Company's Tangled M&A Records Convict Shareholder of Obstructing the IRS

By Donald P. Board • Wood LLP

In December 2017, the Supreme Court heard arguments in *C.J. Marinello* [No. 16-1144], a widely reported tax-obstruction case. A decision is expected later in 2018. The central issue in *Marinello* is the proper scope of criminal liability under the "omnibus clause" of Code Sec. 7212(a). This broadly phrased clause declares that any person who "in any … way corruptly … obstructs or impedes, or endeavors to obstruct or impede, the due administration of [Title 26]" is guilty of a felony punishable by up to three years in prison.

Marinello raises some interesting issues of statutory construction. Chief among them is whether Code Sec. 7212(a) should be construed narrowly to avoid disrupting the "hierarchy of tax crimes" supposedly established by other provisions of the Code. Another important question is how the requirement that the obstructer act "corruptly" relates to the "willfulness" standard that typically applies in criminal cases.

Several *amici curiae* have raised more general policy concerns. The American College of Tax Counsel, for example, has urged the Court to rein in Code Sec. 7212(a). Otherwise, it warns, taxpayers and their advisors—including Fellows of the College—will face felony charges "at a prosecutor's whim" when they are really just engaged in traditional tax planning. [Brief of the American College of Tax Counsel as *Amicus Curiae* in Support of Petitioner, 9.]

On the Paths to Obstruction

We will have to wait to see what the Supreme Court will make of these questions. In the meantime, we can compare two very different ways that taxpayers can use business records to obstruct or impede the IRS's administration of the tax law. The first, on display in *Marinello*, is the regular use a shredding machine and cash transactions to eliminate all traces of what was going on in the taxpayer's business.

The second technique is illustrated by the Tenth Circuit's recent decision in *N.W. Drage* [CA-10, 119 AFTR2d 2017-1055]. In *Drage*, the owners of a reverse-merger business created a mare's nest of entities, nominees, and brokerage and bank accounts. They then engaged in an enormous number of transfers of shares and sales proceeds among the various accounts.

Faced with a mountain of records, a large team of IRS agents found it difficult, if not impossible, to determine how much taxable income the owners or the corporation had derived from an estimated $30 million in stock transactions. The eponymous Mr. Drage was convicted of violating 18 USC §371, which makes it a felony to "conspire … to defraud the United States, or any agency thereof in any manner or for any purpose," so long one of the conspirators performs at least one overt act in furtherance of the conspiracy.

Marinello: If It Moves, Shred It

Carlo J. Marinello II owned and operated a corporate freight-courier service in Buffalo, New York. Between 1992 and 2010, neither Mr. Marinello nor his corporation filed any federal income tax returns. As if that were not bad enough, Mr. Marinello made it his practice to shred or discard nearly all records relating to the business.

When the IRS finally came knocking, the records cupboard was bare. As a result of Mr. Marinello's leave-no-trace ethos, there were no bank statements, employee work statements, gas receipts, or bills for the IRS to review. Employees—including Mr. Marinello—were paid in cash, without withholding. The corporation never issued Forms W-2 or 1099.

The IRS estimated that, toward the end, Mr. Marinello's corporation had enjoyed gross receipts of between $200,000 and $445,000 per year. But what that meant in terms of taxable income was anybody's guess. This seems to have been exactly what Mr. Marinello was counting on.

Mr. Marinello was convicted under Code Sec. 7203 of eight counts of willful failure to file personal and corporate tax returns during 2005–2008. Willful failure to file is a misdemeanor, although it can be punished by up to a year's imprisonment. Mr. Marinello is not seeking review of his convictions on the tax-return counts.

Mr. Marinello was also convicted under Code Sec. 7212(a) of corruptly obstructing the due administration of Title 26 during the years in question. In his case before the Supreme Court, Mr. Marinello has argued he cannot be guilty of corruptly obstructing the IRS based on his actions or omissions *before* he learned that there was a pending IRS investigation.

Mr. Marinello did not learn that he was being investigated until the IRS interviewed him on June 1, 2009. In the wake of that meeting, Mr. Marinello adopted more conventional record-retention practices. Mr. Marinello and the *amici* want the Supreme Court to make it clear that his 18 years of shredding *before* the interview lie beyond the reach of Code Sec. 7212(a).

Drage: If It Moves, Move It Again

Far removed from Marinello's shredding, Nathan Drage and two colleagues (the "associates") engaged for many years in a reverse merger business. The associates would first obtain a controlling interest in a publicly traded "shell" corporation, *i.e.*, a company with minimal assets and liabilities and no actual operations. This was a valuable commodity because merging into a publicly traded shell is an easy way for a privately held company to "go public" without having to do an IPO.

The associates kept a low profile. When they got control of a publicly traded shell, they would install nominees—often relatives—to serve as the corporation's officers and directors. The nominees had no function other than to sign whatever documents the associates chose to put in front of them.

Mr. Drage, who practiced law in Salt Lake City, prepared the documents necessary to transfer stock in the shell companies to individual nominees and entities controlled by the associates. Privately held companies were then merged into the shell companies, with the nominees becoming stockholders in the post-merger company.

Once shares had been issued, a shell game began. Using documentation prepared by Mr. Drage, shares in the post-merger companies held by nominees were transferred to multiple brokerage accounts controlled by the associates. One associate controlled 11 accounts, which were managed by four different brokerage firms. His name was listed on only two of these accounts, although he had authority over all 11.

Mr. Drage was not far behind. He had authority over six accounts with three brokerage firms. Only one was in his name. Twelve additional brokerage accounts were controlled by family members, many of whom also served as nominees in the reverse-merger business.

Shares in the brokerage accounts were eventually converted into cash in a complex series of transactions. The cash was then moved around on a variety of pretexts on its way to bank accounts owned or controlled by the associates. An IRS special agent testified that, between 1999 and 2006, the associates directed 1,029 separate bank account transfers involving stock sale proceeds.

About $5.5 million of the cash that ended up in the associates' accounts was used to pay their rather luxurious personal expenses. Mr. Drage's share of the take came to $1.7 million. The associates were living large, but neither the corporation nor Mr. Drage filed any income tax returns.

Unlike Mr. Marinello and Oswald, Mr. Drage did *not* act alone. Because of his involvement with the associates, Mr. Drage could be charged with conspiring to obstruct the IRS. This was poor planning on his part because tax cheats have been notably unsuccessful in their attempts to challenge 18 USC §371 on constitutional or statutory grounds.

The anti-conspiracy statute was first enacted in 1867. It became a regular part of criminal tax prosecution 60 years ago, when the Second Circuit held that a conspiracy to "impede or obstruct" the IRS qualified as a conspiracy to "defraud" the United States within the meaning 18 USC §371. [*See H.H. Klein*, CA-2, 57-2 USTC ¶9912, 247 F2d 908, *cert. denied*, SCt, 355 US 924 78 SCt 365.] Mr. Drage was convicted of participating in one of these "*Klein* conspiracies."

Concluding Observation

The "obstruct-or-impede" standard, which has drawn so much attention to *Marinello*, is admittedly broad. But it is hardly a novelty. Thanks to *Klein*, taxpayers have been living with it for decades in the form of 18 USC §371. Despite the fact that a conspiracy conviction can lead to *five* years in prison, it appears that most taxpayers have still been managing to sleep at night.

Taxpayers charged with *conspiring* to impede or obstruct the IRS have never been able to avoid prosecution because they were not aware of a pending investigation. Given the obvious overlap of the *Klein* formula with the "obstruct or impede" language of Code Sec. 7212(a), the Supreme Court may think twice before it reads such a defense into the omnibus clause.

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