Zappers & Employment Tax Fraud

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ZAPPERS & EMPLOYMENT TAX FRAUD

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Beyond the grey area of worker misclassifications and general employment tax irregularities there are darker employment relationships where workers are intentionally paid in cash “off-the-books” or “under-the-table.” Grey employment relationships present civil enforcement issues that may become criminal; darker-relationships are criminal from the beginning. Zappers are found on the dark side.

In the grey areas of employment tax fraud workers and their employers operate within the tax system (although they are not fully compliant); those engaged in darker employment tax frauds intentionally operate outside the system. Almost all of the dark employment relationships are carried out in cash. Zappers provide cash.

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1 There is a middle area of concern – embezzlement by third-parties who have been hired to facilitate employment tax compliance. The complexities of IRC Subtitle C, Employment Taxes, has created an industry of third-party payers (TPP) who prepare paychecks for employees as well as the employment tax returns for their employers. TPPs may also file these returns (signed by the employer); make tax deposits; prepare forms like W-3 and W-2’s. However, on occasion TPPs have been found embezzling the funds entrusted to them. The amounts involved can quickly become very significant. See the case of USA v Albert Cipoletti & Kerry Seaman E.D.CA. (2:10-cr-00444-GEB) where over a six-year period the defendants embezzled $19,141,618.24 from their clients through their payroll firm Ingentra HR Services. Clients included: The County of Sacramento, Stanley Black & Decker, Inc. and Scan Disk Corporation. Judgment was filed May 24, 2011, based on a plea bargain. A 78 months prison term, followed by 36 months of supervised release and full restitution was ordered. Restitution however was “interest free” as “… the court determined that the defendant does not have the ability to pay interest …”

The TPP problem is discussed by the Taxpayer Advocate Service in the 2012 Annual Report to Congress. Protect Taxpayers and the Public Fisc from Third-Party Misappropriation of Payroll Taxes, (Vol. 1) 553-559; and also at Most Serious Problems #23, Early Intervention, Offers in Compromise, and Proactive Outreach Can Help Victims of Failed Payroll Service Providers and Increase Employment Tax Compliance, 426-444, available at: TAX ANALYSTS Document Service Doc 2013-504. The National Payroll Reporting Consortium (NPRC) has advanced workable solutions to this problem. The NPRC suggests that all payroll tax deposits to be made through the Electronic Federal Tax Payment System (EFTPS), which should be followed up with an e-mail or letter notification to the employer that deposits have been made. See: NPRC, GOVERNMENT CORNER, New IRS Regulations Require Payroll Firms to Make Quarterly Disclosures to Clients, Federal: August, 2012, available at: www.nprc-inc.org/govc.html & NPRC Letter to IRS, Re: Notice 2012-25 Recommendations for the 2012-2013 Guidance Priority List (April 18, 2011).

A more comprehensive real-time, fully digital compliance regime is being implemented in Brazil (July 1, 2013). In is the third part of Sistema Publico de Escrituracao Digital (Public System for Digital Accounting) or SPED. There is currently Fiscal SPED and Accounting SPED. The next phase is Social SPED. It will digitally integrate wage and labor laws into the Brazilian tax compliance and accounting system. The Brazilian solution merits close attention. It has achieved a high level of success with digital invoicing for prevention of cross-border consumption tax fraud. Wage and payroll fraud is targeted next. See: Newton Oller de Mello, Eduardo Mario Dias, Cuio Fernando Fontana & Marcelo Alves Fernandez, The Evolution of Electronic Tax Documents in Latin America, PROCEEDINGS OF THE 13TH WORLD SCIENTIFIC AND ENGINEERING ACADEMY AND SOCIETY (WSEAS) INTERNATIONAL CONFERENCE ON SYSTEMS (2009) 449, 297, available at: http://dl.acm.org/citation.cfm?id=1627575&picked=prox.
Zappers are fraud-technologies that automatically (and remotely) skim cash from electronic cash registers (ECRs) or back room point of sales (POS) systems. Globally, tax auditors are finding that Zappers frequently provide the cash that is used to compensate “under-the-table” workers. In fact, a Zapper appears to be at the heart of the allegations in Ohio where seven I-HOP franchises allegedly used Zappers (with remote access functionality likely downloaded free from the Internet) to skim cash from their operations. The cash was allegedly used to pay more than 200 illegal immigrants “off-the-books.”

This paper explores the relationship between Zappers and criminal employment tax fraud. It urges greater Federal/State enforcement efforts on the front end and adoption of secure technology-based solutions as part of the criminal restitution on the back end. Security-based restitution could either be statutorily mandated or court imposed. Zappers are far too easy to re-install if an owner is inclined to do so. There is technology that will detect (and prevent the use of) Zappers.

QETP

Since at least November 2007 the IRS has been working with the Department of Labor and State Workforce Agencies under its Questionable Employment Tax Practices (QETP) initiative. QETP is a “collaborative, nationwide program” to share employment

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2 Indictment at ¶¶ 6, 14 & 46-54, notably ¶47, United States of America v. Tarek Elkaafrawi et. al. N.D. Ohio, Case No. 3:12cr 262.
3 FBI (Cleveland Division), Eighteen People Indicted for Role in $3 million Scheme Involving Seven I-HOP Restaurants (May 23, 2012).
4 See for example Senate Bill No. 840 introduced by Senator Ridgeway in the 96th Missouri General Assembly. It would require that any business delinquent in paying sales or use taxes after July 1, 2013, to use a secure automated ECR/POS system, or face revocation of the business’s state sales and use tax license. This bill lapsed with the end of the session, but is expected to be reintroduced in 2013 during the 97th General Assembly.
5 For example, on July 7, 2006 Revenue Quebec announced that 28 companies operating under the name of Casa Grecque pleaded guilty to Zapper fraud. The Budget Speech announcing the plan to require the adoption of cash registers equipped with microcomputers approved by Revenue Quebec had been given on March 23, 2007, and as a result Judge Lise Gaboury of the Court of Quebec decided to impose adoption of security on all ECRs/POS systems in the restaurants in addition to monetary fines of CAN $694,600 (QST), $232,574 (GST), and legal fees of $72,826. Revenue Quebec, News Release, Tax Evasion: Restaurants in the Chain Casa Grecque Guilty of Tax Evasion (July 7, 2006) available at: http://www.revenu.gouv.qc.ca/eng/ministere/centre_information/communiques/ev-fisc/2006/10juillet.asp (in French only, last visited Feb. 16, 2008; copy and translation on file with author).
tax examination results, exchange data, and leverage resources to encourage businesses to comply with federal and state employment tax requirements.7

The QETP initiative has civil and criminal aspects. On the civil side the States and the Federal government have been sharing information about employee misclassification. The misclassification of employees as independent contractors has been a part of QETP from the beginning.8 A September 19, 2011 Memorandum of Understanding between the IRS and the Department of Labor extends this effort.9 It is estimated that misclassification will cost the US Treasury as much as $7.45 billion through 2012.10

The IRS has shown positive results from State QETP referrals. A 2011 report by the QETP Oversight Team records federal revenue recovery of $22,809,165 from 4,362 returns. On the other side of the ledger, participating states have assessed $20,873,017 from 6,981 reclassification audits. All together 71,732 workers representing $1,320,973,305 in improperly assigned compensation have been reclassified.11

The criminal side of QETP is more relevant for this paper’s investigation of Zappers. On this aspect of QETP the IRS publishes case-specific data and examples of criminal enforcement actions. During FY 2010 through FY 2012 the IRS initiated 467 criminal employment tax investigations – prosecution was recommended in 311; sentences handed out in 220; and the average incarceration exceeded 20 months.12 In 98 instances the IRS has prepared short summaries of the criminal cases and posted the text on the net.13 No comprehensive list of criminal employment tax actions is available. In these 98 cases the aggregate restitution is $177,636,824, even though much of it appears unrecoverable.

Are these 98 cases a representative sample of the larger group of 467 investigations? They appear to be, but the IRS makes no statement in that regard. If this is the case, then it is striking that none of the 98 criminal enforcement actions involve Zappers, or sales suppression technology. By all accounts, and based on the prevalence

11 QETP PROGRESS REPORT, supra note 6, at 7-8.
of Zappers in foreign jurisdictions, along with the ready alignment of Zappers with employment tax fraud, there appears to be a gap in US enforcement. A short summary of what these 98 cases show is helpful.

The 98 Cases

The 98 IRS-published cases have common attributes. Almost all are plea-bargained — only 10 go to trial. In 42 cases restitution is only for the tax amount. No interest, and no penalties are imposed. In these cases the judge expressly determines that the defendant does not have the ability to pay interest, and from the sentencing details it is frequently apparent that there is little expectation that there will be a full recovery of the tax. In other words the victories here appear Pyrrhic — too much has been lost already to expect to make a real recovery.

The 98 cases fall into two large groups — the embezzlement cases (61), and the collusion cases (37). In the embezzlement cases workers receive paychecks. On pay stubs withholdings appear to have been made from gross wages, but in fact the preparer has stolen the money. The collusion cases are different. In these case employees are aware of their employer’s fraud, and are willing participants in it. Payments are almost always made in cash. The workers tend to be undocumented labor, or individuals seeking unreported income.

The 61 Embezzlement Cases

These cases are the easiest to audit. There is a clear trail — starting with the worker’s paycheck. The problem is the related tax deposits and returns are missing. In seventeen (17) instances a third-party payroll provider carries out this embezzlement. The next largest grouping of embezzlers is found in various parts of the medical industry (11). The remaining (33) cover a fairly wide range of instances involving professionals or industries ranging from a newspaper publisher, graphic design, several research

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15 For example, in United States of America v. Vanna Kem, D. N.J., 3:12-cr-000264-AET (Judgment filed on October 1, 2012) the defendant is sentenced to 3 years in prison. Restitution is $163,837.94 upon which interest is waived. Ms. Kem ran an employment agency that primarily provided seasonal workers. She paid workers over $1 million in cash and did not file Form 941, or make any withholdings for income tax or FICA (or make FICA payments as an employer). Restitution payments are due at $25 per month while in prison, and after that at $300 per month. Thus, it will take 48 years for Ms. Kem to repay the IRS at which time Ms. Kem (42 years old at the time of judgment) will be 90.

16 United States of America v. Peter Churchill Labovitz, E.D. VA, 1:11-mj-00547-JFA (Information, July 8, 2011) (The president of Connection Newspapers in charge of day-to-day operations who withheld employment taxes but failed to pay them over. Restitution of $647,510 was required.)
Two examples demonstrate the contours of this type of employment tax fraud. The first is an Ohio case involving Scott E. Carter, a marketer of medical products selling

17 United States of America v. Donald Penniston, W.D. WI, 3:10-cr-00155-bbc (Indictment, October 6, 2010) (Concerning the president of a graphic design company who withheld employment taxes, but failed to pay them over to the government in addition to stealing money from his employee’s pension fund. Restitution of $11,319 was required.)

18 United States of America v. Stuart M. Register, M.D. FL, 8:10-cr-00513-JSM-TGW (Indictment, December 8, 2010) (Concerning the operator of a criminal research bureau who employed individuals and withheld employment taxes but failed to pay them over to the government, and filed false personal income tax returns. Restitution of $345,612 was required). United States of America v. John Grinstead & Larry Lough, S.D. Ohio, 1:12-cr-00008-HJW (Information, January 31, 2012).

19 United States of America v. John Fluellen Heard & William Michael Lane, S.D. TX, 4:07-cr-00114 (Indictment, March 29, 2007) (Concerning the owner of a security firm with significant US government contracts who paid wages, made withholdings, but did not but did not pay over the amounts to the government. In business since 1987 he was ordered to pay restitution of $5.7 million).

20 United States of America v. Eleanor Mowery Sheets, N.D. TX, 3:10-cr-00178-BF (Information, June 23, 2010) (Concerning a real estate agent who failed to pay personal and corporate income taxes as well as refusing to pay over employment taxes withheld. Restitution of $1.3 million was ordered).

21 United States of America v. Silford Warren, E.D. NY, 1:11-cr-00778-WFK (Information, December 9, 2011) (Concerning a CPA who failed to pay over the matching portion of employment taxes as well as under-reporting the wages of employees so as to reduce withholding obligations. Restitution ordered of $184,263). United States of America v. Felix Robert Lasaracina, D. CT, 3:11-cr-00128-CFD (Criminal Complaint, October 21, 2010) (Concerning a CPA who defrauded the beneficiaries for $4.1 million, filed to file income tax returns, and pay over withholdings from employees of $734,359. Restitution ordered to include the employment taxes not paid).

22 United States of America v. Rosalyn Marie Quinn, D. KS, 2:09-cr-00275-JWL (Indictment, June 17, 2009) (Concerning a lawyer who employed three to five people in her law practice, withheld employment taxes from their wages, but failed to pay the taxes over to the government. Restitution included $235,600 in employment taxes due).

23 United States of America v. Kulwant Lasher, Tarlochan Lasher & Jaswinder Lasher, E.D. CA, 1:07-cr-00264-AWI (Criminal Complaint, October 4, 2007) (Concerning three brothers who owned a trucking company, paid wages to employees but filed to account for and pay over employment taxes of $793,767).


25 United States of America v. James Clark, D. KS, 2:12-cr-20028-CM (Information, March 9, 2012) (Concerning the owner of the Kansas City Knights basketball team who failed to pay over $502,000 in withholdings to the government from employee pay checks). 2012-14

26 United States of America v. Dong Sun Mun, S.D. NY, 1:11-cr-00149-WHP (Indictment, February 16, 2011) (Concerning the owner of a company that did sewing for NY fashion houses. He cashed checks from customers at check cashing services and paid employees in cash without withholding income taxes or employee taxes of $304,000. Mun jumped bail, fled to Vietnam and Korea and was arrested entering Canada. Full restitution is ordered).

27 United States of America v. Gregory E. Crocker, W.D. MO, 3:11-cr-05036-GAF (Information, November 8, 2011) (Concerning the owner and operator of a cemetery and pre-need funeral services company who withheld and failed to pay over $1,586024 in employment taxes. Full restitution is ordered).
to health care providers. The second involves Jose Figueroa, a New Jersey provider of payroll services with a national client base.

*United States of America v. Scott E. Carter.* Scott E. Carter was the 50 year old president and sole stockholder of Advance Health Systems, Inc. (AHS), an Ohio corporation in the business of marketing medical products (oxygen and related equipment) to health care providers. As the owner and principle officer of AHS, Carter was responsible for collecting, accounting for, and paying over to the IRS on a quarterly basis both the Federal Insurance Contribution Act (FICA) taxes (social security and Medicare), and the income taxes that AHS was required to withhold from taxable wages paid to employees.

AHS was required to file Form 941, the Employer’s Quarterly Federal Tax Return, as well as the companion Forms W-2, Wage and Tax Statement, for each employee at the end of the year. From December 2000 through April 2005 Carter withheld payroll taxes from his employees (including withholdings on his own wage), drafted payroll checks, and prepared year-end W-2’s.

However, Carter never filed Form 941 for any quarter. No deposits were made of any withholdings. Carter began filing Form 941 in 2005. The second and third quarter Form 941’s were filed along with the first and second quarter Form 941’s of 2006. Coincidentally, this voluntary federal compliance followed the February 10, 2005 search of AHS offices by the Ohio Department of Taxation in connection with (and their investigation into) AHS’s failure to file or make payments of Ohio state withholdings.

Also in April 2005 Carter changed the name of his business to Advanced Health Systems Group (AHSG), LLC, secured a new EIN from the IRS, and transferred all payroll reporting, withholding, and deposit obligations over to an independent third-party payroll provider.

This arrangement did not last for long. In September 2006 Carter took back the responsibility for filing Form 941 and making payroll deposits. Once again the returns were not filed, and the deposits were not made. In October 2007 Carter closed AHSG, sold all assets and went bankrupt.

The government alleged aggregate tax losses of $1,098,000.\(^{28}\) Carter entered a plea agreement where he accepted guilt on all counts,\(^ {29}\) and was sentenced to 10 concurrent 25 month prison terms and three years supervised release, with an obligation to provide restitution equal to 10% of his gross income each month until full restitution was paid.\(^ {30}\)


\( ^{29} \) Id., at 23.

United States of America v. Jose Figueroa. Jose Figueroa was Vice President of Operations for First Priority Payroll (FPP). FPP provided payroll services for 3,500 businesses throughout the US. FPP provided paycheck services, prepared employment tax returns, as well as collected payroll taxes and remitted the funds to the IRS and state taxing authorities on behalf of its clients.

From January 2008 through November 2009 Figueroa and co-conspirator Carlos Chorro, the Director of Sales for FPP, devised a scheme to manipulate FPP’s computer system to divert client’s payroll tax funds to bank accounts (and prepaid debit cards) they controlled. Figueroa was responsible for setting up FPP’s money transfer files, and was the technology person responsible for diverting the funds.

This fraud came to light in large part because the IRS sent notices to FPP’s clients and made them aware of shortfalls in tax deposits. As clients began sharing experiences on the internet, it soon became clear that FPP was involved in fraud. Collectively FPP’s clients lost nearly $1 million. The court imposed a prison sentence of 41 months on Figuroa (and 12 months on Chorro in a related case). It required restitution of all unpaid taxes, and required $469,737 to be paid to the US Treasury on behalf of specified payroll clients (interest was waived).

The 37 Collusion Cases

These cases are inherently more difficult to audit. The audit trail is very thin. Transactions are in cash. Both the employer and the employee understand that they are participating in fraud. As a result, information is not as freely available in these examinations as in the embezzlement cases.

These thirty-seven (37) cases fall in two large groups – twenty-one (21) involve the construction industry; thirteen (13) involve employment agencies that provide temporary or seasonal workers and assume all payroll and tax reporting obligation as part of their service. The final three (3) cases are restaurants.

First Priority Pay, Hoboken New Jersey Complaints & Reviews – Payroll Fraud: FPP took out money but did NOT deposit taxes or file returns, at: http://www.complaintsboard.com/complaints/first-priority-pay-hoboken-new-jersey-c319495.html. This is the reason practitioners warn taxpayer to not allow their address of record with the IRS to be changed to that of the third-party payer. Kathryn Keneally & Charles P. Rettig, Worker Classification: IRS Launches Questionable Employment Tax Practice Initiative, JOURNAL OF TAX PRACTICE & PROCEDURE (February-March 2008) at 22.
34 United States of America v. Jose Figueroa, D. N.J., 2:11-cr-00723-SDW (Judgment, April 12, 2012) Doc. No. 10, at 6. These amounts were on behalf of the Adult & Pediatrics Allergist of Central New Jersey ($44,880); Precision Global Consulting, Inc. ($321,974) and Legacy Effects, LLC ($102,883).
Two examples illustrate the common attributes of collusive employment tax fraud. As a general rule, collusion cases involve two elements: (a) undocumented workers (or workers on assistance programs who want to report little or no income), and (b) cash. Many times the greatest barrier to carrying out a collusive employment tax fraud is getting access to enough cash to carry it out.

The first example is a typical construction case. This Florida enforcement action involves Richard Rosaire Routhier, a contractor who ran a custom drywall installation and framing business. A second example is a Massachusetts fraud involving Michael Powers who ran a temporary employment agency that (like Routhier) supplemented his workers' modest paychecks with cash. Both of these frauds were relatively durable, lasting seven and six years respectively before being detected.  

*United States of America v. Richard Rosaire Routhier.* Richard Rosaire Routhier owned and operated Drymension Inc. Over a seven-year period (2002-08) Routhier issued $9,132,516 in checks to a series of seven shell companies for work that was never performed. The checks were negotiated at local check cashing stores (who were aware of the scheme), and were used to carry out two kinds of tax fraud: (a) corporate income was reduced, and (b) a cash hoard was created out of which employees were paid “under the table.” Fictitious invoices were drafted to support the checks.

Routhier secured his workers from two different “employee leasing” companies. These companies were responsible for paying wages, determining employment taxes, worker’s compensation insurance premiums, and filing employment tax returns for the workers. They did this, but only for the amounts that they directly paid to the employees. Routhier did not disclose that additional cash compensation was provided, and as a result, neither FICA nor income tax withholdings were correct for his workers.

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35 On average the employment tax frauds listed by the IRS were uncovered after three or four years. 68% of the cases listed involved frauds of five years or less. The two longest running employment tax frauds listed by the IRS on the internet were: (1) John Heard’s 17 year, $5.7 million fraud (1987 through 2004) and (2) Joseph and John Riley’s 19 year, $1.029 million skimming fraud. See: *United States of America v. John Fluellen Heard et. al.*, S.D. TX, 4:07-cr-00114 (Indictment, March 29, 2007, unsealed October 16, 2008) Doc. No. 1. (Heard provided security services through a number of firms in the Houston Texas area under contract with the Department of Homeland Security and the Federal Protection Service among other clients. Heard withheld, but underreported and did not deposit employment taxes. Tax losses were $5.7 million). *United States of America v. Joseph and John Riley*, D. MN, 0:09-cr-00098-PJS-LIB (Indictment, April 15, 2009) Doc. No. 1. (Joseph and John Riley skimmed profits from their road construction companies by cashing checks in the company name and not recording the income as corporate profits.)

36 Those companies were: Drywall Plus Corp.; Costa Contractors, Inc.; D. Marcus Construction, Inc.; SMART Construction Services Inc.; JOCA Construction, Inc. J.L Construction Group, Inc. and TELA Construction Group, Inc.

37 A representative/agent of Drymension, Inc. typically presented the checks to the check cashing stores, and the cash (less a cut for the store, and a 5% kickback for Routhier) was delivered to the offices of Drymension, Inc. *United States of America v. Richard Rosaire Routhier S.D. FL.*, 1:11-cr-20116-JLK (Plea Agreement, April 25, 2011) Doc. No. 16, at 6-7.
Routhier entered a guilty plea and was sentenced to prison for 60 months followed by 3 years of supervised release. Restitution of $1,243,574 was ordered, and payments were required monthly at not less that 10% of monthly gross earnings.

United States of America v. Michael Powers & John Mahan. Powers (as Treasurer) and Mahan (as President) were 50/50 owners of Commonwealth Temporary Services (CTS), Inc. Understanding that federal employment taxes and workers compensation insurance payments were a function of their payroll, Powers and Mahan arranged to pay the temporary workers they employed in part with a traditional payroll check and in part with cash. The cash portion was never reported as a wage. As a result income tax and FICA were not deducted or reported on these amounts, nor were the full wages used to determine workers compensation insurance.

Hundreds of workers and in excess of $30 million was involved in the CTS “under the table” payroll scheme. Each week the office manager of CTS was required to “… cash massive checks – which checks often exceeded $100,000 – to meet that week’s cash payroll … (with) a variety of denominations so that it could be easily distributed to the workers. … resulting in losses of approximately $8 million in federal payroll and income tax payments, $700,000 in mandatory unemployment insurance payments, and $200,000 in insurance premiums.”

A notable aspect of this case is that Powers had approached the FBI two years after starting CTS as a whistleblower. He explained to the FBI how his former employer (now his business competitor) Daily A. King ran a temporary employee service in exactly the same manner. Powers was in regular contact with the FBI in 2000 and 2001 explaining in considerable detail exactly how King defrauded the IRS, the State of Massachusetts, and various workers’ compensation insurers. An FBI raid on Daily A. King’s business in June 2001 resulted in its closure.

Powers was eventually sentenced for his own employment tax fraud. His prison term was for 84 months, followed by 24 months of supervised release. Restitution of $8,805,277.36 was ordered.

ZAPPERS & COLLUSIVE EMPLOYMENT TAX FRAUD

In a collusive employment tax fraud the employee knows that the unreported cash payments he receives are improper. Yet, the employee cooperates. The reasons for cooperation vary. Sometimes the worker is not entitled to work in the US and does not want his wages reported. Other times the worker may be qualified to work, but may want to disguise his income so that he can qualify for Medicare, food stamps, or other welfare programs. In yet other instances cash-based employment may be the only (or best) work he can find and this employer refuses to treat him as an employee.

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Regardless of the reason, in collusive frauds the weakest link in the arrangement is not the worker taking the cash “under-the-table;” the weakest link is the cash, or securing enough of it to make payments in a manner that does not attract the attention of the authorities. Routhier paid on large invoices drawn on fictitious companies and cashed the checks at small check clearing companies. Powers took large company checks into local banks and took back small denomination bills week-after-week. These check-cashing transactions left a paper trail that ultimately proved fatal to the fraud.

Zappers and phantomware provide certain kinds of businesses a “better way” (a technologically more efficient way) to get the cash they need to pay workers “under the table.” The cash is skimmed from the business directly. Businesses most vulnerable to Zappers are those that record significant levels of cash sales with electronic cash registers (ECR). These would be businesses like: restaurants, convenience stores, gas stations, movie houses, or grocery stores. Once installed, a Zapper allows accurate receipts to be issued, but soon thereafter it will eliminate a select number of transactions. The cash associated with these suppressed sales can be skimmed without detection.

How significant is the Zapper problem? The Province of Quebec has brought over 250 Zapper cases to court. In the early days (1997), Quebec was concerned that

Zappers are special programming options added to ECRs or point of sale (POS) networks. They are carried on memory sticks, removable CDs or can be accessed through an internet link. Because zappers are not integrated into operating systems their use is difficult to detect. Zappers liberate owners from the need to personally operate the cash register. Remote skimming of cash transactions is now possible without the knowing participation of the cashier who physically rings up the sale. This attribute of Zappers allows the incidence of skimming fraud to migrate beyond the traditional “mom and pop” stores. Zappers allow owners to place employees at the cash register, check their performance (monitor employee theft), but then remotely skim sales to cheat the taxman.

Phantomware is a “hidden,” pre-installed programming option(s) embedded within the operating system of a modern electronic cash register (ECR). It is used to create a virtual second till and preserve a digital (off-line) record of the skimming (a second set of digital books). The physical diversion of funds into a second drawer is no longer required, and the need for manual recordkeeping of the skim is eliminated. Because phantomware programming is part of the operating system of an ECR its use can be detected with the assistance of a computer audit specialist.


Roy Furchgott, With Software, Till Tampering Is Hard To Find, NYT C6 (August 20, 2008) indicating: [T]he Canadian province of Quebec may be the world leader in prosecuting zapper cases. Since 1997, zappers have figured in more than 230 investigations, according to the tax collecting body Revenue Québec, which has found an active market for the software. In making 713 searches of merchants, Revenue Québec found 31 zapper programs that worked on 13 cash register systems.


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these US manufactured programs facilitated this fraud. It was far too easily obtain
Zappers over the internet. $500 was the average cost.\textsuperscript{44} Canadian subsidiaries of US
companies in Montreal were early providers and installers.\textsuperscript{45}

Quebec’s concern with this US export product was short-lived. It was only a
short time before the design and installation of Zappers became a domestic “cottage
industry” for local IT professionals. Skimmed cash in Quebec was used for everything
from increasing owner’s profits, to supplementing worker’s wages, and reducing the
price of menu items to meet the competition across the street.

This fraud has developed a lot since 1997. Technology-assisted sales suppression
is no longer just about cash skimming. The technology has allowed this fraud to migrate
to debit/credit card transactions. There are very few published reports of this
permutation, but there are two indications that this is a very serious and growing aspect of
this fraud: one comes from Norway, the other from the proceedings of the Irish Fiscalis
meeting.

\textit{Norway}. Recent Norwegian regulatory proposals on ECRs include a discussion
of “problems related to the terminal – use of an independent terminal.” The detailed
Norwegian discussion explains that debit/credit card terminals are commonly not
connected to the cash register system. The terminal is then programmed to remit funds to
a different (personal) account at a different bank (not the bank used by the business
making the sale). A credit sale (where the funds are sent to a personal account) can be
rung up “as if” it was a cash sale and then zapped as follows:
\begin{enumerate}
\item The cashier scans the purchase;
\item The cash register indicates a sales total ($500, for example);
\item The credit/debit card is swiped for $500;
\item An authorization is received from the debit/credit card intermediary;
\item The cashier then presses “cash sale,” (not credit/debit card sale) a receipt
is issued, and the transaction completed;
\item Later that evening the false cash sale is “zapped” from the system.
\end{enumerate}

Neither the debit/credit card transaction (at 3 & 4), nor the sales transaction (at 6)
is recorded in the cash register system. Under this fact patterns there is no digital trace
for a traditional auditor to follow to determine liability, unless the auditor knows the

\textsuperscript{44} Craig Silverman, \textit{Zapped!}, HOUR (Feb. 19, 2004) available at:
\textsuperscript{45} Turcotte v Quebec (Ministry of Revenue) 1998 CarswellQue 1041, [1998] R.D.F.Q. 110 Superior Court
of Quebec. This case involved the MRQ investigation of Gamma Terminal, Inc., a wholly owned Canadian
subsidiary of an American company, Gamma Micro Systems. This investigation began in 1997 and
focused on the distribution of the Gamma Restaurant Management System. It eventually lead to a number
of conviction of restaurants that used this system to delete sales records, including the companies 136530
utilisé un camoufleur de ventes dans des restaurants de Laval et de Repentigny} (English Trans. Two
companies guilty of having used a camoufleur sales in restaurants in Laval and Repentigny) April 25, 2005
available at http://www.revenu.gouv.qc.ca/eng/ministere/centre_information/communiques/ev-
credit/debit card that was used, and traces the payment from the cardholder’s bank to the (personal) account of the business owner.\textsuperscript{46}

The Norwegian regulations solve this problem by requiring debit/credit card terminals to be tied to the cash register.\textsuperscript{47} The ECR then must be secured. The security measures would (in part) include notifications of changes made in attached credit/debit card terminals (some proposed regulatory provisions are for certified ECRs to be rendered inoperable if a card terminal is switched-out).

\textit{Irish Fiscalis meeting.} How significant is the credit/debit card permutation of sales suppression? Significant enough so that nearly a full day of meetings at the EU Fiscalis held in Dublin, Ireland (October 19-21, 2011) were devoted to this problem with reports from the field filed by the UK\textsuperscript{48} and Portugal,\textsuperscript{49} followed by workshops focused on combating this fraud.

\textbf{AMERICAN ZAPPERS}

One of the features of research in this area is that while most of the world is contending with skimming frauds performed by Zappers and Phantomware applications, the US seems to be an exception. This prompts the question: are there really none of these digital fraud devices in the US, or are the authorities simply not finding them?

There are only three Zapper cases reported in the US – Stew Leonard’s Dairy,\textsuperscript{50} the La Shish restaurants,\textsuperscript{51} and Theodore R. Kramer.\textsuperscript{52} Each results from a federal income tax audit.\textsuperscript{53} None of these cases produced a tax deficiency based in employment

\textsuperscript{46} This appears to be how this fraud was initially detected. Agents would make credit purchases from a business and then look for the transactions on an audit. Because they held the credit card, when an agent found that his purchase was missing from the business records he could then follow the digital payment string through to the proprietor’s personal account.

\textsuperscript{47} Checkout System Regulations (\textit{Kassasystemforskriften}) § 2-5, second paragraph; § 2-8-3 and § 2-8-2(g); Bookkeeping Regulations (\textit{Bokforingsforskriften}) § 5a-2, second paragraph; § 5a-14, third paragraph.

\textsuperscript{48} Chas Coysh, HMRC Indirect Tax Team, Strategic Risk Unit, Large Business Services. His Friday, October 21, 2011 presentation focused on Merchant Acquirer Accounts – Tax Evasion in the U.K.

\textsuperscript{49} Ana Isabel Silva Mascarenhas, the e-Audit Contact Person for the Portuguese Tax Administration, who presented on fraud with Merchant Acquirer Accounts – Tax Evasion in the U.K.

\textsuperscript{50} See: U.S. v. Stewart J. Leonard Sr. & Frank H. Guthman, 37 F.3d 32 (1994), aff’d. 67 F.3d 460 (2nd Cir. 1995) (although the tax case was settled, the details of the fraud are preserved in these federal sentencing appeals - $17 million sales skimmed over a 10 year period, with sales tax losses of $500,000 and a final determination of $1.4 million).

\textsuperscript{51} See: Press Release, U.S. Dept of Justice, Eastern District of Michigan, \textit{Superseding Indictment returned Against LaShish Owner} (May 30, 2007) (indicating that $20 million in cash sales were skimmed over a 5 year period).

\textsuperscript{52} Theodore R. Kramer installed zappers in Detroit, Michigan area strip clubs. In this case the tax amounts lost are not specified. See: U.S. Dept. of Justice, Eastern District of Michigan, \textit{Michigan Software Salesman Pleads Guilty to Conspiracy to Defraud the Government} (November 17, 2010).

\textsuperscript{53} In the Stew Leonard’s Dairy case U.S. Customs searched Stew Leonard Sr. in the Spring of 1991, leading to the execution of search warrants on August 9, 1991 by special agents of the IRS Criminal Investigation Division. \textit{Leonard}, 37 F.3d at 35; \textit{75 YEARS OF CRIMINAL INVESTIGATION HISTORY}, supra note Error! \textbf{Bookmark not defined.}, at 145. The State of Connecticut commenced its audit “… as a result of IRS actions, in February, 1992 …” \textit{Leonard}, 254 Conn. 286, 289 (2003). On July 22, 1993 Stew Leonard...
tax fraud. In each case the owner retained the skimmed cash. The cash was considered a constructive dividend, not a disguised wage.\(^{54}\)

However, a very recent case is working its way through the court system that does link Zappers with employment tax fraud. The Ohio case of *United States of America v. Tarek Elkafrawi, et. al.*\(^{55}\) deals with the Zapper-Employment Tax linkage, and as a consequence it deserves special attention.

In *Elkafrawi* Zappers are allegedly used in seven Ohio I-HOP restaurants to skim sales, and provide cash wages to over 200 illegal workers. The following taxes were not collected or remitted:

- income tax withholdings (state and federal),
- FICA payments (employee and employer portions),
- unemployment taxes (FUTA and state unemployment) and
- payments for workers compensation insurance.

Based on past history (primarily the 98 cases the IRS lists as examples of effective employment tax fraud investigations) there is a strong likelihood that outcome of the *Elkafrawi* case (if he is found to be guilty) will be:

- a plea agreement,
- with a considerable prison term (likely three years, with 3 additional years of supervised release); and
- with financial restitution limited to the tax due (without interest and penalties) after a judicial determination that the 54 year old Elkafrawi (who suffers from a heart condition)\(^{56}\) will not have the resources to make the sizeable payments.\(^{57}\)

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\(^{54}\) The Stew Leonard’s Dairy case did have a companion Connecticut sales tax audit and assessment.


\(^{57}\) There are allegations in the Indictment that Elkafrawi transferred funds to his home in Egypt where they were invested in real estate. The funds were transferred by carrying cash on his person, and by using bank transfers using Western Union. *Elkafrawi*, at ¶ 102.
Because of the importance of this case to the QETP initiative, to federal and state revenue, to the Department of Labor, State Workforce Agencies and US Immigration and Customs Enforcement (ICE) it would be very helpful if a condition in the anticipated plea agreement would be a requirement that Tarek Elkafrawi (and others):

- cooperate with any state or federal officials working to understand and uncover Zapper-assisted frauds;
- be prohibited from owning or operating another retail business without first installing a commercially available device (approved and monitored by the tax administration) that would prevent sales manipulation; and
- be required to use a court-approved third-party payroll service provider whenever they employed workers in another business.

**United States of America v. Tarek Elkafrawi, et. al.**

Elkafrawi is a characteristic collusive employment tax fraud. Elkafrawi’s alleged skimming (and his payment of cash wages to illegal workers) went undetected for far longer than the norm, largely because Elkafrawi’s employees collaborated with him to perpetuate the fraud. The indictment only provides a general measure of the tax losses; FBI indicates that it is “more than $3 million.”

Elkafrawi skimmed (allegedly) for more reasons than simply to secure cash to meet the wage demands of his undocumented workers. Additional advantages sought by Elkafrawi included:

- Reducing the franchise payments to I-HOP Central for land and equipment use (based on net income);
- Reducing the franchise fee to I-HOP Central for royalties and shares of advertising expenses (8% of net income);
- Conversion of commercial rebate checks to personal accounts (theft of corporate assets);
- Diverting cash from skimmed sales to his personal accounts (without declaring federal or state income);
- Under-reporting his own federal and state personal income tax withholding and those of his employees.

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58 Elkafrawi may have engaged in this fraud for nine years (December 18, 2003 through May 22, 2012). *Elkafrawi*, Indictment at ¶ 10. 68% of the 98 employment tax fraud cases listed by the IRS go on for 5 years or less, with the vast majority 3, 4 or 5 year frauds. Only 10 of the 98 were frauds of 9 years or longer. In fact one of the allegations in the case is that Elkafrawi “… created an environment in which the managers were expected to manipulate the Point of Sale systems to reduce the weekly net sales figures.” *Elkafrawi*, at ¶ 29. Thus, the collusive nature of the skimming insulates the fraud and keeps it difficult to detect.


60 *Elkafrawi*, at ¶ 3.

61 *Elkafrawi*, at ¶ 3 (All I-HOP fees were net income based – royalty at 4.5%; advertising at 3% (2% local and 1 % national); additional fees at 0.5% making a total of 8% - and there is a fixed flat fee floor in case the percentage of net falls too low.)

62 *Elkafrawi*, at ¶ 30.

63 *Elkafrawi*, at ¶¶ 31 & 55.
• Under-reporting the employee’s and employer’s FICA taxes;  
• Avoiding payment of overtime on wages;  
• Reducing the federal and state corporate income tax;  
• Reducing workman compensation insurance premiums.  

Elkafrawi’s Zappers. All I-HOP franchises used a SABLE Point of Sale system, until 2010 when I-HOP Corporate required the SABLE systems to be phased out and replaced with a high-end MICROs Point of Sale system. With either system in place, I-HOP Corporate was able to remotely access sales figures from all 1,522 I-HOP global locations. Access was Internet-based.

The MICROs system is comprised of a central server connected to the Internet on the back end, and to a series of terminals (or ECRs) on the front end. Although I-HOP Corporate may have thought its new systems were secure, the technology in the MICROs systems was not a mystery to Elkafrawi. Shortly after the MICROs installation Elkafrawi began manipulating the system “… remotely through the use of software that gave [him] full access and control of the Point of Sale system from [his] home … [using] software called ‘Team View[er].’”

Team Viewer is not a Zapper; it is free software that allows remote access. What Elkafrawi did was to place a Zapper (or Phantomware) in the MICROs Point of Sale system. He then activated the Zapper remotely. A similar (but, “much more brazen”) manipulation was performed on SABLE systems.

The key to Elkafrawi’s skimming was that he knew the date each week when I-HOP Corporate would download sales data. Thus, before this date manipulations could occur. The Indictment mentions a number of them: voiding tickets, applying coupons or discounts to a re-written ticket after a payment is made in cash, turning off a machine while sales are being made, resetting the internal clock to eliminate days and thereby create tickets that would be open for a long time. There are suggestions that there are many more kinds of manipulations, but they are not specified in the Indictment.

64 Elkafrawi, at ¶ 25.  
65 Elkafrawi, at ¶ 26.  
66 Elkafrawi, at ¶ 25.  
67 Elkafrawi, at ¶ 30.  
68 Elkafrawi, at ¶ 27.  
69 Elkafrawi, at ¶ 4.  
70 Elkafrawi, at ¶ 47. Team Viewer software is free, and can be downloaded from the internet at: http://www.teamviewer.com/en/index.aspx.  
71 Elkafrawi, at ¶ 53. The Indictment is not specific about the manipulations of the SABLE system other than to say it was “… because of certain exploitable characteristics of the SABLE system.”  
72 Elkafrawi, at ¶ 107.  
73 Elkafrawi, at ¶ 110.  
74 Elkafrawi, at ¶¶ 52 & 110.  
75 Elkafrawi, at ¶¶ 50 & 109.  
76 Elkafrawi, at ¶ 49.
Elkafrawi’s employment tax fraud. At the heart of Elkafrawi’s (alleged) fraud are the illegal workers who do not want their earnings reported to any government authority. Elkafrawi colluded with (and took advantage of) these workers. He paid them under false names, and cashed checks for them at the I-HOP cash register, or countersigned and negotiated them through his personal bank account. Employment taxes were not taken out. Elkafrawi also systematically underpaid his workers, but he trained them on how to qualify for government assistance (Medicaid and food stamps in particular).

Because the MICROS system records both worker time and business receipts, Elkafrawi needed to coordinate his reductions in staff hours (omitting the time of the workers who were paid in cash) so that Form 941 and the time reports in the MICROS system matched. Elkafrawi learned how to “zap” employee time records and in the same manner as he “zapped” sales records in the MICROS system.

CONCLUSION

Based on the published sample of 98 employment tax fraud cases pursued by the IRS over the past three years, and which provide the foundation for the Federal/State QETP initiative, it is clear that there are two major types of employment tax fraud – embezzlement frauds and collusive frauds.

Embezzlement. Embezzlements tend to be short-lived, although they can still involve large tax losses. Embezzlements tend be identified after two years when third-party payroll providers (TPPP) are involved (Figueroa), but can last longer when the embezzler is the employer (Carter).

The reason for this difference in duration-before-detection appears to be the IRS notices that are issued when a deposit or return is missed. As in Figueroa when notices go directly to the taxpayer/client the fraud is relatively short-lived. However, if the

77 Elkafrawi, at ¶ 104.
78 Elkafrawi, at ¶ 25.
79 Elkafrawi, at ¶¶ 54 – 55 (eliminating 30 minutes from each employee’s work hours, not recording tips and overtime).
80 Elkafrawi, at ¶¶ 93 & 210.
81 Elkafrawi, at ¶¶ 45 & 67.
82 Two new Revenue Procedures (2012-32 and 2012-33) improve the rules in this area. Revenue Procedure 2012-32 provides new requirements for payroll firms and others that act as “Reporting Agents.” Authorized Reporting Agents sign and electronically file federal employment tax returns, such as Forms 940, 941 and W-2, and make federal deposits electronically via the Electronic Federal Tax Payment System (EFTPS) (or another electronic system known as the Federal Tax Application that allows even faster remittances). The Revenue Procedure specifies that Reporting Agents must notify and remind clients at least quarterly that the employer remains liable for employment taxes, even if the outsource tax filings and/or payments to a third party. The disclosure statement must suggest that the employer use the IRS EFTPS system to periodically confirm that deposits have been made as expected, and note that state authorities may offer similar verification programs.

Revenue Procedure 2012-33 modifies and supersedes Revenue Procedure 98-32, and reflects the concept above that “reporting agents” who remit taxes to the IRS on behalf of clients must do so via the Treasury Department’s EFTPS or the Federal Tax Application. It also reflects the fact that a single bank now serves as the Treasury Department’s “financial agent” to enroll taxpayers and their agents in electronic
fraudster is the employer, as in Carter, or if the TPPP convinces the taxpayer/client to make the TPPP their address of record with the IRS the fraud can continue much longer. 83

This suggests that a further digital-check-and-balance mechanism might be appropriate. In the US it is not possible for the individual employee to go online and check to see if the withholding made from his paycheck have actually been put on deposits under his name. This is technically possible in Brazil where withholding records are granularly maintained (by employee name and identifying number) under the employer’s account. It is not even possible to do this under the US EFTPS. US records are aggregate (by the employer). Attribution of withholdings to the employee does not occur until the end of the year. 84

Collusion. Collusive employment tax frauds are more difficult to detect, and as a result tend to last longer. With these frauds there is no IRS notice that exposes the irregularity. Collusive frauds are vulnerable when the large amounts of cash needed to feed the fraud starts to raise suspicion. When collusive frauds are cash-only (Routhier) they tend to rely on undocumented workers, and collapse earlier than those that use cash to supplement minimal, but regular paychecks (Powers).

tax payment systems. The guidance affirms the rule (adopted in 2010 via amendments to the regulations under code Section 6302 —TD 9507) that paper coupons may no longer be used for federal tax deposits.

This is a significant move into the digital economy for compliance and enforcement. It is not as far as Brazil has gone. Brazil requires wage withholdings to be deposited monthly through a system very similar to the EFTPS, but the requirement in Brazil goes directly to the employer. Thus, using a third-party payment service, or doing the withholding and deposits internally makes no difference. Employers have access to their accounts and can check that deposits have been made. However, the Brazilian reporting is granular, not aggregate. The business account at the federal depository is under the business name, but the records are line-itemed by employee-name, and tax ID number. In the US this “attribution” of the deposit to individual employees does not occur until the end of the year. 83 The longest lasting TPPP case listed by the IRS is United States of America v. Albert Cipoletti. In Cipoletti the TPPP (Ingentra) skimmed $19,141,618.24 mostly (93.5%) from payroll filings of the Sacramento County’s Special Districts, [fire, cemetery, parks and recreation districts], but also from ScanDisk Corporation (2.8%), and The Stanley Works and Stanley Solutions, Inc. (Black & Decker, Inc.) (3.7%). The fraud stretched slightly over five years from January 2005 through April 2010. United States of America v. Albert Cipoletti, E.D. CA, 2:10-cr-00444-GEB (Government’s Sentencing Memorandum, April 8, 2011) Doc. No. 39 at 4-5, and (Plea Agreement, October 29, 2010) Doc. No. 12, Exhibit A: Factual Basis for Plea). It was a May 2010 IRS notice to the Sacramento County offices regarding interest and penalties due on taxes due the government that uncovered the fraud. Cipoletti, (Defendant’s Sentencing memorandum and Objections to Pre-Sentencing Report, April 1, 2011) Doc. No. 37 at 3-4.

Far more typical is the case of United States of America v. Jeffrey Sykes, W.D. NY, 6:11-cr-06034-DGL (Information, February dictme15, 2011) Doc. No. 1. Sykes ran Paybooks, Inc. with a client base of 1,100 businesses. He began embezzling tax payments in June 2008. In just four quarters failed to pay over taxes of $3,714,649.28. Sykes was sentenced to eight years in prison with three additional years of supervised release on February 23, 2012. In other words, less than three years after he was caught in a one-year embezzlement scheme he was sentenced to 12 years of confinement with full restitution, interest, and all applicable penalties. 84 Supra note 82.
Collusive frauds that supplement low-wage paychecks facilitate further tax frauds by workers who file returns seeking Earned Income Tax Credits (EITC), Child and Dependent Care Credits (C&DCC), and Additional Child Tax Credits (ACTC) that they would not be entitled to if their undeclared cash earnings were considered. Medicare, food stamp and welfare fraud was a key allegation in Elkafrawi. One of the allegations is:

Using an alternate identity, M.K. split his salary between two paychecks, creating a lower reportable income for each identity. Using these dual identities, M.K. has, to date, claimed approximately $140,000 in Medicaid payments, and $35,000 in food stamps and welfare benefits from the State of Ohio.

Elkafrawi’s alleged fraud went undetected for an exceptionally long time, approximately nine years. It is not at all clear how Elkafrawi came under suspicion. Rather it seems that by hiring over 200 illegal workers from the Middle East he may have drawn the attention of ICE, and this triggered the tax investigation.

Zappers. There is something to be learned by comparing Elkafrawi with the IRS’s 98 selected employment tax fraud cases.

- First, none of the 98 IRS cases identify a fraudster using sales suppression technology to secure cash to pay workers “under the table.” Why is this kind of case missing from the IRS list when there are over 250 litigated cases of exactly this type in Quebec?
- Secondly, the kind of fraud that Elkafrawi presents is very sophisticated and needs to be highlighted in the QETP initiative. Elkafrawi represents a collusive fraud (which is the most difficult kind of employment tax fraud to uncover) that solves the Achilles Heal of this type of fraud by tapping into a readily available stream of cash running through the business. Elkafrawi avoids the necessity of regularly cashing large checks for small denominations at a local bank (Powers) or a check cashing service (Routhier). None of the 98 IRS cases present this patterns as well as Elkafrawi.
- Thirdly, Elkafrawi is a restaurant case. This is the classic setting for a Zapper. The vast majority of Zappers around the world have been found in restaurants, and this is the market segment where jurisdictions like Quebec, Belgium, Norway, and Sweden have moved to secure the ECR and POS systems.

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85 26 USC §32 (refundable credit).
86 26 USC §21 (non-refundable credit).
87 26 UCS §24(d) (refundable credit).
88 Elkafrawi, at ¶ 93.
89 Supra note 58.
90 Jurisdictions that have mandated secure solutions for ECRs and POS systems have all started with the restaurant industry. It is an industry that has a high percentage of cash sales where customers are not always anxious to get a receipt. It is also a highly competitive industry that is both labor-intensive, and known for low wages. This is the classic profile for a type of business that would be drawn to Zappers as a facilitator of “wage savings” through employment tax fraud.
Within the 98 IRS cases there are three restaurant cases. Each is an example of a collusive employment tax fraud. None of the cases indicate that the wages paid to employees “under the table” were funded with cash from technology-assisted skimming.

United States of America v. Maria F. Argueta.91 Argueta owned a Taqueria Arandas restaurant subject to a franchise agreement in Houston, Texas. Argueta kept two sets of books, one complied with her franchise agreement (used to determine her 6% of net income franchise fee); the other was a false set used for tax purposes.

A simple comparison of the two sets of books showed an understatement of gross receipts of $1,432,236 for five years (2000 through 2004). It also showed unreported cash wages of $343,782. The evidence did not explain how the reduction in gross receipts was accomplished, or whether the audit was able to confirm that the franchise books were accurate, or whether either sets of books could be tied back to electronic journal entries in the ECR/POS system.

United States of America v. Opas Sinprasong.92 Sinprasong ran Thai restaurants in Boulder Colorado, and brought workers from Thailand to the US. Workers were charged $4,500 to get to the US, and this fee was deducted from their first three months pay (all of which was handled “off the books”).

Once placed on the regular payroll the workers received two checks. One check was a proper payroll check (with wage and employment taxes deducted); the other was a “corporate check” from which no withholdings were made. The IRS determined that there were unpaid withholdings taxes of $237,561 over eight years (2001 through 2008). The “under the table” wages approximated $1.1 million.

United States of America v. Marino Sandoval & Nicole Sandoval.93 The Sandovals ran a chain of Mexican restaurants (El Balazo) in the San Francisco Bay Area. The Sandovals kept two sets of books, and paid employees (100 or more of whom were undocumented aliens) with cash and checks. Proper withholdings were made from the checks, but no withholdings were made from the cash. Based on a time card analysis the IRS determined that additional employment taxes of $546,820.76 were due. The unreported cash wages approximated $2,734,000.

No evidence in any of these cases explains where the funds for the additional compensation came from: $343,782 in Argueta, $1.1 million in Sinprasong, $2,734,000 in Sandoval. The assumption is that it was skimmed from the restaurant that employed the workers. How was the skimming performed? Can the audited accounts be tied back to the electronic journal, or have the ECR/POS system records been manipulated?

The “under the table” wages in Argueta are less than the skimmed cash by $1,088,454. This means that the cash that was skimmed is 300% more than what shows up in wages. So, how much more was skimmed in Sinprason than showed up in the $1.1 million in “under the table” wages? In Sandoval $2,734,000 was paid out in cash wages. Does this mean that the skimming was 300% of this amount, or $8,202,000? We have no idea, if we cannot secure the ECR/POS system.

The dual sets of wage payments in each of these cases strongly suggest (as in Elkafrawi) that the workers are submitting personal income tax returns that inappropriately claimed EITC, C&DCC, and ACTC. They may also be inappropriately claiming Medicare, food stamps and welfare benefits. One of the more memorable passages in the Elkafrawi indictment is:

Tarel Elkafrawi and M.K. sanctioned and encouraged employees to file fraudulent claims. Khaled Yousef, Tarek Eid Omar, Ramiz Awwad and Jamil Mohammed Awwad were told by Tarel Elkafrawi and M.K. how to minimize their payroll earnings through the use of multiple identities in order to claim benefits. Tarel Elkafrawi told Tarek Eid Omar to either start fraudulently claiming welfare or “quit having children.”

Labor records. One final point can be taken from Elkafrawi. The MICROS system that I-HOP Corporate required to be installed in all of its franchises also recorded labor. Elkafrawi allegedly manipulated not only the sales figures, but also the labor records. This was necessary because there was more than tax fraud going on, and all the numbers needed to tie out.

Many foreign jurisdictions are mandating that all businesses (or all restaurant businesses in some cases) secure their ECRs and POS systems with encryption technologies. They commonly mandate that these systems preserve digital sales records. Recently, there is an effort to go one step further. A demand is being made that these systems also include and preserve labor records (it could be as comprehensive as the entire business – waiters right down to bottle washers).

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94 Elkafrawi, at ¶ 95.

Electronic copy available at: https://ssrn.com/abstract=2207990
Currently the Belgian rules require that records be kept of “users of registered cash register systems” by name and identifying number when they are using the system. This means that a system like the MICROs system used in all I-HOPs would be acceptable in some overseas locations only if it was digitally secured both in its transactional records and in its personnel records.

Thus, in light of the fact that the Elkafrawi case will most likely end in a plea bargain (if Elkafrawi is found guilty), and in light of the further fact that he and his associates seem to have considerable “institutional knowledge” about how to manipulate advanced ECR/POS systems, it would be helpful if a portion of the government’s plea bargain demands include a “technology cooperation” requirement. Tarek Elkafrawi and his associates should be required to assist any State or Federal agency investigating sales suppression technology.

In addition, the court might consider adopting a further restriction. If Tarek Elkafrawi or any of his associates should at a later time own or operate a retail business, then they should be required to install a security system along with their ECR/POS system that would digitally encrypt and secure all transactions. This should be a component of their restitution and a condition blocking the receipt of a future business license.

A final requirement might be that if Tarek Elkafrawi or any of his associates should at a later time own or operate a retail business then they should be required to use a court-appointed third-party payroll service provider.

If full tax recovery is likely to be Pyrrhic when employment tax fraud lasts for more than a few years, then thoughtful use should be made of the plea bargain process. We can deepen our understanding of sales suppression technology in the US if we make good use of the cases we have.

96 Registered Cash Register Systems in the Catering Industry, Implementation of the Royal Decree of 30 December 2009, Circular no. E.T. 122.682 (General Tax Administration no. 22/2012) dd.01.06.2012, at Chapter 3.3 (Mandatory functionality of registered cash register systems).

97 For a discussion of this technology see the papers at supra note 42 and Richard T. Ainsworth & Urs Hengartner, Quebec’s Sales Recording Module (SRM): Fighting the Zapper, Phantomware and Tax Fraud with Technology, 57 Canadian Tax Journal 715 (2009).

98 A similar requirement was imposed on Theodore R. Kramer, and it has proven to be useful to some state tax authorities. Supra note 52.

99 This was a component of the restitution ordered by Judge Lise Gaboury in the Casa Grecque case in the Court of Quebec. Supra note 5.