New York Law Journal

Web address: http://www.law.com/ny

VOLUME 229—NO. 93 THURSDAY, MAY 15, 2003

TAX LITIGATION ISSUES

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Tax Opinions by District Courts in the Second Circuit

DURING THE PAST year, the downward trend in criminal tax prosecutions continued in the districts constituting the U.S. Court of Appeals for the Second Circuit. Notwithstanding the dearth of criminal cases, district judges within this circuit have continued to face issues of import to criminal practitioners, with uniformly favorable results for taxpayers in the more notable cases.

Significantly, in three cases, courts were called upon to resolve issues arising out of the assertion of the Fifth Amendment privilege against self-incrimination in civil tax proceedings. In each case, the court recognized the value of the privilege asserted and sought to make reasonable accommodations to protect the taxpayer who asserted his or her constitutional rights in good faith. In two other cases, courts addressed issues in sentencing tax offenders. In one case, the court applied the U.S. Sentencing Commission Guidelines literally, to the defendant's benefit, and in another case the court granted a tax offender a significant downward departure in recognition of truly extraordinary charitable conduct and family circumstances.

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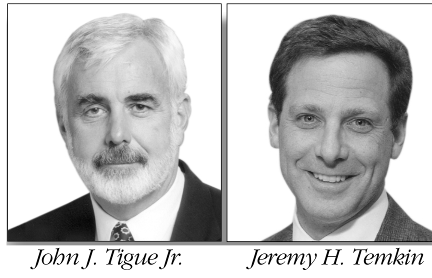

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Fifth Amendment Privilege

In *United States v. Cianciulli,*[1] Southern District Magistrate Judge Theodore Katz found that the taxpayer was justified in withholding certain documents requested by the Internal Revenue Service because the act of producing those documents posed the risk of self-incrimination. In an earlier opinion in the same case, District Judge Richard Berman had held that although the taxpayer could not make a blanket assertion of the Fifth Amendment to avoid attendance at a deposition or production of documents, he could assert the Fifth Amendment in response to specific questions or requests if the responses were in fact potentially incriminating.[2] The taxpayer then produced certain records to the court for in camera inspection seeking a protective order based on the Fifth Amendment.

Citing *United States v. Hubbell,*[3] Magistrate Judge Katz noted that while the Fifth Amendment offers no protection based on the contents of voluntarily prepared documents, it does protect individuals from compelled production of documents where the act of production itself "could implicitly communicate incriminating facts, such as the admission that papers existed, were in [the producing party's] possession or control, and were authentic." He observed that the "act of production" privilege is generally available under two sets of circumstances — where the government does not know of the existence or location of documents sought in a summons, or where the production itself would provide the basis for authentication.

Based on his review of the particular documents in question, Magistrate Judge Katz concluded that "there was no reason to believe that the documents … are known by the government either to exist or to be in the Respondent's possession" and, further, that their existence and their possession and production by the taxpayer could well communicate incriminating facts by "furnishing a link in the chain of evidence needed to prosecute" the taxpayer.

In two recent cases from the U.S. District Court for the District of Connecticut, the court sought to avoid unduly burdening individuals who had previously asserted the Fifth Amendment during tax investigations. In *United*

States v. Snyder,[4] the IRS sought to enforce a tax lien against the daughter of two delinquent taxpayers, asserting, among other theories, that the taxpayers had fraudulently conveyed to her the house in which they lived. The daughter had asserted her Fifth Amendment privilege against self-incrimination during discovery, which she conceded served as a waiver of her right to testify at trial. District Judge Peter C. Dorsey, however, denied the government's subsequent motion to preclude her from testifying at trial on this basis, and allowed the daughter to reserve her right to modify the preclusion order and reopen discovery, should she decide to withdraw her claim of privilege. In so holding, the court recognized the Second Circuit's concern that district courts accommodate litigants' Fifth Amendment interests, noting that courts should take a liberal view towards such applications, inasmuch as they permit adjudication based on all the material facts. The court observed that the primary consideration on such a motion is whether the privilege was "originally invoked in a manner as to manipulate or gain an unfair advantage over opposing parties," and that there was no evidence that the daughter in this case had asserted the privilege in an abusive manner.

In *United States v. Mahler*,[5] District Judge Janet Bond Arterton sought to balance the competing interests of the government in tax enforcement and the taxpayers in protecting their rights against self-incrimination. In *Mahler*, the IRS and the taxpayers had consented to an arrangement under which the taxpayers would appoint an outside agent to review and turn over corporate documents to the IRS and provide deposition testimony regarding that document production.[6]

Although the consent order setting forth the procedure the agent was to follow in collecting and producing the records appeared to have contemplated that the agent would make an independent search of corporate records, it was the taxpayers who actually collected and delivered documents from each of the relevant corporations to a central location. Only after the government objected to the initial effort at compliance did the agent conduct an independent search of the corporate records, which turned up at least one document that was omitted from the original production. Dissatisfied with the manner and timing of the document production, the government ultimately sought contempt sanctions for "delay and obfuscation" during the proceeding.

Because the sentencing guidelines in most tax cases are driven by the tax loss attributable to the offense, computation of tax loss is a common area of dispute.

Notwithstanding his characterization of the summons compliance as resembling "protracted and tedious oral surgery on a difficult patient," Judge Arterton denied the motion, finding that "[w]hile quite strained, it [was] not totally implausible" to read the consent order as authorizing the taxpayers to make the initial determination as to which documents constituted "summoned corporate documents." The court observed that the taxpayer's attorney was "acting out of an abundance of caution" in requesting the use of an agent and in attempting to comply "in the narrowest and most prophylactic way" and concluded that from a "neutral distance" the "long and meandering road to compliance" taken in that case was not so meritless as to justify a determination that it was undertaken with improper purpose.

Attorney-Client Privilege

In *Bria v. United States*,[7] District Judge Christopher F. Droney explored the often-difficult question of the scope of the attorney-client privilege when information is imparted to an attorney who is also serving as a tax preparer. In *Bria*, the government was investigating whether an executor had understated the value of an estate on estate tax returns. The executor's initial attorneys had prepared a draft of the estate tax return, but she terminated that firm's services before the return was filed. The return that was eventually filed omitted certain items that had been included in the original draft, including certain bank accounts valued at over $400,000 and a mortgage held by the deceased. When the government served a summons on the original attorneys, they asserted the attorney-client privilege in response to certain questions.

In ordering the attorneys to divulge some, but not all of the information sought by the government, Judge Droney recognized the general rule that "[i]f the client transmitted the information so that it might be used on the tax return, such transmission destroys any expectation of confidentiality which might have otherwise existed." The court, however, distinguished between actions the attorneys took in their capacity as lawyers and those taken as tax return preparers. Thus, the court permitted the government's inquiry into the attorneys' basis for including the joint bank accounts on the draft return, while barring inquiry into conversations between an attorney and the executor concerning "how to handle" a mortgage held by the deceased. It reasoned that communications concerning the bank accounts were not privileged both because this type of information was reasonably expected to be included on an estate tax return and because the attorney was serving an accounting rather than a legal function. By contrast, any conversations about how to handle the mortgage were likely to have included legal advice as well as communica-

tions that the executor expected to remain private and were thus protected under the privilege.

Sentencing

Because the sentencing guidelines in most tax cases are driven principally by the amount of tax loss attributable to the offense, computation of tax loss is a common area of dispute. The issue was raised last year in *United States v. Trupin*.[8] Following defendant's conviction of evasion of the payment of a tax, in violation of 26 USC §7201, the government argued that the tax loss should be measured by application of §2T1.1(c)(3) of the sentencing guidelines, which provides that "[i]f the offense involved willful failure to pay tax, the tax loss is the amount of tax that the taxpayer owed and did not pay." The defendant argued that the applicable guideline was §2T1.1(c)(1), which provides that "[i]f the offense involved tax evasion or a fraudulent or false return, statement, or other document, the tax loss is the total amount of loss that was the object of the offense (i.e., the loss that would have resulted had the offense been successfully completed)."

In support of its position, the government urged the court to focus on the nature of the conduct in which the defendant had engaged, arguing that evasion of payment "involved a willful failure to pay tax," warranting application of §2T1.1(c)(3). Although acknowledging the appealing simplicity of this argument, Judge McKenna found it ultimately not persuasive. Rather, the court noted that under §1B1.2, as a general rule, the sentencing court should apply the guideline most applicable to the count of conviction, which is defined as the offense conduct charged in the indictment on which the defendant was convicted. The court concluded that under this approach application of §2T1.1(c)(1) was warranted because that provision clearly reflected the language of both the statute the defendant was charged with having violated and the indictment itself.

The court rejected the government's policy-based argument that this outcome would lead to harsher sentences for defendants convicted of the less serious offense of willful failure to pay a tax than those convicted of the more serious crime of tax evasion. It noted that these guidelines were promulgated with the approval of Congress, and that "it has certainly long ceased to be the case that it is up to courts on their own to determine the appropriate range of penalties for various sorts of criminal conduct."

White-collar defendants who, like many tax offenders, are not in a position to offer the government assistance in other prosecutions, are more often than not frustrated in their quest for downward departures. Judge Scheindlin's decision in *United States v. Greene*[9] illustrates that, in truly exceptional circumstances, significant departures are available, even for defendants convicted of serious tax crimes.

The defendant in *Greene* was convicted of assisting in the preparation of hundreds of false tax returns listing fictitious deductions for clients of his tax preparation business. At sentencing, the defendant faced a guidelines sentencing range of 18 and 24 months. Judge Scheindlin, however, imposed a sentence of no incarceration, after departing seven levels based on the defendant's extraordinary charitable works and family circumstances.

Judge Scheindlin noted that pursuant to §5H1.1, civic, charitable and other forms of public service are discouraged bases for departures from the guidelines, but, under *Koon v. United States*,[10] may nonetheless support a departure if present to an exceptional degree. She concluded that the defendant's lifetime of service to disadvantaged children, culminating in his adoption of six emotionally, mentally and physically disabled boys who he raised in an "extraordinarily responsible manner" as a single parent, constituted a record warranting a downward departure. She rejected the government's argument that charitable works departures are particularly disfavored in white-collar cases, noting that although the defendant was technically a white-collar defendant, he was not a wealthy man, and more importantly, that his charity was not financial, but consisted of time, which she found to be a "more valuable commodity."

Judge Scheindlin further found that because three of the six children remained financially and emotionally dependent on the defendant, a departure was also warranted by his extraordinary family circumstances. She found that the government was "simply wrong," that this case did not differ from that of any other single parent of three, noting that the children in this case were particularly vulnerable in light of their disabilities and the traumatic circumstances of their lives before the defendant adopted them.

(1) 2002 WL 1484396 (SDNY July 10, 2002).
(2) 2001 WL 1097919 (SDNY Sept. 19, 2001) (Berman, J.) (discussed in our March 2002 New York Law Journal column).
(3) 530 US 27 (2000).
(4) 233 FSupp2d 293 (D. Conn. 2002).
(5) 195 FSupp2d 379 (D. Conn. 2002)
(6) See *United States v. Barth*, 745 F2d 184 (2d Cir. 1984) (approving use of an agent to provide corporate documents responsive to IRS summons, where existing corporate employees all invoked Fifth Amendment privilege in connection with production of the requested documents).
(7) 2002 WL 663862 (D. Conn. March 26, 2002).
(8) 2002 WL 31106343 (SDNY Sept. 20, 2002).
(9) 2003 WL 115217 (SDNY Jan. 13, 2003).
(10) 518 US 81 (1996).

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