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Government Loses Sham-Transaction *Criminal Tax Case in the Virgin Islands*

PRACTICE TIPS

By Charles M. Meadows, Jr., Josh O. Ungerman and Brian W. Portugal

On March 4, 2009, in the federal courthouse in St. Croix, the Defense heard the jury foreperson say "not guilty" 99 times—each count, each defendant—in the largest criminal tax case ever litigated in the U.S. Virgin Islands.

But the Government's problems began thousands of miles away—first, in Washington, DC and, then, in East St. Louis, Illinois. In 1986, the Congress enacted a special tax credit for Virgin Islanders as part of an effort to develop the Islands' economy. The Virgin Islands have a "mirror" tax code, which is nearly identical to the Internal Revenue Code, but Virgin Islanders file their returns with and pay their taxes to the U.S. Virgin Islands Bureau of Internal Revenue ("BIR"), rather than the U.S. Internal Revenue Service. The special tax credit entitled bona fide U.S. Virgin Islands residents whose income was "effectively-connected" to the Islands to a take a 90% income tax credit. What the legislation did not do, however, was define the meaning of "effectively-connected." To this task, Congress set the U.S. Department of the Treasury.

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But the Treasury Department was a bit dilatory—it didn't promulgate regulations for 18 years. And meanwhile, for purposes of determining where to file a tax return—with the IRS or with the BIR—the tax code defined a "bona fide resident" as a person who was a resident of the Virgin Islands on the last day of the taxable year.

A number of people accepted this Congressional generosity and established residences and service businesses in the Virgin Islands, including a business called Kapok, which provided management services to businesses located on the U.S. mainland. The owners of the mainland businesses established residency on the Islands and joined Kapok as partners. Kapok, in turn, paid the partners

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To kick off the CJS Spring Meeting on April 2 in Birmingham, former U.S. Attorneys Jack Selden and Joe McLean were joined by CJS Chair Anthony Joseph, former AUSA for the Southern District of Alabama Michel Nicrosi, and AUSA for the Northern District of Alabama Joyce Vance for a **Town Hall Meeting on Prosecutorial Perspectives on the Obama Justice Department.**

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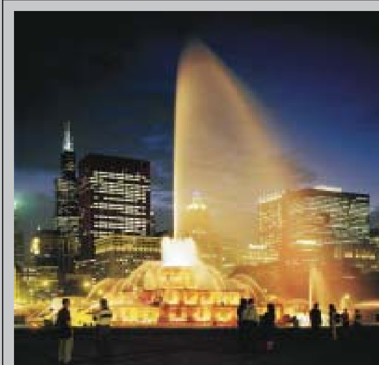

Save the Date:

Criminal Justice Section Annual Meeting

Chicago, IL
July 30-Aug. 2, 2009

Practice Tips

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management fees. The Virgin Islands' Economic Development Commission had certified Kapok as a beneficiary of the special tax credit. The Government, however, had its suspicions, and in 2002, it launched Operation Island Hideaway, an investigation led by the IRS's Criminal Investigation Division. Undercover special agents met with Kapok participants and Kapok employees, ostensibly for the purpose of determining whether to join Kapok as partners, and recorded over 100 hours of conversations, which led to a search warrant that was executed at Kapok's offices in May 2003, where the Government seized almost 30,000 documents.

After the IRS completed its investigation in March 2007, a group of federal prosecutors in East St. Louis, Illinois obtained a Grand Jury indictment of a Kapok partner who owned businesses in Illinois, along with a number of other Kapok participants and entities—four individuals, one partnership, three corporations, and two LLCs. But the Government suffered a game-changing setback when U.S. District Judge Michael J. Reagan granted the defense's motion to transfer venue to the Virgin Islands. Things never got better for the Government. Not long after the transfer, a special judge was designated to hear the case—Chief U.S. District Judge Harvey Bartle, III of the Eastern District of Pennsylvania. One of Judge Bartle's first tasks was to rule on the defense's motions to dismiss the indictment. The defense argued that the tax law at issue (the Virgin Islands credit) was too vague and ambiguous for the defendants to be subjected to criminal liability for violating it. In a memorandum opinion signed on August 26, 2008, Judge Bartle agreed in large part. Specifically, Judge Bartle held that, in the absence of clarifying regulations issued by the Treasury Department, the concept of "effectively-connected income" was too vague to support a criminal prosecution. Judge Bartle therefore dismissed 11 of 35 counts of the indictment and limited the Government's theory on the remaining counts, essentially leaving the government to argue that one of the defendants was not a bona fide resident and that the Kapok business was a "tax sham." Undeterred, the Government obtained a Third Superseding Indictment, adding five new counts and identifying over 89 unindicted co-conspirators.

The two-month trial began on Monday, January 12, 2009. Judge Bartle conducted jury selection in a single day and used less than three hours for voir dire. The Government threw a mountain of evidence at the jury, introducing 5,000 exhibits and calling 40 witnesses—including seven IRS special agents, one Kapok partner who had pled guilty to tax evasion, and another Kapok partner who had been granted "pocket immunity." The defense called only two witnesses, focusing instead on attacking the Government's case. The most significant legal fight, though, involved the jury instructions on the sham transaction issue. The Government proposed an instruction, tracking *Wexler v. United States*, 31 F.3d 117, 127 (3d Cir. 1994), that required the jury to view the entire transaction, apart from the transaction's tax consequences, and determine whether the transaction could result in a profit. The defense argued that the sham transaction doctrine was not applicable in criminal cases or, in the alternative, that in the context of a statutory tax incentive program (the Virgin Islands Credit) the transaction must be viewed as a whole, including its after-tax consequences, to determine whether it could result in a profit, citing *In re C.M. Holdings*, 301 F.3d 96, 98-99 (3d Cir. 2002).

The court settled on an instruction that required the jury to consider "whether what was done, apart from the tax benefits, was the thing which the law intended." The court's instruction, while not what the defense wanted, was certainly better than the Government's proposed instruction, and it was more favorable than the instruction given in *United States v. Stein* (the KPMG case), in which the judge instructed the jury that the government had to prove a) that there was no business purpose for entering into the transaction other than its tax benefit and b) that there was no reasonable possibility that the transaction would result in a profit, disregarding any tax benefit. The Kapok instruction allowed the defense to argue that Kapok's business satisfied the intent of the statute generally and that the jury should never reach the pre-tax profit issues. And apparently it worked, because on the morning of Wednesday, March 4, the jury returned its verdict. The foreperson, speaking in a prim British accent, answered "not guilty" 99 times.

The Kapok defense team was led by Charles M. Meadows, Jr. and Josh O. Ungerman of the Dallas-based law firm of Meadows, Collier, Reed, Cousins & Blau, L.L.P. Associates Brian W. Portugal, Marie H. Kim, and Stephanie G. Mongiello assisted with briefing. Representing other defendants in the case were Blair Brown and Lani Cossette (Zuckerman Spaeder LLP); Lee Rohn; Robert "Bob" Webster and Robert R. Smith (Fitzpatrick Hagood Smith & Uhl L.L.P.); Ed Fickess (Andreozzi Fickess LLP); and Gordon C. Rhea (Richardson, Patrick, Westbrook and Brickman, LLC). The Government was represented by two Special Assistant U.S. Attorneys (detailed from East St. Louis, Illinois) and two Department of Justice Tax Division Trial Attorneys.