnew’s tax returns. Because they were not, Agnew was not merely a crooked politician. He was also a tax cheat.

This concept has some historical precedent, for tax charges had been used to neutralize the most famous mobster of the Prohibition era. On June 5, 1931, Al Capone was indicted in Chicago for attempting to evade his income taxes for the years 1925, 1926 and 1927. Eleven days later, the famous mobster pleaded guilty. Realizing that his guilty plea would not stop law enforcement, led by Eliot Ness, from continuing to investigate his affairs, Capone changed his plea to not guilty. His counsel then attacked the tax indictment, claiming that it was insufficiently precise to protect Capone against the threat of later prosecution, under the Double
Jeopardy clause of the U.S. Constitution.

The tax charges, inexplicably, did not refer to Capone’s illegal activity that gave rise to his income. In fact, the wording of the charges were rather bland. The indictment contained no reference to illegal liquor sales, to extortion, or to murder. The indictment alleged, *inter alia*, that Capone was married and living with his wife during the calendar year 1925, that he had one dependent, that his annual accounting period was on the basis of the calendar year and not on the basis of a fiscal year, and that his legal residence and principal place of business were within the Northern District of Illinois. This is how the indictment described one of the mobster’s crimes:

[I]n 1925, Capone received gross income of $257,286.98, and was therefore required to file under oath, a return stating specifically the items of his gross income and the deductions and credits allowed under Title II of the Act of Congress aforesaid for the purposes of computation, assessment and collection of any tax imposed by Title II of said Act of Congress.

This meant that Capone’s lawyer was not faced with the prosecution he anticipated, and could not mount the defense he had expected – dealing with Capone’s bootlegging activities and strong-armed tactics. Instead of the legal challenge they expected, Capone’s defense counsel was forced to refute charges that were nearly irrefutable. His attempts to have the case dismissed was rejected, and Capone went to trial. He was convicted of several tax charges in a verdict that was upheld on appeal. *United States v. Capone*, 56 F.2d 927 (7th Cir. 1932). Incarcerated on the tax charges, Al Capone died in prison.

The modern-day version of the Al Capone case played out in a Texas courtroom 50 years later, after two enterprising lawyers from the Department of Justice’s Criminal Division, Dan Fromstein and Karen Morrisette, convinced their higher-ups to authorize what may be one of the strangest criminal tax prosecutions in American history, and proceeded to win it. It started with an unsatisfying state attempted murder prosecution.

### 3.2 The Strange Case of Eugene Tafoya

In 1980 there were some 10,000 Libyans living in the United States. One of them, Faisal Zagallai, was a graduate student at Colorado State University and an outspoken critic of the Qaddafi regime. One of Qaddafi’s intelligence officers, employed at the Libyan Embassy in Washington, contacted another Qaddafi loyalist, who in turn contacted a former Green Beret he knew. That person recruited a jobless friend of his—Eugene Aloys Tafoya, a former U.S. Marine—for the contract killing. On October 14, 1980, a drunken Tafoya, poising as an IBM recruiter, visited Zagallai’s home and tried to shoot him in his living room. The attack left Zagallai blind in one eye. Tafoya escaped through a window.

A few months later, two boys playing in an irrigation ditch near Zagallai’s home found a pistol. The serial numbers were traced back to a North Carolina pawn shop near Fort Bragg and
a person who said he had sold it to Tafoya. Using credit card and rental car receipts, authorities tracked Tafoya down in New Mexico, where a search uncovered a Qaddafi hitlist that included American citizens. Tafoya was tied to rogue CIA operatives Edwin Wilson and Frank Terpil. Wilson was eventually convicted several times in U.S. courts. See United States v. Wilson, 750 F.2d 7 (2d Cir.1984) (obstruction of justice and attempted murder of prosecutors and witnesses); United States v. Wilson, 732 F.2d 404 (5th Cir.1984) (illegal shipment of plastic explosives); United States v. Wilson, 721 F.2d 967 (4th Cir.1983) (illegal export of rifle and revolvers).

The Colorado prosecution of Tafoya for the attempt on Zagallai's life did not include the Qaddafi evidence and, although he was convicted, on January 5, 1982, he received only a two-year sentence.

At that point, Fromstein and Morrisette stepped in, obtaining an tax indictment against Tafoya. Their theory: Tafoya committed a crime by filing 1980 and 1981 federal income tax returns that did not include assassination fees he had received from Edwin Wilson. A jury convicted him. Tafoya was sentenced to three years imprisonment on each tax conviction, to run concurrently. The Fifth Circuit, affirming Tafoya's conviction, rejected his argument that the government was unfairly transforming the murder case into a tax prosecution. United States v. Tafoya, 757 F.2d 1522, 1524 (5th Cir. 1985).

3.3 A Question of Fairness

These cases may be unsettling to aspiring criminals, to whom it seems that law enforcement has an unfair advantage. The Capone, Agnew and Tafoya prosecutions were based on a simple notion: illegal earnings - “dirty money” - qualify as income.

Consider why somebody takes such steps to conceal their income-generating activities. Saving taxes is merely one of many possible motives. The hidden income may derive from some illegal activity, such as drug trafficking or extortion. If the person who makes a living this way reports the proceeds and pays his proper taxes on it, he will likely suffer from the fear that the IRS, if it decides to audit him, will discover the true source of the funds, and report him to the DEA or the FBI. Criminal tax cases are occasionally premised on more than just the bottom line – whether the defendants have concealed the true source of their income even when they accurately report the amount. When someone does this, they can generally be prosecuted for tax fraud, money laundering, and any crime that generated the dirty money. When law enforcement needs to move quickly before the investigation is complete, tax fraud may be the only immediate option available.

Is this surprising? Is it fair? Has it always been this way?

In Chapter 2, we imagined an argument by a defense attorney who finds that his client is charged not only with illegal activity, but also with tax fraud for failing to report illegal income. 

-38-
income on her tax return. The slightly bellicose argument went like this:

*Your honor, this case is absurd. It reflects government overreaching at its worst. If my client was dealing marijuana – a fact we plan to vigorously contest at trial – we cannot actually expect her to report this fact on her tax return. To charge her with tax fraud in addition to the drug counts is unfair. We move to dismiss the tax charges. The government is simply piling on, and we as a people should not tolerate it.*

This argument did not work for Al Capone or for Eugene Tafoya. It was not attempted by Spiro Agnew because he preferred to plead to the tax count. It is unavailing because it does not give the court a legal reason to dismiss the tax charge. It is a naked appeal to fairness, by a self-interested defendant who finds herself in the criminal docket. It does not cite any legal authority or constitutional rule. It should fail.

The reasons for this can be explained by some basic assumptions. First, the United States Constitution, as interpreted by the Supreme Court, establishes certain inviolable rights that are neither negotiable nor subject to electoral whim. From this follows the next logical corollary: that those things not guaranteed by the Constitution are subject to the give-and-take of a vibrant democracy. In America, this means not only the political process of enacting legislation, but also efforts to strike a proper balance between individual liberty and collective security through the establishment and enforcement of certain crimes. Just because something does not seem fair does not mean that it is legally cognizable.

In criminal law, defense lawyers sometimes assert something that sounds like an assertion of a right guaranteed by the Constitution. On occasion, these assertions are found to be not constitutionally-based at all, but essentially complaints about the efficiency of the prosecutorial function. They are really appeals to fairness, as if crime is merely the excuse for a sporting event pitting two lawyers against each other, with the court playing a boxing referee tasked with the responsibility of making sure neither fighter gets knocked out. This, however, is not the proper role for a boxing referee, nor for judges. Courts are bound by Constitution, which sets the basic rules of the adversarial context.

If the government could incapacitate Al Capone or Eugene Tafoya through criminal tax charges without proving the full range of their illegal conduct, the constitution does not stand in the way. It is, after all, not unconstitutional for the government to opt for those charges that have no viable offense. If it is constitutional, it is by definition fair.

Defense counsel would be better advised to refine his argument so that it least has the trappings of a legal argument in a motion to dismiss. Consider *Scenario 9* from Chapter 2 relating to Moni SenGupta, the Los Angeles flower shop owner.

*Scenario 8*: In addition to flowers, Moni sells marijuana out of her store and home. She
does not report her marijuana sales, nor the fact of this illegal business, on her tax returns.

Play this forward and assume that Moni is indicted for signing a tax return which omitted her marijuana business and the $45,000 she earned from its sales. The indictment would look like this.

The Grand Jury charges:

On or about April 15, 2004, in the Central District of California and elsewhere, the defendant,

MONI SENGUPTA,

did willfully subscribe a 2003 individual federal income tax return IRS Form 1040 under penalties of perjury, which return was materially false in that, as the defendant well knew and believed, it omitted $45,000 in income received from the sale of marijuana as well as the source of this income; all in violation of Title 26, United States Code, Section 7206(1)

In another count of the indictment, Moni is charged with drug dealing. Her lawyer contemplates a number of defenses to exonerate her of the tax charges:

- *This is tax fraud? Who in their right mind would report drug sale proceeds on their tax returns?*

- *My client did not know that illegal income was taxable, and her failure to include these funds on her tax returns was not “willfull.”*

- *My client was at no time motivated by a desire to evade taxes. Her concealment instead was solely designed to cover her criminal conduct. Taxes never crossed her mind.*

- *The tax charges make reference to other illegal activity – marijuana dealing – which the prejudice the jury against my client and make a fair judgment on the tax charges impossible.*

- *My client has a Fifth Amendment right not to incriminate herself, which he exercised by not including a description of her alleged marijuana business on her tax return.*
Now consider Scenario 10 from Chapter 2, involving Kevin Downing, the New Jersey motorboat mechanic.

Scenario 9: Kevin realizes that, in the course of his work at ShoreCraft, he can secretly pocket some of the customer payments for his services. Meanwhile, he can prepare paperwork reflecting that the customer has paid only that amount that ShoreCraft receives, which is recorded as gross business receipts by the company bookkeepers, and which omit the monies he pockets. ShoreCraft, which is oblivious to Kevin’s theft, does not include the pocketed customer payments on Kevin’s Form W-2. On his tax return, Kevin reports only his salary and withholdings and does not include the portion of the customer payments he secretly pocketed.

Because the embezzlement is a state crime, Kevin is never charged with the theft. An enterprising federal prosecutor takes a look at the facts and presents the following indictment to the grand jury.

The Grand Jury charges:

On or about April 15, 2004, in the District of New Jersey and elsewhere, the defendant,

KEVIN DOWNING

did willfully subscribe a 2003 individual federal income tax return IRS Form 1040 under penalties of perjury, which return was materially false in that, as the defendant well knew and believed, it omitted $13,000 in income he received through embezzlement of his employer, all in violation of Title 26, United States Code, Section 7206(1)

In addition to some of the arguments considered by Moni’s lawyers, Kevin’ counsel contemplates this one:

• The funds my client allegedly received from alleged embezzlement are not income to him, because he would have been required to pay them back if caught.

These arguments, which are a great improvement from the initial one, are not unrealistic, nor are they hypothetical. They are made regularly by actual accused criminals, and have generated case law. How U.S. courts have dealt with these arguments is considered in the succeeding chapters, which deal with embezzlers, crooked accountants, unscrupulous doctors, drug dealers, dirty lawyers, and corrupt public servants who found themselves charged with tax crimes.
3.4 Conclusion

The notion of the “tax cheating criminal” runs through this book. It does not mean that tax cheating is a crime, which is merely a truism. Rather, it is based on the idea that criminal tax charges are useful supplements (or alternatives) to conduct that goes beyond “mere” tax fraud - to persons engaged in embezzlement, bookmaking, narcotics, public corruption, and even terrorism and espionage. Cases falling in these categories are discussed in the next five chapters.
Chapter 4: The Embezzlers

For criminal tax laws to be useful against people who engage in more than just tax fraud, the proceeds from some illegal scheme must be taxable. If it is not, there is no fraud in failing to include it on tax returns. Do illegal earnings qualify as income? This chapter considers that question in the context of embezzlement.

4.1 Eugene James and the Taxability of Embezzlement

Eugene James was a union official who, between 1951 and 1954, embezzled over $738,000 from the union and an insurance company with which the union was doing business. Failing to report the embezzlement proceeds on his tax return, James was convicted of tax perjury and tax evasion, and sentenced to three years in prison. *James v. United States*, 81 S.Ct. 1052 (1961)

At the time of James’ conviction, there was United States Supreme Court precedent for the proposition that embezzlement proceeds did not qualify as “income,” because the embezzler, if caught, would have a legal obligation to pay restitution to the victim of the embezzlement scheme and therefore had not really received unconditional control over the funds. *Commissioner of Internal Revenue v. Wilcox*, 327 U.S. 404, 66 S.Ct. 546, 90 L.Ed. 752 (1946). Six years after Wilcox, however, the Supreme Court held that proceeds of extortion schemes qualified as income. *Rutkin v. United States*, 343 U.S. 130, 72 S.Ct. 571, 96 L.Ed. 833 (1952). Thereafter, the lower courts tried valiantly to harmonize the two seemingly inconsistent opinions, generally by examining whether the victim of illegal schemes were likely to seek restitution.2 In 1961, the Supreme Court decided to use Eugene James’ case to resolve the issue.

The Court in *James* noted the legislative history of the U.S. income tax system which recognized both lawful and unlawful gains as falling within the definition of “gross income:”

Section II B of the Income Tax Act of 1913 provided that “the net income of a taxable person shall include gains, profits, and income . . . from . . . the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever . . . .” 38 Stat. 167. When the statute was amended in 1916, the one word “lawful” was omitted. This revealed, we think, the obvious intent of that Congress to tax income derived from both legal and illegal sources, to remove the incongruity of having the gains of the honest laborer taxed and the gains of the dishonest immune.

---


Taxing Terrorism

J. Breinholt Aug. 2005
Since then, the Court noted, gross income was found to include gains from illicit activity.

This argument makes perfect sense. If the word “lawfully” was dropped from the definition of “income,” we can conclude that Congress intended unlawful proceeds to be taxable. As the Court noted, since 1916, income has included proceeds from the illegal traffic in liquor, protection payments made to racketeers, ransom payments paid to kidnappers, bribes, money derived from the sale of unlawful insurance policies, graft, black market gains, funds obtained from the operation of lotteries, income from race track bookmaking and illegal prize fight pictures.

In *James*, the Court reasoned that, when determining taxability, there was little reason to distinguish between the proceeds of embezzlement (as in *Wilcox*) and extortion (in *Rutkin*):

When a law-abiding taxpayer mistakenly receives income in one year, which receipt is assailed and found to be invalid in a subsequent year, the taxpayer must nonetheless report the amount as 'gross income' in the year received [citation omitted]. We do not believe that Congress intended to treat a law-breaking taxpayer differently. ...

We should not continue to confound confusion, particularly when the result would be to perpetuate the injustice of relieving embezzlers of the duty of paying income taxes on the money they enrich themselves with through theft while honest people pay their taxes on every conceivable type of income.

The dissenting opinion, written by Justice Hugo Black, suggested that victims of embezzlement would be hurt by the majority opinion in *James*, since it basically allowed the United States “a preferential claim for part of the dishonest gain, to the direct loss and detriment of those to whom it ought to be restored:”

The rightful owner who has entrusted his funds to an employee or agent has troubles enough when those funds are embezzled without having the Federal Government step in with its powerful claim that the embezzlement is a taxable event automatically subjecting part of those funds (still belonging to the owner) to the waiting hands of the Government's tax gatherer. We say part of the owner's funds because it is on the supposed 'gain' from them that the embezzler is now held to be duty-bound to pay the tax and history probably records few instances of independently wealthy embezzlers who have had nonstolen assets available for payment of taxes.

Justice Black’s sentiment did not carry the day. The affirmance of Eugene James’ conviction was followed by the conviction of many other embezzlers over the next 40 years. Some of them involved tax professionals who, perhaps more than most, have less of an excuse to
be ignorant about the taxability of embezzlement income.

4.2 Some Crooked Accountants

In the early 1960s, a Nebraska accountant named Edward Milder devised an elaborate scheme to steal from an oil company that was one of his clients. Milder overstated the amounts which the oil company was required to pay for excise taxes, causing company checks to be drawn for these inflated amounts, and then applied the excess funds to the tax obligations of his other clients. When the clients provided him with checks with which to pay their taxes, Milder cashed these checks and placed the currency in a box in his office. The oil company eventually became suspicious, discovered the embezzlement, and demanded restitution. Milder obliged. He never reported the proceeds as income, nor did he deduct the repayment as an expense. *United States v. Milder*, 459 F.2d 801 (8th Cir. 1972).

Thirty years later, Anita Guidry, the controller of Wichita Sheet Metal, managed to steal some three million dollars from her employer. As an authorized signatory on the company checking account, she submitted checks, already signed by her and made payable to the company's bank, to the company owners for their signature. She wrote the checks in $10,000 or $9,000 increments, telling the owners that the checks were for federal tax payments. After collecting the proper signature, Guidry cashed the checks at the company bank and pocketed the cash. To prevent discovery of her scheme, Guidry altered the company's books to make it appear the money she had taken was actually used to purchase inventory for the company, which created a discrepancy between the actual inventory and the inventory reflected on the company's books. The company's owners eventually asked for a detailed audit of the discrepancy, which ultimately uncovered the scheme. The income Guidry reported on her 1993, 1994 and 1995 income tax returns did not include the embezzled proceeds. *United States v. Guidry*, 199 F.3d 1150 (10th Cir. 1999).

In their appeal from their convictions, Edward Milder and Anita Guidry tried a similar defense. They argued that, despite being accountants, they were not aware that embezzlement proceeds were taxable. That is, that claimed they just did not know.

Their arguments took slightly different forms. Milder claimed that the jury should have been instructed with regard to his alleged lack of familiarity with the *James* decision and the effect of this ignorance upon the element of criminal intent. Guidry argued that the "only" evidence supporting willfulness consists of her background and experience in accounting, the testimony to the effect that IRS documents listed embezzled income as taxable income, and the IRS agent’s testimony he observed some of the tax booklets in Mrs. Guidry's files at her home.

Note that these arguments are similar to one of the arguments presented in the previous chapter, in response to Scenario 8:

*Moni’s lawyer:*  *My client did not know that illegal income was taxable.*
and her failure to include these funds on her tax returns was not “willful.”

These arguments failed. In Milder, the court noted that willfulness was a state of mind and, where it is controverted, was for the jury to resolve. It noted that Milder had been permitted to testify in detail regarding his claimed belief that the money in question was not taxable and the alleged basis for this belief, so the jury squarely faced (and resolved) the issue. 459 F.2d at 804. The court in Guidry focused on her unique background as an accountant:

[T]he jury heard evidence of Mrs. Guidry's expertise in accounting via her degree in business and her work experience as the controller of a company. The evidence showed Mrs. Guidry prepared the family taxes, and did so "elaborately" according to her husband. An investigator observed tax booklets from unknown years in Mrs. Guidry's files, and the jury learned the tax booklets specific to the years in question in this case either stated embezzled income should be reported, or referenced a second Internal Revenue Service document where taxpayers might receive that information. The evidence also showed: an ever-burgeoning disparity between the Guidrys' reported income and their actual income as complemented by the embezzlement scheme; the embezzled cash was used to purchase goods, making the money more difficult to detect; the Guidrys took significant charitable deductions on their taxes while not reporting the embezzled income; and the money was embezzled in increments of $9,000 or $10,000. Mrs. Guidry argues the jury should not have been allowed to take evidence of the embezzlement scheme itself into account, but such an argument defies logic.

199 F.3d at 1157.

A similar argument, though with a slight variation, was tried by another accountant after he was caught, tried and convicted of tax fraud based on an embezzlement scheme. It was more akin to the argument made by Kevin Downing’s lawyer in the previous chapter, in response to Scenario 9:

Kevin’s lawyer: The funds my client allegedly received from alleged embezzlement are not income to him, because he would have been required to pay them back if caught.

Larry Tarwater, a certified public accountant, was retained in 1997 by Jefferson Memorial Hospital in Knoxville, Tennessee to perform its annual audit and to prepare its annual Medicare and Medicaid cost reports. When he was hired, the hospital had a consulting arrangement with a reimbursement specialist named Willie Davis, who worked on a contingent basis. When the hospital’s Chief Financial Officer, Karen Bradley Chambers, became suspicious
of Davis’ honesty and refused to work with him, the hospital continued with his contract while transferring the responsibility for paying him to Tarwater.

It turned out to be a bad arrangement. Chambers tried to institute an audit review process to determine the correctness and propriety of the hospital's payments to Davis through Tarwater and complained about the absence of an audit trail, to no avail. The hospital became suspicious that some of the monies appeared to end up in Tarwater’s bank account.

In October, 1994, the hospital’s board of directors held a meeting at which Tarwater was asked about Davis. Tarwater explained who Davis was, what he did for the hospital, and why monies intended for Davis were passed through Tarwater. Tarwater claimed that Davis would call him from Florida and state that he needed payment, and that instead of making a trip to Jefferson City, Tarwater would pay Davis's firm then get reimbursed from the hospital next time he was in town.

Tarwater was terminated, and the board brought in an outside accounting firm to investigate. During an interview, Tarwater claimed that he cashed checks for Davis – sending Davis either the cash, a wire transfer, or a cashier's check--on the not-infrequent occasions when the hospital issued him two checks at a time.

The IRS began an investigation of Tarwater's tax returns for the years 1991 through 1994. When Tarwater both declined to discuss any tax matters with the revenue agent and refused to turn over his personal and corporate records, a summons was issued to Tarwater's bank and accounting firm. Over Tarwater's objection, the records were ultimately obtained by court order. The IRS’ review of those records resulted in Tarwater's indictment on three counts of filing false tax returns – for the years 1992, 1993, and 1994 – in violation of 26 U.S.C. § 7206(1).

Tarwater's case was tried before a jury for five days beginning in late April, 2001. Through the testimony of two IRS agents, Mary Barton and Karen Jackson, the government presented evidence that Tarwater deposited the monies he received from the hospital into four separate accounts at Third National Bank in Knoxville. In 1992, the hospital issued Tarwater twelve checks for a total of $73,460 for work allegedly performed by Davis. Of the total 1992 checks intended for Davis, Tarwater deposited $45,010 in his partnership accounts at Third National Bank. The remaining $28,450 was deposited into his Tarwater, CPA, Account. Contrary to what Tarwater had told the outside accountants, none of the twelve checks was cashed or endorsed over to Davis. In 1993, Tarwater deposited $28,000 of the Davis checks into his bank account. He was convicted.

On appeal from his conviction, Tarwater did not dispute that a sizeable amount of the monies he received from the hospital was not reported as gross income on his tax returns. He argued that the "Willie Davis" monies did not constitute gross income that he should have reported on his tax return. He suggested that he did not report the Willie Davis monies because
he did not believe those monies constituted income to him, challenging the jury's finding that he did not believe his returns to be true and correct.

Thus, unlike Anita Guildor, Larry Tarwater did not argue that he was ignorant of the taxability of embezzlement proceeds. Instead, he opted for a slight alternative argument—that he did not believe the funds were proceeds of embezzlement. The court dealt with these arguments by recounting the caselaw where defendants’ conduct of avoiding standard recordkeeping was the basis for inferring willfulness:

Mindful that section 7206(1) is a perjury statute, requiring the government to prove that a defendant did not believe his or her tax return to be true and correct, several courts have determined that evidence of a defendant's attempts to avoid making records, to conceal assets, or to mislead others is probative of the did-not-believe-the-return-to-be-true element of a section 7206(1) offense. For example, in United States v. Scott, 660 F.2d 1145, 1160 (7th Cir.1981), cert. denied, 455 U.S. 907, 102 S.Ct. 1252, 71 L.Ed.2d 445 (1982), the court determined that the jury had a sufficient basis from which to infer that the defendant did not believe his tax return to be true and correct where the evidence demonstrated (1) that the defendant was a lawyer and an experienced banker who typically invested most of his money derived from ordinary and legitimate sources in high yield interest bearing securities or certificates of deposit; (2) that the defendant secreted large amounts of cash in safe deposit boxes, which was very much out of character for a man who so carefully invested and earned interest on his other funds; (3) that the defendant failed to keep records of his living and travel expenses; and (4) that the defendant made statements to the Tax Division of the Department of Justice which "the jury could have believed ... to be false exculpatory statements, evidencing an intent to mislead or conceal. Scott, 660 F.2d at 1160. See also United States v. Kaatz, 705 F.2d 1237, 1246 (10th Cir.1983) (explaining that the jury could infer willfulness from evidence that the defendants "handled their affairs so as to avoid making the records usual to the businesses which they operated, and they did not disclose to their accountant the receipts which they diverted").

It is interesting that, in these three cases involving crooked accountants, Edward Milder was the only one who tried to take on James directly. He argued that the money he embezzled—which he paid back to the victim—should not be taxable to him. The 8th Circuit disposed of this argument easily by citing the James opinion and rejecting Milder’s suggestion that it should not be followed or overruled. 459 F.2d at 804.

Should accountants be held to a higher standard when judging their willfulness in omitting embezzlement proceeds from their tax returns? Whether they should be, the fact is that they are. Consider the case of an Alaska IRS agent named Joseph Wilson. It seemed that, in the late 1990s, his family went from having difficulty meeting the costs of basic necessities to
having tens of thousands of dollars to spend on luxury purchases and gambling junkets. This resulted from Wilson’s wife, Sara, stealing from her employer, and running some of the money through casino marker accounts. Because Joe Wilson signed their joint returns and seemed to be aware of this increase in disposable money, he was charged and convicted with tax fraud and money laundering. Rejecting Joe’s challenge to the sufficiency of the evidence, the Ninth Circuit emphasized his professional background:

The jury could easily have concluded from the evidence that Wilson, an IRS Revenue Officer with several superior performance commendations, must have known that the family's legal income alone could not support their lifestyle, and that he had to know that the money came from Sara's embezzlement activities. Thus, there was sufficient evidence to support a rational fact finder in concluding that Wilson had actual subjective knowledge of Sara's embezzling and that all the elements of Wilson's aiding and abetting charges were met beyond a reasonable doubt. The fact that the evidence was almost all circumstantial is irrelevant: ... We therefore hold that there was sufficient evidence to support Wilson's wire fraud aiding and abetting convictions.


4.3. The Occurrence of Embezzlement: The Sinking Ship

If persons who make a living performing financial services for others cannot claim ignorance of the taxability of embezzlement, they may try another tact – that they were merely “borrowing” from their clients to make ends meet, fully expecting that they would return the funds once the hard times were over. This argument is similar to the one made by Kevin Downing’s lawyer in the previous section – that the embezzlement proceeds were not income to him, because he would have been required to pay them back if caught. Persons in this situation sometimes reject the characterization of their acts as embezzlement. Instead, they claim they were merely borrowing from their unwitting clients, and therefore they never formed the requisite intent to control the stolen funds. Therefore, the funds did not qualify as income, and they did not willfully fail to report them.

This is the argument tried by Gregory and Dee Ervasti, the married Minnesota couple who ran Corporate Financial Services, Inc. (CFS) in the 1990s. CFS offered its clients a number of services, including the calculation and satisfaction of employee payroll tax obligations.

As described in Chapter 1, employers are required to withhold a portion of their employee paychecks to satisfy the employee tax obligations, and they issue a Form W-2 to the employees and the IRS at the end of the calendar year. Employers are required to report and remit these withheld amounts, plus the employer’s portion of the tax and benefit obligation, to the IRS on a quarterly basis. This is done through the filing of a document known as a Form
The Ervastis, through CFS, performed these functions for other companies. They were eventually charged and convicted of misappropriating over $5.7 million of impounded tax monies from over 100 CFC clients.

How did this happen? Unbeknownst to CFS's clients, the Ervastis from time to time would take funds from the tax account and use them for operating expenses, such as meeting CFS's own payroll. At trial, the Ervastis characterized this practice as "borrowing from the float," that is, using the impounded tax monies during the period between its collection and its deposit with the IRS. As the court noted, the "float" soon began to sink. CFS had chronic cash flow problems and could not meet its own expenses. Although the Ervastis continued to submit the Forms 941 on time, those filings often were not accompanied by a corresponding tax deposit, since they had spent the client's money. They misrepresented that the money due had been timely deposited when it had not. Dee Ervasti signed and submitted many Forms 941 falsely indicating that the amount due had been timely paid. When the Forms 941 were filed, the Ervastis notified their clients that the taxes had been timely paid, when they often had not.

Besides the legal implications, the Ervastis' conduct had disastrous financial consequences for CFS. The late deposits to the IRS triggered a cascade of penalties and interest. By September 1995, CFS's finances were collapsing. By the end, more than 100 clients still owed money to the IRS. Many former CFS clients ended up, in essence, paying their taxes twice: first to the Ervastis and again to the IRS, with penalties and interest. A September 1995 accounting, compiled under Greg Ervasti's direction to assess CFS's debt for the bankruptcy proceedings, revealed that the difference between the amount of impounded tax monies CFS received from its clients and the amount the Ervastis actually deposited with the IRS was over $5.7 million.

Eventually, the IRS caught up with them. They were charged and convicted of mail and tax fraud. On appeal, they argued that there was insufficient evidence to support those convictions, since they just "ended up piloting a sinking ship" and no reasonable jury could come to the conclusion that they intended to harm their clients or defraud the IRS. Rejecting these arguments, the court deferred to the jury’s findings. With regard to the tax charges, it noted,

Here, the numerous purposefully falsified Forms 941, as well as the Ervastis' misrepresentations to the IRS and to their clients that taxes had been paid when they had not, provide sufficient evidence from which a factfinder reasonably could conclude that the Ervastis had a purpose and object to impede and impair the IRS in the performance of its duties. The evidence in support of the [tax] conspiracy is sufficient to support the jury's verdict.

*United States v. Ervasti*, 201 F.3d 1029, 1038 (8th Cir. 2000).

Gregory and Dee Ervasti were sentenced to prison terms of 63 months and 48 months, respectively.
4.4 Corporate Skimming

There is a unique brand of embezzlement that is limited to people who occupy a sufficiently high level in an organization for them to control how monies are used and expenses are booked. Criminal tax practitioners have come to refer to this type of embezzlement as “corporate skimming.” The result is a double fraud on the IRS.

Consider these three scenarios from Chapter 1:

Scenario 6: Moni systematically omits a portion of the gross receipts she reports on her Schedule C, by taking cash out of the cash register before it is recorded on the flower shop’s books and records.

Scenario 7: Moni records some of her personal living expenses (such as her apartment payment and grocery sales) as business expenses of the flower shop.

Scenario 10: Kevin realizes that, in the course of his work at ShoreCraft, he can secretly pocket some of the customer payments for his services. Meanwhile, he can prepare paperwork reflecting that the customer has paid only that amount that ShoreCraft receives, which is recorded as gross business receipts by the company bookkeepers, and which omit the monies he pockets. ShoreCraft, which is oblivious to Kevin’s theft, does not include the pocketed customer payments on Kevin’s Form W-2. On his tax return, Kevin reports only his salary and withholdings and does not include the customer receipts he secretly pocketed.

A true corporate skim is a scheme in which a portion of a company’s earnings are paid directly to its owners while being kept off of the company’s books. If the individuals receiving those funds fail to report them on their individual income tax returns, the result is a double fraud: both the corporation and the individual owners have understated their actual income on their respective income tax returns. Of the three scenarios above, Scenario 10 is probably the closest to a true skim, since it involves two taxpayers: Kevin Downing and Shorecraft Inc. If they are the same taxable entity, Moni SenGupta and her flower shop, the result is not a double fraud. Instead, the fraud is defined by the single amount by which Moni’s total tax is understated.

The last 15 years have seen a number of prominent Americans convicted of tax crimes taking advantage of the institutions they controlled, some with more complicated versions of these three scenarios.

4.5 Leona Helmsley and William Aramony

When Leona Helmsley, prominent New York hotel heiress of the 1980s, got caught with her hand in the cookie jar, she could not be saved even with the best legal talent money could buy. Her August 1989 convictions included tax fraud, and revolved around her scheme to...
charge personal expenditures to various business enterprises. She ultimately received a four-year prison sentence, based on unreported income of over $2.5 million and an attempted tax fraud of over $1.2 million. The Helmsley case illustrates the concept of a double tax fraud. It was a more complicated version of Scenario 7, and involved a larger fraud.

In June 1983, Helmsley and her husband purchased a 21-room mansion known as Dunnellen Hall in Greenwich, Connecticut, and undertook major renovation and decoration of it, including a $2 million addition that enclosed one of two swimming pools and featured a rooftop marble dance floor, four jade art pieces costing $500,000, and an indoor/outdoor stereo system worth over $100,000. The Helmsleys also did extensive gardening and landscaping work. Beginning at the end of 1983 and continuing for two more years, the Helmsleys schemed to charge personal expenses associated with Dunnellen Hall and elsewhere to various Helmsley business entities. With the collaboration of Joseph V. Licari, Senior Vice President and Chief Financial Officer of HEI, and Frank J. Turco, Vice President and Chief of Financial Services for Helmsley Hotels, the Helmsleys arranged for hundreds of thousands of dollars of their personal expenses to be paid by companies they owned and controlled and to be carried on the company books as business expenditures.

The result of the fraud was a double tax benefit. First, by having the companies pay the expenses rather than distribute taxable income to the Helmsleys, the Helmsleys avoided personal income taxes. Second, because the various Helmsley companies involved treated the payment of these personal expenses as business expenditures, the companies enjoyed artificially inflated business expense deductions. The tax returns filed by the Helmsleys and by the various firms reflected the false billings.

Meanwhile, a New York Post reporter, Ransdell Pierson, had at one time pursued a tip about the misuse of corporate funds by the Helmsleys but had abandoned the quest after finding little hard evidence. However, an investigation into a sales tax avoidance scheme by two jewelers had caused Mrs. Helmsley to make two appearances before state grand juries during which she gave immunized testimony. Some time later, a New York Times article implicated Mrs. Helmsley in the state sales tax avoidance scheme. Pierson's interest was renewed by the Times story, and, tipped by a disgruntled former Helmsley employee named Jeremiah McCarthy, Pierson published an article in the Post on December 2, 1986, stating that the Helmsleys had used false invoices to pay personal expenses with corporate funds. This article triggered investigations by both the United States Attorney for the Southern District of New York and the New York State Attorney General. Their investigations, later combined, resulted in the federal indictment that is the genesis of the instant case and in a separate state indictment, since withdrawn.

Helmsley’s main argument on appeal to the tax charges involves the claim that, as a civil tax matter, she actually overpaid her taxes during the years in question. The Second Circuit, an an opinion written by Judge Winter, rejected this argument, which was based on proffered expert testimony about how the Helmsleys could have hypothetically structured their
assets. It also rejected her claim that the government had failed to be consistent in characterizing the nature of the false deductions on the corporate returns. *United States v. Helmsley*, 941 F.2d 71 (2nd Cir. 1991).

A similar fate awaited prominent charity executive William Aramony a few years later, although his scheme did not involve a corporation paying for a dream house. Instead, Aramony got caught taking advantage of a prominent U.S. charity to help him maintain his romances with young women.

In 1970, Aramony became chief executive of the United Way of America (UWA), the nonprofit organization that acts as a service organization for local United Way organizations located throughout the United States. This position made him one of the most prominent individuals in American philanthropy. His friend, Thomas Merlo, a certified public accountant, became UWA’s chief financial officer in 1989. A third executive, Stephen Paulachak began working for UWA in the 1970s. Beginning in the mid-1980s, the three were involved in a plot to use UWA funds or personal gain.

Aramony dated Lori Villasor from December 1986 to July 1990. He travelled to Gainesville, Florida, Villasor's hometown, at least once a month to visit her, with UWA paying for these trips. On some of his trips Aramony used UWA money to pay for rental cars. Aramony used UWA money to help pay for taking Villasor with him on UWA business trips and vacations. In December 1988, he took her to London and Paris for her birthday. In December 1989, he took her on a two-week trip to London and Cairo. And in April 1990, he used UWA money to fly Villasor to London, England to be with him while he and Paulachak attended a board meeting. Merlo gave Laura Shifflet, one of Aramony's assistants, his UWA corporate credit card number so that she could use it to charge Villasor's airline tickets.

Aramony used Merlo to provide Villasor with money. From 1988 to 1991, Merlo received over $300,000 in consulting fees despite doing no work for the money. Merlo, in turn, paid Villasor a total of $89,000 over this period. One manner of getting Villasor this money was to have Merlo pay her a monthly salary despite Villasor doing, at the most, only a day or two of work.

Anita Terranova lived in Florida and had a long history with Aramony. As with Villasor, Aramony often traveled to Florida at UWA expense to visit her. Importantly, Aramony bought a condominium in Florida to rendez-vous with her. The money for this apartment came from a donation that Mutual of America (MOA)--an insurance company that did business with UWA--made to UWA

Aramony’s perfidy did not stop with young women. When he visited New York, he often used the chauffeuring service of Charles Harrison. From 1988 to 1990, incurred over $100,000 chauffering expenses. Although Aramony used the service for UWA business, he also used it for personal business which he billed to the company. All of the expenses were paid by
Aramony and Merlo were convicted of conspiracy to defraud the United States by impeding the lawful functions of the IRS, mail fraud, wire fraud, interstate transportation of fraudulently acquired property, money laundering, and filing false tax returns. Aramony unsuccessfullly argued on appeal that the district court admitted inflammatory and unfairly prejudicial evidence depicting his sexual misconduct, including the fact that one of his paramours was under age. This type of defense is addressed in later chapters. United States v. Aramony, 88 F.3d 1369 (4th Cir. 1996).

4.6 Some Unscrupulous Doctors

For some reason, physicians have been known to engage in the act of corporate skimming involving their medical practices.

Dale Grunewald is a Iowa physician who practiced medicine in the Medical Services Partnership from 1975 through 1987. He was in charge of maintaining the partnership books and records, and was solely responsible for calculating and paying the partners their respective partnership draws. In 1983, he was appointed medical director of a medical clinic, and payments for his services in this position were deposited into the partnership account. Beginning in January 1985, these payments and all 1099 forms were sent directly to Grunewald's home and not deposited into the partnership account, and he did not enter the payments in the partnership books and records. Instead, Grunewald endorsed each of the checks and deposited them into his personal bank account.

Midway through 1985, Grunewald's partners noticed that their income had decreased, and they confronted him. Grunewald convinced them that the salary he received from the medical clinic was not partnership income. The accountant who prepared the tax returns for the partnership and for each of the individual partners relied solely upon information provided to him by Grunewald, and Grunewald did not inform him that he had received any income from Mercy, nor did he inform the accountant that there was $63,000 in income each year that was not reflected in the partnership books and records.

In May 1987, one of Grunewald's partners approached a patient who was an IRS agent, and told him that Grunewald was not depositing money received from the medical clinic in the partnership account and was not reporting this income on his personal tax returns. Throughout the IRS investigation, Grunewald assured agents that his salary from the clinic had been deposited into the partnership account, and had been reported to the IRS by the partnership. He eventually acknowledged the truth and was indicted and ultimately convicted. On appeal, he unsuccessfully argued that his statements to the IRS should have been suppressed since they were obtained in a criminal investigation under the guise of a civil audit. (This argument is a recurring issue in criminal tax jurisprudence, and is discussed in Chapter 9.) United States v. Grunewald, 987 F.2d 531 (8th Cir. 1993).
The tax fraud scheme crafted by doctors Frank Kresock and Rosemary DePaoli of Scranton, Pennsylvania was slightly different. A married couple, Kresock was a cardiologist while DePaoli was a dermatologist. In 1988, they formed a medical corporation known as Columbia Medical Group, Inc., with each owning one-half of the shares and both acted as the corporation's employees, lessors and creditors.

In 1995, a routine IRS audit of the medical practice’s 1993 corporate tax return led to a criminal investigation. Kresock and DePaoli used corporate funds to purchase thousands of dollars worth of guns and jewelry, misrepresenting these purchases to the accounts as "office supplies." With corporate funds, they purchased several vehicles, including a Ferrari Testarossa and Harley Davidson motorcycles, and dipped into the practice to renovate their vacation home, purchase jewelry, gold coins and many other personal items and services, including child care, home furnishings, groceries, diapers, children's toys, tampons and mustache wax. Many of Kresock's receipts were altered. They did not declare the personal expenses they paid for with the practice’s funds as income on their personal tax returns. Instead the expenses frequently were treated as business-related items on the corporate returns.

The scheme was a classic corporate skim, similar to Scenario 8. The doctors took steps to conceal the personal nature of the corporation's expenditures by falsely coding the check stubs to make the expenses appear businessrelated. The purchase of a Harley Davidson motorcycle, for example, was coded as "equipment rental" for a cardiac echo machine. They also omitted income on their personal tax returns from other sources, including fees from speaking engagements and for work performed at Bloomsburg Hospital. A jury convicted them of tax fraud. Kresock received a 20-month prison sentence, while DePaoli received 16-months.

Mahendra K. Tandon ran the Saint Clair Industrial Medical Center in Cleveland, Ohio during the 1980s. In April 1985, Tandon had purchased the property where his medical practice was located, but soon began taking steps to conceal his ownership of it, despite continuing to pay the mortgage on the property and also depreciated it on his 1986 and 1987 income tax returns and receiving the rental money generated by apartments and a garage located on the property. His personal income tax returns understated the income received from his medical practice. In addition, Superior Medical's corporate return for 1988 failed to report tens of thousands of dollars in medical income and Tandon's personal income tax return for 1988 failed to report the income omitted from the corporate return, which Tandon was directly involved in preparing.

In what turned out to be a very bad move, Tandon depreciated a Rolls-Royce he had leased at the end of 1986 on his 1986 and 1987 returns, and Superior Medical depreciated the vehicle on its 1988 corporate return, even though this could not be done under the tax code because neither Tandon nor Superior Medical owned the car. Tandon also reported the depreciation of the vehicle so that the IRS had no way of knowing that it was a car that was being depreciated; nowhere on any of the returns was the car described or identified and it was
depreciated in a section of the returns that specifically stated, "Do not use this part for automobiles."

Tandon also funneled money from his medical practice into several different accounts. The receipts from Superior Medical were deposited into various accounts to which Tandon had access, although his name did not appear on all of them.

Following a civil audit that prompted Tandon to file amended tax returns, the case was referred for criminal investigation. Tandon then tried to stall the investigation and gave a series of misleading statements. After indictment and a jury trial, Tandon was convicted on three counts of willfully filing false personal income tax returns for the years 1986, 1987, and 1988, in violation of § 7206(1), and one count of willfully aiding and assisting in the filing of a false corporate return for the year 1988, in violation of § 7206(2). The district court sentenced him to 18 months in prison. The conviction was upheld on appeal, which focused on Tandon’s claim that the depreciation of the Rolls Royce was the result of professional advice he had received. United States v. Tandon, 111 F.3d 482 (6th Cir. 1997).

4.7 Conclusion

In addition to being taxable, embezzlement schemes frequently involve the fabrication of records that necessarily result in false returns being filed by other entities or people, raising the specter of a double tax fraud. It is no surprise, given the well-established principle that embezzlement proceeds are income, that embezzlers often find themselves charged with tax fraud in addition to theft. Is that necessarily automatic? The next chapter discusses this issue.
Chapter 5 Embezzlement (Part 2): A Question of Motive

In Chapter 4, we saw some embezzlement schemes that involved more than one person. The Ervastis were a husband-wife team, as were doctors Frank Kresock and Rosemary DePaoli. Leona Helmsley and William Aramony probably could not have achieved their frauds without some other people helping them. These four cases were conspiracies.

Conspiracy cases are unique because they require prosecutors to establish an agreement to undertake some illegal object, to prove the defendants’ motive. While criminal prosecutions typically involve proof of criminal intent, motive is generally not an element of the offense. The crime of conspiracy is an exception to this rule. Criminal tax has its own unique type of conspiracy. This chapter discusses how the tax conspiracy has been used in embezzlement cases, and the requisite motive that must be demonstrated.

5.1 Tax Conspiracy (Klein)

There is a particular type of conspiracy theory that is frequently used in tax case. Known as a Klein conspiracy, it relies on the general conspiracy provision of the U.S. Criminal Code:

§ 371. Conspiracy to commit offense or to defraud United States.

If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined under this title or imprisoned not more than five years, or both.

A conspiracy to defraud the IRS is known as a Klein conspiracy, based on the New York case that first recognized it. Hyman Harvey Klein, Maurice Haas, and Morris O. Alprin in the late 1940s used seventeen foreign corporations to carry on their business operations to hide income and evade taxes, and they were convicted of conspiracy despite their success in getting some of the substantive tax charges dismissed at trial. Their convictions under § 371 were affirmed by the Second Circuit, with Judge Clark noting, “Here tremendous American profits were skillfully concealed from the [tax] collectors' eyes until they were uncovered by this patient investigation and trial. The result should be salutary.” United States v. Klein, 247 F.2d 908 (2nd Cir. 1957).

The Klein conspiracy is one of the tools that make criminal tax so efficacious in redressing illegal activity that transcends “mere” tax fraud, for criminal defendants are frequently charged in a single multiple-object § 371 conspiracy, in which one of the goals is a
Klein object. This raises some legitimate questions: can a Klein object be included in any conspiracy that involves concealment of some illegal activity? What type of tax motive must be present if a more general illegal agreement is charged as a Klein conspiracy?

5.2 Tax Motive in Embezzlement Cases

The embezzlement cases described above how involved creative arguments in defense of the tax charges: ignorance of the taxability of embezzlement proceeds, ignorance of the embezzlement itself, and claims that the funds, because they would eventually be returned, did not meet the definition of embezzlement and were therefore not taxable. On occasion, embezzlers accused of tax fraud take on the allegations more directly, arguing that their motivation - however nefarious - did not include any thought of tax consequences. When we consider tax conspiracies, to what extent must the prosecution show that each of the conspirators shared a motive to defraud the IRS?

Consider the recent case of Anthony Gricco, who served as regional manager for private companies that contracted with the Philadelphia Parking Authority. His chief assistant was his brother-in-law, Michael McCardell, who oversaw the day-to-day activities of the tollbooths and picked up money from the cashiers at the end of their shifts.

Normally, the parking fees were collected through automated ticket machines, which customers would take when they entered and turn in with their payment when they exited. The tickets were machine-read, and resulted in a digital display of the the parking fee owed. The customer would then pay the cashier in the tollbooth. At the end of a shift, each cashier would bundle together the tickets and cash received and put them in a brown bag labeled with the cashier's name and the number of the tollbooth. The cashier would also place in the bag a tape from the ticket-reading machine that provided a record of the tickets that the machine had processed. The supervisors then would forward the bags to Gricco's assistants.

In early 1990, Gricco, McCardell, and others started to substitute the customers' real tickets with replacement tickets showing false dates and times of entry. A customer who had parked in the lot for a long period of time would have a real ticket reflecting a high parking fee. On leaving the lot, the customer would pay this fee to the cashier. However, instead of inserting the real ticket into the ticket-reading machine, a cashier would insert a replacement ticket, and the machine would calculate the parking fee based on the false date and time stamped on the replacement ticket. The replacement ticket would indicate that the customer had parked for only a short period of time, and thus the parking fee would be much lower. The thieves would pocket the difference between the amount paid by the customer and the amount of the fee shown on the replacement tickets.

Michael Flannery, a technician for the company responsible for maintaining the ticket machines, provided the replacement tickets. Flannery disabled the fare displays on the ticket-reading machines so that customers could not see that the parking fees that they were paying
were higher than the fees recorded by the machines.

Flannery initially supplied Gricco with replacement tickets by removing tickets from the ticket-issuing machines and then resetting the counters on those machines. In the beginning, Flannery obtained 30 tickets a day using this method, and one cashier, enlisted by Gricco, used the replacement tickets to steal cash. Gricco scheduled either McCardell or David Million, another supervisor, to oversee the tollbooth plaza at which this cashier worked. Gradually, more corrupt cashiers were enlisted, and eventually Flannery began printing counterfeit tickets.

Gricco, McCardell, Million, and Flannery expanded their scheme over the next four years. At first, Gricco enlisted cashiers who had engaged in a similar but smaller scheme in 1988. Eventually Gricco recruited about 15 other cashiers to participate. Flannery delivered the counterfeit tickets that he manufactured to Gricco, McCardell, or McCardell's wife. McCardell then distributed the replacement tickets to the corrupt cashiers, and at the end of their shifts, McCardell picked up the stolen money and forwarded it to Gricco, who distributed the money among the participants. The cashiers received a portion of the proceeds stolen during their shifts, and the rest was divided into four equal shares for Gricco, McCardell, Million, and Flannery.

The leading participants in the scheme did not report their unlawful income on their federal income tax returns. Gricco kept his money in a safe, loaned cash to others and received repayments in the form of checks or money orders, gave cash to family members, and placed real estate under his family members' names. Through a real estate broker named Ludwig Capozzi, Gricco purchased several properties for cash. Capozzi also engaged in real estate transactions with McCardell's wife, who used cash to purchase properties under both her own and McCardell's name.

The cashiers also failed to report their unlawful income on their income tax returns. They did not deposit their embezzled funds into banks for fear of being detected by the IRS. Gricco cautioned some cashiers not to put their money in banks, and he advised Flannery and Million to invest in real estate through Capozzi.

The scheme ended in September 1994, when the Philadelphia District Attorney's Office executed search warrants at the airport. In July 1996, the Commonwealth of Pennsylvania brought state charges of theft, forgery, and unlawful use of a computer against Gricco, McCardell, Flannery, Million, and numerous cashiers. The cashiers waived their right to a jury trial and were convicted in the Philadelphia Court of Common Pleas. After a three-day jury trial, Gricco, McCardell, and Million were acquitted, and the judge dismissed Flannery's case.

In April 1999, a federal grand jury returned an indictment against Gricco, McCardell, Million, and Flannery for a Klein conspiracy; attempted tax evasion (§ 7201); and making false federal income tax returns (§ 7206(1)). Prior to trial, Million and Flannery pleaded guilty and agreed to testify for the prosecution. Gricco and McCardell proceeded to trial. The jury found
Gricco and McCardell guilty on all counts.

On appeal, Gricco and McCardell argued that the government had failed to show that the embezzlement scheme included the goal of defrauding the IRS. In essence, the argument was like the one used by Moni SenGupta’s lawyer in Chapter 1:

*My client was at no time motivated by a desire to evade taxes. Her concealment instead was solely designed to cover her criminal conduct. Taxes never crossed her mind.*

In Gricco’s case, the government pointed to three categories of circumstantial evidence that showed the plotters had a tax fraud motive. The court found the first two - that none of the conspirators reported their embezzlement as income and Gricco consciously tried to avoid banks - unconvincing. It was the third category that carried the day for the prosecution, for Gricco’s claimed lack of tax motive was quite obviously belied by the evidence.

The government's best evidence against Gricco is testimony that he told various participants not to deposit their illicit income in a bank but instead to purchase safes for their homes. These individuals testified that they followed this advice because they did not want to attract the attention of the IRS. It is likely that a person who acquires illegal cash and places that cash in a home safe, rather than a bank, will not report the cash as income on his or her tax returns. Accordingly, a rational jury could infer that Gricco knew that the participants to whom he gave this advice would, in all likelihood, not pay tax on their illicit income.

The difficult question is whether a rational jury could go further and find that Gricco not only foresaw that this would occur but actually intended for it to occur. Although the question is close, we conclude that the evidence, viewed as a whole, could persuade a rational jury to make such a finding. A rational jury could conclude that, if participants in the embezzlement scheme had reported their illicit income, this might have sparked an investigation that might have ultimately led to Gricco. Thus, not only did Gricco have strong grounds to foresee that the participants he advised would not report their illegal income, but a rational jury could conclude that he had also a reason to desire this result and that the result was something that he specifically intended. Viewing all of the evidence against Gricco together, we hold that it is sufficient to support his conspiracy conviction.

We reach the same conclusion respecting McCardell.

*United States v. Gricco*, 277 F.3d 339, 349 (3rd Cir. 2002).
What about the fact that Gricco and McCardell were acquitted of the embezzlement scheme in state court? Did that make the subsequent federal prosecution for the same conduct unfair? Charging them in federal court after the state acquittal was somewhat like charging Eugene Tafoya with tax fraud after he received minimal punishment for his attempted murder of Faisal Zagallai. Is it fair?

Gricco tried these arguments, to no avail. First, they claimed that the federal government was collaterally estopped from introducing evidence of the thefts because he and McCardell had already been acquitted of theft charges in state court. The Third Circuit ruled against him on what was essentially a Double Jeopardy Clause argument:

We reject this argument because collateral estoppel does not apply in successive prosecutions by different sovereigns. It is well settled that there is no violation of the Double Jeopardy Clause or the Due Process Clause in successive prosecutions for the same offense by the federal government and a state government. Since different sovereigns are permitted to prosecute the same defendant for the same crime, "[i]t would be anomalous indeed if a sovereign were allowed the greater power of reprosecuting individuals for offenses for which they had been acquitted but were denied the lesser power of proving the underlying facts of such offenses." [citations omitted].

Second, Gricco and McCardell argued that the district court erred in refusing to admit evidence of their state acquittals. The court had no trouble rejecting this, noting, inter alia, evidence of prior acquittals is generally inadmissible, and that judgments of acquittal are not even relevant on the issue of guilt because they do not necessarily prove innocence but may indicate only that the prosecution failed to meet its burden of proof beyond a reasonable doubt as to at least one element of the crime.

Gricco illustrates the power of criminal tax remedies. It seems that embezzlers can be prosecuted for tax fraud even if they are acquitted of the underlying embezzlement in a separate state court proceeding! In the end, Gricco and McCardell were sentenced to 120 months and 108 months of imprisonment, respectively.

5.3 A Limiting Principle?

Does Gricco ultimately prove too much? Can federal prosecutors simply hang around the state courthouses to see who is being charged with theft, determine whether their theft involved the preparation of papers relied on by the victim’s tax returns preparers, then charge them with aiding a tax fraud? Some other cases suggest a limiting principle.

Louis Joseph Salerno and Frederick Arnold Pandolfo worked at the Stardust Casino in the 1980s, where they crafted a scheme to steal millions of dollars. The scheme involved their preparing documents that falsely indicated that money was lost in the course of the casino’s
In order to monitor gaming revenue and prevent embezzlements like that which occurred here, the Stardust had an elaborate system of internal controls to inventory accurately the chips won or lost at each gaming table during each shift.

At the beginning of each shift, a count of chips was made and recorded. During the shift, when patrons won chips from this initial inventory, thereby depleting it, a "floorman" or "pit boss" would order more chips by preparing and signing a form called an "order for fill" and handing a copy of it to a "chip runner." The runner would carry it to the casino "cage," which serves as the casino's bank. At the cage the runner would trade his copy of the order to fill for a "fill slip" and the requisite number of chips. He brought the fill slip and chips to a "shift boss" for verification and signature. During the embezzlement scheme, Pandolfo served as the Stardust's shift boss and assistant casino manager. Salerno was the casino manager.

After obtaining the signature of the shift boss, the runner carried the chips and the fill slip to the proper table where the fill slip and the chips were compared to the original order to fill, the order to fill and the fill slip were dropped into a slot in the gaming table called a "drop box," and the chips were deposited at the table. At every stage of the procedure, multiple copies and multiple signatures were required. Copies of each form were kept at the casino cage and in the drop box under each table.

At the completion of each shift, "inventory cards" compiled from the forms in the drop boxes were compared with the fill slips at the cage, and the win for each table was computed. This computation was made by first taking the total table income for the shift (which included the ending chip inventory and the payments in the drop box for chips purchased during the shift) and subtracting from that amount the opening inventory plus fills. The table wins were eventually recorded on "stiff sheets" and finally posted to the general ledger that was used to prepare the income tax returns.

The government's evidence established that between 1979 and 1981 Salerno, the casino manager, forged dealer signatures in advance on hundreds of fill slips. These forged fill slips found their way into both the drop boxes and the cage with the help of pit boss Pandolfo, a cashier and a runner. The evidence also indicated that Salerno either removed chips or cash from the cage in amounts equal to the forged fill slips. Both the cashier and the runner were
indicted and tried with these defendants. The runner, James Frank Gabriele, was acquitted. The cashier, Lawrence Franklin Carpenter, was convicted but his appeal was dismissed following his death.

The scheme was not immediately detected because, as a result of the forgeries, the amount of chips in the cage and on the tables was always matched by fill slips. It appeared that gambling patrons had won the money that in fact had been removed.

Pandolfo and Salerno were charged and convicted of aiding and assisting in the preparation false corporate returns relating to the Stardust, violation of § 7206(2), based on the theory that the false paperwork they prepared to conceal their embezzlement would be relied on by the casino’s tax preparers. They challenged their tax convictions, arguing that their motive did not include an intent to cause the casino to file false returns.

The Ninth Circuit agreed, stating that, as part of the government's burden of proof, the evidence "had to show beyond a reasonable doubt that [the defendants] engaged in this scheme not merely for their own benefit but with a specific intent to cause the casino to file false tax returns." It noted that "[t]he law requires specific intent to defraud the I.R.S. and this means that the government must prove not only that the defendant's conduct affected tax revenue, but that tax fraud was an objective." United States v. Salerno, 902 F.2d 1429 (9th Cir.1990).

The apparent message of this case was that the government, in order to sustain its burden of proof in criminal tax cases, must show that the defendants acted with the purpose and objective of violating the internal revenue laws of the United States. Mere knowledge that his actions may result in a false entry in another's tax return is insufficient to satisfy the willfulness requirement of these tax laws. Alas, criminals charged with tax fraud for not reporting their illegal earnings may have some moves after all.

Why did this argument not work for Gricco and McCardell? When compared to Pandolfo and Salerno, they certainly suffered from some inconvenient evidence - they actually discussed the need to conceal their activity from the IRS. Not all investigations, however, will yield such findings, and prosecutors need to be careful in including tax charges, at least when it comes to embezzlement cases.

Howard Levy and George Foy, for example, who were charged under § 7206(2) in Nashville, based on their role in an embezzlement scheme involving Service Merchandise Corporation, in which they falsified documents in order to conceal their embezzlement. The problem was that there was no applicable federal embezzlement statute. Instead, Levy and Foy were charged with tax fraud, on the theory that they knew these false documents might eventually be used by Service Merchandise in the preparation of its corporate income tax returns.

Following the government’s case, Levy and Foy moved for an acquittal under Rule 29
The government, in order to sustain its burden of proof for the charges alleged in this indictment, must show that the defendant acted with the purpose and objective of violating the internal revenue laws of the United States. Mere knowledge that his actions may result in a false entry in another's tax return is insufficient to satisfy the willfulness requirement of these tax laws. Otherwise, as the Ninth Circuit observed in Salerno, "any embezzlement or theft by a person knowledgeable about taxes ... would be a violation of section 7206(2)." 902 F.2d at 1433.

In the case at bar, the indictment alleges, and the government has proffered sufficient proof, that the defendant and others conspired to embezzle money from Service Merchandise and to conceal this theft from Service Merchandise by falsifying invoices. However, the government has not presented any evidence that tax fraud was a motive, objective, or purpose of the defendant's actions. There is no proof, let alone independent proof, that tax fraud was an objective of any of the co-conspirators, except Levy, who was charged separately with personal income tax evasion. Foy is not charged in connection with Levy's personal income tax fraud. The proof indicates the purpose of the conspirators was to conceal an embezzlement for the financial good of Levy and Brymer. The defendants simply did not have Service Merchandise's taxes in mind.

The fact that one of the tangential consequences of the defendant's conduct may have been the filing of a false corporate tax return by the victim of the embezzlement is insufficient, as a matter of law, to sustain a conviction under section 7206(2) because this offense is not a general intent crime. The testimony of the co-conspirators, who have already pleaded guilty in this matter, indicated that the purpose of the scheme was not related to taxes and that there was no intent to violate corporate tax law. There is simply no evidence that defendant Foy or his co-defendants acted for the purpose of affecting Service Merchandise's tax returns or tax liability in any way. Their sole purpose, insofar as the government's proof shows, was to embezzle funds from Service Merchandise and to cover up their embezzlement by falsifying corporate records.


The Supreme Court has provided guidance on this issue, albeit not in the context of embezzlement.

-64-
In the 1950s, from his garage in Atlanta, Georgia, Horace Ingram ran a large-scale lottery and numbers operation that employed over two dozen people, which violated Georgia state law. Ga.Code, §§ 26-6501, 26-6502. In addition, there was at the time a federal law that required persons in the business of accepting wagers to register with the government and to pay a special tax on those wages. 26 U.S.C.A. §§ 4411, 4412 (1954), which Ingram and his partners operation failed to do. When federal authorities discovered Ingram’s enterprise, 31 people were indicted. The trial lasted 19 days and resulted in guilty verdicts.

The defendants had various roles in the operations, and there was evidence that there was a conscious decision to avoid detection by law enforcement. They registered motor vehicles in the names of nonexisting or deceased persons at fictitious addresses, and vehicles used in the business had been repainted in a different color or colors. Car were “souped-up” to permit escape or avoid surveillance, and a truck had been fitted with a secret compartment for the transporting of lottery tickets and other gambling paraphernalia. The employees of the operation frequently traveled in roundabout routes that often changed in carrying on the business of the lottery.

On appeal, some of the main defendants – including Horace Ingram and Rufus Jenkins – unsuccessfully argued on appeal that, apart from their effort to conceal the illegal operation (which they acknowledged) there was no evidence of any agreement or concert of action to evade and defeat the payment of the tax owed to the United States. United States v. Ingram, 259 F.2d 886 (5th Cir. 1958). The Supreme Court granted certiorari to consider these arguments. Ingram v. United States, 79 S.Ct. 1314

The opinion, Ingram v. United States, 79 S.Ct. 1314 (1958), written by Justice Potter Stewart, noted the overwhelming evidence that the defendants had engaged with numerous others in a closely organized and large-scale numbers operation and that, through a variety of carefully planned stratagems, they made every effort to conceal its operation; that Ingram and Jenkins were liable for the federal taxes imposed by §§ 4401 and 4411 of the Internal Revenue Code and willfully failed to pay them; and that they were required by § 4412 of the Code to register with the official in charge of the Internal Revenue District, and that they failed to do so.

However, the Court reversed the conviction of two participants in an illegal gambling business – L.E. Smith and Mary Law – for conspiracy to evade taxes owed by the Ingram and Jenkins as a result of the large profits their business earned. The fact that they participated in concealing the gambling profits, according to the Court, was not enough to prove that they intended to evade income taxes, since the illegality of the business alone provided sufficient reason for concealing the income, and thus it was "not a case where efforts at concealment would be reasonably explainable only in terms of motivation to evade taxation." 79 S.Ct. at 1320. As it noted:
Indulging, as of course we must, in that view of the evidence most favorable to the Government, we simply cannot discern adequate foundation in the present record for a finding that Smith and Law had such knowledge of Ingram's and Jenkins' wagering tax liability. The record is completely barren of any direct evidence of such knowledge. It was not shown, for example, that any reference had ever been made by any of the petitioners to possible tax liability, or that they had filed a return or paid a tax in previous years. The Government relied instead upon evidence which, it asserts, circumstantially proved the requisite knowledge on the part of Smith and Law. These circumstances were simply the intimate connection of Smith and Law with the operation of the lottery itself, their cooperation in conducting it secretly, and their apparent knowledge that it was conducted at a profit. The Government points out that not only would payment of the taxes have decreased the profits to be derived from operation of the lottery, but in addition would have required registration, including the names and addresses of the bankers and writers, with the local internal revenue office and the posting of a wagering tax stamp at the place of business. 26 U.S.C. (Supp. V) ss 4412, 6806(c), 26 U.S.C.A. ss 4412, 6806(c). The information contained in the registration would have been available to local law enforcement officials. 26 U.S.C. (Supp. V) s 6107, 26 U.S.C.A. s 6107.


5.5 Conclusion

Did _Ingram_ mark the death knell to the use of criminal tax charges in more general illegal schemes? Can captured criminal exonerate themselves of tax charges by simply claiming that the issue of tax liability never crossed their minds, and that they therefore lacked the requisite _mens rea_?

As always, the answer will depend on the facts of the particular case. Tax charges will continue to be appropriate where the evidence shows that the defendants were mindful of the need to conceal their activity from the IRS, as in _Gricco_. In addition, how much did the holding in _Ingram_ depend on the fact that the business itself – an underground numbers racket – was illegal, which allowed the defendants to argue a more prominent non-tax motive for their efforts to conceal? The years since _Ingram_ have seen tax charges used to redress the quintessential illegal enterprise – drug distribution networks. These cases are the subject of the next chapter.
Chapter 6 Drug Dealers and Their Lawyers

In Chapters 4 and 5, we saw criminal tax laws used to redress embezzlement. This chapter deals with a different type of criminal – drug dealers and the people who help them. It elaborates on this situation described in Chapter 2, relating to the Los Angeles flower shop owner:

Scenario 9: In addition to flowers, Moni sells marijuana out of her store and home. She does not report her marijuana sales, nor the fact of this illegal business, on her tax returns.

6.1 The Basics: Alfredo Garcilaso and John Paul Jones

In 1966, New York City police has a wiretap on a suspected marijuana trafficker named Juan Santos. They overheard Santos talking to a would-be buyer, and followed him to his stash house. It turned out to be the apartment of Alfredo Garcilaso. Police arrested Santos as he emerged from the apartment carrying a suitcase full of marijuana. They went inside and arrested Garcilaso, finding a larger stash.

The wiretap that led to the arrest was later ruled illegal. Santos pled guilty and received a three and a half year sentence. The drug case against Garcilaso was dismissed after the marijuana found in his apartment was ordered suppressed as the fruit of the search of his apartment which, being warrantless, violated his constitutional rights.

Garcilaso was then charged in federal court under § 7206(1), for failing to report the income from narcotics sales on his 1966 tax return. The jury convicted him in June, 1973. On appeal, he complained about the prosecutor's reference in his closing argument to Garcilaso's failure to report that marijuana sales were the source of additional income. This argument was dealt with rather summarily by the Second Circuit:

The theory of the government's case, as propounded by the prosecutor, was that Garcilaso violated § 7206(1) by his failure to report his additional income, not by his failure to report that narcotic sales were the source of this additional income. In proving its case against Garcilaso the government was required to establish the existence of income from narcotic sales in order to show that he had unreported income. The prosecutor referred to this evidence merely as probative of an essential element of the government's case, the existence of unreported income. A taxpayer's intentional nondisclosure of income is not excused because it is derived from criminal activities.

United States v. Garcilaso, 489 F.2d 761, 765 (2nd Cir. 1974).

Criminal tax charges have been featured in drug cases ever since.

-67-
From August 1979 until March 1981, John Paul Jones worked as a physician's assistant at the Central Clinic in Kansas City, Kansas, where he was able to illegally obtain and distribute prescription drugs. The clinic was owned by Francis Jones, a doctor of osteopathy, who had leased the clinic to Vernon Webb, another doctor of osteopathy. Jones masqueraded as a physician at the clinic and prescribed drugs to his patients using Dr. Webb's DEA controlled-substance registration number. He also called in false prescriptions to local pharmacies (again using Dr. Webb's registration number), sent runners to pick up the drugs, and then sold the drugs on the street. From his illegal drug activities, Jones earned $21,000 in 1979 and $23,000 in 1980. These amounts did not make their way onto his tax returns. Jones was charged both with drug dealing and tax fraud.

Recall some of the arguments considered by Moni SenGupta’s counsel in Chapter 1 after she is indicted in Scenario 9:

- This is tax fraud? Who in their right mind would report drug sale proceeds on their tax returns?

- My client was at no time motivated by a desire to evade taxes. Her concealment instead was solely designed to cover her criminal conduct. Taxes never crossed her mind.

Jones was ultimately convicted. His appeal tried a variation of these arguments. The Tenth Circuit had little trouble disposing of them. In fact, it rejected it in a single paragraph:

Finally, defendant contends that the evidence is insufficient to sustain his conviction for attempting to evade income taxes. In his brief he argues that "[w]illful failure to file a return, together with willful failure to pay the tax, does not, without more, constitute an attempt to evade income tax." We agree with defendant that, under Spies, the Government must also prove that he committed some affirmative act constituting an attempt to evade taxes. The evidence demonstrates, however, that defendant did commit such acts. He did not merely fail to file his tax returns or fail to pay his taxes; rather, he did file his tax returns, but misstated his incomes for 1979 and 1980 by failing to report his earnings from illegal drug activities. Defendant's filing of his tax returns with the knowledge that he should have reported more income is sufficient to sustain the jury's conclusion that defendant willfully attempted to evade taxes.

*United States v. Jones*, 816 F.2d 1483, 1488 (10th Cir. 1987).

These were relatively easy cases for the tax prosecutors. Neither Alfredo Garcilaso nor John Paul Jones tried to argue that proceeds from drug dealing were not taxable, an argument that would fail in light of the embezzlement cases discussed in Chapter 3. After all, drug dealers...
do not operate on the illusion that the money they receive from their clients represent a loan that may have to be repaid.

However, using criminal tax charges in narcotics cases are does not always present as easy of a case as these, as the following cases illustrate. This is due to fact that drug dealers typically take precautions to conceal what they are doing, including taking steps to hide how they achieved their wealth.

6.2 Piercing the Drug Dealer’s Veil

A Cleveland drug dealer named Ronald Bencs was exposed in the course of an investigation of his accountant. The IRS had a criminal investigation focused Robert on Gross, for allegedly helping drug dealers launder their proceeds and evade their taxes. Agents raided Gross’ office in April 1988, and, among other documents, seized the financial records related to Bencs and his company, Diversified Financial Enterprises. Comparing these financial records with what Bencs reported on his tax returns, the IRS noted a large disparity. When he was interviewed, Bencs told the agents that Diversified's business had sources of income from striping parking lots; selling jewelry, art work and Christmas trees; and renovating houses. He also claimed nontaxable sources of income in the form of loans from various individuals and banks, and denied income from any illegal activities.

Bencs had formed Diversified in 1978, and hired Gross to maintain its financial records. Diversified's bank records and tax returns were strange. They did not reflect expenses customarily incurred by businesses engaged in sales and contracting work, such as cost of goods sold, rent, utilities, and labor. The company’s tax returns reflected losses for all years but one, when it reported a $241 gain.

The IRS had a good idea that Bencs was a marijuana dealer. Agents spoke to several of his sources, including one who said he had sold Bencs over 9000 pounds of marijuana between 1980 and 1985. This alone would not make a criminal tax case. They needed a way to determine how much income he received from his illicit sales, and compare it to how much he reported.

Because Bencs took precautions to set up a seemingly legitimate front company for his marijuana business, the tax charges depended on the IRS establishing his income in a way more complicated than necessary in the case of John Paul Jones. Bencs transacted business almost exclusively in cash and had records inadequate to determine his tax liability. To deal with this problem, the IRS undertook what, in tax litigation, is referred to as a “net worth analysis.”

After poring over Bencs’ financial transactions for these years, the agents concluded that Bencs' net worth for the years 1984-88 exceeded his reported income in amounts ranging between $68,000 and $99,000, and that he had underpaid income tax for those years in amounts ranging between $21,000 and $40,000. They did this by taking a snapshot of his financial
position at the beginning and at the end of the relevant period. The financial position was measured by his net worth: the amount by which Bencs’ assets exceeded his liabilities.

Bencs was ultimately charged with conspiring to defraud the United States, evading income tax, money laundering, and structuring financial transactions to avoid cash reporting requirements applicable to transactions in excess of $10,000. At trial, Bencs presented an expert witness at trial who concurred with the IRS’ methodology and used most of his calculations, and he was convicted. United States v. Bencs, 28 F.3d 555 (6th Cir. 1994).

A few years earlier in Alabama, Joe Pritchett ran a similar operation, although it involved cocaine rather marijuana. Like Bencs’, Pritchett’s drug distribution network involved efforts to conceal the income he received from drug sales. It also resulted in tax charges.

Pritchett’s operation was a family affair. It included his brother, David Pritchett, David's wife, Rhonda Pritchett, and David's and Joe's nephew, Phillip Boothe. Joe decided when and how much cocaine would be purchased, and he controlled the profits. David, Rhonda and Phillip delivered cocaine to buyers, hid cocaine in their homes, and accompanied Joe on purchasing trips to Miami. Another member of the conspiracy, Tom Cook, who lived in south Florida, occasionally appeared at Joe's house in Mobile to assisted him in buying and selling cocaine.

In 1983, Joe moved from Tuscaloosa to Mobile. Both Joe and David purchased homes there with large amounts of cash, and they had title to the houses put in the name of Joe's son, Mark Pritchett. Joe, David and Mark also became involved in several legitimate businesses in Mobile. Joe loaned $100,000 in cash to Stan Johnson, the owner of Beltline Auto Brokers, a used-car lot. When Stan became unable to repay the $100,000 loan, Joe agreed to cancel the debt by accepting two parcels of land from Stan, and by taking over another of Stan's businesses, an Ugly Duckling car rental franchise. Mark operated the franchise. Joe and Mark also went into business with Mike Sheffield, the owner of Mobile Towing, a wrecker service.

Between 1983 and 1987, Joe invested hundreds of thousands of dollars, all in cash, in trucks, cars and motorcycles. He transferred title to these vehicles to Beltline Auto Brokers, Mobile Towing or Co-Op Leasing, a corporation set up by Joe and Mark to lease equipment to Mobile Towing. During this time, Joe did not file personal income tax returns. Between 1983 and 1986, his personal income tax liability exceeded $160,000.

The government eventually unraveled this scheme. In July, 1988, the members of the operations were charged with narcotics violations and tax fraud, and Joe with conducting a criminal enterprise involved in trafficking cocaine. Joe left town and became a fugitive

David and Mark’s trial began September, 1988. After the trial began Mark's attorney became ill, and the court granted his motion for severance. The jury reached a verdict on only one count of the superseding indictment as to David, finding him guilty of conspiracy to evade
taxes. In November, 1988, defendants David, Rhonda, Phillip and Mark were tried together and were convicted.

Joe was arrested in November 3, 1988, and eventually pleaded guilty to tax fraud and operating a criminal enterprise. He received a 30-year prison sentence. *United States v. Pritchett*, 908 F.2d 816 (11th Cir. 1990).

6.3 *Bencs, Pritchett and a Question of Fairness, Reprised*

Remember this argument by Moni SenGupta’s lawyer in his motion to dismiss, in Chapter 2?

*Your honor, this case is absurd. It reflects government overreaching at its worst. If my client was dealing marijuana – a fact we plan to vigorously contest at trial – we cannot actually expect her to report this fact on her tax return. To charge her with tax fraud in addition to the drug counts is unfair. We move to dismiss the tax charges. The government is simply piling on, and we as a people should not tolerate it.*

As noted, this argument will generally be unavailing. However, there were some alternatives for persons charged with tax crimes for failing to report their illegal proceeds that seemed more worthy of consideration. One of these more refined arguments had particular potential for drug dealers charged with tax fraud:

*The tax charges make reference to other illegal activity – marijuana dealing – which will prejudice the jury against my client and make a fair judgment on the tax charges impossible.*

Ronald Bencs tried a variation of this argument. He argued that the court should have bifurcated the tax evasion charges from the money laundering charges, since his defense to the former was prejudiced by evidence admissible only on the laundering charges. He claimed that the prejudice is apparent from the government's reference to his drug dealing in its opening statement of the trial. This argument was rejected by the Sixth Circuit:

*Joinder of the money laundering and tax evasion counts was proper. Evidence of Bencs' marijuana income was admissible on the evasion charges regardless of whether Bencs was simultaneously tried on the money laundering charges. The charge of tax evasion requires proof of the willful attempt to evade or defeat a federal tax. 26 U.S.C. § 7201. The government may prove tax evasion through the net worth method, pursuant to which the government demonstrates with reasonable certainty the defendant's net worth at the commencement of the relevant period, and then at the end. If the ending amount is greater than the beginning, and the government proves beyond a reasonable doubt that the defendant had one or more sources of*
taxable income, the jury can find that the receipts constituted taxable income
to the defendant. Drug proceeds constitute taxable income. Thus, in United
States v. Wirsing, 719 F.2d 859 (6th Cir.1983), the court concluded that tax
evasion charges were properly joined with a marijuana distribution charge,
where the defendant's unreported income was allegedly derived from his
illegal activity in distributing drugs. Accord United States v. Clark, 928 F.2d
639, 644 (4th Cir.1991).

The evidence which Bencs claims was prejudicial was admissible against him
on both the evasion charges and laundering charges, and the government was
entitled to make reference to this evidence in its opening statement.
Consequently, Bencs has not demonstrated that the district court erred in
denying his motion to bifurcate or his motion for a mistrial.

28 F.3d at 559.

Thus, even when the fairness arguments are couched in legally cognizable terms such
as prejudice, they are unlikely to succeed where drug dealers are simultaneously charged with
narcotics and tax fraud charges.

6.4 Tax Motive in Drug Cases

Chapters 4 and 5 considered an argument made by embezzlers who are eventually
catched and charged with conspiracy to commit tax fraud, and in the case of Anthony Gricco and
the Philadelphia Airport parking lot scam. Gricco and his colleagues claimed that taxes never
crossed their minds in the course of their embezzlement, and that therefore they lacked the mens
rea to be convicted of those charges. In Gricco’s case, this argument was belied by the evidence
that he actually discussed the need to conceal the proceeds from the taxing authorities. This
lack-of-tax-motive argument was tried in Pritchett, by some of the more minor players in the
conspiracy, with better success.

After their convictions, David Pritchett and Mark Pritchett claimed that the evidence
was insufficient to convict them of joining in a conspiracy to evade the income taxes owed by
Joe Pritchett. In addressing this argument, the Eleventh Circuit relied on the law relating to
Klein conspiracies, concluding that, in such cases, the government must prove that David and
Mark knew that by conducting his financial affairs in cash and by hiding his ownership interests
in the assets he purchased (including the safe deposit boxes opened by Mark), Joe intended to
avoid paying income taxes. It noted that when efforts at concealment are reasonably explainable
in terms other than a motivation to evade taxes, the government must offer independent proof
that those who participated in the concealment intended to assist the taxpayer in evading taxes.

By this standard, the court found the tax conspiracy case against David and Mark
Pritchett lacking, since Joe's habit of putting assets he purchased in someone else's name and his
almost exclusive use of cash do not by themselves serve to disguise the money as non-taxable income:

[T]he government presented sufficient evidence to prove that David and Mark participated in concealing Joe's ownership of various assets, including his interest in the unknown contents of the safe deposit boxes opened by Mark, and to prove that David knew that Joe's money was earned contemporaneously through drug sales, rather than coming from a "cash hoard" from previous year's income. However, the government presented no independent evidence of David's and Mark's knowledge of Joe's tax liability and that Joe's motivation for hiding his income and ownership interests was to evade income taxes. . . . Because David knew about and participated in the drug sales, his efforts at hiding the income are explained in terms of an effort to prevent detection of the drug business. The evidence does not show that Mark knew Joe's cash represented current income, and therefore only shows that Mark knew that Joe was hiding his ownership interests in various assets. Several witnesses testified that Joe explained the hiding of his ownership interests as an effort to keep his wife from claiming an interest in those assets in the event of a divorce. Other than offering evidence that Joe did not file tax returns in the years that he was earning money from the drug sales, the government offered no independent proof that Joe was motivated by a desire to evade income taxes. Therefore, we find the evidence presented at their trials was insufficient to convict either David or Mark of conspiracy to evade income taxes because nothing in the evidence indicates that either man knew that Joe was not filing tax returns and did not intend to pay his federal income taxes.

908 F.2d at 821.

_Pritchett_, then, stands for the same principle in the drug context as _Gricco/Foy_ illustrated in the embezzlement context: that the intent to conceal illegal activity cannot automatically be transferred to the _mens rea_ required for tax charges. Something more is needed. This suggests that the Supreme Court’s 1959 opinion in _Ingram_ survives to this day, even in the area of narcotics enforcement.

### 6.5 Money Laundering

At the intersection of drug crime and tax fraud lies the crime of money laundering. A crime designed to reach conduct that is typically at the outer edges of drug conspiracies, money laundering involves the tracing of financial transactions and the skills of tax investigators.

What is money laundering? There are a series of money laundering crimes in the U.S.
Criminal Code, but it comes down to a fairly simple act: engaging in financial transaction for the purpose of making dirty money appear to be legitimate. The easiest to understand is the crime of “structuring” currency transactions, its origin, and how it operates today.

The war on drugs, announced in the 1980s, has gone beyond aggressively enforcing the crimes of importing, distributing, and possessing, controlled substances. It involved social scientific research on the drug culture, and how modern drug dealers operate. From there, statutes were enacted to criminalize that conduct, even if such conduct falls short of drug dealing. Money laundering was the main example. It gets criminalizes something – financial transactions - that are not otherwise obnoxious if unconnected to some illegal activity.

As we have seen in some of the cases described above, drug dealers cannot enjoy the proceeds of their crime unless they could find a way to spend them without drawing attention to themselves. To do this, they had to rely on financial institutions to store and transfer their illegal proceeds, and find ways to make their proceeds appear legitimately derived. This was the essential conduct of Ronald Bencs and Joe Pritchett.

Part of the U.S. money laundering program involved establishing required reports that must be generated and provided to the Treasury Department upon the occurrence of an act that conforms with what we know about drug dealers' operations. Illegal drugs are generally purchased with cash, therefore, drug dealers typically make large cash deposits into their bank accounts. Beginning in 1986, banks were required to generate a report, known as a Currency Transaction Report (CTR), anytime a customer deposited more than $10,000 in cash.

Is this fair to the person in a legitimate cash business who happens to deposit cash in excess of $10,000? Bear in mind that the 1986 law merely required the submission of a report. It properly recognized that there may be legitimate reasons to make large currency deposits. Persons who fall into that category should have no reason to fear the issuance of a report, assuming that they are paying taxes on their cash earnings. The same was not true for drug dealers, of whom the required reports would draw unwanted scrutiny.

To accomplish their financial goals after the imposition of this new requirement, drug dealers began dividing their currency deposits into smaller increments, each of which would be under the $10,000 triggering amount for a CTR. In response to this expected phenomenon, Congress created the crime of "structuring currency transactions" to avoid the reporting requirement. Where bank records show that someone made several $9,900 deposits at several different banks in the same day, prosecutors can ask the jury to infer that the person had a large amount of cash and intentionally structured it to avoid the CTR requirement, thereby committing a federal felony.

The structuring offense (31 U.S.C. § 5324) is an example of a carefully crafted statute that prohibits conduct that is not inherently offensive (making several large cash deposits in a single day) in those circumstances that separate the innocent from the guilty. It provides, in
§ 5324. Structuring transactions to evade reporting requirement prohibited

(a) Domestic coin and currency transactions involving financial institutions.-- No person shall, for the purpose of evading the reporting requirements of section 5313(a) or 5325 or any regulation prescribed under any such section, the reporting or recordkeeping requirements imposed by any order issued under section 5326, or the recordkeeping requirements imposed by any regulation prescribed under section 21 of the Federal Deposit Insurance Act or section 123 of Public Law 91-508--

(1) cause or attempt to cause a domestic financial institution to fail to file a report required under section 5313(a) or 5325 or any regulation prescribed under any such section, to file a report or to maintain a record required by an order issued under section 5326, or to maintain a record required pursuant to any regulation prescribed under section 21 of the Federal Deposit Insurance Act or section 123 of Public Law 91-508;

(2) cause or attempt to cause a domestic financial institution to file a report required under section 5313(a) or 5325 or any regulation prescribed under any such section, to file a report or to maintain a record required by any order issued under section 5326, or to maintain a record required pursuant to any regulation prescribed under section 5326, or to maintain a record required pursuant to any regulation prescribed under section 21 of the Federal Deposit Insurance Act or section 123 of Public Law 91-508, that contains a material omission or misstatement of fact; or

(3) structure or assist in structuring, or attempt to structure or assist in structuring, any transaction with one or more domestic financial institutions.

The enactment of this crime effectively closed a loophole available to drug dealers who aspired to use the U.S. financial system to wash their illegal proceeds, forcing them to rely on other means. If persons other than drug dealers were ensnared in the process, these people are limited to those who had reason to fear the generation of a CTR.

This is a simple example of money laundering enforcement in action. It will involve the combined efforts of the Drug Enforcement Administration (DEA) and the IRS. How has money laundering enforcement worked in practice, and what role does the IRS play in it?

6.6 The Intersection of Tax Crimes, Drugs and Money Laundering
A New York case from the late 1990s illustrates the interplay between, tax, drugs and money laundering, and how modern narcotics cases necessarily involve an investigation of finances related to the drug trade which typically lead to an investigation of the suspected dealer’s tax returns.

The joint DEA/IRS investigation of Shu Yan Eng began in February 1998, based on information provided by confidential informants who claimed that Eng imported narcotics from the Far East and laundered money through various businesses. As is customary following the commencement of narcotics and money laundering investigations, the IRS began a tax evasion investigation of Eng in August or September 1989, assigning it to IRS Agent Thomas Interdonato.

Interdonato began his investigation with Eng's personal tax returns, which were prepared by Wang F. Luk, an accountant. The interest income information reported on Eng's tax returns indicated that Eng had personal bank accounts in New York at Manhattan Savings Bank, Hang Seng Bank, National Westminster Bank, and Bowery Bank. Bowery Bank was subpoenaed for account records but responded (erroneously, as it later turned out) that it had no account for Eng.

Interdonato confirmed that Eng paid the mortgage on the residence listed on his tax return. However, according to informant information, Eng also owned a condominium at 141 Division Street and Chinese Moon Palace Restaurant, Inc., located in the 26 Bowery building in New York City. The Chinese Moon tax returns listed a bank account at National Westminster Bank. Interdonato subpoenaed National Westminster Bank for Chinese Moon account records, obtaining monthly statements and information on deposits. They showed cashier's checks, totalling $140,000, issued by Hang Seng Bank, deposited to Chinese Moon's account in June and September of 1987. Through the government's Treasury Enforcement Communication System, Interdonato further learned of two large cash deposits of $20,000 and $12,000 to Chinese Moon's account.

Two months into the tax investigation, Eng was arrested on drug charges, and a search warrant yielded extensive financial information. On the day of his arrest, Eng's personal safe unlawfully was searched without a warrant. The materials seized from the safe included cancelled checks from various bank accounts, customer records of money orders, documents revealing the unit number of a condominium located at 141 Division Street, a checkbook of a corporation called World Express International, Inc., documents revealing the previous owners of 26 Bowery Corp.; and documents evidencing Eng’s ownership of property and a boat in Florida.

In April 1990, about six months after the search of the safe and eight months after Interdonato's investigation began, a superseding indictment added to the existing charges against Eng three tax evasion counts relating to the tax years 1986 through 1988. After a jury trial, Eng was convicted of the tax evasion charges, but was acquitted of the continuing criminal enterprise,
money laundering and narcotics charges. The district court sentenced Eng to a term of imprisonment of forty-eight months but granted bail pending appeal. On appeal, Eng argued that the tax charges were based on information obtained during the unconstitutional search of his premises and safe, and must therefore be reversed. *United States v. Eng*, 971 F.2d 854 (2nd Cir. 1992).

Resolution of this issue, spanning across several judicial opinions, turned on the applicability of the legal doctrine of “inevitable discovery.” The Second Circuit in July 1992 vacated judgment of conviction and remanded the case to the district court "for particularized findings as to the manner in which, if at all, each piece of evidence challenged by Eng, and said by the government to be admissible under the inevitable discovery exception, would have been inevitably discovered." *United States v. Eng*, 971 F.2d 854, 856 (2d Cir.1992). The detailed findings required by the remand were thereafter provided in a seventy-five page "Memorandum and Order" dated March 31, 1993. See *United States v. Eng*, 819 F.Supp. 1198, 1208 (E.D.N.Y.1993). The Second Circuit, based on these finding, affirmed Eng’s conviction, finding that the evidence underlying the tax charges would have inevitably been discovered even without the unconstitutional search of the safe. The opinion quoted the district court’s findings:

[I]n order to establish the type of behavior that constitutes tax evasion, the government must engage in a lengthy and detailed analysis of the taxpayer's resources and expenditures; thus, although the tax evasion investigation of Eng was still in its formative stages when the illegal search of the safe occurred, the government's motivation to pursue that investigation was compelling, and the agents' behavior in the Summer and Fall of 1989 was consistent with their active pursuit of this investigation.

971 F.2d at 990-1.

In other words, Eng could be taken down by tax charges, even without the search warrant incident to the drug investigation.

The relationship between tax, drug, and money laundering charges is even more pronounced where law enforcement focuses on legal professionals whose role is to help the drug dealers hide their illegal proceeds. Recent history has a number of examples of lawyers gone bad whose conduct has been redressed, in part, through criminal tax charges.

6.7 Lawyers Gone Bad

In previous chapters, we considered some crooked accountants and some unscrupulous doctors. It is not surprising that when the war on drugs expanded to an examination of how drug dealers hide their proceeds, some attorneys would be muddied in the process. Dirty lawyers have often been charged with tax fraud for their efforts to assist their drug dealer clients. There are three particularly good examples of this, which illustrate the investigative methods used to
The FBI began an undercover investigation into illegal drug trafficking and smuggling in South Florida in the 1980s. The front for this investigation was a company called C.R.V. Associates (CRV), which purported to be an investment counseling firm with a commercial listing in the telephone directory and a business office in Miami, Florida. In reality, CRV was an FBI front, established by the FBI to attract drug dealers and money launderers.

CRV operated solely on a referral basis. The money laundering schemes set up by CRV involved counting and converting illegally-obtained United States currency into some other form of negotiable instrument, such as a cashier's check, or transferring the currency to corporations or bank accounts set up by CRV in foreign countries. The laundering process was complete when the money was returned to its owners in the form of fictitious loans or salaries from offshore corporations. Meetings between CRV customers and the undercover FBI agents held at CRV's offices were videotaped by the FBI.

In April of 1980, Donald Raulerson, the head of a large marijuana importation business operating in South Florida, was referred to CRV. Between April 24, 1980 and July 31, 1981, Donald Raulerson and other members of his organization, Billy Maddox, Robert Ewan Jr., and John Paul Browning, brought a total of over four million dollars into the CRV offices to be laundered. Twenty three meetings were videotaped.

At one of the meetings, Browning told the undercover FBI agent named Gaffney that he had previously tried to set up a corporation in the Grand Cayman Islands in order to conceal his ownership of "drug boats." Gaffney told Browning that CRV could set up a corporation for him in the Grand Cayman Islands.

Browning and Raulerson told Gaffney that they were having difficulties collecting on their "merchandise," a term referring to their sales of marijuana. A few days later, Browning arrived at CRV offices with $293,350 in currency. Browning told Gaffney that they were having better luck collecting on their merchandise than before, and that he would like Gaffney to open an account for him in the Grand Cayman Islands.

In addition to money laundering, the discussions included references to the IRS and tax consequences. In a September 1980 videotaped meeting among CRV agents, Donald Raulerson and Billy Maddox, Raulerson stated that his purpose in laundering the money was to hide the source of the income in the event of an audit by the IRS:

DER [Raulerson]: Say I come down here and got a check, a cashier check for a million dollars.

RKC [FBI agent]: Right.
DER: I bought this piece of property with it, right?

RKC: Right.

DER: Alright, the Internal Revenue when my file my income tax, they're gonna say where did you get these million dollars from?

RKC: Um hum.

DER: I borrowed it. Who'd you borrow it from?

RKC: From an offshore corporation.

DER: Or whatever. I'm asking you. I got the check from y'all.

RKC: You could do it through an offshore corporation.

DER: I mean, how do y'all so ... set y'all's books up books up, showing where y'all give me a check for a million dollars.

AF [FBI agent]: We have ah, we have an accountant ah, and an attorney who works with us.

DER: Alright, can I say I borrowed the money from

* * *

DER: But I'm, I'm that's why I'm putting the corporation down there to keep me from taking the checks here.

RKC: Um hum.

DER: 'Cause I got the IRS on my ass anyhow. About a million dollars.

In a videotaped meeting between Billy Maddox and CRV agents on November 24, 1980, Maddox requested that CRV set up a corporation for him in the Grand Cayman Islands to launder money and return it in the form of a fictitious consulting fee from the corporation. Maddox told the agents that he wanted the fictitious fee set up as a payment in the next taxable year for a sale he had supposedly made for the corporation because he did not wish to report any more income in the current year. Maddox's reason for not wanting to show a large amount of
income in any one taxable year was to avoid attracting IRS attention and a possible audit. The following exchange was caught on tape:

RKC: Have, have you ever been audited?
BM: No.

RKC: No.
BM: Never.

RKC: Yeah, see as long as, as long as you're paying in that and they don't ... I mean they see a guy who pays a ... a lot of income tax, they're gonna let him alone. As far as they

BM: I, I've never been touched.

RKC: But I, I ... I tend to think that there's probably some people that they probably audit every year.

BM: There is. Here, here's some of those mistakes okay. They go, they buy a new Mercedes, new pick-ups, new truck, pay off their houses, buy boats, buy this ... and rings and this and that and everything's paid cash. They don't owe a goddamn thing. They got a 50,000 dollar year income and how--where the hell did they get all of this?

* * *

RKC: What hurts these guys is when they fill out a simple form and they're just living like ah ... you know...

BM: Well they do it (unintel) when the Internal Revenue gets on your ass, you're in trouble.

In a videotaped meeting between Raulerson and CRV agents on March 13, 1981, Raulerson told the undercover agents that his bookkeeper was aware that the loans received from CRV were sham transactions, but that he was not concerned because he had previously bribed the IRS agent who had performed his audit and as a result was audited "for nine hundred and sixty-three thousand dollars. Well, they could've hit me for more than that, hit me for about two million." Raulerson also discussed his hesitation in setting up a corporation in the Grand Cayman Islands for fear that the Grand Cayman Island authorities might release information to the IRS.
AF [FBI agent]: From our experiences, we think that the Caymans are better.

DER [Raulerson]: Yeah, but everybody's lookin' at the goddamn Caymans all the time.

AF: They may be lookin' at 'em but they're not gettin' shit outta there.

DER: You don't think they'll turn over information.

AF: No, no.

RKC [FBI agent]: No, no.

DER: What if it was a sus, sus, suspect, like say, somebody like me and they went down and say, we suspect this son of a bitch here.


DER: Yeah.

These conversations, admissible as evidence, seemed to place Browning, Raulerson and Maddox in the position of the defendants Gricco, and distinguish them from Foy and the low-level operatives in Pritchett. In an opinion written by Judge Johnson, the Eleventh Circuit agreed:

[T]he evidence in this case demonstrated a single conspiracy with dual, complementary objectives: laundering money to disguise the source of illegal income and through the money laundering scheme to impair the identification of revenue and the collection of tax due and owing on such revenue. Browning's knowing participation in the money laundering objective of the conspiracy is clear and, coupled with the videotapes of his co-conspirator's statements concerning the purpose of the money laundering scheme in impairing the effective functioning of the IRS, is sufficient to support a reasonable inference that the money laundering transaction in which Browning knowingly participated was also an integral part of the purpose of the overall scheme to impair the effective functioning of the IRS.

*United States v. Browning*, 723 F.2d 1544 (11th Cir. 1984)

The prosecution of lawyers-gone-bad for tax crimes has continued. What other defenses have they tried?
Joseph Jerkins, a Michigan attorney, became associated with Matthew Myers in the early 1970's, when Myers sought legal help for one of his marijuana distributors. They became friends. In the 1970s and early 1980s, Myers accumulated large quantities of cash from his marijuana dealing, of which he had a problem disposing without drawing unwanted law enforcement scrutiny. Between 1977 through 1986, Jerkins and Myers purchased several pieces of property in Florida, Michigan and Aspen, Colorado. Myers would typically give his share of the purchase price in cash to Jerkins, who would deposit the funds in his law firm's trust account and write a trust account check for the purchase price. Myers and Jerkins took precautions to conceal Myers' interest in the properties.

In the spring of 1979, Jerkins introduced Myers to Ernest Steiner, an accountant, to prepare Myers' 1978 income tax return. Steiner had helped Jerkins in preparing delinquent tax returns when Jerkins was under investigation for not filing returns in the early 1970's. In 1980, Myers reported income of $42,722, which was considerably less than he earned from the sale of marijuana. Jerkins reviewed the return, and vouched for figures used on it. In 1981, the year in which many of the property purchases occurred, and a year when Myers distributed a semi-truck load of marijuana, Myers intended to report $40,000 to $60,000 on his income tax return. Steiner prepared a 1981 return showing $42,922 in income. Jerkins again vouched for the figures. In 1982, Myers reported $48,000 in W-2 income from his construction company, despite the fact that the company had no income that year. Myers was depositing cash into the company bank account and was drawing checks so he could have W-2 income. Jerkins approved of this plan.

In 1982, Jerkins and Myers split up their interests in the properties they had purchased. Because of the difference in value of the properties, Myers gave Jerkins $58,800 in cash, which Jerkins did not report on his 1982 income tax return. In 1984, Myers purchased three pieces of property on Academy Street from Skila LTD, a partnership consisting of Jerkins and his law partners. The purported purchase agreements was $92,856. Myers paid $150,000 for the properties, with the difference in the purchase price and the contract price being paid to Jerkins in cash. Jerkins omitted this amount on his 1984 income tax return.

Jerkins was eventually charged and convicted of (1) conspiring with Myers to defraud the United States by impeding, impairing, obstructing and defeating the IRS, (2) attempting to evade Myers' 1980 income taxes, (3) attempting to evade Myers' 1981 income taxes, (4) aiding and assisting in the preparation of Myers' false return for 1982, (5) attempting to evade his own taxes for 1982, (6) filing a false return for 1982, and (7) filing a false return for 1984.

Jerkins' appeal focused on two arguments: (1) that the conspiracy charges should have been dismissed because the object of the crime – avoiding taxes - was not illegal, and (2) the indictment allied him with various drug dealers in an unfair attempt to find him "guilty by association."

Each of these claims was rejected by the Sixth Circuit, which reasoned that taxpayers
have the right to avoid taxes only by means which the law permits, whereas the indictment alleged a conspiracy to avoid taxes by illegal means, *i.e.*, false returns and concealment of income. As a result, while it may be true that Jerkins and Myers entered into may have been legal on their face, the indictment clearly alleged, and evidence was presented at trial, that the purpose behind the transactions was to conceal income. Moreover, the indictment also alleged that the filing of false returns was also part of the conspiracy. The court disposed of the “guilt by association” argument in a single sentence: “Given the evidence presented at trial and the broad discretion granted the district court in balancing probative value against potential prejudicial impact, we conclude that the district court did not err in allowing references to other drug dealers during the course of the trial.”

*United States v. Jerkins*, 871 F.2d 598 (6th Cir. 1989)

Gerald Popkin practiced law in Atlanta. In early 1978, a drug dealer named Stephen Musick hired him to prepare his 1977 tax return, which omitted $250,000 Musick earned through drug sales. Four years later, Musick was arrested for selling approximately 12 kilograms of cocaine.

While serving his prison term, Musick agreed to participate in a government sting operation aimed at Popkin. He contacted him in 1985, and set up an appointment at Popkin’s law office. At the meeting, which was secretly taped, Musick told Popkin that he had earned approximately $200,000 on cocaine deals while he was in prison and that he now wanted to resurface and start showing income by filing tax returns for 1983 and 1984 and by getting into the construction and real estate business in California. Musick’s concocted story was that his drug money was being held by an entity called Mid-American Financial in an offshore account, and that he wanted Popkin’s help in repatriating the money in a transaction that would disguise the source of the funds and require paying less than full income taxes.

Popkin obliged. He recommended that Musick form a California corporation, that he sell stock in the new corporation to Mid-America Financial for $200,000, report heavy losses in the new corporation and then repurchase the stock for $3,000 to $10,000. He cautioned Musick to comply with the formal requirements for running a corporation in order to maintain the proper appearance. Later that day, Musick arranged to meet with the Popkin and two undercover agents posing as representatives of Mid-America Financial. The parties discussed the formation of Musick's new corporation and methods of repatriating Musick's offshore funds.

In April 1985 Popkin met again with Musick and the two undercover agents in a videotaped meeting at Mid-America's offices in St. Louis. At this meeting, Popkin delivered to Musick tax returns for the years 1983 and 1984 he had prepared. Popkin had reported Musick as receiving $50,000 as gross income on Schedule C of the tax returns for each year. This sum was reported only as gross receipts or sales without any further indication of its source. These tax returns were never filed.
Popkin thereafter set up the S corporation, Musick Corporation in California, obtained a corporate seal which he mailed to Musick, and filed a statement of domestic stock corporation with the State of California. He billed Musick a total of $1,755 for costs associated with formation of the corporation. This bill was paid by Mid-America Financial. Popkin also received $5,000 for preparation of the two income tax returns.

Popkin was charged in January 1990. He was acquitted of the charges of preparing Musick's false tax returns for 1983 and 1984, but convicted under 26 U.S.C. § 7212(a), a tax crime that was being brought back into use following a long hiatus. It provides:

§ 7212. Attempts to interfere with administration of internal revenue laws

(a) Corrupt or forcible interference.--Whoever corruptly or by force or threats of force (including any threatening letter or communication) endeavors to intimidate or impede any officer or employee of the United States acting in an official capacity under this title, or in any other way corruptly or by force or threats of force (including any threatening letter or communication) obstructs or impedes, or endeavors to obstruct or impede, the due administration of this title, shall, upon conviction thereof, be fined not more than $5,000, or imprisoned not more than 3 years, or both, except that if the offense is committed only by threats of force, the person convicted thereof shall be fined not more than $3,000, or imprisoned not more than 1 year, or both. The term "threats of force", as used in this subsection, means threats of bodily harm to the officer or employee of the United States or to a member of his family.

On appeal, Popkin renewed his argument that the § 7212(a) statute should not have been used to prosecute him, because an essential element is that the act or conduct of the accused involve the use of force or threats of force against the person of a particular government agent, which the prosecution failed to prove as to him. He argued that interference with the operation of the IRS as an agency was not included, nor contemplated by the statute. The court disagreed:

The first clause [of § 7212(a)] does require an endeavor to intimidate or impede an officer or employee by force or threats of force, or corruptly. The second clause, however, while retaining the requirement that the accused act corruptly, greatly expands the reach of the statute by providing that it is violated if a person "in any other way," either corruptly or by force or threats of force does the prohibited act. And here, the prohibited act need not be an effort to intimidate or impede an individual officer or employee. Instead, this clause prohibits any act that either obstructs or impedes or endeavors to obstruct or impede, the "due administration" of the Internal Revenue Code.

The defendant's interpretation would render the insertion of "in any other way" and the use of "the due administration of this title" in place of "any officer or employee of the United States" in the second clause meaningless.
... What is determinative is the clear language of the statute. The second clause conspicuously omits the requirement that conduct be directed at "an officer or employee of the United States government." The defendant concedes that § 7212(a) is not ambiguous, and the different language used in the second clause indicates an intent to sweep more broadly than the language of the first clause.

The court then found that there was sufficient evidence to support Popkin’s conviction for violating § 7212(a), using language illustrating the dilemma for the drug dealer who needs for his illegal income to look legitimate and offering a lesson for attorneys who endeavor to help them:

The record reveals that the defendant did create the California corporation for the purpose of enabling Musick to disguise the character of illegally earned income and to repatriate it. Popkin acted corruptly, moreover, because at least one intent in creating the corporation was to secure an unlawful benefit for his client. The purpose of the corporation went beyond repatriating money held in a foreign bank. It provided a means, in creating a paper loss from inter-corporate transactions, by which the funds held abroad and repatriated appeared to be less than the actual amount of untaxed money that Musick should have reported for 1983 and 1984.

At the first monitored meeting on March 26, 1985, Musick stated three objectives for which he was seeking the defendant's help:

1. He wanted to retrieve approximately $220,000 that he had made on two cocaine deals in 1983 and 1984, from a foreign account controlled by Mid-America Financial;
2. He wanted to "surface and start making a living, showing a living" by getting into building and real estate in California;
3. He wanted to avoid paying full income taxes on the $220,000. As Musick said to the defendant, "I wanna pay taxes a little bit, but, you know, I don't wanna get raped again, you know." He also wanted to avoid acknowledging an interest bearing foreign account.

Musick asked the defendant for suggestions because his associates at Mid-America Financial were not tax specialists and did not want any problems with the IRS while "doin a service." He also told the defendant that he was "very vulnerable to IRS" and didn't want to be tied into the foreign account that was in Mid-America Financial's name. With this background, the defendant advised Musick, "the best thing you can do is go into your own business" because capital infusion is different from loans and other cash transactions. Ultimately the defendant advised Musick to issue stock in his new corporation to Mid-America Financial for $200,000, then report "bad
business" and buy the stock back for $3,000 to $10,000. The people at Mid-America would not get hurt—they were just providing a service all along. Once the stock was repurchased for $3,000 to $10,000 Musick would again own 100% of the new corporation, and the corporation would have the $200,000. At the end of these various steps, the defendant advised that this money would be "just plain old money that you sold stock for."

The effect of all these maneuvers would be more than just to disguise the source of the money thus repatriated. It would also place in Musick's wholly owned corporation the power to determine when, if ever, the $200,000 earned in 1983 and 1984 would be reported for income tax purposes. The income tax laws require annual reporting of all income in the year earned. The entire system is built on the basis of annual reporting, and any arrangement that permits a taxable entity to avoid reporting income in the taxable year when earned has the effect of skewing the system and thus impeding or obstructing the due administration of the tax laws.

A review of the entire record leaves no doubt that the defendant endeavored to impede or obstruct the due administration of the tax laws in the advice he gave Musick. He was clearly aware that one of Musick's three purposes was to avoid paying the full tax on his 1983 and 1984 drug-related earnings. Throughout the conversation of March 26 the defendant referred to the tax issue as well as the need to disguise the illegal source of the money and repatriate it. While it involved "laundering" $200,000, the plan the defendant proposed involved more than money laundering. It was designed also to secure an unlawful tax benefit for Musick, an endeavor that § 7212(a) prohibits.

United States v. Popkin, 943 F.2d 1535, 1540-1 (11th Cir. 1991).

The use of § 7212 against people who take particularly aggressive efforts to prevent tax collection is discussed in Chapter 11.

6.8 Conclusion

The crime of money laundering makes criminal tax an important part of drug investigations and prosecutions. Although prosecutors should endeavor to develop evidence that hiding income from the IRS was a part of the scheme, the fact that money laundering has become a major enforcement program means that most drug dealers understand the need to hide their wealth from U.S. law enforcement authorities, including the IRS.
Chapter 7 Public Servants Gone Astray

Chapter 3 described how criminal tax offenses were the mechanism for forcing Spiro T. Agnew out of office, whereas he would have otherwise succeeded Richard Nixon as President of the United States. This chapter addressed cases in which public servants have been prosecuted under the tax laws for graft, and some of the legal issues that arise in these cases.

7.1 William Hart and the Detroit Police Special Fund

Judge Nathaniel R. Jones, writing for the Sixth Circuit Court of Appeals, referred to the saga of William Hart as “one of the saddest, yet most egregious cases of public corruption to come before this court in recent years.” Hart was the Chief of Police in Detroit, appointed to that position in 1976 with a 24-year career that started when he was hired as a uniformed beat cop. He served as chief for 15 years, until he was terminated for theft of public monies. He was ultimately convicted in federal court of embezzlement and filing false tax returns. United States v. Hart, 70 F.3d 854 (6th Cir. 1996).

Hart’s trouble arose from a pool of money, known as the Detroit Police Department’s "Secret Service Fund," that was disbursed at the discretion of the Chief for covert police operations. Despite his $95,000-per-year salary, Chief Hart dipped into the pool for his own private purposes. Between 1982-89, Hart requested disbursements in excess of $1.2 million. During the joint FBI/IRS investigation, he gave the investigating agents various false and contradictory explanations for the expenditures, and provided the agents with a list of several "investigations" that he claimed received money from the fund. He steadfastly refused, however, to disclose either the amount of money that was channelled to these alleged investigations or to whom the money was transferred, as well as an audit by the Auditor General. Eventually, the agents learned that many of the investigations included on Hart's list either required no funding or were funded by other divisions, and that of the $1,292,542, Chief Hart’s fraud was aided by his friend Kenneth Weiner, a former cop who ran several bogus corporations to which Hart funneled $1,292,305 from fund. During the time of Hart's embezzlement scheme, several units in the Detroit Police Department experienced serious financial difficulties, as a result of their inability to obtain reimbursement from the funds for their sub-accounts.

Federal agents prepared a financial profile of Hart for the years of 1971 to 1984. It showed that from 1971 to 1981, Hart's income did not exceed his expenditures. Beginning in 1982, when the fund was created, Hart's demonstrable expenditures exceeded his income by $210,000. Hart reported none of the fund money as income on his tax returns between 1982 and 1989.

Hart was indicted in June 1991 on three counts of embezzlement, one count of tampering with a witness, and three counts of tax fraud. He was convicted after a 14-week trial, and sentenced to 10 years in prison.
The appeal was a rather academic exercise. Hart argued that the trial court’s refusal to allow the questioning of government agents regarding misleading statements Weiner had made in an unrelated case denied him his right to present a defense. This claim was rejected. He unsuccessfully argued that a state prosecutor should not have been permitted to serve as a Special United States Attorney during this prosecution.

On the tax charges, Hart complained about the government hiding the ball, claiming that he was prejudiced by the prosecution’s reliance on the “specific item” method of proving his income that was different from what he was told would be the government’s method in the months leading up to the trial.3 The Sixth Circuit had little trouble disposing of this argument:

[T]he government introduced evidence of particular SSF funds that Hart embezzled but failed to report on his income tax returns. Hart now claims that the introduction of this evidence created a "fatal variance" between the government's asserted pre-trial method of proof and the proof at trial.

Hart argues that he was prejudiced by the evidence presented in support of the government's expenditure theory. He claims that the government proved that his expenditures exceeded his income for the years 1985-87 by introducing "explosive" and highly prejudicial proofs indicating Mr. Hart engaged in several extramarital intimate sexual relationships, gambled, and purportedly purchased vast quantities of lottery tickets." According to Hart, this evidence would have been unnecessary and inadmissible if the government had used only a specific-item method of proof.

Hart was not unaware of the charges against him; he knew from the onset of this case that the government sought to prove he had embezzled SSF funds and failed to report this money as income. It is clear from the record that Hart denied taking the money and initially argued that the money was indeed used for legitimate law enforcement purposes. Hart could, therefore, have anticipated that the government would dispute this by presenting evidence that money beyond his reported income was used for other identifiable, illegitimate causes. Finally, Hart has not supported his claim that evidence regarding his personal conduct was "explosive" or prejudicial, nor did he object at trial or

3This is a reference to the fact that there are two methods of proof in a tax case. In the "direct" or "specific item" method, specific items are demonstrated as the source of unreported income. In the "indirect" method, the defendant's finances are reconstructed via circumstantial evidence including (1) net worth analysis; (2) bank deposits; and (3) cash expenditures in excess of reported income, which require certain investigative steps but are well-recognized by the courts.
appeal on these grounds. We therefore conclude that no fatal variance occurred.

70 F.3d at 860-1.

Hart’s corruption was redressed in part by tax charges, which rounded out the government theory of the case since they relied on proof that belied Hart’s defense that he never took control of the funds. It remains an excellent example of how criminal tax tools can be applied against persons beyond “mere” tax cheats. His conduct was akin to an embezzlement scheme, although his employer happened to be a government entity.

Other tax cases that have involved public corruption have involved officials who, like Spiro Agnew, who took bribes from special interests rather than stole public monies.

7.2 Fraud at the Illinois Governor’s Office

A revered public figure, Otto Kerner Jr. served as Governor of Illinois between 1961 and 1968, when he resigned to become a judge on the Seventh Circuit Court of Appeals. On July 15, 1970, two IRS special agents visited Judge Kerner in his chambers, gave him the Miranda warnings, and told him that he was under criminal investigation for income tax violations.

The agents were focused on Kerner’s 1966 and 1967 income tax returns. On the latter, Kerner reported his acquisition of 14,000 shares of “Chicago Co.” on July 13, 1966 for $5,600, and their sale on May 25, 1967 for $28,000, and the 1962 acquisition of “Exchange C.T. Co.” stock for $25,000, with a May 12, 1967 sale for $150,000. Kerner treated each transaction as a long-term capital gain on his 1987 return. The government had reason to believe that the items referred to were stocks which had been acquired in 1966, which then had a value of $28,000 and $150,000 respectively. According to the government, Kerner received the stock as bribes, and they were thus taxable as ordinary income in 1966. Kerner’s receipt of the stock was not reported on his 1966 return.

Agent Stufflebeam asked Kerner to identify the “Chicago Co.” stock listed on the 1967 return. Kerner said that it was a financial institution, that he had purchased the stock on the advice of his broker, and that a friend of his, Isidore Brown, was a corporate officer. This was untrue. In fact, the Chicago Co. was privately owned, that Kerner had never owned any of its stock, and Isidore Brown had never been involved with that company. Kerner also denied that the Chicago Co. transaction had anything to do with Chicago Harness Racing Company. This too turned out to be a lie.

How did Judge Kerner find himself in this position? It all started in his 1960 campaign for Governor, during which he was supported by elements of the state’s horse racing industry.

For many years prior to 1960, Marjorie Lindheimer Everett had assisted her father, Benjamin Lindheimer, in the operation of his thoroughbred racing interests in the Chicago area.
Lindheimer controlled the companies that owned Arlington Park and Washington Park race tracks, while Everett owned some stock in the Balmoral Jockey Club. Lindheimer was a social acquaintance of William S. Miller, a member of the Illinois Racing Board who, after Lindheimer’s death, agreed to help Everett continue in her father’s racing enterprise. The result was Chicago Thoroughbred Enterprises (CTE), financed by bank loans of more than $8 million. CTE issued 3,000 shares of stock of which 2,000 went to Everett who pledged them at the bank as collateral to secure the CTE loan. Arlington Park Jockey Club and Washington Park Jockey Club became divisions of CTE.

Miller assisted in financing Kerner’s 1960 campaign and, through Miller, Everett's companies contributed $45,000 in cash through Kerner’s campaign manager, Theodore Issacs. After Kerner won, he appointed Isaacs as Director of the Department of Revenue and Miller as chairman of the racing board.

In 1961, Miller suggested to Everett that she enter the field of harness racing to get more income from greater use of Arlington Park and Washington Park facilities. This would require legislation to permit one corporation to own two race tracks, to allow a racing company to conduct a meet at a track other than its own and to authorize a foreign corporation to own and operate race tracks in Illinois. Senate Bill 717, which approved such corporate actions, was lobbied through the Illinois legislature by Miller, and Kerner signed it into law. In 1962, Chicago Harness Racing, Inc., CHR, was organized by Everett and Miller and had a landlord-tenant relationship with CTE. Miller suggested to her that 50,000 shares of CHR stock be made available for distribution to those who he thought might help the company.

Miller informed Everett that Isaacs would act as a liaison between Miller and Governor Kerner on racing matters. Miller thought it essential that she have a friend in the Kerner administration in order to ensure the award of racing dates at CTE's tracks and generally favorable consideration from the governor. CHR stock would be the vehicle. In November 1962, Miller met with Kerner and Isaacs in the governor's Springfield office and told them of Everett's offer to allow Kerner and Isaacs to purchase CHR stock for a nominal fee. Kerner reportedly said, “That's very nice of Marj.”

The CHR stock transfer did not occur until 1966. In the interim, Kerner took some official actions that benefitted Everett. In the spring of 1964, for example, Kerner was confronted with the problem of the allocation of racing dates to Maywood Park Trotting Association, a competitor of Everett's enterprises. Kerner ordered an aide to “cancel the dates” that the Harness Racing Commission had set aside for Maywood for the fall of 1964 and to reassign them to Sportsman's Park and Washington Park, the latter a division of CTE, controlled by Everett. When the aide refused, Kerner responded: “Well, now Tom, this is an order.”

In 1964, Kerner successfully ran for reelection as governor. Everett made a $15,000 cash contribution to his campaign which was delivered by Miller to Kerner. Other friendly political interventions by Kerner followed.
An Illinois law enacted in 1965, Ill.Rev.Stat., Ch. 8, § 37a1 (1965), prohibited members of the Racing Board from maintaining any interest in a harness racing company. Thus Miller, as chairman of the Board, found himself in late 1965 in the position of having to dispose of 50,000 shares of CHR which had been allocated to him at the company's formation in 1962. Eventually 28,000 of the shares came into the possession of Isaacs and Kerner.

In January 1966, Isaacs informed Miller that “the old man and I are irritated about that delay in receiving Marj's (CTE) stock.” Miller promised to contact Everett at once. When given Isaacs' message, Everett commented that she would do something about it as soon as possible. What followed was a series of strange transactions, involving backdated documents and promissory notes that documented loans, that resulted in Kerner and Isaacs receiving the shares. They received dividends that year, based on their stock ownership.

In 1967, Miller, who had stepped down from his position as Chairman of IRB, was asked by a longtime friend, Joseph Becker, whether he knew of any race track stock for sale. Miller proceeded to arrange a deal whereby Becker and his brother would purchase the 28,000 shares of CHR held by Isaacs and Kerner. The sale went through. The end result of all these transactions was that Isaacs and Kerner had each gained $159,800 from sales and dividends and were each out of pocket only $15,079.

Kerner and Isaacs were charged with conspiracy, mail fraud, use of interstate facilities in furtherance of bribery, perjury, tax evasion, and filing false tax returns. Following a six-week trial before a jury in Chicago, they were found guilty on February 19, 1973 of a variety of offenses.

The tax counts focused on Kerner’s failure to report his receipt of the shares in 1966, and his 1987 returns’ misidentification of CTE, CHR, and BJC, and the claim of long-term capital gains based on a 1962 acquisition date. The appeal focused on the sufficiency of the evidence regarding the bribery, and Kerner conceded that the tax charges stood or fell on the sufficiency of the proof of bribery. The Seventh Circuit, affirming the bribery conviction, upheld the tax counts in a single sentence. United States v. Isaacs, 493 F.2d 1124 (7th Cir. 1974).

Do tax counts flow this easily in public corruption cases? How have tax charges been pursued, and how valuable have they been, in the context of public corruption cases? The published cases from the last few decades illustrate how difficult it is for the prosecution to show that payments to public officials are a quid pro quo for some official action, and how that challenge has been met by law enforcement. Tax charges sometimes fill the gap.

7.3 The Sunrise City Council in the Early 1980s

Sunrise is a city in Broward County, Florida. In the early 1980s. John Montgomery was a member of the Sunrise City Council, and Robert O'Keefe was a member and later chairman of
the Sunrise Planning and Zoning Board. They were also partners in a private firm known as Nob Hill Realty of Sunrise, Inc. and B & J Associates. In terms of public confidence in the county’s elected officials, it was not a very good combination.

William McKettrick and Thomas Allgood, who had been partners in nursing home projects in Georgia, decided to erect a nursing home in Broward County. In May, 1981, a realtor introduced McKettrick to Montgomery and O'Keefe. Montgomery located a suitable site for the nursing home within Sunrise and an option contract was signed with the property's owner. Montgomery and O'Keefe ultimately received a sales commission of $36,900.00 from this transaction. If that was all they did, they would not have been indicted.

Due to high interest rates then prevailing, it soon became apparent that conventional financing was unfeasible for the project, and McKettrick and Allgood turned to tax-exempt industrial revenue bonds to finance the project. The City of Sunrise, through its city council, had to approve the issuance of these bonds. In October or November, 1981, Montgomery explained this process to McKettrick and Allgood, and offered to help sell the bonds for a fee.

In November, 1981, O'Keefe and Montgomery traveled to Augusta, Georgia, at Allgood's invitation. While in Georgia, they requested $10,000 as an advance on the sale of the bonds.

Montgomery participated in the discussion and votes on the nursing home issues before the city council. On each of these three related issues, he voted in favor of the resolutions. O'Keefe, a member of the Planning and Zoning Board, voted in favor of the special exemption use ordinance.

Under the Florida law then in effect, FSA § 112.3143, a public official could vote on any matter in which he has a private interest, provided he discloses the "nature of his interest" in a public memorandum within 15 days of the vote. After each vote, the O'Keefe and Montgomery filed the conflict of interest forms, which disclosed the real estate commissions, but did not describe the other fees. However, once the other fees were paid, both defendants made the appropriate disclosures.

The transaction closed on August 25, 1982, and the real estate commission was paid to Nob Hill and a $32,500 check was issued to Montgomery and O'Keefe's corporation, B & J Associates, for consulting fees. The fee paid to B & J was disclosed on the bond disclosure documents, and a portion of the consulting services were described on an invoice submitted at the closing.

An investigation ensued. Montogomery and O'Keefe were charged with extortion and with failing to report the fee on their tax returns. At trial, their primary defense to the tax charges was that the unreported income consisted of loans to and from Nob Hill Realty and B & J Associates. Alternatively, they maintained that they were sloppy bookkeepers and any
discrepancy between their income and the returns was the result of negligence, not willfulness. Montgomery claimed maintained that he relied on O'Keefe to accurately report his Nob Hill income to their tax preparer. To the extortion charges, they asserted that the money they received was reasonable compensation for legitimate services rendered.

At the close of the Government's case, O'Keefe and Montgomery moved for a judgment of acquittal on all counts. After expressing some reservations about the extortion charges, the district court denied the motions and sent the entire case to the jury, which returned a verdict of guilty on all counts. The defendants filed a motion for judgment of acquittal. At the sentencing hearing, the court announced that he was granting the motion for a judgment of acquittal as to the extortion-related charges. Meanwhile, it denied the motions as to the remaining tax charges and sentenced O'Keefe and Montgomery to probation.

The appellate decision focused on alleged prosecutorial conduct before the grand jury, the court’s decision to exclude defense expert testimony, and the court’s refusal to require the defendants to be provided a copy of the IRS Special Agent’s Report, as well as the government appeal of the dismissal of the extortion counts. The Eleventh Circuit affirmed the tax convictions, while upholding the dismissal of the extortion charges. United States v. O'Keefe, 825 F.2d 314 (11th Cir. 1987).

A similar thing occurred a few years later in the case of Robert Clemmer, a Dayton, Ohio police officer who was charged with accepting bribes and not reporting them on his 1983 tax return. He was acquitted of the bribery but convicted on the tax charges. Finding that the split verdict was inconsistent, the district court granted Clemmer’s post-trial motion for a judgment of acquittal. United States v. Clemmer, 748 F.Supp. 1249 (S.D. Ohio 1989). It probed into the jury's reasoning and attempted to divine why it acquitted him of the bribery counts and convicted him of the tax offense, ultimately concluding that a conviction for failing to report bribe income would be inconsistent with an acquittal on the underlying bribery charges. The government appealed.

The Sixth Circuit agreed with the prosecution that the tax convictions should have stood, noting that separate charges in an indictment should be treated like separate indictments, and since acquittal on a criminal charge would not constitute res judicata on any other charge in the indictment, courts should let inconsistent verdicts stand and adopt a policy against judges from looking into the motivations behind jury verdicts.

Naturally, the government believes that the source of the unreported income is the bribes, but their inability to convict defendant of bribery does not conflict with the evidence that defendant's net worth and expenditures exceeded those of a person with his reported income and admitted nonreportable income. The jury may have believed that defendant had extra reportable income that he did not report, but may not have believed beyond a reasonable doubt that this
income came from bribes.


*O’Keefe* and *Clemmer* show the value of the tax charges in the prosecutors’ arsenal. The extortion charged against O’Keefe and Montgomery were premised on the notion that the $32,000 payment was an illegal bribe. Their defense was that it was a legitimate fee. Even when this claim was credited by the court, it did not excuse their failure to report the “fee” on their tax returns. Their convictions were affirmed. The same was true for Robert Clemmer, when the bribery case fell short.

On the other hand, *O’Keefe* shows that a politician’s mere receipt of outside fees does not always rise to the level of actionable corruption. Though it was a close call in *O’Keefe*, law enforcement needed to show firmer indications of a *quid pro quo*. The issue gets even more complicated when the public official is an elected leader who has to solicit campaign contributions.

### 7.4 Bribes vs. Campaign Contributions

Robert McCormick represented an economically depressed, coal mining region of West Virginia in the state’s House of Delegates, and was a leading advocate of a program that allowed graduate of foreign medical schools to legally practice in areas of the state that lacked medical professionals. In the 1980s, a legislative proposal emerged to end the program. Several of the foreign doctors who would be impacted hired a lobbyist, John Vandergrift, to represent them in the state capital. McCormick agreed to sponsor legislation that would allow the program to continue.

During his 1984 reelection campaign, McCormick told Vandergrift that his campaign was expensive, that he had not "heard from" the doctors, and that he wanted Vandergrift to contact them. Vandergrift contacted the leader of the doctor’s group and, on the morning of June 1, 1984, Vandergrift received an envelope with nine $100 bills which he delivered to McCormick at his business office. A second delivery of $2,000 in cash occurred the same afternoon. McCormick neither reported these payments as campaign contributions on the required reporting statements nor listed them on his income tax return. After June 1, McCormick dealt directly with the doctors and received three more cash payments, on November 1, November 12, and December 19, 1984. On May 15, 1985, two weeks after the McCormick-sponsored bill became law, McCormick received the last cash payment. For each of these payments, an operative wrote a check on the Association account payable to "Cash," cashed the check, and then placed the cash in envelopes which were personally delivered to McCormick's business office.

In September 1988, a federal grand jury charged McCormick with extortion and with filing a false 1984 tax return. Following a six-day jury trial, McCormick was found guilty. McCormick was fined $50,000, plus $900 restitution and costs, plus three years suspended
sentence and probation. McCormick’s case would ultimately reach the U.S. Supreme Court.

McCormick’s argument on appeal was that the payments were campaign contributions and not illegal payoffs because there was no coercion or quid pro quo exchange for the payments. He argued that he could not be convicted of the tax offense because the payments were not personal income but rather a non-taxable contributions to his reelection campaign. The Fourth Circuit disagreed. Since the jury had convicted McCormick of violating the Hobbs Act, it had implicitly rejected his attempts characterize at least the initial payment as a campaign contribution. Moreover, the Fourth Circuit found that conviction under the extortion statute, known as the Hobbs Act, did not necessarily require proof that the payments were made as part of a quid pro quo:

We agree with the Second Circuit that alleged "political contributions" may violate the Hobbs Act in more than one way. When there are specific promises given or threatened actions withheld in exchange for political contributions, ... this quid pro quo exchange is persuasive evidence that the money was extorted in violation of the Hobbs Act. But in addition, if payments to elected officials are not treated as legitimate campaign contributions by either the payor or the official [as in McCormick’s case], then a jury may reasonably infer that these payments are also induced by the official's office in violation of the Hobbs Act. Otherwise, unless there was an explicit quid pro quo promise, elected officials could avoid the Hobbs Act merely by calling the money "campaign contributions." In this situation, the actual intent of the parties is the key determining factor.

Therefore, according to the Fourth Circuit, the jury had found the funds were personal income. United States v. McCormick, 896 F.2d 61 (4th Cir. 1990).

McCormick’s conviction was ultimately reversed by the Supreme Court, in a majority opinion written by Justice Byron White, which found that the Fourth Circuit had erred when it concluded that a quid pro quo is not necessary for a Hobbs Act conviction when an official receives a campaign contribution:

Serving constituents and supporting legislation that will benefit the district and individuals and groups therein is the everyday business of a legislator. It is also true that campaigns must be run and financed. Money is constantly being solicited on behalf of candidates, who run on platforms and who claim support on the basis of their views and what they intend to do or have done. Whatever ethical considerations and appearances may indicate, to hold that legislators commit the federal crime of extortion when they act for the benefit of constituents or support legislation furthering the interests of some of their constituents, shortly before or after campaign contributions are solicited and received from those beneficiaries, is an unrealistic assessment of what
Congress could have meant by making it a crime to obtain property from another, with his consent, "under color of official right." To hold otherwise would open to prosecution not only conduct that has long been thought to be well within the law but also conduct that in a very real sense is unavoidable so long as election campaigns are financed by private contributions or expenditures, as they have been from the beginning of the Nation. It would require statutory language more explicit than the Hobbs Act contains to justify a contrary conclusion. Cf. *United States v. Enmons*, 410 U.S. 396, 411, 93 S.Ct. 1007, 1015, 35 L.Ed.2d 379 (1973).

This is not to say that it is impossible for an elected official to commit extortion in the course of financing an election campaign. Political contributions are of course vulnerable if induced by the use of force, violence, or fear. The receipt of such contributions is also vulnerable under the Act as having been taken under color of official right, but only if the payments are made in return for an explicit promise or undertaking by the official to perform or not to perform an official act. In such situations the official asserts that his official conduct will be controlled by the terms of the promise or undertaking. This is the receipt of money by an elected official under color of official right within the meaning of the Hobbs Act.

This formulation defines the forbidden zone of conduct with sufficient clarity.


What happened to the conviction on the tax count? It too was reversed and remanded, the Supreme Court reasoning that the Fourth Circuit based its affirmance of the tax conviction solely on the extortion conviction. The extortion conviction, according to Justice White, did not demonstrate that the payments were not campaign contributions and hence taxable, since the instructions permitted the jury to convict McCormick of the tax charge if it was convinced that the payments were campaign contributions but was also convinced that the money was extorted. The extortion conviction did not demonstrate that the payments were not campaign contributions and hence taxable.

This finding does not necessarily exhaust the possible grounds for affirming on the tax count. Had the court focused on the instructions actually given at trial, it would have been obvious that the jury could have convicted McCormick of the tax charge even though it was convinced that the payments were campaign contributions but was also convinced that the money was received knowing that it was given with an expectation of benefit and hence was extorted. The extortion conviction did not demonstrate that the payments were not campaign contributions and hence taxable.

Id. at 275-6.
How can prosecutors establish a *quid pro quo* required in public corruption cases? This exacting requirement sometimes is accomplished though such time-tested investigative techniques as undercover sting operations, electronic surveillance, and the help of insiders.

7.5 **Undercover Sting: Operation Vespine in Atlanta**

John H. Evans, Jr., an Atlanta zoning official, was taken down by an FBI sting known as Operation Vespine. An FBI agent named Clifford Cormany, Jr., masquerading as "Steve Hawkins," passed himself off as a land developer who had recently moved to the Atlanta area and was representing a group of investors that was considering developing various land projects in DeKalb County. The ruse led to his introduction in early 1985 to Evans, a member of the county’s Board of Commissioners. Over the next 18 months, Evans and “Hawkins” had a series of meetings and telephone conversations that were videotaped or audiotaped by the FBI.

In a May 1986 conversation, Cormany informed Evans that they wanted to get an area zoned for the highest density possible and that they were willing to do whatever was needed in order to get the zoning passed. They discussed Evans' campaign for reelection, which was just getting started. In response to a query about what size contribution would be considered meaningful, Evans replied that at a recent fundraising event, contributors were encouraged to give a thousand dollars apiece. Asked whether he needed any “expense money,” Evans stated that he had to order a voter registration list and mailing labels in order to do a precinct mailing. He estimated that it would cost him about $260. Cormany wrote out a check to Evans for a $300 contribution. Evans used this money to buy the list and sent a thank-you note to Cormany.

In a conversation a few months later, Cormany informed Evans that there was a "generous budget for anything we do." Evans produced a document which he referred to as the "draft constitution of the United States," which contained his campaign budget from June 29 to August 12, the date of the primary. The document showed his outstanding campaign debts as well as an estimate of his anticipated campaign expenses throughout the primary. Evans stated that of his $14,180 budget, he had received $6,295, leaving a shortfall of $7,885. The conversation included the following verbatim exchange, which was one of the best examples of a electronically-captured *quid pro quo* in the annals of American criminal justice:

   Cormany: Can I, can I talk frankly with you ...

   Evans: Yeah. . . . .

   Cormany: And, and this is between you and I. I need, I desperately need, your help and your support on this project. You, I'm in one business, you're in another.

   Evans: Yeah, yeah you got me.
Cormany: You're, you're the influence you have over there, and the assistance you have over there, I can probably cover that for you.

Evans: Well, let me tell you. I, it's it's cause, see you don't know how I operate. What I'm, what I'm telling you is that, this is what the shortfall is and then you can decide whatever part you want to handle of that.

Cormany: You're talking about seven eight eighty-five.

Evans: Right.

Cormany: That's the balance of what the ...

Evans: Of what the budget was from June 29th through August 12.

Cormany: But what I'm asking you John, I mean, is if I pick up the entire amount, I mean, does that, would that satis-- would that be a reasonable relationship, a reasonable

Evans: Oh, I'll, let me make sure, and I understand both of us are groping ...

Cormany: Yeah.

Evans: ... for what we need to say to each other.

Cormany: All I want ... let me, let me kinda ..

Evans: I'm gonna work. Let me tell you I'm gonna work, if you didn't give me but three, on this, I've promised to help you. I'm gonna work to do that. You understand what I mean.

Cormany: Yeah.

Evans: If you gave me six, I'll do exactly what I said I was gonna do for you. If you gave me one, I'll do exactly what I said I was gonna do for you. I wanna' make sure you're clear on that part. So it doesn't really matter. If I promised to help, that's what I'm gonna do.

Cormany: I understand.
Evans: You see, what I'm doing is giving you is a fair assessment of what my needs are to be re-elected on August 12.

Cormany: Okay.

. . . .

Cormany: You need cash?

Evans: Yeah ...

Cormany: Check?

Evans: I think we better do it that way.

Cormany: Cash?

Evans: Yeah, I think so in this case.

Cormany: Okay.

Evans: I think so, so there won't be any, any, tinges, or anything.

Cormany: Okay.

Evans: Or, we can do this.

Cormany: You, you, tell me how you prefer it done?

Evans: I mean, let me, let me tell ya'.

Cormany: I can write the check ...

Evans: I know.

Cormany: Or I can give you, I can give you ...

Evans: Okay, I'll tell you now, we don't have to do that. What you do, is make me out one, ahh, for a thousand.

Cormany: Make you out a check for a thousand?

Evans: And, and that means we gonna record it and report it and then the rest would
be cash.

Cormany: The rest will be cash?

Evans: Yeah.

On July 25, Cormany gave Evans $7,000 in cash, which Evans placed in an envelope, and a check for $1,000 payable to the "John Evans Campaign." Evans locked the $7,000 in cash in a drawer in a file cabinet in his campaign office. Evans did not at that time record the $7,000 in cash given to him by Cormany on his books nor on the required state disclosure form. He did not report the $7,000 he received from Cormany in his 1986 tax return.

On October 7, FBI Special Agents Clarence Joe Tucker and Gary Morgan interviewed Evans at his office on the issue of campaign contributions he had received from land developers. Evans told them that Cormany had given him a campaign contribution of $1,000 and that all of the contributions he received from individuals were reflected on his campaign disclosure reports. Evans failed to mention the additional $7,000 in cash that he had received from Cormany. A month later, Evans was informed about the undercover operation.

Evans was charged with extortion and tax fraud for his receipt of the $7,000 which he did not report on his return.

His appeal attacked the investigation on a number of fronts: he claimed that the jury instruction on the extortion charge was erroneous, that the district court erred in admitting a government chart and foundation testimony into evidence that purported to summarize his finances, that it should have permitted him to present an expert witness on linguistics in the field of conversation and discourse analysis, and that he should have been able to cross-examine the FBI undercover agent on whether he complied with the FBI undercover guidelines.

The main argument on the tax charges centered on Evans’ claim of entrapment. He challenged the district court’s refusal to give an entrapment instruction to the § 7206(1) charge. The Fifth Circuit explained that a criminal defendants is entitled to have jury instructions relating to a theory of defense for which there is any foundation in the evidence. It explained that, for an entrapment instruction, a defendant must come forward with some evidence that the government's conduct created a substantial risk that the offense would be committed by a person other than one ready to commit it. This standard led to a review of whether the district court correctly concluded that Evans had failed to present more than a scintilla of evidence in support of the entrapment claim. The Fifth Circuit affirmed the trial court’s decision:

Evans first contends that the evidence that was sufficient to authorize the entrapment charge on the extortion count (Count I) would also authorize it on the count of failure to report $7,000 as income (Count II). Evans's argument appears to be that when he was entrapped into extorting the money, he was simultaneously entrapped into not
recording $7,000 of it as a campaign contribution. He goes on to argue that once he decided not to record that money as a campaign contribution, he was "logically" foreclosed from disclosing it to the I.R.S. We find this argument, though creative, to be without merit. First, while there may be evidence sufficient to support a charge of entrapment on the general offense of extortion, there is no evidence that the government played any role in Evans's decision, after receiving the $8,000, to record only $1,000 as a campaign contribution. Even if such evidence existed, Evans's subsequent decision not to declare the additional $7,000 on his income tax form was wholly separate from his decision not to record it in his campaign ledgers. Thus, we find that the giving of an entrapment charge on Count I in no way required the court to give an entrapment charge on Count II.

Evans argued that his entrapment defense was supported by the transcript of his July 24, 1986, meeting with Cormany, in which Cormany requested that the payment not be disclosed. Evans contended that when he responded that he would not disclose the $7,000, he "clearly signaled his future intention with regard to disclosure to the I.R.S." The Eleventh Circuit did not need to reach the latter question of whether a mere request by a government agent not to disclose money to the IRS would provide a sufficient basis for an entrapment charge, since it appeared that the undercover agent made no such request. Although he requested that Evans not inform anyone of the transaction, the transcript showed that Cormany did not suggest or request that Evans not report the money to the IRS in his tax return.

*United States v. Evans*, 910 F.2d 790 (11th Cir. 1990).

### 7.6 Help of Insiders: The Corrupt Border Agent, His Uncle, and His Outraged Wife

Ronnie Brickey joined the Immigration and Naturalization Service (INS) in August 1996, where he served as a border inspector at the San Luis, Arizona, Port of Entry. A December 1997 fight with his wife, Veronica, led her to report him to his supervisors for bribery. Veronica had noticed unexplained cash and a number of expensive items Ronnie had acquired, and she had overheard his telephone conversations between Ronnie and his uncle, Pablo Cordova-Barva, in which they seemed to be speaking in code about smuggling items over the border. When she inquired, Brickey had told her that, "I just had to close my eyes and I would get $15,000 per car. My uncle was the one arranging the cars that would go across the border."

After Veronica reported him, Brickey bought her a diamond bracelet, and he and his attorneys tried to get her to recant her statements. An IRS investigation showed that Brickey had 1987 income of $149,730.70, rather than the $25,315 he reported on his return. The understatement meant that his actual tax liability was $46,448.71, rather than the reported $4,413.

Brickey denied causing loads of illegal drugs to enter the United States or closing his
eyes to allow drug cars across the border. He also denied that any of the money he spent during 1997 was income to him for that year, claiming instead that all of the funds had come from savings he had accumulated. He was charged in the District of Arizona with one count of attempting to evade taxes, in violation of § 7201, and one count of willfully making a false federal income tax return, in violation§ 7206(1). On July 21, 2000, the jury returned verdicts finding him guilty on both counts.

Besides the argument that he was unfairly sentenced based on his position of trust, Brickey’s main argument on appeal was that that there is no evidence that the allegedly unreported 1997 income was received during 1997 instead of 1996. This argument was rejected by the Ninth Circuit:

The government's proof at trial, when viewed in the light most favorable to the prosecution, clearly establishes that a rational trier of fact could conclude that Defendant received substantial income during 1997 that he did not report on his federal income tax return for that year. The evidence at trial established that during 1997, $23,345.23 was deposited into Defendant's bank accounts and Defendant made cash expenditures totaling $130,264.01. The government's evidence also proved that the $130,264.01 in unreported cash was income that Defendant should have reported on his federal income tax return. The testimony of Defendant's former wife also supports this conclusion. She testified about their finances during the relevant period. She was responsible for paying household bills during her marriage to Defendant, and, as his spouse, knew of his disposable income, his lifestyle, and spending habits. Given all of the evidence produced at trial, a rational factfinder could easily conclude that Defendant received substantial income in 1997 that he did not report on his federal income tax return for that year.

*United States v. Brickey*, 289 F.3d 1144, 1151 (9th Cir 2002).

### 7.7 Fleecing the Unions

Although they are not public officials, union leaders have a fiduciary obligation to their membership. Criminal tax charges sometimes help redress instances in which this trust is violated, a prosecutorial practice that goes back several decades. For example:

- In 1968, Aniello Dellacroce received 22,500 shares of Yankee Plastics, Inc. stock (valued at approximately $123,000) for services rendered by Dellacroce and his assistant, Michael Catalano, to help Yankee Plastics, Inc. acquire a company known as Mr. Hanger, Inc, and to insure “labor peace” at the acquired company. In order to avoid showing this stock as income to Dellacroce, the stock was placed in the name of a nominee, Preston Smith, and the stock certification were never in Dellacroce’s physical possession.
John Cody was a salaried official at a Teamsters local that represented truck drivers who deliver building materials to construction sites throughout the New York metropolitan area and Long Island. In the late 1970s, he used his position to extort home construction services, chauffering services, and the use of a rent-free luxury condominium from contractors hoping to avoid a union organizing drive by their employees or expensive labor costs on future construction projects. In addition to racketeering, Cody was charged with tax fraud for failing to report and pay taxes on some of the kickbacks. United States v. Cody, 722 F.2d 1052 (2nd Cir. 1983).

The boss of the Luchese crime family, Vic Amuso, gained control of the union responsible for window replacement in New York City, Local 580 of the Architectural and Ornamental Ironworkers, and extorted illegal payoffs from window replacement companies in exchange for labor peace. In addition to fourteen murders which charged Amuso approved, the indictment Amuso with a tax fraud conspiracy. United States v. Amuso, 21 F.3d 1251 (2nd Cir 1994).

Tommy Briscoe, president of the 3,000 member Chicago Local of the American Postal Workers Union created a loan program for postal employees he represented, and received a portion of every repayment. He also embezzled from the union, even paying his delinquent personal tax liability with a union check. In addition to embezzlement, he was charged with tax evasion for failing to report the embezzled proceeds on his tax returns. United States v. Briscoe, 65 F.3d 576 (7th Cir 1995).

7.8 Distinction Between Bribery and Embezzlement

We saw, in the context of embezzlement, a creative defense to the corresponding tax charges: that the embezzled funds were a temporary loan that would ultimately be repaid, and therefore did not constitute income to the embezzler. Public corruption, in some cases, is a variation of embezzlement. The intersection of these two types of mischief is illustrated by the defense of an accused political operative who found himself indicted on tax charges in the 1950s.

Frank A. Wyss was the treasurer of the campaign of Henry E. Branning, who was elected mayor of Ft. Wayne, Indiana in 1947. Based on his acquaintance with Branning, Wyss received payments from persons seeking public contracts with the city. After a lengthy bench trial, Wyss was convicted of failing to report these monies on tax returns. His appeal acknowledged receipt of the funds, but argued that they were not income to him because they were either (1) “gifts” he received from long-time friends in appreciation for leads he provided them about upcoming city
procurement, or (2) embezzlement proceeds rather than bribes or kickbacks, since the payments should have been made to the city.

It was obvious why the gift characterizations would have exonerated him of the tax charge, but why would Wyss prefer to have his conduct be embezzlement rather than bribery? His prosecution occurred a decade before the Supreme Court's *James* decision, when embezzlement proceeds were not considered income and the lower courts were trying to harmonize *Wilcox* and *Rutkin*.

This odd situation – that an accused tax cheat, for strategic reasons, would prefer to be characterized as an embezzler rather than a recipient of bribes – was not lost on the Seventh Circuit Court of Appeals, whose written opinion dripped with outrage at the state of affairs that would make this position rational. It rejected Wyss’ appeal:

Following in the wake of *Wilcox*, an occasional taxpayer has firmly insisted upon being recognized and classed as a self-made embezzler hoping to avoid the economic impact, and penal provisions, of the Internal Revenue Code by insulating against the majority views reported in *Rutkin*. This case is faithful to that pattern.

Convicted, after a comparatively lengthy bench trial, of [filing false tax returns] through omissions of sums of money from his joint tax return for the calendar years 1948 and 1949, Wyss contends here that the amounts admittedly received and excluded by him were derived from two sources: (1) funds he “embezzled” and (2) “gifts” received by him from a long-standing friend for leads defendant supplied to prospective purchasers of soda fountain equipment. That these moneys were simply not income, illegal or otherwise, is the pith of Wyss' attack on the judgment appealed.

[T]he defendant urges on us that the funds were not in fact or in law his regardless of his subjective attitude toward them. He contends that if the funds were 'kickbacks' they belong to the City of Fort Wayne or, in the alternative, if they were misappropriated by him they were embezzled. Both record and briefs for the parties exhibited the undisputed fact Wyss received the moneys in question.

Detailing all the evidence is unnecessary in this opinion for it is a tragic situation where the government prosecuted on the theory of unreported bribes with the defendant denying he was bribed but claiming he embezzled. From that thesis Wyss contends that if such funds were “kickbacks” then they constituted money which under the *Wilcox* case [FN1] were nontaxable because he was supposed to return or repay them.
[W]e are told by the defendant if they were the former then the money belonged to the City of Fort Wayne, but if they were political contributions-- donated to a political trust fund, then Wyss embezzled them and therefore in either event were nontaxable.


Until the funds in question are reclaimed if they were “kickbacks” we think they constituted taxable income despite Wyss' alleged vulnerability, if any, under Indiana law to return it when and if, or because of a duty of the Indiana Attorney General or County Attorney to institute recovery proceedings. We are not rescinding Wilcox, as defendant's anticipatory argument suggests but observing that Wyss cannot come within the Wilcox holding unless the district judge found him to be an embezzler. And as both sides unanimously agree this Court does not weigh evidence nor find facts. Defendant has confused weight and credibility with questions of law.

United States v. Wyss, 239 F.2d 658 (7th Cir. 1957)

7.9 Conclusion

How does the pursuit of criminal tax charges in public corruption cases differ from their use in embezzlement and drug cases? The cases discussed in this chapter suggest that the corrupt official who fails to report his bribes cannot escape the tax fraud charges even when he succeeds in casting doubt on the illegality of the payments themselves. Unlike the embezzler, the corrupt official generally does not claim that the payment was a temporary loan that would eventually be repaid. Like the drug dealer or the attorneys who help them, the crooked politician’s best defense to the tax charges may be that proof of the alleged illegal activity is so prejudicial that it makes a fair trial on the tax counts impossible. This claim is addressed in the next chapter.
Chapter 8: Prejudice in Illegal Income Tax Cases

Recall Chapter 2, and the scenario of Moni SenGupta supplementing her flower shop income through marijuana sales on the side. Charged both with drug dealing and tax violations, her attorney tries this argument:

*The tax charges make reference to other illegal activity – marijuana dealing – which will prejudice the jury against my client and make a fair judgment on the tax charges impossible.*

We have seen a hint of this argument in some of the cases described in the preceding chapters. This chapter focuses on it as a defense when criminal tax charges are joined with the crimes that gave rise to the unreported illegal income, and how courts have dealt with it.

8.1 The Strange Case of Eugene Tafoya (continued)

Eugene Tafoya was the drunk ex-Green Beret described in Chapter 3, who found himself charged with criminal tax violations for his failure to report his assassination fees in the early 1980s, after his attempted murder of Faisal Zagallai at Colorado State University went awry.

Imagine Tafoya’s chagrin at finding himself in federal court in San Antonio, Texas, charged with tax crimes after he was able to essentially beat the murder rap in Colorado. Was this a fair fight? How could a Texas jury give Tafoya a fair shake when they realizes that the income he was accused of not reporting was fees from his job as a paid assassin?

The federal judge in San Antonio clearly had his work cut out for him. The prosecution was entitled to prove the income-nature of the payments Tafoya failed to report on his return. Their theory was that the payments were income because they were for services rendered – as a hit-man for for Edmund Wilson and Mohamar Ghaddafi. This needed to be done in a way that did not turn the jury against Tafoya based on evidence whose prejudice exceeded its probative value.

Tafoya was ultimately convicted. His appeal, however, focused on this dilemma, and the claim that his defense to the tax charges was prejudiced by the illegal activity that gave rise to his unreported income. At trial, Tafoya's defense was that the payment he received for the violence was not income:

The key issue at trial was whether Tafoya was paid for his work. Dean, who recruited Tafoya, admitted that Tafoya's initial assignment was undertaken for expenses only—and the hope of more remunerative future assignments. Tafoya testified that, indeed, Wilson promised payment for future assignments. Tafoya contended, however, that Wilson failed to fulfill his promise. According to Tafoya, he "fronted"
the expense of costly international travel and received only partial reimbursement. In short, Tafoya testified that he reported no income from Wilson because Wilson cheated him out of salary. Tafoya also characterized one payment by Wilson as a loan or a gift.

_United States v. Tafoya_, 757 F.2d 1522, 1524 (5th Cir. 1985).

The trial court refused to allow the prosecutors to put on evidence that "Tafoya, in the course of his employment with Wilson, (1) shot a Libyan residing in Colorado, (2) firebombed a home in Canada, and (3) sought to obtain poison in London for the purpose of killing an unknown person." _Id._ at 1525. "During cross-examination, the prosecutor asked Tafoya if he had "shot an individual just for expenses."

Tafoya admitted the shooting but denied receiving the salary promised for the shooting." _Id._ at 1526. The prosecutor then asked, "After that incident in [Colorado], by the way, isn't it correct that [the Libyan] lost the sight of one of his eyes as a result of that shooting?" _Id._ This led to an admonishment by the court.

One of the issues on appeal involved the prosecutor's cross-examination:

Evidence of the fact of Tafoya's assassination efforts was relevant. Tafoya claimed to have received only expenses, loans, or gifts. A jury reasonably could assess the credibility of Tafoya's claim differently depending on the nature of Tafoya's employment. It is unlikely that one would attempt three killings in exchange largely for expenses—or continue killings for over a year if not paid for the first one. Moreover, the nature of Tafoya's employment was probative of his motive to conceal the employment by failing to report illegal income. Finally, and on the simplest level, the government had to show the jury that Tafoya did _something_ to earn the income it alleged he failed to report. This is a frequent problem in tax prosecutions, and prosecutors consistently have been permitted to prove the source of unreported income, a rule that here permitted evidence to establish the job for which Tafoya was hired and paid.

_Id._ at 1527 n.5.

The court did, however, have choice words for the prosecutor's questions:

_[T]he prosecutor repeatedly required the district court to exclude details of Tafoya's assassination efforts. The district court made plain its intent to exclude the potentially prejudicial details of Tafoya's assassination efforts. At several turns the prosecutor bridled against this limitation but was effectively restrained by the district court. The district court's attentiveness avoided the necessity of a reversal. However, we caution prosecutors that tax cases are not to be transformed—by evidence, argument, or implication—into trials for other crimes. Some evidence of income source is necessary to prove a false return case and to make it intelligible, but emphasis of the_
illegal source of income or dwelling on lurid details is inappropriate. If it distracts a jury's focus, we will not hesitate to reverse.

_Id._ at 1528.

Note that these comments did not focus on the propriety of using the criminal tax laws to redress terrorism that may not have been adequately redressed by the state court. In fact, the Fifth Circuit, affirming Tafoya's conviction, considered his argument that the government was unfairly transforming the murder case into a tax prosecution. Tafoya was sentenced to three years imprisonment on each tax conviction, to run concurrently. _Id._

In a post-script, in 1983 Tafoya was found extraditable to Canada, where he was wanted for the firebombing. _In the Matter of the Extradition of Tafoya_, 572 F.Supp. 95 (W.D. Tex. 1983). After his U.S. conviction, he also litigated the question of whether his U.S. military pension should be applied to reimburse the government for the costs of his court-appointed attorney. _United States v. Tafoya_, 803 F.2d 140 (5th Cir. 1986).

8.2 Jerry Whitworth: The Tax Cheating Spy

If Tafoya represents an extreme tax case – where the unreported income is assassination fees – the case of Jerry Alfred Whitworth is on the same scale.

Whitworth worked as a radioman on board the U.S.S. _Arlington_, a communications ship, and the U.S.S. _Ranger_, an aircraft carrier, between 1968 and 1970. He was accused of selling classified Navy communications and cryptographic material to the Soviet Union through coconspirator John A. Walker, Jr., between 1975 and 1984.

Whitworth first met Walker while attending radioman instructor school in San Diego in 1970 following his tour of duty aboard the U.S.S. _Ranger_. The two became friends. By 1974, Walker had been selling cryptographic material and other Navy secrets to the Soviet Union for six years. He successfully pitched Whitworth – who by this time was a civilian – to become a spy in September, 1974 at a San Diego restaurant. This is how Walker described the overture:

We went to a secluded portion of the bar ... and I told him I was interested in using him on an illegal activity, and that even discussing it was illegal.... He was excited and was interested in hearing what I had to say.... So I told him I'd been involved in selling classified material for a number of years, and it was profitable, and I could build him into the--into the sale.... He responded affirmatively, that he would be interested.... [H]e was mostly curious as to who the buyers were. I told him it was--that I wasn't sure. I was working with people I had met, possibly could have been organized crime, Mafia, but that the buyers were allied countries, such as Israel, or
private defense organizations, such as Jane's Fighting Ships.

Whitworth agreed to rejoin the Navy and steal messages and cryptographic material for Walker. The classified information was to be passed on to the buyers by Walker and Whitworth was to be paid one-half of the cash proceeds. Whitworth expected to receive $2,000 to $4,000 per month for spying.

Whitworth reenlisted in the Naval Reserve in October 1974 and rejoined the regular Navy one month later, to take advanced satellite communications classes in New Jersey. He met with Walker in Norfolk, Virginia in February 1975, and received a $4,000 "inducement" and instructions "to try to photograph or assemble cryptographic material and anything else sensitive that came across his desk." In April 1976, Whitworth again met Walker in Norfolk and delivered the material he had stolen during his one-year assignment at the communications center. Walker paid Whitworth $18,000 for the delivery from cash Walker had received from his Soviet contact. Similar meetings with Walker occurred over the next several years, during which Whitworth went between a number of sensitive Navy jobs that involved him in the use of cryptographic equipment and material.

In April 1984, Whitworth and Walker got into a fee dispute. Three weeks later, the San Francisco FBI office received a typewritten letter dated May 7, 1984, which stated:

Dear Sir:
I have been involved in espionage for several years, specifically I've passed along Top Secret Cryptographic Keylists for military communications, Tech Manuals for same, Intelligence Messages, and etc. I didn't know that the info was being passed to the USSR until after I had been involved a few years and since then I've been remorseful [sic] and wished to be free. Finally I've decided to stop supplying material--my contact doesn't know of my decision. Originally I was told I couldn't get out without approval, this was accompanied with threats. Since then I believe the threats were a bluff.
At any rate the reason for this letter is to give you (FBI) an opportunity to break what probably [sic] is a significant espionage system. (I know that my contact has recruited [sic] at least three other members that are actively supplying highly classified material). (I have the confidence of my contact).
I pass the material to my contact (a US citizen) who in turn passes the material to a contact overseas (his actual status--KGB or whatever--I don't know). That is not always the case tho, sometimes US locations are used. A US location is always used to receive instructions and money.
If you are interested in this matter you can signal me with an Ad in the Los Angeles Times Classified Section.... What I would expect to cooperate is complete immunity from prosecution and absolutely no public disclosure of
me or my identity. I will look for an Ad in Monday editions only for the
next four weeks....
Sincerely,
RUS

The FBI responded, and a series of mailed communications ensued between the FBI
and Whitworth (who refused to identify himself). On August 14, one day after sending the
final RUS letter to the FBI, Whitworth wrote to Walker and announced his "resignation" from
espionage.

In November 1984, Walker’s wife reported his espionage activities to the FBI. With
the help of a telephone wiretap, the FBI arrested him in rural Maryland after he dropped off a
package intended for his Soviet handlers. A search of his house yielded records that identified
Whitworth, who was interviewed in California and consented to a search of his house.

Whitworth was arrested on June 3, 1985. In December 1985, a third superseding
indictment charged him with one count of conspiracy to deliver national defense information to
a foreign government, 18 U.S.C. § 794(c); six counts of delivery of national defense
information to a foreign government, 18 U.S.C. § 794(a); one count of unlawfully obtaining
national defense information, 18 U.S.C. § 793(b); four counts of making false tax returns, 26

Whitworth's espionage and tax counts were consolidated. Trial began on March 24,
1986. The government's key witness was John Walker, who by that time had pleaded guilty.
Whitworth's claimed that he did not know that the information passed to Walker was being
 relayed to the Soviet Union.

On July 24, after deliberating for ten days, the jury found Whitworth guilty on each
count of the indictment except that of unlawfully obtaining national defense information, on
which no verdict was returned.

On August 28, the court sentenced Whitworth to 180 years in prison on each of the
seven espionage counts, three years on each of the four tax evasion counts, and five years on the
conspiracy to defraud the government count. Judge Vukasin announced that he was sentencing
Whitworth, who was 47 years old at the time, to a cumulative term of 365 years in custody, and a
minimum of 60 years in custody before he will be considered eligible for parole. United States v.
Whitworth, 856 F.2d 1268 (9th Cir. 1988)

In his appeal, Whitworth challenged some of the evidentiary rulings at the trial and
whether he truly consented to the search of his home. His argument on the tax charges was that
there misjoined with the espionage counts, an argument that was rejected by Judge Boochever of
the Ninth Circuit:
In a pretrial motion, Whitworth argued that the tax offenses were not congruent with the espionage conspiracy because they were distinct in time and based on evidence from different witnesses. Yet he acknowledged that the money allegedly received in exchange for classified information was the same as that involved in the tax charges. The government contended, and the district court agreed, that the offenses were performed as part of a common plan and that proof of the tax counts was inextricably intertwined with the proof of the espionage charges.

Judge Vukasin correctly noted that where tax evasion flows directly from other criminal activity and such evasion results in large part from the necessity of concealing the illegal proceeds of that activity, joinder of the substantive and tax charges is proper under Rule 8(a). . . .

Having found that initial joinder was proper, we address the related issue of whether the court abused its discretion by denying Whitworth's pretrial motion for severance. Fed.R.Crim.P. 14 provides in part:

If it appears that a defendant or the government is prejudiced by a joinder of offenses or of defendants in an indictment or information or by such joinder for trial together, the court may order an election or separate trials of counts, grant a severance of defendants or provide whatever other relief justice requires.

. . . .

Whitworth contends that he desired to testify concerning the espionage counts but wanted to assert his privilege against self-incrimination with respect to the tax evasion charges. To justify severance on this ground, a defendant must demonstrate that he has important testimony to give concerning some counts and a strong need to refrain from testifying on others. We agree that Whitworth failed to meet this burden. His defense to the espionage charges was based on a lack of knowledge that the Soviet Union was the buyer of the stolen messages and cryptographic material. It would not have been inconsistent with this strategy for Whitworth to be cross-examined regarding receipt of the unreported cash.

*Id.* at 277-8 [citations omitted].

The cases of Eugene Tafoya and Jerry Whitworth show the application of criminal tax charges to some rather remarkable fact patterns. Some of the prejudice arguments they made are attempted by persons charged with illegal activity that does not rise to the same level of national security threats.
If the U.S. criminal justice system is going to allow the prosecution of persons who fail to report their illegal income on their tax returns, it somehow has to deal with the situation where the conduct giving rise to the income is so obnoxious that it will surely prejudice the jury against the tax defendant. One way of doing this is to insist on the tax charges being tried separately from the charges on the illegal activity. This is essentially the requested remedy of a motion to sever, based on a claim that the tax charges cannot be fairly judged if presented alongside charges of other criminal conduct. Recall this exchange from Chapter 2, arising out of Scenario 8:

*Your honor, this case is absurd. It reflects government overreaching at its worst. If my client was dealing marijuana – a fact we plan to vigorously contest at trial – we cannot actually expect her to report this fact on her tax return. To charge her with tax fraud in addition to the drug counts is unfair. We move to dismiss the tax charges. The government is simply piling on, and we as a people should not tolerate it.*

The prosecutor responds:

*The grand jury has indicted the defendant on separate charges, which are properly joinable under the Federal Rules of Criminal Procedure. Both the tax charges and the drug charges arise out of the same transactions. Defense counsel has failed to articulate a valid reason for dismissing any of the charges. Judicial economy suggests that we should proceed with the entire indictment to the same jury.*

We saw how the court dealt with this argument in *Whitworth*. How have courts dealt with these arguments in more typical prosecutions?

### 7.3 The Indiana Barber Shop That Fixed DUI Citations

Kenneth Anderson was a barber in Crown Point, Indiana. His friend was John Marine, an official at the county courthouse. Anderson spread the word that he could fix drunk driving tickets for a fee. The Indiana State Police initiated an undercover operation to flush him out.

An officer named Gerald J. Hole, masquerading as a "Dan Mingo," approached Anderson claiming he had been booked for DUI. Andersons told him to come to the barber shop, where they agreed on a $1,600 price to fix the ticket. Mingo made a $200 downpayment. Mingo taped each of his subsequent meetings with Anderson. Anderson's phone was also tapped.

Mingo visited Anderson again a few days later and gave him the balance of $1,400 in a blue envelope. Anderson assured him that the ticket would be fixed without Mingo needing to appear in court. Anderson said also that the person who fixed tickets for him in the court was going to come to the shop that day. After Mingo left, Marine came to the shop and left with a blue envelope sticking out of his shirt pocket.
The police monitoring the situation did not notice anything strange with the fake case they had lodged against Mingo. Mingo arranged once more to be arrested and posted a $1,000 bond. He visited Anderson and complained, demanding both that the charge be fixed and that he receive his $1,000 bond back. Anderson phoned Marine, who said that a computer error was to blame. He assured Anderson that the charge was no longer in the computer and that Mingo would receive his bond money back. Mingo asked Anderson to have the check mailed to him at a specified address. It was.

Mingo also asked Anderson to take care of a drunken driving ticket for "Richard Ryan," an undercover FBI agent. Mingo paid Anderson $1,600 cash at the barber shop. After Mingo left, Anderson phoned Marine and told him that he had something for him. Marine agreed to come soon. Ryan did not go to court. The fake ticket was never fixed.

Anderson and Marine were charged and convicted of a number of offenses arising out of the scheme, including tax evasion for failing to report the bribes. The jury acquitted Marine of tax evasion but convicted him of filing a false tax return. On appeal, Marine claimed that the tax evasion count was wrongly joined with the other counts, based on the argument very similar to the hypothetical one described above. Here is how the Seventh Circuit resolved the issue:

Under Federal Rule of Criminal Procedure 8, joinder of counts is permitted when "the offenses charged ... are based on the same act or transaction ..." The Mulvihill bribe was the foundation of one Hobbs Act count, was a predicate act for the RICO count, and was one of three sources of unreported income for the tax evasion count. Joinder of a tax evasion count is appropriate when it is based upon unreported income flowing directly from the activities which are the subject of the other counts.

Moreover, even if joinder had been in error, erroneous misjoinder is reversible only if it results in substantial prejudice to the defendant. The fact that the jury acquitted Marine on tax evasion and convicted him on the lesser included offense of filing a false return tends to negate any possibility that he was prejudiced on the tax count by its joinder with the other counts. Marine, apparently recognizing that, argues instead that he was prejudiced as to the bribery, mail fraud, and racketeering counts by the joinder of the tax evasion count. The evidence of tax evasion supposedly put him in an even worse light than he already was. This curious argument cannot prevail in the face of the clear evidence of his venality.

_United States v. Anderson_, 809 F.2d 1281, 1288-9 (7th Cir. 1987) [citations omitted]

The court in Anderson set forth this rule of thumb: joinder of a tax fraud charge is appropriate when it is based upon unreported income flowing directly from the activities which are the subject of the other counts. _United States v. Kenny_, 645 F.2d 1323, 1344 (9th Cir.1981),
What about prejudicial spillover? John Cody, the corrupt New York Teamster official described in the last chapter (Section 7.6) made a similar argument, claiming that the trial court erroneously failed to sever the kickback counts of the indictment from the tax counts. The court response married the joinder issue with the question of prejudice:

An appellate court will reverse a district court's denial of a Rule 14 motion to sever only upon the showing of a clear abuse of discretion [citation omitted] In order to establish such an abuse the appellant must prove that he suffered prejudice so substantial as to deny him a fair trial [citation omitted]. Denying appellant's severance motion was not an abuse of discretion. Joinder was entirely proper since Count I(c) of the indictment and the two tax counts were based on the same transaction--the kickback Cody received from Strong. Further, Cody failed to demonstrate prejudice. We acknowledge that some prejudicial effect will inevitably appear whenever two charges are joined, if only due to the fact that they arise out of the "same act or transaction." Apart from this, however, appellant has offered only conclusory allegations. The government presented sufficient, independent evidence on each count of the indictment, and the fact that the jury voted to acquit Cody on two of the RICO predicates indicates that it considered each count separately.


8.4 When Is Relevant Evidence of Unreported Income Too Prejudicial?

Rule 403 allows for the federal trial courts, in their discretion, to exclude relevant evidence whose probative value is outweighed by its prejudicial nature. It has been invoked by accused tax criminals charged with not reporting some of their illegal income.

Joseph Abodeely was charged with tax evasion in 1978 and 1979, for failing to report all of his income, some of which he earned in a slightly embarrassing way. He received income from several Northern California business ventures, including a motel, a fast food restaurant, and a bar that featured exotic dancers. He also received money from promoting prostitution out of his motel, using the dancers employed at the bar.

After he was convicted, Abdoleely argued that the trial court should not have admitted the prostitution evidence, because it was overly prejudicial. The Eighth Circuit disagreed, noting
that gains from unlawful activity are taxable and the prostitution evidence was relevant because it has the tendency to make it more probable that Abodeely had unreported income from a taxable source.

Evidence of this nature is undoubtedly prejudicial to the defendant. The rule requires, however, that the probative value be substantially outweighed by the danger of unfair prejudice. Fed.R.Evid. 403 . . . Numerous cases have upheld the admission of highly prejudicial evidence that was inextricably tied to proving the taxable nature of the income. United States v. Tafoya, 757 F.2d 1522, 1526-27 (5th Cir.), cert. denied, --- U.S. ----, 106 S.Ct. 252, 88 L.Ed.2d 259 (1985) (payment for assassination attempts); United States v. Ochs, 595 F.2d 1247, 1260-61 (2d Cir.), cert. denied, 444 U.S. 955, 100 S.Ct. 435, 62 L.Ed.2d 328 (1979) (income derived from extortion, loansharking and prostitution); United States v. Carrillo, 561 F.2d 1125, 1127 (5th Cir.1977) (unsavory business dealings that may have been the basis of state criminal prosecution).

The court has no conceptual difficulty with the evidence concerning prostitution. While it is certainly prejudicial, it is highly probative of unreported taxable income. The gambling evidence, while having less direct probative value, is much less prejudicial, and indeed if its admission was error (which this court does not conclude), the error was harmless beyond a reasonable doubt. After all, having been shown that Abodeely ran a bar and a brothel, even the most straitlaced Iowa jury could hardly have been adversely affected by a showing of his participation in the legal, though perhaps sinful and worldly in the eyes of a midwestern jury, activity of gambling in Nevada.

United States v. Abodeely, 801 F.2d 1020, 1025-6 (8th Cir. 1986).

The criminal tax investigation of Charles Blandina started when the IRS heard that he had bought an Indianapolis liquor store for $108,203.40, and paid $94,203.40 of the purchase price in cash. His 1983 tax return had reported taxable income of only $66,190.00. He was eventually indicted, on two counts of attempted evasion for the years 1983 and 1984.

In addition to presenting witnesses and exhibits regarding Blandina's 1983 and 1984 expenditures, the prosecutors called Richard Aaron, who testified that that he had delivered 30 to 40 pounds of marijuana to Blandina on two occasions in 1984. Aaron stated that Blandina paid for the first delivery in cash at a price of $300 to $400 a pound, but returned the second quantity of marijuana without paying for it because it was unacceptable, being of inferior quality. The jury convicted Blandina on both counts, and he was sentenced two years' imprisonment.

Blandina argued that it was unfair to admit the Richard Aaron marijuana testimony, since he was not charged with narcotics offenses and the prejudicial effect of this evidence greatly outweighed its probative value. The Seventh Circuit disagreed:

**Taxing Terrorism**
J. Breinholt Aug. 2005
Aaron's marijuana transactions with Blandina are directly related to the question of Blandina's likely sources of taxable income--one of the core issues at trial, not an act collateral to those charged in the indictment. Thus, the proper inquiry is whether the evidence is relevant to the tax evasion charges, and, if relevant, whether Fed.R.Evid. 403 bars the admission of Aaron's testimony because its probative value is "substantially outweighed by the danger of unfair prejudice."

In a net worth tax evasion prosecution the government is required to prove a likely source of income or negate all non-taxable sources of income. Holland, supra. A defendant's possession of a controlled substance in a quantity sufficient for resale is relevant and admissible to show a likely source of income. United States v. Chu, 779 F.2d 356, 366 (7th Cir.1985). Thus, under Chu Aaron's testimony concerning Blandina's purchase of 30 to 40 pounds of marijuana--a quantity sufficient for resale--is clearly relevant in this case.

Relevant evidence is not inadmissible under Rule 403 unless its probative value is substantially outweighed by the danger of unfair prejudice. The fact that evidence is prejudicial or damaging to the defendant does not of itself classify the evidence as inadmissible. United States v. Medina, 755 F.2d 1269, 1274 (7th Cir.1985). Indeed, "[r]elevant evidence is inherently prejudicial; but it is only unfair prejudice, substantially outweighing probative value, which permits exclusion of relevant matter under Rule 403." United States v. McRae, 593 F.2d 700, 707 (5th Cir.), cert. denied, 444 U.S. 862, 100 S.Ct. 128, 62 L.Ed.2d 83 (1979).

The trial transcript reflects that the trial judge conducted a hearing outside the presence of the jury in which Aaron testified about his marijuana transactions with Blandina. Only after the judge had determined that Aaron was a credible witness did he permit Aaron to testify in the presence of the jury. Further, immediately after the jury heard Aaron's testimony, the trial judge carefully instructed the jury as follows:

You just heard a witness, Richard Aaron, testify that he sold marijuana to the defendant, Charles Blandina. This testimony concerns things that happened outside what is charged in the indictment. As you are aware, the indictment has to do with two charges of evading taxes in 1983 and 1984. I would like to remind you at this point that this evidence should be considered only so far as it goes to show law violations pertaining the indictment which we have here under consideration. No consideration should be given by the jury as to whether the defendant is guilty of violating any other
We are convinced that the trial judge's preliminary finding regarding Aaron's credibility combined with his cautionary instruction immediately following Aaron's testimony abated any possible unfair prejudicial effect Aaron's testimony might have had on the jury's decision-making process. Accordingly, we hold that the district court did not abuse its discretion in admitting Aaron's testimony.

United States v. Blandina, 895 F.2d 293 (7th Cir. 1989)

Other caselaw examples, in which the defendants claimed prejudice in slightly different ways, abound. Vincent DiGirolamo ran a painting contracting company in Northern California known as Top Line, which involved submitting bids in a sealed bidding process. To win jobs announced by First National Savings, DiGirolamo made payments to John Warner, a bank employee, and to a company Warner set up to receive the kickbacks. In return, Warner provided DiGirolamo with information regarding the low bid so he could circumvent the bidding process. The payments to Warner were falsely listed on Top Line's 1983 and 1984 corporate tax returns as a business expense or as cost of goods sold (i.e. purchases of inventory). DiGirolamo was charged with filing false corporate tax returns, and he and his wife were charged with filing false individual income tax returns for those same years.

In a pretrial motion to dismiss, the DiGirolamos sought to exclude the kickback evidence under Fed.R.Evid. 403, claiming that - because the jury will find the kickbacks immoral – it would prejudice them on the individual tax returns counts. He noted that since 1984, several major scandals involving financial wrongdoing resulted in a strong public reaction against financial wrongdoing, although he did not specify which ones. The district court rejected the motion. United States v. DiGirolamo, 808 F.Supp. 1445 (N.D. Cal. 1992).

In March, 1997, a jury convicted Defendant Denis M. Neill in Washington D.C. of filing individual tax returns which falsely claimed that he had no interest in or authority over a foreign bank account. (This is a “yes/no” question on the Schedule B attached to IRS Forms 1040). Neill was also charged and convicted of obstruction of justice, relating to his attempt to evade compliance with a grand jury subpoena relating to the foreign account and some inaccurate statements before the grand jury. In a post-verdict motion for a new trial, Neill argued that the evidence underlying the obstruction counts prejudiced a fair trial on the other charges. He claimed the obstruction was inflammatory and resulted in prejudicial spillover.

The court rejected Neill’s motion for a new trial, noting that he never moved for severance. Moreover, even if he had, the court would not have granted it, because severance was neither necessary nor appropriate to ensure that Neill received a fair trial. It found that the obstruction evidence was probative of Neill’s motive, plan, knowledge or absence of mistake in failing to report his signature authority over foreign bank accounts - that is, a common plan of

8.5 Conclusion

These cases in this chapter show that persons charged with serious crimes have a difficult time arguing that the tax charges should not be included because of the likely prejudice, and the possibility that a jury will not be able to give them a fair shake. A motion for severance will generally not give such persons the relief they request, since they would still face tax charges in a separate trial. Moreover, when the tax charges are based on the failure to report funds received from the illegal activity that is also charged, joinder is appropriate under federal criminal pleading rules. This is bad news for criminals, and is a further illustration of the efficacy of criminal tax tools in redressing conduct that goes beyond tax cheating.
Chapter 9 - Privilege Against Self-Incrimination

So far in this book, the arguments considered by Moni SenGupta and Kevin Downing’s lawyers in Chapter 3, when their clients were facing tax charges based on illegal income, have not fared particularly well. These arguments, and the brief answer to them based on the foregoing chapters, are as follows:

- *This is tax fraud? Who in their right mind would report drug sale proceeds on their tax returns?*

This argument does not work because it is merely rhetorical. The Supreme Court has said that income includes earnings from illegal activity, and tax charges have been included in embezzlement, extortion, drug dealing, and public corruption, terrorism and espionage cases.

- *My client did not know that illegal income was taxable, and her failure to include these funds on her tax returns was not “willful.”*

This argument generally fails. People have any obligations to know the law, which is that illegal earnings are taxable.

- *My client was at no time motivated by a desire to evade taxes. Her concealment instead was solely designed to cover her criminal conduct. Taxes never crossed her mind.*

This is the best argument so far, and the one that has the best chance of success. If the government fails to show any evidence of a tax motive or goal to conceal activity from the IRS, it may win.

- *The tax charges make reference to other illegal activity – marijuana dealing – which will prejudice the jury against my client and make a fair judgment on the tax charges impossible.*

As discussed in Chapter 8, this argument is generally a loser.

- *The funds my client allegedly received from alleged embezzlement are not income to him, because he would have been required to pay them back if caught.*

This argument would be limited to embezzlement, and was rejected by the Supreme Court in *James*.

This chapter focuses on the only argument from Chapter 3 that has not been addressed:
• *My client has a Fifth Amendment right not to incriminate herself, which she exercised by not including a description of her alleged marijuana business on her tax return.*

### 9.1 The Fifth Amendment: The Basics

The Fifth Amendment of the United States Constitution provides, in part: “No person . . . shall be compelled in any criminal case to be a witness against himself.”

In practice, this means that the government cannot compel someone to provide testimonial evidence, if that evidence would tend to incriminate them in any current or future criminal proceeding. If a person’s refusal to answer is covered by the Fifth Amendment, that fact cannot be held against them. Law enforcement is free to continue to build a criminal case against the person who asserts his Fifth Amendment rights, but the evidence must be developed without the benefit of the person’s testimony.

Law enforcement *can* do a number of things that are not prohibited by the Fifth Amendment. It *can* compel people to provide non-testimonial evidence against themselves. For example, one could be forced by court order to provide DNA, a handwriting sample, blood or hair samples or fingerprints, which can be analyzed and, if inculpatory, used against the provider. What the government cannot compel is a statement that implicates the speaker in a crime for which she can be prosecuted.

Law enforcement *can* obtain and use a defendant's incriminating statements if they are not compelled. For example, police can interview people who witnessed a criminal suspect's statements, made on his own volition without coercion. In white collar cases, this is often the best evidence of a defendant's intent.

By the same token, the government *can* compel someone to provide testimonial evidence against himself if it agrees not to prosecute him based on the basis of that evidence. This is referred to as immunity. Many people think that immunity is something requested by someone as a *quid pro quo* for helping law enforcement. The fact is that many people are granted immunity over their own objections, since they do not want to cooperate. The grant of immunity takes away their Fifth Amendment privilege, and leaves them with no legal recourse if they refuse to provide testimony. If they persist in their refusal, they can be held in contempt of court. See *United States v. Balsys*, 525 U.S. 666, 692 (1998).

Thus, to be protected by the Fifth Amendment, evidence must be testimonial, requested by the government under threat of compulsion, and of a type that would tend to incriminate the provider. If the requested evidence meets this condition, he government can seek it but only under a grant of immunity.
9.2 Income Tax Returns and the Fifth Amendment

Are tax returns testimonial? They are signed under oath. Are they compelled? Anyone in the U.S. whose income exceeds a certain level is required to file them, and it is a crime not to do so. 26 U.S.C. § 7203. What prevents someone from claiming that the Fifth Amendment protects her from being required to report the illegal source of income? The answer to this question starts with a 1927 Supreme Court case.

Manly S. Sullivan was a midwestern bootlegger who did not file income tax returns. He was convicted for this failure and appealed. A unanimous Court upheld the conviction, holding that a tax return was required. Justice Oliver Wendall Holmes, writing for the Court, explained why a person could not refuse to file a federal tax return on the ground that certain disclosures in the return would tend to incriminate him.

If the form of return provided called for answers that the defendant was privileged from making he could have raised the objection in the return, but could not on that account refuse to make any return at all. We are not called on to decide what, if anything, he might have withheld. Most of the items warranted no complaint. It would be an extreme if not an extravagant application of the Fifth Amendment to say that it authorized a man to refuse to state the amount of his income because it had been made in crime. But if the defendant desired to test that or any other point he should have tested it in the return so that it could be passed upon.

United States v. Sullivan, 47 S. Ct. 607 (1927)

Justice Holmes’ opinion did, however, specifically left open the possibility that a taxpayer might be able to point to the Fifth Amendment to avoid answering certain questions on a tax return which might incriminate him.

9.3 The Modern Example: Gambling

When Prohibition was lifted, the crime of bootlegging ceased to exist. We saw in earlier chapters a number of other crimes that were addressed, in part, through tax crimes. For purposes of understanding the Fifth Amendment jurisprudence relating to tax returns, gambling-related prosecutions may be the best modern vehicle.

Chapter 5 discussed the case of Horace Ingram, who was convicted of violating a federal law that required persons in the business of accepting wagers to register with the government and pay a special tax on those wagers. Unfortunately for Ingram and his co-conspirators, they were covered by a Georgia state law that prohibited numbers running. This made reporting the operation on their tax returns a dicey proposition.

In the United States today, gambling is legal in some places, and is heavily regulated.
Meanwhile, it is a crime to engage in gambling in an unregulated setting. That means that there is a legal way to report gambling earnings on Forms 1040, and the mere fact that “gambling” is listed as a source of income is not necessarily inculpatory. The means of reporting legal gambling earnings, as usual, is illustrated by real cases, where the defendants have done something that gets them in trouble.

9.4 Mechanics of Reporting Legal Gambling Activities

F.L. McLanahan liked to gamble, and occasionally traveled to Las Vegas. He was indicted in Ft. Worth for failing to report $50,000 in gambling winnings on his 1951 income tax return. His appeal argued that, in reality, his losses for that year exceeded his winnings, and he therefore had not duty to include the gambling winnings. The government conceded that only the excess of gambling winnings over gambling losses represents taxable income, but claimed that McLanahan had an obligation to report his winnings as income and then claim his losses as deductions. On this point, the Fifth Circuit agreed with the government:

This Court has long since held that gambling winnings of the type here involved are includable in gross income and that gambling losses, to the extent permitted by statute, are deductions. Under the requirements of the gross income tax section of the [Internal Revenue] Code, therefore, there is a duty for a taxpayer to report his winnings. He may then, if he wishes to take advantage of the statutory provision, claim his gambling losses as deduction. Thus, where it was conceded that there were unreported gambling winnings, the government was under no burden to prove that there were no unclaimed deductions in order to carry its burden of proof here.

*United States v. McLanahan*, 292 F.2d 630, 632 (5th Cir. 1961)[citations omitted].

McLanahan also argued that the government did not pursue leads in an effort to substantiate his claim that he sustained large gambling losses at the racetracks and at a half dozen or so different gambling establishments in Las Vegas, Nevada. This too was rejected, as the government was under no duty to run down these leads, even if they had been specific enough to make such investigation feasible. The burden of showing the losses was on McLanahan, once he admitted the existence of the winnings.

9.5 Tax Fraud Arising from Legal Gambling

Of course, concealing the extent of one’s legal gambling winnings is tax fraud, even though the source of the income is legal. An example of this is a scheme at racetracks known as “ten-percenting,” in which one person cashes a winning pari-mutuel ticket in place of the actual winner, who does not want his name associated with the winnings.

The goal of “ten-percenting” is for the persons with the winning ticket to avoid the reporting of gambling earnings to the IRS. In order to verify whether a taxpayer has reported all
of his income (including gambling winnings) in a particular year, the IRS requires certain information from those who pay others. The Tax Code requires that persons engaged in a trade or business and making payments to another person of $600 or more in any taxable year "shall render a true and accurate return to the Secretary, ... setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment." 26 U.S.C. § 6041(a). The Code further provides that "the name and address of the recipient of income shall be furnished upon demand of the person paying the income" when such action is necessary to make the provisions of this section effective. 26 U.S.C. § 6041(c).

The Tax Code requires that the income tax on certain kinds of income, including certain gambling winnings, be collected at its source. 26 U.S.C. § 3402(q) describes which gambling winnings are subject to withholding at the source. "Proceeds of more than $1,000 from ... a wagering transaction in a pari-mutuel pool with respect to horse races, dog races, or jai alai if the amount of such proceeds is at least 300 times as large as the amount wagered" are subject to withholding at the source. 26 U.S.C. § 3402(q)(3)(C)(ii). The statute requires that: "Every person who is to receive a payment of winnings which are subject to withholding shall furnish the person making such payment a statement, made under the penalties of perjury, containing the name, address, and taxpayer identification number of the person receiving the payment and of each person entitled to any portion of such payment." 26 U.S.C. § 3402(q)(6). The duties of the payor of such winnings are also detailed: "Every person ... making any payment of winnings which are subject to withholding shall deduct and withhold from such payment a tax in an amount equal to 20 percent of such payment." 26 U.S.C. § 3402(q)(1).

To determine whether these requirements were being observed, the IRS visited Lincoln Greyhound Park in Lincoln, Rhode Island in late 1986. On October 30, 1986, IRS Special Agent John L. Toti, Jr., acting in an undercover capacity, obtained a winning ticket worth $649 at Lincoln Greyhound park. As Toti walked toward the IRS window, he was accosted by Anthony Monteiro, who whether Toti had "hit the trifecta" and how much it was worth. Toti said the ticket was worth $649, and Monteiro inquired whether he wanted someone else to cash it for him. When the agent said yes, Monteiro motioned to James Rogers. Toti then gave the ticket to Rogers.

Monteiro remained with Toti while Rogers cashed the ticket. Toti asked if there would be 20% taken out of the winnings. Monteiro answered "No, the only time they take out 20% it's got to pay over $1,000" and then "For 649, you've just got to sign your name." Rogers returned with $649, and gave it to Toti. Rogers then left, telling Monteiro that he would see him upstairs. Agent Toti then gave Monteiro $64 and the then told him, "I'm usually right upstairs if, uh, you know, you get lucky." The IRS documented similar activity over the next three weeks.

Monteiro was indicted on a Klein conspiracy and several § 7206(2) charges, convicted by a jury in 1988, and sentenced to 24 months in prison. United States v. Monteiro, 871 F.2d 204 (1st Cir. 1989).

9.6 Illegal Bookmaking
Title 18 U.S.C. § 1955 was enacted as Part C of Title VIII of the Organized Crime Control Act of 1970, 84 Stat. 937, and aimed to curtail syndicated gambling. It provides, in relevant part:

§ 1955. Prohibition of illegal gambling businesses

(a) Whoever conducts, finances, manages, supervises, directs, or owns all or part of an illegal gambling business shall be fined not more than $20,000 or imprisoned not more than five years, or both.

(b) As used in this section--

(1) "illegal gambling business" means a gambling business which--

(i) is a violation of the law of a State or political subdivision in which it is conducted;

(ii) involves five or more persons who conduct, finance, manage, supervise, direct, or own all or part of such business; and

(iii) has been or remains in substantially continuous operation for a period in excess of thirty days or has a gross revenue of $2,000 in any single day.

(2) "gambling" includes but is not limited to pool-selling, bookmaking, maintaining slot machines, roulette wheels or dice tables, and conducting lotteries, policy, bolita or numbers games, or selling chances therein.

(3) "State" means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, and any territory or possession of the United States.

(c) If five or more persons conduct, finance, manage, supervise, direct, or own all or part of a gambling business and such business operates for two or more successive days, then, for the purpose of obtaining warrants for arrests, interceptions, and other searches and seizures, probable cause that the business receives gross revenue in excess of $2,000 in any single day shall be deemed to have been established.

Thus, the statute requires that three elements be established to constitute an offense: there must be a gambling operation which: (1) violates the law of a State or political subdivision in which it is conducted; (2) involves five or more persons who conduct, finance, manage, supervise, direct or own all or part of such business; and (3) has been or remains in substantially continuous operation for a period in excess of thirty days or has a gross revenue of $2,000 in a single day.

How does the government go about proving a § 1955 violation? Two cases from the
1980s illustrate how illegal gambling schemes are prosecuted and the interplay between gambling and tax crimes. United States v. Pinelli, 890 F.2d 1461 (10th Cir. 1989); United States v. Parrino, 816 F.2d 414 (8th Cir. 1987). Each involved electronic surveillance, and the collection of evidence that required some interpretation in order to be understood by the court and the jury. This necessitated calling expert witnesses to describe how gambling, or bookmaking, operations work. In Pinelli, this function was performed by an FBI agent named William Holmes. The resulting judicial opinions described a number of concepts and definitions particular to such sports betting operations.

- The "odds" or "handicaps" or "point spreads" on the wagered contests. This is a list of the teams and events with a certain number of points attributed to the nonfavored team. To win a bet on the favored team, that team must win by a score exceeding the point spread given to the nonfavored team. The "line" is subject to change as a given event approaches and a bookmaker may alter the "line" on a particular event in order to try and even out the money wagered on each side.

- The "point spread" or "line" as having the purpose of attracting equal amounts of betting on each side of a contest. Bookmakers change the line on a particular game to attract betting on the other team. A line of "Denver minus six" means Denver is favored by six points, and to win a bet on Denver, Denver must win by seven or more points.

- The term "vig" or "vigorish" represents a ten percent commission charged to losing bets, which compensates the bookmaker for the privilege of placing bets. In other words, a $100 losing bet would require payment of $110, which payment includes a $10 "vig." A bookmaker theoretically strives to accept the same amount of bets on each side of a contest, or balance his books, and take the "vig" as profit.

- A bookmaker normally engages in "lay off" betting, whereby he passes on to another bookmaker the amount of bets by which his own "book" is unbalanced; thus to the extent he loses to his own customers, he wins back from the other bookmaker, or vice versa. The "lay off" bet is therefore, in effect, bookmaker's insurance or reinsurance. The concept of "lay-off wagering" is to allow a bookmaker to get rid of wagers that he feels he is not financially able to handle and reduce the risk of great financial loss by having to pay out on large sums of money. For example, suppose Bookmaker X has wagers of $1,500 on team A and $1,000 on team B. Bookmaker X would lay-off the $500 excess on team A with Bookmaker Y. If team A wins, Bookmaker X would collect $1,000 from those who bet on team B, plus the 10% vig for a total of $1,100. Bookmaker X would collect his $500 lay-off wager from Bookmaker Y, which would make the total amount collected $1,600. From this amount, he would have to pay his bettors who had bet $1,500 on team A. Bookmaker X would thus make a profit of
$100 without risking any of his own money. If Bookmaker X had not laid-off his excess wagers and team A had won, then he would have collected $1,100 from the losers ($1,000 + 10% vig) and had to pay out $1,500 to the winners for a net loss of $400.

See also United States v. Thomas, 508 F.2d 1200, 1202 n. 2 (8th Cir. 1975).

9.7 Phil Pinelli and Friends (Colorado)

Phil Pinelli, David Pinelli, Robert Sheehan, Martin Mosko, Thomas Gottone, William Burbidge, and Aaron Mosko were seven of the 14 defendants charged in a 35-count federal indictment in Colorado in February 1986, and they were convicted by a jury. (Of the remaining seven defendants, four entered pleas of guilty and three were acquitted by the jury). In addition to the § 1955 charges, the indictment included charges under 18 U.S.C. § 1952 (interstate use of a telephone to facilitate the gambling business), as well as three types of tax charges; 26 U.S.C. § 7201 (attempt to evade the 2% excise tax on wagers accepted), 26 U.S.C. § 7262 (failure to pay gambling occupation tax), and 26 U.S.C. § 7203 (failure to file requisite tax forms).

The trial focused on a Colorado gambling operation between September to December 1984, and consisted of the testimony of 36 witnesses, including numerous bettor witnesses, the introduction of several hundred tape recordings of telephone conversations intercepted pursuant to court-authorized electronic surveillance over a 24-day period, documentary evidence seized pursuant to search warrants executed on December 9, 1984 after the termination of the wiretap, and, as noted, expert testimony by FBI William Holmes about the roles played by the various defendants in the gambling operation. The government's wiretap evidence and seized records in this case indicated the gambling business in question accepted wagers in excess of $2,300,000 in November and December, 1984. Holmes’ opinions were based on review of the electronic surveillance and search evidence. He did not rely on and was not privy to the testimony of the bettor witnesses.

Phil Pinelli accepted over $800,000 in wagers during November and December, 1984. Intercepted telephone conversations between Phil Pinelli and his brother, David Pinelli, demonstrated a mutuality of risk between the two brothers in their wagering activities, and indicated that the brothers had mutual financial interests. The wiretaps captured Phil accepting wagers from, and placing wagers with, other bookmakers. The government introduced a taped conversation between Aaron Mosko and Phil Pinelli in which Mosko told him that he "needed" certain amounts on various games, and between Pinelli and a person identified as "Doc," in which Pinelli said that he had "about five or six bookmakers and they unload their, like Aaron and them guys, they load all their shit on me." A taped conversation between Pinelli and Aaron Mosko had Pinelli explaining to Mosko that he kept his books in a certain manner so "if they ever pick up my book, they'll say twenty to twenty, you know, they can't say what they are." Pinelli received line information for his gambling activities by placing telephone calls to Las Vegas. He kept his gambling records in such a way as to obfuscate their true meaning. A review of seized records indicates that none of his accounts were identified by recognizable names, but rather by entries
such as "K" and "PB."

At the conclusion of the government's case, Phil Pinelli moved for a severance of the two tax evasion counts (Counts 11 and 12) from the remaining counts, or alternatively, a court-imposed restriction on the scope of cross examination if Pinelli chose to testify as to the tax evasion counts. He also made a related request to waive a jury trial on the two tax evasion counts. The requests were grounded on Pinelli's assertion that he desired to testify regarding the tax evasion counts, but retain his Fifth Amendment privilege with respect to the gambling charges. His brother, David Pinelli, who also faced two tax charges (Counts 14 and 15), made the same request with respect to Count 14 only. The government declined the defendants' offers to waive a jury trial, and the district court denied the defendants' requests. This decision became an issue on appeal to the Tenth Circuit, which rejected it as both untimely when raised at trial and non-meritorious:

Both defendants requested for the first time at the conclusion of the government's case-in-chief a severance of counts and a proposed waiver of jury, and none of the pretrial motions filed by the defendants suggested any fifth amendment concerns associated with the joint trial of the gambling charges and the tax counts. Since the tax and gambling charges in this case were inextricably intertwined, even a timely motion for severance would have posed a formidable obstacle for the defendants in this case. Here, however, the severance motions were not timely made and therefore were appropriately denied.

Id. at 1476.

9.8 The Parrini-Trupiano Operation (St. Louis)

In November of 1982 the government commenced court-authorized wiretaps on several phones used by Frank C. Parrino who, along with Matthew Trupiano, was suspected of conducting an illegal bookmaking operation in Eastern Missouri. During December, 1982, a tap was placed on Trupiano's home phone. As a result of the recorded phone conversations, the government expanded its investigation to include John Vogt, Tommy Williams, Eugene Pisani, Raymond Peter Rask, Nando Bartolotta, Fred Roethler, Edmund Foreman and Fred Garozzo.

On January 23, 1983 the FBI searched the persons and residences of these men as well as those of Trupiano and Parrino. All ten were indicted for conducting an illegal gambling business in violation of 18 U.S.C. §§ 1955 and 2. Trupiano and Parrino were also indicted for failing to comply with the wagering tax laws in violation of 26 U.S.C. § 7201. Trupiano was indicted for not complying with the tax laws in violation of 26 U.S.C. § 7203. United States v. Parrino, 816 F.2d 414 (8th Cir. 1987).

Only Parrino and Trupiano went to trial before a jury. Roethler died before the trial began, while Vogt, Rask, Foreman and Bartolotta entered guilty pleas. Pisani, Williams and Garozzo
submitted their cases for determination by the court without a jury based upon the evidence presented at Parrino and Trupiano’s trial. As in Pinelli, the federal prosecutors in Parrini relied on recorded telephone conversations and physical evidence seized during the searches, and a government expert witness on gambling.

Appellants argue that a willful omission is not sufficient to satisfy the requirements of § 7201. They contend that the instruction allowed the jury to find them guilty solely because they failed to file various tax returns. We disagree.

The instruction clearly indicates that the jury was to make a finding that appellants had the specific intent to evade the tax laws and acted consistent with that intent. The instruction did not improperly allow, as appellants contend, the jurors to infer the required intent from their conduct. We have allowed juries to infer willful intent from conduct. See United States v. Berzinski, 529 F.2d 590, 593 (8th Cir. 1976). Moreover, the statute plainly states that a prohibited attempt to evade taxes may be committed "in any manner." Therefore, the district court properly instructed the jury as to the requirements of § 7201.

Appellants finally argue that the district court erred by denying their motion for a judgment of acquittal and submitting the tax evasion counts to the jury. Appellants contend that the government failed to produce evidence sufficient to demonstrate that they were aware of the tax laws' requirements.

Several of the recorded phone conversations indicate that Parrino and Trupiano had specific knowledge of the tax laws' requirements. In addition, they conducted their bookmaking operation in such a way that intent to circumvent the tax laws could be reasonably inferred by the jury. The district court did not err in denying appellants' motion for judgment of acquittal.

Consequently, we affirm the judgment of the district court.

Id. at 417.

8.9 Gamling, Tax Returns, and the Fifth Amendment

The foregoing cases show that one can (1) legally report legal gambling winnings, (2) illegally omit legal gambling winnings, or (3) illegally omit illegal gambling winnings. The Fifth Amendment issues comes to the fore in the situation when one is faced with the prospect of accurately reporting the illegal nature of how one earns his income, as in Pinelli and Parrino. If one reports earnings from crime on an income tax returns, can the returns be used as evidence in a prosecution for that crime?

The Supreme Court considered a variation of this issue in the 1960s. Recall from Chapter
that Horace Ingram, who ran an illegal Atlanta numbers operation, was subject to a federal law that required persons in the business of accepting wagers to register with the government and to pay a special tax on those wages. 26 U.S.C.A. § § 4411, 4412 (1954). In 1968, the Supreme Court ruled that the privilege against self-incrimination bars prosecution under the federal wagering tax statutes. *Marchetti v. United States*, 390 U.S. 39, 88 S.Ct. 697, 19 L.Ed.2d 889 (1968) and *Grosso v. United States*, 390 U.S. 62, 88 S.Ct. 709, 19 L.Ed.2d 906 (1968). These cases involved persons in Connecticut and Pennsylvania who were convicted of conspiracy to evade payment of the special wagering taxes, despite their claim that payment would have obliged them to incriminate themselves in violation of the Fifth Amendment. In reversing the convictions, the Supreme Court held that information obtained as a consequence of the federal wagering tax laws was readily available to assist the efforts of state and federal authorities to enforce these penalties on illegal gambling, and that the prospect of self-incrimination was “real and appreciable,” and not merely “imaginary and unsubstantial.” It is important to note that these two cases did not affect the taxability of illegal earnings. As the Court noted in *Marchetti*:

> The issue before us is not whether the United States may tax activities which a State or Congress has declared unlawful. The Court has repeatedly indicated that the unlawfulness of an activity does not prevent its taxation, and nothing that follows is intended to limit or diminish the vitality of those cases. The issue is instead whether the methods employed by Congress in the federal wagering tax statutes are, in this situation, consistent with the limitations created by the privilege against self-incrimination guaranteed by the Fifth Amendment.

*Marchetti*, 390 U.S. 39, at 44 [citations omitted].

Although *Marchetti* and *Grosso* impacted the gambling tax regime, the limitations of the ruling to tax enforcement generally became clear within a matter of months. When the opinions were issued, James D. Knox had been charged in Austin, Texas with six counts of violation of federal law in connection with his wagering activities. The first four counts of the indictment charge that, between July 1964 and October 1965, he engaged in the business of accepting wagers without first filing Internal Revenue Service Form 11--C, the special return and registration application required by § 4412 of the Internal Revenue Code of 1954, and without first paying the occupational tax imposed by § 4411 of the Code. Counts Five and Six charged that when Knox did file such a form on October 14, 1965, and when he filed a supplemental form the next day, he knowingly and willfully understated the number of employees accepting wagers on his behalf—in violation of 18 U.S.C. § 1001, a general criminal provision punishing fraudulent statements made to any federal agency.

Knox moved to dismiss the indictment, based on *Marchetti/ Grosso*. The District Court dismissed all six counts, reasoning that Knox could not be prosecuted for his “failure to answer the wagering form correctly” since his Fifth Amendment privilege against self-incrimination would have prevented prosecution for “failure to answer the form in any respect.” 298 F.Supp. 1260, 1261. The United States, which had abandoned Counts 1 through 4, filed a direct appeal to the U.S. Supreme Court from the dismissal of Counts 5 and 6 charging violations of § 1001.
The Supreme Court, in a majority opinion written by Justice John Harlan, ruled that the “validity of Government's demand for information, as required on wagering registration forms, was not element of violation of general criminal provision punishing fraudulent statements made to federal agency, and that fact that Knox, on claim of privilege against self-incrimination, could have validly refused to complete such form would not bar prosecution for making false statement on such form.” United States v. Knox, 90 S.Ct. 363 (1969).

This is a key point in the applicability of the Fifth Amendment to tax returns: while the filing requirements of the tax laws might constitute compulsion, such compulsion does not constitute a defense to a prosecution for the falsification of the information required to be reported. This is the whipsaw for criminals that is described throughout this book: the fact that earning a living through illegal activity does not relieve you of the obligation to report it on income tax returns. This is illustrated by how the gambling/tax cases played out in the aftermath of Knox, in the particular context of illegal gambling income reported on Forms 1040.

Roy Garner was a California resident who supported himself by illegal gambling. On his tax returns between 1965 and 1967, he reported gambling as the source of most of his income. Problem was, it was the illegal type of gambling, for which he was ultimately prosecuted. What better evidence that a person engaged in a particular crime than a statement by that person on his tax return, signed under oath, that his income derived from that crime?

Over his objection, Garner's sworn 1965-1967 tax returns were introduced against him in his prosecution for illegal gambling, and he was convicted. On appeal, Garner argued that his tax returns, which were required by law, were testimonial in nature and compelled, and it was a violation of his Fifth Amendment rights to admit them. Garner v. United States, 501 F.2d 228 (9th Cir. 1972)

Did Sullivan answer the question posed by Garner's appeal? Unlike Manly S. Sullivan, the bootlegger from the 1920s, Roy Garner actually filed an accurate tax return which reported the illegal source of his income. If he could prevent these returns from being used against him in his illegal gambling prosecution, the act of filing a tax returns would have represented a shield. That is, what Garner was seeking was essentially immunity from all illegal activity reported on tax returns, making the returns inadmissible in all non-tax criminal proceedings. The Ninth Circuit initially accepted this argument:

It is our opinion then, that the admissibility of appellant's disclosures here must be determined by an examination of the context in which they were made. First is the question of whether the disclosures were compelled. We are clear that the answer is yes. 26 U.S.C. § 7203 makes it a crime to fail to file any return, pay any tax, or supply any information. 26 U.S.C. § 7206 likewise makes it a crime for a person to make and subscribe any return “which he does not believe to be true and correct in every material matter . . ..” For the Internal Revenue Service to correctly evaluate a taxpayer's claim of particular expenses, deductions, and losses, the Service must of course be provided with information showing whether or not
the taxpayer qualifies. This is especially true where the taxpayer's occupation brings into play special provisions of the tax laws and regulations. For example, a person whose income is derived from wagering may deduct his wagering losses only to the extent of his winnings from wagering, 26 U.S.C. § 165(d). Gambling losses may not be carried back or carried over (See 5 Mertens, Law of Federal Income Taxation § 28.85), and a gambler whose losses offset his winnings must nevertheless report all winnings as gross income and losses as deductions. McClanahan v. United States, 292 F.2d 630, 631 (5th Cir. 1961). Disclosure in the tax return of a gambler's source of income is thus essential. If a gambler fails to provide this information, he subjects himself to a criminal prosecution for tax evasion or perjury; his “choice” to disclose is thus a Hobson's choice.

Nor can we automatically conclude that submitting to the statutory compulsion constitutes waiver of the right to object to the use of the incriminatory disclosure. ... It would be “artificial, if not disingenuous,” to distinguish this principle by assuming a waiver of appellant's Fifth Amendment rights in this case merely because he disclosed the source of his income truthfully under the statutory compulsion to truthfully state all material tax information on his return. It is one thing to say that government can compel a person to make disclosures which are deemed necessary for government to adequately administer a program such as the revenue collection system. It is entirely another matter, however, to then disregard the fact that the disclosure was forced and to say that, since the original purpose of compelling disclosure was not inherently hazardous to an individual's rights, any subsequent use of that compelled information is the use of “volunteered” information and therefore constitutionally inoffensive. Such a formulation makes the government's need for the information, rather than the individual's relinquishment of a known right, the controlling factor in the waiver determination, and would allow comprehensive schemes of self-reporting in non-criminal areas to become data banks containing numerous “admissions” of criminal activity, available without limitation to prosecuting authorities. To consider information supplied to the government under such circumstances as 'voluntarily supplied would ' . . ultimately license widespread erosion of the privilege through 'ingeniously drawn legislation'.

Id. at 233-234 [citations omitted].

Judge Wallace dissented, writing that Garner should have asserted his Fifth Amendment privilege at the time he filed his return, and his failure to do so constituted a waiver.

The Ninth Circuit agreed to a rehearing en banc, and proceeded to reverse the original opinion. Judge Wallace wrote the majority opinion. It seems that Garner should have asserted his Fifth Amendment privilege at the time he filed his return:

Garner provided the source of his income on his return and failed to invoke his
privilege. Can he, at the late date of his trial, assert it? Assume Garner had witnessed an automobile accident in the parking lot of Pomona Fairgrounds on September 25, 1968. If he had been subpoenaed as a witness in a civil trial concerning the accident and had testified that he was there and saw everything, those admissions could have been used in his conspiracy trial to prove that he was at the race track on the day when the first race was allegedly fixed. His privilege would be unavailable because he had failed to assert it during the civil trial. At the civil trial, he was subpoenaed to testify by the power of the court; and he could have been awed by the direction of the judge to answer the questions. But, if he failed to assert his privilege and proceeded to testify, his answers could be used against him. His failure to invoke his privilege in his tax return produces a similar result.

Recent Fifth Amendment cases have indicated that compelled disclosures in response to governmental inquiries may violate the privilege against self-incrimination. ... However, the compulsion in those cases was intended to elicit incriminating responses and was directed at individuals “inherently suspect of criminal activities' in ‘an area permeated with criminal statutes . . .”

There is a vast difference between an in-custody interrogation and filling out a tax return in the quiet of one's home. We have no doubt that every taxpayer is under a form of “compulsion” to complete and file his return not dissimilar to the compulsion involved in other activities in which the government also has a legitimate regulatory interest. This form of compulsion, however, is not the kind of involuntariness that was condemned in Miranda. The questions asked on the tax return were completely neutral; only Garner knew a response might be incriminating. As to all taxpayers in general, there was only “compulsion” to provide the government with the information it was entitled to demand. As to Garner specifically, there was “compulsion” to incriminate. But because Garner knew his answers might be incriminating, he had a choice either of claiming his privilege or declining to do so and answering the questions. Had Garner chosen to claim his privilege on the tax return, the government would ultimately have had to decide whether it was willing to grant him immunity in order to obtain the answer. But the granting of immunity must be in the hands of the government, not in the hands of taxpayers who provide incriminating answers rather than assert their privilege.

... .

Accepting appellant's contention would provide us with an unpalatable result. We have held that a taxpayer must assert his privilege against self-incrimination in his return in response to a specific question. Just as he has no right to be immune from questioning, likewise he is not free to immunize himself from prosecution by volunteering information to the government. To hold otherwise would allow any
witness in any proceeding the later protection of the Fifth Amendment to frustrate
the use of information derived from earlier testimony when that witness failed to
invoke his privilege. If this were the law, immunity from use of incriminating
information might well be achieved without government approval by merely
including it in a tax return.

_Id_. at 238-240.

9.10 The “Fifth Amendment Return”

In light of _Garner_, how does one who earns income through illegal activity negotiate that
delicate area between filing false tax returns and filing incriminating tax returns. Can one simply
not file or assert the Fifth Amendment in one’s dealing with the IRS? This did not work for
Manly Sullivan. More recently, the strategy did not work for another taxpayer.

Daniel Dack, an Indiana longshoreman, failed to file income tax returns for 1984 and
1985, and was indicted for attempted evasion under § 7201. At the close of the trial, the judge
instructed the jury:

The fifth amendment privilege against compulsory self-incrimination cannot be
asserted to justify a failure to file a tax return. To rightfully invoke the fifth
amendment privilege, an individual must assert it on the tax return form.

After his conviction, Dack challenged this decision to give this instruction, noting that this
was not a defense he asserted. The Seventh Circuit disagreed.

_Evidence was elicited at trial regarding Fifth Amendment rights and Dack’s concern
that he not give up any privileges. In response to an IRS agent's request
for an interview, Dack stated: "I will answer any questions I can as long as in
doing so I do not surrender any rights or privileges or break any law." Dack also
raised the issue of privileges in his response to the denial of his refund claim for
taxes paid. Through cross-examination Dack elicited evidence which showed that
he had been advised by Special Agent Hruska of his Fifth Amendment right. He
also received an affirmative response when he asked whether these rights were
applicable to a person defined as a taxpayer by the code. In view of this evidence,
the court was acting within its province in instructing the jury on the legal effect of
the Fifth Amendment privilege as it relates to tax evasion. See _United States v.
Verkuilen_, 690 F.2d 648, 654 (7th Cir.1982) (a valid Fifth Amendment privilege
must be asserted on the tax return and there must be a colorable showing of
involvement in activities which may be revealed through data supplied on the form
and which would subject the individual to possible criminal prosecution); see also
_United States v. Green_, 757 F.2d 116, 123 (7th Cir.1985); _United States v. Jordan_,
508 F.2d 750, 752 (7th Cir.), _cert. denied_, 423 U.S. 842, 96 S.Ct. 76, 46 L.Ed.2d
People who fear disclosing to the IRS how they earn their living need another strategy. How would the IRS react to a return that accurately reported the extent of one's income while refusing to specify the source?

Nevada resident Ted Kimball tried it. In the late 1970s, Kimball participated in a program marketed by a group called American Law Association (ALA), whose leaders were thereafter convicted of tax fraud. At ALA’s advice, Kimball funneled his income through a series of foreign trusts, then claimed he was not required to provide information about the trusts on his tax return. In April 1981, after the IRS had sent him four notices of delinquency, Kimball filed an IRS Form 1040 for the year 1979 on which he wrote only asterisks in the spaces provided and signed his name "Ted Kimball" at the bottom of the form. The asterisks referred to a sentence stating: "This means that specific objection is made under the 5th Amendment, U.S. Constitution. Similar objection is made to the question under the 1st, 4th, 7th, 8th, 9th, 10th, 13th, 14th, and 16th Amendments for civil issues."

The IRS disagreed, and sent him a registered letter warning him that such a submission was inadequate and might subject him to prosecution for failure to file an income tax return under § 7203. Kimball submitted similar forms for 1980, 1981, and 1982 as the returns for those years fell due. Each time, the IRS sent him warning letters.

In 1986, Kimball was charged with three § 7203 violations, relating to the years 1979, 1980, and 1981. Kimball waived his right to trial before a federal district judge and consented to be tried by a jury in front of a federal magistrate. The jury found Kimball guilty on all three counts. In August 1986, the magistrate sentenced him to three consecutive one-year terms and ordered him to pay $30,000 in fines and the costs of his prosecution.

On appeal, Kimball argued that, as a matter of law, he filed "returns" for the years in question and therefore could not be convicted of failure to file. The Ninth Circuit agreed that the completed Form 1040s Kimball submitted to the IRS for the 1979, 1980, and 1981 years, however frivolous and incomplete, constituted "returns" as a matter of law under section 7203. United States v. Kimball, 896 F.2d 1218 (9th Cir. 1990).

As it did in Garner, the entire Ninth Circuit agreed to rehear the case en banc, and overruled it, finding that Kimball's Fifth Amendment return was invalid.

Kimball contends that his 1040 forms constitute returns as a matter of law. As a general rule, a document "which does not contain any information relating to the taxpayer's income from which the tax owed can be computed" is not a return within the meaning of section 7203. United States v. Klee, 494 F.2d 394, 397 (9th
Here, Kimball's 1040 forms contain no financial information whatsoever, and therefore, appear squarely within the rule of Klee. Other circuits considering documents similar to Kimball's have held they do not constitute returns. See, e.g., United States v. Upton, 799 F.2d 432, 433 (8th Cir. 1986); United States v. Green, 757 F.2d 116, 121 (7th Cir. 1985); United States v. Heise, 709 F.2d 449, 451 (6th Cir.), cert. denied, 464 U.S. 918, 104 S.Ct. 285, 78 L.Ed.2d 262 (1983); United States v. Booher, 641 F.2d 218, 219 (5th Cir. 1981).

The three-judge panel, however, held that the 1040 forms filed by Mr. Kimball did constitute "returns" on the basis of United States v. Long, 618 F.2d 74, 75-76 (9th Cir. 1980) (Long) (a form containing only zeros entered in the spaces provided for exemptions, income, tax, and tax withheld constitutes a return under section 7203), and Fuller v. United States, 786 F.2d 1437, 1439 (9th Cir. 1986) (taxpayers filing blank tax forms or forms containing only asterisks or the word "object" in the spaces provided for financial information had filed purported returns under section 6702). See Kimball, 896 F.2d at 1220. We conclude Long and Fuller do not control.

Turning first to Fuller, we point out that the questions presented by section 7203 in this appeal and section 6702 in Fuller are distinct. Section 7203 asks whether the taxpayer has filed a return. See 26 U.S.C. § 7203 ("Any person ... who willfully fails to ... make such return"). Section 6702 raises a different issue: whether the taxpayer has filed a purported return. See 26 U.S.C. § 6702 ("any individual [who] files what purports to be a return"). We have previously observed this distinction in Bradley v. United States, 817 F.2d 1400, 1403 (9th Cir. 1987), where we held that "[s]ection 6702 requires only that the document filed purport to be a tax return, not that it actually be a tax return." We should not rely on any superficial similarity between sections 6702 and 7203. It is not incongruous to hold that an individual has failed to file a tax return under section 7203 and, nonetheless, has filed a frivolous purported return under section 6702. One can submit a document which purports to be a tax return, but which fails to meet the requirements for filing.

Nor does Long assist Kimball because its reasoning excludes the facts of his case:

The zeros entered on Long's tax forms constitute "information relating to the taxpayer's income from which the tax can be computed." The I.R.S. could calculate assessments from Long's strings of zeros, just as it could if Long had entered other numbers. The resulting assessments might not reflect Long's actual tax liability, but some computation was possible.

Long, 618 F.2d at 75, quoting Klee, 494 F.2d at 397. Long properly turns on the
presence or absence of financial information, in keeping with *Klee*. "Nothing can be calculated from a blank, but a zero, like other figures, has significance. A return containing false or misleading figures is still a return." *Id.* at 76. Here, as with Long 's hypothetical blank form, nothing can be calculated from Kimball's asterisks. A proper reading of Long demonstrates that Kimball did not file a return.

*Long* 's distinction is admittedly formalistic. It may be that whether a form contains zeros, asterisks, or nothing at all, it makes essentially the same point: the taxpayer refuses to report income. We nevertheless reaffirm Long 's analysis. A line must be drawn somewhere, and given the need for clear law on an arcane point, it should be as bright as possible. Long accomplishes that, consistent with *Klee*.

*United States v. Kimball*, 925 F.2d 356, 357-8 (9th Cir. 1991).

### 8.11 Production Immunity

As noted above, the Fifth Amendment creates a privilege against providing testimonial evidence against oneself. Non-testimonial evidence – such blood, or handwriting or hair sample - can be compelled. The same is true of pre-existing written records in one’s possession, since the creation of these records were not compelled. However, the act of producing voluntarily-prepared papers can be protected by the Fifth Amendment on the theory that the act of production is itself testimonial, and a symbolic statements about the existence, authenticity and official in the 1990s.

In 1994, Webster Hubbell, a former law partner of Hilary Rodham Clinton, resigned his position as Associate Attorney General amidst allegations that, before coming to Washington, he systematically stole money from his Arkansas law firm and its clients. He eventually pleaded guilty and was sentenced to 16 months in prison. He was released in late 1996.

In the course of its ongoing investigation into possible criminal activity related to Madison Guaranty Savings & Loan Association and the Whitewater Development Corporation, Independent Counsel Kenneth Starr learned that Hubbell had received payments from entities "associated with" President Bill Clinton for consulting work allegedly performed after his resignation from the Justice Department. Starr sought to determine whether the payments were related to what it later described as Hubbell's unwillingness to cooperate fully with the Whitewater investigation. On October 31, 1996, the federal grand jury in the Eastern District of Arkansas issued a subpoena directing Hubbell to turn over eleven categories of business and income related documents, as well as personal records of his activities and of his family's finances, covering the period from January 1, 1993 to the date of the subpoena.

On November 19, 1996, Hubbell appeared before a grand jury in the Eastern District of Arkansas and formally invoked his Fifth Amendment privilege against self-incrimination. When
questioned, he expressly declined to state whether there are documents within my possession, custody, or control responsive to the Subpoena. The Independent Counsel had previously obtained an order signed by Judge Susan Webber Wright directing Hubbell to respond and granting immunity "to the extent allowed by law." After receiving immunity, Hubbell turned over some 13,120 pages of documents and records. The Independent Counsel then led Hubbell through a series of questions tied to each of the eleven categories of documents requested in the subpoena. With respect to each, the prosecutor read the relevant paragraph and then asked either, "Did you provide all those documents?" or "Those are all the records in your possession, custody, or control; is that correct?" Hubbell answered "Yes" to all eleven queries. The Independent Counsel closed the session by inquiring "have you searched or have you made a thorough search or caused a thorough search to be made in response to this Subpoena?" Hubbell again replied "Yes."

The evidence investigation revealed potential violations of the Tax Code. Using the contents of the documents Hubbell turned over to the grand jury, the Independent Counsel identified and developed evidence that culminated in a criminal tax prosecution. On April 30, 1998, a federal grand jury in the District of Columbia issued a ten-count indictment alleging that Webster Hubbell, Suzanna Hubbell, and their financial advisors committed a Klein conspiracy, endeavored to obstruct and impede the due administration of the revenue laws, in violation of 26 U.S.C. § 7212(a), attempted payment of the proper income tax owed by the Hubbells for the calendar years 1989-1992 and 1994-1995, in violation of § 7201, and committed both mail and wire fraud, in violation of 18 U.S.C. §§ 1341, 1343. Webster Hubbell were each charged with preparing and presenting a fraudulent tax return, in violation of § 7206(2). The indictment alleged that Webster Hubbell had received large payments for consulting services, and then conspired to hide this and other income through elaborate financial machinations.

In a July 1, 1998 the district court granted Webster Hubbell's motion to dismiss the indictment as violative of the order giving him immunity and compelling his response to the grand jury's subpoena duces tecum. It found that all of the evidence to be offered by the Independent Counsel at trial derived, either directly or indirectly, from Hubbell's immunized response. The district court found that Hubbell had not only communicated the authenticity and his possession of the documents, but also implicitly testified as to the very existence of documents which added to the "sum total" of the government's information against him. United States v. Hubbell, 11 F.Supp.2d 25, 34 (D.D.C.1998). The Independent Counsel appealed the dismissal.

The Court of Appeals for the District of Columbia agreed with the defense argument, affirming the dismissal. Key to its reasoning was the extent to which Hubbell’s response to the subpoena was testimonial in nature. If the responsive documents existence were a “foregone conclusion,” according to Fifth Amendment jurisprudence, the act of production may not rise to a level of communication that would merit the Fifth Amendment's protection.

To illustrate its analysis, the D.C. Circuit relied on the following analogy. Assume that the police discover a victim's body in the basement of a large apartment building, and an autopsy establishes stabbing to be the cause of death.
Lacking any clues, a grand jury issues a subpoena to every resident in the building, asking each to produce all knives and other forms of cutlery that are now, or in the preceding month have been, in your possession or control. The residents object *en masse*, asserting *inter alia* their Fifth Amendment privilege against self-incrimination. After the prosecutor obtains an order compelling production and granting immunity to the maximum extent allowed by law, the residents comply with the subpoena. Among the recovered knives, the police discover the murder weapon. The prosecutor indicts its owner for murder. The defendant moves to dismiss the indictment, claiming that his immunized subpoena response testified as to the existence, his possession, and the authenticity of the knife he produced. Having handed the government the murder weapon, and provided the explicit link between it and himself, can the accused nevertheless be prosecuted consistent with the Fifth Amendment provided that the government finds some independent way to link him with the knife? If our protagonist has once again left behind fingerprints and traces of his blood, could they be used as evidence, together with the knife, so long as no one testified as to the means of recovery?

Where, as in this scenario, the government had no evidentiary knowledge independent of that from testimony communicated through compelled production, the scope of the Fifth Amendment's protection cannot be measured by merely imagining that our knife appeared, “like manna from heaven,” in the grand jury room.

In the case of Webster Hubbell, according to the court, government's knowledge of the existence or possession of the extensive documentation sought via subpoena was scant. It concluded:

Where the testimonial value of document production is high, and the government obtains a large quantum of information directly from the witness' mental faculties, the government labors under "a heavy burden of proving that all evidence it seeks to introduce is untainted by the immunized act of production. If the government did not have a reasonably particular knowledge of subpoenaed documents' actual existence, let alone their possession by the subpoenaed party, and cannot prove knowledge of their existence through any independent means, [the Fifth Amendment] forbids the derivative use of the information contained therein against the immunized party.

. . . .

Unless the Independent Counsel can establish its knowledge of the existence and possession of the documents sought in the subpoena with greater detail and particularity, it will have to live with the consequences of its decision to compel production.

9.12 Conclusion

This chapter addresses the last of the hypothetical arguments raised in Chapter 3, by criminals who finds themselves prosecuted not only for their illegal acts, but for failing to report their illegal income on their tax returns. How courts have addressed these various arguments is, for the most part, not good news for criminals who occupy this position. What about the law enforcement side? Do these cases suggest a danger to having tax police who are so efficient? Is it fair? Are there limits on law enforcements? The next chapter addresses some of the claims that have been available to accused tax cheats, based on the legal limitations imposed on IRS investigators.