Aldrich H. Ames v. Commissioner of Internal Revenue, 112 T. C. 304 (1999)

Income from illegal activities must be reported in the year it is actually received, not when it is promised or set aside, under the cash method of accounting.

Summary

Aldrich Ames, a former CIA agent convicted of espionage, argued that he should have reported income from his illegal activities in 1985 when the Soviet Union allegedly set aside funds for him, rather than in the years 1989-1992 when he actually received the money. The U. S. Tax Court ruled against Ames, holding that the income was reportable in the years it was physically received and deposited into his bank accounts. The court also rejected Ames's claims that the work product doctrine did not apply to a criminal reference letter and that tax penalties violated the Double Jeopardy Clause. This decision clarifies when income from illegal activities must be reported under the cash method of accounting.

Facts

Aldrich Ames, a CIA employee, began selling classified information to the Soviet Union in 1985. He was informed that year that $2 million had been set aside for him. Ames continued his espionage activities until his arrest in 1994. During 1989-1992, he deposited cash payments from the Soviets totaling $745,000, $65,000, $91,000, and $187,000 into his bank accounts. Ames did not report these amounts on his tax returns for those years. In 1994, he pleaded guilty to espionage and tax fraud, receiving life imprisonment and a concurrent 27-month sentence.

Procedural History

The Commissioner of Internal Revenue determined deficiencies and penalties for Ames's unreported income from 1989-1992. Ames petitioned the U. S. Tax Court, arguing that the income should have been reported in 1985 under the constructive receipt doctrine. The Tax Court rejected Ames's arguments and ruled in favor of the Commissioner.

Issue(s)

1. Whether Ames constructively received income from his illegal espionage activities in 1985 when it was allegedly promised and set aside, or in the years 1989-1992 when he received and deposited the funds.
2. Whether Ames is liable for accuracy-related penalties for the years 1989-1992.
3. Whether the imposition of tax and penalties on Ames's espionage income violates the Double Jeopardy Clause of the Fifth Amendment.
4. Whether the work product doctrine applies to the Commissioner's criminal reference letter in this civil proceeding.
5. If the work product privilege applies, whether Ames has shown substantial need to overcome the privilege.

Holding

1. No, because Ames did not have unfettered control over the funds in 1985; the income was reportable in the years it was actually received and deposited.
2. Yes, because Ames's failure to report the income constituted negligence or disregard of tax rules, and he did not show that the Commissioner's determination was erroneous.
3. No, because the imposition of tax liability and accuracy-related penalties are civil remedies, not criminal punishments, and thus do not violate the Double Jeopardy Clause.
4. Yes, because the criminal reference letter was prepared in anticipation of litigation and there is a nexus between the criminal and civil proceedings.
5. No, because Ames failed to demonstrate substantial need for the criminal reference letter that would overcome the work product privilege.

Court's Reasoning

The court applied the constructive receipt doctrine, which requires income to be reported when it is credited to the taxpayer's account, set apart for them, or otherwise made available without substantial limitations. The court found that Ames did not have unfettered control over the funds in 1985, as he had to use a complex arrangement to receive payments and the Soviets retained control over the funds. The court rejected Ames's argument that his failure to report the income was due to fraud rather than negligence, noting that fraudulent concealment is inclusive of negligence. The court also applied a two-step test from Hudson v. United States to determine that the tax liability and penalties were civil, not criminal, remedies. Finally, the court found that the work product doctrine applied to the criminal reference letter because it was prepared in anticipation of litigation and there was a nexus between the criminal and civil proceedings.

Practical Implications

This decision clarifies that income from illegal activities must be reported in the year it is actually received under the cash method of accounting, even if it was promised or set aside in a prior year. Tax practitioners should advise clients to report such income in the year of receipt to avoid deficiencies and penalties. The decision also reinforces the applicability of the work product doctrine in civil tax proceedings following criminal investigations. Practitioners should be aware that criminal reference letters may be protected from discovery in subsequent civil proceedings. Finally, the decision confirms that tax liabilities and penalties are civil remedies, not criminal punishments, and thus do not violate the Double Jeopardy Clause even if the taxpayer has been criminally prosecuted for the same underlying conduct.