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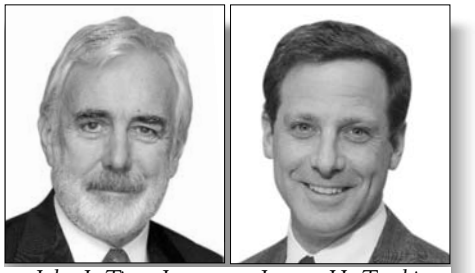
The United States' Role in Foreign Tax Evasion Cases

The globalization of the economy extends to criminal activity, which is becoming more complex and international in scope.

One result of this phenomenon is increased cooperation between the United States and foreign governments in gathering evidence and sharing information. This is especially true with respect to tax crimes, where offenders are more likely to cross borders in order to secrete assets or evade taxes. As a result, evidence needed to investigate and prosecute tax offenses may be located outside the country whose taxes are being evaded.

Recent cases from the Supreme Court and the U.S. Court of Appeals for the Second Circuit have examined the limits on a foreign government's ability to enforce its tax laws in U.S. courts. Although the common-law revenue rule precludes foreign governments from bringing civil suits to collect unpaid taxes, by virtue of treaties and information exchange agreements, many countries have access to information located within the American borders relevant to tax prosecutions. This includes evidence in the possession of the U.S. government, as well as that held by third-parties such as banks.



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Limits of the Common-Law Revenue Rule

Dating back to the 18th century, the common-law revenue rule provides that U.S. courts ordinarily will not enforce the tax judgments of a foreign country. The Second Circuit had occasion to address the scope of the common-law revenue rule in *European Community v. RJR Nabisco, Inc. ("European Community I")*. In *European Community I*, various members of the European Community and several departments of the government of Colombia sued various tobacco companies under the Racketeer Influenced and Corrupt Organizations Act (RICO statute) claiming lost tax revenues and law enforcement costs resulting from a conspiracy to smuggle cigarettes into plaintiffs' territories.[1]

During the pendency of *European Community I*, the Second Circuit affirmed the dismissal of *Attorney General of Canada v. R.J. Reynolds Tobacco Holdings ("Canada")*, holding that the revenue rule barred Canada from using the RICO statute to recover lost tax revenue in the United States.[2] The plaintiffs in *European Community I* sought to distinguish their case on the grounds that, after the Second Circuit's decision in *Canada*, Congress had enacted the USA PATRIOT Act, which they argued indicated an intention to allow foreign governments to bring lawsuits under the RICO statute. The Second Circuit rejected this argument, holding that the legislative history cited by plaintiffs was not controlling and that nothing in the language of the PATRIOT Act itself evidenced congressional intent to expand the scope of the RICO statute to abrogate the revenue rule.[3] Plaintiffs appealed and the Supreme Court granted certiorari.

'Pasquantino'

Before resolving the question presented in *European Community I*, the Supreme Court decided *Pasquantino v. United States*, another case involving the common-law revenue rule. In *Pasquantino*, the Court addressed a split among circuit courts of appeals as to whether the revenue rule barred a criminal prosecution under U.S. law for conduct amounting to the fraudulent evasion of foreign taxes. The Court answered this question in the negative, holding that, notwithstanding the revenue rule, a scheme to defraud a foreign government of tax revenue could be prosecuted under the federal wire fraud statute.[4]

In *Pasquantino*, the defendants had

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smuggled liquor purchased in Maryland into Canada, thereby avoiding Canadian taxes on the importation of alcoholic beverages, which were approximately double the purchase price of the alcohol. Upholding the defendants' convictions under the federal wire fraud statute, the Court rejected the argument that the prosecution violated the common-law revenue rule, concluding that no common-law revenue rule case decided as of 1952 (the year the wire fraud statute was enacted) had held or implied that the revenue rule barred the government from prosecuting a case involving a fraudulent scheme to evade foreign taxes.[5]

Furthermore, the Court noted that the revenue rule was created primarily to guard against actions seeking to collect the tax obligations owed to foreign nations. The Court rejected the argument that the revenue rule was implicated by the fact that the Canadian government was the beneficiary of the restitution aspect of the defendants' sentences. Rather, the Court found that "the wire fraud statute advances the Federal Government's independent interest in punishing fraudulent domestic criminal conduct…. The purpose of awarding restitution in this action is not to collect a foreign tax, but to mete out appropriate criminal punishment for the conduct."[6] Finally, the Court said that the prosecution at issue did not promote actions to collect foreign tax obligations, stating that "this prosecution poses little risk of causing the principal evil against which the revenue rule was traditionally thought to guard: judicial evaluation of the policy-laden enactments of other sovereigns."[7]

'European Community I' Remanded

A week after deciding *Pasquantino*, the Supreme Court remanded *European Community I* to the Second Circuit for reconsideration in light of its decision in *Pasquantino*. On remand, the Second Circuit observed that the rule barring courts of one nation from enforcing final tax judgments or unadjudicated tax claims of other nations was a doctrine designed to address two concerns: "first, that policy complications and embarrassment may follow when one nation's courts analyze the validity of another nation's tax laws; and second, that the executive branch, not the judicial branch, should decide when our nation will aid others in enforcing their tax laws."[8] Accordingly, in examining whether an action violates the common-law revenue rule, a court must examine the twin issues of sovereignty and separation of powers.

The Second Circuit noted the Supreme Court's careful consideration of these issues in *Pasquantino*. With regard to both issues,

Where no formal treaty exists, a foreign government may seek information via a tax information exchange agreement.

the fact that *Pasquantino* involved an action by the U.S. government enforcing its own domestic criminal law was significant. Sovereignty was not an issue where "[t]he fact of prosecution implie[d] an assessment of risk by the executive branch" and the conclusion that such prosecution posed "little danger of causing international friction." Furthermore, there were no concerns about separation of powers where a criminal case is brought by the Executive Branch itself.[9] The Second Circuit observed that these factors did not exist in the *European Community* case though. Rather, it was a civil suit brought by foreign governments to which the executive branch of the United States government had neither intervened nor signaled its consent.[10]

Noting that the U.S. government had argued in both *Pasquantino* and *Canada* that the revenue rule does not apply to criminal prosecutions, but continues to bar civil cases brought by foreign governments involving any direct or indirect attempt to enforce their tax laws, the Second Circuit found that the Supreme Court's holding in *Pasquantino* did not disturb its prior conclusion that civil RICO actions brought by foreign governments were barred by the revenue rule.[11] The plaintiffs in *European Community II* again sought to take the case before the Supreme Court, however, certiorari was denied in January 2006.[12]

Access to Evidence

• ***Foreign Governments' Access to Evidence Located Within the United States.*** Although the Second Circuit's decision in *European Community II* makes clear that foreign governments cannot enforce their tax laws through civil actions in United States courts, this does not mean that foreign tax cheats may act with impunity when their conduct occurs in whole or in part in this country. Not only are foreign tax cheats subject to criminal prosecution of the sort sanctioned in *Pasquantino*, but the United States government has entered into a number of treaties and agreements that allow foreign governments to obtain information from within the United States in order to prosecute tax offenses in their own countries.

Mutual Assistance Treaties

Such conventions or agreements exist in the form of Mutual Legal Assistance Treaties (MLATs) and tax information exchange and currency transaction information exchange agreements. These agreements create contractual obligations between the signatory countries to assist each other in criminal matters. Each agreement is unique in how it addresses the exchange of information in tax cases, and several are more restrictive in relation to tax investigations than other criminal matters.[13]

MLATs are negotiated and concluded by the U.S. Department of Justice in conjunction with the U.S. Department of

State and provide for a wealth of assistance from the cooperating country including, but not limited to, obtaining documents or testimony, service of relevant summons or documents, immobilizing assets, and assisting in forfeiture or restitution proceedings.[14] When the United States receives a request from a foreign country with which it has a treaty, the request is forwarded to a centralized authority within the Internal Revenue Service (IRS) which reviews the request and authorizes the production of information. If the information sought is within the control of the United States government, it may be produced without the taxpayer's knowledge. Where the information is in the possession of a third party, such as a bank, the IRS can issue a summons to collect the information. When it does, however, the taxpayer will be notified of the summons and, therefore, afforded an opportunity to intervene and raise any applicable defenses.[15]

Where no formal treaty exists between two countries, a foreign government may seek information pursuant to a tax information exchange agreement (TIEAs). TIEAs are negotiated by the U.S. Department of Treasury in conjunction with the IRS and the Justice Department's Tax Division and specifically provide for mutual assistance in criminal and civil tax investigations and proceedings.[16] In addition, the United States has entered into Simultaneous Criminal Investigation Programs (SCIPs) with Canada, Italy, France and Mexico, which seek to eliminate problems caused by taxpayers using the border to avoid production of records and reporting of income and allows the participants to cooperate in the simultaneous investigation of individuals or companies involved in "substantial tax violations in both countries."[17] Because such agreements are reciprocal, they provide the United States government with the ability to seek information from foreign countries when investigating American tax offenses.[18]

Section 6103(k)(4) of the Internal Revenue Code provides that "a return or return information may be disclosed to a competent authori-ty of a foreign government which has an income tax or gift and estate tax convention, or other convention or bilateral agreement relating to the exchange of tax information, with the United States but only to the extent provided in, and subject to the terms and conditions of, such convention or bilateral agreement." Furthermore, §25.5.8.3 of the Internal Revenue Manual states that "[a] summons may be issued to obtain information from individuals and entities within the United States, relating to the foreign tax liability of a foreign citizen, in response to a formal request made through the Director, [and] [c]ompliance by the foreign competent authority under income tax treaties, estate and gift tax treaties, or tax information exchange agreements."

The IRS's issuance of summons at the request of foreign authorities repeatedly has been upheld by courts. In *United States v. Stuart,* the Supreme Court upheld a summons served by the IRS in response to a request from Canadian authorities pursuant to a treaty between the United States and Canada. The Court concluded that as long as the IRS acts in good faith and in compliance with applicable statutes regarding service, it is entitled to enforcement of the summons. To prove good faith in issuing the summons, the government must make a prima facie showing "'that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed….'"[19] Finally, the Court found that restrictions placed on the IRS in issuing summonses once an investigation has been referred to the Justice Department are inapplicable where a summons is issued to aid a foreign prosecution since the provision of information to foreign authorities does not affect the rights of potential criminal defendants in this country.[20]

If Signatory to an MLAT

Thus, although a foreign country cannot seek to recover unpaid taxes through a civil suit brought in the United States, if they are a signatory to an MLAT or similar information exchange agreement with the United States, they reasonably can expect the American government's cooperation in obtaining evidence of foreign tax evasion that is located in the United States. This includes the production of tax return information held by the United States government, as well as the summons of information held by third parties.

1. *European Community v. RJR Nabisco, Inc.,* 355 F.3d 123, 127-129 (2d Cir. 2004).
2. *Attorney General of Canada v. R.J. Reynolds Tobacco Holdings,* 268 F.3d 103 (2d Cir. 2001).
3. 355 F.3d at 133-136.
4. 125 S. Ct. 1766, 1770 (2005); see John J. Tigue and Jeremy H. Temkin, "The Supreme Court and Taxes: The 2004-2005 Term," NYLJ, July 21, 2005 (discussing the *Pasquantino* decision).
5. Id. at 1773-74.
6. Id. at 1777.
7. Id. at 1775, 1779.
8. *Europe Community v. RJR Nabisco, Inc.,* 424 F.3d 175, 179-180 (2d Cir. 2005) (*"European Community II")* (quoting *Attorney Gen. of Canada v. R.J. Reynolds Tobacco Holdings, Inc.,* 268 F.3d 103 (2d Cir. 2001), cert. denied, 537 U.S. 1000 (2002)).
9. 125 S.Ct. at 1779-80.
10. 424 F.3d at 181.
11. Id. at 181, fn. 8, 182.
12. 126 S.Ct. 1045 (Jan. 2006).
13. Criminal Tax Manual §41.02, United States Department of Justice Tax Division (1994).
14. Id. at §41.02[7].
15. 26 U.S.C.A. §6103(e)(7); Bruce Zagaris, "Extradition, Evidence Gathering, and Their Relatives in the Twenty-First Century: A U.S. Defense Counsel Perspective" 23 Fordham Int'l L.J. 1403 (June 2000).
16. Criminal Tax Manual at §41.04.
17. Internal Revenue Manual §§9.13.2.4 and 9.13.2.4.1 (available at http://www.irs.gov/irm/part9/ch13s02.html).
18. See id. at §9.13.2, "Treaties, Mutual Assistance Laws, Simultaneous Investigation Programs, and Agreements".
19. *United States v. Stuart,* 489 U.S. 353, 359 (1989) (quoting *United States v. Powell,* 379 U.S. 48, 57-58 (1964)).
20. Id. at 365-66; see also *Fernandez-Marinelli v. United States,* 1995 WL 704965 (S.D.N.Y. 1995) (upholding IRS summons served on behalf of Mexican tax authorities).