

New York Law Journal



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

VOLUME 228—NO. 55

THURSDAY, SEPTEMBER 19, 2002

TAX LITIGATION ISSUES

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Second Circuit Tax Cases in 2002

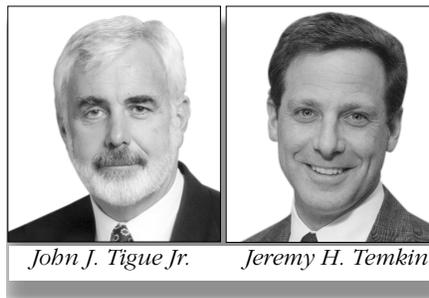
Among the Second Circuit's criminal tax decisions within the past year was an important ruling delineating the scope of the work-product protection governing an attorney's observations at an interview of her client by Internal Revenue Service agents.

The court held that while an attorney might be called upon to testify in an investigation relating to the truth or falsity of statements made at such an interview, such testimony could not be used in an investigation into the activity that was the subject of the interview and concerning which the attorney had been retained to represent the witness.

As in the past, most of the court's remaining criminal tax decisions focused on sentencing issues. In one case, the court held that, in calculating tax loss, a defendant is entitled to credit for unclaimed deductions so long he can prove that those deductions are proper, and it also addressed the method for grouping tax and mail fraud counts. In other cases, the court upheld a vulnerable victim enhancement predicated on harm to an individual who was not victimized by the offense of conviction (tax fraud) but by a related scheme and upheld a significant increase in a defendant's offense level predicated upon conduct related to his wife's criminal activity.

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Finally, the Court of Appeals also considered and rejected a statute of limitations challenge to a superceding indictment that charged the defendant with subscribing to false tax returns predicated upon a source of income not alleged in the initial indictment.

1. Limited Work-Product Protection

IRS Interview of Client. In *In re Grand Jury Subpoena Dated October 22, 2001*,¹ the Court of Appeals considered the propriety of a prosecutor's efforts to compel an attorney to testify before the grand jury as to the substance of her client's statements to two IRS agents during an interview some four years earlier. One of the agents had since died, and the government maintained that it needed the attorney's testimony to prevent the case from becoming a "swearing contest" between the surviving agent and the witness as to what was said during the interview. Before the district court, the prosecutor represented that the attorney's testimony was sought to demonstrate what the client had said during the interview in order to support charges that her client had made false statements to the IRS agents and, thus, that the attorney was merely

being asked to give testimony concerning a crime that she had witnessed by virtue of her presence at the interview. On appeal, the government conceded that it also sought to use the attorney's testimony to support charges that her client had been involved in the underlying tax fraud that the IRS was investigating when it conducted the interview.

The Court of Appeals found this shift in the government's approach to be significant, noting that if the attorney's testimony was sought only with respect to the commission of a crime during the interview, the work-product privilege might not bar the prosecutor's access to her eyewitness testimony. It held, by contrast, that the work-product doctrine was properly invoked to prevent the government from using the attorney's testimony to prove her client's commission of the very tax crimes concerning which the attorney had been hired to represent the client. The Court reasoned that "[f]or the attorney to be subpoenaed to testify to the observations made in the course of [preparing her client for potential litigation] in order to help the putative adversary prove the offense as to which the attorney was providing representation would do substantial injury to the values that justify the work-product doctrine." Accordingly, the Second Circuit reversed the district court's denial of the motion to quash the subpoena.

The Court, however, left open the possibility that the government could issue a new subpoena for the attorney's testimony before a grand jury that was investigating the client's alleged false statements rather than his underlying criminal activity, but made a number of cautionary observations as to how such a subpoena should be evaluated on any subsequent

motion to quash. First, it expressed concern with the district court's observation that the work-product doctrine applied only to opinions and not to facts. It found that while the doctrine is most concerned with protecting the attorney's opinions and strategies, it saw "no reason why work-product cannot encompass facts as well." The Court also took issue with the government's argument that it had demonstrated "substantial need" for the attorney's testimony as corroboration for the surviving agent's account of what was said at the interview. The Court noted that such corroboration, if necessary at all, was needed only at trial and could not support a subpoena for grand jury testimony inasmuch as a grand jury is simply called upon to make a finding of probable cause, which could be predicated on the uncorroborated testimony of a single agent.

2. Sentencing Issues

a) Tax Loss Calculation — Deductions Should be Considered. As we have previously written, the Sentencing Guidelines contain numerous pitfalls for the tax offender and, as a general rule, tend to work in the direction of increased sentencing exposure, with little possibility of decrease other than for acceptance of responsibility.² The guidelines governing tax offenses provide that the base offense level is to be determined by the tax loss involved, which is determined by the loss that would have resulted had the offense been successfully completed.³ The application notes explain that tax loss in such cases is to be computed in part by multiplying the amount of unreported gross income by 28 percent, "unless a more accurate determination of the tax loss can be made." In *United States v. Gordon*,⁴ the Second Circuit offered some tax offenders the ability to use the potential of a more-accurate determination of tax loss to reduce their offense level by demonstrating that the tax loss attributable to their conduct can be offset by potential deductions.

In *Gordon*, the defendant was convicted of operating a massive telemarketing fraud scam through a corporation known as Worldwide and for failing to pay taxes on income generated by that scam. In the district court, he unsuccessfully argued for a reduction in his

base offense level based upon dicta in the Second Circuit's previous decision in *United States v. Martinez-Rios*,⁵ which noted that a "determination of the tax loss involves giving the defendant the benefit of legitimate but unclaimed deductions." Thus, the defendant in *Gordon* argued that, in calculating the tax loss attributable to his activities, the district court should treat funds that he had transferred to himself from Worldwide as a deductible salary expense and that the loss attributable to his failure to report that income on his individual return should accordingly have been offset by the corporate deduction Worldwide could have, but did not take for payment of his salary.

The Court of Appeals held that the sentencing court had, in fact, erred in refusing to consider this potential deduction, but that the error was harmless because the defendant had not proven that the money he took from Worldwide would have been treated as salary, rather than as a non-deductible distribution. Noting that the defendant bore the "full burden of proof in establishing the appropriateness of consideration of such an unclaimed deduction," the court concluded that his argument that such salary treatment of the funds in question was likely did not constitute sufficient proof to establish an unclaimed deduction for the purposes of offsetting tax loss. While the defendant was ultimately unsuccessful in obtaining a reduction in his offense level, *Gordon* provides a potential source of mitigation to defendants facing sentencing under the tax guidelines.

Grouping

b) Grouping. In *Gordon*, the court also had occasion to clarify the rules governing grouping of mail fraud and tax evasion counts. Although the Second Circuit's decisions in *United States v. Fitzgerald*⁶ and *United States v. Petrillo*,⁷ had established that grouping of such counts is proper, until its decision in *Gordon*, the Court had not expressly decided under which subsection of §3D1.2 that grouping should occur. The district court in *Gordon* had grouped the defendant's tax fraud and mail fraud counts under §3D1.2(c), which applies to counts that

involve substantially the same harm because one of the counts embodies conduct that is treated as a specific offense characteristic in or other adjustment to the guidelines applicable to another count. While it did not object at sentencing, the government appealed that determination arguing that the counts should have been grouped under subsection (d), which applies when the offense level for both counts is "determined largely on the basis of the total amount of harm or loss ... or if the offense behavior is ongoing or continuous in nature and the offense guideline is written to cover such behavior."

The court found that the trial court had erred in grouping the offenses under subsection (c). It held that its approach in *Petrillo* and *Fitzgerald*, as well as the structure of the relevant guidelines, require that crimes whose harms are quantifiable be subject to the unique treatment afforded by subsection (d), which calls for a sentence based on an aggregation of the total harm. Thus, the court concluded that because subsection (c) is appropriate only when the counts being grouped may properly be considered a single crime, it was plain error for the sentencing court to group tax evasion and mail fraud under that provision. Because the offense level is determined by aggregating the losses from all offenses of the same general type, grouping under subsection (d) generally yields higher sentences than grouping under subsection (c), which requires that the offense level be determined by the highest level for an indicted offense within the group. As a result, this aspect of *Gordon* may result in higher offense levels, and thus higher sentences, for those tax offenders who are also charged with having engaged in fraud.

Vulnerable Victim

c) Vulnerable Victim Enhancement. In another case arising out of fraudulent telemarketing scheme, the government in *United States v. Firment*⁸ dismissed mail fraud charges against the defendant in exchange for his plea of guilty to a conspiracy to impede the lawful functioning of the IRS. Notwithstanding the dismissal of the fraud charges, the district court enhanced the defendant's sentence pursuant to §3A1.1(b)(1), finding that the defendant

knew or should have known of the vulnerability of the victims of his fraudulent telemarketing scheme (many of whom were elderly and had already been victimized in previous scams). On appeal, the court rejected the defendant's argument that the individuals in question were not the victims of the offense for which he was convicted and that because he pleaded guilty to the tax charge alone, the only victim of that crime was the United States, which could not be considered vulnerable. Relying on the commentary to §3A1.1(b)(1), which defines a vulnerable victim as any person "who is a victim of the offense of conviction and any conduct for which the defendant is accountable under §1B1.3," as well as its earlier decisions in *United States v. Borst*,⁹ and *United States v. Echevarria*,¹⁰ the Court held that a vulnerable victim enhancement is appropriate when offense conduct victimizes a vulnerable person "even though the entity directly targeted by the offense of conviction was a different person."

d) Relevant Conduct. The Court's decision in *United States v. Feola*¹¹ presents a useful discussion of the application of the relevant conduct rules in tax cases. In *Feola*, the defendant's wife had embezzled millions of dollars from her employer over a five-year period. The couple failed to reflect those funds on their 1996 and 1997 tax returns and failed to file any returns at all in 1998 and 1999. They also presented a copy of a 1998 tax return falsely representing it had been filed with the IRS in support of a bank loan application. The defendant pleaded guilty to one count of bank fraud and one count of failing to file a 1998 tax return. Based on the defendant's 1998 income of \$47,000, the government stipulated in the plea agreement to an offense level of nine for the tax count. The probation department, however, found that the tax loss was more than \$1.3 million based upon the funds embezzled by the defendant's wife that the couple had failed to report on their tax returns between 1996 and 1999. This resulted in an offense level of 19. The district court accepted the probation department's calculation, rejecting as "almost inconceivable" the defendant's arguments that he did not know about the money or that he thought it was a loan from his wife's employer.

The Second Circuit upheld the district

court's rejection of the defendant's argument that the failure to report income for years other than 1998 should not be considered relevant conduct because he lacked knowledge of the embezzled funds, and, thus, criminal intent. It relied on the fact that the defendant had knowingly submitted the fraudulent 1998 tax return to the bank and that during the period in question, the defendant and his wife spent far more money than either of them earned. In addition, some of the embezzled funds had gone into the defendant's business, as well as towards the purchase of a mobile home. The Court also rejected the defendant's argument that relevant conduct is limited to conduct alleged in the indictment.

The defendant also challenged the fact that his sentence on the bank fraud count was enhanced by conduct relevant to his tax offense, resulting in a sentence that exceeded the statutory maximum for the tax crime, and thus violated the rule of *Apprendi v. New Jersey*.¹² If the tax offense had been his only offense of conviction, the adjusted offense level would have yielded a sentence of 24 to 30 months, more than the 12-month statutory maximum applicable in a failure to file cases. But because he was also convicted of bank fraud, the multicount sentencing rules embodied in §5G1.2(b) and (c) required that the 24 to 30-month sentence be imposed on the bank fraud count, which carries a statutory maximum of 360 months. The Court held that the use of relevant conduct for one offense to enhance an aggregate sentence on multiple counts is fully consistent with its holding last year in *United States v. White*,¹³ in which sentences were run consecutively to yield a total punishment greater than the statutory maximum for any of the individual crimes of conviction.

3. Statute of Limitations

Relation Back. In *United States v. LaSpina*,¹⁴ the Court rejected the defendant's contention that charges that he had filed false income tax returns were time-barred because the superceding indictment under which he was convicted had broadened the scope of the charges beyond those alleged in the original indictment. On appeal, the defendant argued that because the superceding indictment

added allegations in a non-tax count concerning a kickback scheme, which provided an additional source of unreported income not alleged in the original indictment, the basis for the false filing charges was impermissibly broadened, and those charges were untimely.

The Court of Appeals held that the superceding indictment related back to the date of the original indictment, rejecting the defendant's argument that a new source of unreported income constituted a material broadening of the initial tax charges. Both the original and the superceding indictment charged the defendant, in identical language, with having subscribed to false income tax returns for the tax years 1992 and 1993. Neither indictment alleged the sources of income that the defendant failed to declare, which the Court noted is not an essential element of the offense. The Court concluded that because the charging language and the essential elements of the offense remained unchanged between the original and the superceding indictment, the defendant had adequate notice of the offense with which he was charged, and "any change in the proof regarding the source or amount" of unreported income did not alter the charges.



(1) 282 F.3d 156 (2d Cir. 2002). One of the parties seeking to quash this subpoena was represented on appeal by the authors' law firm. The witness in question was a former associate of the firm.

(2) See, e.g., John J. Tighe & Jeremy H. Temkin, "Downward Departures for Tax Offenders," N.Y.L.J. (Sept. 21, 2000).

(3) U.S.S.G. §2T1.1

(4) 291 F.3d 181 (2d Cir. 2002).

(5) 143 F.3d 662 (2d Cir. 1998).

(6) 232 F.3d 315 (2d Cir. 2000).

(7) 237 F.3d 119 (2d Cir. 2000).

(8) No. 01-1243, 2002 WL 1583583 (July 18, 2002).

(9) 62 F.3d 43 (2d Cir. 1995).

(10) 33 F.3d 175 (2d Cir. 1994).

(11) 275 F.3d 216 (2d Cir. 2001).

(12) 530 U.S. 466, 120 S.Ct. 2348 (2000).

(13) 240 F.3d 127 (2d Cir. 2001).

(14) No. 01-1219, 2002 WL 1758404 (2d Cir. July 30, 2002).

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