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Essential Elements of Tax Crimes

a. Willfulness

One small word is all that distinguishes a civil tax controversy from a criminal tax matter. That pestilent word is called "willfulness." It is the cornerstone of any criminal tax matter. Willfulness is an essential element not only of tax crimes but also of the civil willful FBAR penalty.

In the criminal setting, the government carries the burden of proving – beyond a reasonable doubt – that the taxpayer-defendant acted willfully. It is defined as an "intentional violation of a known legal duty."

i. Proving Willfulness For Purposes of the Crime of Failure to File a FBAR

How do courts interpret willfulness? The only thing that a person need know is that he has a reporting requirement. And if a person has the requisite knowledge, the only intent needed to constitute a willful violation of the statute is a conscious choice *not* to file the FBAR. The latter is collectively referred to in legal circles as the theory of "willful blindness."

Under the theory of willful blindness, a jury may *infer* willfulness whenever a taxpayer intentionally fails to inquire or learn about his or her filing obligations. In other words, instead of proving that the defendant intentionally violated a known legal duty, the government need only show that "the defendant consciously avoided any opportunity to learn what the tax consequences were." *United States v. Bussey*, 942 F.2d 1241, 1428 (8th Cir. 1992).

At the outset, it is important to recognize that willful blindness is not the gold-plate standard when it comes to interpreting willfulness in the overwhelming majority of circuit courts. There are two reasons. First, it is a "watered-down" substitute for the burden of proof on the single most important element of a tax crime – the mens rea requirement. Very simply, willful blindness is far easier for the government to prove than an *intentional* violation of a known legal duty.

Second, for precisely this reason, willful blindness is ripe for abuse in cases where the government does not have sufficient evidence to prove willfulness under the heightened standard. This is why many courts have found its use to be "rarely appropriate." *United States v. deFrancisco-Lopez*, 939 F.2d 1405, 1409 (10th Cir. 1991) (relying on several Ninth Circuit cases). And those that do permit it have restricted its use to cases where the taxpayer has blatantly avoided learning about the reporting requirements with impunity by burying his head in the sand like an ostrich. The fact that the defendant was negligent in failing to inquire is *not* enough.

How does the government *prove* willfulness in the prosecution of a taxpayer for failing to file an FBAR? Few if any cases produce witnesses and only in a rare case would a defendant admit the required state of mind. So what does the government rely on? Indirect evidence. Specifically, conduct or acts from which a person's state of mind can be inferred. These acts are commonly referred to as "badges of fraud."

Below are some "badges of fraud" that are as dangerous as waiving a red flag in front of a bull at a rodeo and are sure to attract the attention of the IRS:

- A taxpayer who checks the box off "no" on Schedule B in response to the question, "Do you have an interest in or signature authority over a financial account in a foreign country?" when, in fact, he has just such an account.

- Whether the failure to report the account occurred *continuously* over a period of years or whether it was merely an *isolated* incident. In other words, did the taxpayer's failure to file an FBAR occur over the course of time or just one year?

- Whether the taxpayer failed to report a foreign account in a later year despite having checked the box off "yes" on Schedule B of his tax return in an earlier year (and/or filing an FBAR in an earlier year). This reveals that the taxpayer *knew* that he had an FBAR-reporting obligation in the later year.

- The high watermark balance of the account: The amount of money at stake is crucial. Unreported accounts with maximum aggregate balances that are half-a-million or greater are heavily scrutinized. As one prominent tax attorney is quoted as saying, "If a person has a $10 million account, I don't want to hear he was nonwillful, and neither does the government."

- Whether the taxpayer told his tax preparer about the account(s).

- Whether the account was held in such a way as to *conceal* ownership. For example, was it in the name of a "foreign shell corporation or foreign trust," or some other entity that would make it difficult for the IRS to learn the true identity of the owner? Was the account a numbered account? Was the taxpayer issued a credit or debit card without his or her name visible on the card itself?

- Did the bank help the taxpayer repatriate cash to the U.S. using covert means? Did bank managers and their U.S. clients use code words in emails to gain access to funds? Did U.S. clients ever use coded language, such as asking their private bankers, “can you download some *tunes* for us?” or note that their “gas tank [was] running empty” when they required additional cash to be loaded to their cards.

- Whether the taxpayer closed the foreign account and transferred the assets to another bank in the wake of a DOJ press release or media coverage reporting that the taxpayer’s bank had become the target of an IRS summons demanding U.S. accountholder information or that it had agreed to participate in FATCA. Example: Headlines splashed across the front page of major newspapers.

- Whether a taxpayer who has a duty to file an FBAR checks the box off “yes” to the question, “Do you have an interest in or signature authority over a financial account in a foreign country?” but “no” to the follow-up question, “If ‘Yes,’ are you required to file Form TD F 90-22.1 [FBAR] to report that financial interest or signature authority?” This question gets to the heart of the matter: “Must an FBAR be filed?”

- The amount of interest generated by the foreign account and whether that interest – no matter how negligible – was reported on the taxpayer’s U.S. tax return. If the interest was reported on a U.S. tax return, the IRS generally views the filing of an FBAR as a mere formality. In that case, the taxpayer can usually come into compliance with his U.S. tax obligations by filing a delinquent FBAR.

- Whether the taxpayer instructed bank personnel to hold back his bank statements and not mail them to him in the U.S. (if the U.S. residence was listed as the accountholder’s primary residence).

- Whether the taxpayer had been subject to a previous audit involving unreported offshore assets or bank accounts.

- The number of foreign accounts held (i.e., one versus six).

Ultimately, the jury must "look into the mind of the defendant-taxpayer to determine whether he intentionally violated the statute."[i] The more badges of fraud that the government shows, the more likely the government will have satisfied its burden of proving criminal intent beyond a reasonable doubt through circumstantial evidence.[ii]

How many badges of fraud must exist in order for the government to prove willfulness? Two? Three? This question is inherently flawed because the *number* of badges of fraud is not dispositive of willfulness, especially if those badges are just as much a characteristic of conducting legitimate business operations as they are fraudulent ones and are consistent with the type of business that the taxpayer is in. At the same time, the more badges of fraud that exist, the less flattering a picture of the taxpayer the jury will get. It is never good for a jury to be left with the impression that the taxpayer-defendant exhibited a callous indifference to comply with his U.S. tax obligations.

A single badge of fraud, alone, is rarely enough to prove willfulness. As courts have said time and time again, it is a totality of the circumstances test. For example, consider an offshore account that is in the name of a foreign shell corporation or foreign trust. Setting up an account in such a form has any one of a number of legal purposes aside from the fraudulent purpose of concealing ownership in order to evade the reporting requirements.

ii. Proving Willfulness For Purposes of the Crime of Failure to File a Tax Return

Willfulness is often the battleground in failure to file cases. And it is a battleground where the odds are stacked against the taxpayer who has failed to file. When willfulness exists, it is like the "Helen of Troy," in the sense that the government will mount an offensive as massive as the "launching of one thousand ships."

While the government must establish that the taxpayer knew of his duty to file the return, I hazard to guess that few if any taxpayers could legitimately argue that they did not know that they had a duty to file. To the extent that the taxpayer asserts such a defense, it can easily be overcome by a showing that the taxpayer filed returns in earlier years.

How does the government prove willfulness in a failure to file prosecution? The most common way is by a pattern of failing to file tax returns for consecutive years in which returns *should* have been filed. Courts examine the following "human factors" to determine whether the taxpayer was willful in failing to file: the background of the taxpayer; the filing of returns in prior years; whether the taxpayer was a college graduate with accounting knowledge; whether the taxpayer was familiar with books and records and operated a business; and what type of income the taxpayer earned.

How about defenses? The case of *United States v. McCorkle*, 511 *F.2d* 482 (7th Cir. 1975) (*en banc*) provides a catch-all list of defenses that have previously been asserted but which did not pass muster. They can be grouped in the category, "factors beyond the control of the taxpayer." As such, they range from the sublime to the ridiculous: the defendant had no funds available to pay his taxes, the defendant feared that the IRS was going to attach a lien on his property, the defendant was going through a bitter divorce, the defendant did not keep accurate records, and the defendant was contemplating suicide.

iii. No Willfulness Required For *Klein* Conspiracy

Unlike Code Sec. 7206(1) and 31 USC §§ 5314 and 5322(a), the *Klein* conspiracy does not contain a willfulness element. Rather, the *Klein* conspiracy merely requires that the taxpayer intentionally enter the conspiracy and utilize deceit, trickery, or other means that are dishonest. The taxpayer need not know that defrauding the IRS was a "no-no." However, the government must prove that the defendant acted dishonestly. In this sense, the *Klein* conspiracy may be easier for the government to prove than the other two crimes.

iv. Practical and Sound Advice Regarding Willfulness

The ease with which willful blindness can be proven is a stark reminder to taxpayers of the risks inherent in making a quiet disclosure. It is the flashing neon sign in the store window. And if that sign could speak, it would say: "A quiet disclosure is not an exercise for the faint of heart, the risk-averse, or for anyone without some tolerance for risk."[iii] The only guaranteed result is to get in OVDP and stay in it.

b. Criminal Tax Deficiency

The second critical element to any criminal tax case is a tax deficiency. Tax deficiency is defined as "additional tax due and owing." You might be wondering why there is so much fuss about tax deficiency when tax deficiency is *not* a required element of any one of the tax crimes discussed above.[iv] Indeed, only tax evasion requires tax deficiency as an element of the crime and to date, the government has never charged tax evasion in connection with a foreign bank prosecution.[v]

i. Tax Deficiency In Connection With the Crime of Failure to File a FBAR

Although willful failure to file an FBAR does not require a tax deficiency, the government usually does not prosecute taxpayers unless it has evidence of a substantial tax deficiency.[vi] There are two reasons. First, criminal tax prosecutions usually result in jail time,[vii] thus depriving citizens of what our founders viewed as the most fundamental right protected by the U.S. Constitution: our freedom. And second, the potential backlash from the public. As a preliminary matter, one of the government's primary goals in bringing a criminal tax prosecution is deterrence – in other words, to make an example out of the taxpayer by putting him to shame in order to deter others from engaging in similar conduct.

But if the government targets a taxpayer with a small tax deficiency, there is a real risk that this strategy will backfire, resulting in a backlash from the public. For example, it may reinforce the public's perception of Uncle Sam as a greedy "big brother" who picks on the little guy. In that sense, the government risks heightening the public relations nightmare that has already put it on the defensive in connection with the FATCA debacle.

For this reason, the IRS is often willing to *overlook* the failure to file FBARs, even for consecutive years, so long as the taxpayer has reported and paid tax on *all* offshore income. Conversely, taxpayers who have *failed* to report and pay tax on all offshore income are pursued as aggressively as a hare being chased by a fox.

How much of a tax deficiency must there be before the government will bring a tax prosecution? The unofficial rule is that there must be a $ 40,000 tax deficiency for all of the years in question.[viii]

ii. **Tax Deficiency In Connection With the Crime of Filing a False Tax Return**

In theory, a false statement could have no effect whatsoever on calculating tax liability, yet still be considered *material* for purposes of violating Code Sec. 7206(1).[ix] For example, consider an offshore account that generates no interest and no taxable income (or if it does generate interest, that interest is so light that is it completely offset by the foreign tax credit). Further, assume that the taxpayer fails to report the account on Schedule B not due to an oversight, but instead because he didn't want the government to know about the account.

If you thought that was harsh, it doesn't even come close to taking the prize. As outrageous as this might sound, a taxpayer could be found to have violated Code Sec. 7206(1) even by *over*-reporting income and tax. How is that possible? Because filing a false tax return requires a material false statement and overreporting income could theoretically distort the correct amount of tax due and owing just as much as underreporting income could. For this reason, it might be considered a "misrepresentation."

c. **Remaining Elements of These Crimes**

Proving the remaining elements of these crimes is as seamless for the government to accomplish as finding a free drink in Las Vegas. For example, to prove that the taxpayer made and signed a return, the prosecutor need only point to the taxpayer's signature on the return while citing Code Sec. 6064, which states that a taxpayer's signature is *prima facie* evidence – for *all* purposes – that the return was signed by him.[x]

Similarly, to prove that the return contained a written declaration that it was signed subject to the penalties of perjury, the prosecutor need only highlight the jurat beneath the signature space which states that the taxpayer is signing the return under penalty of perjury.[xi]

Endnotes:

[i] "What's Your Client's Criminal Exposure on His Undeclared Foreign Bank Account?" Robbins, Edward; Toscher, Steven; and Perez, Dennis; Journal of Tax Practice & Procedure, CCH; p. 69, October-November 2012.
[ii] Id., supra, note (i), at 69-70.
[iii] Tax Crimes, Townsend, John, Campagna, Larry, Johnson, Steve, LexisNexis, 2008.
[iv] Id., supra, note (i), at 69.
[v] Id., supra, at 69.
[vi] Id., supra, at 69.
[vii] Id., supra, at 69.
[viii] Id., supra, at 69.
[ix] Id., supra, at 69.
[x] Id., supra, at 70.
[xi] Id., supra, at 70.