THE GRAND JURY OF THE SUPREME COURT
OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

REPORT OF THE GRAND JURY
OF THE SUPREME COURT
STATE OF NEW YORK
FIRST JUDICIAL DISTRICT
ISSUED PURSUANT TO
CRIMINAL PROCEDURE LAW
SECTION 190.85 SUBDIVISION (1)(c)

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DISTRICT ATTORNEY
NEW YORK COUNTY

After considering evidence before it and legal instructions from the District Attorney of New York County, the Grand Jury hereby submits a report, pursuant to Criminal Procedural Law § 190.85(1)(c), "[p]roposing recommendations for legislative, executive or administrative action in the public interest based upon stated findings."

INTRODUCTION

Before recent technological advances, some merchants who were obligated to pay sales tax sought to cheat on their tax obligations by unlawfully choosing not to "ring up" transactions on their cash registers, or by maintaining off-line registers. Paper receipts were either not generated, or were discarded. These merchants' accurate business records were hidden from the tax man, whereas the proverbial "second set of books," with misleading information, was presented.

Today, old-fashioned cash registers are disappearing as many retail merchants are equipped with electronic hardware to track sales activity – ranging from electronic cash registers[1] to Point of Sale ("PoS") systems.[2] Unscrupulous individuals have developed automated suppression software programs that can falsify sales activity, particularly cash transactions, on such

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[1] An electronic cash register is a computer system that records data for the purpose of compiling sales transactions.

[2] A PoS system records all transactions made through a computer system that tracks all sales transactions, including what product is sold, the selling price, the quantity sold, the

PoS systems. The technology changes, but the goal remains the same – to evade paying taxes.

The Grand Jury received testimony from witnesses familiar with technology used in business establishments and with the collection of New York State and New York City sales tax, and listened to numerous recorded conversations between undercover investigators and a PoS system provider about methods of concealing true sales transactions or otherwise providing false information to the tax authorities.[3] The Grand Jury received testimony about seven owners of eateries who either deleted sales from or concealed sales in their PoS systems, and thus reduced their tax obligations. All seven merchants have pleaded guilty and admitted to underreporting an aggregate of over two million dollars in sales tax principal. The Grand Jury has indicted a PoS software provider who has assisted at least a half dozen merchants in using suppression software to evade taxes. That software provider removed cash sales from customers' PoS systems. In one instance, one week of recorded cash sales was reduced by $10,000, and in another instance, one month of recorded cash sales was reduced by over $100,000. The Grand Jury's investigation is continuing.

In view of the pervasiveness of this type of crime, however, the Grand Jury has chosen to issue a report proposing reforms that it believes will get to the root of the problem of tax evasion by those using PoS-systems. The Grand Jury therefore proposes the following actions to deter the dissemination of any software program created to assist in the evasion of tax obligations and to provide law enforcement with appropriate tools to prosecute those who traffick in this software:

1. Impose serious penalties on those who traffick in suppression software programs designed to evade taxes; and

2. Provide funding to supply merchants with counter-suppression devices.

HOW SUPPRESSION SOFTWARE AIDS THE TAX EVADER

In this county, New York State and local sales tax must be collected on most goods and services, including all meals, beverages, and catering services. Since August 1, 2009, the combined New York State and New York City sales tax has been 8.875%.

Merchants are obligated to collect these taxes in the proper amount from customers, and to remit the collected taxes to the State, along with a timely sales tax return. The merchant is also required to retain, for three years, records of sales transactions detailing all individual items sold, the selling price, the sales tax, invoice number, date of sale, method of payment, and, if

applicable, the PoS terminal number, and PoS transaction number. Receipts provided to a customer must detail the amount of the sales tax charged. Records maintained in electronic form must be produced to taxation authorities in electronic form, even if hardcopy documents are available.

The Grand Jury learned that some authorized suppliers of PoS systems assist merchants to evade tax by providing services or software programs that suppress electronically-recorded sales. Automated sales suppression programs may be (a) embedded into the operating system of the electronic hardware, regarded as "phantom-ware," (b) maintained on an external device such as a USB memory stick (thumb drive) or on a compact disc, euphemistically known as a "zapper," or (c) remotely manipulated off-premises through an internet link.

The process may work in a variety of ways, for example: (1) hiding all of the merchant's transactions for an entire day, thus making it appear that the merchant's establishment was closed, when in fact it was open and engaging in business transactions; (2) hiding some of the daily sales, thus making it appear that the merchant engaged in fewer transactions than the business really did; or (3) altering the details of particular sales transactions (for example, prices associated with certain menu items can be systematically reduced, or some items ordered by customers may be simply deleted), thus making it appear that the business collected less in each transaction than it in fact did.

To further the fraud, original records may be overwritten or altered. For example, the Grand Jury heard testimony that guest checks may be re-numbered and totals re-tabulated, inventory adjusted, and reports modified to sync with any changes to the original data. The Grand Jury also heard testimony that data can be changed so that transactions are recorded not as sales but merely as non-taxable sales entered as part of training exercises. In other instances, the programs may make it appear that transactions were discounted or voided, even though they were not. The PoS service provider may even destroy the hard drive on the business premises, while preserving a virtual second set of books in an encrypted database or off-premises, perhaps in the "cloud," which may be located outside of New York State.

These suppression programs benefit businesses that conduct many transactions in cash, such as restaurants, convenience stores, gasoline stations, liquor stores, nail and hair salons, and other retail establishments. The software programs may also hide credit card transactions by directing them to bank accounts maintained in fictitious or third-party names, and may be used to inflate business expenses to offset income.

FISCAL IMPACT

For every dollar removed from the sales records, the cheating merchant keeps the sales tax collected from customers, which should have been remitted to the public coffers. But the harmful consequences of the merchants' cheating

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do not stop there. Witnesses explained that the cheating merchant may also underreport the business's gross receipts, and thus underpay the corporate tax, MTA surcharge tax, or New York City unincorporated business tax. Personal income tax returns may be falsified, as well, by business owners who hide the money they are pocketing. Moreover, merchant employers may use the skimmed cash to pay employees off-the-books, thereby underpaying withholding tax and unemployment insurance tax, and relegating their employees to the underground economy, thus depriving them of social insurance programs that provide them with benefits in the event of death, injury, disability, or unemployment. Employees may also lose overtime pay, and receive little or no health, vacation, and retirement benefits.

The honest taxpayer, meanwhile, is forced to compete on an uneven playing field, and the public is forced to shoulder a heavier tax burden than it would but for merchants' deceit.

RECOMMENDATION ONE

ENACT FELONY CRIMES AND INCREASE MONETARY SANCTIONS TO CURB THE TRAFFICKING OF SOFTWARE PROGRAMS THAT FALSIFY ELECTRONIC DATA

The proliferation of software that falsifies business transactions increases the opportunity for wide-scale tax evasion. Sophisticated technology that distorts sales transactions allows fraudsters to conceal income easily, while simultaneously making it more difficult, if not impossible, to detect the manipulation. Those who traffick in such technology should be treated as felons, but there is currently no criminal statute that squarely addresses their behavior. Furthermore, because these traffickers play a crucial role in corrupting the integrity of the data on which auditors rely, and thus make the merchant's evasion so difficult and costly to detect, the traffickers should be required to recompense the government for the costs incurred in tax evasion investigations. To accomplish these goals, the Grand Jury recommends the following four steps.

First, the legislature should enact a statute making it a felony to manufacture, create, sell, buy, possess, install, maintain, enhance, or use any software for the purpose of evading the accurate determination and payment of taxes.[4] This offense should apply to software that aids in the evasion of any

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[4]   At least twenty states have enacted statutes of this type, commencing with Georgia in 2011 and continuing into 2014 with Kentucky.

type of tax -- including sales tax, personal income tax, corporation tax, city

business tax, and withholding tax, and to any form of suppression software --

whether embedded in the hardware, housed on an external device, or accessed

remotely.

The Grand Jury recommends that the statute make it a felony to engage

in the proscribed activity and to attempt to do so. The reason that the attempt

and the completed act should be treated the same is that so much tax evasion

goes undetected, and thus if only completed acts are prosecutable, the crime of

tax evasion will be severely under-deterred. The legislature has provided for

the punishment of the attempt to commit some crimes that are similarly hard

to detect and that pose similarly significant economic consequences with the

same severity as the punishment of the completed crimes.[5] It should do the

same here.

Second, the legislature should create a felony-level conspiracy crime for

those who conspire with merchants to defraud the government through

suppression programs and devices. Software providers and the merchants who

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[5]   The crimes of Penal Law § 176.15 through § 176.40, Insurance Fraud in the Fourth
Degree through Insurance Fraud in the First Degree, respectively, provide that a person can
be convicted of felony-level insurance fraud when he or she "commits a fraudulent
insurance act and wrongfully takes, obtains or withholds, or *attempts* to wrongfully take,
obtain or withhold property" of a specified dollar amount. *And see* Penal Law § 470.15 (2)(a)
& (2)(b), Money Laundering in the Second Degree prohibiting the transportation,
transmission, or transfer or the *attempt* to transport, transmit, or transfer monetary
instruments of a particular dollar threshold; and General Business Law § 340 & § 341

collude to shirk tax obligations that may spiral well into the tens of thousands of dollars are worthy candidates for augmented treatment. The legislature has seen fit to do so for similarly serious crimes.[6]

Third, the Tax Law and the New York City Administrative Code should be amended to include a new "tax fraud act" targeting those who aim to commit evasion through the use of sales suppression software programs. A "tax fraud act" is an element of each degree of Criminal Tax Fraud and City Criminal Tax Fraud.[7] Currently, both statutes list eight separate activities, including filing a false return, failing to file a return, failing to collect tax, and failing to remit collected tax.[8] A ninth "tax fraud act" should be added to encompass the purchase, possession, installation, maintenance, or use of an automated sales suppression software program.

Fourth, pecuniary measures should be enhanced. The Grand Jury has seen first-hand that the investigation and prosecution of technology-rooted tax crimes is resource-intensive and correspondingly expensive. Such cases often involve long-term undercover operations and will always involve the work of computer specialists and forensic financial investigators equipped with

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(Donnelly Act) criminalizes the action of any person who makes or *attempts* to make or enter into any contract, agreement, arrangement or combination in restraint of trade.

[6] *See, e.g.* Penal Law § 105.10(3) Conspiracy in the Fourth Degree in which persons who intend and agree to engage in the crime of Money Laundering in the Third Degree receive felony treatment.

[7] Tax Law § 1802 et seq. and New York City Administrative Code § 11-4003 et seq.

[8] Tax Law § 1801(a) and New York City Administrative Code § 11-4002(a).

sophisticated analytical tools. Complex electronic data and voluminous paper records need to be analyzed, not only to detect the presence of a suppression software program, but to reconstruct the true financial data to compute the amount of the evaded tax. Those who traffick in this software even make it a selling point that their products will frustrate any subsequent audit or prosecution. During recorded conversations played for this Grand Jury, a software provider touted that the program's encryption was impenetrable to third parties. The Grand Jury therefore recommends that the punishment of these architects of evasion should include a special monetary sanction that would reimburse (at least in part) the public for the cost of the experts and equipment needed to investigate and prosecute these cases.

Thwarting those who traffick in tax-evasion software and devices is as necessary as thwarting the tax cheats themselves, and prosecutors should be given the tools needed to do the job.

RECOMMENDATION TWO

PROVIDE FUNDING TO SUPPLY MERCHANTS WITH DEVICES THAT MUST BE USED TO RECORD SALES IN A UNIFORM AND ELECTRONICALLY-ACCESSIBLE MANNER

Even after law enforcement authorities determine that a merchant has engaged in tax cheating, the suppression software may make it difficult to calculate the dollar amount of unreported sales, *i.e.*, the extent of the cheating, because the true data may have been deleted or altered in a manner that defies reconstruction. With the press of a single button, thousands or even tens of thousands of dollars of transactions can be erased from a PoS system. And even when true records are maintained, they may be hidden in any number of ways: concealed from view in an encrypted file, copied to an external device, kept off-site, or stored with a third party among hundreds of other customers.

Establishing the dollar amount of the evasion, by proof beyond a reasonable doubt, is an element of certain tax-related crimes, so a determination of that amount is vital to the prosecution of any tax cheat.[9] Moreover, the amount is often critical in establishing *mens rea*, and in determining the criminal fine to be imposed and the amount of restitution or reparation the defendant must make.

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[9] For example, the felony degrees of Criminal Tax Fraud and City Criminal Tax Fraud require a threshold dollar amount ranging from in excess of three thousand dollars to in

The Grand Jury heard witnesses describe devices that capture data from the sales receipts given to the customers and maintain that data for later use by auditors. One such device (a module) can be placed on the printer, so that, when, for example, a restaurant patron pays the bill, the information is fed into the device at the same time it is reported into the PoS system. Critically, it is difficult to tamper with this module, and thus data contained within it can be used to determine the true amount of the sales generated by the merchant-taxpayer. Indeed, within one year after such a module was in operation in Quebec, Canada, the amount of the collected "value added tax" increased over $100 million. Moreover, such devices do not disrupt the PoS system and are not a burden to the honest taxpayer, because they do not require any additional effort or record-keeping.

The legislature should provide funding to supply these modules, or similar devices, to merchants. The merchants should be required to install them so that the data is available to auditors. Capturing the data in a uniform and tamper-resistant form should more than pay for itself by deterring tax fraud. As an added benefit, these devices will also decrease the duration and the cost of an audit, and maximize the efficiency of auditors already at work.

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excess of one million dollars. Tax Law § 1803 through § 1806 and New York City Administrative Code § 11-4004 through § 11-4007.

CONCLUSION

The recommendations proposed by this Grand Jury will ensure that the public coffers are not cheated of taxes rightfully owed, especially sales tax paid by customers and entrusted to merchants for remittance to the State. These revenues are needed for a wide array of governmental services, including education, public health, and safety -- services enjoyed by the tax cheat as well as the honest taxpayer.

WE THE GRAND JURY OF THE SUPREME COURT, STATE OF NEW YORK, FIRST JUDICIAL DISTRICT, PURSUANT TO THE PROVISIONS OF CRIMINAL PROCEDURE LAW SECTION 190.85(1)(c), BASED UPON OUR STATED FINDINGS, SUBMIT THIS REPORT RECOMMENDING LEGISLATIVE, EXECUTIVE AND ADMINISTRATIVE ACTION IN THE PUBLIC INTEREST.