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TAX LITIGATION ISSUES

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Second Circuit Tax Cases in 2003

AMONG THE QUESTIONS of criminal tax law considered by the U.S. Court of Appeals for the Second Circuit over the past year were the discoverability of an Internal Revenue Service criminal investigative agent's report and the admissibility of an agent's expert testimony in a criminal tax trial; the appropriateness of a conscious avoidance jury charge; and the relevance of a civil settlement in related criminal proceedings.

All of these decisions were issued in the form of summary orders, signaling some reluctance on the court's part to imbue them with application beyond the case at hand.¹ But given the paucity of published opinions on substantive criminal tax law questions, these decisions are worthy of note. On the civil side, the court issued a decision which highlights the extent to which even the "kinder, gentler" IRS of the past few years is still capable of committing acts of tremendous, unchecked injustice. The court also upheld the denial of a request made by one of the authors of this article for access to a report submitted by a prosecutor in the U.S. District Court for the Southern District of New York to a commission investigating the Criminal Investigation Division of the IRS.

Use of Agents' Testimony and Reports

The Second Circuit's decision in *United States v. Boykoff*² addresses both the defendant's attempts to make use of an IRS special agent's report based on a review of other returns the defendant had prepared, as well as the prosecution's use of an IRS agent's expert testimony. The court ruled against the defendant on both issues, upholding the trial court's denial of the defen-



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dant's request for production of the agent's report in discovery, and its admission of another agent's expert testimony against the defendant.

The defendant in *Boykoff*, a CPA convicted of preparing false returns and income tax evasion, argued that he was entitled to discovery of the special agent's report under *Brady v. Maryland*,³ because it would help him show that any inaccuracies on returns for which he was being prosecuted were careless errors. Distinguishing its earlier decision in *United States v. Sternstein*,⁴ in which the trial court denied the defendant's request for an agent's report without first reviewing the report, the *Boykoff* Court stressed that trial court had reviewed the report in question, and found that it did not contain exculpatory evidence. The court concluded that there was thus no error in denying discovery of the report.

The court also rejected the defendant's challenge to the government's use of an agent as an expert witness on the question of the propriety of various business deductions claimed by the defendant. The defendant argued that by permitting the agent to say that the defendant had reported personal expenses as business expenses, the government had improperly shifted the burden of proof to the defendant. The Second Circuit disagreed, noting that the agent was not the trier of fact, but was merely testifying to his opinion, and that the jury retained responsibility for determining whether the business deductions were properly taken, without requiring the defendant to prove anything.

Conscious Avoidance

In a pair of orders, the Court of Appeals reject-

ed the defendants' challenge to the trial court's conscious avoidance jury charge in *United States v. Rhodis*.⁵ In that case, the government charged two brothers, George and John Rhodis, with conspiracy to defraud the United States and filing false personal and corporate tax returns for failing to report approximately \$700,000 in rental income generated by properties they owned and which they deposited into their personal bank accounts. The evidence at trial established that while both brothers were involved in the management of the business, John was more intimately involved with its finances instructing the corporate bookkeeper to keep cash deposits below \$10,000 per day in order to avoid IRS notification and to maintain an accurate record of receipts including those payments deposited to the brothers' personal accounts, but to conceal those records from the corporation's tax preparer. The court found that the overwhelming evidence of John's direct participation in the scheme rendered any error in the conscious avoidance instruction harmless as to him.

The case against George was more attenuated — consisting primarily of numerous rent checks made out to and endorsed by him personally; tax returns bearing his signature that did not reflect that income; and a loan application that reported higher monthly income for the corporation than reflected on the corporation's income tax returns. In upholding the conscious avoidance jury instruction, the court, citing *United States v. Ferrarini*,⁶ noted that such an instruction is proper where the element of the defendant's knowledge is in dispute, and an appropriate factual predicate for the charge exists. It found that in this case the defendant had put at issue the question of his knowledge when his attorney, in his opening statement, asserted that the corporation's bookkeeper took advantage of the defendant, who was "unfortunately ... not paying keen attention" to the bookkeeper's conduct. Relying on *United States v. Rodriguez*,⁷ the court held that the discrepancy between the tax returns and the loan application, combined with George's degree of involvement in the operations of the business supported the conclusion that either he knew the tax returns were false or that he was aware of a high probability that they were false and

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consciously avoided confirming that fact.

Two appellate decisions issued last year underscore the separate nature of civil and criminal tax proceedings, and the extent to which a taxpayer's satisfactory resolution in one forum will not necessarily aid him in the other. In *Manko v. United States*,⁸ the Second Circuit rejected habeas corpus challenges to tax fraud convictions of co-defendants based on the trial court's exclusion of evidence that the IRS had settled civil claims against them concerning some of the same transactions on which they were later prosecuted.

Based on the IRS's policy against compromising tax claims unless there is some doubt as to their validity,⁹ the defendants argued that evidence that the IRS had compromised civil claims against the defendants based on the same transactions which gave rise to the prosecution, undercut the government's claim that those transactions were fraudulent. The Second Circuit found no abuse of discretion in the district court's determination that exclusion of the settlement evidence was proper. It held that even if the settlement evidence was relevant, any probative value was outweighed by the potential to mislead the jury because the settlement reflected doubts about the IRS's ability to prove its case rather than doubts as to whether the transactions were fraudulent. The court also noted that the fact that the settlement disallowed 80 percent of the claimed deductions, showed that any doubts the IRS may have had about its ability to prove its case were not strong. It concluded that "[i]f the evidence were admitted, the trial would have been diverted from the central issue of guilt or innocence to a complicated inquiry into the IRS's bureaucratic mechanisms in hopes of divining the IRS's true intent in reaching the settlement."

The Second Circuit agreed that the taxpayer in *United States v. Ripa*¹⁰ found himself in a "Kafkaesque" situation. He had been stopped at the Canadian border with \$350,000 in cash gambling winnings that he had not reported as required by 31 USC 5317(b). Those funds were seized by United States Customs, after which the IRS made a "termination assessment" against the taxpayer for \$170,000 in taxes owed on the cash he was carrying.¹¹ The taxpayer did not contest that assessment, but claimed that he was unable to pay it, because the money he needed to pay the taxes had been seized by customs before the assessment was made.

The United States tried unsuccessfully to forfeit those funds during protracted litigation that was stayed during similarly unsuccessful criminal tax evasion charges brought against the defendant relating to the same funds. The final judgment in the taxpayer's favor in the forfeiture proceeding was not issued until some fourteen years after the money was seized. By that time, the penalties and interest on the civil tax liability had swelled to more than \$750,000. Because the interest owed to the taxpayer on the wrongfully seized funds was calculated at a far lower rate than

the penalties and interest that accrued on his tax liabilities, he ended up owing the government far more than it owed him despite his success in the forfeiture action. Those funds became the subject of an interpleader action which was the subject of the Second Circuit's decision in *Ripa*.

The two issues before the Court of Appeals were whether the taxpayer's attorney's lien had priority over the federal tax lien, and whether the district court erred in refusing to grant equitable relief to the taxpayer from the interest that had accrued during the government's wrongful retention of his funds. The Court held that the tax code provision granting a superpriority to attorney's liens¹² contains an exception for a lien on a judgment on a claim or cause of action against the United States. Although it acknowledged that the statutory language produced some

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ambiguity as to whether the exception should apply to a judgment in a forfeiture action, which after all is brought against the funds in question rather than the United States, the Court held the intent of the statute was to collect taxes, not to bestow benefits on attorneys, and that that purpose was not advanced where the funds generated were obtained through litigation with the government.

The Court also denied the taxpayer's request for equitable abatement of the interest and penalties. Without disputing the unfairness of the taxpayer's situation, the Second Circuit noted that Congress had not given the federal courts general equitable powers to grant relief from unfairness prescribed by federal law. It found that the differential rates of interest were set by statute, as were the conditions under which the courts can abate penalties. It further noted that requests for abatement of interest must be made in the first instance to the secretary of the Treasury, and that the taxpayer had not done so in this case. The Court concluded that it was "no more able to relieve [the taxpayer] of the absurdity of his situation than [it is] able to relieve Kafka's Joseph K of the absurdity of his."

Access to Report Reviewing Criminal Investigation Division Functions Denied. The Second Circuit also upheld Southern District Judge Alvin K. Hellerstein's denial of a Freedom of Information Act (FOIA) request for access to a report prepared by a Southern District prosecutor, which was submitted to and quoted by the

Webster Commission, appointed by IRS Commissioner Charles Rossotti to improve the effectiveness of the IRS's Criminal Investigation Division (CID). In a decision issued in *Tigue v. United States Department of Justice*,¹³ the court held that the report fell within the "deliberative process privilege" and was thus exempted from the disclosure requirements of FOIA under 5 USC §552(b)(5). The court rejected the plaintiff-appellant's contention that because the report was submitted to a public commission, which was not a government agency, it did not qualify for the deliberative process privilege, which is available only for inter- or intra-agency communication. It reasoned that because the commission was acting as a consultant to the IRS, the memorandum qualified as an interagency communication. The court also rejected the argument that the government had waived any privilege covering the memorandum because the Webster Commission cited the memorandum in its final report. Citing *NLRB v. Sears, Roebuck & Co.*,¹⁴ the court noted that waiver occurs only when an agency expressly adopts or incorporates by reference a predecisional protected memorandum. Finding that the Webster Commission's "minor references" to the memorandum could not be said to be an express adoption or incorporation, and were not inconsistent with the desire to keep the report confidential, the court found no waiver of the privilege.

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(1) The Second Circuit advises that its summary orders may not be cited as precedential authority, but may be called to the attention of that, or any other court, in any related proceeding or for purposes of collateral estoppel or res judicata.

(2) No. 02-1435, 2003 WL 21191002 (2d Cir. 2003).

(3) 373 US 83 (1963).

(4) 596 F2d 528 (2d Cir. 1979)

(5) *United States v. George Rhodis*, No. 02-1009, 2003 WL 151254 (2d Cir. 2003) and *United States v. John Rhodis*, No. 01-1688, 2003 WL 151264 (2d Cir. 2003).

(6) 219 F3d 145 (2d Cir. 2000), cert. denied, 532 US 1037 (2001).

(7) 983 F2d 455 (2d Cir. 1993).

(8) Nos. 98-2639(L) and 98-2676 (CON), 2003 WL 1973404 (2d Cir. 2003).

(9) See 26 CFR "601.203, Rev. Proc. 80-6," 4.01.

(10) 323 F3d 73 (2d Cir. 2003).

(11) A termination assessment, authorized by 26 USC 6851, is made when the IRS discovers large cash amounts which are presumed to constitute taxable income and the IRS fears that collection of the taxes will be thwarted if the person puts himself or the cash outside of the government's reach. Under a termination assessment, the tax year is terminated on the date of the assessment, and the taxes become due and owing immediately.

(12) 26 USC 6323(b)(8).

(13) 312 F3d 70 (2d Cir. 2002) (One of the authors of this article was the plaintiff-appellant and the authors' firm was counsel to plaintiff-appellant in this action).

(14) 421 US 132, 161 (1975).

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