



# The New Environment in Corporate Criminal and Tax Enforcement

A New Push Begins...

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# Prosecutors Like Corporate Fraud Cases

- Highly visible, lots of victims, and lots of \$ and headlines
- **DOJ Corporate Fraud Task Force**
  - Adelphia, MCI WorldCom, others
  - Tax area -- Tommy Hilfiger
- Then, into the tax shelter area  
KPMG, E&Y investigations, banks, law firms, investment advisors
- And now – UBS, other banks?
- State enforcement – Tyco



## And Likely to Continue...

- Perhaps an even less “business friendly” administration
- Recession based fraud cases – a lagging indicator of recovery
- LMSB has made it plain that they will be on the lookout for fraud referrals from examinations
- The new IRS Whistleblower Office
- No one needs money more than the good ole USG
- Email – the prosecutor’s best friend

# So a Good Time to Take Stock



## Four Topics:

- I. Principles of corporate criminal liability
- II. Policies for prosecution of business entities
- III. Specific concerns for tax departments
- IV. Strategies and tactics

# “It Could Never Happen Here.”

Many times during this presentation, you will say to yourself:

“This could never happen at my company,”  
or  
“This would never happen to me.”

**It could.**

# I. Principles of Corporate Criminal Liability

- Corporations are "legal persons" capable of committing crimes
- Corporate criminal liability derives from illegal acts of its directors, officers, employees, and agents
- A low threshold – the government must establish that the corporate agent's actions:
  - (i) were within the scope of the agent's duties and
  - (ii) were intended, at least in part, to benefit the corporation
- Anytime the government thinks someone in a company has engaged in wrongful conduct, they will look to see if they can indict the company

# To Charge a Company or Not?

- Most prosecutors prefer to charge individuals with a crime, since corporations cannot serve time in prison
- But prosecuting a company has many attractions to the government and dangers to the entity:
  - Substantial, even potentially draconian criminal penalties
    - Can be 2X the gain to the company, or loss to the victims
    - Siemens – over \$1 billion, UBS \$756 million
  - Influence over a company's business practices
  - Debarment from government contracts
  - Publicity and deterrence
  - Damage to brands and goodwill

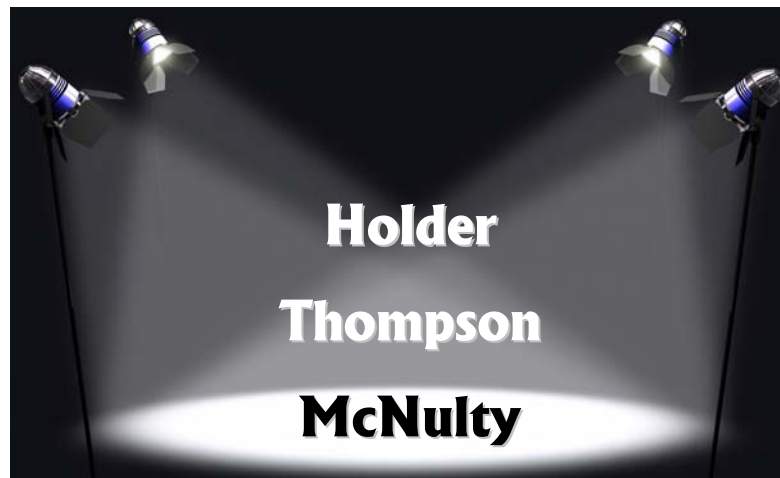
# A Low Threshold

- It is remarkably simple for the government to charge a company with criminal conduct
  - The actions of one bad actor, even actions that *no system of internal control or compliance could ever have captured*, can, in theory cause the company to become a prosecution target itself
- Second Circuit recently rebuffed attempts by business interests to tighten the standard by holding that criminal liability would ensue only if the company lacked an effective compliance program. (*US v. Ionia Mgt*, 2d Cir. 2009)



# Prosecutorial Discretion







- Given the ease with which the government could charge a company with criminal wrongdoing, the DOJ has adopted a set of policies to guide prosecutors in exercising their discretion in this area
- Lots of attention to these policies lately – by name of the Deputy AG who issued them – Holder, Thompson, McNulty, etc.



## But It's Also About Leverage

- The mere THREAT of a corporate indictment can lead a company down the road of extensive cooperation, to assist the government in prosecuting the individual wrongdoers
  - “Strap on a badge....”
- See change in approach to these cases compared to 20 years ago – then it was about protecting individuals; now, it's about protecting the company

## II. DOJ Criteria for Prosecuting a Company

-  The nature and seriousness of the offense, e.g., harm to the public, government priorities
-  The pervasiveness of wrongdoing in the company, including “complicity” or “condoning” conduct
-  Company’s history of misconduct, including civil or regulatory problems
-  Timely and voluntary disclosure, and willingness to COOPERATE
-  Existence and effectiveness of corporate compliance programs
-  Remedial actions – improvement in compliance programs, management changes, disciplinary actions, and (again), cooperation

## DOJ Criteria Contd.



Collateral consequences to employees, pension holders, shareholders, other “innocents”



The “adequacy” of prosecuting the individuals for the crime



The “adequacy” of non-criminal remedies

To address a few of these in more detail...

# 1. Nature and Seriousness

- In a potential corporate criminal tax case, the IRS and Tax Division will generally make the decision whether a corporate prosecution in a particular case is consistent with their tax enforcement priorities
- Thus, “hot issues” are more likely to get attention than others
  - Example now – undisclosed foreign accounts, international cases (use of sham entities), etc.

## 2. Past History

- In a potential criminal tax case, was the issue ever spotted on audit before?
- Have civil penalties ever been imposed previously?
- Any prior record of financial or other issues?
  - Example – Arthur Andersen – prior SEC problems were a factor in the decision to indict the firm

## 3. Cooperation – The Big One

### **Best case: voluntary disclosure**

- If potential criminal conduct is discovered, follow voluntary disclosure practice in tax area
- Contact with CID...meeting with SAC or Special Agent, outline facts, propose amended filings, agree to pay and cooperate, etc.



## Cooperation Contd.

### **Next best case: immediate and full cooperation upon IRS discovery and contact**

- Includes:
  - Document production – including data, email, etc.
  - Company efforts to assist agents
  - Internal Investigation?
  - Employee interviews, disclosure of same to IRS?
  - Engagement of outside experts to do the government's work for them, or to supplement



# Cooperation Contd.

## What about privilege?

- Lots of attention in KPMG-related prosecution and others; a perception that prosecutors were “compelling” waiver of attorney-client and work product privileges
- New guidelines make it clear that this is not required
- DOJ wants “disclosure of the relevant facts”
- Same cooperation credit will be given for this with or without privilege waiver

## Cooperation Contd.

### **Legal advice and work product —not necessary to disclose, and DOJ cannot even ask unless:**

- Individual or company asserts a “reliance on counsel” defense
- Legal advice is covered by the “crime fraud” exception to the privilege, i.e., it was in furtherance (knowingly or unknowingly) of criminal conduct

## 4. Compliance Programs

- All companies should have them
- They should routinely be reviewed and strengthened
- They will be evaluated under a microscope if the government believes criminal wrongdoing has occurred
- More later...

## 5. Restitution and Other Remedies

- DOJ criteria state that a prosecutor may consider the company's willingness to make restitution
- Technically in criminal tax context, a bright line between criminal and civil – money is supposed to be irrelevant
- Not in the world of corporate enforcement, however...

# Possible Corporate Dispositions

- Indictment and trial
- Plea agreement – company pleads to a felony
- Deferred prosecution agreement
- Non-prosecution agreement

# Deferred Prosecution

- DOJ files a criminal charge but does not pursue it
- DOJ and company enter into an agreement
  - “corporate probation”
  - Compliance programs
  - \$\$\$\$\$
  - Acknowledgement of wrongdoing (civil implications...)
  - Possible monitor
  - Continued cooperation in investigation
- Withdrawal of charge after certain time

# Non-prosecution

- No charge filed, usually no acknowledgement of wrongdoing
- Still potential for changes in business practices, improvements in compliance programs, payment of \$\$\$
- Often available only where there has been a voluntary disclosure

## The Issue Is Leverage...

- It's easy to charge corporate criminal conduct
- Government really wants the individuals involved to go to jail
- Threat of corporate indictment leads to cooperation and willingness to do just about anything to keep the company from getting indicted...
- Thus, people get thrown under the bus



# III. Criminal Tax Concepts for Tax Departments

1. Conspiracy
2. Aiding and abetting
3. Criminal intent and willful blindness
4. The “FBAR”

# Concept #1: Conspiracy

- Conspiracy is a crime – an agreement among 2 or more persons to engage in unlawful conduct and an overt act toward that objective:
  - Conspiracy to commit a criminal offense
  - Conspiracy to “defraud the United States”
- In other words, if two or more people agree to commit a crime or to defraud the US and take a step in that direction, they are committing a felony

# A “Klein” Conspiracy

- A “conspiracy to defraud” in the tax context is generally referred to as a “*Klein*” conspiracy, named after Harvey Hyman Klein, a case from the late 1950s
- Klein and others were charged with conspiring to defraud the United States by “impeding the functions of the Internal Revenue Service”
- They argued that this conspiracy charge was too vague
- They lost – the court said that the “conspiracy to defraud” clause reached any agreement to impair the IRS determining or collecting tax

# A “Klein” Conspiracy

- This type of case can involve an agreement to cheat the government out of money, **or** even just to interfere with or obstruct one of its lawful government functions by deceit, craft, trickery, or dishonest means
- But the government does not have to show that the scheme succeeded – it is the **AGREEMENT** that is the crime
- So it’s often a simple case to prove – all the feds need is evidence that 2 or more people agreed to throw sand in the eyes of the IRS somehow...and took a single step in that direction

# “Klein” Conspiracy Examples

- Complex but sham transactions designed to create losses
- Use of corporate checks to fictitious payees to generate cash, failure to record and issue receipts for cash sales
- Fraudulent settlement of a sham lawsuit to generate a false deduction
- Backdating documents to create a false deduction
- Payment of personal expenses made to look like business expenses
- Alteration of invoices, documents, company books, to conceal or disguise the true purpose of a transactions
- Paper goes one way, money flows different

## Concept #2: Aiding and Abetting

- Another way to “expand the reach” of the criminal code in a corporate context – aiding and abetting
- The tax code has a specific provision making it a crime to “aid and assist” another in committing a tax offense
- This provision makes it a crime for anyone to assist another person (or entity) in filing a false tax return or other document with the IRS (IRC 7206(2))

## Aiding and Abetting Contd.

- Applies not just to tax return preparers but to anyone who causes a false return to be filed
- Not just tax returns – this can extend to any other false document required or authorized to be filed with the IRS
  - Not statements or submissions under audit; those are covered by 18 USC 1001
- Elements – i) willful aiding or assistance; ii) presentation of a materially false document in connection with a federal tax matter
  - Note – not necessary to prove a tax deficiency

## Aiding and Abetting Contd.

- Example:
  - employees who executed backdated documents to entitle others to claim false depreciation deductions
  - employee who prepared false bookkeeping records so the company could save on its taxes
- In a company, anyone who prepares a false document or book entry, or otherwise makes any kind of misrepresentation with an understanding that it will affect a tax return or form can be convicted under this provision
- Signing the return is irrelevant



## Concept #3: Criminal Intent and Willful Blindness

- For most criminal offenses, the government must prove that the defendant acted willfully and knowingly
- Willfulness is a voluntary, intentional violation of a known legal duty
- Specific intent is often difficult to prove – absent an admission or confession or accomplice testimony, willfulness is generally inferred from a person's actions

# Actions That Show Intent

- Keeping a double set of books
- False entries or alterations
- 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
- Any conduct, the likely effect of which would be to mislead or to conceal

## Also Can Be Looking the Other Way



- Can you have criminal intent if you don't know what's going on? No, but...
- If one deliberately looks the other way, perhaps he or she actually was trying to avoid giving the appearance (and incurring the consequences) of knowledge
- “Willful blindness” is intentionally staying in the dark

## Looking the Other Way...

- How does the government show someone was intentionally “looking the other way?”
  - Evidence that given the defendant’s position in an entity
  - Or his or her regular practice of keeping informed about particular matters...
  - Or text of a compliance program or other policies stating that the person should have been in the loop
- In the current prosecutorial environment, if the government cannot prove specific knowledge, it can still indict where it has proof that an individual deliberately ignored wrongdoing

# Concept #4: The FBAR

- The FBAR – Treas. Dept Form 90-22.1
  - Reports signature or other authority over, **or** a financial interest in, foreign accounts.
  - Filed on or before June 30 every year
- Applies to companies and employees
  - Theoretically – a dual filing requirement – company files for its financial interest, individuals file for their signature authority
    - Individuals – check the box on their own 1040...
  - Exception – certain large or listed companies
  - If > 25 accounts, can file without detail

# Recent FBAR Guidance: IRS Notice 2010-23

- Suspension of filing requirement for “signature authority only” filers through 6/30/11
  - Includes 2009 FBAR (otherwise due 6/30/10)
  - Also includes prior year FBAR “corrective actions”
  - NO need to check box “yes” for signature authority only
  - Dual Filing requirement – burdensome but necessary
  - So IRS is considering a change...we’ll see
- Same notice – investment in “private” foreign hedge funds not reportable, but investment in “public mutual funds” is reportable
  - Also covers current and prior years

## The FBAR Contd.

- Notwithstanding guidance, still a major issue
- Significant penalties – willful violations can be penalized up to 50% of account value, per year, no cap
- \$10,000 penalty for non-willful violations
- Fall 2008 – LMSB advised its auditors to be on the lookout for unfiled or incomplete FBARs
- Does your company need to consider a voluntary disclosure?

## IV. Strategies and Tactics

1. Reliance on professional advice
2. Corporate compliance programs
3. What to do if the Special Agent shows up?
4. Suspected whistleblowers





# 1. Reliance

- The corporate tax department is “ground zero” as to the primary defense that might be asserted by a company under investigation for tax fraud – the “reliance on professional advice” defense
- Elements:
  - 1) full disclosure of all relevant facts to a professional advisor or return preparer
  - 2) the advisor’s or preparer’s recommendation or approval of the position under investigation, and
  - 3) the individual’s good faith reliance on the professional’s advice

## Reliance Contd.

- The simple case is the individual tax return preparer – did the client tell the preparer the relevant fact (i.e., about the Swiss account...)?
- In a company, it's often more complicated. Many are often involved in preparing the returns, each with specific responsibilities, i.e., those who compile information, review reporting positions, consult with outside lawyers or accountants, and do the drafting
- There might also be outside advisors, who may review the return or actually sign the return as a preparer
- In-house and outside counsel might also be involved

## Reliance Contd.

- In a criminal tax case, this defense is a potential ticket out of trouble
- Thus, companies and top executives (especially those who are not tax people) will look to whoever prepared the corporate tax return as their “professional advisors” for the reliance defense
- Corporate tax directors should therefore maintain records of, for want of a better phrase, “what they knew and when they knew it” in the event a corporate return comes under scrutiny

## But...Reliance or Conspiracy?

- But...remember the Klein conspiracy?
- It is a fine line between a “reliance defense” and a “Klein conspiracy”
- In the “tax shelter wars,” the reliance defense disappeared, and the cases were (and still are) being prosecuted as conspiracies...
- CPAs said the tax lawyers looked at it, vice versa, and *everyone* was indicted

## So, Be a Bit Wary...

- If the transactional people plan a deal that comes under criminal scrutiny, they can't just escape by saying that the tax department knew...
- For the reliance defense to succeed, there must be full disclosure and "good faith" conduct and reliance on all sides
- The lack of full disclosure, or evidence that people knew the tax treatment was not quite right will blow up the reliance defense
- And for a tax person, this is where the issue of "willful blindness" comes in...if the tax professional is aware of a problem with the deal, a conspiracy charge may reach in that direction

## 2. Corporate Compliance Programs

- Every corporation, and indeed, every tax department, should have a compliance program in place –you probably all have such a program
- Advantages of a program:
  - Deterrence of wrongdoing
  - Mitigating fact for prosecutors and under sentencing guidelines
  - Avoidance of civil litigation risk – if a company officer can argue that the compliance program was observed
  - May even provide exculpatory evidence – showing, for example, that an employee acted outside the scope of his duties

## Corporate Compliance Programs Contd.

- Tax compliance programs should facilitate whatever role the tax department plays in the overall corporate compliance process
- Each organization is different, and it is difficult to suggest a “template” for a compliance program that might apply to organizations of any size or substance
- However, there are certain components that are obvious

# Corporate Compliance Programs Contd.

- Thresholds for multiple internal review of certain types of transactions
- Triggers for obtaining written opinions from outside advisors
- Requirements for review, approval and documentation of all communications from the tax department in connection with preparation of financial statements; maybe a separate set of guidelines for dealing with the tax reserve
- Internal processes for communications with outside auditors and documentation requirements



# Corporate Compliance Programs Contd.

- Special procedures, including special forms of review and approval and consultation with outside advisors, relating to instances where the company might have participated in a listed transaction or other sort of tax shelter
- Templates for the topics that must be addressed and representations that must be made when submitting any request to an Audit Committee for approval to hire outside auditors for tax services
- A chain of reporting for any tax department member or corporate employee who suspects an impropriety of any kind, including violations of the internal compliance program itself; perhaps even an anonymous reporting line

## Corporate Compliance Programs Contd.

- Processes for maintaining the integrity of tax department data, work papers, files and other documents and electronic media that might be needed for an IRS audit
- Appropriate mechanisms for the preservation of tax practitioner and attorney-client privileged communications
- Rules governing the disclosure of company tax returns to anyone, including lenders or adversaries in litigation; such rules might require review and sign off of previously filed returns when they are requested by an outside party

## Corporate Compliance Programs Contd.

- Guidelines for the conduct of tax department personnel during a state or federal tax audit, or any kind of investigation
- Processes for ensuring that tax department personnel are kept abreast of relevant administrative, regulatory, judicial and legislative developments
- Adoption of written certifications and education and training programs for departmental personnel to ensure their understanding and observation of the compliance program itself

## 3. Criminal Investigations

- What to do when one starts?
- A federal criminal tax investigation usually begins with the visit of one or more IRS Special Agents to the taxpayer
- Not much notice...Special Agents may just show up to visit the company's tax director
  - Possibly even in the evening and at the home of the individual involved
  - If it arises from an audit, the audit would have been “suspended”
- Notify in-house or outside counsel immediately

## Criminal Investigations Contd.

- Search warrants also possible...
- Enables government to grab all the evidence, secure electronic data, and perhaps get some side interviews...
- If this happens, contact counsel immediately and do absolutely nothing to interfere with the conduct of the search; you can send employees home...

# Criminal Investigations Contd.

- Criminal investigations arise from various sources, including ongoing audits, whistleblowers, and publicity
  - Concept of “Eggshell Audit” – agent has not yet discovered the potentially criminal issue
  - Significant tactical challenges
- If a criminal investigation starts, the IRS has already done a lot of work...they already suspect fraud and have some evidence of wrongdoing
- Civil exam (generally) stops – CID will work the case until they either refer it for prosecution, or decide not to do so

## Criminal Investigations Contd.

- The company will conduct its own investigation and want to interview the relevant employees
- The employee will (and should) want a lawyer; employer can pay the fees, subject to a claw back if the employee has done something wrong...but see the KPMG CASE
- Employee interview by GC or outside lawyer is **not** covered by the employee's attorney client privilege, only the corporation's privilege
  - The government will ask company counsel for notes of interviews and may use them against the employee
- And if the employee doesn't talk to the company's lawyers, the company is likely to fire him or her...so, it's not a happy moment...

## Criminal Investigations Contd.

- The government will also seek to interview the employees, and will try to do so before they have individual counsel
- Agents are known to show up at home...and try to get an employee to talk
- The employee may politely decline to answer any questions until counsel is engaged
- A premature (meaning unprepared) interview with IRS Special Agents or other law enforcement authorities can be disastrous
- And it never shuts down the case...



## Criminal Investigations Contd.

- Obviously – if a criminal case has started don't tamper with evidence; preserve document integrity, including all electronic data
- No one should destroy, backdate or create evidence in order to support any defense he may believe that he has to potential charges
- The obligation to preserve the integrity of documents arises not just when a summons or subpoena is served, but only upon one's *reasonable belief that such process might be forthcoming*

# Criminal Investigations Contd.

- Similarly, a potential witness should not talk to other potential witnesses about the case
- Any of this sort of conduct constitutes independent federal crimes, and makes it easier for the government to prove willfulness and intent as to any underlying conduct
- Finally, during a criminal tax investigation, the taxpayer generally should almost never file delinquent or amended returns, unless part of a negotiated disposition with the government
- The filing of such returns constitutes either a confession or, if they are not complete and truthful, a separate criminal offense

## 4. Whistleblowers and Informants

- The IRS has a new “Whistleblower Office,” and recent legislation increased the reward payable to a tax informant
- Whole law firms are forming to stoke whistleblowers to make claims so the lawyers can collect a contingent fee
- Lots of criminal tax cases started with informants
- If a criminal inquiry has begun, ASSUME there is an informant
- The safest thing to do is for no one to discuss the case without legal counsel present...this advice is difficult to follow among employees who are friends and see each other many times each day, but it is essential

## Whistleblowers and Informants Contd.

- The company may not act against the informant, if his or her identity becomes known – such action might be deemed obstruction of justice
- Moreover, there are now specific felony provisions that prohibit any kind of retaliation against an informant, including interfering with an individual's livelihood or employment status

# Conclusion

- Very few criminal tax cases have involved larger companies
- In my 29 years, I've seen only about a half-dozen or so (Most criminal tax cases involve individuals, etc...)
- However, in an era when the government is increasingly focusing on corporate crime, and the IRS is flexing its enforcement muscles, it's time to be careful:
  - Understand how corporate criminal liability can occur and how a company can be charged with a crime
  - Review compliance programs
  - Understand how what may appear to be an innocuous event can cascade into a fraud inquiry
  - Be aware of the general steps to take if one suddenly develops

# Questions?





Thank You

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