Criminal Charges: Washington's Ultimate Tax Collection Mechanism

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In this article, the two discuss how collection of Washington business taxes can mutate without warning into a criminal investigation and prosecution, and the serious concerns this raises.

Despite an array of civil enforcement mechanisms at its disposal to collect unremitted taxes, a Washington state revenue agent sometimes starts gathering information to make a criminal case against a taxpayer — unbeknownst to the taxpayer. This article describes some of those cases, particularly one in which the authors' firm is involved in defending former NFL football player Sam Adams.

The cases raise serious concerns about fair tax enforcement, including a modern-day version of debtors' prison, an uncomfortably close relationship between the public prosecutorial function and the Department of Revenue, the misimpression created by a revenue agent engaged in civil collection activities at the same time as he is conducting a criminal investigation, and the need for evidence that nonpayment was willful.

I. How Collection Mutates Into Criminal Charges

A. The Partnership: The DOR and the Attorney General's Office's Criminal Litigation Unit

The DOR has an unwritten partnership with the state Office of the Attorney General through the AG's criminal litigation unit (CLU). The CLU also partners with four other state agencies (the Office of the Insurance Commissioner, the Department of Labor and Industries, the Employment Securities Department, and the State Auditor's Office) and boasts "recovery awards in excess of $10 million."[1] Though the DOR's website is replete with information, CLU references are curiously absent. A broader online search turned up only a few reports alluding to DOR referrals of taxpayer accounts to the CLU culminating in criminal prosecutions.[2]

Though not published online, written protocols exist for the DOR's referral of cases for criminal investigation.[3] DOR employees refer a taxpayer account to the CLU by means of a criminal investigation referral form. Before and after the referral, DOR employees may pursue civil enforcement of tax liabilities. The civil remedies are powerful, including the ability to impose interest and penalties, levy a taxpayer's bank account, seize property, revoke business licenses, and attach personal liability for unpaid sales tax against business owners or responsible officers.[4]

In the case of a CLU referral, the same DOR employees may also function — without any warning to the taxpayer of the changed role — as criminal investigators, both up to and after the referral. In fact, investigating and documenting cases for criminal prosecution are part of the job description for some revenue agents, and a background in collection of "criminal debt," criminal justice, or law enforcement is listed as desirable.[5] DOR policies and procedures neither separate the DOR's civil and criminal functions nor require any notification to the taxpayer that the DOR is conducting a criminal investigation.

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[1]AG website.

[2]*See, e.g.*, Washington Departments of Labor & Industries, Revenue, and Employment Security, "Underground Economy Benchmark Report (RCW 18.27.800): 2014 Annual Report to the Legislature," at p. 13 (Dec. 2014) (*available at* Lni.wa.gov/LegReports).

[3]Washington DOR Audit Division, "Procedure for Referring Cases to the Criminal Litigation Unit (CLU) of the Attorney General's (AG's) Office" (Apr. 26, 2012).

[4]*See, e.g.*, WAC 458-20-217 (summarizing DOR collection remedies and procedures); and RCW 82.32.145 (permitting assessments of personal liability for unremitted sales tax against some "responsible individuals" for a business entity).

[5]Washington State Human Resources Job Class Descriptions for Revenue Agent 3 and Revenue Agent 4, http://1.usa.gov/29kucQS.

B. The Case of Sam Adams

After retiring from his career as a star defensive lineman for the NFL's Seattle Seahawks and the Baltimore Ravens, Sam Adams acquired six fitness clubs — two in the Seattle area and four in Oregon. His clubs contracted with a third party, Allstate Financial Group (AFG), to handle billing, back-office functions, and additional financing for the clubs. AFG was responsible for collecting club membership dues and paying the clubs' rent. After further deducting fees for its services, AFG was to remit the remaining revenue to the clubs.

But AFG routinely held on to the funds without timely paying the clubs' obligations or remitting the remaining revenue to the clubs. As a result, the clubs faced serious financial problems. At the same time, the DOR was finding irregularities and underpayments in the clubs' tax reporting and payments. A DOR revenue agent began working with Adams to collect debts owed by the clubs to the DOR. Adams told the revenue agent about the financial problems and the funds being improperly withheld by AFG. The DOR did not investigate AFG's improper withholding of funds. Instead, the revenue agent continued to escalate payment demands, including threats to close clubs unless demands for payment were quickly satisfied.

Had the DOR investigated the circumstances described by Adams, it would have found that his clubs were among many others suffering similar problems with AFG. AFG's owner filed for bankruptcy in 2015, and the bankruptcy proceedings included a complaint from a leasing company that AFG defrauded various fitness club owners, misappropriated funds belonging to the clubs, and failed to pay rent, payroll, and taxes as required under contracts with the clubs.[6] AFG's owner admitted in sworn testimony in a deposition in the case that he was running a type of payday-loan scheme that included conspiring with landlords in order to put Adams's clubs increasingly behind in their finances with each passing month.[7] His admitted goal was to wrest ownership of the most desirable clubs from Adams through foreclosure — a goal that AFG's owner ultimately achieved.[8]

AFG similarly predated on other clubs, including ones in Maryland and Ohio owned by Greg Tayman and ones in Georgia and North Carolina owned by Mark Montgomery, according to sworn affidavits from those owners. In essence, AFG had a practice of siphoning money away from its customers using its position as billing servicer, failing to pay bills, and ultimately taking over the clubs.

The DOR ultimately escalated the collection issues with Adams's clubs into a criminal referral. The revenue agent told Adams, "Your case has been officially transferred to the State of Washington Attorney General's Office for criminal prosecution for filing false tax returns and theft of sales taxes (both are charged as felonies)." He said Adams was named as a responsible party. When Adams sought an explanation, the revenue agent merely told him he could discuss the criminal case with the AG but should continue discussions regarding the taxes with the revenue agent. No one warned Adams that the revenue agent would funnel to CLU everything Adams provided to him in order to use it in the criminal case. In his numerous subsequent communications regarding tax payments and returns, Adams understood that he was working with a civil collections agent.

Then, in 2015, the AG charged Adams with 17 counts of theft and filing a false or fraudulent tax return. One of its primary witnesses is AFG's owner — the same person accused of defrauding fitness club owners, including Adams. The DOR director claimed in a press release about the case that Adams and his codefendant "flagrantly disregarded the law" and that their actions "amount to taking nearly $500,000 in tax dollars."[9] Obviously Adams, reeling from AFG's putting his clubs into financial ruin, does not agree. David Smith (one of the coauthors of this article) represents Adams in the case, which is pending in King County Superior Court.[10]

C. Other Cases

Adams's case is one of many the DOR brings against businesses. In a 2013 report on the department's achievements, it boasted a "100 percent rate of prosecution" on cases it referred to the CLU.[11] In one case after another, the AG has offered extraordinary plea deals in which the defendant's sentencing is postponed for years or the sentence reduced so long as the defendant agrees to make regular repayments to the DOR, allowing defendants to buy their way out of prison a dollar at a time by satisfying the DOR's financial demands.

The DOR's press releases provide a picture of some of the other cases. For example, when a short-lived restaurant failed and the owner used sales tax revenue to pay federal taxes and restaurant employees instead of remitting it to the DOR, the AG got the owner to plead guilty to criminal charges.[12]

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[6]Complaint to Determine Dischargeability of Debts Pursuant to 11 U.S.C. section 253, *In re John Joseph Michael and Michelle Bailey Michael*, No. 15-1252-MLB, ECF No. 224 at 11-13 (Bankr. W.D. Wash. Dec. 11, 2015).

[7]Deposition upon Oral Examination Pursuant to Bankruptcy Rule 2004 of John Joseph Michael (June 2, 2015).

[8]*Id.*

[9]"Attorney General Ferguson Files Criminal Wage Theft and Fraud Charges Against Athletic Club Executives Sam Adams and Dana Sargent" (Feb. 5, 2015), *available at* http://1.usa.gov/29kucQS.

[10]*State v. Adams*, King County Superior Court No. 15-C-00888-5 SEA.

[11]Washington State DOR, *Fiscal Year 2013 Achievements* at p. 10 (http://dor.wa.gov/docs/pubs/misc/dorachievements.pdf).

[12]"El Mestizo Restaurant Pleads Guilty to Filing False Tax Return to Cover Theft of Sales Tax" (Mar. 1, 2013), *available at* http://1.usa.gov/298ku8b.

In another case involving a failed restaurant, *State v. Rutledge*, the CLU alleged first-degree theft and filing of false or fraudulent tax returns for failure to remit nearly $463,000 in sales tax to the DOR.[13] In 2012 Rohn M. Rutledge entered a plea agreement in which he pleaded guilty to all counts, with language allowing for an exceptional sentence upward on the standard sentence range of 12 to 14 months. As part of the agreement, the CLU would set aside sentencing for up to 10 years based on monthly payments by Rutledge to total nearly $800,000. If Rutledge failed to meet the payment schedule, the CLU would recommend a duration of confinement in accordance with the amount paid: payment of less than $525,160.66 would result in a recommendation for 60 months' confinement; payment of more than that amount would decrease the recommendation to 36 months or less depending on the amount paid. On full compliance with the payment schedule, plus accumulated interest, the CLU would permit Rutledge to withdraw his guilty plea.

Claiming failure to remit approximately $30,000 in sales tax, the CLU brought criminal charges against Calvin Gilpin in connection with his Seattle pest control business in 2013.[14] Six months later, Gilpin entered a plea agreement similar to the one in the *Rutledge* case, with his sentence recommendation reducing to the extent he meets the agreement's payment schedule.[15]

At the same time, the CLU charged a landscaper with felony theft of sales tax in *State v. Villegas* but with a very different outcome.[16] The DOR alleged Laura Villegas stole approximately $112,000 in sales tax. She did not receive the benefit of the type of plea agreement offered to Rutledge and Gilpin. She was sentenced to full payment and confinement. But the magnitude of the CLU's allegations are strangely out of proportion with the light conditions for her confinement: The CLU alleged a major economic offense committed over a series of years, but her confinement was a mere 90 days of electronic home detention. Apparently the CLU was unable to leverage criminal charges against Villegas into a payment plan that would satisfy the DOR.

II. Serious Concerns

These and other cases in Washington establish a pattern that raises at least four serious concerns:

1. the cases violate the prohibition against debtors' prisons;

2. they violate the requirement for prosecutorial independence;

3. the taxpayer may have no warning that the DOR is gathering information for a criminal investigation; and

4. the DOR is charging criminal offenses without evidence of willful violations.

A. These Cases Violate the Prohibition Against Debtors' Prisons

The Washington Constitution prohibits imprisonment for debt.[17] It is one of 40 states that bans debtors' prisons.[18] Washington courts have long been loath "to turn the criminal justice system into a mechanism for collection" of debts.[19] And yet in the cases described in this article, the DOR appears to be trying to use the AG to coerce tax payments under threat of imprisonment. Plea agreements that promise to reduce incarceration time depending on the amount the defendant pays toward tax debts are operating as a modern-day equivalent to debtors' prisons.

The illegality of incarceration for nonpayment of legal financial obligations recently came before another Washington superior court in *Fuentes v. Benton County*,[20] with a positive resolution in June: Benton County has now agreed to change its systemic policies of generating revenue by incarcerating or threatening to incarcerate indigent defendants.[21] Until the *Adams* case, it did not appear that the DOR's partnership with the AG had come under criticism for similar policies. Given the clear unconstitutionality of the practice and the ample tools for civil enforcement of tax debts, the DOR and the AG should stop using the threat of incarceration to collect taxes.

B. These Cases Violate the Requirement for Prosecutorial Independence

When the AG brings criminal charges as a result of a DOR referral, the attorney general's office behaves as

[13]Affidavit for determination of probable cause filed by the state in *State v. Rutledge*, Kitsap County Superior Court, No. 11-1-00958-9. *See also* "Peninsula Restaurant Owner Pleads Guilty to Felony Theft of Sales Tax, Filing False State Tax Returns" (Feb. 22, 2012), *available at* http://1.usa.gov/2917jU2.

[14]"State Charges Pest Control Operator With Felony Theft of Sales Tax" (May 20, 2013), *available at* http://1.usa.gov/29bKz3d.

[15]"Pest Control Contractor Pleads Guilty to Sales Tax Theft" (Oct. 15, 2013), *available at* http://1.usa.gov/294L28j.

[16]"Landscaper Charged With Felony Theft of Sales Tax" (May 20, 2013), *available at* http://1.usa.gov/28ZMeqm; and "Landscaping Business Owner Pleads Guilty to Sales Tax Theft" (Nov. 21, 2013), *available at* http://1.usa.gov/290XhA9.

[17]Washington Const. Art. 1, section 17.

[18]The other states are Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Maryland, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Wisconsin, and Wyoming.

[19]*State v. McFarland*, 60 Wn. 98, 105, 110 P. 792 (1910).

[20]No. 15-2-02976-1 (Super. Ct. Wash. Yakima County Oct. 6, 2015).

[21]Kristin M. Kraemer, "ACLU, Lawyers Settle 'Debtors' Prison' Lawsuit Against Benton County," *Tri-City Herald,* June 1, 2016.

though it represents the DOR as a client. Unlike a private attorney, a criminal prosecutor "has the responsibility of a minister of justice and not simply that of an advocate."[22] The party attempting to enforce collection of a debt is not the prosecutor's client; rather, the prosecutor's client is society as a whole, including "the defendant and his family and those who care about him" and "the vast majority of citizens who know nothing about a particular case, but who give over to the prosecutor the authority to seek a just result in their name."[23] The American Bar Association has promulgated criminal justice standards that emphasize the prosecutor's duty not to any particular agency, law enforcement personnel, or victim, but to the public:

> The prosecutor generally serves the public and not any particular government agency, law enforcement officer or unit, witness or victim. When investigating or prosecuting a criminal matter, the prosecutor does not represent law enforcement personnel who have worked on the matter and such law enforcement personnel are not the prosecutor's clients.[24]

In its "partnership" with the DOR, however, the AG has apparently lost sight of those fundamental principles. It instead focuses on serving the interests of the department and satisfying its financial demands. The AG's confusion about its proper role is perhaps inevitable given the fact that the DOR pays the salaries of the AG prosecutors it works with. The DOR provides the AG a biennium allocation for salaries and other direct costs incurred by the CLU ranging from $600,000 in 2009 to approximately $450,000 in 2015.[25] That creates a systemic conflict of interest for the attorneys prosecuting DOR referrals. It also limits their independence in evaluating the prosecutorial merits of a referral, as highlighted by the DOR's "achievement" that the CLU prosecutes all cases the DOR refers to it.[26]

C. The Taxpayer May Have No Warning That the DOR Is Gathering Information for a Criminal Investigation

In Adams's case, the revenue agent appeared to Adams to be working with him on his business's civil liabilities for taxes both before and after the referral to CLU. In fact, throughout his interactions with Adams, the revenue agent was also operating as a special agent for the CLU and investigating possible criminal liability. When the agent's purpose becomes obtaining incriminating evidence, the taxpayer should be afforded the opportunity to exercise constitutional rights, and the revenue agent should suspend collection efforts.

Barry Leibowicz, an attorney in New York, even recommends that whenever a taxpayer receives notice of an audit, especially one from the New York State Department of Taxation and Finance or New York City, the taxpayer should confirm that it is a civil matter and not a criminal investigation.[27] He criticizes the fact that enforcement personnel there "often have both civil and criminal enforcement roles, so their title is no indication as to the civil or criminal nature of the inquiry. It sometimes seems that the investigators intentionally give the inquiry the outward appearance of a civil matter, thereby lulling taxpayers and their representatives into making statements and disclosures."[28] A prudent taxpayer who knows the investigation is criminal would likely seek criminal counsel for the audit.[29]

In contrast, the Internal Revenue Service has long recognized the potential for misconduct when civil tax examinations become enmeshed with criminal investigations and prosecutions. For that reason, the Internal Revenue Manual provides clear guidance to all IRS employees regarding the boundaries between civil functions and criminal investigations. The manual requires that IRS civil employees "suspend the examination/collection activity" once "firm indications of fraud/willfulness have been established."[30] When a compliance employee refers a matter for criminal investigation, the manual establishes a process in which four other employees evaluate whether to accept the referral: the referring employee's group manager, the evaluating special agent, the supervisory special agent, and a fraud technical reviewer.[31] The IRS's Office of Chief Counsel has issued several memoranda that discuss the case law on improper conduct of civil agents in criminal case development.[32] Those memoranda are designed to guide IRS employees to avoid violations of taxpayers' Fourth and Fifth amendment rights. To that end, the IRS separates its civil and criminal functions to ensure that evidence for use in the criminal case is not developed under the guise of the civil investigation.

Taxpayers should be warned: The Washington DOR exercises none of those safeguards.

D. The DOR Is Charging Criminal Offenses Without Evidence of Any Willful Violation

The DOR has civil sanctions at its disposal to enforce collection of tax, interest, and penalties without resorting to

[22]ABA Model Rules of Professional Conduct, Comment on Rule 3.8.

[23]*Lindsey v. State*, 725 P.2d 649, 660 (Wyo. 1986) (*quoting* Carol A. Corrigan, "On Prosecutorial Ethics," 13 *Hastings Const. L.Q.* 537-539 (1986)).

[24]ABA Criminal Justice Standards for the Prosecution Function, Standard 3-1.3 (4th ed.).

[25]Compiled from Office of Attorney General legal services invoices.

[26]Washington State DOR, "Fiscal Year 2013 Achievements," at 10, *available at* http://1.usa.gov/291eJFC).

[27]Barry Leibowicz, "Tax Audits, Investigations, and Appeals (Civil and Criminal) in New York," *J. MultiState Tax'n and Incentives* (Oct. 2009).

[28]*Id.*

[29]*Id.*

[30]Internal Revenue Manual section 25.1.3.2 (08-05-2015).

[31]*Id.* section 25.1.3.3 (08-05-2015).

[32]*See, e.g.*, Office of Chief Counsel, IRS, Memorandum GL-125610-07 (Aug. 16, 2007).

criminal charges. The DOR and the Board of Tax Appeals regularly publish many decisions that involve civil sanctions for nonpayment of sales tax, including finding personal liability of business owners and company officers.[33] Trying to discern meaningful factual differences between those cases and the nonpayment involved in the CLU's criminal cases is difficult, if not impossible.

A criminal case requires an important element that civil cases do not require. The most basic principle of criminal law is that a crime cannot exist unless there has been a violation of a known legal duty and that violation is willful — that is, voluntary and intentional.[34] For example, referral to criminal investigation for a federal tax crime requires "affirmative acts (firm indications) of fraud/willfulness."[35] Merely failing to pay tax is not a crime. Evidence of a willful violation is imperative to bring criminal charges.

The case of Adams's failed fitness clubs casts doubt on whether the CLU is, as it claims, "prosecut[ing] unscrupulous businesses."[36] It appears instead to be unscrupulously prosecuting businesses that have suffered financial ruin, when nonpayment was involuntary and unintentional. Given the financial straits of those defendants, it is perhaps unsurprising that no Washington appellate case law exists for those types of cases to review whether the CLU has the evidence necessary to support criminal convictions. A series of press releases boasting plea deals and a "100 percent rate of prosecution" does nothing to show that evidence of fraud or willfulness supports the DOR's referrals to CLU. It is the prosecutor's responsibility to evaluate that sufficient evidence of a crime exists; a 100 percent rate strongly indicates that the AG is not properly performing that evaluation.

III. Conclusion

Use of criminal charges as the ultimate debt collection mechanism is antithetical to fair tax administration and basic taxpayer rights. In Washington, blurred lines between the functions of civil tax collection, criminal investigation, and prosecutorial decisions worsen the situation. For the sake of Adams and other taxpayers, Washington's system urgently needs systemic improvements, including strict separation of those three functions and a process that ensures careful, independent evaluation of all criminal referrals in tax. ■

[33] *See, e.g.*, *Coffman v. Department of Revenue*, Nos. 85111, 85911, 86924 (2015) (holding corporate officers with check-signing authority personally liable for unremitted sales taxes and finding that nonpayment was willful since they used the sales tax funds to pay other obligations); Wash. DOR Det. No. 15-0081, 34 WTD 431 (2015) (holding the president and managing member of a limited liability company personally liable for unremitted sales tax); and Wash. DOR Det. No. 14-0339, 34 WTD 238 (2015) (holding a treasurer/director of a corporation personally liable for unremitted sales tax).

[34] *See, e.g.*, IRM section 9.1.3.3.2.2.3 (05-15-2008).

[35] *Id.* section 25.1.3.1 (08-05-2015).

[36] *Supra* note 9.