Corporate Tax Departments and the New Focus on Corporate Criminality

by Scott D. Michel

In little more than a year, a "Perfect Storm" combination of events — earnings restatements, SEC inquiries, criminal investigations, indictments and convictions, sweeping legislative and regulatory changes, political pressures, and media scrutiny —have reshaped the relationship between corporations, corporate management, and the criminal law.

Before large portions of the developed world had heard of Enron, the criminal law was a relatively bright line, clearly visible to someone wearing a "white collar" to work. Responsible corporate employees knew that it was a crime to sign a false document submitted to a financial institution or to the government, to cause false statement of corporate income or expense on financial statements or tax returns, or to obstruct or impede a government inquiry. While the government routinely prosecuted garden-variety securities, accounting, or tax fraud cases, the notion that most senior corporate officials would run afoul of potential criminal exposure was far from the minds of most such individuals.

Now the world is different. One individual's misconduct, or even poor judgment, can place an entire enterprise at risk. The most seemingly innocuous email — for example, instructing employees to comply with record destruction policies — can be catastrophic to a corporate entity and lead to imprisonment for senior management. The Sarbanes-Oxley Act, enacted in the summer of 2002, imposed broad new requirements on management and directors, where missteps can result in felony indictments. Financial statements, tax returns, and even corporate press releases are examined under a bright new light, with microscopic lenses. Whistleblowers and informants can lurk everywhere.

Recognizing the new environment, this article discusses some topics every corporate tax director or staffer should know. To set things in context, it begins with a brief description of relevant Department of Justice policies relating to the prosecution of business entities and important components of the U. S. Sentencing Guidelines concerning organizations. The factors that the Department considers in deciding whether to charge a corporation with one or more criminal offenses, and certain key provisions of the Sentencing Guidelines, have reshaped the relationship between companies and their employees when a criminal investigation commences.

Next, the article discusses criminal law concepts that are noteworthy in the context of corporate criminal matters. It makes manifest that the criminal law's reach is broader than one might think. To be sure, every corporate tax director knows that it is a crime for one, with knowledge and willfulness, to sign a false tax return, to engage in conduct aimed at causing the filing of a false tax return, or to fabricate, falsify, or conceal material information during the course of an IRS audit. But there are other crimes, and other ways in which the government seeks to prove criminal conduct, that are increasingly relevant given the new focus on corporate criminality. Four criminal law concepts are illuminated: the breadth of the "*Klein* conspiracy" offense, the notion of aiding and abetting, the aspect of criminal intent called "willful blindness," and the broad scope of the federal money laundering statutes.

Moreover, an important defense to an allegation of criminal conduct — the "reliance on professional adviser" defense — is significant as well. If there is a potential for criminal tax charges within an organization, individuals on the "transactional" side (and the corporation as an entity) are likely to argue that all relevant information was known to personnel in the tax department, and it was those individuals who made the decision about how to report a particular item. Thus, the reliance defense, perhaps helpful to an overall corporate defense, will spotlight the conduct of a corporate tax department.

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Finally, the article describes certain preventative steps that a company, and a corporate tax department specifically, can take in order to put itself in a position to prevent the occurrence of events that, however innocent they might have seemed at the time, might appear as crimes to a prosecutor or federal agent with search warrant or subpoena in hand. These include implementing or revising company compliance programs, including modifications in light of certain provisions of Sarbanes-Oxley, and basic instructions on reacting to an investigation and avoiding mistakes.

I. DOJ Policies on Corporate Prosecutions and Sentencing Guidelines for Organizations

It is an elementary principle of criminal law that companies, not just individuals, can be charged with a crime. Department of Justice guidelines on corporate prosecutions make this clear:

> Corporations are "legal persons," capable of suing and being sued, and capable of committing crimes. Under the doctrine of *respondeat superior*, a corporation may be held criminally liable for the illegal acts

> of its directors, officers, employees, and agents. To hold a corporation liable for these actions, the government must establish that the corporate agent's actions (i) were within the scope of his duties and (ii) were intended, at least in part, to benefit the corporation. In all cases involving wrongdoing by corporate agents, prosecutors should consider the corporation, as well as the responsible individuals, as potential criminal targets.[1]

Most prosecutors prefer to charge individuals with a crime, since corporations cannot serve time in prison. But for many companies, the collateral consequences of a criminal conviction can be devastating — potentially draconian criminal fines, possible debarment from government contracts, and negative publicity and damage to brands and goodwill.

In 1999, the Department of Justice issued a set of guidelines on the prosecution of corporations, and in 2003, the guidelines were revised and updated.[2] The guidelines highlight factors that federal prosecutors consider in deciding whether to bring criminal charges against a corporation. They provide that no single factor is determinative, but rather a prosecutor's decision whether to indict a corporation as an entity should be based on all relevant facts and circumstances. The relevant factors can be summarized, as follows:

- The nature and seriousness of the offense, including the risk of harm to the public, and applicable government policies and priorities, if any, governing the prosecution of corporations for particular categories of crime (such as special initiatives against accounting fraud, health care fraud, procurement fraud and tax fraud).

- The pervasiveness of wrongdoing within the corporation, including the complicity of corporate management.

- The corporation's history of similar conduct, if any, including prior criminal, civil, and regulatory enforcement actions.

- The corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney-client and work product protection and the disclosure of internal investigative reports.

- The existence and adequacy of the corporation's compliance program.

- The company's remedial actions, including any efforts to implement an effective corporation compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies.

- Collateral consequences, including disproportionate harm to shareholders, pension beneficiaries, and employees who were not involved in the offense, and the impact on the public arising from the prosecution.

- The adequacy of the prosecution of individuals responsible for the corporation's malfeasance.

- The adequacy of remedies such as civil or regulatory enforcement actions.

In addition to these policies, the U. S. Sentencing Guidelines play a role in the new landscape of corporate crime. Sentences in all federal criminal cases are pursuant to the Guidelines. In most white-collar criminal cases, the Guidelines require a mechanical calculation of the period of incarceration for individual defendants, and fines for organizations, based largely on the amount of money involved. Federal judges have little discretion to sentence a defendant outside the mandatory range. In nearly all criminal tax cases, individual defendants are sentenced to a period of incarceration.

With regard to organizations (which can include corporations, labor unions, trusts, or any legal entity), there is a "scoring" process that culminates in the determination of a fine. Fines can range from minimal amounts to $300 million or even more, depending on various circumstances. Factors that can exacerbate the amount of the fine include the involvement of high level personnel in the offense, prior corporate misconduct, and obstruction of justice during the investigation. Importantly, one potential mitigating factor is the presence of a corporate compliance program.[3]

The DOJ policies on the indictment of corporations and the Sentencing Guidelines have changed the relationship between companies and their employees in the context of a criminal investigation. Before the last decade, the reaction of many corporate clients had been to stonewall against potential charges and "protect our people" as much as possible. Obviously, no company wanted to get indicted. But quite often, company counsel would work with counsel for individual employees, whose legal fees were paid by the corporation, in an attempt to present a united, and it was hoped, overwhelming defense to potential criminal charges, such that the government would decide at some point to abandon a criminal case and seek civil remedies.

Now, times are different. First, companies realize that a detailed compliance program is essential. Such a compliance program needs to be clear, well-conceived, in writing, and preferably reviewed by counsel. Employees need to be certified and trained in its observance. Even so, the government may seek criminal charges if there is a serious offense or if the government believes that the program was not observed or followed.

Second, if any error or problem is discovered on a company's tax return before audit, the company should seriously consider a voluntary disclosure pursuant to the IRS's revised voluntary disclosure policy.[4] If no criminal investigation or civil examination has begun, the company might escape criminal prosecution with a timely, complete, and truthful voluntary disclosure to the government. Even if an inquiry is underway, however, a corporate entity may

have no choice but to reveal its own discovery of potential wrongdoing in an attempt to seek pre-emptive leniency.

On the other hand, if a criminal investigation begins, the interest of the company and its employees are likely to diverge immediately. The Justice Department policies make it clear that a company that finds itself subject to criminal scrutiny must be completely cooperative in a criminal investigation to attempt to avoid a potential indictment. This may include (1) providing the government with any internal investigative reports or memos of employee interviews, (2) prompt discharge of employees where evidence points to any misconduct by such persons, (3) waiver of attorney-client and work product privileges, and (4) even declining to pay the legal fees of employees suspected of wrongdoing.

II. The Breadth of the Criminal Law — Some Concepts

The danger to companies and their employees in the context of potential criminal investigations is significant enough, but the breadth of the criminal law gives prosecutors and agents powerful weapons to charge criminal offenses against an entire entity, or a large group of individuals, over the actions of a few. To prove a crime the government must demonstrate that at least one person, and in a corporate context, usually more than one, acted willfully and knowingly to violate a criminal provision. But the criminal code is so broad that the government can meet this burden in a number of potentially surprising ways. This section of the article describes four such contexts — the "Klein" conspiracy, the concepts of aiding and abetting and willful blindness, and the federal money laundering statutes.

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A. The "Klein" Conspiracy

The federal criminal code contains a broad proscription against any conspiracy, the knowing and willful participation in an agreement to engage in unlawful conduct plus the occurrence of a single overt act in furtherance of that agreement.[5] Most people are aware that it is a crime to engage in a conspiracy to commit another criminal offense, such as a conspiracy to file a false tax return or engage in money laundering. Fewer know that federal law also prohibits a conspiracy to "defraud the United States." In other words, if two or more people agree to defraud the United States and take a step in that direction, they are committing a felony, even though the conduct they agree upon does not fit the precise contours of another federal criminal provision.

The latter type of conspiracy is typically referred to as a "*Klein*" conspiracy, named after the case of Harvey Hyman Klein, who lived in New York City in the late 1950s.[6] Klein and two other defendants were charged with various criminal acts, including concealment of income and conspiring to defraud the United States by "impeding the functions of the Internal Revenue Service." When they appealed their conviction, they argued that this sort of conspiracy charge was too vague. The court disagreed, finding that the government could, under the "conspiracy to defraud" clause, charge as a crime any agreement to impair the IRS in the pursuit of its lawful and designated function, namely, the ascertainment and collection of taxes.

The *Klein* case affirms the government's right to look to conspiracies aimed at frustrating the IRS at its job, whether or not a particular action might itself not be unlawful or was not the basis of an independent federal charge. For example, in *Klein*, the court looked to the following acts that would support a conviction for conspiracy to defraud the United States:

- Alteration of the books to make liquidating dividends appear as commissions;
- Alteration of the books to make a gratuitous payment of $1.5 million appear as a repayment of a loan;
- A false book entry disguising as commissions what was actually a dividend, which in turn was diverted to corporate nominees;
- A false statement in a personal income tax return regarding the payment for a stock purchase;
- False answers to Treasury interrogations seeking to identify the owners of various corporations;
- A false return reporting that stock was sold for an immense profit;
- An evasive affidavit from a secretary denying that he remembered altering certain books; and
- Income tax returns which falsely claimed a sale of stock.[7]

The Justice Department interprets its power to bring *Klein* conspiracy charges broadly, leaving the possibility for such allegations in any context where two or more people knowingly agree to frustrate a government function. In the criminal tax context, the standard charging language is, as follows:

> [T]o defraud the United States by impeding, impairing, obstructing and defeating the lawful functions of the Internal Revenue Service of the Department of the Treasury in the ascertainment, computation, assessment, and collection of the revenue: to wit, income taxes.

Thus, the scope of the conspiracy to "defraud clause" is broad. The Supreme Court has held that this clause can cover any agreement (1) to cheat the government out of money or property or (2) to interfere with or obstruct one of its lawful government functions by deceit, craft, trickery, or at least by dishonest means.[8] The government does not have to establish a pecuniary loss to the United States, or show that the scheme succeeded or that the government was harmed. Furthermore, the government need not show that the fraud itself was a crime. Therefore, a prosecutor does not have to establish the elements of an underlying fraud offense, but simply that the members agreed to interfere with or impede one of the government's lawful functions, and that they took one step in that direction.[9]

The government routinely considers *Klein* conspiracy charges in criminal tax cases where the facts support such a charge. The rules of evidence are such that prosecutors have great leeway in introducing evidence in support of a conspiracy charge, and, as explained, all the government must prove is a knowing agreement "to defraud" plus a single overt act. The overt act itself need not be illegal, so long as the government can show that it was in furtherance of the conspiracy.

Here are some selected cases that, taken together, demonstrate the reach of the *Klein* conspiracy concept, covering essentially any concerted conduct that seeks to "throw sand in the eyes" of a potential government regulator about any issue:

- In federal gasoline excise tax context, creation of sham paper sales of gas among various entities; and creation of shell corporations to hold tax exemptions licenses.[10]

- Parking stock to generate false tax losses and false claims for deductions, accumulating stock through nominees; and failing to comply with SEC reporting requirements.[11]

- Use of corporate checks to fictitious payees to generate cash; and failure to record and issue receipts for cash sales.[12]

- Complex transactions designed to create losses and provide cash flow from illegal underwriting of a small corporation; and fraudulent settlement of sham lawsuit to generate a false deduction.[13]

- Creation of false deductions by backdating documents relating to a real estate tax shelter investment.[14]

- Company payment of owners' personal expenses and costs for constructing a new church and school, all written off as business deductions or charitable donations, alteration of invoices.[15]

- Creation of 150 corporations, some in tax havens and listing nominees as owners of the corporations; use of the corporations to conceal income and to make it difficult to trace income, expenses and cash skims; and destruction of corporate records after receipt of subpoenas.[16]

- Concealment of corporate receipts using secret bank account, second sales journal, alteration of deposit tickets, false notations on memo portion of corporate checks, and forged sales invoices supplied to an IRS auditor.[17]

- Schemes to obtain loans from banks and receive kickbacks from the proceeds of the loans that were not reported on tax returns;[18] to avoid reporting of bonus income by arranging for corporate accounting records to be falsified;[19] and to falsify deductions, misclassify payments, and create phony debts.[20]

Indeed, the breadth of fact patterns that can constitute a *Klein* conspiracy is coextensive with the imagination of a wrongdoer's mind.

B. Aiding and Abetting

A second core concept used by federal prosecutors to expand the reach of the federal criminal code is the concept of aiding and abetting. The Internal Revenue Code contains a specific provision making it a crime to "aid and assist" another in committing a tax offense. This provision states:

> Any person who 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; … shall be guilty of a felony….[21]

This is the tax code's aiding and abetting provision, and applies not only to tax return preparers but also to anyone who causes a false return to be filed. While frequently the false document will be a tax return or information return, any document required or authorized to be filed with the IRS can give rise to the offense. In order prove a violation, all a prosecutor need show is that the defendant willfully aided or assisted in the preparation or presentation of a document in connection with a federal tax matter and that the document was materially false.

This section was designed to reach tax return preparers who help taxpayers cheat, but it is not limited to return preparers. Rather, it can reach anyone who causes the preparation of a false return or tax filing, or files or furnishes information that leads to the filing of a false

return. The sole question is whether the defendant acted consciously in a way that leads to the preparation or filing of a false return or other document.

Two examples demonstrate the breadth of this provision. In one case, the defendants, who were not return preparers, were convicted after they executed backdated documents to entitle other individuals to obtain false depreciation deductions.[22] In another case, the defendant was convicted after he prepared false bookkeeping records knowing that someone else would use them to prepare tax returns that were, as a result, materially false.[23]

Thus, in a corporate environment, anyone who prepares a false document or entry in a book of account, or otherwise makes any kind of misrepresentation with an understanding that it will affect a tax return or form can be convicted of aiding and assisting a tax offense. Whether the individual actually signed or filed the tax filing at issue is irrelevant (though the government rarely prosecutes a case where there is not some tax filing caused by the defendant's conduct). Nor does it matter whether the taxpayer who submitted the false filing knew that it was false or, if he or she did, was or is being charged with the filing of a false return. The taxpayer can be entirely innocent or completely culpable but not prosecuted.[24]

More broadly, there is an omnibus aiding-and-abetting provision in the federal criminal code making anyone who "aids, counsels, commands, induces or procures" the commission of a federal offense just as culpable as if the individual had committed the actual offense.[25] Thus, anyone who helps another person commit a crime or, indeed, causes another person to commit a crime is no less culpable than the person who did so. To invoke the provision, the government must establish that the defendant associated with the criminal venture, knowingly participated in it, and sought by his or her actions to make the venture succeed. "Association" means that the defendant shared in the criminal intent of the principal, and "participation" requires that the defendant acted affirmatively to aid the venture.[26]

The implication of "willful blindness" is that even where the government cannot prove that the defendant acted with specific knowledge of a specific wrongful act, it may in certain cases obtain a conviction where the defendant "looked the other way."

C. 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.[27] The element of willfulness can be the most difficult element to prove in an evasion case. Absent an admission or confession or accomplice testimony, willfulness is rarely subject to direct proof and must generally be inferred from the defendant's acts or conduct.

In the seminal case of *Spies v. United States*, the Supreme Court set forth a number of examples, "by way of illustration and not by way of limitation," of conduct from which a fact finder could infer willfulness:

> [K]eeping 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.[28]

Thus, any conduct suggesting that an individual was taking an affirmative step to mislead someone about, or to conceal his or her conduct, could be used to prove willfulness. And as described above, such conduct can be imputed to a corporation as a whole.

While it is a defense to a finding of willfulness that an individual was ignorant of the law or of facts that made the conduct illegal, if the individual deliberately avoided acquiring knowledge of a fact or the law, a jury may infer that he or she actually knew it and was merely trying to avoid giving the appearance (and incurring the consequences) of knowledge. This is "willful blindness," or the purposeful avoidance of knowledge. In some cases, the government may prove willfulness in this manner.[29] Prosecutors will ask a jury to find that the defendant acted willfully if he or she "is aware of a high probability of the existence of the fact in question unless he actually believes it does not exist."[30]

In addition to serving as the proof of intent or knowledge, willful blindness can also exacerbate the fines imposed under the sentencing guidelines. The guidelines provide for enhanced penalties where "an individual within high-level personnel of the organization participated in, condoned, or was willfully ignorant of the offense."[31] Thus, the government can not only convict a corporation based on the knowledge of one or more people, but it can seek an enhanced penalty based on the willful blindness of others.

The implication of "willful blindness" is that even where the government cannot prove that the defendant acted with specific knowledge of a specific wrongful act, it may in certain cases obtain a conviction where the defendant "looked the other way." Thus, where the government can muster substantial evidence that given the defendant's position in an entity and his or her regular practice of keeping informed about particular matters, a prosecutor can ask a jury to infer willfulness notwithstanding a defendant's position that he did not "know" what was transpiring. In the current aggressive prosecutorial environment, then, the government is likely to approve the bringing of criminal charges where it believes it has sufficient proof that an individual deliberately ignored wrongdoing.

D. Money Laundering — A Financial Transaction with Tainted Money

There are two criminal provisions prohibiting money laundering, 18 U.S.C. §§ 1956 and 1957. They are both

complex and section 1956 is quite lengthy. In a nutshell, the provisions punish an individual who engages in a financial transaction with money that he or she knows to be "tainted" in a certain way. Section 1956 prohibits certain financial transactions where, for example, they occur in connection with the intent to engage in tax evasion or the filing of false tax returns.

What makes money "tainted" is based on a long list of federal and state crimes, captioned "specified unlawful activity," including mail fraud, wire fraud, and securities fraud (but not tax fraud). For example, a corporation that deposits funds into its bank account, where such funds are derived from an accounting fraud, may have engaged in money laundering.

The levels of intent required for a money laundering violation differ among the various statutes. In general, anyone who deposits what they know to be funds derived from nearly any kind of mail, wire, accounting, or securities fraud is at risk of a money laundering charge.

The implication from the breadth of these statutes should be obvious because most corporate fraud cases involve the two key elements of money laundering — a financial transaction and tainted money. Under the Sentencing Guidelines, in the typical fraud case, if the government can also prove money laundering, the potential sentences of incarceration for individuals or fines for organizations skyrocket. This gives the government enormous leverage to seek plea bargains in cases where a money laundering charge is possible. The government is technically not supposed to threaten to charge a defendant with money laundering unless he or she agrees to plead to a lesser charge. Money laundering laws are so broad, however, that in nearly every white-collar fraud case, both the government and defense attorneys know the risk of such a charge, and that enters into the tactics and decision making on both the government and the defense sides.

E. Reliance on Professional Advice — A Defense or an Invitation to Blame?

Complicating the life of a corporate tax official is a longstanding defense to criminal tax charges, the "reliance on professional advice" defense. It is a well-accepted defense to criminal tax charges for an individual to claim that he or she relied on professional advice. To establish this defense, an individual must demonstrate: (1) full disclosure of all relevant facts to a professional adviser or return preparer, (2) the adviser'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.[32] The reliance defense can be relatively simple in the case of an individual who hires a CPA to prepare the tax return — there are two people involved, taxpayer and accountant, and the professional either knew or did not know of the relevant facts.

In a corporate tax department, this defense becomes far more complicated. There are numerous individuals involved in the preparation of a corporation's income tax returns, each with specific responsibilities, including those who compile information, review reporting positions, consult with outside lawyers or accountants, and draft returns. There might also be outside advisers, who may review the return or actually sign the return as a preparer. Whether the matter involves a tax reporting position or the approval of a specific transaction, both in-house and outside counsel might be involved as well.

In even the most collegial corporate environment, if a criminal investigation begins relating to the company's tax returns, it is likely that non-tax personnel who may be caught up in the inquiry will argue that the corporate tax department knew about the transaction(s) involved and signed off on the reporting.

For any taxpayer, the reliance defense is a potential ticket out of a criminal case. Thus, corporations, and even corporate executives under scrutiny, have an incentive to point to those involved in the preparation of a corporate tax return as their "professional advisers" in hopes of establishing the reliance defense. In even the most collegial corporate environment, if a criminal investigation begins relating to the company's tax returns, it is likely that non-tax personnel who may be caught up in the inquiry will argue that the corporate tax department knew about the transaction(s) involved and signed off on the reporting. Corporate tax directors should therefore maintain precise 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.

A corporation or an individual may not necessarily escape sanction, however, by disclosing all information to a professional adviser. Rather, the government might consider the conduct a conspiracy and charge everyone involved. This is demonstrated by a simple hypothetical, where an individual has a secret, undisclosed account in the Cayman Islands. He so informs his return preparer. The return preparer concurs with the taxpayer in deciding not to report the account on the tax return. Here, the taxpayer, in theory, might assert the reliance defense, arguing that he had disclosed the relevant facts to his preparer and relied on the preparer's advice. The government, however, will contend that the taxpayer could not have relied on that advice in good faith, since he knew that it was a crime to fail to disclose a foreign account. Accordingly, the government is likely to treat the transaction as a conspiracy between the taxpayer and the preparer, and indict both of them.

Similarly, in a corporate environment, if the government believes it can prove that both the individuals involved in the suspect transaction and someone in the tax department were aware of the manner in which the transaction might cause the filing of a false tax return, there is likely to be a conspiracy charge. In such a case, the people on the transactional side will not be able to rely on someone in the tax department whom the government believes was

in on the offense.

The reliance defense is complicated in a company when there are multiple transactions or professionals involved at various levels. Various lawyers, accountants, and financial personnel might have played a role from the point at which a transaction begins until it hits a tax return. The key point is that in order for the reliance defense to succeed, there must be full disclosure and "good faith" conduct and reliance on all sides. If there is any evidence that there was not full disclosure, or that the individuals involved had knowledge that the tax treatment was not quite right (again, keeping in mind the concept of willful blindness), the people on the transactional side will be unable to prevail with a "reliance on the tax department" defense. On the other hand, if the tax professional is at all aware of a problem with the transaction, he or she may not be able to foist all of the criminal culpability on those who engaged in it.

III. Corporate Compliance Programs – Sarbanes-Oxley and Selected Issues for the Tax Department

Every corporation and, indeed, every tax department should have a compliance policy in place. In the tax context, this policy should address all aspects of the maintenance of records, the preparation of tax returns and other forms, and responding to and handling IRS inquiries and audits. It should go without saying that having such a program will enhance the observance of and compliance with legal requirements across the board. Such a program is also essential because a key factor in prosecutorial discretion where corporations are involved, and in the federal sentencing guidelines, is the presence and implementation of such a plan, as well as the training of employees to observe it and the enforcement of its disciplinary provisions.

Aside from these good reasons for an effective compliance program, the Sarbanes -Oxley Act makes one essential. Many of the new requirements imposed by Sarbanes-Oxley affect corporate tax departments.[33] There are a number of such issues arising under the new law that have implications under criminal laws.

Financial Statement Certification: CEOs and CFOs must now certify quarterly and annual financial reports filed with the Securities and Exchange Commission. Specifically, these statements must be true, must include all material items, must "fairly present" the company's financial condition, and must make certain other representations about the entity's internal controls and the fact of any disclosure of improprieties to outside auditors. There are enhanced criminal penalties for violating this requirement.[34]

Tax Return Preparation: Obviously, most companies have rigorous processes in place for tax return preparation, but Sarbanes-Oxley expressed the "sense of the Senate" that a company's CEO should be required to sign the company's federal income tax return. If this provision becomes law, it will undoubtedly alter how a company goes about the preparation of a tax return, and the processes will likely resemble financial statement preparation more than they do now.

Obtaining the Approval of the Audit Committee to Engage the Outside Auditor to Perform Tax Services: Sarbanes-Oxley created a requirement that a company may engage its auditing firm to perform "tax services" only with approval from the Audit Committee of the Board of Directors. Thus, whenever company management seeks this approval, there will be representations made to the Audit Committee that must be true and complete, and companies will surely adopt procedures to ensure that this is the case.

Financial Statement Audits: Sarbanes-Oxley and the implementing regulations prohibit the making of false or incomplete statements to financial auditors. This rule extends to officers and directors of covered entities. In addition, officers, directors, and "any person acting" under their direction may not take any action to manipulate or mislead outside auditors if they knew or believe that doing so will result in a material false statement or omission.

Tax Audits or Other Federal Examinations: Sarbanes-Oxley contains an omnibus provision that contains enhanced criminal penalties for tampering with, fabricating, or concealing any record or data in order to impair or impeded any kind of federal examination or inquiry of a covered entity. This is analogous to the prohibitions of obstruction of justice and *Klein*-type conspiracies, but the statute provides for a maximum penalty of 20 years for this offense.

New Criminal Provisions: Sarbanes-Oxley creates new or enhanced criminal penalties for securities fraud, certain misconduct by auditors, certain types of conspiracies, and retaliation against informants. These and many other provisions of the law will lead (and have already lead) companies to adopt new processes, such as those to ensure that the CEO's and CFO's certification of financial statements is correct. These processes may affect company tax officials, such as by asking for their own personal certification of relevant items.

Because of the number of people that might be involved in tax department operation, and in the relationship between tax and financial reporting, these new requirements create a potential minefield of instances where one individual's error in judgment can impact many other people and the entity itself. Thus, it is essential that the company as a whole, and the tax group in particular, have a set of procedures in place to govern compliance issues, and that all personnel are required to understand and observe these procedures.

A compliance program should contain provisions to ensure observation of the new Sarbanes-Oxley requirements, and tax directors should consider their own internal programs to facilitate whatever role the tax department plays in the overall 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. There are, however, certain components that flow from Justice Department policies, various criminal provisions, or mandates under Sarbanes-Oxley that seem essential. Here is a list of processes and ideas that ought to be considered for implementation; there are

undoubtedly others that will come to mind of the tax executive as well:

- Thresholds for multiple internal review of certain types of transactions.
- Triggers for obtaining written opinions from outside advisers.
- Requirements for review, approval, and documentation of all communications from the tax department in connection with preparation of financial statements; perhaps a separate set of guidelines for dealing with the tax reserve.
- Internal processes for communications with outside auditors and documentation requirements.
- Special procedures, including special forms of review and approval and consultation with outside advisers, 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.
- Processes for maintaining the integrity of tax department data, workpapers, 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.
- Guidelines for the conduct of tax department personnel during a state or federal tax audit.
- 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.

This is by no means a complete list, but it should lead to further thinking by corporate tax management on the proper contours of a compliance program.

IV. Audits and Investigations

Notwithstanding the best compliance programs, audits and even criminal investigations begin. Tax executives are quite familiar with the general rules of handling IRS civil examinations. This portion of the article summarizes the topics and issues a corporate tax manager should consider at the commencement of any examination or criminal investigation. Missteps during such a governmental review may violate independent federal statutes, ease the government's ability to prove intent in a complex case, or result in professional sanctions.

A federal criminal tax investigation usually begins with the visit of one or more IRS Special Agents to the taxpayer. Thus, it is possible that a company might learn of a criminal tax investigation when Special Agents seek to visit the company's tax director. Sometimes, Special Agents initiate such visits in the evening and at the home of the individual involved. Obviously, when this happens, the company's in-house or outside counsel should be notified immediately. Non-tax investigations may begin in a similar manner.

Increasingly, the government commences many criminal investigations through the execution of a search warrant. If the office is the subject of search warrants, one should contact counsel immediately and do absolutely nothing to interfere with the conduct of the search.

Criminal investigations arise from various sources, including ongoing audits, informants, and publicity. If the IRS has decided to commence an investigation and Special Agents have appeared, the IRS already suspects fraud and has something more than a mere allegation of wrongdoing. Moreover, the Special Agents will work the case until they complete a Special Agent Report and refer the case for prosecution, or decide to conclude the criminal case without recommending charges.

A corporate employee who has been contacted in a criminal investigation of the company may also want to consider hiring his or her own personal counsel. The corporation may, and in these times likely will, have separate interests from any particular employee. Any disclosure made by an employee to in-house counsel, or to counsel hired to represent the corporation, is generally not covered by the employee's attorney-client privilege. Rather, it is protected, if at all, under the corporation's privilege. The corporation may decide to waive its privilege and turn over information provided by the employee in any such communication, which can later be used against that individual. As a practical matter, however, if corporate counsel wishes to interview an employee, and the employee refuses, the company is likely to discharge him or her.

An employee should consult with the company's counsel to determine whether the company may appropriately indemnify the employee and advance the legal fees associated with the individual representation. This is permissible under many state laws, but the government increasingly frowns on it. If the employee is later found to have engaged in misconduct, the employee may be required to reimburse the corporation for any amounts advanced.

When an investigation begins, the government usually wants to conduct interviews of relevant corporate staff. If an employee is caught off guard by a visit from federal law enforcement agents, the employee may politely decline to answer any questions until counsel is engaged. A premature interview with IRS Special Agents or other law enforcement authorities can be disastrous to both the individual involved and his or her employer. Moreover, it will rarely, if ever, succeed in terminating the investigation.

It should be obvious, but is worth emphasizing, that someone who learns he or she is under investigation should not destroy, backdate, or create evidence in order to support any defense he may believe that he has to potential charges. Indeed, in light of the *Arthur Andersen* case, it is important to note that the obligation to preserve the integrity of documents arises not merely with the service of a summons or subpoena, but only upon one's *reasonable belief that such process might be forthcoming*.[35]

Moreover, a person contacted by the government at the early stage of an investigation should not communicate with other individuals with knowledge of the transactions under investigation and attempt to persuade them to testify in a helpful manner or to refuse to testify or cooperate with the investigation. As with the manipulation, fabrication, or destruction of documents, such activity may constitute an independent federal crime, and makes it easier for the government to prove willfulness and intent concerning any underlying conduct.

Finally, during a criminal tax investigation, the taxpayer generally should never file delinquent or amended returns. The filing of such returns constitutes either a confession or, if they are not complete and truthful, a separate criminal offense.

V. Suspected Whistleblowers or Informants

Many criminal tax cases (and white-collar criminal cases in general) originate with tips and allegations from informants. If an investigation has begun, and management believes that it originated with a known, suspected, or unknown informant, management must take some steps and avoid others.

With regard to the ongoing investigation, company personnel should not discuss the case with one another, period, except for discussions with legal counsel. Where the identity of an informant is not known it could be anyone, and the safest course of action is for people simply not to talk about any aspect of the case. This advice is difficult to follow among employees who are friends and see each other many times each day, but it is essential.

The company may not act against the informant, if his or her identity becomes known. Such action might be deemed obstruction of justice. Moreover, Sarbanes-Oxley contains two criminal provisions relating to whistleblowers. The first is a specific anti-retaliation provision, making it a crime to take any action that harms an individual intending to retaliate against him or her for providing truthful information to federal law enforcement about potential federal crimes. Such action is specifically defined to include interfering with an individual's livelihood or employment status.[36]

The second provision makes it a crime to take any negative action whatsoever against an employee — firing, demoting, harassing, threatening, etc. — where the employee has lawfully provided information or assistance to (1) federal regulators, (2) federal law enforcement officials, (3) Congress, (4) supervisors, or (5) anyone else working for the employer to help prevent misconduct. This provision applies to information that discloses mail, wire, securities, bank, and other kinds of fraud. (This provision also creates a civil cause of action as well.) Finally, most states have laws that prohibit any retaliation against an employee who acts as a whistleblower or an informant.[37]

VI. Conclusion

Thankfully, few corporate tax directors have ever been through a criminal investigation, and one can hope that such an occurrence remains rare. In an era when the government is increasingly focusing on corporate crime, however, and the IRS is flexing its enforcement muscles, it behooves corporate tax executives and employees to consider implementing new or revising existing compliance programs and to understand the many ways in which what appears to be an innocuous event can cascade into multiple problems, including potential criminal inquiries. Given the breadth of the criminal statutes, the government's aggressiveness in enforcing, and the dramatic, if not catastrophic results that might occur under federal sentencing guidelines, a new sensitivity to the criminal arena is essential.

[1] U. S. Department of Justice, Memorandum from Deputy Attorney General (Jan. 20, 2003) (http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm).

[2] *Id.*

[3] *See* United States Sentencing Guidelines, §§ 8C2.5 (f) and 8A1.2, comment (n.3 (k)) (Nov. 2002).

[4] *See, e.g.*, Internal Revenue Manual, Tax Crimes, 9.5.3.3.1.2.1.

[5] 18 U.S.C. § 371.

[6] *United States v. Klein*, 247 F.2d 908 (2d Cir. 1957).

[7] *Id.* at 915.

[8] *Hammerschmidt v. United States*, 265 U.S. 182 (1924).

[9] The Ninth Circuit requires proof of an extra element for a *Klein* conspiracy, *i.e.,* that the agreement was to defraud the United States by "deceitful or dishonest means." In other words, without "deceit, craft, or trickery," or by other dishonest means, obstruction of governmental functions by itself does not about to defrauding. *United States v. Caldwell*, 989 F.2d 1056 (9th Cir. 1993).

[10] *United States v. Aracri*, 968 F.2d 1512 (2d Cir. 1992).

[11] *United States v. Bilzerian*, 926 F.2d 1285 (2d Cir.), *cert. denied*, 112 S. Ct. 63 (1991).

[12] *United States v. Olgin*, 745 F.2d 263 (3d Cir. 1984), *cert. denied*, 471 U.S. 1099 (1985).

[13] *United States v. Hirschfeld*, 964 F.2d 318 (4th Cir. 1992), *cert. denied*, 113 S. Ct. 1067 (1993).

[14] *United States v. Bourgeois*, 950 F.2d 980 (5th Cir. 1992).

[15] *United States v. Chesson*, 933 F.2d 298 (5th Cir.), *cert. denied*, 112 S. Ct. 583 (1991).

[16] *United States v. Sturman*, 951 F.2d 1466 (6th Cir. 1991), *cert. denied*, 112 S. Ct. 2964 (1992).

[17] *United States v. Price*, 995 F.2d 729 (7th Cir. 1993).

[18] *United States v. Kapnison*, 743 F.2d 1450 (10th Cir.), *cert. denied*, 471 U.S. 1015 (1985).

[19] *United States v. Carrodeguas*, 747 F.2d 1390 (11th Cir. 1984), *cert. denied*, 474 U.S. 816 (1985).

[20] *United States v. Dale*, 991 F.2d 819 (D.C. Cir.), *cert. denied*, 114 S. Ct. 286 (1993).

[21] I.R.C. § 7206(2).

[22] *United States v. Crum,* 529 F.2d 1380, 1382 (9th Cir. 1976).

[23] *United States v. Maius*, 378 F.2d 716 (6th Cir.), *cert. denied*, 389 U.S. 905 (1967).

[24] *United States v. Dunn*, 961 F.2d 648, 651 (7th Cir. 1992); *United States v. Motley*, 940 F.2d 1079, 1084 (7th Cir. 1991); *United States v. Nealy*, 729 F.2d 961, 963 (4th Cir. 1984).

[25] 18 U.S.C. § 2.

[26] *United States v. Jaramillo*, 42 F.3d 920 (5th Cir.), *cert. denied*, 514 U.S. 1134 (1995); *United States v. Martiarena*, 955 F.2d 363 (5th Cir. 1992); *United States v. Rodriguez Cortes*, 949 F.2d 532 (1st Cir. 1991). Aiding and abetting is not a separate criminal offense, but rather is a vehicle that allows the government to charge an aider and abettor as a principal in the commission of the offense. Thus, the defendant must also be charged with a substantive offense with respect to which the defendant was an aider or abettor.

[27] *United States v. Pomponio*, 429 U.S. 10 (1976).

[28] *Spies v. United States*, 317 U.S. 492, 499 (1943).

[29] *United States v. Picciandra*, 788 F.2d 39 (1st Cir.), *cert. denied*, 479 U.S. 847 (1986) (tax evasion conviction upheld based on proof of conscious avoidance); *United States v. Ramsey,* 785 F.2d 184 (7th Cir.), *cert. denied*, 476 U.S. 1186 (1986) (actual knowledge and deliberate avoidance of knowledge both demonstrate willfulness in mail and wire fraud case); *United States v. MacKenzie*, 777 F.2d 811 (2d Cir.), *cert. denied*, 476 U.S. 1169 (1986) (deliberate ignorance could satisfy the knowledge requirement in a conviction for various counts of conspiracy, false filing of tax returns, and aiding and abetting false filling); *United States v. Callahan*, 588 F.2d 1078 (5th Cir. 1979) (where the tax avoidance scheme was obvious, the defendant could not avoid criminal liability for tax evasion merely by deliberately closing his eyes to the scheme).

[30] Courts have approved the use of a jury instruction allowing a finding of willfulness based on deliberate ignorance under proper circumstances. The DOJ Criminal Tax Manual advises prosecutors, however, not to request such an instruction unless it is clearly warranted by the evidence in a particular case. Crim. Tax. Man. at ¶ 8.06[4].

[31] *See, e.g.,* U. S. Sentencing Guidelines § 8C2.5(b)(1)(A)(i).

[32] *See United States v. Bishop*, 291 F.3d 1100 (9th Cir. 2002) (defense of good faith reliance on the advice of a tax professional requires full disclosure of all relevant information to that professional); and *United States v. Becker*, 965 F.2d 383 (7th Cir. 1992), *cert. denied*, 113 S. Ct. 1411 (1993) (reliance defense unavailable where there was no evidence that defendant made full disclosure to his attorney, attorney gave defendant specific advice based on that disclosure, and defendant followed such advice).

[33] Public Law 107-204, at 116 STAT. 745.

[34] 18 U.S.C. § 1530.

[35] United States v. Ruggiero, 934 F.2d 440 (2d Cir. 1991) (defendant who destroys documents in anticipation of grand jury subpoena can be convicted of obstruction of justice); United States v. Frankhauser, 80 F.3d 641 (1st Cir. 1996) (criminal destruction of documents can occur even if defendant does not actually know that an official proceeding has been commenced).

[36] 18 U.S.C. § 1513(e).

[37] See, e.g., NY Labor § 740; NY Civ. Serv. § 75-b; Calif. Senate Bill 777 (passed Sept. 4, 2003).