The Metropolitan Corporate Counsel®

www.metrocorpcounsel.com

Volume 13, No. 9 © 2005 The Metropolitan Corporate Counsel, Inc. September 2005

TAX INSIGHTS from ROBERTS & HOLLAND LLP

Is Evading Foreign Taxes A U.S. Crime?

By Abraham Leitner

Most tax practitioners are fully cognizant of their duty to ensure that their U.S. tax planning activities don't cross the line from permissible tax minimization into the unethical and sometimes illegal territory of tax evasion. However, when tax practitioners acting on behalf of multinational corporations engage in multi-jurisdictional tax planning seeking to reduce tax liabilities to foreign countries, the question of where to draw that line may sometimes not get the thought it deserves. A recent decision of the Supreme Court should alert professionals to the fact that they may face penalties in the United States, including possible criminal prosecution, for conduct that might be characterized as evasion of foreign taxes.

Under the "common-law revenue rule," which dates back to a decision by Lord Mansfield in the English courts in 1775, courts will ordinarily not enforce tax judgments of a foreign country, and it has long been established that U.S. courts will not enforce the tax laws of a foreign country. However, in *Pasquantino v. U.S.*[1] the U.S. Supreme Court decided that the principle embodied in the revenue rule would not protect taxpayers whose activities in the United States resulted in the fraudulent evasion of foreign taxes.

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The *Pasquantino* Case

Carl and David Pasquantino were convicted of wire fraud for carrying out a scheme to evade Canadian excise taxes. The federal wire fraud and mail fraud statutes, using substantially identical language, prohibit the use of interstate wires or the mail to effect "any scheme or artifice to defraud, or for obtaining property by means of false or fraudulent pretenses, representations, or promises." The trial court found that the Pasquantinos, while in New York, ordered liquor over the telephone from discount package stores in Maryland. They employed several individuals to drive the liquor over the Canadian border without paying the required Canadian excise taxes. The drivers avoided those taxes by hiding the liquor in their vehicles and failing to declare the goods to Canadian Customs officials. In the district court, and on appeal to the Fourth Circuit Court of Appeals, the Pasquantinos argued first, that their prosecution contravened the common-law revenue rule because it required the court to recognize the revenue laws of Canada. Second, the defendants argued that the right of the Canadian government to collect excise tax did not constitute a property right within the meaning of the wire fraud statute. The Fourth Circuit initially agreed with the defendants' revenue rule argument and rendered a decision in their favor, but on rehearing the case *en banc,* the court retracted its prior decision and affirmed the defendants' convictions.

The Common-Law Revenue Rule

Under the common-law revenue rule, courts will ordinarily not enforce tax judgments of a foreign country. In some cases, courts have also applied the revenue rule more broadly to bar indirect enforcement of foreign tax laws. For example, one Irish case held that a private liquidator of a corporation could not recover assets that were unlawfully distributed and moved to Ireland by a director of the corporation because any assets recovered would be used by the liquidator to satisfy the corporation's Scottish tax obligations.[2] A reasonable argument could be made that, as a corollary to this established rule prohibiting enforcement of a foreign government's tax law, U.S. courts should not be able to convict an individual of a federal crime such as wire fraud where the act involved is the evasion of a foreign tax. However, the extent to which the revenue rule would prevent a prosecution of fraudulent tax evasion of a foreign tax under a domestic criminal statute has historically not been clear.

Prior to *Pasquantino*, several federal cases had addressed the issue of when acts that occur in the United States as part of a plan to defraud a foreign government of tax revenue may constitute a crime under U.S. law. The first case to directly address this issue was *Boots*,[3] in which the First Circuit Court of Appeals held that the common law revenue rule barred prosecution under the federal wire fraud statute of a defendant accused of evading Canadian tobacco excise taxes, on the theory that such a prosecution would be tantamount to allowing the government of Canada to enforce its tax laws in the

courts of the United States. Later, in *Trapilo,*[4] the Northern District of New York followed *Boots* in holding that the common law revenue rule barred the government from treating the proceeds of a Canadian tobacco smuggling scheme as proceeds of a "specified unlawful activity" (*viz.,* wire fraud) for purposes of the federal money laundering statute. On appeal by the government, the Second Circuit Court of Appeals[5] reversed the lower court decision, holding that the revenue rule should not be interpreted so broadly as to prevent the prosecution of an act constituting a crime under U.S. domestic law.

Supreme Court Decision

The U.S. Supreme Court granted *certiorari* in *Pasquantino* to resolve the conflict between the Courts of Appeals and rendered its decision on April 26, 2005. The court concluded first, that Canada's right to excise taxes constituted a "property" interest that can serve as the object of a fraud within the meaning of the wire fraud statute. Second, following an analysis of the history of the common-law revenue rule, the court held that the rule does not bar the United States from prosecuting a fraudulent scheme to evade foreign taxes as a wire fraud. In the view of the court, the common-law revenue rule prohibits the U.S. government from enforcing foreign penal law, but it does not prevent the government from enforcing domestic criminal law. The court stated: "Petitioners' offense was complete the moment they executed their scheme intending to defraud Canada of tax revenue inside the United States....Therefore only domestic conduct is at issue here." Thus, the court upheld the conviction of the individuals for criminal activities carried on in the United States.

Although the defendants in *Pasquantino* were convicted of defrauding Canada of an excise tax, nothing in the court's rationale would limit the court's holding to such taxes. It seems clear that a scheme to defraud a foreign government of its right to collect income taxes could also be prosecuted under the U.S. federal wire fraud or mail fraud statutes. Thus, use of the telephone or mails in the United States in pursuit of a scheme to evade foreign taxes by means of filing a tax return that omits an item of income or falsely claims a deduction might constitute criminal wire or mail fraud in the United States. Even in the absence of a false return, it is possible to imagine that a prosecutor in the United States might assert that active concealment of income or assets in order to avoid foreign tax, for example by formation of a tax haven entity, suffices to constitute fraud.

Money Laundering

The Supreme Court's decision in *Pasquantino* also expanded the range of acts that may constitute criminal money laundering. The federal money laundering statute makes it a felony for anyone who:

> . . . knowing that the property involved in a financial transaction represents the proceeds of some form of unlawful activity, conducts or attempts to conduct such a financial transaction which in fact involves the proceeds of specified unlawful activity . . . (B) knowing that the transaction 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; or (ii) to avoid a transaction reporting requirement under State or Federal law. 18 USCA §1956(a)(1).

The term "specified unlawful activity" includes wire fraud and mail fraud.[6] Thus, if an individual assists a person in a financial transaction intended to disguise the nature, source, ownership, or control of amounts that should have been paid over to a foreign government to satisfy a tax liability, and the avoidance of the tax involved constitutes wire fraud or mail fraud, then the individual may be guilty of federal money laundering (a crime punishable with up to 20 years imprisonment).

Mandatory Victims Restitution Act

The Mandatory Victims Restitution Act, a federal law enacted in 1996 (the "Act"), provides that if any person is convicted of wire fraud or mail fraud (among other crimes) the court is required to order the defendant to provide full restitution to the victim of the fraud.[7] Would the Act entitle a foreign government to collect a tax it is owed by a convicted defendant? The court in *Pasquantino* did not decide this issue, reasoning that even if restitution under the Act were contrary to the common-law revenue rule, that would not prevent the defendants' wire fraud convictions – rather the remedy would be for the court not to order restitution. However, the court did hint that the revenue rule might not prevent mandatory restitution under the Act, since the purpose of awarding restitution is merely to mete out appropriate punishment for criminal conduct. If courts ultimately adopt that view, it would give foreign governments a significant incentive to seek to cause tax evaders to be prosecuted for criminal fraud in the U.S. federal court system. To date, foreign governments have tried unsuccessfully to collect taxes under the RICO civil treble damages provisions.[8]

Broad Implications

The *Pasquantino* decision could have very serious implications for U.S. multinationals, as well as for their tax advisors. Under the court's holding, conduct that facilitated evasion of a foreign tax was considered to constitute a crime. Although *Pasquantino* was a prosecution of a taxpayer, or "principal," a lawyer or other tax professional who advises a taxpayer in connection with an improper multi-jurisdictional transaction might be considered as aiding and abetting conduct deemed to be fraudulent, and could thus be subject to criminal prosecution as well. In addition, situations that involve structuring transactions in which funds on which foreign taxes have been evaded are used may risk running afoul of the federal money laundering statute. Because of the breadth of the implications of this case, U.S. multinationals and their advisors should ensure that they apply the same standards of conduct on foreign tax matters as they do on U.S. tax matters.

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[1] Pasquantino v. U.S., *2005 LEXIS 3701.*

[2] Peter Buchanan Ltd. v. McVey, *1955 A.C. 516, 529-530 (Ir. H. Ct.1950), app. dism'd, 1955 A. C. 530 (Ir. Sup. Ct. 1951).*

[3] U.S. v. Boots, *80 F.3d 580 (1st Cir. 1996).*

[4] U.S. v. Trapilo, *1996 U.S. Dist. LEXIS 19237.*

[5] *130 F.3d 547 (1997).*

[6] See *18 USCA §1956(b)(7)(A) & §1961(1)(B).*

[7] *18 USCA §3663A.*

[8] Attorney General of Canada v. R.J. Reynolds Tobacco Holdings Inc., *268 F. 3rd 103 (2nd Cir.* 2001); Republic of Honduras v. Philip Morris Cos., *341 F.3rd 1253 (11th Cir. 2003);* European Community v. RJR Nabisco, Inc., *355 F.3d 123 (2d Cir. 2004). The Supreme Court recently vacated the decision of the Second Circuit Court of Appeals in* European Community *and ordered the Circuit Court to reconsider its decision in light of the Supreme Court's holding in* Pasquantino.