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TACKLING ILLEGAL ACTIVITIES THROUGH TAX LAW – AL CAPONE CASE STUDY

Matej Kačaljak¹

Abstract

This paper discusses the Al Capone case and identifies legal institutions which contributed to the conviction of Al Capone for tax evasion in the USA and discusses similarities in Slovak law. The Slovak legal environment is assessed with the aim of identifying potential room for improvement. Under an assumption of identical factual circumstances, it is tested whether Al Capone would be convicted of tax evasion in the Slovak Republic and if not, what would be the main reasons. The paper concludes that due to some, probably unintentional, specifics of Slovak tax and criminal law, Al Capone could not be convicted of tax evasion by the Slovak courts. In our opinion, these specifics do not, however, constitute material elements of the basic structure of Slovak tax and criminal law and could be relatively easily corrected.

Keywords

Personal Income Tax, Tax Evasion, Net Worth Method, Al Capone, Slovak Republic

I. Introduction

As a result of the ongoing debt crises, EU Member States are displaying increased efforts to increase government incomes. For example, the Slovak Republic has implemented several measures in recent years, inter alia, increasing the rates of various taxes and charges and introducing new measures tackling tax evasion both in income tax and VAT. A significant body of research worldwide has been dedicated to the impact on public budgets of tax evasion², the informal economy³ and outright illegal activities. As Slovak law may still be

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² E.g. Andreoni, Erard and Feinstein (1998).

³ E.g. Schneider (2014), inter alia concluding that “most influential factors on the informal economy are tax policies and state regulation”. The size of the shadow economy thus provides for a significant potential source of additional tax revenues, if the tax policies are properly structured.

described as being in a state of transition, there is still great potential for improvement in, e.g. measures to fight tax evasion.

The aim of this paper is to examine measures which have been used with success in the United States of America (“USA”) and the feasibility of their implementation in the Slovak Republic. To identify potential room for improvement, a study of the Al Capone case is used. In the following text, particularities of US tax and criminal law leading to the conviction of Al Capone will be described. Further, it will be assessed whether there are any similarities between Slovak and US law and finally, an assessment will be made as to whether Al Capone would be convicted in the Slovak Republic under the assumption of identical factual circumstances. If the result is negative due to the specifics of Slovak law, there may be scope for improvement in Slovak legislation.

II. Brief summary of the Al Capone case

Alphonse Capone was one of the most well-known gangsters in the USA in the late 1920s. Operating in Chicago, Illinois, in the so-called “prohibition era”, the activities of Al Capone and his gang allegedly spread from manufacturing and selling (then illegal) beer and alcohol through racketeering to operating gambling houses and houses of prostitution. Al Capone *“has been mentioned in connection with practically every major crime committed in Chicago within [the late 1920s].”*⁴ However, due to the severe bribing of local police officers and also to considerably cautious behavior, it was impossible to charge Al Capone with any of the crimes he allegedly committed.

Eventually, on October 18, 1931, Al Capone was *“convicted of three felony counts of tax evasion and two misdemeanor counts of failing to file a tax return [and] sentenced to eleven years in Federal prison, a fine of \$50,000, and court costs of \$30,000. Additionally, Capone [was] ordered to pay \$215,000 plus interest for back taxes.”*⁵

The Al Capone case is interesting due to the fact that he was incarcerated for a “substitute/proxy” crime. This method was afterwards implemented in the USA on several occasions, with Al Capone and Jake Guzik being the first instances, and Aldrich Ames being one of the recent cases in the 1990s.

In the following text, several specifics of the Al Capone case will be discussed from the US legal point of view.

III. US legal background of Al Capone case

Firstly, the power of federal government to impose income tax on the citizens of the USA originates in the 16th Amendment to the US Constitution, ratified in 1913, which reads *“[t]he Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration”*. Federal income tax was introduced by the United States Revenue

⁴ IRS (2015).

⁵ Porazzo (2015).

Act of 1913 (ch. 16, 38 Stat. 114, October 3, 1913) imposing tax on the net income of the individual. Under the 1913 Revenue Code “*subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent.*” The interpretation of this general, sweeping definition by the US Supreme Court is such that the “*broad language of [the respective provision] indicates the purpose of Congress to use the full measure of its taxing power within the definable categories specified therein*”⁶ and that any exemptions and deductions must be expressly stipulated by law.

Later, when the statute was amended in 1916, the one word ‘lawful’ (underlined above) was omitted. According to the interpretation of the US Supreme Court, “*this revealed, we think, the obvious intent of that Congress to tax income derived from both legal and illegal sources, to remove the incongruity of having the gains of the honest laborer taxed and the gains of the dishonest immune*” and further, that “*there has been a widespread and settled administrative and judicial recognition of the taxability of unlawful gains of many kinds.*”⁷

As for the scope of income subject to federal income tax in the USA, it may be concluded that both under the statutory provisions and constant judicial practice, income from illegal sources is subject to federal income tax.

For the Al Capone case it is further relevant that willfully failing to file a tax return and, in broader terms, tax evasion were considered federal⁸ criminal offences under US law. Issues have arisen with respect to the fact that by declaring unspecified income, one may indicate to the authorities that this income comes from illegal sources. Therefore, the US Supreme Court had to examine whether such requirement does not violate the right of an individual to remain silent under the Fifth Amendment to the US Constitution, which, inter alia, reads “*no person shall [. . .] be compelled in any criminal case to be a witness against himself*”. The US Supreme court has ruled on this issue on several occasions. Firstly, the US Supreme Court ruled that “[i]t would be an extreme, if not an extravagant, application of the Fifth Amendment to say that it authorized a man to refuse to state the amount of his income because it had been made in crime.”⁹ On the other hand, it ruled that a person may claim Fifth Amendment rights directly in the tax return. And that “*the*

⁶ E.g. US Supreme Court cases James v. United States (348 US 121), Helvering v. Clifford (309 US 331) and Commissioner of Internal Revenue v. Wilcox (327 US 404).

⁷ US Supreme Court case Rutkin v. United States (343 US 130).

⁸ This may be of importance as with respect to offences under the laws of the Illinois state it was harder to bring any charges against Al Capone due to his strong ties to the local police forces. E.g. when Al Capone was arrested “*on a vagrancy charge, [the] state attorney had to dismiss the case for the reason that no policeman could be found in Chicago who knew Al Capone*” IRS (2015).

⁹ US Supreme Court case United States v. Sullivan (274 U.S. 259).

general rule applies that if a witness does not claim the privilege his disclosures will not be considered as having been ‘compelled’ within the meaning of the Fifth Amendment.”¹⁰ Still, as tax evasion is an intentional offence, the intention to evade taxes would have to be proven by the prosecutor in criminal proceedings. In the Al Capone case, the US government introduced the so-called “net worth method”. This method was thereafter implemented in numerous tax evasion cases in the USA and, despite extensive scrutiny of the US Supreme Court,¹¹ it is still being used.¹² Further, “[e]xcept for a period of refinement in the middle 1950s following Holland and its companion cases, these methods remain substantially unchanged.”¹³

“In a typical net worth prosecution, the Government, having concluded that the taxpayer’s records are inadequate as a basis for determining income tax liability, attempts to establish an ‘opening net worth’ or total net value of the taxpayer’s assets at the beginning of a given year. It then proves increases in the taxpayer’s net worth for each succeeding year during the period under examination and calculates the difference between the adjusted net values of the taxpayer’s assets at the beginning and end of each of the years involved. The taxpayer’s nondeductible expenditures, including living expenses, are added to these increases, and if the resulting figure for any year is substantially greater than the taxable income reported by the taxpayer for that year, the Government claims the excess represents unreported taxable income. In addition, it asks the jury to infer willfulness from this understatement, when taken in connection with direct evidence of ‘conduct, the likely effect of which would be to mislead or to conceal.”¹⁴

Finally, neither US tax law nor criminal law contained any material provisions allowing for exoneration. This, inter alia, allowed the judge in the Al Capone trial to reject the plea bargain negotiated between the prosecutor and Capone’s attorneys.¹⁵

It therefore seems that US legislators place(d) more emphasis on punishing the tax evasion, once it was discovered, than on any potential income that might come from the indicted taxpayer.¹⁶

From the above, it may be concluded that the following legal factors contributed to the conviction of Al Capone:

- (i) broad, sweeping definition of income subject to tax;
- (ii) consistent judicial practice, according to which income from illegal sources is subject to tax;
- (iii) consistent judicial practice upholding, in essence, the use of the net worth method; and
- (iv) non-existence of provisions in law providing for automatic exoneration.

¹⁰ US Supreme Court case *Garner v. United States* (424 U.S. 648).

¹¹ E.g. US Supreme Court cases *Spies v. United States* (317 U.S. 492), *Holland v. United States* (348 US 121) and *United States v. Johnson* (319 U.S. 503).

¹² US Department of Justice (2015).

¹³ *Knight and Knight* (1992).

¹⁴ US Supreme Court case *Holland v. United States* (348 U.S. 121).

¹⁵ Linder (2015).

¹⁶ According to one source citing prosecutor Johnson, the attorneys of Al Capone eventually “*offered to pay \$4,000,000 for his \$215,000 in delinquent back taxes*” Gomes (2015).

Now, assuming the factual circumstances of the Slovak Al Capone case would be identical to the actual Al Capone trial, including e.g. the motivation and means of the police forces and prosecution, it may be tested as to whether the substantive tax and criminal rules would result in a greater or lesser probability of Al Capone being convicted of tax evasion in the Slovak Republic.

The Slovak law equivalents (if any) of the abovementioned factors will be discussed in the following text.

IV. Transposition of the Al Capone case to Slovak law

Sweeping definition of income subject to tax

The Slovak constitution contains a relatively simple provision on taxes and fees, stating in Art. 59 that “*taxes and fees are state[wide] and local*” and that “*taxes and fees may be imposed only by an act [of Parliament] or under such act [of Parliament]*”.

The Slovak courts did not rule specifically on the taxability of incomes from illegal sources; however, the Slovak Constitutional Court formulated several criteria for the constitutional review of Slovak tax legislation. It stated that “*in the sphere of taxes [...] a greater amount of discretion of the legislator must be accepted*”¹⁷ and formulated the following four aspects according to which the taxes (and fees) may be reviewed by the Slovak Constitutional Court:

- (a) adherence to the legality principle;
- (b) whether the tax seeks a legitimate aim and whether it has rational basis;
- (c) adherence to the proportionality principle, balancing the need for government financing and the legitimate interests of the (different groups of) taxpayers; and
- (d) adherence to the non-discrimination principle, i.e. whether the tax does not make unreasonable (arbitrary) differences between different groups of taxpayers or whether a relatively reasonable differentiation does not interfere with any other constitutional right (e.g. the right to property).

The abovementioned aspects might indicate that, as in the USA, the government wields full taxing power. Therefore, if the hypothesis of taxability of income from illegal sources were to be tested by the Slovak Constitutional Court, it might be reasonably expected that it would take a similar approach to that of the US Supreme Court (see above).

Further, the Slovak Income Tax Act No. 595/2003 Coll. as amended (the “**Income Tax Act**”) includes a relatively broad definition of the scope of income tax. According to Art. 2(b) of the Income Tax Act any “*income (revenue) from the activity of the taxpayer and from the assets of the taxpayer with the exemption of the specific scope of income tax [relating to some nonprofit corporations]*” is subject to income tax. The income is broadly defined as “*[both] monetary and in-kind consideration, also if accrued through barter, valued by current prices in the place of receipt or consumption, in dependence of sort, quality, or [if applicable] depreciation, unless it is expressly stipulated otherwise*”.

¹⁷ Slovak Constitutional Court Award No. PL. ÚS 5/2012.

This might indicate that it was indeed the intent of the legislator to cover all kinds of income, i.e. similarly as in the USA, to use the full taxing power given by the Slovak Constitution. This, however, has not yet been directly addressed by the Slovak court in practice.

On the other hand, the Supreme Court of the Slovak Republic ruled that “*income accrued on the bank account of the taxpayer, with respect to which a legal title is not clear, may be considered other [taxable] income, unless the taxpayer proves otherwise*”¹⁸ and that “*the burden of proof is on the taxpayer*”¹⁹. It is possible that the Slovak Tax Authorities might also choose a similar approach with respect to other forms of income than monetary income.

Use of net worth method

The net worth method is not commonly used in the Slovak Republic, nor is it properly addressed in the available literature.

Art. 48 of the Slovak Act on Administration of Taxes No. 563/2009 Coll. as amended (the “**Tax Administration Act**”) indicates that the net worth method might be used as an “aid” (in Slovak: *pomôcka*). Nevertheless, the occasions when the tax office might use aids for the assessment of tax obligation of the taxpayer are limited. Under Art. 48(1) of the Tax Administration Act, the tax office might use aids for the assessment of tax obligation of the taxpayer if the taxpayer,

- “(a) does not file a tax return after a notice from the tax office;
- (b) does not fulfill an obligation imposed by a tax office to cure deficiencies in the tax return in an additional cure period and the tax office did not start the tax audit;
- (c) does not fulfill any of the statutory obligations when proving the factual declarations made in the tax return, as a result of which the tax may not be properly assessed; or
- (d) obstructs the tax office from performing the tax audit.”

This means that, although the tax office might use the net worth method in the event that the taxpayer does not file a tax return at all, if the taxpayer files a tax return where only incomes from legal sources are declared, the tax office must first prove the incompleteness of the tax return in a tax audit performed under Art. 46 of the Tax Administration Act.

Considering the fact that the net worth method comprises some steps that might be time and resource consuming, e.g. an expert opinion on the value of property acquired in the respective tax period, it might be expected that the tax authorities would be reluctant to implement this method if the probability of the successful correction of the tax obligation was low. There have been a multitude of occasions on which Slovak media indicated that, e.g. a particular politician could not possibly earn enough to acquire the said property, but without any tax/criminal consequences.²⁰

¹⁸ Supreme Court of the Slovak Republic decision No. 3 Sžf 6/2007 (Blašková c/a Tax Directorate of the Slovak Republic, as cited in Rumana (2013).

¹⁹ Ibid.

²⁰ E.g. Plus 7 Dní (2015), Nový Čas (2015) and Sme (2015).

Non-existence of provisions in law providing for automatic exoneration

As opposed to the US example, there are several institutes in Slovak law which provide quasi “safe harbours” for persons not paying tax on incomes from illegal sources.

Firstly, under Art. 3(2)(a) of the Income Tax Act, gifts are not subject to income tax in the Slovak Republic. This means that such income does not even have to be declared in the tax return. The incentive for the abolishment of the gift tax was the ambition to reduce the administrative burden of taxpayers and also the fact that the difference between the yields from this tax and the respective tax expenses was negligible in fiscal terms.

Without disputing the reasons for the abolishment of gift tax, this nevertheless enables taxpayers to claim that their increase in assets was due to a gift. They might even claim it was a gift of great value provided in the past beyond both tax and criminal statute of limitations. As the taxpayer is not obliged to hold any accounts or evidence of income from gifts, the burden of proof would likely shift to the tax office. As “*the subjectively perceived risk of detection does [exert a negative influence on the informal economy]*”²¹, the deterrence effect on tax evasion and informal economy in general would thus be lower in an environment where a taxpayer might have a relatively simple defense at hand if confronted with a tax audit.

This might be partially mitigated by the application of the Act on Restriction of Cash Payments No. 394/2012 Coll., which prohibits, under a penalty threat, cash payments exceeding EUR 5,000 (EUR 15,000 in the case of transaction between non-entrepreneur individuals). However, as the act is effective as of January 1, 2013, taxpayers can still claim for some time that the cash payment was a gift which occurred before January 1, 2013.

Further, Slovak criminal law provides for so-called “effective regret” (*in Slovak: účinná ľútosť*), under which an act ceases to be a criminal act once specific conditions are met. With respect to tax evasion, prior to January 1, 2013, the act ceased to be a criminal act if the person who committed the act voluntarily (i) cured the damage caused by the act, and (ii) notified the respective authorities, i.e. the police force or the state prosecutor.

This means that, once the tax authorities initiated the tax audit and found that the taxpayer committed tax evasion, the taxpayer could no longer claim the “effective regret” benefit and would have to face criminal proceedings.²²

As of January 1, 2013, due to an individual motion by a member of the Slovak Parliament (i.e. not due to a ministry/government proposal that would be subject to due consultation proceedings), the mechanism of “effective regret” with respect to tax evasion was changed. Currently, the taxpayer may claim the “effective regret” benefit until the day after he could acquaint himself with the outcome of criminal investigation. In practice this is the day after he was indicted by the prosecutor. The “effective regret” could not be claimed if in the previous twenty-four months the taxpayer was already penalized (i.e. convicted) for

²¹ Schneider (2014).

²² Refer to the Supreme Court of the Czech Republic cases 3 Tdo 1134/2011 and 8 Tdo 1452/2009 and the Constitutional Court of the Czech Republic case IV. ÚS 3093/08. Note that, although Czech court decisions are not binding on Slovak courts, due to the considerable similarity of laws of the Slovak and the Czech Republics, Czech court decisions are regularly cited by Slovak courts.

tax-related crime or if the “effective regret” was already claimed with respect to tax-related crime in the same period.

With respect to the Al Capone case, this means that if Al Capone paid all the back taxes at the moment he was indicted, the charges would have to be dropped due to the “effective regret” benefit.

The motivation for such an amendment declared by the legislator was to give priority to fiscal objectives before punishment and detention objectives. This motivation is at best disputable, as it gives a clear motivation to taxpayers not to duly report their taxes.

Firstly, as indicated below, it would have marred the one shot the authorities had at Al Capone.

Secondly, using *reductio ad absurdum*, if taxpayers were to cease to file tax returns on a mass basis, it would be virtually impossible for the tax authorities to assess the taxes of every taxpayer and for the criminal authorities to indict every taxpayer.²³ Considering that each and every one of these taxpayers could prevent his conviction, the criminal authorities would lack any real motivation to investigate and indict such crimes. The tax expenses connected with the assessments through “aids” would likely exceed the potential tax yields.

Finally, as there are no statistics available on the use of the new “effective regret” institute, the fiscal effects of the change are unknown.

V. Conclusion

Slovak law and the law of the USA share the same common principles with respect to the taxability of incomes from illegal sources, i.e. these incomes should in general be subject to tax in both jurisdictions. However, Slovak law and legal practice lack some aspects that are necessary for the effective taxation of incomes from illegal sources, in particular, the consistent application of the net worth method is absent in the Slovak Republic. Further, Slovak law provides several quasi “safe harbours” for taxpayers who do not declare income from illegal sources, namely the non-taxation of gifts and the “effective regret” institute with respect to the tax evasion crime.

In short, all of the abovementioned would result in Al Capone not being convicted of tax evasion in Slovakia, even if the factual circumstances were identical to the actual Al Capone case.

We believe that, based on the conclusions of this paper, amendments might be made to the Slovak tax and criminal laws (and potentially to the laws of other jurisdictions) which might help tackle the issue of incomes from illegal sources.

Firstly, it would be necessary to amend the criminal code and redefine the “effective regret” rules.

Secondly, an “opt-in” system might be considered with respect to gifts of material value, which would be exempt from tax only if the gift was declared in the tax return. This might

²³ As experimental evidence suggests, “increasing the penalty rate [and] the probability of audit [. . .] lead to higher compliance”. Blackwell (2009). It might then be reasonably assumed that the discussed “effective regret” will have a negative impact on the overall compliance rate in Slovakia.

provide the tax authorities with a chance to check the source of the gift and, potentially, apply corrections through the “substance over form” rule.

Finally, the net worth method could be used more extensively with respect to some classes of taxpayers (e.g. high government officials, judges, tax auditors) as an indicator of whether they have undeclared sources of income.

We also believe that, as the methodology of this case study is rather simple, similar studies in neighboring jurisdictions (the Czech Republic, Poland, and Hungary) might be performed and, eventually, follow-up policy/legislation adjustments might be carried out.

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