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Article

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CRIMINAL TAX LAW IN THE U.S. – A MODEL FOR IMPROVING GERMAN CRIMINAL TAX LAW ENFORCEMENT?

MATTHIAS ZAHNER*

The article looks at criminal tax law and tax law enforcement in the United States, providing an overview of the issues in connection with the term “criminal tax”. After discussing the various dimensions of criminal tax, we introduce concepts and methods that could be adopted by other jurisdictions. For the author, writing in a German context, it is natural to raise the question as to whether the German system of tax investigation (*Steuerfahndung*) could learn from the experiences of American criminal tax law reform.

The area of “criminal tax” is surely one of the most controversial but also one of the most interesting legal fields worldwide, particularly in the United States. As the term “criminal tax law” is very broad, the following aspects have to be considered:

- The organizational aspect: Internal structure of the revenue authorities and their law enforcement component as well as their integration in and interrelation with other (especially law enforcement) agencies.
- The strategic aspect: Strategies and programs used by the competent authorities to plan their course of action on the tactical level.
- The tactical aspect: Instruments (e.g. personnel and technical equipment) and methods of operation (e.g. selection of cases and use of investigative powers) employed by the competent authorities.

* The article is based on the author's book, *Steuerfahndung in den USA, The Criminal Investigation Division of the IRS - Modell für die Steuerfahndung in Deutschland?*, Duncker & Humblot, Berlin, 2005. E-mail: zahner@vr-web.de

- The legal aspect: Scope of criminal tax law statutes and the consequences of breaches of law for the taxpayer.
- The evidentiary aspect: Methods of proving actual breaches of law.

It would go beyond the focus of a short article to analyze all these areas in depth.¹ Thus, the article concentrates on concepts and methods that are most promising for an adoption by the German legal system. Those areas will be identified within the five aspects mentioned above.

The organizational aspect

Integration of the criminal tax enforcement component

The Internal Revenue Service (IRS) is charged with the administration of federal taxes in the United States.² The Criminal Investigation Division (CID) is the law enforcement component of the IRS. The IRS and the CID are integrated into a network of law enforcement agencies.

Figure 1 shows some of the agencies that are involved in criminal tax proceedings or which have supervisory authority over the IRS and the CID. After referral by the CID, the Justice

¹ For a more complete analysis see Zahner, 2005.

² See Internal Revenue Manual 1.1.1.2: “The IRS is organized to carry out the responsibilities of the secretary of the Treasury under IRC Art. 7801. The Secretary has full authority to administer and enforce the internal revenue laws and has the power to create an agency to enforce these laws. The IRS was created based on this legislative grant. IRC Art. 7803 provides for the appointment of a Commissioner of Internal Revenue to administer and supervise the execution and application of the internal revenue laws.”

Figure 1

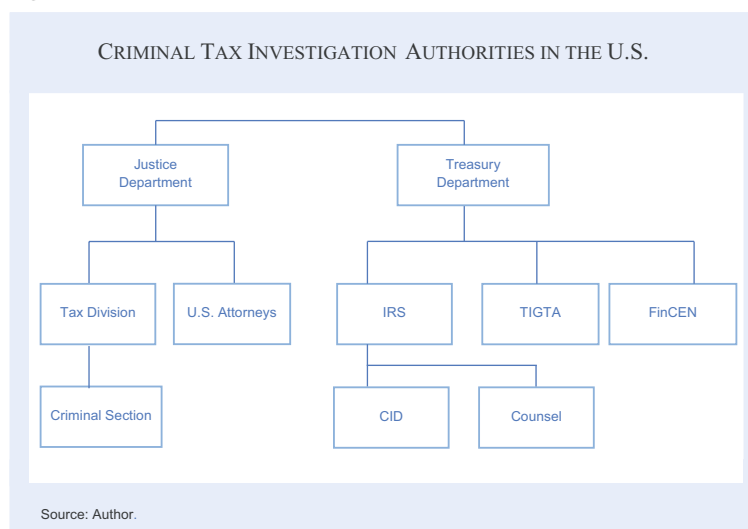
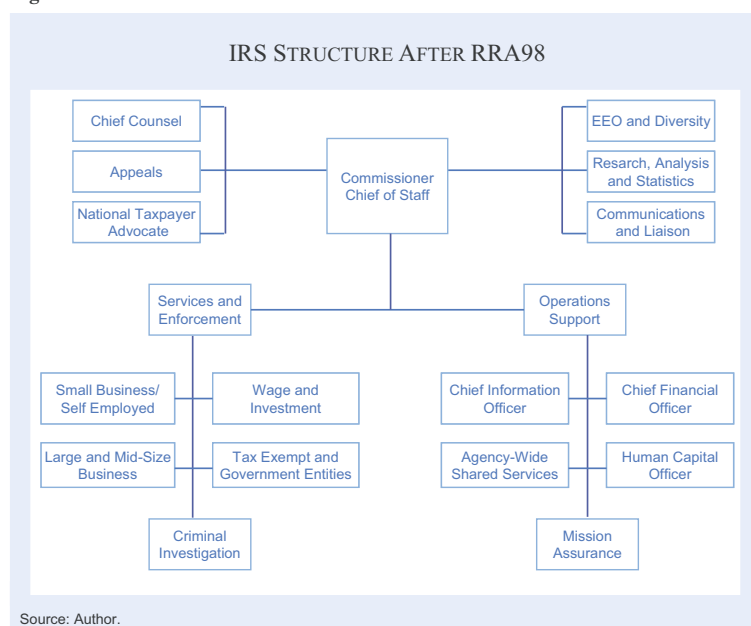


Figure 2



Department/Tax Division/Criminal Section and the U.S. Attorneys decide whether to prosecute or not.

The Treasury Inspector General for Tax Administration (TIGTA) is a separate agency within the Treasury Department. TIGTA was established on the basis of the Restructuring and Reform Act of 1998 (RRA98) in response to IRS misconduct. Additional supervision is provided by internal IRS components, such as the National Taxpayer Advocate and EEO (Equal Employment Opportunities), see Figure 2.

The Financial Crimes Enforcement Network (FinCEN) is a bureau within the Treasury Department that is primarily responsible for combating money laundering by supporting law enforcement agencies and building cooperation between them. In addition to that, CID cooperates with other law enforcement agencies on federal and state levels, such as the FBI, CIA and BATF (Bureau for Alcohol, Tobacco and Firearms).

Although some of these agencies are necessary to support the missions of the IRS and the CID efficiently, there are two main points of criticism.

Firstly, the fragmentation of the law enforcement agencies collaborating with IRS and CID leads to overlapping competencies as well as to doubts as to which particular agency should take action in cases of unclear or shifting prerogatives. Secondly, the vast number of internal and external oversight and con-

trol authorities threatens to paralyze tax administration and especially criminal tax enforcement. The reasons for this are the amount of time consumed by oversight procedures and the fact that agents hesitate to take action for fear of being rebuked by their supervisors.³

The situation in Germany is somewhat similar, as there are no less than four units with supervisory functions for the German Criminal Tax Investigation Divisions (*Steuerfahndung*), see Figure 3. The situation could be improved by delegating all control and supervisory functions to one single agency.

In addition to that, the efforts of the various agencies involved need to be coordinated in order to achieve a high degree of efficiency.

Internal structure of the IRS and CID

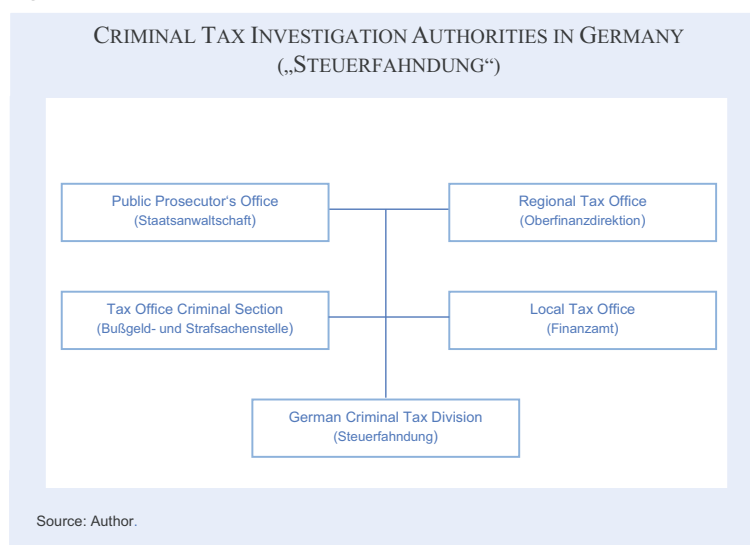
Internally, both the IRS and the CID have undergone radical reforms and restructuring as a result of the Internal Revenue Service Reorganization and Reform Act of 1998 (RRA 98) and in response to the 1999 Webster Report delivered by the Commission headed by William Webster. The mere fact that such comprehensive reforms of a major governmental institution were carried out successfully should not be underestimated. The consequences of these reforms are seen as predominantly positive; consequently they will be a focal point of this article.

The IRS structure

The IRS Restructuring and Reform Act of 1998 prompted the most comprehensive reorganization and modernization of IRS in nearly half a century. The IRS reorganized itself to closely resemble the private sector model of organizing around customers with similar needs. Although the new customer orientation of the IRS is a sign of a modern understanding of the term “administration”, it may be

³ Treasury Inspector General for Tax Administration, Report 2001-30-063, March 2001, p. 7: RRA 98 has made many employees with examination functions fearful of participating in the fraud referral program because to do so might bring about a termination for misconduct.

Figure 3



argued that too much weight has been put on customer satisfaction. The collection of taxes is always the primary goal of a tax administration.

Figure 2 shows the IRS structure after RRA98. It should be noted that this structure is not static but has been modified repeatedly over the last years. Specialized IRS units like the National Taxpayer Advocate and EEO report directly to the Commissioner's office. The Deputy Commissioner Services and Enforcement oversees the four primary operating divisions and the CID. The Deputy Commissioner Operations Support oversees the integrated IRS support functions, facilitating economy of scale efficiencies and better business practices.

Not all of these units have an equal impact on the CID's work. One important source for CID cases are referrals by the operating divisions. Consequently, the cooperation with these units is vital for the CID's work. Although the referral process has been criticized in RRA98, the IRS has found it difficult to increase the number of referrals.

The operations support units support the CID's mission by providing the necessary resources and infrastructures. Specialized units like the National Taxpayer Advocate and EEO have a supervisory function over the CID and other IRS components

The structure of the CID

In contrast to the structure prior to the reforms, line authority has been achieved for the Criminal Investigation Division. Thus, the Chief CI now

reports directly to the Deputy Commissioner for Services and Enforcement. This development is seen as especially positive. Before the reforms, local CID offices at regional and district levels had to report to civil IRS officers. This often rendered their work inefficient, as most civil officers did not have a law enforcement background and consequently were not able to provide proper guidance.

The same problems exist in Germany, where in most cases the tax investigation (*Steuerfahndung*) is a dependent part of the local tax office.⁴ In the light of the findings of the Webster Commission, it appears preferable to set up the *Steuerfahndung* as a separate agency. However, it is not possible to transfer the organizational structure of the CID indiscriminately. Setting up a separate criminal investigation agency on a federal level would not fit in with the system of law enforcement agencies in Germany. Furthermore, the constitutionality of such a construction seems doubtful.⁵ It is possible, however, to install separate criminal tax enforcement agencies at the level of the federal states. To retain the connection with the tax offices, the *Steuerfahndung* could be subordinate to the same supervisory authority as the tax offices.

The installation of the *Steuerfahndung* at the level of the federal states does not mean that the law enforcement efforts of different agencies cannot be coordinated on a federal level as a standard practice or on a case-to-case basis.

Jurisdiction of the CID

According to IRC Art. 7608, the CID alone has the authority to investigate crimes occurring under the Internal Revenue Laws.⁶ The IRS also has explicit enforcement responsibilities with regard to money laundering offences⁷ and violations of the re-

⁴ This is especially the case in the federal states of Baden-Württemberg, Bavaria, Brandenburg, Bremen, Hessen, Mecklenburg-West-Pomerania, Rhineland-Palatinate, Saarland, Saxony, Saxony-Anhalt, Schleswig-Holstein and Thuringia.

⁵ Due to the similarity of the *Steuerfahndung* to a police agency, Art. 87 Sec. 1 S. 2 GG (Basic Constitutional Law of the Federal Republic of Germany) could be violated.

⁶ IRM 9.1.2.2.1.

⁷ 18 USC Arts. 1956, 1957.

porting requirements under the Bank Secrecy Statutes.⁸

The fact that the CID is only responsible for law enforcement tasks is preferable to the situation in Germany where the *Steuerfahndung* is also charged with the assessment of taxes. This split competency might tempt the *Steuerfahndung* to shift between two incompatible types of investigation in order to circumvent the taxpayer's rights. Additionally, the taxpayer can never be sure if he can invoke his rights as a defendant or if he has to act in accordance with his compliance duties.

The fact that the CID has the authority to investigate crimes like money laundering, which can be seen as financial crimes and not tax crimes in a narrow sense, is problematic. Because of their expertise in investigating financial crimes, CID special agents frequently support other agencies, especially with respect to money laundering and narcotics investigations. Although CID agents provide valuable input to such investigations, this practice has shifted the CID's focus from their original responsibility of investigating genuine tax crimes. This development was criticized by the Webster Commission. Consequently CID efforts to investigate legal source tax crimes have been intensified (Matthews 2001, 2).

The strategic aspect

A specific feature of the criminal tax enforcement effort in the United States is the extensive use of strategic planning to develop programs that provide the special agents of the CID with detailed guidelines for their work. In accordance with its mission statement, the CID develops a strategic plan and the three major programs that specify the areas of CID activities, namely the Legal Source Tax Crimes Program, the Illegal Source Financial Crimes Program and the Narcotics Related Financial Crimes Program. This kind of strategic planning is crucial to identifying the focal points of law enforce-

Criminal investigation program, by status or disposition, fiscal year 2005

Status or disposition	Total	Legal source tax crimes	Illegal source financial crimes	Narcotics-related financial crimes
Investigations initiated ^{a)}	4,269	1,693	1,632	944
Investigations discontinued	1,245	594	426	225
Referrals for prosecution	2,859	951	1,141	767
Information and indictments ^{b)}	2,406	731	993	682
Convictions	2,151	655	894	602
Sentenced	2,095	615	900	580
Incarcerated ^{c)}	1,738	495	716	527
Percentage of those sentenced who were incarcerated ^{c)}	83.0	80.5	79.6	90.9

^{a)} Since actions on a specific investigation may cross fiscal years, the data shown in cases initiated may not always represent the same universe of cases shown in other actions within the same fiscal year. – ^{b)} Both “information” and “indictments” are accusations. “Information” means an accusation made by law enforcement without the intervention of a grand jury, whereas an “indictment” is an accusation made by a prosecutor and issued by a grand jury. – ^{c)} Incarcerated may include prison time, home confinement, electronic monitoring, or a combination thereof.

Source: IRS Data Book, FY 2005, Publication 55b. Also, Criminal Investigation, Communications and Education Division.

ment activities and in allocating the available resources in order to achieve a high level of efficiency. Although the Webster Report has called for focusing the CID's efforts on legal source tax crimes, The table shows that the number of illegal source financial crimes and narcotics-related financial crimes is still comparatively high.

Although the high level of strategic planning itself consumes a considerable amount of resources, the strategic dimension of law enforcement should not be neglected. Broadly speaking, two spheres of criminal strategy can be distinguished: planning and operative strategy. While planning strategy deals with the identification of abstract and concrete objectives, operative strategy describes the attainability of these objectives by practical means. Operative strategy provides guidelines for the tactical level of law enforcement, for example, regarding personnel training, choice of equipment and use of investigative powers.

The tactical aspect

Selection of cases

In the United States criminal tax cases are selected for prosecution on three different levels: the CID, the Criminal Section of the Justice Department/Tax Division and the US Attorneys. Among the factors that determine whether a prosecution will be initiat-

⁸ 31 USC Art. 5311 et seq.

ed are the probability of a conviction (convictability), the amount of taxes evaded and the publicity of the case. The unusually high percentage of convictions can be seen in the table (83 percent in FY2005).

The fact that only a comparatively small amount of cases are brought to court is open to criticism from a criminological point of view. To achieve a sufficient deterrence, it is important to successfully prosecute a sufficient number of tax crimes to create a high probability for the offender to be sanctioned. Although the deterrence effect is often debated in criminology, there are convincing arguments that tax offenders decide rationally whether to commit a tax crime or not. During this deliberation process, different factors are taken into account, among them the probability of being convicted.

In addition to its inadequate criminological impact, the selective prosecution of tax crimes in the United States endangers the rights of equality of the defendants. In Germany, an imitation of the practice in the United States would violate the principle of legality⁹ (*Legalitätsprinzip*) and consequently has to be ruled out for constitutional reasons.

Use of investigative powers

The amount and the extent of investigative powers that can be used by CID special agents is comparatively large. However, it seems questionable whether all these powers are really necessary when dealing with tax crimes, as the taxpayers' rights could be endangered. However, when dealing with organized crime, narcotics crimes or money laundering, some of these powers (e.g. undercover investigations and electronic monitoring) are sometimes necessary for a successful enforcement. Notwithstanding the question whether the CID should be involved in the war against organized crime and terrorism, it is important to differentiate according to the type of suspect against whom a particular investigatory power is used.

The legal aspect

Statutory criminal tax law

The attempt to transplant a certain statute or set of statutes from one legal system into another is always

challenging, especially when dealing with two more or less incompatible legal systems, such as the case law system of the United States and the statute law system of Germany.

It is not easy to define the term criminal tax law in the United States. The authority of the CID encompasses several titles of the United States Code, in particular the tax crimes of Title 26 (Internal Revenue Code), the money laundering and tax-related crimes of Title 18 and the bank secrecy provisions of Title 31. The scopes of these statutes overlap in some cases. For example, IRC Art. 7207 and 18 USC Art. 1001 both sanction the filing of false tax returns. This situation leads to uncertainty for the taxpayer as well as for the investigator as to which statute covers a particular action.

Some of the crimes that fall under the authority of the CID were never meant to be tax crimes, in particular Mail and Wire Fraud.¹⁰ This has led to harsh sanctions under the RICO,¹¹ statutes that were originally designed to combat organized crime. Consequently, it is possible – at least in theory – to employ sanctions that seem overly harsh.

Finally, some statutes, especially the conspiracy¹² and money laundering¹³ statutes, seem to be problematic in themselves. While the conspiracy statute compensates the lack of a statute for an attempt in the Federal Criminal law by transferring the culpability threshold to an earlier preparatory stage, the money laundering statute is extremely complicated and almost incomprehensible even for legal specialists.

All in all, the adoption of one or several US criminal tax statutes in the German legal system cannot be recommended.

The problem of sanctioning

Sanctioning in connection with federal criminal tax cases is highly regulated by the US Sentencing Guidelines. While these guidelines guarantee a uniform sentencing practice throughout the United States, they also leave little space for the judge to take the particularities of the case into account. The

⁹ In principle, German law enforcement agencies and prosecutors have to investigate suspected crimes ex officio.

¹⁰ 18 USC Arts. 1341, 1343 can apply if a false tax return is filed electronically or per mail.

¹¹ Racketeer Influenced and Corrupt Organizations Act, 18 USC Arts. 1961 et seq.

¹² 18 USC Art. 371.

¹³ 18 USC Art. 1956 (Laundering of Monetary Instruments), especially Art 1956(a)(1)(A).

table shows that sentences are comparatively severe, given the high number of incarcerations. However, the deterrence effect of this practice seems doubtful, especially when considering the low conviction probability resulting from the selective prosecution of criminal tax cases described above. Consequently, an adoption of the US sentencing practice is not unproblematic from a criminological point of view.

In addition, the sentencing practice in the United States shifts the sentencing decision from the judge to the prosecutor and the legislator. It is doubtful whether this practice is compatible with German constitutional law.

The evidentiary aspect – methods of proof

Proving that an actual tax crime has been committed can be the most challenging part of the investigative process for government agents. Although many problems are connected with proving a tax crime, two areas merit special attention: indirect methods of proof and forensic accounting.

Indirect methods of proof

In criminal tax proceedings, indirect methods of proof are used extensively when a financial crime cannot be proven by the “specific items method”, i.e. by proving actual fraudulent transactions. The most common indirect method of proof is the net worth method, which analyzes increases in the net worth of a taxpayer’s assets. If the taxpayer uses illegal money to finance an excessive lifestyle, the cash expenditures method is applied.

Although a conviction would otherwise be impossible in many cases, indirect methods of proof can shift the burden of proof to the defendant. To prevent an infringement on the defendant’s rights, the courts have held that indirect methods of proof may be used only if the taxpayer did not keep any books at all or if the books are incomplete or false. It is not sufficient to prove that a taxpayer has untaxed income; the government must additionally establish a likely source of taxable income. In Germany, similar indirect methods of proof are used in criminal tax cases (Barkmann 1995).

Forensic accounting

An important feature of US practice is the use of forensic accountants to prove criminal tax violations.

Forensic accounting has become so important in proving financial crimes that it has been described as the “seventh basic investigative technique” (Nossen 1977). Forensic accountants are used by law enforcement agencies such as the IRS and the FBI and as expert witnesses in criminal proceedings. Basically, forensic accounting is the use of accounting techniques to detect criminal acts. The schemes utilized by white collar criminals have become so intricate that highly trained specialists are necessary to prove actual breaches of law. Especially in highly complex cases, the use of forensic accountants is necessary in Germany as well as in the United States.

Conclusion

Apart from providing an interesting field of study, the concepts and methods used in combating criminal tax in the United States can be used to improve the work of German tax investigation and other related agencies, especially with respect to the organizational and the strategic dimension. The organizational structure of the CID seems superior to the German tax investigation, in that the CID is established as a separate part of the IRS without neglecting the important flow of information between the civil and criminal part of the IRS. In addition, a high level of strategic planning makes it possible to use the scarce resources of the criminal tax enforcement agencies as efficiently as possible.

The other areas described above cannot be considered as suitable for adoption by the German legal system. This is especially true for the statutory criminal tax law and the sanctioning system applied in the United States.

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