
SHOP TALK

Using Extended FTC S/L to Defend Against Tax Evasion Charges

> *This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. Readers are invited to write to the editors: Sheldon I. Banoff, Suite 1900, 525 West Monroe Street, Chicago, Illinois 60661-3693, Sheldon.Banoff@kattenlaw.com, and Richard M. Lipton, 130 East Randolph Drive, Chicago, Illinois 60601, Richard.Lipton@bakermckenzie.com.*

[pg. 358]

In Rubinger and **Weinstein**, "Foreign Tax Credits: Can a Deficiency Be Retroactively Wiped Out for Criminal Tax Evasion Purposes?," 112 JTAX 166 (March 2010), the authors suggested that the Section 901 foreign tax credit (FTC) is available as a defense to a prosecution for federal income tax evasion. The premise is that, if the FTC is equal to or greater than the evaded tax liability, the FTC relates back to the year in which the tax was evaded and effectively eliminates the tax otherwise due and owing ("the deficiency," as used in common parlance).

The Department of Justice Tax Division's policy disagrees with this position (see DOJ *Criminal Tax Manual,* 1994 ed., section 8.05[5]). Oddly enough, IRS Chief Counsel's position is the opposite, acknowledging that the FTC can indeed be a valid defense to a charge of tax evasion (see Office of Chief Counsel, Criminal Tax Division, *Tax Crimes Handbook* (2009), section 1.03[3][g]5).

Andrew H. **Weinstein**, senior international tax partner in the Miami office of the law firm of Holland & Knight LLP, and co-author of the prior article, writes to us about a recent development in this area.

In *Tilga,* 108 AFTR 2d 2011-7129 (DC N.Mex., 11/8/11), the issue in connection with a sentencing proceeding was whether the court should accept that portion of a plea agreement that stipulated to a tax loss which did not include the evaded tax because of the FTC. The court accepted the stipulation and agreed that, as a matter of tax law, the FTC related back to eliminate evasion of tax. The court cited our article in THE JOURNAL to support its decision, noting that it is one of only two articles that discusses the impact of *Cruz,* 51 AFTR 2d 83-1114 698 F2d 1148 (CA-11, 1983), which held that the taxpayer must pay any foreign taxes due before trial on tax evasion charges, in order for there to be an available FTC.

Tilga, in which your author served as counsel from the indictment forward, involved both charges of tax evasion under Section 7201 for 1999-2004 and conspiracy to defraud the U.S. (a "*Klein* conspiracy") for 1998-2004. (See 18 U.S.C. section 371 and *Klein,* 52 AFTR 614 247 F2d 908 (CA-2, 1957).) The plea agreement called for dismissal of the evasion counts in exchange for voluntary payment in full of the U.S. taxes that otherwise would be due, were it not for application of the FTC, and a plea of guilty to one count of conspiracy for a year as to which the FTC was not available (1998) because the statute of limitations already had expired with respect to a timely claim for relation back of the FTC (see Sections 905(c)(2)(B) and 6511(d)(3)(A)).

To better understand the application of the FTC, it is necessary to first explain more about the proceedings in *Tilga.* During the investigation and related pre-indictment administrative proceedings, defense counsel did not raise the FTC issue. This may account for IRS having proceeded with a recommendation for prosecution, rather than even considering the published position of Chief Counsel to the contrary. Following indictment, the taxpayer retained tax counsel to review the circumstances. Early on, it was concluded that the subject income was sourced in Canada and that Canadian income tax compliance was absent.

In an effort to bolster the defense, the taxpayer then engaged Canadian tax counsel to submit a voluntary disclosure to Revenue Canada. The Canadian income tax exceeded the U.S. income tax. The tax was finally assessed in Canada and accrued as required by U.S. law (i.e., Section 901(a)), but was not paid. The taxpayer then timely filed a claim for relation back of the Canadian tax liability within the ten years allowed by Section 6501(d)(3)(A), thus preserving the right to pay the Canadian tax within a reasonable time thereafter. According to *Cruz,* that would be prior to trial, although Section 6511 itself contains no such requirement and only requires the timely filing of a claim.

In *Tilga,* the Canadian tax was accrued but not paid. The taxpayer paid the U.S. taxes otherwise due and owing. She did not pay the taxes assessed in Canada, although there was testimony that they were on deposit in the law firm's trust account. The taxpayer remains exposed to liability in

Canada. Were she to be required to also pay in Canada, there would be double taxation and no Competent Authority relief because the primary liability would be in Canada and the plea agreement waives any right to a refund of the stipulated tax that otherwise would be due, without the benefit of application of the FTC.

In fact, in an effort to avoid being in a position where she could be exposed to double taxation, the taxpayer attempted to withdraw the voluntary disclosure. Nevertheless, Revenue Canada determined that the taxes were due and owing and assessed them with penalties and interest. (Under a voluntary Canadian disclosure, penalties and interest would not be assessed.) It remains uncertain if and when the taxpayer will be obligated to pay the assessed Canadian taxes because they are on appeal and the U.S.-Canada Income Tax Treaty (Article XXVI A 8) does not provide for collection against a person who was domiciled in the U.S. when the Canadian taxes were accrued.

Another argument may have the effect of eliminating exposure to the

[pg. 359]

civil fraud penalty. In short, if no tax is due for criminal tax purposes because of the FTC, then no tax can be due for civil fraud purposes. *Query* if a taxpayer will have sufficient financial reserves to prepay taxes and penalties before any tax litigation. If so, then the taxpayer may benefit from a collateral estoppel in any refund litigation in the same district, whereas deficiency litigation in the Tax Court may arguably yield the opposite result, at least until the court of appeals in the same circuit decides the issue.

In reaching its decision in *Tilga* over the government's objections, the district court admitted testimony of an expert witness for the taxpayer. That expert testified on the application of the FTC, emphasizing that there is only one Code and it applies for both civil and criminal tax purposes. More specifically, the relevant Code sections applicable to the FTC apply without regard to whether civil tax credits or criminal tax evasion is involved. As suggested above, the same result should obtain if the issue involves civil tax fraud: no tax due equals no civil fraud penalty.

Based on the expert testimony and on the independent findings of the court, the salient points of the decision are as follows:

- In the Tenth Circuit, for sentencing guideline purposes, a taxpayer is not allowed a second opportunity to claim deductions after having been convicted of tax fraud (see *Spencer,* 83 AFTR 2d 99-2709 178 F3d 1365 (CA-10, 1999); U.S.S.G., section 2T1.1, Note A).
- Nevertheless, the guidelines do not categorically prevent a court from considering unclaimed deductions (see *Hoskins,* 108 AFTR 2d 2011-5714 654 F3d 1086 (CA-10, 2011)).
- The court may exercise its discretion to determine the relevant tax loss for sentencing purposes so the U.S. does not reap a windfall by asserting that it lost revenue that would never have been collected.

- The deductions must be related to the offense at issue, but the court—applying the same rule for credits as for deductions—then found this to be so because the taxpayer was charged with evading the very same taxes as gave rise to the FTC.
- It is the province of the judiciary to determine what the law is (*Marbury v. Madison,* 5 U.S. (1 Cranch) 137 (1803)) and the parties cannot stipulate away that responsibility on a case-by-case basis because the court must be as consistent and principled as possible. As such, the court will decide whether federal law permits a defendant to claim an FTC post-indictment.
- The FTC may be claimed or changed at any time before the period prescribed for making a claim for refund (Section 901(a)).
- There is a ten-year limitations period for filing the claim and if taxes are paid on a timely basis, they relate back to the tax year in which accrued (Section 6511(d)(3)).
- Although the result seems incongruent with ordinary criminal law practice, the ten-year limitations period for the FTC and the sentencing guidelines (U.S.S.G., section 2T1.1) create a unique set of circumstances in which a defendant may reduce her liability.
- The court, in determining the application of the FTC, follows the Tenth Circuit in *Hoskins* rather than the Eleventh Circuit's holding in *Cruz,* although the holding is consistent with *Cruz* that a defendant may claim an FTC after being indicted.
- The court noted the finding in *Cruz* that an FTC must be claimed before trial and stated that there was no principled rationale therefor but does not decide that issue, observing that even though there is a six-year statute of limitations for tax evasion and a ten-year period in which to claim an FTC, lengthy tax evasion schemes allow for prosecution based on the last affirmative act of evasion. In addition, not every FTC will be sufficient to eliminate federal tax liability (Canada being an exception because its income taxes are higher than those of the U.S.).
- It is not a proper task for the court to rewrite the law to protect the public interest, this being for Congress.
- The taxpayer fixed her foreign tax liability before trial, thereby satisfying the rule in *Cruz* as well.
- The taxpayer may claim the FTC for all years within the limitations period.

Although not stated by the court, taxpayers in similar circumstances should exercise extreme caution to ensure that they file timely claims for refund of the FTC, even if the foreign taxes will not be paid within the ten-year statutory period, in order for the FTC to relate back.

Tilga arguably presents a unique set of circumstances limited to the FTC as a defense to a tax evasion prosecution, but the decision may well open the door for other arguments relating to post-indictment expense deductions not originally claimed on the return.

Of perhaps greater importance is the admonition to defense counsel in any tax evasion prosecution to focus on the merits of the underlying tax liability at the first point when the case is ripe for prosecution, thereby perhaps avoiding indictment and the personal and financial disruption attendant to the defense thereof.

Timely filing of claims for refund are a necessary adjunct to the defense process and are likely mandated even after conclusion of any criminal proceedings so as to preserve similar defenses for civil fraud penalty purposes.

Finally, even the best of defenses will come at a cost, in this case, potential exposure to double taxation.

Shop Talk thanks Mr. **Weinstein** for his insights.

END OF DOCUMENT -