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MEMORANDUM FOR ASSISTANT COMMISSIONER (CRIMINAL INVESTIGATION)

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SUBJECT: Recent Case Law Analyzing 18 U.S.C. § 371

This memorandum provides analysis and review of two recent court decisions which examine 18 U.S.C. § 371, conspiracy to impede the Internal Revenue Service in the lawful collection of revenue.[1]

BACKGROUND

On September 21, 1991, a grand jury empaneled by the United States District Court for the Northern District of Florida, Pensacola Division, returned a 115 page, fifteen count indictment against fourteen defendants. Count I alleged a broad conspiracy to commit an offense against the United States in violation of 18 U.S.C. § 371.[2] The five objectives of the conspiracy were to impede the Internal Revenue Service (IRS); to defraud two privately owned banks; to commit mail and wire fraud in defrauding the banks; and, to transport fraudulently obtained loan proceeds interstate. The remaining fourteen counts alleged substantive violations of the same offenses and money

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[1] United States v. Adkinson, 135 F. 3d 1363 (11th Cir. 1998) (Adkinson I) and United States v. Adkinson, 158 F. 3d 1147 (11th Cir. 1998) (Adkinson II).

[2] 18 U.S.C. § 371 provides:

If two or more persons conspire to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each [shall be guilty of a crime].

laundering. The charges essentially arose out of a land development project in the Florida panhandle, where false statements and misrepresentations were made to procure large loan amounts which were then allegedly diverted by the defendants for their personal use.

At the time of trial, according to the controlling law of the circuit, the 18 U.S.C. § 371 conspiracy that the government intended to prove was not a crime in the jurisdiction.[3] Over the defendants' repeated objections, the district court allowed massive amounts of irrelevant evidence to be presented to the jury regarding the tax conspiracy. The defendants were subsequently convicted of conspiring to impede the IRS. On appeal, the court reversed the convictions, stating "[t]he circumstances underlying the trial of Count I were fundamentally unfair." United States v. Adkinson, 135 F. 3d 1363, 1374 (11th Cir. 1998) (Adkinson I). The court then directed further documentation on the sufficiency of the evidence to sustain the convictions obtained to permit retrial upon remand. Id. at 1380.

ANALYSIS

18 U.S.C. § 371
Conspiracy to Impede the Internal Revenue Service

A Section 371 conspiracy where the victim is the IRS and the objective is to defeat its lawful functioning is known as a "Klein conspiracy." United States v. Klein, 247 F. 2d 908 (2d Cir. 1957), cert. denied, 355 U.S. 924 (1958). Here, the government charged the defendants with a conspiracy to impede the IRS by concealing income from fraudulently obtained bank loans and by failing to file and filing false income tax returns. "While the alleged failure to properly report income can constitute the requisite act in furtherance of a Klein conspiracy, the government must still allege and prove there was an agreement whose purpose was to impede the IRS (the conspiracy), and that each defendant knowingly participated in that conspiracy." United States v. Pritchett, 908 F.

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[3] The then controlling law of the circuit required the United States to be the victim of a Section 371 conspiracy. United States v. Hope, 861 F. 2d 1574, 1577 (11th Cir. 1988) (Hope I); United States v. Hope, 901 F. 2d 1013, 1018 (11th Cir. 1990) (Hope II). The government described a conspiracy targeted at two private banks, not the United States. The government realized that when Count I was drafted, it failed to state an offense under the then prevailing law in the jurisdiction. Nevertheless, it was gambling that the circuit court would overrule Hope I and Hope II, due to the fact that it had recently agreed to hear en banc, United States v. Falcone, 934 F. 2d 1528 (11th Cir. 1991), where the court had expressed some doubts as to Hope I's continued vitality. Id. at 1539. This strategy failed, for when the government rested its case, Hope I was still the prevailing law in the jurisdiction.

2d 816, 821 (11th cir. 1990).[4] Because conspiracies are cloaked in secrecy, circumstantial evidence may be used to prove a conspiracy allegation. Glasser v. United States, 315 U.S. 60, 80, 62 S. Ct. 457, 86 L. Ed. 680 (1942). However, the government must show "circumstances from which a jury could infer beyond a reasonable doubt that there was a meeting of the minds to commit an unlawful act." United States v. Adkinson, 158 F. 3d 1147, 1154 (11th Cir. Oct. 1998) (Adkinson II) (quoting United States v. Parker, 839 F. 2d 1473, 1478 (11th Cir. 1988)).

A. The Agreement

An agreement between two or more parties to impede the IRS is the first element of a Klein conspiracy. In their analysis of this key element, the court, in Adkinson II, noted that the government failed to provide any direct evidence of an agreement between the defendants to evade income taxes. Not a single conversation between the defendants regarding taxes was introduced into evidence.[5] Forced to rely upon circumstantial evidence then, the government argued on appeal, that an agreement by the defendants to impede the IRS was demonstrated through the DGI corporate records showing that various payments to the defendants were not reported to the IRS.[6] Also, the defendants' tax returns failed to disclose this alleged income.

The failure to disclose income is, without more, generally insufficient to establish a Klein conspiracy. Klein at 916. When the government relies upon circumstantial evidence to establish a tax conspiracy, the circumstances must be such as to warrant a jury's finding that the alleged conspirators had some common design with unity of purpose to impede the IRS. Id. at 918. In Klein, the defendants participated in a massive scheme to import and sell whiskey in the United States with a common objective of minimizing the amount of United States income tax they would have to pay. This agreement was demonstrated in part by the filing of false income tax returns, however, it was further proved through other acts of concealment, false statements made by the defendants concerning their taxes and an overall broad scheme aimed at evading taxation. Id. at 915. In Adkinson II, the court, in weighing the government's circumstantial evidence,

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[4] See United States v. Krasovich, 819 F. 2d 253, 255 (9th Cir. 1987); United States v. Vogt, 910 F. 2d 1184, 1203 (4th Cir. 1990).

[5] In fact, in the government's brief, filed in response to the appellate court's request that it cite specifically to the record evidence supporting the tax conspiracy convictions, the IRS is referred to once in 68 pages of text. Moreover, the word "tax" is used a single time.

[6] The Development Group, Inc. (DGI) was the corporate vehicle through which Adkinson operated his real estate business.

stated “[t]his evidence...at most implies separate purposes to evade taxes; it does not support an inference that each alleged tax evader even knew of the other’s tax evasion, much less that they agreed to do so.” Adkinson II at 1155. In the court’s opinion, “[w]ithout some independent evidence that the defendants knew there was a tax conspiracy in progress and that they voluntarily and knowingly joined this conspiracy, the proof of the requisite agreement to impede the IRS is insufficient.” Id.

B. Intent to Impede the Internal Revenue Service

The next essential element of a Klein conspiracy is the requisite intent of the conspirators to impede the IRS. The government must show that the purpose of the agreement was to interfere with the lawful functions of the IRS in collecting taxes. United States v. Hernandez, 896 F. 2d 513 (11th Cir. 1990). Furthermore, this tax purpose must be the object of a Klein conspiracy, and not merely a foreseeable consequence of some other conspiratorial scheme. Dennis v. United States, 384 U.S. 855, 861, 86 S. Ct. 1840, 16 L. Ed. 2d 973 (1966). In the case at hand, the government at trial and in its appellate briefs argued that the purpose of the conspiracy was bank fraud. The government stressed that the victims in the case were Hill Financial and Vision Banc, the two private banks the defendants were accused of defrauding. Moreover, the government alleged that the scheme of the defendants was to obtain property by use of the victim’s money, which they would never have loaned to the defendants, had they known the true facts. In presenting this bank fraud scheme to the jury, any “tax related activities” of the defendants were referred to in the context of their efforts to conceal the money they had defrauded the banks out of and to conceal the diversion of this money in the form of loans. The false tax returns furthered the concealment of this diversion. The issue as framed by the court was “[i]f these tax related activities were merely part of the defendants’ efforts to conceal their income from another crime, can they also support the inference that the defendants intended to impede the IRS?” Adkinson II at 1156.

To aid in answering this question, the court turned to two prior cases where Klein conspiracies had been sustained, United States v. Browning, 723 F. 2d 1544 (11th Cir. 1984) and United States v. Enstam, 622 F. 2d 857 (5th Cir. 1980). Both cases involved defendants who had developed intricate money laundering schemes to funnel drug money to offshore banks which was then returned in the form of fictitious loans to sham Florida corporations operated by the defendants. The defendants argued that the purpose of their schemes was to conceal the source of illegal income, not to evade taxes. Browning at 1547; Enstam at 861-62. In discussing each case and why a Klein conspiracy had transpired, the court stated “we were able to find sufficient independent evidence of a tax purpose.” Adkinson II at 1156. This independent evidence came in the form of bogus business expense and interest deductions; undercover agent testimony as to the defendants repeated expressions of their fear of detection by the IRS; the defendants boasting of their foolproof “tax dodge” scheme; the defendants

offering advice to others as to how to evade taxes and one conspirator detailing how he attempted to bribe an IRS agent who was conducting an audit. Enstam at 862; Browning at 1547-48. This independent evidence of an intent to evade taxes permitted the jury to infer that the defendants had the 'complementary objectives' of laundering illegally obtained money in order to hide the true source of such income, and of impairing the IRS in its lawful functions. Id. at 1546. In each case, however, the court reserved the issue as to whether a tax conspiracy may exist, through the mere concealment of illegally obtained money, absent some form of independent evidence of a tax purpose.

In comparing the present case to Enstam and Browning, the court found that the government had failed to provide any similar independent evidence or proof that the defendants intended to impede the IRS. In fact, "the government has argued just the opposite, that the purpose of this conspiracy was to defraud the banks and divert the income, and that the 'tax related activities' of the defendants were an effort to conceal the illegal diversion of that income to themselves." Adkinson II at 1157. Finding no independent evidence of a tax conspiracy, the court next addressed the issue it had previously reserved in both Enstam and Browning: whether a tax conspiracy to impede the IRS can be inferred, strictly from efforts to conceal illegally obtained income?

For guidance, the court analyzed the case of United States v. Pritchett, 908 F. 2d 816 (11th Cir. 1990). There, the court vacated the convictions of two defendants who had been found guilty of conspiring to evade the income taxes of a drug dealer. The evidence demonstrated that the two defendants participated in concealing the drug dealer's
ownership of various assets which had been purchased with drug profits. In vacating the convictions, the court reasoned that there was no independent evidence of the two defendants' knowledge of the drug dealer's tax liability. Furthermore, and equally important, there was no independent evidence that the drug dealer was motivated to hide his illegal income and ownership interests in various assets in order to evade income taxes. The court stated "when efforts at concealment are reasonably explainable in terms other than a motivation to evade taxes, the government must offer proof that those who participated in the concealment intended to [impede the IRS] ." Pritchett at 821 (citing Ingram v. United States, 360 U.S. 672, 679, 79 S. Ct. 1314, 3 L. Ed. 2d 1503 (1959))(fact that professional gamblers hid their profits was insufficient to prove a Klein conspiracy because the illegality of their business standing alone was sufficient reason to conceal their incomes).[7]

[7] It should be noted that the defendants in Pritchett were charged with conspiring to evade the personal income taxes of the drug dealer, Joe Pritchett, in violation of 26 U.S.C. § 7201, not with a Klein conspiracy.

Interpreting the holdings in the three cases, the court now stated "[w]hether concealment alone can establish a tax purpose may depend upon the extent to which a tax purpose can be inferred from the nature of the scheme itself." Adkinson II at 1158. In Enstam and Browning, it was clearly evident that the elaborate design of the foreign and domestic corporations, functioning solely to receive and transfer money, coupled with the bogus business expense and interest deductions of the defendants, demonstrated a clear scheme of not only hiding the source of illegal income, but of evading taxes on that income. A money laundering scheme of this type would be sufficient to sustain a tax conspiracy conviction. Adkinson II at 1158. On the contrary, in Pritchett, the money laundering scheme was far less intricate and the tax connections were not extremely obvious. On facts such as these, we require "independent evidence of a shared intent" to evade taxes to sustain a Klein conspiracy conviction. Adkinson II at 1158 (quoting Pritchett at 822).[8]

Similarly, in the present case, the court found that the scheme itself did not support an inference of an intent to impede the IRS. The government had detailed a scheme devised by the defendants to defraud two private banks. The only "tax related activities" of the defendants, filing false income tax returns and reporting certain illegal payments as loans, occurred in concealing the diversion of the bank fraud proceeds. This was not a case then "where efforts at concealment would be reasonably explainable only in terms of motivation to evade taxation." Adkinson II at 1159 (quoting Ingram v. United States, 360 U.S. 672, 679 (1959)). Furthermore, the court found no independent evidence, direct or circumstantial, of an intent to impede the IRS. Absent substantial evidence of both an agreement and intent to impede the IRS "a conspiracy to conceal the source of illegally obtained money is not automatically a Klein conspiracy, even if it collaterally impedes the IRS in the collection of taxes." United States v. Vogt, 910 F. 2d 1184, 1202 (4th Cir. 1990). Accordingly, the defendants' convictions on Count I were reversed and not remanded for retrial.

CONCLUSION

Adkinson I and Adkinson II are valuable cases, for they provide a thorough examination of the manner in which the government should pursue a tax conspiracy charge arising out of a money laundering scheme. Outside of the First Circuit, the government must be able to establish independent evidence of the defendant's intention to impede the

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[8] But see United States v. Tarvers, where in the context of a money laundering scheme charged under a Klein conspiracy theory, the First Circuit has held that an agreement to launder money derived from drug trafficking is evidence of an act of impeding the IRS in the collection of taxes.

IRS in its lawful collection of revenue. The government may not rely on the mere filing of false income tax returns, where the main goal of the defendant is to conceal illegally obtained income. If the defendant can reasonably explain his efforts at concealment in terms other than a motivation to evade taxes, the government must show independent proof of an intent to impede the IRS. Failure to present some type of purpose or objective of the defendant to impede the IRS will subject a Klein conspiracy prosecution to vigorous attack.

cc: Assistant Regional Counsel (CT)

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