South Carolina Law Review

Volume 10 | Issue 4 Article 5

Summer 1958

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AVOIDANCE VS. EVASION OF INCOME TAXES*

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It has been facetiously suggested that the difference between avoidance and evasion of income tax is about five years in jail.

In a crude way, this illustrates a fundamental difference between avoidance and evasion, as the terms are generally used. One is legal and the other is a crime. "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."[1] On the other hand: "Any person who willfully attempts in any manner to evade or defeat any [internal revenue] tax . . . shall, in addition to other penalties provided by law, be guilty of a felony . . . ."[2]

A more sophisticated distinction between avoidance and evasion is beyond the scope of this paper.[3] It is sufficient for our purposes to recognize that both avoidance and evasion have common goals, the elimination or minimization of taxes, and that, particularly in periods of high taxes, there are pressures on the tax adviser to sanction or devise methods of reducing taxes by dubious avoidance schemes and, in some instances, by outright fraudulent acts.

An illustration of the latter was brought out during a discussion at the 1952 annual banquet of the *Tax Law Review*. The discussion centered on the ethical problems encountered by a number of leading tax practitioners.[4] A case was mentioned of a client who informed his tax advisor on January 10, 1952, that he would like to sell his boat to a friend. The sale would have resulted in a capital gain. The tax adviser discovered that the client had a capital loss carryover expiring in 1951 which would have offset the gain had the sale of the

*Adapted from a talk delivered at the Federal Tax Symposium, University of South Carolina Law School, on November 22, 1957.

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1. Gregory v. Helvering, 293 U. S. 465, 469 (1935).
2. INT. REV. CODE OF 1954, § 7201.
3. As the late Randolph E. Paul put it in his excellent article, *The Lawyer As a Tax Adviser*, 25 ROCKY MT. L. REV. 412 (June 1953) at footnote 6: "Long ago I gave up an over-ambitious attempt to distinguish the terms 'tax avoidance' and 'tax evasion'."
4. The discussion is reported at 8 TAX L. REV. 1 (Nov. 1952).

boat occurred in 1951. When advised of this, the client suggested that the document of sale be predated to December 28, 1951.

To predate a document under such circumstances is a fraudulent act. There are few who would disagree that an ethical tax practitioner would refuse to assist or take part in such conduct.

The same uniformity of feeling does not always exist, however, as to the role of the tax practitioner in presenting or disclosing facts to the Revenue Service.

For example, when advising how to allocate a lump-sum purchase price of a business among the machinery, inventory, and good-will acquired, is the tax practitioner justified in recommending that the purchaser allocate only a nominal amount to good-will even though it appears that good-will has more than a nominal value?

One of the panelists at the 1952 banquet of the *Tax Law Review* suggested that this would be a type of deception which bordered on an attempt to evade taxes, even though he suspected that it was often done by tax practitioners who would be horrified at the thought of predating a contract of sale.[5] Others felt that in such a situation it would be a disservice to the client not to exaggerate the allocation in the client's favor so as to counterbalance the tendency of some Internal Revenue personnel to exaggerate in favor of the Government.

On the question of disclosing facts, there were some who argued that full disclosure of all facts pertinent to an issue under consideration by the Internal Revenue Service, whether favorable or unfavorable to one's client, should be the duty of every tax practitioner. Most, however, agreed that full disclosure is not necessary, but that concealment of any requested facts or trickery is not ethical.[6]

In such areas of tax practice where there are differences of opinion as to the obligations of the tax practitioner, it is

5. Hellerstein, *Ethical Problems in Office Counselling*, 8 TAX L. REV. 4, 7 (Nov. 1952).

6. Seymour S. Mintz, in his article, *Negotiations and Settlements at the Administrative Level*, 1954 Tulane Tax Institute, p. 41, suggests that if the practitioner purports to give "the facts of the case" to Internal Revenue, as distinguished from "the facts upon which the taxpayer relies," he should set forth all the facts which are material to the determination, including those adverse to his client. On the other hand, Mr. Mintz points out that if the practitioner does not attempt to give the impression that he is presenting all material facts, he is under less of an obligation, both legally and morally, to present all the facts.

up to the attorney or accountant himself to determine his own code of conduct. It is helpful every now and then to pause long enough to reflect on how one's actions have conformed to what one thinks they should. In this connection, it is well to keep in mind that since tax practitioners have the same opponent case after case, *i. e.*, the Government, one's code of conduct soon becomes known to the opposition.

Leaving this brief excursion into the ethical problems of tax practitioners, let us concentrate on certain aspects of tax evasion. Because of the serious nature of a charge of criminal tax evasion and the importance of all stages of the investigation, including the initial and early contacts by Government agents with the suspected taxpayer, it is well for every tax practitioner to be familiar with the Government's right to obtain information, the constitutional limitations on such rights, and the advantages and disadvantages of co-operation.

The Government can obtain information concerning the affairs of a suspected taxpayer from several sources. The taxpayer, himself, through his statements and books and records may supply a good deal of material. Other persons employed by or who have dealt with the taxpayer, or who may have records concerning transactions with the taxpayer, are another source. Bank records and other corporate records often provide clues and information for the Government agent seeking facts.

Chapter 78 — Discovery of Liability and Enforcement of Title and, in particular, Subchapter A — Examination and Inspection (of the 1954 Internal Revenue Code) contain the statutory authority under which Revenue Service is empowered to examine books and records or other data which may be relevant or material to an inquiry for the purpose of ascertaining the correctness of any return, making a return where none has been made, and determining the liability of any person for any internal revenue tax or for collecting any such liability. In addition, Revenue Service personnel are authorized to take testimony under oath of both the taxpayers and third persons for the same purposes. The Government can issue a summons for the appearance of a person or the production of records which, if not obeyed, can be enforced by application to a district court or United States Commissioner, for a hear-

ing as to why the summoned person should not be punished for contempt.[7]

In the ordinary civil tax investigation, the Government has little need to rely on its investigatory powers to secure information. Unless the taxpayer cooperates, the Commissioner can assert deficiencies based on resolving doubts in favor of the revenue, thereby forcing the taxpayer to produce evidence to satisfy the burden of proof on the taxpayer. In a case involving the charge of tax evasion, however, the Government has the burden of proving the charge and is likely to invoke its full investigatory powers. Such powers are subject to certain constitutional limitations. The fourth amendment to the Federal Constitution guarantees the right of citizens against unreasonable searches and seizures and the Fifth Amendment can be invoked to prevent self-incrimination.

A general knowledge of these constitutional privileges is important for even those tax practitioners who handle only cases involving civil tax liabilities, for a fraud case often develops out of an ordinary civil tax investigation and may involve, even in the early stages, questions of constitutional privileges.

The Fourth Amendment contains two restrictions on investigatory powers which may be applicable. It may be used to resist the production of documents if the Government summons is lacking in reasonable specificity on the ground that judicial enforcement of the summons would be an unreasonable search. It can also be asserted to prevent the use by the Government of evidence obtained through subterfuge.

For example, in *Schwimmer v. United States*,[8] the Government was unsuccessful, because of lack of specificity, in its efforts to force production of all books accumulated by an attorney in a ten-year practice but was successful in enforcing a second subpoena which differed from the first in that the requested records pertained to only three named clients, who were the object of the inquiry. It should be noted that lack of specificity can be asserted by the taxpayer under investigation or by a third party. Banks and other third parties are often requested to supply documents. If the demand is not specific as to persons or, even though specific as to persons, is so general as to type of document that it imposes a heavy burden

7. INT. REV. CODE OF 1954, § 7604.
8. 232 F. 2d 855 (8th Cir. 1956), *cert. denied* 352 U. S. 833 (1956).

on the custodian, it may be possible to successfully resist enforcement of a subpoena.[9]

Evidence obtained by the Government through the use of force, fraud, stealth or trickery can be the subject of a motion by a taxpayer to exclude or suppress the evidence and to compel its return. To be successful, the taxpayer must also have a property interest in the premises searched or in the property seized. Thus, the taxpayer cannot suppress evidence obtained through unreasonable search from third persons where he has neither a property interest in the premises or in the evidence obtained.

The question of excluding evidence generally arises where the taxpayer has furnished evidence to the Government without realizing that it may be extremely damaging and without being warned that the evidence may be used in a criminal proceeding against him.

There appears to be no affirmative duty on the part of a government agent examining a taxpayer's return to inform the taxpayer that he may be or is under investigation for fraud or to remind him of his constitutional privileges.[10] On the other hand, complete misrepresentation of the status of the government agent as, for example, when the agent gained entry by posing as a refrigerator salesman,[11] will result in exclusion of the evidence obtained. There is a split of authority as to whether evidence can be suppressed which was obtained by an agent under the guise of a routine audit when in fact a fraud investigation is under way. The majority of cases hold that describing a fraud investigation as a routine audit by the agent will not affect the admissibility of the evidence but may be taken into account by the jury in weighing the credibility of the evidence.[12]

As long as there is no clear duty on the part of a government agent to inform the taxpayer if he is under investigation for fraud, the tax practitioner should be alert for any signs which indicate that the investigation might not be routine. If the practitioner is at all suspicious, he should ask the

9. *See* First National Bank of Mobile v. United States, 160 F. 2d 532 (5th Cir. 1947).
10. Scanlon v. United States, 223 F. 2d 382 (1st Cir. 1955).
11. United States v. Mitchneck, 2 F. Supp. 225 (D. C. Pa. 1933).
12. For a discussion of what the rule should be, see *Constitutional Aspects of Federal Tax Investigations*, 57 COLUM. L. REV. 676, 685 (May 1957).

agent sufficiently blunt questions (with witnesses present) so that if the agent does misrepresent the purpose of the audit, full advantage can be taken of the misrepresentation. It may not be sufficient misrepresentation to result in suppression of any evidence obtained from the taxpayer thereafter, but at least it will be a helpful point if the case goes to trial.

The fifth amendment to the Federal Constitution also limits the Government's power to secure information by establishing the privilege against self-incrimination. The defendant in a criminal tax proceeding may not be compelled to testify against himself. A witness other than the defendant may not refuse to appear and be sworn but may object to answering specific questions as self-incriminatory. However, a corporation cannot avail itself of the privilege against self-incrimination.[13] Even though the corporation may have but a single stockholder, he cannot refuse to turn over the corporate books and records for examination.[14]

There is at the present time some doubt as to whether the Fifth Amendment protects against the compulsory production of books and records of individuals and partnerships. In 1948, a sharply divided Supreme Court held[15] that the privilege against self-incrimination cannot be maintained in relation to records required to be kept by law. The records in this case, the *Shapiro* case, were required under the Emergency Price Control Act. Since the Internal Revenue Code requires the keeping of records for certain tax purposes, it can be argued that under the *Shapiro* decision, such records are no longer privileged. Such an argument has not yet been decided by the Supreme Court, but most tax commentaries take the view that the *Shapiro* decision should not be extended to the tax area.[16]

The constitutional privileges outlined above must be carefully considered by the tax practitioner in deciding how best to protect his client's interests. It must be kept in mind that anything voluntarily (and not as the result of subterfuge) disclosed can be used against the client should a criminal proceeding develop out of an investigation. It is important,

13. Hale v. Henkel, 201 U. S. 43 (1906).
14. Wilson v. United States, 221 U. S. 361 (1911).
15. Shapiro v. United States, 335 U. S. 1 (1948).
16. *See*, for example, *Constitutional Aspects of Federal Tax Investigations*, 57 COLUM. L. REV. 676, 698 (May 1957).

therefore, to know how to assert a constitutional privilege.

A taxpayer cannot merely ignore requests for information or he may find that he has violated section 7203 of the 1954 Internal Revenue Code which makes it a misdemeanor to willfully fail to supply information. If requested, he should appear at the agent's office with any books or records requested but should refuse to answer incriminating questions or turn over the books or records on the ground of self-incrimination. If the agent then has the taxpayer subpoenaed to appear before a district court, the taxpayer again must appear with any subpoenaed records but again he should refuse to answer incriminating questions or turn over the records. If he answers the questions or turns over the records, he will be deemed to have waived his privilege against self-incrimination insofar as the testimony or records are concerned.

A third person cannot refuse to turn over books and records in his possession pertaining to a taxpayer on the ground that they will incriminate the taxpayer. The privilege is purely personal. It is for this reason that an accountant is in a vulnerable position in a fraud investigation. He must, if served with a valid subpoena, turn over the taxpayer's books and records in his own possession and produce his own work papers.

The accountant's lack of privilege is undoubtedly one of the reasons why the statement of principles promulgated by the National Conference of Lawyers and Certified Public Accountants contains the following statement:[17]

> Criminal tax investigations. When a certified public accountant learns that his client is being specially investigated for possible violations of the Income Tax Law he should advise his client to seek the advice of a lawyer as to his legal and constitutional rights.

The accountant should also advise his client that communications between them are not privileged and that he (the accountant) can be forced to testify as to what was said by the client. Consideration should be given to returning to the client all books and records showing his transactions, since the client, but not the accountant, is in a position to protect them by exercising his constitutional rights. The accountant should understand, however, that until he is served with a

17. Published in A.B.A.J. 517 (July 1951).

valid summons, he is under no obligation to produce records or give any information concerning his client's business affairs.

The attorney-client relationship provides an exception to the rule that third persons can be forced to produce evidence pertaining to a taxpayer's affairs. This privilege extends to communications between a client and an attorney acting in his capacity as a lawyer provided strangers were not present and provided the privilege has not been waived by the client. A lawyer's secretary, telephone operator, associate, or law clerk would not be deemed a stranger to the attorney-client relationship. There have been some efforts to have an accountant excluded from the stranger category if he is employed by a lawyer to assist in a fraud case, but, at the present, it is not safe to have the accountant present during any conversations between the attorney and client about matters which they would not want the Government to obtain.[18] It should also be emphasized that the attorney-client privilege can only be invoked if the attorney is acting in his capacity as legal advisor. The attorney can be forced to testify with respect to actions taken in some other capacity, such as banker or accountant.[19]

Although the accountant-client relationship is not privileged, it is often necessary in a tax fraud case to assume some risk in order to obtain the valuable services an accountant may be able to play in preparing to defend a charge of tax evasion. The risk can be minimized by having the attorney act as a conduit or go-between to pass necessary information from the client to the accountant and by not permitting the accountant to have any records pertaining to the case, including his own work papers, in his possession.

Keeping in mind the privileges which can be asserted to block the Government's efforts to secure information in a tax fraud case, let us now turn to a decision which must be made in every such case — whether or not to cooperate with the Government's request for information.

This decision should be thoroughly considered as early as possible in a tax investigation for once information is voluntarily given to the Government it cannot later be withdrawn

18. *See* Barker, *The Accountant in Fraud Cases: A Thorough Picture of a Fast-Changing Field*, 6 J. TAXATION 20, 24 (Jan. 1957).
19. See Lourie and Cutler, *Lawyer's Engagement of Accountant in a Federal Tax Fraud Case*, 10 TAX L. REV. 227, 234 (Jan. 1955).

no matter how damaging it might be. Furthermore, the decision is of such critical importance that it should only be made after the attorney has had an opportunity to evaluate all available evidence and to advise his client as to the consequences of the various courses of action. If the attorney is called in while the investigation is under way, he should refuse to furnish any additional information or cooperate with the Government until he has satisfied himself that such action will be helpful to his client.

During the early stages of the investigation, before the government agents have made up their minds whether to recommend prosecution, cooperation may incline them to favor the taxpayer, while non-cooperation may tend to prejudice the taxpayer. However, this human factor should not be accorded as much weight as what cooperation itself is likely to reveal. If the attorney is satisfied that there is no real basis for a fraud charge, cooperation can be expected to lead the Government to a similar conclusion. On the other hand, if the evidence indicates that there was fraud, or possible fraud, cooperation may lead the Government to damaging material which it might not otherwise obtain.

It has been suggested that if the answer to the problem of whether to cooperate is not clear cut, the safer course is a policy of non-cooperation.[20] This would seem to be a particularly good suggestion to a general tax practitioner who has had little experience in weighing the various factors involved in the decision.

20. Boxleitner, *The Handling of Tax Fraud Cases: Practical Considerations* (Part 2), 2 PRACTICAL LAWYER 30, 39 (May 1956).