CROSS-BORDER TAX EVASION

Cross-Border Tax Evasion and Bretton Woods II (Part 5)

This installment covers recent developments in tax evasion, money laundering, and foreign bank and financial accounts.

Author: David Spencer

David Spencer, an attorney in New York City, is a member of the Board of Advisors of the Journal and a frequent contributor.

[pg. 50]

This article continues the author's series on cross-border tax evasion and international tax cooperation including the *Yusuf* decision on tax evasion as money laundering; the Fraud Enforcement and Recovery Act of 2009 (FERA); changes in the U.S. obligation to report foreign bank and financial accounts; and a possible role for the IMF. [1] Next month the series will conclude with other recent developments on cross-border tax evasion and regulatory reform.

Tax Evasion and Money Laundering: *Yusuf*

In *Yusuf*, 536 F3d 178 , the issue was the relationship between tax crimes and U.S. money laundering statutes. The Third Circuit held that unpaid taxes, which the taxpayer unlawfully disguised and retained by filing false tax returns through the U.S. mail, were “proceeds” of mail fraud for purposes of sufficiently stating a money laundering offense under the U.S. federal money laundering statute (18 U.S.C. section 1956 (a)(2)(B)(i)). The court held that funds “retained” (unpaid taxes) as a result of unlawful activity can be treated as the “proceeds” of a crime. The Supreme Court declined to review the appellate court's decision. [2] The U.S. government alleged that the taxpayers failed to report on both Virgin Islands and U.S. federal tax returns tens of millions of dollars as gross receipts from the ownership and operation of three supermarkets in the U.S. Virgin Islands, failed to pay a Virgin Islands tax of 4% of gross receipts, and engaged in various efforts to disguise and conceal the illegal scheme and its proceeds, which they sent outside of the United States. The indictment relied on mail

[pg. 52]

fraud (18 U.S.C. section 1341) as the predicate offense of “specified unlawful activity.” See Exhibit 1 for the relevant part of the federal money laundering statute, 18 U.S.C. section 1956(a)(2).

The court noted that under 18 U.S.C. section 1961(1), mail fraud is a “specified unlawful activity,” but tax fraud simpliciter is not. On the U.S. mail fraud statute (18 U.S.C. section 1341), the court said:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises ... for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service ... shall be fined under this title or imprisoned not more than 20 years, or both.... Stated plainly, the elements necessary to establish the offense of mail fraud are (1) a scheme or artifice to defraud for the purpose of obtaining money or property and (2) use of the mails in furtherance of the scheme.

> Therefore, once these two requirements are met, mail fraud has been committed.

The Supreme Court has interpreted the elements of mail fraud, holding that a scheme to defraud need not contemplate the use of the mail as an essential part of the scheme so long as the mailing is “incident to an essential part of the scheme.” [3]

The Third Circuit observed:

> [I]n the District Court's view, the tax savings (i.e., unpaid taxes) cannot be considered “proceeds” of mail fraud because such *tax savings* (1) represented a percentage of unreported gross receipts that were *lawfully obtained* in the day to day business of Plaza Extra Supermarket, and, thus, such tax savings cannot thereafter be categorized as “proceeds” from an unlawful activity; and (2) were merely *retained*, rather than *obtained*, money resulting from defendants' noncompliance with the Virgin Islands' gross receipts reporting statute. (Emphasis in original.)

Vacating the district court decision, the Court of Appeals held that “the unpaid taxes, which are unlawfully disguised and retained by means of the filing of false tax returns through the U.S. mail, constitute 'proceeds' of mail fraud for purposes of supporting a charge of federal money laundering." The court stated: "[W]e reject the suggestion that to qualify as 'proceeds' under the federal money laundering statute, funds must have been *directly* produced by or through a specified unlawful activity, and we agree that funds *retained* as a result of the unlawful activity can be treated as the 'proceeds' of such crime.” (Emphasis in original.) See Exhibit 2.

FERA

FERA, S. 386, signed by President Obama on May 20, 2009, amended the U.S. money laundering statute by defining “proceeds” in new 18 U.S.C. section 1956(c)(9) as “any property derived from or obtained or retained, directly or indirectly, through some form of unlawful activity, including the gross receipts of such activity.” The reason for the amendment is described in the statement made when FERA was introduced on February 5, 2009:

> This bill will also strengthen one of the core offenses in so many fraud cases—money laundering—which was significantly weakened by a recent Supreme Court case. In United States v. Santos, the Supreme Court misinterpreted the money laundering statutes, limiting their scope to only the “profits” of crimes, rather than the “proceeds” of the offenses. The Court's mistaken decision was contrary to Congressional intent and will lead to financial criminals escaping culpability simply by claiming their illegal scams had not made a profit. This erroneous decision must be corrected immediately, as dozens of money laundering cases have already been dismissed. [4]

The new definition of “proceeds” does more than resolve the issue decided in *Santos*—it confirms the decision in *Yusuf* that “proceeds” include funds retained, such as by the nonpayment of taxes.

U.S. tax evasion as money laundering offense.

FERA as originally proposed included an amendment [5] that would have made U.S. income tax evasion a money laundering offense, but only if there was a transfer of funds or a “monetary instrument,” and the transfer was (1) from the United States to outside the United States, or (2) from outside the United States into the United States. The proposed FERA amendment to the U.S. Code read as follows:

> Whoever transports, transmits, or transfers, or attempts to transport, transmit, or transfer a monetary instrument or funds from a place in the United States to or through a place outside the United States or to a place in the United States from or through a place outside the United States (A) (i) ... or (ii) with the intent to engage in conduct constituting a violation of section 7201 or 7206 of the Internal Revenue Code of 1986....

[pg. 53]

That proposed amendment would have applied only to violations of Section 7201 (Attempt to Evade or Defeat Tax) or 7206 (Fraud and False Statements). It would not cover tax evasion under foreign law. That is, a person evading foreign tax would not have been covered by the proposed FERA amendment.

The proposed amendment was opposed by “a group of concerned practitioners, many of whom are members of the American Bar

Association Sections of Taxation, International Law, and Criminal Justice, and alumni of the Department of Justice," who wrote a letter to congressional committees and the Executive branch. Bruce Zagaris summarized in the International Enforcement Law Reporter the arguments in that letter opposing the inclusion of a violation of Sections 7201 and 7206 as a money laundering offense under 18 U.S.C. section 1956(a)(2)(A). [6] Congress passed FERA, but removed the provision making U.S. tax evasion a money laundering offense. [7]

The OECD report, "Engaging With High Net Worth Individuals on Tax Compliance" (May 2009) ("HNWI Report"), refers to the relationship of anti-money laundering laws and tax evasion. In Annex B of that report (page 80), "Proposals for Consideration by Countries Concerned by the Offshore Tax Risk," one proposal is to "[a]nalyze the implications of anti-money laundering rules in countering offshore tax and explore how the interplay between these sets of rules could be improved." [8]

Under the proposed Combating Money Laundering and Terrorist Financing Act of 2007 (S. 473), the U.S. money laundering statute would be amended to cover both U.S. domestic tax evasion and foreign tax evasion.

Foreign Bank and Financial Accounts

The Service amended Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts ("FBAR"), in October 2008 [9] and these changes were analyzed in the *Journal* by Ian M. Comisky and Matthew D. Lee. [10]

A Role for the IMF?

[pg. 54]

Proposed U.S. legislation in 1989 could serve as a guide for a future role for the IMF. The proposed legislation, the International Development and Finance Act of 1989, Title IV, International Debt Provisions, would have required the Treasury Secretary to instruct the U.S. Executive Director of the IMF to propose that the IMF conduct a study on multilateral means by which the banking industry might help reverse capital flight from countries that are engaged in debt restructuring, including (1) the feasibility of disclosing the names of account holders whose accounts may consist of flight capital, and the balances of these accounts; (2) the usefulness of such disclosures in deterring the creation and maintenance of these accounts, and how this deterrence would operate or be defeated; (3) the extent to which any information is gathered and to whom the information is made available; (4) the receptiveness of countries to the disclosure of information; (5) the difficulties in, and the cost of, collecting the information and overcoming legal obstacles used to disguise the true ownership of these deposits, including the feasibility of using the threat of confiscatory penalties to prevent the disguising of the ownership of deposits; (6) the usefulness of using taxes as a means to encourage the repatriation of flight capital; and (7) the applicability (if any) of efforts to facilitate the identification, tracing, seizure, and forfeiture of drug crime proceeds, and to prevent the use of the banking system and financial institutions for the purpose of money laundering. [11] Section 404(b) of the proposed legislation defined "flight capital" as "any asset (1) that is deposited in a banking institution for safekeeping or investment purposes; or for which a financial institution serves as a conduit, agent, or fiduciary in a transaction; and (2) the owner of which may be a legal resident of a country other than the country in which the institution is located."

The IMF has been opposed to adopting or supporting the OECD project on harmful tax practices that is aimed at cross-border tax evasion. The

[pg. 55]

reasons are detailed in an article by Richard Gordon, a senior IMF staff member from 1994-2003, "On the Use and Abuse of Standards for Law: Global Governance and Offshore Centers." [12] Gordon's article makes two points about the IMF not confronting cross-border tax evasion: (1) the IMF lacks jurisdiction to deal with tax-haven treatment (confidential and tax-free treatment) provided by one country that results in tax evasion by residents/citizens of another country; and (2) the OECD proposals were not a commonly accepted standard that was applied universally to all jurisdictions. Gordon points out that the IMF's Articles of Agreement specify three principal functions of the IMF:

> (1) Jurisdiction to exercise surveillance over members' obligations to direct their economic and financial policies toward fostering orderly economic growth and underlying economic and financial conditions ("Surveillance Principle").
>
> (2) Balance-of-payment loans and conditionality ("Loan Conditionality Principle").

(3) Technical assistance consistent with the purposes of the IMF (“Technical Assistance Principle”).

Gordon emphasized that “it was the view of the IMF management and staff, as articulated by the IMF's Legal Department in a number of un-published memoranda, that there was nothing in the IMF Articles of Agreement that created any ... obligation [of IMF members] or IMF policy that members should take action to benefit another member at their own expense,” such as one member (Country X) assisting another member (Country Y) to enforce the tax laws of that other member (Country Y). This was the principle of “no obligation to sacrifice for another member.” Gordon stressed that the IMF is concerned with the impact of a member's tax policies on its own economic and fiscal well-being, not that of other members.

Gordon pointed out the importance of generally accepted standards and a neutral adjudicator to carry out a program of assessments. He observed that

[pg. 56]

(1) the standards developed for “prudential financial regulation,” by the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors, and (2) the standards developed for AML/CFT [13] compliance, were considered professionally developed, and were “not seen as having been developed only to benefit onshore countries to the detriment of the offshore jurisdiction.”

Gordon noted that there was no internationally accepted standards on international tax cooperation, that is, no international accepted rule on tax comity. This is the "revenue rule": courts and administrative agencies of one jurisdiction do not enforce the revenue laws of another jurisdiction except on the basis of reciprocity.

Some IMF Executive Directors were opposed to any IMF involvement with the OECD proposals because of their coercive nature; some OECD financial centers were trying to impose “standards” that were not internationally accepted or applied by other OECD financial centers. Gordon emphasized that there was no broad consensus or norm with regard to the OECD proposals, as OECD financial centers were providing the same “tax haven treatment” as offshore tax haven jurisdictions “blacklisted” by the OECD, so the OECD “standard” could be considered “illegitimate”: “Because the OECD ... [was] dominated by larger onshore jurisdictions, they did not have sufficient legitimacy to be accepted as a neutral party that could create generally accepted standards and/or assess compliance with them.” Gordon noted that when then Treasury Secretary O'Neill stated publicly in June 2001 that the United States could not fully support the OECD proposals, “a number of [IMF] staff concluded that the efforts to involve the Fund in anti-tax haven activities would now be over.”

However, with regard to the IMF's jurisdiction, there is a strong argument that it has jurisdiction over cross-border tax evasion and the resulting capital flight. One of the IMF's purposes is "[t]o promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems” (Article 1(i) of the Articles of Agreement). Gordon said that “this has been interpreted broadly as including oversight of the international financial system" and “strengthening the international financial architecture.” After September 11, 2001, the IMF, in effect, adopted the Financial Action Task Force's (FATF's) AML/CFT program, basing it on the IMF's role in overseeing the international financial system. In view of the quantification of cross-border tax evasion, capital flight (particularly capital flight and other cross-border illicit financial flows from developing countries) has been a major macroeconomic concern and a fundamental issue in the international financial system. Indeed, capital flight has been particularly relevant to the balance-of-payment problems of developing countries.

In June 2004, the IMF's Independent Evaluation Office issued a detailed “Report on the Evaluation of the Role of the Fund in Argentina, 1991-2001” (“IMF Argentina Report”). The Report, however, mentions capital flight only in passing. For example, in discussing a meeting of select senior IMF staff in late August 2001 to consider augmenting the IMF standby arrangement for Argentina: [14]

> However, a clear majority of those present disagreed, saying that the IMF might not be spared from blame in any case. The additional few billion dollars would not buy enough time to make a difference, but would be more likely to disappear in capital flight, leaving Argentina more indebted to the IMF.

The IMF staff responded:

> Moreover, there is an internal inconsistency in the Report's presentation of the Fund's decisions during late 2000 and early 2001.... If, as suggested in the Report, the Fund had drawn the line several months earlier by failing to complete the May 2001 review, the basic features of the crisis would have been the same: Argentina would not have avoided a

> wrenching default and a forced exchange rate regime change, with their deleterious effects on private and public balances sheets and the real economy. The main—but not inconsequential—difference is that the Fund would have avoided

[pg. 57]

> increasing its exposure to Argentina by about $9 billion, which in the event largely financed capital flight. [15]

The IMF Argentina Report also referred to the technical assistance provided by the IMF's Fiscal Department to Argentina's tax authorities, but without specific reference to the problems of tax evasion resulting from capital flight from Argentina.

The Managing Director of the IMF, Dominique Strauss-Kahn, was reported by Europa Press (February 18, 2009) to have made a comment in an interview with the press (France-Inter) that he "was in favor of an action with dynamite against tax havens."

Antonio Hyman-Bouchereau, Senior Counsel, IMF Legal Department, and a Panamanian, in a letter on February 18, 2009, commented on Strauss-Kahn's statement, and described the IMF's position that "the alleged harmful competition in tax matters is not a criteria related to any international standard," so the IMF does not concern itself with that:

> [The statement of Dominique Strauss-Kahn] may be the personal position of the [IMF] Managing Director (assuming that the reporter accurately reported what he said). Nevertheless, the position of the [IMF] Directors and the IMF staff is different: (1) The IMF is not in the business of combating "tax havens." (The IMF tries to avoid using that term, as there is no generally accepted definition.) (2) There are no essential differences between "onshore" and "offshore" jurisdictions, and therefore they receive equal treatment in their relations with the IMF. (3) To the extent that such supposed "tax havens" are members of the IMF or jurisdictions which are not members but which have substantial weight in the global financial system, the IMF attempts to make sure that their juridical and institutional characteristics are in conformity with international standards in financial matters. (The alleged "harmful competition" in tax matters is not any criteria related with any international standards.)

The traditional reluctance of the IMF to confront cross-border tax resulting from capital flight, as detailed by Richard Gordon, could change as the OECD now claims that there is an "international standard for exchange of information." [16]

However, the OECD's "international standard" is merely exchange of information on request. As will be discussed further in Part 6 of this article, governments and non-governmental organization (NGO) advocates of automatic exchange of information assert that (1) the OECD's policy of exchange of information on request is not an "international standard," and (2) in any event, exchange of information on request is not effective. Nevertheless, if the IMF does accept the OECD's "international standards" (at least as a first step), the IMF could become involved in confronting capital flight and other illicit financial flows, the resulting cross-border tax evasion, and the consequential challenge to the international financial architecture.

Conclusion

Part 6 will conclude this article with discussion including U.N. and OECD developments and the impact of the proposed Stop Tax Haven Abuse Act.

Exhibit 1. U.S. Federal Money Laundering Statute

> (2) Whoever transports, transmits, or transfers, or attempts to transport, transmit, or transfer a monetary instrument or funds from a place in the United States to or through a place outside the United States or to a place in the United States from or through a place outside the United States—
>
> (B) knowing that the monetary instrument or funds involved in the transportation, transmission, or transfer represent *the proceeds of some form of unlawful activity* and knowing that such transportation, transmission, or transfer is designed in whole or in part—
>
> (i) to conceal or disguise the nature, the location, the source, the ownership, or the control of *the proceeds of specified unlawful activity*

shall be sentenced to a fine of not more than $500,000 or twice the value of the monetary instrument or funds involved in the transportation, transmission, or transfer whichever is greater, or imprisonment for not more than twenty years, or both. (18 U.S.C. section 1956(a)(2)(B)(i), emphasis added).

Exhibit 2. Excerpts From Third Circuit Decision in *Yusuf*

Based upon the Supreme Court's decisions in *Santos*, *Schmuck*, and *Kann*, and our decision in *Morelli*, we hold that unpaid taxes, which are unlawfully disguised and retained by means of the filing of false tax returns through the U.S. mail, constitute “proceeds” of mail fraud for purposes of supporting a charge of federal money laundering. Here, 4% of the unreported gross receipts that should have been paid as tax to the Virgin Islands but were instead included in the lump sums of money which the defendants sent to Amman, Jordan, were clearly “proceeds” of the fraudulent scheme perpetuated by defendants. Specifically, the defendants' fraudulent scheme was that of concealing certain gross receipts from the Virgin Islands government through the mailing of fraudulent tax returns in order to defraud, cheat, and deprive the government of the 4% gross receipts taxes it was owed, thus enabling the defendants to unlawfully retain such government property and profit from their scheme. See *Pasquantino v. United States*, 544 U.S. 349, 355-56 (2005) (holding that Canada's right to uncollected excise taxes on imported liquor is “property” in its hands, depriving Canada of that money inflicts “an economic injury no less than had they embezzled the funds from the Canadian treasury.”); *Hammerschmidt v. United States*, 265 U.S. 182, 188 (1924) (explaining that to defraud the United States primarily means “to cheat the government out of property or money” and to deprive the government of “something of value by trick, deceit, chicane, or overreaching”). Here, the mailings were both for the purpose of executing the scheme and were material to the consummation of the scheme. See *Kann*, 323 U.S. at 94. The use of the mail to file fraudulent tax returns and fail to pay all taxes owed was not only incident to an essential part of the scheme, but also was clearly *an* essential part of the scheme because such mailings were the defendants' way of concealing the scheme itself by making the fraudulently reported gross receipts seem legitimate. See *Schmuck*, 489 U.S. at 711; *Pereira*, 347 U.S. at 8.

Furthermore, the mailings of the fraudulent tax returns resulted in “proceeds” of mail fraud based on the nature of the *entire ongoing fraudulent scheme* because the unpaid taxes unlawfully retained by defendants represent the “proceeds” of a fraud that was also furthered by previous mailings. See *Morelli*, 169 F. 3d at 806-07. Each mailing, whether it occurred before or after a given act of tax fraud, served to promote and conceal each month's unlawful retention of taxes, either *ex ante* or *ex post*, and made it more difficult for the government to detect the entire fraudulent scheme. See id. Moreover, each mailing of the fraudulent tax forms “contributed directly to the duping” of the Virgin Islands government, and subsequent mailings were essential to keep defendant's scheme going because it would have come to an end if the tax collecting authorities did not continue to receive these mailings. See *Schmuck*, 489 U.S. at 712. Accordingly, it logically follows that the unpaid taxes, unlawfully disguised and retained through the mailing of the tax forms, were “proceeds” of defendants' overall scheme to defraud the government. This scheme was both dependent on and completed by the monthly mailing of the false Virgin Islands gross receipts tax returns.

Finally, in light of the Supreme Court's decision in *Santos*, we recognize that the “proceeds” from the mail fraud in this case also amount to “profits” of mail fraud. See 2008 WL 2229212, at 5-6. By intentionally misrepresenting the total amount of Plaza Extra Supermarkets' gross receipts through the mailing of fraudulent tax returns, the defendants were able to secretly “pocket” the 4% gross receipts taxes on the unreported amounts which were the property of the Virgin Islands government. Cf., *Pasquantino v. United States*, 55 U.S. 349 (2005) (recognizing no material difference between defrauding a government of taxes due and embezzling money from the treasury, the Supreme Court held that unpaid tax constituted property under the wire fraud statute). Other than some small expenses incurred in perpetuation the mail fraud—i.e., the postage stamp affixed to their monthly tax return or any other preparation fees relating to the return—the unpaid taxes retained by defendants amounted to profits. Once these profits were included in the lump sums sent abroad by defendants, the offense of international money laundering was complete.

[1] See Part 1, 20 JOIT 44 (May 2009); Part 2, 20 JOIT 44 (June 2009); Part 3, 20 JOIT 44 (July 2009); Part 4, 20 JOIT 48 (August 2009).

[2] Yusuf, No. 08-981 (2009).

[3] *Schmuck*, 489 US 705, 103 L Ed 2d 734 at 710-711.

[4] See Abramowitz and Bohrer, "The U.S. Supreme Court: Money Laundering Decisions," N.Y. Law J., July 1, 2008, page 3; Fernich,

"Money Laundering After *Santos*: A Supreme Mess," N.Y. Law J., October 17, 2008, page 4.

[5] Proposed 18 U.S.C. section 1956(a)(2)(A)(ii).

[6] Zagaris, "Practitioners Discuss Defects of Criminalizing International Tax Fraud as a Separate, Money Laundering Offense," 25 Int'l Enforcement L. Rptr. 181 (May 2009).

[7] Zagaris, "U.S. Congress Passes Fraud Enforcement Bill After Removing International Tax Crime Provisions," 25 Int'l Enforcement L. Rptr. 277 (July 2009).

[8] www.oecd.org/document/5/0,3343,en_2649_33749_42902277_1_1_1_1,00.html. Part 6 of this article will discuss the scope of money laundering offenses under the U.N. Convention Against Corruption.

[9] 31 U.S.C. sections 5314 and 5322; 31 C.F.R. sections 103.24 and 103.11(2).

[10] See Comisky and Lee, "Increased IRS Scrutiny of Offshore Activity: Raising the Stakes for U.S. Citizens with Bank Accounts Abroad, 20 JOIT 38 (January 2009).

[11] Section 404, Study on Elimination of Capital Flight.

[12] 88 N.C. L. Rev. (forthcoming 2010).

[13] Anti-Money Laundering/Combating the Financing of Terrorism. See www.amlcft.com.

[14] Para. 169, page 88.

[15] Staff Response, July 23, 2004, to Evaluation by the Independent Evaluation Office of the Role of the Fund in Argentina, 1991-2001, para. 5, page 2.

[16] See Spencer, "The G-20 London Summit and Tax Haven Jurisdictions," 20 JOIT 58 (June 2009).