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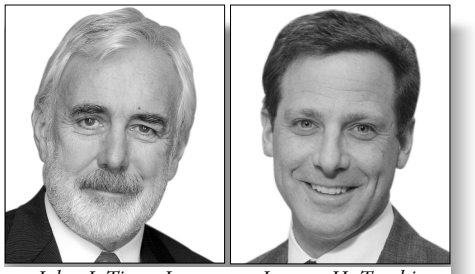
TAX LITIGATION ISSUES

BY JOHN J. TIGUE JR. AND JEREMY H. TEMKIN

Limitations on State Tax Prosecutions

Since the days of Al Capone, tax laws have provided a vehicle for prosecuting those whose more pernicious crimes are harder to prove. Prosecutors regularly tack on tax counts to indictments charging other varieties of economic crime. While this phenomenon is not limited to federal prosecutors, two decisions from earlier this summer may limit the ability of local prosecutors to bring tax charges against defendants. Although both cases turned on application of non-tax statutes (in one case a provision of the Penal Law providing an exemption for certain types of accessorial liability, and in the other, on New York's criminal jurisdiction and venue provisions), both reflect important limitations on the scope of state tax prosecutions.



John J. Tigue Jr. *Jeremy H. Temkin*

No Criminal Liability

State Supreme Court Justice Michael J. Obus handed down the first of those decisions in *People v. L. Dennis Kozlowski*.[1] That case charged the former Chief Executive Officer of Tyco International Ltd. with a violation of §1817(c) of the Tax Law, conspiracy, tampering with physical evidence and falsifying business records, all in connection with his alleged arrangements with vendors permitting him to avoid payment of thousands of dollars of sales tax on the purchase of several valuable paintings. (This indictment preceded Kozlowski's prosecution on more serious charges that he looted Tyco of millions of dollars — a case that resulted in a mistrial in April of this year.)

Kozlowski moved to dismiss the entire indictment on the grounds that failure of a customer to pay sales tax, as distinct from the failure of a vendor to collect and pay over sales tax to the state, is generally treated as a civil, rather than a criminal offense under New York's comprehensive tax law scheme. Although the trial court rejected much of the defendant's reasoning, it ultimately agreed that the tax counts were not sustainable. The court, however, declined to dismiss the remaining counts charging the defendant with conspiracy, tampering with physical evidence, and falsifying business records.

Section 1817(c)(2)(a), by its own terms, criminalizes only a vendor's failure to collect sales tax, providing that "[a] person is guilty of failure to collect sales tax when he fails to collect a sales tax required to be collected … and when … he does so with the intent to defraud the state or a political subdivision thereof and thereby deprives the state or a political subdivision thereof, or both together, of ten thousand dollars or more." Justice Obus observed that the tax charges against Kozlowski involved a unique application of this statute, noting that those charges were not based upon Kozlowski's actions as a principal (which would clearly exceed the scope of the statute), but were rather based solely upon the theory that he acted in concert with the vendors — initiating and advancing the plan to forego the vendor's collection of sales tax.

The defendant's next argument relied on the Court of Appeals' decision in *People v. Valenza*,[2] which held that where New York's comprehensive and integrated tax laws provided civil penalties for a particular tax offense, that conduct could not be charged under a separate criminal provision. He reasoned that *Valenza* barred his prosecution for the tax offenses at issue because failure to pay sales tax is a civil offense under the New York Tax Law. Justice Obus rejected that argument. While accepting the premise that Kozlowski could not be charged criminally for conduct that violated exclusively civil provisions of the tax code, he noted that the rationale of *Valenza* did not preclude prosecution under the Penal Law for all criminal conduct related to such a violation. Accordingly, he concluded that the defendant's alleged falsification of invoices and bills of lading and conspiracy to commit those crimes, as well as the conspiracy to fail to collect sales taxes, could legitimately be prosecuted under the Penal Laws regardless of the limitations imposed by the Tax Laws.

Significantly, the limitations imposed by *People v. Valenza* apply exclusively to state criminal prosecutions for failure to remit sales tax. In *U.S. v. Porcelli*,[3] the U.S. Court of Appeals for the Second Circuit held that the federal mail fraud statute may be invoked to bring federal criminal charges based on precisely such conduct. Relying on its earlier decision in *U.S. v. DeFiore*,[4] upholding the use of the wire fraud statute to prosecute state cigarette tax evasion, the Court stressed that the focus of the federal fraud statutes is on any scheme or artifice to defraud using the mails, rather than on the regulation of state affairs.

While rejecting the arguments that accessorial liability for the tax crimes of the vendors could not be based on any limitation imposed by the Tax Law and the application of *Valenza*, Justice Obus dismissed the counts at issue, relying on a separate provision of the Penal Law that carves out a narrow exemption for criminal liability based on the conduct of another. That provision, Penal Law §20.10, provides in pertinent part that "[a] person is not criminally liable for the conduct of another person constituting an offense when his own conduct, though causing or aiding the commission of such offense, is of a kind that is necessarily incidental thereto. If such conduct constitutes a related but separate offense upon the part of the actor, he is liable for that offense only and not for the conduct or offense committed by the other person." Under this provision, an individual who offers a bribe cannot be prosecuted as an accessory to a public official's receipt of the bribe, much as the drug purchaser cannot be prosecuted as an accomplice of the drug seller. [5]

Relying exclusively on the second sentence of this provision, relating to reciprocal criminal liability, the People argued that because failure to pay sales tax is not a crime in its own right,

John J. Tigue Jr. *is a principal in Morvillo, Abramowitz, Grand, Iason & Silberberg and a fellow of the American College of Trial Lawyers.* **Jeremy H. Temkin** *is a principal in Morvillo, Abramowitz, Grand, Iason & Silberberg, and a former Assistant U.S. Attorney for the Southern District of New York.* **Judith L. Mogul,** *an attorney, assisted in the preparation of this article.*

Kozlowski was not in a "reciprocal situation," with the tax evading vendors, and thus fell outside the exemption provided by §20.10. Justice Obus noted that although §20.10 is typically invoked in cases of reciprocal crimes, such as the purchase and sale of narcotics, "criminal reciprocity is not the test" for application of that provision. Rather, he stressed, the operative inquiry for application of §20.10 is whether the accessorial conduct charged is "necessarily incidental" to the criminal conduct of the primary actor.[6] He noted at least one other instance in which §20.10 was applied in a non-reciprocal context, citing *People v. Tomasello*,[7] which held that a defendant could not be convicted of promoting gambling based on placement of his own wagers — conduct which was necessarily incidental to the bookmaker's criminal activity, but not criminal in its own right.

Justice Obus concluded that Kozlowski's failure to remit sales tax on the artworks at issue was necessarily incidental to the vendors' criminal failure to collect that tax, noting that "[a]fter all, in this case, as in virtually every instance, there had to be a buyer in order for the merchant to fail to collect sales tax due." On that basis, he dismissed the charges against Kozlowski for violating the Tax Law, but held that §20.10 did not exempt him from prosecution for tampering with evidence or falsifying business records because the evidence presented to the grand jury in support of those charges went beyond his mere receipt of those false documents, and was sufficient to support the inference that he had actively solicited their creation.

Venue Limitations

The second case, *Taub v. Altman*,[8] arose in, and is most likely entirely limited to, the unique context in which New York City finds itself because the city is made up of more than one county, and (for jurisdictional purposes), tax offenses affecting the entire city may take place in only one of those constituent counties. The defendant in *Taub* was charged in connection with a scheme to steal millions of dollars through the imposition of inflated mortgages on a home for mentally disabled adults located in Queens County. In addition to 29 counts of grand larceny, the indictment also contained five counts of offering a false instrument for filing based on the defendant's under-reporting of income derived from those mortgages on his state and city tax returns. The defendant did not challenge jurisdiction with respect to the grand larceny counts, but argued that New York County lacked jurisdiction to prosecute the tax offenses. New York Court of Appeals agreed that the tax counts could not properly be prosecuted in New York County.

The court noted at the outset that none of the returns was mailed from or received in Manhattan, and that no other act establishing any of the relevant offenses was committed in Manhattan. For these reasons, the people based their assertion of jurisdiction on a theory known as "particular effect" or "injured forum" jurisdiction provided for in §20.40[2][c] of the Criminal Procedure Law. That section permits a criminal court to exercise jurisdiction or venue over an offense when conduct constituting the offense occurred entirely outside the county, but "had, or was likely to have, a particular effect upon such county or a political subdivision or part thereof, and was performed with intent that it would, or with knowledge that it was likely to, have such particular effect therein." Conduct will be deemed to have a "particular effect" on a county, if it "produces consequences which, although not necessarily amounting to a result or element of such offense, have a materially harmful impact upon the governmental processes or community welfare of [the] particular [county], or result in the defrauding of persons in such [county]."[9]

The Court of Appeals noted that in order to invoke "particular effect" jurisdiction, the People would have to show that New York County, and not New York City as a whole, suffered a particular effect as a result of the defendant's allegedly criminal conduct. It further noted that the requirement of a materially harmful impact can only be satisfied by a showing of "concrete and identifiable injury" to the county government or the entire community, rather than to a particular individual.[10] The Court recognized that the defendant's alleged conduct had a materially harmful impact on the governmental processes and community welfare of the whole of New York City, inasmuch as the loss of revenue from under-reporting of his tax liabilities deprived the city of funds for services and governmental operations. But it stressed that the question was not whether the defendant's conduct constituted a perceptible injury to New York City, but rather whether New York County had suffered a specific injury distinct from the remainder of the city.

The people sought to meet this burden by arguing that as the "seat of City government," city income tax returns were processed and remitted to the city through the Transitional Finance Authority located in New York County as well as through bank accounts located in New York County. It further reasoned that these accounts were controlled by the Commission of Finance, and that the collection and management of city taxes was overseen by the Department of Finance's Bureau of the Treasury, and that both of those offices were located in New York County.

The Court concluded that "in a prosecution whose gravamen is the deprivation of revenue from New York City — the location of the City agencies and bank accounts is alone insufficient to establish a particular effect on the county in which they happen to be located." The Court cautioned that permitting the exercise of jurisdiction based on the amorphous fact that revenues are processed in New York County would give that county jurisdiction to prosecute not only all city tax offenses, but also other offenses that arguably affect city revenues or expenditures. By way of illustration, the Court noted that "[s]uch jurisdiction would include prosecution of a Bronx toll taker who embezzles funds, or of a person who steals from a City agency in Kings County or vandalizes City property in Queens or Richmond."

The Court noted that the limited circumstances in which "particular effect" prosecutions have been upheld typically involve more readily identifiable injury to the prosecuting county, such as the destruction of a dam in one county causing flooding in a neighboring county, or violation of an order of protection issued by the prosecuting county where the conduct constituting the violation occurred in a different county. Because the harm caused by the defendant's conduct in this case was felt equally by all five counties comprising New York City, where the only link between the prosecuting county and the out-of-county conduct is the location of offices and accounts, the Court concluded that the statutory requirements of §20.40[c][2] had not been satisfied.

Both *Kozlowsky* and *Taub* turn on the application of seldom invoked provisions, and could be read as narrow decisions strictly limited to their unusual factual circumstances. But they support and even suggest a broader interpretation — one that indicates that New York State courts at both the trial and appellate levels will be less than solicitous of efforts by local district attorneys to use the tax laws to expand their prosecutorial reach.

1. Indictment No. 3485/02 (Order entered June 14, 2004).
2. 60 NY2d 363 (1983).
3. 865 F2d 1352 (2d Cir. 1989).
4. 720 F2d 757 (2d Cir. 1983), cert. denied, 467 US 1241 (1984).
5. See *People v. Reynolds*, 667 NYS 2d 591 (Sup Ct NY Cty 1997) (" 'the drafters [of the Penal Law] posited that the crime of bribe giving by A to B is necessarily incidental to the crime of bribe receiving by B.' …Consequently, A is not chargeable with bribe receiving, and B is not chargeable with bribe giving, even though they would be under the general principles of Penal Law 20.00.") quoting Practice Commentary, McKinney's Cons. Laws of N.Y., Book 39, Penal Law 20.10 at 53 (1987); see also *People v. Manini*, 79 NY2d 561 (1992) (applying §20.10 in narcotics context).
6. 189 AD2d 903 (2d Dept. 1993).
7. 593 NYS2d 65 (2d Dept. 1993).
8. 2004 WL 1472618 (2004).
9. CPL §20.10[4].
10. *Taub*, 2004 WL 1472618 at *2, citing *People v. Fea*, 47 NY2d 70 (1979); *Steingut v. Gold*, 42 NY2d 311 (1977).