

MASSACHUSETTS ZAPPERS – COLLECTING THE SALES TAX THAT HAS ALREADY BEEN PAID

Boston University School of Law Working Paper No. 09-28
(May 28, 2009)

Richard T. Ainsworth

This paper can be downloaded without charge at:

<http://www.bu.edu/law/faculty/scholarship/workingpapers/2009.html>

MASSACHUSETTS ZAPPERS – COLLECTING THE SALES TAX THAT HAS ALREADY BEEN PAID

Richard T. Ainsworth

No other New England state is as vulnerable to Zappers as is the State of Massachusetts.¹

Zappers and related software programming, Phantom-ware, facilitate an old tax fraud – skimming cash receipts. In this instance skimming is performed with modern electronic cash registers (ECRs).

Zappers are a global revenue problem, but to the best of this author's knowledge they have not been *uncovered* in Massachusetts. A global perspective says: it is highly unlikely that Zappers are not in the Commonwealth – we just need to find them. In fact, using a Quebec template,² tax losses from Zappers and related frauds in the Massachusetts restaurant industry alone could exceed \$600 million.³

¹ Massachusetts has the largest GDP of any of the New England states. See: Demographia, *Regional Gross Domestic Product (GDP): Ranked North America, Europe, Japan & Oceania(Purchase Power Parity)* Wendell Cox Consultancy available at <http://www.demographia.com/db-intlppp-region.htm>. Massachusetts also has the largest restaurant sales profile of any of the New England states. Projected to be \$11,788,189 in 2009 (up 1.8% even in a down economy from 2008). NATIONAL RESTAURANT ASSOCIATION, 2009 RESTAURANT INDUSTRY FORECAST 27.

² The rough estimate that follows assumes that Zappers are as prevalent in Massachusetts as they are in Quebec where some of the most empirically accurate studies on Zappers have been conducted. It further assumes that because the Massachusetts economy (\$239.4) is larger (143% larger) than the Quebec economy (\$166.9) based on relative GDP (measured on a purchase power parity basis) that Massachusetts losses to this fraud would similarly be about 143% of the Quebec losses. Some caveats are appropriate: (1) losses are most likely much higher, because the best Quebec studies were limited to the most abused sector – the restaurant industry – even though Zapper-based ECR frauds are common in grocery stores (USA, Netherlands, Brazil), hairdressing salons (France, Netherlands, Germany), and discount clothing stores (Australia); and (2) to the extent that the Massachusetts economy is more or less dependent on the restaurant and hospitality sector than is Quebec then estimates should again be adjusted. The data used to compare the Massachusetts and Quebec economy comes from the US Department of Commerce and Statistics Canada. See: Demographia, *Regional Gross Domestic Product (GDP): Ranked North America, Europe, Japan & Oceania(Purchase Power Parity)* Wendell Cox Consultancy available at <http://www.demographia.com/db-intlppp-region.htm>.

³ On January 28, 2008 the Quebec Minister of Revenue, Jean-Marc Fournier, published the revenue loss estimated that were based on the empirical work of Statistics Quebec when he stated:

Although the majority of restaurant owners comply with their tax obligations, the restaurant sector remains an area of the Quebec economy where tax evasion is rampant, both in terms of income taxes and sales taxes. Tax losses in this sector are significant. Revenue Quebec estimates them at \$425 million for the 2007-2008 fiscal year.

Revenue Quebec, Press Release, Jean-Marc Fournier, *Pour plus d'équité dans la restauration : il faut que ça se passe au-dessus de la table*; (English trans. *For more equity in the restaurant sector it is required that [business is conducted] above the table*) available at :

Thus, if Massachusetts is indeed in need of revenue it might do well to look for Zappers and Phantom-ware installed in the ECRs of retail establishments that have a high volume of cash sales. Given the recent attempt to increase in the sales tax by 25% to 6.25%, an effort that is supposed to raise \$600 million in new taxes, it might be appropriate to consider looking for the software add-on programs that are taking the same amount of “old taxes” from the public fisc.⁴

There should be the political will to this. Governor Deval L. Patrick conceded that there is a need to raise additional revenue when he promised to veto the tax increase on April 27, 2009.⁵ The legislature agreed with the Governor (at least on this point) when it passed the rate increase by veto-proof margins. It is also likely that the citizens of the State are in accord. At least with respect to the sales tax, what we are essentially taking about is recovering the taxes that the citizens have already paid. This should be preferable to paying more taxes.

ZAPPERS AND PHANTOM-WARE

Technology has changed the efficiency with which businesses skim cash receipts. The agents of change are software applications – Phantom-ware and Zappers.⁶ Phantom-ware is a “hidden,” pre-installed programming option(s) embedded within the operating system of a

http://www.revenu.gouv.qc.ca/eng/ministere/centre_information/communiqués/autres/2008/28jan.asp (last visited May 12, 2009). See also the accompanying powerpoint presentation, *Facturation obligatoire dans le secteur de la restauration, L'évasion fiscale au Québec, Sous-déclaration des revenus dans le secteur de la restauration*; (English Trans. *Tax Evasion in Quebec : Obligatory Billing in the Restaurant Sector – Under-declaration of revenues in the restaurant sector*) 3 (January 28, 2008) (in French) (on file with author, with translation). Thus, 143% of \$425 million = \$607 million.

⁴ Michael Levenson, *Senate Approves Sales Tax Hike: 6.25% levy would include alcohol; margin veto-proof in both chambers*, Boston Globe, May 20, 2009 available at:

http://www.boston.com/news/local/massachusetts/articles/2009/05/20/senate_approves_sales_tax_hike/

⁵ Governor Deval L. Patrick, *Letter to the Massachusetts Senate*, (April 27, 2009) available at: http://www.boston.com/news/local/breaking_news/MESSAGE%20FROM%20THE%20GOVERNOR.pdf

⁶ For more detailed discussion of Zappers and Phantom-ware see: Richard T. Ainsworth, Zappers: Tax Fraud, Technology and Terrorist Funding http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1095266; Zappers & Phantom-Ware: A Global Demand for Tax Fraud Technology http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1139826; Zappers and Phantom-Ware at the FTA: Are They Listening Now? http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1147023

modern ECR. It can be used to create a virtual second till and may 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 Phantom-ware programming is part of the operating system of an ECR its use can be detected with the assistance of a computer audit specialist.

Zappers are more advanced technology than Phantom-ware. 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 more difficult to detect. Zappers liberate owners from the need to personally operate the cash register to skim receipts. Remote skimming of cash transactions is now possible without the knowing participation of the cashier who physically rings up each sale. This attribute of Zappers allows the incidence of skimming fraud to migrate beyond the traditional “mom and pop” stores (where manual skimming was common). Zappers now allow owners to place employees at the cash register, check their performance (monitor employee theft), but then remotely skim sales to cheat the taxman.

AN ANOMALY

It is something of an anomaly that Zappers and phantom-ware appear to be a very serious problem in wide range of developed countries (Canada, the Netherlands, Germany, Brazil, Australia and Sweden) but they do not appear to be a concern in the US. Massachusetts is not alone in its inability to uncover these programs. In fact, there are only two Zapper cases in the US, the \$17million skimming fraud at Stew Leonard’s Dairy (a grocery store) in Connecticut⁷

⁷ 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).

and the \$20 million skimming operation at the LaShish restaurant chain in Michigan.⁸ It is alleged that the cash skimmed at the LaShish was used to finance Hezbollah terrorists in Lebanon.⁹ In both cases the size of the fraud attracted the attention of the IRS because gross receipts were substantially understated. Lesser levels of fraud seem to fly under the IRS radar, and never seem to attract State authorities in business or sales taxes.

The Massachusetts experience with Zappers – no experience at all – contrasts dramatically with the Zapper enforcement activity of the Quebec Ministry of Revenue (MRQ). Over 230 Zapper cases have been prosecuted over the past ten years just 300 miles north of Boston. Is there something Massachusetts can learn from the MRQ?¹⁰

THREE STORIES FROM QUEBEC

The MRQ first discovered that Zappers were in wide use in 1997, and has engaged in an aggressive enforcement action ever since. Some of the highlights of this activity over the past ten years include, for example, the Audio Lab investigation, the Stratos restaurants investigation, and the investigations related to Mr. Luc Primeau.

The Audio Lab investigation first became public on April 8, 2004 after search warrants were executed at the San Antonio Grill, a restaurant in Laval, Quebec. The allegation was that a “sales Zapper” (*camoufleur de ventes*) was used to delete sales records.¹¹ The owner pleaded

⁸ Press Release, U.S. Dept of Justice, Eastern District of Michigan, LaShish Financial Manager Sentenced for 18 months for Tax Evasion (May 15, 2007) *available at*:

http://www.cybersafe.gov/tax/U.S.aopress/2007/txdv072007_5_15_EIAouar.pdf (last visited Feb. 3, 2008).

⁹ Press Release, U.S. Dept of Justice, Eastern District of Michigan, Superseding Indictment returned Against LaShish Owner (May 30, 2007) *available at*:

http://www.justice.gov/tax/usaopress/2007/txdv072007_5_30_chahine.pdf (last visited Feb. 3, 2008).

¹⁰ Personal e-mail communication, Gilles Bernard, Adjunct Director General for Fiscal Research, Revenue Quebec November 24, 2008 (on file with author).

¹¹ Revenue Quebec, News Release, Tax Evasion: The Ministry of Revenue Suspects the Restaurant Grill San Antonio de Laval of having used a Zapper (Apr. 8, 2004) *available at*:

http://www.revenu.gouv.qc.ca/eng/ministere/centre_information/communiqués/ev-fisc/2004/08avril.asp (in French only, last visited Feb. 8, 2008).

guilty one year later.¹² But more importantly on October 14, 2005, Revenue Quebec announced that it was executing five more search warrants in Montreal and Laval on Audio Lab LP, Inc. as it was under suspicion of having developed and marketed the sales Zapper used in the cash registers at San Antonio's Grill. Audio Lab LP, it turns out, not only developed the operating software in the cash registers at San Antonio's Grill (called Softdine),¹³ but it developed and sold the Zapper that defeated it.

On June 26, 2007 Audio Lab LP, Inc. pleaded guilty to charges of having, "... designed and marketed a computer program designed to alter, amend, delete, cancel or otherwise alter accounting data in sales records kept by means of a software that [Audio Lab LP] had designed and marketed."¹⁴

The Stratos restaurants investigation highlights two other characteristics of large scale technology-assisted skimming frauds: the way skimmed cash is used to corrupt other businesses, businesses selling to the "zapping" enterprise, and the ease with which this fraud can sweep through a chain of related businesses. To dispose of the excess cash from skimmed sales the Stratos restaurants (1) put a double billing system in place with suppliers (to conceal purchases made without invoices in cash), and (2) wages were paid to employees in cash (and were not reported as income). All together twenty-eight Stratos restaurants eventually were involved in

¹² The director, Mr. Apostolos Mandaltsis, was personally fined \$65,681.00 and \$10,300 respectively for PST (Provincial Sales Tax) and GST (federal Goods and Services Tax). Taxes and interest were due in addition.

¹³ Revenue Quebec, News Release, Revenue Quebec Investigation of a Software Designer Outlet Suspected of having Developed and Distributed Zappers (Oct. 14, 2005) *available at*: [http://www.revenu.gouv.qc.ca/eng/ministere/centre_information/communiqués/ev-fisc/2005/14oct\(2\).asp](http://www.revenu.gouv.qc.ca/eng/ministere/centre_information/communiqués/ev-fisc/2005/14oct(2).asp) (in French only, last visited Feb. 8, 2008).

¹⁴ Revenue Quebec, News Release, The Company Audio LP, Inc. Convicted of Tax Evasion (Sept. 21, 2007) (on the conviction fines were imposed of \$12,475) *available at*: http://www.revenu.gouv.qc.ca/eng/ministere/centre_information/communiqués/ev-fisc/2007/21sep.asp (in French only, last visited Feb. 8, 2008).

the fraud. Guilty pleas came in waves – nineteen companies pleaded guilty on September 26, 2002; another six on October 11, 2002, and the four remaining on March 21, 2003.

Press releases provide details of only the final ten companies. In aggregate the taxes and penalties for these companies came to \$1,816,070.90, but the real thrust of the news releases were that “... the Department has conducted searches in order to establish proof that the designer of the IT function associated with the cash register software Terminal Resto had participated in the scheme set up by restaurants in the Stratos chain.”¹⁵ On April 25, 2003, Mr. Michel Roy and his two sons Danny and Miguel admitted that they were guilty of facilitating the Stratos tax evasion. The father (Michel) was the creator of the Zapper that worked with Resto Terminal. He promoted it and made the sales. His sons (Miguel and Danny) were also implicated in creating the zapper. Aggregate fraud penalties assessed against the Roys were \$1,064,459.¹⁶

The third example involves Mr. Luc Primeau, a software designer who became the focus of an investigation that began with the announcement on March 17, 2003 that seven Patio Vidal restaurant franchises and a bar, La Tasca, from Gatineau, Quebec as well as another bar named O’Max in Masson-Angers, Quebec were convicted of adding Zappers to their Microflash cash register software (later upgraded to a new version called Caracara). Mr. Primeau not only

¹⁵ The breakdown is: \$429,179.07 (GST) + \$492,023.11 (PST) + \$214,589.55 (federal penalties) + \$625,028.89 (provincial penalties) + \$55,250.28 (judicial fees). Revenue Quebec, News Release, All Stratos Restaurants Convicted of Fraud in Connection with the use of a Zapper (Mar. 18, 2003) *available at*: http://www.revenu.gouv.qc.ca/eng/ministere/centre_information/communiqués/ev-fisc/2003/18mars.asp (in French only, last visited Feb. 8, 2008).

¹⁶ Revenue Quebec, News Release, Fines of more than One million dollars – A Father and his Two Sons convicted for Tax Evasion in connection with the Zapper (May 2, 2003) *available at*: http://www.revenu.gouv.qc.ca/eng/ministere/centre_information/communiqués/ev-fisc/2003/02mai.asp (in French only, last visited Feb. 8, 2008).

designed Microflash and Caracara, but was the developer of the associated Zapper program that these businesses used.¹⁷

On October 17, 2005 Mr. Primeau admitted that his software assisted these companies to evade \$435,000 in GST and QST. All together these companies skimmed \$2.7 million in cash sales. Mr. Primeau was fined for his involvement. More importantly for this analysis we need to see Mr. Primeau as the classic example of the software designer who is a real threat to the tax system. By morphing into a business consultant Mr. Primeau actively spread Zappers throughout the restaurant sector. He brought this fraud to a series of bars and restaurants that might not otherwise have been involved if the risk of detection were not minimized by his software.¹⁸

Similar stories can be culled from litigation in the Netherlands, Germany, Brazil, Sweden and Australia. There are government studies that measure the significance of this problem, a multi-nation task force in the European Union looking at it, and a national study by Her Majesty's Revenue and Customs in the United Kingdom just coming to conclusion.

CONCLUSION

In these times of fiscal constraint, Massachusetts might benefit from a consideration of the enforcement options being developed around the globe. Waiting for the IRS to develop enforcement tools in this area might not be the optimal choice. Unlike the rest of the world, the

¹⁷ Revenue Quebec, News Release, Mr. Marcel St. Louis de l'Outaouais Convicted of Tax Evasion related to the use of a Zapper (Mar. 17, 2003) *available at*: http://www.revenu.gouv.qc.ca/eng/ministere/centre_information/communiqués/ev-fisc/2003/17mars.asp (in French only, last visited Feb. 8, 2008).

¹⁸ Revenue Quebec, News Release, The Zapper Designer of Boucherville Pleads Guilty to Various Charges brought by Inland Revenue Quebec (Oct. 26, 2005) (additional penalties of \$22,513.19 under the GST and QST, as well as income tax of \$17,297.08 and related penalties of \$26,621.35) *available at*: http://www.revenu.gouv.qc.ca/eng/ministere/centre_information/communiqués/ev-fisc/2005/26oct.asp (in French only, last visited Feb. 8, 2008).

US has no national consumption tax, so oversight of cash registers on a transactional basis is not a high priority of the Service.

The bottom line for the Commonwealth should be that it is preferable to collect a tax that is already due, and that has already been paid by the citizen (admittedly to an agent of the State who has placed this revenue in his own pocket) than it is to raise taxes on everyone else.