

VALUATION OBSERVATIONS

*Some practical observations from a practicing
business appraiser.*

VLLC

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TAX FRAUD

Is it civil fraud? Or is it criminal? The two are said to differ (other than potential jail time) only as to the degree of proof required to support a guilty verdict – beyond a reasonable doubt for crimes, and clear and convincing proof for civil fraud. The decision to undertake a criminal investigation, a civil fraud proceeding, or no action at all, is made by the IRS Criminal Investigation Division (CID) after a Revenue Agent discovers a “firm indication of fraud” during an audit. Agents of CID are law enforcement officials called “Special Agents,” not unlike FBI agents. Beware, whenever an IRS Special Agent appears in a tax investigation, it means that the IRS is viewing the case as potentially criminal.

In addition to traditional IRS audits, how can criminal tax investigations come about? The Treasury Department receives many thousands of tips each year involving allegations of tax fraud. Informers’ motives are as broad-ranging as human nature. Whether it comes from a profiteer (seeking a reward), a jealous neighbor, a scorned lover, an estranged spouse, an underpaid bookkeeper, a concerned citizen, a beaten competitor, or a co-conspirator that found religion, they can and have blossomed into successful tax fraud cases. The field of criminal tax leads is wide. A taxpayer’s known racketeering or gangster activities can lead to a tax prosecution. Do you remember Al Capone’s conviction for tax evasion?

Tax fraud is governed by Internal Revenue Code sections 7201 through 7207. Attempt to evade or defeat tax, and willful filing of false returns are classified as a felony. Willful failure to file a return is a misdemeanor. Additionally, any person who willfully delivers to the IRS any document known by him to be fraudulent or to be false as to any material matter shall be subject to a misdemeanor. “Willfulness” is a key element, meaning more than a careless disregard for the truth. Questions of knowledge and intent are also characteristics to be considered.

Fraud requires a clear and convincing showing that the taxpayer intended to evade a tax known or believed to be owed by conduct intended to conceal, mislead, or otherwise prevent the collection of tax. This intent may be proven by circumstantial evidence because direct proof of a taxpayer’s intent is rarely available. Reasonable inferences may be drawn from the relevant facts. Courts have relied on certain indicia of fraud in deciding whether a taxpayer had the requisite fraudulent intent. These indications include: (1) understating income, (2) maintaining inadequate records, (3) failing to file tax returns, (4) giving implausible or inconsistent explanations of behavior, (5) concealing assets, (6) failing to cooperate with tax authorities, (7) engaging in illegal activities, (8) attempting to conceal illegal activities, and (9) dealing in cash. The taxpayer’s education and business background are also relevant to the determination of fraud. The presence of several indications is persuasive circumstantial evidence of fraudulent intent.

Major tax crimes carry substantial penalties, but before the enactment of the U.S. sentencing guidelines many individuals who were convicted of a tax crime and who were not involved in other illegal activity received fines and/or probationary sentences without any period of incarceration. The actual sentence imposed upon the tax defendant was discretionary with the trial court. In the Comprehensive Crime Control Act of 1984, Congress established the U.S. Sentencing Commission, which promulgated the U.S. sentencing guidelines in the Sentencing Reform Act of 1984. The Commission was of the view that tax defendants had been sentenced too leniently. Does that give you an indication of where this is going?

Under pre-guidelines practice, roughly half of all tax evaders were sentenced to probation without imprisonment, while the other half received sentences that required them to serve an average prison term of twelve months. The guidelines are intended to reduce disparity in sentencing for tax evasion and to somewhat increase average sentence length. One effect of the sentencing guidelines is that for most convictions, a period of incarceration will be required.

The application of the sentencing guidelines to a tax crime is both mechanical and analytical. The end result of the process is the determination of a “guideline range” reflecting a minimum and maximum number of months to which the defendant may be sentenced. The mechanical part is to determine the base offense level by calculating the “tax loss”. But the tax loss is not what you may think. It is calculated as a percentage of (1) the unreported gross revenue or (2) the amount of improperly claimed deductions. This percentage calculation is used unless a more accurate determination of tax loss can be made.

If the offense involves both individual and corporate tax returns, the tax loss is the aggregate tax loss from the offense taken together. For example, Harvey was convicted of selling his corporation’s scrap metal and keeping the proceeds for himself. Neither he nor the corporation reported the proceeds. The individual and the corporate tax losses were combined to determine the base level of the offense. Additionally, if Harvey resides in a state that also has an income tax, he will potentially be faced with an increased tax loss and more severe sentence under the Guidelines. The base level provides the minimum length of incarceration.

The analytical part of the process considers whether special circumstances may justify a departure from the guidelines. And a departure could go either way – up or down. An upward departure is referred to as an “enhancement”, and could be because the unreported income, for example, was obtained by way of a criminal activity. The most common specific offense characteristic enhancement is if “sophisticated means” are involved. Sophisticated means includes conduct that is more complex or demonstrates greater intricacy or planning than a routine tax evasion case – a more elaborate or carefully planned scheme that takes the case beyond garden variety tax fraud. A defendant’s “special skill” may also be cause for enhancement. Attorneys and accountants are especially susceptible to this one. These are just a few examples of upward adjustments.

There are also a few characteristics that may warrant a downward adjustment. You might be surprised to find that age is not ordinarily relevant in determining a sentence. Although health conditions may be considered, older tax defendants will find little relief for their senior status. The court has been known to consider family circumstances. For example, a downward adjustment was granted to a defendant who was the sole support for three young children. And if a tax crime is unusually unsophisticated, like paying a bribe with a personal check), a downward departure may apply.

So what does all this mean? Let’s say that Danny takes a deduction on his tax return for a worthless loan (bad debt) in the amount of \$200,000 in 2004 and \$215,000 in 2005. However, this was not really a loan, but was monies invested in his company for capital improvements. CID investigates, and convicts. Calculating the tax loss for the two years, and including the state tax loss because he lives in Ohio,

provides for a total tax loss of \$137,000. This would put him at a base offense level of 16. Provided there are no upward or downward adjustments to the base level, Danny would be subject to an incarceration term of somewhere between 21 and 27 months.

Mandatory terms of imprisonment can be as high as 5 years. Additionally, fines of up to \$100,000 can be assessed. This is in addition to the actual tax owed and traditional interest and penalties.

If you would like additional information, or have a question, please do not hesitate to call.

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.