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CA-2's Narrow View of *Pasquantino* Does Not Affect Enlarged Scope of Federal Fraud and Money Laundering

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While the common law revenue rule has been held to bar the use by a foreign government of U.S. law and courts to collect treble damages under the civil provisions of RICO for evasion of a foreign tax, the Supreme Court's interpretation of the revenue rule as not barring a federal criminal prosecution may have severe implications for practitioners whose clients have evaded a foreign tax.

The Supreme Court decision in *Pasquantino,* 96 AFTR 2d 2005-5392, 161 L Ed 2d 619 (2005), which was handed down by the Court earlier this year, raised some speculation among practitioners and commentators that we might be entering a new era in which foreign governments will effectively be able to use U.S. courts to pursue tax evasion claims against U.S. nationals. In a sign that such concerns are probably overblown, the Second Circuit recently decided, in *European Community v. RJR Nabisco, Inc.,* 424 F3d 175 (2005), ("*European Community II*"), that foreign governments are barred from using the treble damages provisions of the Racketeer Influenced and Corrupt Organizations Act (RICO) [1] to seek damages for lost tax revenue from cigarette smuggling activities. The court held that its prior decision in this case (355 F3d 123 (CA-2, 2004); "*European Community I*") was not affected by the Supreme Court's decision in *Pasquantino.*

THE COMMON LAW REVENUE RULE

Under the common law revenue rule, which dates back more than 250 years to an English case decided by Lord Mansfield, [2] it is well established that courts ordinarily will not enforce tax judgments of a foreign country. In some cases, courts also have 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. [3]

European Community I

The *European Community* cases involved three suits filed in 2000 and 2001 by various members of the European Community and several departments of the Government of Colombia against RJR Nabisco Co. [4] The suits all sought treble damages under the civil damages provision of RICO for lost tax revenue and reimbursement of the plaintiffs' costs of enforcing their tax laws to prevent smuggling activities. [5] All three suits alleged that the defendants conspired to participate in smuggling activities involving the importation of tobacco and the avoidance of tobacco excise taxes. Because the suits were virtually identical they were consolidated in the Eastern District of New York.

While the case was pending in the Eastern District, the Second Circuit decided *Attorney General of Canada v. R.J. Reynolds Tobacco Holdings,* 268 F3d 103 (2001) ("*Canada*"), which involved virtually identical claims made by the government of Canada against the same defendants. In *Canada,* the Second Circuit affirmed the dismissal by the Northern District of New York of the plaintiff's suit, holding that the revenue rule barred Canada from using U.S. courts to recover lost tax revenue. [6]

The plaintiffs in *European Community* sought to persuade the court that the legislative history of the Patriot Act, which was enacted 10/26/01 shortly after *Canada* was decided, indicated that Congress intended to allow foreign governments to bring lawsuits under RICO to stop tobacco smuggling activities. Indeed, the legislative history of the Patriot Act did contain some language that was favorable to the plaintiffs' claims. In a predecessor version of the Patriot Act that was passed by the House of Representatives, the section of the Act that added new international money laundering offenses to RICO's list of predicate acts [7] initially provided that the amendments were subject to the following "rule of construction":

"None of the changes made by [the Patriot Act] shall expand the jurisdiction of any Federal or State Court over any civil action or claim for monetary damages for the non-payment of taxes or duties under the revenue laws of a foreign state, except as such actions or claims are authorized by United States treaty that provides the United States and its political subdivisions with reciprocal rights to pursue such actions or claims in the courts of the foreign state and its political subdivisions." [8]

The rule of construction was subsequently deleted from the Act. Several members of the House commented favorably on this deletion. For example, a member of the House Judiciary Committee stated that: "It is our intent to recognize and assist the efforts of our allies in our joint effort to fight fraud and money laundering wherever and in whatever form we find it. If our allies are victimized by fraud, smuggling or money laundering emanating from U.S. soil, they should have the benefit of U.S. laws and U.S. courts to combat those offenses. The expanded definition of Specified Unlawful Activities will ensure that money laundering associated with crimes or fraud committed against our allies shall constitute violations of U.S. law thereby giving the United States and our allies the maximum capability to utilize U.S. laws to combat money laundering." [9]

The plaintiffs argued that this language, as well as similar statements made by other legislators,[10] indicated that Congress understood that the revenue rule would not bar the plaintiffs' claims against the tobacco companies. The Second Circuit rejected this argument, however, holding that the legislative history merely indicated that some legislators held an incorrect view of the scope of the revenue rule, as interpreted by *Canada,* and that nothing in the language of the Patriot Act itself evidenced an intent by Congress to expand the scope of RICO in this fashion.

PASQUANTINO

Pasquantino addressed another aspect of the revenue rule that historically has never been clear, namely the extent to which the revenue rule would prevent the criminal prosecution by U.S. authorities of fraudulent evasion of a foreign tax under a domestic criminal statute.

This issue was addressed for the first time in *U.S. v. Boots,* 80 F3d 580 (CA-1, 1996). The First Circuit held that the common law revenue rule barred the prosecution, under the federal wire fraud statute, [11] of a defendant who was accused of smuggling tobacco into Canada without paying the excise taxes Canada imposes on imported tobacco.

Later that year, in *U.S. v. Trapilo,* 1996 WL 743838 (DC N.Y., 1996), *rev'd* 130 F3d 547 (CA-2, 1997), 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" (namely, wire fraud) for purposes of the federal money laundering statute. On appeal by the government, the Second Circuit reversed the lower court decision.

Carl and David Pasquantino and a co-defendant were convicted at trial of carrying out a scheme to evade Canadian excise taxes. In the district court, and on appeal to the Fourth Circuit, the Pasquantinos argued that their prosecution contravened the common law revenue law because it required the court to take cognizance of the revenue laws of Canada. The defendants also argued that the right of the Canadian government to collect the excise tax owed to it 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 Supreme Court granted certiorari to resolve the conflict in the circuit courts.

The Court concluded at the outset that Canada's right to excise taxes constitutes a "property" interest that can serve as the object of a fraud within the meaning of the wire fraud statute. Following an analysis of the history of the common law revenue rule, the Supreme Court held that that rule does not bar the U.S. from prosecuting a fraudulent domestic scheme to evade foreign taxes. In the Court's view, the common law revenue rule prohibits the U.S. government from enforcing foreign penal law, but it does not prevent the government from enforcing a domestic criminal law.

The Supreme Court, in deciding *Pasquantino,* did not address the issue raised by *European Community I.* In fact, the court noted: "We express no view on the related question whether a foreign government, based on wire or mail fraud predicate offenses, may bring a civil action under the Racketeer Influenced and Corrupt Organizations Act for a scheme to defraud it of taxes." The Court did discuss a closely related issue, however, namely whether the government of Canada would be entitled to recover damages from the defendants in *Pasquantino* under the Mandatory Victims Restitution Act.

The Restitution Act, a federal law enacted in 1996, 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 make full restitution to the victim of the fraud. [12] The Supreme Court did not decide the Restitution Act question, but it did comment that "[w]e do not think it matters whether the provision of restitution is mandatory in this prosecution. Regardless, the wire fraud statute advances the Federal Government's independent interest in punishing fraudulent domestic criminal conduct, a significant feature absent from all of petitioners' revenue rule cases. The purpose of awarding restitution in this action is not to collect a foreign tax, but to mete out appropriate criminal punishment for that conduct." [13] Thus, the Supreme Court seemed to take the view that the revenue rule would not apply where the foreign government's recovery was premised on a criminal statute designed to punish the defendant's conduct.

One week after deciding *Pasquantino,* the Supreme Court remanded *European Community I* back to the Second Circuit for reconsideration in light of the Court's decision.

EUROPEAN COMMUNITY II

In considering the impact of *Pasquantino* on the European Community's RICO claims, the Second Circuit ignored the Supreme Court's suggestion that the revenue rule should not prevent a court from ordering a payment to a foreign government for lost tax revenue under the Restitution Act because the purpose of the Restitution Act is not to collect a foreign tax but to mete out

appropriate criminal punishment for that conduct. Arguably, the very existence of a treble damages requirement is evidence that the purpose of the RICO civil damages provision is to mete out punishment for criminal behavior. This argument is supported by the legislative history of the Patriot Act amendments to RICO discussed above. Instead, the Second Circuit concluded that the holding in *Pasquantino* should be limited to criminal prosecutions brought by the U.S. and that the Supreme Court did not intend to narrow the scope of the revenue rule to allow civil claims made by foreign governments, even under a criminal statute such as RICO.

In light of the court's approach in *European Community II,* it remains unclear how the Restitution Act issue would be decided. While the Second Circuit refused to allow any monetary claim by a foreign government for lost tax revenue premised on an allegation of a RICO criminal violation, the reasoning of the court focused on the identity of the plaintiff as a foreign government. This leaves open the possibility that in a true criminal proceeding brought by the U.S., a foreign government might be awarded restitution for lost tax revenue.

LEGACY OF *PASQUANTINO*

Although the defendants in *Pasquantino* were convicted of defrauding Canada of an excise tax, there is nothing in the Supreme Court's rationale that would limit the Court's holding to such taxes. It seems clear that a scheme to defraud a foreign government of its right to uncollected income taxes also could be prosecuted under the U.S. federal wire fraud or mail fraud statutes.

The Court's decision in *Pasquantino* has greatly expanded the range of acts that may constitute criminal money laundering. The scope of activities that can fall under the definition of money laundering may surprise some practitioners, to whom these rules are particularly relevant. 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...." [14]

The term "specified unlawful activity" is defined to include wire fraud and mail fraud. [15] 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 an act constituting wire fraud or mail fraud, then the individual may be guilty of federal money laundering (a crime punishable by up to 20 years' imprisonment). Advisors who get involved in structuring transactions that use foreign source income on which taxes were evaded risk running afoul of the federal money laundering statute.

CONCLUSION

While *European Community II* narrowed the potential scope of *Pasquantino* to civil claims under RICO, it left untouched *Pasquantino*'s abrogation of the revenue rule in criminal prosecutions. Under the Supreme Court's holding in *Pasquantino,* use of interstate wires or the mail to evade a foreign tax may constitute a federal crime, and a lawyer who advises a taxpayer in connection with such evasion could be viewed as aiding and abetting the fraudulent conduct. Prudent advisors should hold themselves to the same standards of conduct in advising clients on foreign tax matters as they do in advising on U.S. tax matters.

Practice Notes

After *Pasquantino,* the scope of activities that can fall under the definition of money laundering may surprise some practitioners, to whom these rules are particularly relevant. Advisors who get involved in structuring transactions that use foreign source income on which taxes were evaded risk running afoul of the federal money laundering statute.

[1] 18 U.S.C. sections 1961-1968.

[2] Holman v. Johnson, 98 Eng. Rep. 1120 (K.B., 1775).

[3] Peter Buchanan Ltd. v. McVey, 1955 A.C. 516, 529-530 (Ir. H. Ct., 1950), *appeal dismissed* 1955 A.C. 530 (Ir. Sup. Ct., 1951).

[4] See Department of Amazonas v. Philip Morris & Companies, No. 00 Civ. 2881 (NGG); European Community v. RJR Nabisco, Inc., No. 01 Civ. 5188 (NGG); European Community v. Japan Tobacco, Inc., 186 F Supp 2d 231 (DC N.Y., 2002).

[5] The European Community first filed suit against the defendants in 2001 but the case was dismissed for lack of standing by the plaintiff. See European Community v. RJR Nabisco, Inc., No. 00 Civ. 6617 (NGG). The case was refiled in 2001, this time with member governments of the EC joined as plaintiffs in the lawsuit.

[6] The Eleventh Circuit reached a similar result in a case brought against Philip Morris by the governments of Honduras, Ecuador, and Belize. See Republic of Honduras v. Philip Morris Companies, Inc., 341 F3d 1253 (2003).

[7] See 18 U.S.C. sections 1956, 1961(1).

[8] Financial Anti-Terrorism Act of 2001, H.R. 3004, 107th Cong., section 106(b). The Financial Anti-Terrorism Act of 2001 was later subsumed into the Patriot Act. See 147 Cong. Rec. H7198 (daily ed., 10/23/01).

[9] See 147 Cong. Rec. E1936 (daily ed., 10/29/01) (statement of Rep. Wexler (D-Fla.)).

[10] See 147 Cong. Rec. S11028 (daily ed., 10/25/01) (statement of Sen. Kerry (D-Mass.)).

[11] 18 U.S.C. section 1943.

[12] 18 U.S.C.A. section 3663A.

[13] The Court also stated that even if restitution under the Restitution 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.

[14] 18 U.S.C.A. section 1956(a)(1).

[15] See 18 U.S.C.A. sections 1956(c)(7)(A) and 1961(1)(B).