



TALKING ABOUT TAXES

Tom Rhodus
Gray Reed & McGraw

Tax Controversy Update Phone Forum – November 29, 2017

- A developing trend in criminal tax that historically has not seen very much use:
 - Sec. 7202, Willful failure to collect, truthfully account for and pay over employment taxes (a 5-year felony).
 - In lieu of (or in addition to) Sec. 6672, the civil “trust fund recovery penalty” (TFRP).

Employment tax deficiencies have traditionally been **EXCLUSIVELY** the subject of civil enforcement.



Today, examinations traditionally presumed to be “civil” in nature are breeding grounds for bad surprises!



The historical non-use of criminal sanctions in connection with employment taxes means that a criminal investigation comes as a huge shock to the defendants (and their counsel).



“Cooperation” with the investigating civil agents can prove to be self-incriminating.



Basics of Employment Taxes

- Employers are required to file two basic IRS employment tax returns:
 - Form 940 - *Employer's Annual Federal Unemployment (FUTA) Tax Return*
 - Form 941 - *Employer's QUARTERLY Federal Tax Return*

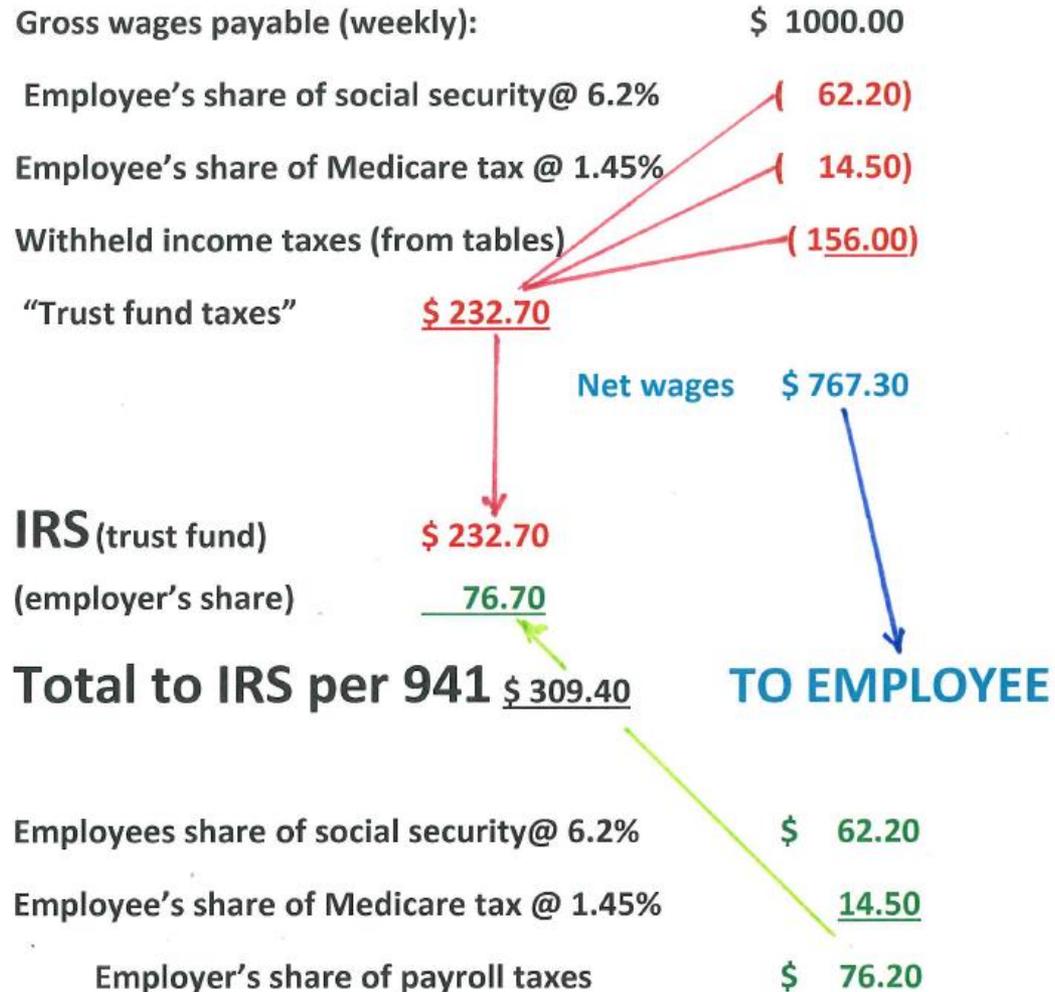
Basics of Employment Taxes

- Form 940 Basics:
 - For 2017, the FUTA tax rate is 6.0%.
 - All paid by employer. No withholding, so no “trust fund.”
 - The tax applies to the first \$7,000 you pay to each employee as wages during the year.
 - Generally, you can take a credit against your FUTA tax for amounts you paid into state unemployment funds. The credit may be as much as 5.4% of FUTA taxable wages.

Not Relevant to this discussion

- Form 941 Basics:
 - The social security tax rate is 6.2% each for the employee *and* employer
 - For 2017, the social security wage base limit is \$127,200.
 - The Medicare tax rate is 1.45% each for the employee *and* employer.
 - There is no wage base limit for Medicare tax.

Illustration of Payroll Taxes



Uncollected payroll taxes are a HUGE problem.

- As of December 2015, 1.4 million employers owed approximately **\$45.6 billion** in unpaid employment taxes, interest, and penalties.



Source: Report of the Treasury Inspector General for Tax Administration, March 21, 2017

- “Employment tax noncompliance occurs for many reasons.
- “Sometimes, employers experiencing economic strain ‘borrow the money for a short while’ to use the withheld taxes to fund the employer’s operations.
- Other employers willfully divert the withheld taxes for their own personal benefit.”



Source: Report of the Treasury Inspector General for Tax Administration (“TIGTA”), March 21, 2017

While a business owner may consider delinquent employment taxes to be an undocumented “loan” from the government, the government considers it to be **THEFT**.



The Traditional Civil Remedy:

Internal Revenue Code § 6672 provides that any person required to collect, account for, and pay over taxes who willfully fails to perform any of these activities can be assessed a Trust Fund Recovery Penalty (TFRP).

IRC § 6672

By way of background and introduction:

- IRC § 6672 saddles a taxpayer with personal civil liability for the trust fund portion (only!) of unpaid payroll taxes (“TFRP”).

The TFRP may be assessed against any person who:

- Is responsible for collecting or paying withheld income and employment taxes; and
- Willfully fails to collect or pay them.



Source: IRC, § 6672

Who Can Be A Responsible Person?

A "responsible person" is one who:

a) has the duty to perform

or

b) the power to direct

c) the act of collecting, accounting for, or paying over trust fund taxes.

Who Can Be A Responsible Person?

More than one person may be held responsible, not just the most responsible person. *Howard v. United States*, [711 F.2d 729](#) (5th Cir. 1983)

Who Can Be A Responsible Person?

In some cases a person may be liable for failure to pay over withheld funds to the United States, even if ordered by the corporation's chief executive officer not to pay the taxes. *Roth v. United States*, [779 F.2d 1567](#) (11th Cir. 1987).

Who Can Be A Responsible Person?

The holding of corporate office, control over financial affairs, the authority to disburse corporate funds, stock ownership, and the ability to hire and fire employees are important factors to consider in determining responsibility. *Thibodeau v. United States*, [828 F.2d 1499](#) (11th Cir. 1987).

Who Can Be A Responsible Person?

Most TFRP cases involve officers of corporations. However, a responsible person may be one or more of the following:

- an officer or employee of a corporation
- a member or employee of a partnership
- a corporate director or shareholder
- a related controlling corporation

Who Can Be A Responsible Person?

The IRS' view is that anyone with signatory authority is “responsible”.

What is Willfulness?

“Willfulness” is the intentional act of paying other creditors instead of the IRS.

What is Willfulness?

- A responsible person's failure to investigate or correct mismanagement after being notified that withholding taxes have not been paid satisfies the IRC 6672 willfulness requirement. *Finley v. United States*, [123 F.3d 1342](#) (10th Cir. 1997).

What is Willfulness?

- If funds are not available to cover both wages and withholding taxes, a responsible person has a duty to prorate the available funds between the United States and the employees so that the taxes are fully paid on the amount of wages paid. *Hochstein v. United States*, [1991 U.S. Dist. LEXIS 5317](#).

What is Willfulness?

- A mistaken belief that payments to other creditors were required to be made in preference to trust fund taxes does not make the failure to pay non-willful. *Thomsen v. United States*, [887 F.2d 12](#), [****17-18**] (1st Cir. 1989).

But.....

“In virtually every case, the IRS does not pursue criminal prosecution and instead relies on collection and penalty assessment authority to encourage compliance.”



Source: Report of the Treasury Inspector General for Tax Administration, March 21, 2017

In former times, what little criminal enforcement there was with respect to payroll taxes was limited to Sec. 7215.

§ 7215 - Offenses with respect to collected taxes

(a) PENALTY

Any person who fails to comply with any provision of section 7512(b) shall, in addition to any other penalties provided by law, be guilty of a misdemeanor, and, upon conviction thereof, shall be fined not more than \$5,000, or imprisoned not more than one year, or both, together with the costs of prosecution.

(b) EXCEPTIONS. This section shall not apply—

(1) to any person, if such person shows that there was reasonable doubt as to (A) whether the law required collection of tax, or (B) who was required by law to collect tax, and

(2) to any person, if such person shows that the failure to comply with the provisions of section 7512(b) was due to circumstances beyond his control.

Criminal proceedings under § 7215 involve a two-step process.

- It applies only to a person who “fails to comply with any provision of § 7512.”
- § 7512 provides that if the IRS serves a delinquent taxpayer with a written notice “delivered in hand”, the taxpayer must deposit all payroll taxes that are due within two banking days after payroll is made into a special trust account.
- If the taxpayer ignores and fails to abide by the warning in the § 7512 notice, THEN (and only then) is he subject to prosecution under § 7215.
- NOTE that § 7215 does not include the word, “willful”, i.e., it is a strict liability statute.
- ALSO NOTE that § 7215 is a misdemeanor offense, meaning that the maximum term of imprisonment is one year per count.

As part of the civil payroll tax delinquency investigation routine, taxpayers are given a copy of IRS letter 903.

The old version of this letter described the § 7215 process, leading taxpayers to believe that they would first be served with a notice requiring prompt deposit of payroll taxes before any criminal procedure would be instituted.

Old Version of Letter 903

Internal Revenue Service
4050 ALPHA RD
MS 5115 NDAL
FARMERS BRANCH, TX 75244-4201

Department of the Treasury

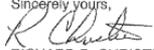
Date: 01/11/2011

Employer Identification Number:
See Attached
IRS Person to Contact:
MANDALA R RIVEROS
IRS Employee Identification Number:
1000218648
Contact Telephone Number:
(972)308-7868

Dear Mr.

Our records show you haven't deposited federal employment taxes as required by deposit rules set forth in Employment Tax Regulations section 31.6302. If you don't comply with these rules in the future, we must consider stricter enforcement procedures.

above.

Sincerely yours,

RICHARD D. CHRISTIAN
MANAGER

Enclosure:
Notice 931

Letter 903 (DO) (Rev. 6/97)
Catalog No. 10737Q

Under the provisions of the law for special bank deposit requirements, we may also require you to deposit your withheld taxes in a special bank account within 2 banking days after you pay employees their wages. These deposits would remain in the bank account until paid over to the Internal Revenue Service. Under the law we may charge you criminal penalties, such as a fine up to \$100,000 and up to one year in jail upon conviction, if you don't comply with the special bank deposit requirements.

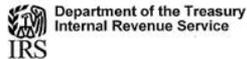
In 2013, the IRS altered the form of its Letter 903 to remove references to § 7215 and instead, to emphasize the possibility of prosecution under § 7202.

I.R.C.

IRC § 7202 – Willful failure to collect or pay over tax.

Any person required under this title to collect, account for, and pay over any tax imposed by this title who willfully fails to collect or truthfully account for and pay over such tax shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.

New Version of Letter 903



Date:

Person to contact:

The DOJ can also pursue criminal charges based on the willful failure to report and pay over withheld taxes (Section 7202 of the Internal Revenue Code). Willfulness is evident if an employer paid net wages and didn't leave enough funds to make the required tax payments or used withheld trust fund taxes for other purposes. **Convictions may result in imprisonment and other penalties. Other criminal statutes may also apply.**

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we may:

- **File a Notice of Federal Tax Lien (NFTL) to protect the government's interest**

By filing this notice, we are making a legal claim to your property as security for the payment of your tax debt. An NFTL is a public notice to your creditors that we have a claim against all your property, including property you acquire after we file the lien. An NFTL can have a negative effect on your credit rating. We may also seize (levy) your property. A levy is a legal seizure of property to satisfy a tax debt.

- **Assess a trust fund recovery penalty under Internal Revenue Code Section 6672 for the unpaid trust fund taxes**

We can assess a trust fund recovery penalty against anyone who is responsible for, and willfully fails to, collect, account for, or pay to the IRS income and employment taxes the law requires to be withheld. Willfulness exists if a person allows payment of net wages when the employer has insufficient funds to pay the taxes or uses withheld taxes for other purposes. Willfulness also exists if a person who knows of a previous failure to pay taxes allows payments to others (including payment of additional wages) rather than using available funds to pay the tax delinquency.

- **Refer the matter to the Department of Justice (DOJ) to institute a civil suit or to seek criminal prosecution**

In a civil suit, the DOJ can seek an injunction that requires the employer to comply with the federal employment tax laws and prohibits the employer from paying any amounts until the employer pays the correct amounts to the IRS. The DOJ may also ask the court to appoint a receiver to take control of the business to ensure tax compliance.

Letter 903 (Rev. 8-2013)
Catalog Number 10737Q

Letter 903 (Rev. 8-2013)
Catalog Number 10737Q

In 2014, the DOJ's *Criminal Tax Manual* was amended by inserting the following notice in the portion of that document dealing with prosecutions under § 7215:

“Notice: § 7512, which makes it a misdemeanor to fail to comply with § 7512(b) is obsolete, because the IRS no longer issues notices under § 7212(b) requiring the use of special deposit procedures for collected employment taxes.”



The Federal Sentencing Guidelines “*Commentary*” pertaining to Section 7202 (§2T1.6) formerly contained the following observation:

“Background: The § 7202 offense is a felony that is infrequently prosecuted.”

And then...

- In Nov. 2016, the Federal Sentencing Guidelines' reference to § 7202 being “infrequently prosecuted” was removed.
- The 2016 Guidelines do not provide a basis for this change (the former reference to “infrequent prosecution” was simply removed).
- Some say that this amendment was because some lawyers used the “infrequency of prosecution” language to urge courts to give more lenient sentences; but a better reason is because as a matter of fact, prosecutions under § 7202 are no longer “infrequent”.

Department of Justice, Tax Division, *Criminal Tax Manual*:

DOJ is well aware of the substantial similarity between the traditional civil remedy, § 6672 and its criminal counterpart, § 7202.

“Under section 6672, the civil counterpart to section 7202, a voluntary, conscious, and intentional act of paying the claims of other creditors ... constitutes a “willful” violation of the duty to pay over. . . . Similarly, it is the Tax Division's position that a person willfully fails to pay over tax under section 7202 when, instead of paying the trust fund taxes, he voluntarily and intentionally uses the money to pay the claims of other creditors.”

Department of Justice, Tax Division, *Criminal Tax Manual*:

DOJ is also well aware of the potential interplay between the civil and criminal functions:

“Prosecutors should ascertain whether an IRS Form 2751, Proposed Assessment of Trust Fund Recovery Penalty, or an IRS Form 4180, “Report of Interview with Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes,” was completed during the civil administrative part of the case, because these documents may contain relevant admissions or statements by the defendant.”

Form 4180

Form 4180 (August 2012)	Department of the Treasury - Internal Revenue Service	
	Report of Interview with Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes	
Instructions: The interviewer <i>must</i> prepare this form either in person or via telephone. <i>Do not</i> leave any information blank. Enter "N/A" if an item is not applicable.		
Section I - Person Interviewed		
1. Name		2. Social Security Number (SSN)
3. Address (street, city, state, ZIP code)		4. Home telephone number ()
		5. Work telephone number ()
6. Name of Business and Employer Identification Number (EIN)	7. Did you use a third-party payer, such as a payroll service?	
	<input type="checkbox"/> Yes (If yes complete Section VI A) <input type="checkbox"/> No	
8. What was your job title and how were you associated with the business? (Describe your duties and responsibilities and dates of employment.) If person being interviewed is a payroll service provider or a professional employer organization, complete Section VI B		

Form 4180

Section II - Responsibilities

1. State whether you performed any of the duties / functions listed below for the business and the time periods during which you performed these duties.

Did you...	Yes	No	Dates	
			From	To
a. Determine financial policy for the business?	<input checked="" type="checkbox"/>	<input type="checkbox"/>		
b. Direct or authorize payments of bills/creditors?	<input checked="" type="checkbox"/>	<input type="checkbox"/>		
c. Prepare, review, sign, or authorize transmit payroll tax returns?	<input checked="" type="checkbox"/>	<input type="checkbox"/>		
d. Have knowledge withheld taxes were not paid?	<input checked="" type="checkbox"/>	<input type="checkbox"/>		
e. Authorize payroll?	<input checked="" type="checkbox"/>	<input type="checkbox"/>		
f. Authorize or make Federal Tax Deposits?	<input checked="" type="checkbox"/>	<input type="checkbox"/>		
g. Authorize the assignment of any EFTPS or electronic banking PINS/passwords?	<input checked="" type="checkbox"/>	<input type="checkbox"/>		
h. Could other individuals do any of the above? <i>(Complete Section IV and V)</i>				
Name		<input type="checkbox"/>		
Contact Number		<input type="checkbox"/>		
i. Have signature authority or PIN assignment on business bank accounts?				
Bank Name(s)				
Account Number(s)				

Affirmative answers to these questions mean that your client is “responsible”.

Form 4180

Section V - Knowledge / Willfulness

1. During the time the delinquent taxes were increasing, or at any time thereafter, were any financial obligations of the business paid?
(such as rent, mortgage, utilities, vehicle or equipment loans, or payments to vendors)

No

Yes Which obligations were paid?

Who authorized them to be paid?

2. Were all or a portion of the payrolls met?

No

Yes

Who authorized

3. Did any person or organization provide funds to pay net corporate payroll?

No

Yes *(explain in detail and provide name)*

4. When and how did you first become aware of the unpaid taxes?

5. What actions did you attempt to see that the taxes were paid?

6. Were discussions ever held by stockholders, officers, or other interested parties regarding nonpayment of the taxes?

No

Yes

Identify who attended, dates, any decisions reached, and whether any documentation is available.

7. Who handled IRS contacts such as phone calls, correspondence, or visits by IRS personnel?

When did these contacts take place, and what were the results of these contacts?

Honest answers to these questions are likely to show that your client is “willful”.

Form 4180

Section III - Signatures	
I declare that I have examined the information given in this interview and to the best of my knowledge and belief, it is true, correct, and complete.	
Signature of person interviewed	Date
Signature of Interviewer	Date

Space for signing the “confession”.

Direct Comparison of § 6672 to § 7202

Sec. 6672 - Failure to collect and pay over tax, or attempt to evade or defeat tax.

- 1. Any person required to collect, truthfully account for, and pay over any tax imposed by this title** who
- 2. willfully**
- 3. fails to collect such tax, or truthfully account for and pay over such tax**, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

Direct Comparison of § 6672 to § 7202

Sec. 7202 - Willful failure to collect or pay over tax.

1. Any person required under this title to collect, account for, and pay over any tax imposed by this title who
2. willfully
3. fails to collect or truthfully account for and pay over such tax shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.



So....what's the difference between a routine delinquent payroll tax case and a § 7202 criminal proceeding?

According to the government, only one thing: Burden of Proof

In § 6672 cases, the IRS' assessment is presumed correct; and the taxpayer has the burden of proof of rebutting it by a preponderance of evidence.

In § 7202 cases – as in all criminal cases – the government has the burden to prove all elements of the crime beyond a reasonable doubt.

“It all depends on your point of view.”



TIGTA Report § 7202

March 21, 2017 – TIGTA released a new report titled:

A More Focused Strategy Is Needed to Effectively Address Egregious Employment Tax Crimes



TIGTA Report § 7202

Synopsis or Report:

- Employment tax noncompliance is a serious crime.
- When employers willfully fail to account for and deposit employment taxes ... they are in effect stealing from the Government.
- In order to promote compliance, § 7202 needs to be used more often.

Takeaways

The similarities between Section 7202 and its civil counterpart Section 6672

+

The government's new attitude towards aggressive use of Section 7202 prosecutions

=

There is no longer any such thing as a "routine" payroll tax investigation.



Takeaways

- Every payroll tax delinquency situation - at least in any situation where the facts would arguably justify imposition of the TFRP -- is a potential Section 7202 prosecution.

Case 5:16-cr-00013-D-BQ Document 3 Filed 03/16/16 Page 1 of 19 PageID 4

SEALED IN THE UNITED STATES DISTRICT COURT
OF THE NORTHERN DISTRICT OF TEXAS
LUBBOCK DIVISION

CLERK US DISTRICT COURT
NORTHERN DIST. OF TX
FILED
2016 MAR 16 PM 1:27

DEPUTY CLERK *crf*

UNITED STATES OF AMERICA
v.
JOHN W. BEAKLEY

No. **5-16CR0013-C**

INDICTMENT

The Grand Jury Charges:

Introduction

At all times relevant to this indictment:

1. The Internal Revenue Code required employers to pay to the United States of America the employer's share of Federal Insurance Contribution Act taxes (also called "FICA" and "social security" taxes) and Medicare taxes owing on wages paid to employees.
2. The Internal Revenue Code also required employers to: 1) withhold from the wages of their employees the employees' share of FICA taxes, Medicare taxes, and income taxes; 2) to account for those taxes; and 3) to pay the withheld amounts over to the United States.
3. A person was responsible for collecting, accounting for, and paying over to the United States the FICA, Medicare, and income taxes, described in paragraphs 1 and 2 above, if that person had the authority to exercise significant control over the employer's

John W. Beakley
Indictment- Page 1

Takeaways

- Very carefully consider the potential downside of allowing the client to be interviewed or to fill out the TFRP questionnaire, Form 4180.



Takeaways

- In view of the developing trends in this area, there is probably a valid Fifth Amendment privilege against providing any information at all to the IRS.



SEALED

UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
LUBBOCK DIVISION

CLERK US DISTRICT COURT
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DEPUTY CLERK *CAF*

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Indictment - Page 1

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
LUBBOCK DIVISION

2017 SEP 29 AM 8:28

DEPUTY CLERK *BMG*

UNITED STATES OF AMERICA,

Plaintiff,

VS.

JOHN W. BEAKLEY,

Defendant.

VERDICT

We, the jury in the above-entitled case, find the defendant (answer "Guilty" or "Not Guilty" in the spaces provided):

- | | |
|-------------------|-----------------|
| <u>Not guilty</u> | on Count One |
| <u>Not guilty</u> | on Count Two |
| <u>Not guilty</u> | on Count Three |
| <u>Not guilty</u> | on Count Four |
| <u>Not guilty</u> | on Count Five |
| <u>Not guilty</u> | on Count Six |
| <u>Not guilty</u> | on Count Seven |
| <u>Not guilty</u> | on Count Eight |
| <u>Not guilty</u> | on Count Nine |
| <u>Not guilty</u> | on Count Ten |
| <u>Not guilty</u> | on Count Eleven |
| <u>Not guilty</u> | on Count Twelve |

Keys to success in *United States v. Beakley*

1. No Form 4180:

In *Beakley*, the defendant controlled or managed many business entities, virtually all of which has payroll tax deficiencies.

However, the 12-count sec. 7202 indictment alleged violations with respect to only two entities.

The revenue officer had filed out only one Form 4180 form, which was duly signed by the defendant. The revenue officer apparently intended the Form 4180 form to cover all delinquent entities, but it actually only named one entity. ***That entity was not one of the entities charged in the indictment.***

Keys to success in *United States v. Beakley*

2. Unusual Economic and Physical Climate:

The time periods specified in the indictment covered the quarterly periods for 2010 and 2011.

Not only was this the time of the Great Recession (when hundreds of thousands of businesses failed), this time period also involved unusually severe winter storms in the Texas Panhandle known as “snow-mageddon”). (The defendant’s primary business was operating Dairy Queen restaurants: “You don’t sell many Blizzards during a real blizzard”.)

As a result, the defendant was faced with a moral choice: Should I close all of my business (and put over 2,000 employees out of work); or should I continue to operate (continuing to run up payroll tax deficits in the short run) in hopes that I will eventually be able to earn my way out of this mess?

Keys to success in *United States v. Beakley*

3. Entrapment by Estoppel:

The revenue officer in *Beakley* acquiesced in the defendant's keeping his the businesses open and operating, even though the defendant told the collection officer and he knew that there was no way to pay the accruing payroll taxes.

A criminal defendant may raise a defense of **entrapment by estoppel** “when a government official or agent actively assures a defendant that certain conduct is legal and the defendant reasonably relies on that advice and continues or initiates the conduct.” [*United States v. Trevino–Martinez*, 86 F.3d 65, 69 \(5th Cir.1996\)](#) (internal quotations and citation omitted).

Even though the revenue officer had no actual authority to allow the defendant to continue to violate the law by pyramiding payroll tax deficiencies, the IRS agent's acquiescence still helped to form the defendant's state of mind and good faith understanding that what he was doing did not violate the law.

Keys to success in *United States v. Beakley*

4. Jury Charge on Willfulness:

“For a “willful” violation of a statute, the government must prove that the defendant acted with the knowledge that his conduct violated the law, and not because of mistake, accident, negligence, or other innocent reason. This element of the offense requires that the government prove beyond a reasonable doubt that the defendant actually knew that his conduct was illegal and that the defendant acted with the purpose and intent of violating the law. . . .

“Good faith is a complete defense to each of the charges in the indictment, because good faith on the part of the defendant is inconsistent with the requirement that he acted willfully. . . . If you have a reasonable doubt concerning whether the defendant acted in good faith, you must find the defendant not guilty of the offense charged in the count of the indictment under consideration.

“In determining whether or not the government has proved that the defendant acted willfully, as alleged in the indictment, or whether the defendant acted in good faith, you must consider all of the evidence received in the case bearing on the defendant’s state of mind.”

Tom Rhodus



Gray Reed

- Partner, Tax Section

Education

- B.A., Southern Methodist University
- J.D., SMU Dedman School of Law

Experience

- Tom was a trial attorney with the DOJ Tax Division (1972-1979 and has taught tax fraud at SMU's Dedman School of Law since 1980. He recently obtained an acquittal in a Section 7202 prosecution (*U.S. v. Beakley*, Sept. 29, 2017 (N.D. Texas, Lubbock Division)).

Gray Reed & McGraw



- 140 attorneys
- Full-service, commercial law firm
- Offices in Dallas & Houston
- Opened in 1985
- Tax section was ranked in the 2018 *U.S. News & World Report and Best Lawyers'* "Best Law Firms" rankings



Thank you!



Tom Rhodus

trhodus@grayreed.com

Gray Reed & McGraw

www.grayreed.com