

# Business Better (Season 4, Episode 5): Tax Audits, Investigations, and Global Enforcement: A Conversation with IRS Special Agent Jonathan Schnatz

Speakers: Peter Hardy, Chris Jones, Siana Danch, and Jonathan Schnatz

Steve Burkhart:

Welcome to Business Better, a podcast designed to help businesses navigate the new normal. I'm your host, Steve Burkhart. After a long career at global consumer products company BIC – where I served as Vice President of Administration, General Counsel, and Secretary – I'm now Special Counsel in the Litigation Department at Ballard Spahr, a law firm with clients across industries and throughout the country.

In today's episode, we are joined by Special Agent Jonathan Schnatz, Senior Analyst with IRS Criminal Investigation. Special Agent Schnatz will discuss his work with an international law enforcement and tax compliance group, and how that work directly impacts US businesses and individuals. Joining this discussion are my Ballard Spahr colleagues Peter Hardy, Chris Jones, and Siana Danch, all of whom are members of the firm's tax controversy team. So now let me turn the conversation over to Peter, who will kick things off.

Peter Hardy:

Hello everyone. Thank you very much for joining us. I think you're going to enjoy our podcast. I'm Peter Hardy, I'm a partner at Ballard Spahr in the Philadelphia office, and I'm part of our tax controversy team as well as our anti-money laundering team, our white-collar group, and our general tax group. And I mentioned all that because I think it's relevant because it reflects the many issues and the crossover issues that we're going to be talking about today on our podcast.

And I would be remiss if I didn't also mention to folks to check out our blog, Money Laundering Watch, where we talk about a lot of the issues that we're going to talk about today in that blog. So first I'm going to introduce our fabulous guest speaker and my colleagues from Ballard Spahr, Chris Jones and Siana Danch are going to introduce themselves. So on that note, I'm really pleased to introduce a special agent, Jonathan Schnatz, who's a senior analyst with IRS Criminal Investigation, otherwise known as CI. And I'm going to refer shorthand throughout this podcast to CI.

So Jonathan chairs the Professional Enabler Group as part of the Joint Chiefs of Global Tax Enforcement, otherwise known as the J5. So we're going to talk about the J5 and we're also going to talk about the professional enabler group to dumb it down. That's really about the government going after alleged dirty professionals such as lawyers, bankers, investment advisors, etc. Prior to this position, Jonathan was a senior analyst within the international operations. He served as the deputy attache at the US Embassy in London, UK, and as a supervisory special agent and special agent in the Philadelphia field office.

So Jonathan travels all over the world. He's going to tell you about it. It's really a fascinating job. And I had the pleasure of doing a few cases with Jonathan many, many years ago back when I was with DOJ. And prior to his government service, he worked in a public accounting and he's got a dual degree in accounting and finance, and he's also a CPA, although inactive. So thank you, Jonathan, for joining us. We're really, really happy to have you here. Chris?

Chris Jones:

Thanks, Peter. My name's Chris Jones. I'm a partner in Ballard Spahr's Philadelphia office. I'm one of the co-leaders of our tax group and a member of the tax controversy team. My practice is almost exclusively civil in nature, but I deal with a little bit of everything, federal, state, and local, and that includes quite a bit of controversy work, disputes with the IRS as well as state and local taxing authorities. Siana?

Siana Danch:

Thank you, Chris. I'm Siana Danch. I'm an associate in Ballard's Philadelphia office and also part of the tax controversy group. I work with Peter and Chris both on the civil and criminal side. On the civil side, I assist clients from the beginning of an audit through litigation and tax court or refund suit and also collections. And on the criminal side, I helped them defend in a DOJ or AUSA investigation.

Peter Hardy:

Thanks, Siana. And thanks, Chris. Okay, so we're going to cover a lot of ground today. We've got a lot of interesting topics and we're going to do the opposite of the usual. Usually folks start broad in their conversation and then get more narrow. We're going to do the reverse. We're going to start on a more narrow topic, and then broaden our discussion. So just headlines here, three parts. First we're going to talk about J5, what it is, what's its purpose. Then Chris is going to talk with Jonathan about how J5 works with Civil IRS and LB&I, a Large Business and International for those of you not familiar with IRS acronyms. And then finally, Siana will bring us home talking about how civil audits can turn into referrals to criminal investigation to CI.

So on that note, let's just dive right in. Jonathan, welcome. And let's just start off here with what is J5, what does it do, and what's its purpose?

Jonathan Schnatz:

Good morning, Peter, and thank you for having me. So the J5 is five years old right now. So as you mentioned earlier, it's the Joint Chiefs of Global Tax Enforcement, and that is spun out of OECD, which is the Organization for Economic Cooperation and development. So about five years ago, OECD came to several chiefs, criminal chiefs, for several countries and said, "We realized that professional enablers are a really bad area for global tax and money laundering and financial crime, so let's form a group to try and address this issue."

So the J5 was born out of those conversations in Paris and the J5 consists of IRS Criminal Investigation for the US. For Canada, the Canadian Revenue Agency, the Dutch FIOD, and I will not try and pronounce the Dutch name. We'll be here all day. The ATO in Australia. And what am I missing here?

Peter Hardy:

Our friends in the UK, I think.

Jonathan Schnatz:

And the UK, sorry. Yes. How dare I forget, our friends at HMRC in the UK.

Peter Hardy:

I'm sorry, what's HMRC? There's a lot of acronyms floating around here.

Jonathan Schnatz:

His Majesty's Revenue and Customs.

Peter Hardy:

Okay. So this thing was born and what does it do? I mean, what's its purpose?

Jonathan Schnatz:

Yeah. So the purpose of the J5 is really to share intelligence on global financial crimes, be it money laundering, tax evasion, really sharing typologies, trends, emerging jurisdictions. And again, the professional enabler group was the first to come out of

the J5. And really, as you mentioned in your intro, Peter, looking for bad actors who are promoting marketing, facilitating the movement of funds both for money laundering purposes, so dirty money to hide it from governments, and also for tax evasion. So for promoters that are marketing complex structures offshore, I know a lot of people may hear the term tax haven. We try not to use that term anymore because we don't want to insult certain countries, but it's really jurisdictions that may have laws that bad actors take advantage of.

So if there are disclosure issues or it may be difficult for government agencies to track down and obtain evidence for a criminal investigation, the bad actors know those jurisdictions. A lot of them have secrecy laws in place that make it a crime for those jurisdictions to disclose to other governments. And again, the bad actors will take advantage of that and use that to their benefit and help money launderers and tax evaders.

Peter Hardy:

Okay, thanks. So there's a lot packed into what you just said and I want to just pick up on some of the things. You mentioned information sharing and I think some folks listening to this are going to understand exactly what you mean and others may not have a full handle. So can you put a little bit more meat on the bone in terms of what that means? And just to briefly to set the table here, back 20 years ago when I was with DOJ, if you wanted information from overseas, you had to do, well, there's several things you could do, but one of the things you had to do was called an MLAD.

And without going on and on and on, and those are still around, it was a very, very time-consuming process where you would send a request, a formal request to another country, it would go through their legal process, and then sometimes years later you would get information back. And at times it could be precisely not what you asked for. And there you were, and time marches on. So what kind of information sharing is J5 and you and your colleagues doing?

Jonathan Schnatz:

Yeah, that's correct. So the MLAD is a great example, and what we would call that or refer to that is a formal exchange of information. So we really deal with formal and informal. So formal exchanges of information will be tax treaties, MLADs, EGMA requests, which will go through the FIU, to FIU.

Peter Hardy:

What's FIU stand for?

Jonathan Schnatz:

Sure, Financial Investigative Unit. Each country has one. The US FIU is FinCEN. So FinCEN is both a regulator and an FIU in the United States. So as part of the J5, what we're looking to do is share information formally through those channels, but also informally. So if there are ways to share information, either through police to police or informal channels, depending on the type of investigation, the type of information that we're looking to share with our other countries, we figure out the laws of the US, the laws of the other countries, and we're working through now the best way to share information, again, to try and get ahead or only one step behind bad actors instead of, as you put it, you may wait years and years for evidence.

So we don't want to necessarily wait years and years to get information and evidence, because by that time it's really difficult to prosecute a criminal case.

Peter Hardy:

Okay, thanks. That was super helpful. And look, I know that there are limits on what you can say today, but generally speaking then, so information is shared and the two processes you just described, how is it used high level?

Jonathan Schnatz:

So depending, again, on the type of information and the way it's shared, it could either be used as intelligence only. So if a country shares information with us and says, "This is not for evidence purposes," we can take that information and try and

develop it into a criminal investigation. Also, they could share it with us for evidence purposes, which means when we take that information and we know that we can then use that in a court of law as part of a criminal case.

Peter Hardy:

Okay. So then I'm going to round things out here before turning it over to Chris to ask you a little bit more about the Gatekeeper Initiative. Maybe kind of a master of the obvious question, but why are you and your colleagues focused on gatekeepers here on the professionals?

Jonathan Schnatz:

Yeah. Well, I kind of take it back to the Swiss Banks investigations, where typically as part of a criminal case, we would look to identify US citizens that perhaps were hiding money offshore. To me, the Swiss Bank case has really broken open and made it more worthwhile for us to go after the professionals. So the bankers, the financial institutions, the accountants, the lawyers really, instead of building a criminal case from the ground up, really looking to identify those that are promoting it so that we can stop the really bad actors from facilitating all of the financial crime.

Peter Hardy:

And I think you all had at least one fairly well publicized example last year. I'm going to slaughter his name. Well, I'm going to leave it to you. Do you want to tell us just a little bit about that as an example?

Jonathan Schnatz:

Yeah, absolutely. So Frank Butselaar was a Dutch citizen, and who we identified as a promoter. Really interesting is his clients, he had some high-profile clients. Some were professional DJs that make a lot of money, surprisingly, and some clients in the fashion industry. So what Mr. Butselaar was doing was he was coming up with schemes to help his clients hide their US taxable income. So when they would work in the US and they would then have a US taxable footprint, he set up offshore shell companies and many times would use the family members of his clients as the beneficial owners of those shell corporations to hide the income from the IRS.

Peter Hardy:

And I got one last question before I turn it over to Chris. Is it the case that J5 is involved in coordinating actual activities? I'm thinking maybe this is me, my mind in the crypto sphere, maybe somebody in the US is getting charged, but at the same time somebody in the UK is, there's a search warrant going on, etc., etc. Does that happen?

Jonathan Schnatz:

Yeah, it does. And really what I'm involved in is more of the intelligence and information sharing. Once it turns into what we call operational, that's when a US attorney's office would be involved. There might be a parallel investigation both in the US and say in the UK for your reference for search warrants. As you know, being in the Justice Department, it's delicate when you have parallel investigations, especially foreign investigations, you have to make sure that you're disclosing the correct information the correct way. But that's the ultimate goal, is to have coordinated operations in multiple countries because we really want the biggest promoters who are affecting not just the US, but our J5 partners as well.

Peter Hardy:

Got it. And that's actually a nice transition on the note of coordination and multiple activities or investigations, if you will. I'm going to turn it over to Chris. And thanks very much, Jonathan, for all that information you just shared.

Chris Jones:

Yeah. Thanks, Peter. As I said up top, my controversy practice is pretty much exclusively civil in nature and J5 has its roots in combating criminal tax activity. Could you talk just a little bit about if there is any coordination between J5 and Civil IRS, maybe LB&I or other units within Civil IRS?

Jonathan Schnatz:

Yeah, absolutely. And I know we constantly talk about criminal as part of J5, but the main goal is to disrupt. So we view civil intervention as a key piece of that as well. So we do coordinate with not just LB&I and SPSC for Civil IRS, but our foreign counterparts as well are also coordinating. So we work closely with LB&I because a lot of these cases that we're looking at may have a lot of clients, the professionals, and say a financial institution may have a lot of clients that are hiding their money from the IRS. The IRS Criminal Investigation Unit just doesn't have the bandwidth to investigate, say all of the clients, in that hypothetical of a bank. So we would coordinate with LB&I, again, to disrupt and have them do some civil work as well.

Chris Jones:

Is there any kind of information sharing that goes the other way? For example, would Civil IRS sort of uncover some kind of pattern perhaps and let J5 know, which then could be shared with other units within J5?

Jonathan Schnatz:

Yeah, we are constantly talking with especially LB&I as part of for the J5 purposes, what information they're seeing, what jurisdictions of risk that they're seeing, new patterns. So obviously LB&I is a bigger part of the IRS than CI. For your listeners, IRS total is approximately 80,000 employees. Criminal investigation is 3,000. So we have a much smaller footprint, so we definitely rely on our civil colleagues to help us with, like I said, typologies, trends, things that we should be looking at criminally. And also we help coordinate a lot because of our close relationships with our J5 partners. A lot of times our partners like HMRC will have questions about the way IRS Civil handles certain campaigns. So a lot of times we'll coordinate meetings and the flow of information back and forth.

Chris Jones:

Thank you. And I know that you're obviously limited in some of the things that you can talk about, but do you know of any examples of perhaps an initiative that popped up either within the civil unit and spread to the criminal or vice versa?

Jonathan Schnatz:

Yeah. So recently we had a case that was a joint J5 investigation that affected every country, and it was the use of sales suppression software. So for your listeners, it would be an app or a program that would be used by mostly restaurants and it would help to hide income from the government, from taxing authorities. It was not as big in the United States, but some of our farm partners, it was a really big problem. So we coordinated with them on a day of action and search warrants, interviews, action took part in all of the countries. And as part of that, we knew that there's going to be a significant amount of civil work that's going to come out of it.

Again, as I said earlier with the bank example, if there are a lot of clients that are using, or a lot of restaurants that are using this sales suppression software, we can't criminally investigate all of those. So as part of that, we coordinated with Civil IRS. And in fact, we put in our J5 press release that anyone that suspects that they had broken the law and maybe used the software and cheated on their taxes could enter the IRS's voluntary disclosure practice. So that's a way for a taxpayer to come in and basically admit to the IRS that they may have done something criminal and we will review it.

And if they're not already, and this is just bare high level here, if they're not already under criminal investigation and some other factors, they can then enter into a civil resolution with the IRS.

Chris Jones:

Terrific. Thank you. And I think that is, again, a good segue into Siana's questions about the way that some of the referrals work.

Siana Danch:

Thank you, Chris. Can you explain to us very generally what really is the difference in a civil and a criminal case? For example, is there a difference in the burden and in the standard? I think that would help us differentiate?

Jonathan Schnatz:

Absolutely. So in a criminal IRS tax case, the burden of proof is on the government. So if I have a criminal investigation, it is up to me as the investigator to prove all of the allegations in a criminal indictment. So if I am as part of the investigation, hypothetically alleging that someone did not report all of their income, or if it's a sophisticated business and they took false deductions or entered into some sophisticated tax strategy that is not civil in nature, but more criminal in nature, that there are factors in play, it is up to me to prove that that is a crime.

On the contrary, for a civil IRS examination, it is up to the taxpayer to prove everything on their tax return. So again, if a Civil IRS opens an examination and part of the examination is focusing on the deductions on a corporate tax return, it is up to the business to show all of the books and records to justify those deductions.

Siana Danch:

What happens with a referral, like say for example, a case is a civil case, but then the examining agent, like you said, with these deductions, what would trigger an examining agent in the civil stage to think that maybe something more is going on?

Jonathan Schnatz:

So in order for a civil exam to be referred over to a criminal investigation, what the civil examiner is trained and taught to look for are what are called badges of fraud. So in our example, if the civil examiner is focusing on deductions on the corporate tax return, and as part of that, remember as I said, it's up to the taxpayer to prove those deductions. So let's say as part of that, the taxpayer gives the civil examiner false invoices or false documents to justify those deductions on the corporate tax return. That would be something that a civil examiner would look at and say, "This elevates this from a civil examination to a criminal case."

Siana Danch:

After you've accepted the initial referral, what happens next? Do you continue to dig? Is there a specific information-gathering process?

Jonathan Schnatz:

Yeah, so typically as part of the referral process, I, as a criminal investigator will meet with the civil examiner because we really want to understand what they've done, what they've uncovered, who they've talked to. So just because a civil examiner thinks that there's fraud there, that's not always the case. So that's the burden then is on me as the criminal investigator to review the information and then say, "I accept that as a criminal referral, then I will have to do a full criminal investigation, make sure I have," again, so the burden of proof now shifts from the taxpayer, to the government, to me. So I need to make sure I have all of the documents that I've interviewed all the witnesses, the accountant, everyone that would be a witness in that case, I need to continue to do a full criminal investigation.

Siana Danch:

But it is still possible at that stage after all of this investigation that for whatever reasons, it does not become an indictment? That's still a possibility at that state?

Jonathan Schnatz:

Not when I'm the agent. No, I'm just kidding. No, it's always possible. And again, it could be referral, it could be a criminal investigation. I mean, I've had many, or I've had criminal investigations that do not end up with criminal charges. I mean, that's all part of it is for any number of reasons, but yes, in our instance, just because it is referred over to criminal investigation does not necessarily mean that criminal charges will be brought. Again, for your clients, it elevates it. So now it's a different ballgame, so I would say it's a little bit more serious. But yeah, criminal charges are not always brought in those cases.

Peter Hardy:

It's been a while since I kept track of the stats, but I have it in my head. This is maybe old, but at least as of several years ago. And all of these stats are kind of funky and to be taken with a grain of salt. But I think for criminal tax investigations, I'm talking like pure false return, not like y'all are working with the FBI and a money laundering case or something like that. I think the percentage of cases that were referred that went to an actual charge, it's actually like 50/50. It's one of the lowest in the federal system.

Now, that includes everything, not just referrals from civil audit, but whatever the disgruntled spouse or a business partner contacting the IRS, everything. But it's pretty even, which I think speaks to the carefulness and intelligence of the IRS CI and the excellence of the Tax Controversy book. I'll leave it at that.

Siana Danch:

If the case did move forward, what happens to the civil audit at that point?

Jonathan Schnatz:

Yeah. So the majority of the time the civil audit would stop. There are times when there would be a parallel civil examination at the same time as the criminal. That is going to be a very rare occurrence. The majority of the time, once a civil audit gets referred to criminal, all civil work will stop and should stop.

Siana Danch:

We've talked a lot, we've talked about some false deductions, we've talked about hiding income, so that sounds like issues with income tax. Do you see other tax issues that IRS CI investigates?

Jonathan Schnatz:

So we do a lot of employment tax cases, and that would be where a business is either paying employees under the table or falsifying their books to save on the employment taxes that are being paid. Those cases are surprisingly, the dollar amounts are very large because they typically will last several years, and the penalties are actually pretty stiff on those interest and penalties. So that would be a typical non-income tax-type case that we would investigate and charge criminally.

Siana Danch:

Thank you, Jonathan, for this concise overview of how a civil IRS case can turn criminal.

Peter Hardy:

Thanks, Siana. I just wanted to end on one last topic. It's related to what we've been discussing, but it's its own topic in and of itself. We could spend an entire podcast on it, which we won't, but I just have to ask you because it's kind of the hot topic, which is the Corporate Transparency Act. And so condensing greatly, the Corporate Transparency Act is a US statute that was passed. FinCEN has been promulgating regulations. There's still some more to be done, but again, condensing greatly covered entities that as businesses, the government would say shell corporations, but it's really a variety of businesses.

And in fact, it's estimated that there will be over 30 million such entities that have to disclose information. They need to disclose directly to FinCEN, their beneficial owners as defined. And I'm not going to get into all the nuances of the beneficial

ownership definition other than to say it's anyone with a 25% ownership or more, and anyone who's deemed to, quote, "Control the entity." And that's a super broad term. So this has been a long time in coming, and you use the phrase earlier on, Jonathan, tax haven, and I understand that y'all refer to tax countries as tax havens, but the U.S. itself has been referred to as tax havens by, well, the rest of the world.

And in response to that, one of the responses was passing the Corporate Transparency Act. So this thing is out there now, it's just getting going. FinCEN has just started up, the database is still out of issues, both practical and legal to iron out, blah, blah, blah. Having said all that, are you and your counterparts in the US and abroad, what's your thinking on the CTA and are you looking forward to diving in to getting all that information?

Jonathan Schnatz:

Yeah, thank you, Peter. I think there are several issues. One, it's a good first step. So the US should have an open registry or a registry. We will see if it's open. That's one. So I think it's a good first step. As a criminal investigator, I want to make sure, or my question will be, is it going to be complete? And is the information in there going to be accurate? So there are some concerns that I would have as an investigator. Also, who has access. Is the usefulness of this going to be for solely me as a US law enforcement personnel, or is it going to be open and available to financial institutions that may, they're a lot of times the first line of defense in financial crime that if they're facilitating or helping move money, unbeknownst to them, if it's dark money and the shell corporations being used, this information might be helpful for them.

And also foreign law enforcement, that there are a lot of entities formed in the US that they would like the information on, so it would be useful for foreign law enforcement. So yeah, I mean, I think at this point, it's a good first step, but I think a lot of us are waiting to see exactly how it plays out over the next year or so to see what information is in the registry, and then the availability of it to everyone.

Peter Hardy:

Yeah, really interesting. And definitely accuracy is a big issue. Thank you for that. Okay. Well, thank you for the entire podcast. I want to say thank you to our listeners as well. Hope you all enjoyed it. Thank you, Chris. Thank you, Siana. And again, we invite you if you're interested in these sorts of issues, to check out our blog, Money Laundering Watch, and we wish you a good day. Thanks, everyone.

Steve Burkhart:

Thanks again to Peter Hardy, Chris Jones, Siana Danch, and Jonathan Schnatz. Make sure to visit our website, [www.ballardspahr.com](http://www.ballardspahr.com) where you can find the latest news and guidance from our attorneys. Subscribe to the show in Apple Podcasts, Google Play, Spotify, or your favorite podcast platform. If you have any questions or suggestions for the show, please email [podcast@ballardspahr.com](mailto:podcast@ballardspahr.com). Stay tuned for a new episode coming soon. Thank you for listening.