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Federal Prosecution of Income Tax Cases

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FEDERAL PROSECUTION OF INCOME TAX CASES

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With the rates of federal income tax steadily increasing the incentive to evade a part of the levy thus imposed is bound to increase. If a man is obligated to pay, for example, fifty percent of his net income to the Collector of Internal Revenue, when formerly he was obligated to pay only thirty per cent, he would be more inclined to omit a part of his earnings or profits from his return. Not only is the tax rising but the number of taxpayers is steadily increasing, due both to a broadening of the tax base and the increase in population. For these reasons the question of fraud and federal prosecution for evasion of tax is one of growing importance to the attorney

Initiation of the Case

It is interesting to note how prosecution cases arise. As one means, the Treasury Department makes use of informers. Congress annually appropriates a sum of money to be used in the payment of rewards to those who submit information of value to the Department in "detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws, or conniving at the same."[1] But the hope of gain is not the only impelling force inducing informants to report cases of alleged evasion. Discharged employees, disgruntled relatives, or envious competitors often furnish leads for the purpose of obtaining revenge or inflicting detriment. Much of the information thus gained by the Bureau of Internal Revenue proves to be unsupported rumor or suspicion, but a substantial part is surprisingly accurate.

Criminal investigations also commence from the routine examination of returns by revenue agents. The agent is assigned a particular return for audit in the normal manner and commences his work without suspecting falsification. Before he has progressed

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[1] Section 3792, INT. REV. CODE. See also T.D. 5770, 1950-1 C.B. 26.

far however, his findings indicate that there are serious shortcomings. When this is true, he stops his examination, reports his tentative findings, and recommends that a fraud investigation be undertaken.

Another manner in which a criminal case commences is the office audit given all returns. This review is undertaken primarily to ascertain whether the arithmetic on the return is accurate and whether the tax has been properly computed. However, it sometimes comes to the attention of the auditor, from such information as has been set forth on the return, that more serious faults might exist. When this happens the return is set aside for a field examination to determine whether a fraud on the revenue has been perpetrated.

Occasionally the Bureau undertakes "drives" against certain groups of taxpayers which it believes guilty of wrongdoing. During the immediate post-war period, groups of agents were detailed to examine the returns of automobile dealers who were believed to have received cash which they did not report. During the later years of the war many meat packers and wholesalers were similarly brought under scrutiny Currently the Commissioner has set up "Racket Squads" to inquire into the tax liability of persons known or suspected of being engaged in illegal activities.[2]

Procedure

All criminal fraud investigations are under the direction of a special agent. Special agents are members of the Intelligence Division of the Bureau and have special training in assembling evidence for use in prosecuting evaders. Normally they work with a revenue agent (or occasionally a deputy collector) and conduct a joint investigation. The revenue agents assigned to cooperate with the Intelligence Division are also, as a rule, specialists in evasion cases and are members of the so-called "fraud squad."

If the special agent and revenue agent, as a result of their examination, feel that criminal prosecution is warranted, they so recommend in the report of their findings. Their reports are submitted to the Special Agent in Charge who is the chief officer of the Intelligence Division in the area. If the Special Agent in

[2] Press Release S-2930, January 10, 1952, 525 CCH, Par. 6079.

Charge agrees with this recommendation he refers the reports, together with the documentary evidence assembled, to the regional office of the Penal Division.

The Penal Division of the Chief Counsel's Office of the Bureau has representatives in many of the larger cities throughout the country. Its members are attorneys and their task is to analyze the case to ascertain whether the recommendation is based upon sound legal premises and whether there is a reasonable likelihood of suc cessful prosecution. The taxpayer, or his counsel, may be afforded a conference at this point to present his side of the case, if the regional office in its discretion feels that such a hearing is warranted. If the Penal Division believes that the recommendation of the agents is justified, the case is sent directly to the Tax Division of the Department of Justice in Washington proposing that the taxpayer be indicted and tried.[3]

The matter is then referred to the Criminal Section of the Tax Division for further review The Criminal Section gives the case much the same scrutiny as applied in the Penal Division, its objec tive being to ascertain whether the proposed prosecution is legally sound and whether there is a reasonable prospect of conviction. If the Criminal Section concurs in the Bureau s recommendation, the proceeding is transmitted to the appropriate United States Attorney with instructions to place the matter before the grand jury The taxpayer is normally afforded an opportunity for a hearing while the case is in the Department of Justice, irrespective of whether he was granted a similar privilege in the Penal Division.

Civil Liability

The disposition of the criminal phases of the case do not mitigate or ameliorate the civil liability. Even though the defendant is fined and sentenced to serve a term in the penitentiary for wilfully evading or defeating his tax, he is still obligated to pay the full amount of the deficiency together with interest and penalty. If fraud is present the taxpayer is required to pay a penalty equal to fifty per cent of the understatement in tax.[4] This

[3] Until recently cases were referred to the Bureau in Washington for review before being sent to the Department of Justice. Now, however, they are transmitted directly from the field office of the Penal Division. Press Release S-2927, January 8, 1952, 525 CCH, Par. 6078.

[4] Section 293(b), INT. REV. CODE.

addition to the tax is a civil sanction which is due and payable even though the criminal liability has been exacted.[5]

Usually the Bureau makes no effort to assert the civil obligation until the criminal aspects of the case have been disposed of. Occasionally, however, the internal revenue officials have occasion to issue the prescribed notice of deficiency[6] before that time, usually because the statutory period for assessment is about to expire.[7] While the period for assessment is extended indefinitely if fraud can be established,[8] they may feel that the case does not warrant taking the risk of so demonstrating, especially since the government has the burden of proof in such instances.[9]

Determination of Net Income

One of the most interesting and important questions involved in the trial of a criminal tax case is the means employed to ascertain the taxable income. Each case, of course, depends upon its own particular circumstances, but some generalizations can be made.

Rarely, if ever, in such matters are the books and records of the taxpayer kept in a complete and accurate manner. If the returns are falsified, the books are either equally false or so inadequate and incomplete that it is impossible to ascertain from them the actual net income. Sometimes, where the defendant's gross income is received from a comparatively few customers, it is feasible to determine from the testimony or records of such customers just how much was paid him. In so many cases, however, the receipts are derived from a great many individuals and firms, often in cash, and for practical purposes leave little trace. If the taxpayer keeps no secret account of these sums or stands upon his constitutional privilege against self incrimination, the difficulty of arriving at the correct net income is readily apparent.

One method frequently used by internal revenue investigators is the so-called "net worth analysis." In using this device the agents ascertain the amount of property owned by a taxpayer (assets minus liabilities) at the beginning of the taxable year and the

[5] Helvering v. Mitchell, 303 U.S. 391 (1937).
[6] Section 272(a) (1), INT. REV. CODE.
[7] Section 275(a) and (c), INT. REV. CODE.
[8] Section 276(a), INT. REV. CODE.
[9] Section 1112, INT. REV. CODE.

amount held at the end of the year.[10] By subtracting the beginning net worth from that at the end of the year, the increase in net worth is arrived at. To this increase is added non-deductible expenditures for the year such as living expenses, income taxes paid, and political contributions. The aggregate of these amounts is considered to be the taxable net income.

This means of finding the tax base has been tested frequently in the courts and has been held to constitute an adequate basis for conviction, where the necessary elements are present.[11] The two elements which have been most frequently disputd in the courts are (1) a possible source of taxable income to account for the increases in net worth[12] and (2) the accuracy of the amount of cash (or other highly liquid and easily concealed assets) on hand at the beginning of the taxable year.[13] This second point is so often in controversy because the defendant claims that the increase in his property during the taxable period was acquired with cash which he had accumulated in years prior to those for which he is being tried.

A corollary of the net worth method, in fact another version of it, is the so-called "expenditures analysis." In this type of case the defendant has not accumulated property, but rather has spent more funds for non-deductible purposes than he has reported as income. This means of determining net taxable income has also received the sanction of the courts if the required elements have been adequately established by the prosecution.[14]

A third method employed is the totaling of the taxpayer's bank deposits, after eliminating transfers between bank accounts and items which are known to represent non-income deposits such as loans or gifts. Normally the government must show that the defendant is engaged in a lucrative calling and that the deposits are of such a periodic nature as to reflect current receipts. Where

[10] In making this computation, assets and liabilities are taken at their cost or other tax basis, not at their present realizable values.

[11] Buttermore v. U.S., 180 F 2d 853 (C.A. 6, 1950); Lurding v. U.S., 191 F 2d (C.A. 6, 1951).

[12] For examples see U.S. v. Chapman, 168 F 2d 997 (C.A. 7, 1948), cert. den. 335 U.S. 853 (1947-48); and Schuerman v. U.S., 174 F 2d 397 (C.A. 8, 1949), cert. den. 338 U.S. 831 (1948-49).

[13] For examples see U.S. v. Skidmore, 123 F 2d 604 (C.A. 7, 1941), cert. den. 315 U.S. 800 (1941); and Barcott v. U.S., 169 F 2d 929 (C.A. 9, 1948), cert. den. 336 U.S. 912 (1948).

[14] U.S. v. Potson, 171 F 2d 495 (C.A. 7, 1948); Jelaza v. U.S., 179 F 2d 202 (C.A. 4, 1950).

these factors are clearly enough developed and not explained on behalf of the defendant, the bank deposit computation has been considered sufficient to sustain a conviction.[15]

Often, more than one of these indirect methods of ascertaining income will be employed. For example, the government will predicate its case upon bank deposits, but introduce evidence of net worth increases to support the analysis of deposits.[16] Or an analysis of expenditures may be bulwarked by proof of bank deposits.[17]

Statute of Limitations

Most indictments are predicated on the charge that the defendant wilfully attempted to evade and defeat his income tax.[18] Prosecution for this offense must be commenced within six years from the time the attempt was made.[19] Normally the crime is completed when the taxpayer has knowingly and wilfully filed a fraudulent return with intent to evade and defeat a part or all of the tax.[20] Other illustrations of a wilful attempt are given by the Supreme Court in *United States* v *Spies*:[21]

> " affirmative wilful attempt may be inferred from conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal. If the tax-evasion motive plays any part in such conduct the offense may be made out "

A wilful attempt consists of affirmative action and cannot be composed of a mere omission or failure to act such as failure to file a return.[22]

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[15] Gleckman v. U.S., 80 F 2d 394 (1935), cert. den. 297 U.S. 709 (1935); Stinnett v. U.S., 173 F 2d 129 (C.A. 4, 1949), cert den. 337 U.S. 957 (1948); U.S. v. Venuto, 182 F 2d 519 (C.A. 3, 1950).

[16] Gleckman v. U.S., *supra.*

[17] Jelaza v. U.S., *supra.*

[18] Section 145(b), INT. REV. CODE.

[19] Section 3748(a) (2), INT. REV. CODE.

[20] Guzik v. U.S., 54 F 2d 618 (C.A. 7, 1932), cert. den. 285 U. S. 545 (1931); See also Cave v. U.S., 159 F 2d 464 (C.A. 8, 1947), cert. den. 331 U.S. 847 (1936).

[21] 317 U.S. 492 (1942).

[22] U.S. v. Spies, *supra.*

Wilfully failing to file a return[23] is also an offense, but it is only a misdemeanor and the statute of limitations provides that prosecution must be brought within three years.[24] Other offenses sometimes charged in connection with income tax evasion are wilfully aiding or assisting in the preparation and presentation of false and fraudulent returns[25] and wilfully making and subscribing a return which is not believed to be correct in every material respect.[26] The statutory period in the latter instance is three years, while in the case of the preparation and presentation of false returns the term is six years.[27] Such period is tolled while the offender is absent from the federal judicial district wherein the crime was committed.[28]

Voluntary Disclosures

For many years the Treasury Department adhered to a policy of encouraging tax evaders to voluntarily confess the understatements of income and tax on their returns. If the disclosure was made before an examination or investigation had been instituted, the evader would not be subjected to criminal prosecution, although, of course, the Department would insist upon payment of the full amount of taxes, penalties, and interest due.[29]

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[23] Section 145(a), INT. REV. CODE.
[24] Section 3748(a), INT. REV. CODE.
[25] Section 3793(b) (1), INT. REV. CODE.
[26] Section 3809(a), INT. REV. CODE.
[27] Section 3748(a), INT. REV. CODE.
[28] *Ibid.*
[29] Hon. Fred M. Vinson, then Secretary of the Treasury, writing as a guest columnist in Drew Pearson's "Washington Merry-Go-Round" (The Washington Post, August 21, 1945) stated in part " Treasury policy even permits the wilful evader to escape prosecution if he repents in time. The Commissioner of Internal Revenue does not recommend criminal prosecution in the case of any taxpayer who makes a voluntary disclosure of omission or other misstatement in his tax return or of failure to make a tax return. Monetary penalties may be imposed for delinquency, for negligence and for fraud, but the man who makes a disclosure before an investigation is under way protects himself and his family from the stigma of a felony conviction. "

On May 14, 1947, Mr. J. P. Wenchel, then Chief Counsel, Bureau of Internal Revenue, declared in part: "For years the position of the Department has been that where the taxpayer makes a voluntary disclosure of intentional evasion before investigation has been initiated criminal prosecution will not be recommended. A voluntary disclosure occurs when a taxpayer of his own free will and accord, and before any investigation is initiated, discloses fraud upon the government." 474 CCH, Par. 8697.

Some cases which have discussed the question of voluntary disclosures are U.S. v. Lustig, 163 F 2d 85 (C.A. 2), cert. den. 332 U. S. 775; U.S. v. Levy, (U.S. Dist. Ct., Conn.) 51-2 USTC Par. 9388; In re White, et al. (U.S. Dist. Ct., S.D., Miss.) 51-2 USTC Par. 9382; In re Liebster (U.S. Dist. Ct., E.D. Pa.) 50-2 USTC Par. 9357.

This policy has now been abandoned, and persons who wilfully evade their taxes will be subject to prosecution even though they voluntarily disclose the understatements on their returns. In announcing the discontinuance of the Treasury Department's former position, Secretary Snyder stated that the administration of the policy had proven difficult as shown by court litigation over what constituted a truly voluntary disclosure, and the intensified enforcement activities of the Bureau are "ferreting out the wilful tax evaders."[30]

The Bureau has also reversed its stand where the health of the taxpayer is involved. Formerly if a potential defendant was in such physical or mental condition that his life or sanity would be endangered by standing trial, the Commissioner would not recommend indictment. Now the Bureau will propose that the accused be prosecuted irrespective of his health.[31] Presumably, however, the Tax Division of the Department of Justice still feels that a man's life and sanity should not be jeopardized by trial.

Conclusion

With the abolishing of its former policies of not recommending prosecution where the taxpayer's health was poor or where he made a voluntary disclosure, it is apparent that the Treasury is getting "tougher" in its enforcement program. And this is being done at a time when tax rates are increasing and the incentive to evade is greater.

There are a number of means by which cases of alleged evasion are brought to the attention of the Bureau of Internal Revenue. When direct evidence of understatement is lacking in such instances, the special agents and revenue agents have been ingenious in devising indirect means of ascertaining the taxable net income, such as net worth, expenditure, and bank deposit analyses. These methods have been approved by the courts where the necessary elements are present.

Before prosecution is instituted all cases are carefully reviewed in the Penal Division of the Bureau and in the Tax Division of the Department of Justice. An indictment for wilfully attempting to evade and defeat income taxes may be returned within six years

[30] Press release S-2930, January 10, 1952, 525 CCH Par. 6079.
[31] Press release S-2910, December 11, 1951, 525 CCH Par. 6046.

from the time the offense is committed. Conviction does not mitigate or lessen the civil liability and a fraud penalty may be imposed although the defendant has already been severely punished by fine and imprisonment.

When we consider that an evader is subject to (1) fine (2) imprisonment (3) payment of the tax deficiency (4) a fifty per cent fraud penalty (5) interest (6) attorney s fees (7) accountant's fees and (8) court costs, to say nothing of the wear and tear on his nervous system, it is readily apparent that falsification of one's returns is a very serious and costly matter.

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