Learning From a Wrongful Criminal Tax Prosecution

by William Comiskey

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Introduction

This is the story of Dave Monsour, an upstate New York small business owner who — as the district attorney ultimately publicly acknowledged — was wrongly indicted for tax crimes he never committed. It is a story that has lessons for everyone concerned about how state criminal tax laws are being administered as states aggressively mine for additional revenue and increased compliance. Law enforcement officers and managers should study the case to avoid repeating the mistakes that led to Monsour's wrongful indictment. Tax practitioners should look at the case for strategies to protect their clients and for clues in understanding how some criminal tax investigators work and how to deal with them. And finally, the case should put every small business owner and business organization on high alert. If this can happen to Monsour, a man who tried to do everything right, it could happen to anyone.

Criminal Tax Investigations in New York

First, some context is in order.

Criminal tax enforcement in New York has skyrocketed since 2007. As part of a strategic plan to increase compliance and to close New York's enormous tax gap, the Department of Taxation and Finance determined in 2007 to more aggressively use its criminal enforcement powers to crack down on tax fraud.[1] As a direct result of this new enforcement initiative, the number of criminal investigations opened by the department between 2007 and 2010 jumped 1,000 percent and the number of criminal tax fraud arrests increased by a similar percentage. According to the department's press releases, the department's commitment toward increased criminal enforcement has continued since 2010 under the administration of Gov. Andrew Cuomo (D).

But New York was not content to merely increase its enforcement presence. The state also overhauled its criminal tax code in 2009 to replace poorly drafted and ineffective criminal laws with strong statutes that clearly defined criminal tax fraud to cover virtually every type of deliberate deception that a taxpayer, or a taxpayer's representative, employee, or witness, could use to evade state or local tax obligations. Those laws also substantially increased the criminal penalties for tax fraud, elevating the felony level for serious cases of tax fraud and raising the risk that those charged might well face prison sentences.[2]

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Armed with those new laws and the department's new commitment to criminal tax enforcement, the

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[1]The department's 2007 enforcement strategic plan can be found in the department's "2006-2007 Annual Report to the Governor," *available at* http://www.tax.ny.gov/pdf/taxnews/2007_ann_rep.pdf.

[2]For a detailed analysis of the new laws, which primarily revamped article 37 of the Tax Law, see Comiskey, "New Criminal Tax Laws — Taking Aim at Tax Evaders," *New York State Bar Association Journal*, Vol. 81, No. 9, Nov.-Dec. 2009.

department's criminal investigators began to use their sweeping criminal enforcement powers to investigate and prosecute tax fraud. It might surprise some to learn that the department's criminal investigators possess traditional police powers.[3] More surprisingly, they have some powers that even the police don't have. Like traditional police investigators, the department's investigators conduct undercover investigations, seek and execute search warrants, refer cases to prosecutors, and summarily make felony and misdemeanor arrests. Also, and unlike traditional police, they can issue subpoenas to compel the production of documents and testimony from witnesses and even targets. Although New York's district attorneys can issue grand jury subpoenas, even they lack the power to issue office subpoenas — a power that the New York tax department uses "regularly," as recently noted by New York Tax Commissioner Thomas Mattox.[4] Finally, the department's auditors and investigators have a statute that is the envy of police officers throughout the state — they have the power to arrest individuals who willfully lie to them during an investigation or audit.[5]

Given this dramatic shift toward aggressive criminal tax enforcement, the department issued criminal prosecution guidelines that spelled out the factors that department personnel are required to consider when determining whether to investigate or pursue criminal state tax fraud cases.[6] Those guidelines recognize the gravity of the decision to pursue criminal sanctions for tax violations and sensibly note that the pursuit of a criminal tax case is "a significant step with likely adverse consequences to the subject of the action." Investigators are instructed to consider — before they initiate a criminal case — the nature and seriousness of the misconduct, the putative defendant's history of tax offenses, and whether the taxpayer has been cooperative and has accepted responsibility for his actions. Moreover, as a fundamental part of their analysis, investigators are required to carefully evaluate the strength and "quality of the proof of the crime, particularly the intent elements and the resources required to pursue the case to establish those elements." As the guidelines recognize, "unless the misconduct can be proven to have occurred beyond a reasonable doubt, the case cannot be prosecuted."

Those guidelines formally articulate important safeguards that are designed to ensure that only guilty taxpayers who deserve to be criminally prosecuted will become defendants in a tax fraud case. They require investigators to conduct a careful review of the evidence and, to the extent that they require evaluation of the taxpayer's remorse and acceptance of responsibility, they obviously anticipate that the taxpayer will have an opportunity to be heard before a criminal prosecution is launched.

It is a mystery how Monsour was ever indicted given the requirements of those guidelines, especially given that the department's criminal enforcement personnel are overwhelmingly dedicated professionals who know how to conduct tax fraud investigations and who traditionally conduct thorough and meticulous investigations.

Monsour's Indictment and Arrest

The nightmare began for Monsour when he received a phone call from a state police trooper on the morning of November 18, 2011.

The trooper told Monsour that a Warren County grand jury had indicted Monsour on felony tax fraud charges and that he had a warrant for Monsour's arrest. The trooper gave Monsour a choice — come to the station and surrender in the next 30 minutes or the police would be out to arrest him. Knowing that his returns had been scrupulously prepared and filed by his CPA, Monsour initially thought the caller was a prankster. He learned quickly, however, that the call was no joke and that he was about to begin the worst ordeal of his life.

Monsour surrendered and was arrested that day. He was arraigned on a sealed six-count felony indictment that charged him with filing false income tax returns for the years 2006 to 2009 and was informed that he faced as much as seven years in state prison.

Shortly after his arraignment, Monsour was shocked to learn that the tax department's criminal auditors had informed the grand jury that they had examined his bank accounts and his income tax returns and had concluded that Monsour had earned $1,079,073 between 2006 and 2009 that he had not reported on his returns. He came home from his arraignment to find that the local newspaper had written a headline that screamed "Local Business Owners Accused of Tax Fraud."[7] Even worse, the

[3]*See* New York Criminal Procedure Law sections 1.20(q) (defining police officers in New York to include some tax department investigators in their enforcement of the Tax Law) and Criminal Procedure Law section 2.10(4) (vesting peace officer status on the department's investigators).

[4]*See* the commissioner's comments in a June 17, 2011, press release announcing, "Orange County Man Faces Jail for Failure to Obey Subpoena in Tax Case." The release can be found on the department's website at http://www.tax.ny.gov/press/rel/2011/devarti061711.htm.

[5]Tax Law section 1801(3).

[6]The guidelines can be found at http://www.tax.ny.gov/pdf/enforcement/siu_guidelines.pdf.

[7]*Glens Falls Post Star*, Nov. 11, 2011, p. B1. Monsour's arrest was reported in an article that also reported the arrest of another businessman for sales tax fraud.

article named his businesses and mistakenly reported that Monsour had been charged with stealing sales tax dollars that he had collected from his customers. Even the district attorney repeated that mistake when she was quoted as saying that Monsour's case was "the first sales tax case her office had been asked to prosecute."

One problem with this news report was that Monsour had not been indicted for sales tax offenses; he was charged with underreporting his personal income. Although both crimes are serious, stealing the sales tax dollars that customers pay over is on a different order of magnitude from merely underreporting income. Customers react badly when they think that you are stealing their money, and it was no different here. In the months following this article, Monsour's business plummeted and irate customers repeatedly and loudly complained to Monsour and his employees that they were never going to do business again with such a "tax cheat."

A 'Secret' Investigation

Monsour was blindsided by his indictment. Only a few years earlier, his businesses had been the subject of a sales tax audit that concluded in 2007 with no changes and no findings against him. As the sales tax auditors found when they conducted this 2007 audit, Monsour's operation was completely legitimate. All his earnings, transactions, and payments were meticulously and dutifully recorded in his books and records. His records were prepared and reviewed by his bookkeeper and shared with his accountant, an experienced CPA, who used the records to prepare Monsour's personal and business tax returns. Under his accountant's watchful eye, Monsour recorded and reported every penny he earned. Everything was transparent. Every payment he received from his businesses was in a check he signed, made payable to himself, and deposited into his own accounts. There were no hidden cash transactions or payments. Everything was aboveboard.

Before his indictment, Monsour had no idea that anyone from the department was investigating or auditing his personal or business income tax returns. No one told him he was under audit, let alone that he was being criminally investigated by the department or the district attorney, and he was never advised that the grand jury was hearing evidence against him. No one spoke to his accountant about the returns he prepared, signed, and filed for Monsour, nor did anyone speak with Monsour's bookkeeper. Even more surprising, no one even looked — or tried to look — at his books and records. The entire income tax criminal investigation was a secret.

'Friendly' Conversation With the Department's Investigators

Monsour did, however, have an unusual encounter with two tax department criminal investigators and an auditor in March 2011, eight months before he was indicted.

The investigators showed up at his store unannounced and spoke with Monsour and with Monsour's accountant on the telephone and represented that they were doing a random retail store visit. To gain Monsour's trust and the trust of his accountant, the investigators told Monsour that they were just "getting general information about the business and not inquiring about specific sales figures."[8] Monsour, who had a fair number of law enforcement customers and no prior experience with criminal investigations or investigators, was left with the impression that they were gathering background information relevant to sales tax compliance by retailers. He cooperated with the investigators, answered their questions during their hour-long meeting, and was not threatened by the encounter, which he viewed as unusual but "friendly." He freely told the investigators how his businesses operated, what banks he used, and how he maintained records and handled payroll. Neither he nor his accountant made any incriminating admissions — there was nothing to admit — and he did his best to be helpful.

In truth, the investigators were there to build a criminal income tax case. Months earlier — in October 2010 — they had issued subpoenas to the banks that Monsour used and their report recited that they were meeting with Monsour "to interview [him] regarding a possible false filing case."[9] They did not, however, ever tell Monsour or his accountant their true purpose. Nor did they disclose that they were investigating whether Monsour had filed

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[8]Quoted from the investigator's report describing this interview.

[9]Neither the banks nor the department notified Monsour that his records had been subpoenaed. In New York, prosecutors and law enforcement agencies frequently ask third parties not to notify the subject of a subpoena in a criminal investigation, stressing to the third party that disclosure could compromise the ongoing investigation. Although some prosecutors can make that request seem like a command, unless a court has ordered nondisclosure, subpoenaed third parties are generally free to tell their customers that they have received a subpoena. Most do not.

false income tax returns. Indeed, they never asked a question regarding the contents of any of those returns or gave Monsour any indication that they thought any entry on any return was questionable.

Criminal tax investigators in New York do not have to play by the rules that govern civil tax audits and collections regarding notice and taxpayer rights during interviews.

The way this surprise field interview was conducted provides an instructive example of a criminal investigative strategy that tax practitioners (and taxpayers) should know about. Criminal tax investigators in New York are not bound by the taxpayers' bill of rights that is codified in article 41 of the New York Tax Law. They do not have to play by the rules that govern civil tax audits and collections regarding notice and taxpayer rights during interviews.[10] To the contrary, as all criminal defense attorneys and seasoned criminals know well — criminal investigators are not even required to tell the truth to their targets during their investigations. Our courts have repeatedly upheld investigations in which investigators directly lied, as long as their lies did not entice the defendant to make false admissions. Here, the investigators misrepresented what they were doing and what they were looking at but they were not acting illegally when they adopted that tactic.

Significantly, before the meeting ended, Monsour's accountant offered to meet again with the investigators to give them any additional information that they might want in the future, and Monsour provided the investigators with his bookkeeper's name and telephone number as well. The investigators, however, never followed up with either the accountant or the bookkeeper and Monsour heard nothing more from the tax department until he was arrested eight months later.

What the Department Would Have Learned If It Had Performed a Real Audit

Criminal tax prosecutions based on net worth or bank deposit methods are always difficult and are notoriously subject to unusual or complicated defenses. The cases almost beg for explanations from the taxpayer regarding the source of their assets or money received. In this case, however, the department's investigators did not look for answers or evidence from key witnesses who would have been in a position to help build the case or to contradict it.

That the investigators never followed up with Monsour's accountant was especially surprising. That accountant prepared and signed Monsour's federal and state personal and business tax returns, and he vigorously vouched for their accuracy. He prepared those returns after examining Monsour's meticulous books and records, which were maintained by Monsour's bookkeeper, another key witness whom the department chose not to interview. The accountant and bookkeeper communicated regularly, and the accountant had an active role in helping Monsour structure his businesses and set up his books and records.

The investigators never asked to examine Monsour's books and records before asking a grand jury to indict him for felony tax fraud. Even more perplexing, they did not obtain or examine Monsour's federal income tax returns, which contained information that negated some of their theories of fraud, nor did they conduct a focused interview of Monsour to ask key questions that would have revealed whether he had unreported taxable income and whether he knowingly failed to include that additional income in his filed tax returns.

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So what did the department rely on to establish that Monsour knowingly and fraudulently filed false tax returns that underreported his income by $1 million?

In the months that followed Monsour's indictment, it became clear that the department's "finding" that Monsour had more than $1 million in "additional audit income" — a finding that was apparently presented under oath to the grand jury and that led to his indictment — was based exclusively on a purported "audit" that consisted of nothing more than adding up the money deposited into Monsour's personal and business bank accounts and then treating all that money as income without conducting any analysis of the source of the money deposited. If money was deposited into one of Monsour's accounts, the department's auditors treated it as taxable income. That, in total, was their case.

But every tax practitioner (and, I would suggest virtually every taxpayer) knows that not all money received by a taxpayer is taxable income. Because no analysis was conducted as to the source of the deposits, the department's investigators made unbelievable mistakes.

[10]Tax Law section 3006(d).

Consider, for example, that the following deposits were included in their calculation of additional "audited income":

- *mortgage loan proceeds* received by Monsour in connection with a mortgage on a new home he built and lived in;
- *proceeds received when he sold his prior residence* that were not taxable because his gain was less than $250,000 and because he met the tests set forth in IRS publication 523;
- *gross receipts (as opposed to net gain)* Monsour received in connection with the sale of some real estate that he had purchased and improved with two other individuals. Monsour reported those transactions on his federal income tax returns and spelled out on those returns the gross receipts, expenses, and net gain he had earned in connection with those real estate transactions. He reported the net gain on his state returns and paid tax on that gain. Because the department's investigators never obtained or examined his federal returns before his indictment, they mistakenly included every dollar Monsour deposited into his bank accounts for those transactions in their calculation of unreported taxable income without giving him any credit for the expenses he had incurred and reported;
- *reimbursements for expenses he owed or paid* that he received from the individuals who were his partners in purchasing and improving real estate;
- *money transferred by Monsour from one account to another* was included as taxable income when it was deposited into the second account. Some deposits were, apparently, wrongly counted as taxable income twice; and
- *nontaxable shareholder distributions* from his capital account in his subchapter S corporation, made in checks signed by Monsour and deposited directly into his personal account, that were fully reported on his federal income tax returns that the investigators, as noted, never reviewed.

The Exoneration

When those numbers were removed from the department's findings, all that was left was a minor (disputed) tax liability that clearly did not support a criminal prosecution, as the district attorney acknowledged. It is no wonder that the district attorney described the audit as "inaccurate" when she dismissed the case with a public declaration that no tax crime had been committed.

But more than the audit was flawed. The grand jury proceedings and the entire investigation were inadequate. Although the district attorney's staff commendably considered the evidence presented by Monsour after he was indicted and correctly came to the conclusion that "the charges against Mr. Monsour were based on an inaccurate calculation of unreported income and that proof of criminal intent [was] lacking,"[11] the analysis that brought the district attorney to that conclusion was one that should have been done before Monsour was charged. All the evidence that Monsour provided to the district attorney and the department should have been obtained by the prosecution before indictment and before arrest. It was all there and could have been had for the asking.

Lessons to Be Learned

It was a mistake to conduct this investigation in secret.

It is highly unusual for prosecutors to pursue tax fraud charges against a local, established business through a secret grand jury investigation that culminates, as this one did, in a sealed indictment. That process is more typically used to investigate members of organized crime, violent offenders, drug dealers, and similar major criminals who present a flight risk or when law enforcement fears that evidence or witnesses might be lost if the defendants were to know of the investigation. In my experience, in nearly all criminal tax prosecutions the prospective defendant becomes aware at some point that an investigation is underway either because the defendant had been under a civil audit (before the case was referred for a criminal investigation) or because investigators used an investigative tool, such as a search warrant, subpoena, witness interview, or interview of the target to gather evidence. Indeed, the department's guidelines require that the taxpayers under civil audit be notified if their case is transferred to the department's criminal division.

There are good reasons why criminal tax investigations are not generally conducted in secret. There are obvious risks when white-collar cases are investigated in total secrecy and no information is sought directly from the target of the investigation or from the target's agents, employees, or witnesses before the indictment is returned. Prosecutors will see only one side of the case before they initiate charges, and the chances that they might bring a wrongful prosecution will increase exponentially as a result. So too, when prosecutors move forward without completion of the basic steps of an investigation, they lose valuable opportunities to make their cases better by uncovering evidence of criminal intent and

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[11] "Tax Fraud Charges against Queensbury Businessman Dropped," *The Post Star*, Apr. 5, 2012, *available at* http://poststar.com/news/local/tax-fraud-charges-against-queensbury-businessman-dropped/article_392884c4-7f66-11e1-8c0d-001a4bcf887a.html.

knowledge through direct interviews of critical witnesses, the examination of the defendant's business records, and directed interrogations of the target of the investigation.

Acting prematurely also ends law enforcement's best opportunity to hear from the prospective defendant. For law enforcement, only good things can happen when a prospective defendent is confronted with specific allegations before filing charges. In the best case scenario, the taxpayer will make admissions that will help the prosecution. Alternatively, the defendant might lie and offer demonstrably false exculpatory explanations that the investigators can refute. Those false statements are often powerful evidence of criminal intent. Even if the taxpayer's starements don't amount to false exculpatory statements, they may provide insight and limit the defenses the taxpayer can raise at trial. Prosecutions brought against defendents who are locked into a theory are often easier that those brought against moving targets. Finally, the taxpayers might even present compelling evidence of his innocence sufficient to persuade law enforcement not to bring the case . That too is a win for law enforcement that both achieves justice and avoids embarrassment.

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In short, there is no downside when tax investigators conduct substantive and focused interviews with defendents. The interview can be conducted informally or formally and, in some circumstances, it makes sense to do both. In New York, before a case is referred to a prosecutor, the department has the power to subpoena the taxpayer to answer questions about the suspected misconduct. Of course, the taxpayer might refuse to answer on self-incrimination grounds, but in actuality, a surprising number of taxpayers respond to those subpoenas to answer questions, and those depositions regularly produce useful evidence. Once the department initiates a criminal prosecution or refers the case to a prosecutor, the department's authority to issue subpoenas ends. Moreover, once a taxpayer is indicted, the taxpayer cannot be interviewed, at least in New York, without the presence or consent of his attorney, so the chances that an interview will take place become more remote. The opportunity to gather admissions or false exculpatory statements from the target will have been lost forever.

Investigators can find "smoking gun" evidence only if they actually gather and examine records. They can get useful statements only if they interrogate a suspect and focus on the matters under investigation. They will learn what critical witnesses have to say only if they actually talk to those witnesses.

Conversely, investigators can learn if they are pursuing an innocent target only if they actually conduct an investigation. Given the stakes involved, investigators, like prosecutors, have an ethical responsibility to exercise due diligence to be sure that they are wielding their powers correctly and fairly. When investigators proceed by the book they do not act until they have taken the fundamental steps necessary to complete their investigation — steps that include, obviously, gathering relevant documents, interviewing key witnesses, and confronting the target. In fact, those steps are essentially required by the department's own guidelines.

None of those fundamental investigative steps was taken in this case. No one has explained why they were not, but what is clear now is that a hardworking, decent man would not have been wrongly indicted if the investigation had proceeded by the book.

It was almost as though the prosecution believed that once the department demonstrated that Monsour had received the money deposited into his accounts, the burden had somehow shifted to Monsour to prove that the receipts were not taxable income. That approach might have applicability in a civil tax audit, but it has no place in a criminal prosecution. In a criminal case, it is always the people's burden to prove every element of the offense, whether before the grand jury or at trial, and in this case the people had to show that Monsour knowingly and fraudulently filed a false return that misrepresented his income. Showing that he had received money without also showing that the money received was taxable income was not enough, and the prosecution would have known that mistake if Monsour had been alerted to the investigation before he was indicted.

There are also lessons for taxpayers and practitioners. When a taxpayer is approached by a criminal auditor or investigator, everyone should go on high alert. Investigators do not have to tell the truth, and in building their cases, often misrepresent what they are doing and what they are examining. Although Monsour's interview luckily produced no damaging evidence, the fact of the matter is that everything anyone says to a criminal investigator is "on the record" and may well provide the prosecution with evidence to later use against the taxpayer. The safest path, even for the most innocent and honest taxpayer, is to avoid talking to criminal investigators when they show up unannounced. In those circumstances, taxpayers should tell the investigators they would be happy to speak with them but that they want to speak with their attorney first. For many honest people — people who believe that they have "nothing to hide"

— that approach goes against the grain, but that is nonetheless the best path any careful taxpayer should follow.

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Second, looking at this matter with the benefit of hindsight, things might have turned out differently if Monsour's accountant (or better, an attorney with criminal experience acting on Monsour's behalf) reached out to the department in the months following the office interview to ask whether anything was going on. That type of inquiry might have opened a line of communication that could have worked in Monsour's favor. Of course, those approaches have their own risks, but taking that path here should have been seriously considered.

Conclusion

This wrongful prosecution — of a hardworking, decent businessman with no prior criminal record and no history of tax noncompliance — would never have been initiated if the department's investigators had adhered to their own guidelines. I hope that now the department makes clear to its investigators that adherence to the general principles articulated in the guidelines is the department's strong and expected criminal enforcement policy.

But even more can be done. The department should consider strengthening the guidelines to add specificity to its general principles. The guidelines should spell out the steps that criminal investigators should pursue in common tax fraud cases before a prosecution is initiated. Unless management agrees that there are compelling investigative reasons in a case that would support taking a different investigative path (when, for example, the target might flee, records might be destroyed, or witnesses tampered with), the guidelines should require, at a minimum, that before tax fraud charges can be initiated in a particular case, the department's tax fraud investigators should:

- obtain and examine the target's relevant business records through whatever means necessary, including a request, subpoena, or search warrant;
- interview key witnesses, including the target's accountant, and others with knowledge of the facts relevant to alleged misconduct;
- obtain and examine the target's relevant federal tax returns;
- confer with the department's subject matter experts in the audit division to ensure that the audit methods used by the criminal investigators were adequate and thorough and that their audit conclusions are sound;
- confer with seasoned investigative tax counsel experienced in prosecuting tax cases; and most importantly,
- inform the target of the allegations and provide the target with an opportunity to address them and present evidence.

With clear guidance from management and comprehensive oversight of criminal enforcement staff, the department should be able to continue its laudable commitment toward increased criminal enforcement of the Tax Law while ensuring that only those who are, in fact, guilty and who deserve to be criminally prosecuted ever face arrest.