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TAX LITIGATION ISSUES

Expert Analysis

Sentencing for Tax Crimes: Giving Credit for Untaken Deductions

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Notwithstanding the Supreme Court's 2005 decision in *United States v. Booker*, the United States Sentencing Guidelines play a significant role in the sentences imposed on defendants convicted of federal crimes. While the "influence of the guidelines…has diminished in fraud cases,"[1] district judges are required to begin the sentencing process by properly determining the applicable guidelines range,[2] and a recent report from the U.S. Sentencing Commission found that the majority of sentences are still within guidelines range.[3]

In tax cases, the "advisory" guidelines are predicated on an estimate of the "tax loss" associated with the defendant's conduct. The rationale for this reliance on tax loss is the assumption that "a greater tax loss is obviously more harmful to the treasury and more serious than a smaller one with otherwise similar characteristics."[4] The guidelines provide that, in the case of individuals, "tax loss" is presumed to be 28 percent of the underreported gross income or improperly claimed deductions, exemptions, or credits, "unless a more accurate determination of tax loss can be made."[5] This begs the question of how a sentencing court goes about making a "more accurate determination of tax loss" in a given case.

One common issue in computing "tax loss" is whether a convicted defendant is entitled to credit for previously untaken deductions. Over the years, federal courts have split as to how to handle deductions a defendant neglected to take on his original (fraudulent) return: The Second and Tenth circuits allow the sentencing court to give defendants credit for legitimate but unclaimed deductions,[6] while the Fourth, Fifth, Seventh, Eighth, Ninth and Eleventh circuits forbid the consideration of such deductions.[7] This circuit split yields disparate (and arguably unfair) results depending on where the defendant was charged, convicted and sentenced. Earlier this year, the Sentencing Commission proposed alternative amendments to the guidelines to resolve this circuit split.[8] Because the alternatives take vastly different approaches to the problem, the commission's choice could significantly impact the sentences imposed on tax offenders for many years to come.

Legitimate but Untaken

In many tax cases, defendants who neglect to report income also fail to report expenses associated with generating that income; in other cases, defendants who omit income either do not have any related expenses or take the corresponding deductions without reporting the income. The ultimate sentence imposed on a tax offender can vary significantly depending on whether the sentencing court reduces the tax loss for the untaken deductions.

For example, assume Taxpayers A and B are both contractors. Taxpayer A conducts a portion of his business "off the books," neglecting to report $100,000 he received in connection with a home improvement project as well as $60,000 he spent on materials and labor to complete the job. By contrast, while Taxpayer B also fails to report $100,000 that a customer paid him to remodel a home, he nonetheless deducts the cost of the supplies and labor associated with the project.

Assuming a 30 percent tax rate, a court applying a "no deductions" rule would calculate the tax loss for both taxpayers as $30,000, even though the actual tax loss in Taxpayer A's case is only $12,000 (30 percent of the $40,000 net profit). If neither taxpayer has any prior convictions, the $30,000 tax loss will correspond to an advisory guidelines range of 10 to 16 months in prison, while a $12,000 loss would result in an advisory guidelines range of six to 12 months, which does not require any time in prison. Taxpayer A and his lawyer would certainly consider treating the harm caused by his offense the same as that caused by Taxpayer B's offense to be unfair. Many impartial observers might agree.

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Courts Allowing Deductions

In the Second and Tenth circuits, district judges are permitted to consider evidence of legitimate unclaimed deductions and credits in computing the tax loss caused by a defendant's conduct. Thus, in *United States v. Gordon*, the defendant was the president and CEO of two corporations involved in marking memberships in "Who's Who" directories. While Bruce Gordon represented himself to the IRS as an "impoverished salesperson who slept in his car,"[9] he lived in two expensive properties owned by the corporations and drove luxury cars leased by the corporations. Gordon was convicted of mail fraud and tax evasion and sentenced to 97 months in prison and $10 million in restitution.

On appeal, Gordon argued that the district court should have considered "potential, but unclaimed, deductions that might reduce the total amount of tax loss for which he was responsible." The U.S. Court of Appeals for the Second Circuit held that the most accurate calculation of "tax loss" should reflect the actual harm to the government, and thus that the defendant must necessarily be given "the benefit of legitimate but unclaimed deductions."[10] In reaching this conclusion, however, the court made clear that the defendant "bears the full burden of proof in establishing the appropriateness of consideration of…unclaimed deductions" and that Gordon had failed to meet that burden.[11]

Similarly, in *United States v. Hoskins*,[12] the defendant operated an escort service with her husband. While Jodi Hoskins reported approximately $900,000 in income from the business in 2002, based on evidence of credit card payments and assumptions regarding cash intake, the government estimated that she had failed to report $1.2 million of income, with a resulting tax loss of approximately $485,000. At sentencing, Hoskins sought to reduce this tax loss by claiming deductions for commissions paid to her employees. Giving Hoskins credit for the proposed deductions would have reduced the tax loss to $160,202 and the corresponding sentencing range to 33 to 41 months (as opposed to the 51 to 63 month range sought by the government). The district court rejected Hoskins' arguments, adopted the higher range and, after applying a downward variance, sentenced Hoskins to 36 months in jail.[13]

On appeal, the U.S. Court of Appeals for the Tenth Circuit rejected the notion that unclaimed deductions could never be considered in computing tax loss, holding that "[w]here a defendant offers convincing proof [of unclaimed deductions] nothing in the Guidelines *prohibits* a sentencing court from considering evidence of unclaimed deductions in analyzing a defendant's estimate of the tax loss suffered by the government."[14] In reaching this conclusion, the court noted that "the government is not supposed to reap windfall gains as a result of tax evasion…. [T]he Guidelines do not require courts to base their sentencing analysis on unadjusted gross receipts figures untethered to actual taxes to which the government was entitled but did not receive as a result of tax evasion."[15] Notwithstanding its holding that a defendant could take advantage of unclaimed deductions, the Tenth Circuit affirmed the sentence imposed finding that Hoskins had failed to present sufficient evidence to support her proposed loss calculation.

> Over the years, federal courts have split as to how to handle deductions a defendant neglected to take on his original (fraudulent) return.

The Alternative Approach

By contrast, the Fourth, Fifth, Seventh, Eighth, Ninth and Eleventh circuits have articulated a blanket prohibition on consideration of unclaimed deductions. For example, in *United States v. Chavin*, the defendant was convicted of tax and bankruptcy fraud. At sentencing, Leonard Chavin unsuccessfully argued that the court should consider his unclaimed deductions, lowering the tax loss from $199,000 to $57,302, which would have corresponded to a lower sentencing level.

In affirming the sentence imposed, the Seventh Circuit concluded that "tax loss" is intended to reflect the "*attempted* or *intended* loss, rather than the *actual* loss to the government,"[16] and that "reference to other unrelated mistakes on the return such as unclaimed deductions tells us nothing about the amount of loss to the government that his scheme intended to create."[17] The Court acknowledged that although the actual tax loss to the government might have been the lower amount, the relevant calculation was the intended tax loss as revealed by the tax returns he actually filed. Underpinning the Seventh Circuit's reasoning was the conclusion that "[i]t is simply not the role of this court to consider other hypothetical ways that the defendant could have completed his return."[18]

Circuits that impose a blanket prohibition on previously untaken deductions are especially concerned with the attempts to take advantage of deductions or a filing status arguably unrelated to the underlying scheme. The Eleventh Circuit's decision in *United States v. Clarke*[19] exemplifies this view. The taxpayer in *Clarke* was a pastor, school superintendent and the manager of a credit union whose salary (for all three positions) was paid by his church. In its investigation, the IRS found that Gregory Louis Clarke failed to report income from other sources as well as various personal expenses paid by the church. Treating these payments as taxable income, the government argued that the tax loss attributable to Clarke's conduct was $35,811, with a resulting guidelines range of 21 to 27 months, after relevant enhancements.

At sentencing, Clarke argued that the tax loss should be calculated as if he and his wife had filed a joint tax return, rather than the married, filing separately status taken on the original return. This alternative filing status would have resulted in a tax loss of $28,186 and a guidelines range of 15 to 21 months, after the relevant enhancements. The district court rejected this argument and sentenced Clarke to 21 months in prison.

On appeal, the Eleventh Circuit concluded that tax loss "is the amount of loss the defendant intends to create when he falsifies his return and must therefore be calculated based upon the fraudulent return."[20] Thus, it held that although Clarke's tax liability could have been lower if he filed jointly, "filing separately is…irrelevant to the determination of the amount of loss to

the government that he *intended* when he under-reported his income."[21] Citing the Seventh Circuit's decision in *Chavin*, the court concluded that tax loss should be computed "based on the fraudulent return Clarke actually filed, and not on the tax return Clarke could have filed but did not."[22]

Proposed Amendments

On Jan. 18, 2013, the Sentencing Commission offered three alternative amendments to the guidelines to resolve this circuit split. The first option, mirroring the approach taken by the Second and Tenth circuits, provides that the determination of tax loss should include credits, deductions, or exemptions to which the defendant was entitled, regardless of whether the defendant claimed them at the time of the offense. Especially in the case of deductions for expenses incurred in generating the unreported income, this option enables the sentencing court to realistically assess the actual harm caused by the defendant's conduct.

By contrast, the commission's second option follows the categorical approach purportedly followed by the Fourth, Fifth, Seventh, Eighth, Ninth and Eleventh circuits and provides that the determination of tax loss shall not include credits, deductions, or exemptions, unless the defendant was entitled to them and claimed them at the time the tax offense was committed. This amendment offers the easy administration of a bright-line rule, albeit at the cost of recognizing differences in the harms caused by differently situated defendants.

Finally, the third option provides that the determination of tax loss shall not include unclaimed credits, deductions or exemptions unless the defendant demonstrates an entitlement through contemporaneous documentation. This option restricts the approach adopted by the Second and Tenth circuits by limiting the type of evidence a defendant can present to support the previously unclaimed deduction. By contrast, while those courts impose a burden on the defendant to "establish[] the appropriateness of consideration of such an unclaimed deduction,"[23] they do not limit the type of evidence that can be used to meet that burden. Such flexibility is consistent with the general principle that sentencing judges can consider relevant evidence and circumstances from a variety of sources.

Conclusion

The Sentencing Commission's effort to resolve the conflicting approaches taken by different circuits reflects the importance of uniform rules for calculating tax loss across the country. While "[s]entencing courts do not want to become embroiled in mini tax loss trials, especially when the offsetting deductions have little or nothing to do with the investigation" or underlying offense,[24] an accurate tax loss calculation is important in preserving the fairness of sentencing. Ultimately, in the post-*Booker* era, sentencing judges have discretion to consider a wide range of factors to achieve a sentence "sufficient, but not greater than necessary, to comply with the purposes" underlying the federal sentencing regime.[25] For many lawyers representing defendants in tax cases, consideration of unclaimed deductions in calculating tax loss is necessary to enable judges to set the starting point for their sentencing decisions based on a realistic assessment of the loss actually caused by the underlying conduct.

> Earlier this year, the Sentencing Commission proposed alternative amendments to the guidelines to resolve the circuit split. Because the alternatives take vastly different approaches to the problem, the commission's choice could significantly impact the sentences imposed on tax offenders for many years to come.

1. U.S. Sentencing Commission, Report on the Continuing Impact of *United States v. Booker* on Federal Sentencing (February 2013) ("Report on Continuing Impact of Booker") at 67.
2. *United States v. Rita*, 551 U.S. 338, 351 (2007).
3. Report on Continuing Impact of Booker at 5 (finding that between December 2007 and September 2011, "80.7% of federal sentences were either within the guideline range (53.9% of sentences) or below the range pursuant to a government motion (26.8% of sentences). Less than one quarter (17.4%) of sentences were non-government sponsored below range sentences."). Tax offenders do better than defendants generally; according to the Sentencing Commission, during Fiscal 2011, 42.3 percent of tax offenders received non-government sponsored below-guidelines sentences. See U.S. Sentencing Commission FY 2011 Annual Report and Sourcebook, Table 27A (2011).
4. U.S. Sentencing Guidelines Manual, §2T1.1, Commentary.
5. U.S. Sentencing Guidelines Manual, §2T1.1(c)(1), Notes A-C. In the case of a corporate taxpayer, the presumptive rate is 34 percent.
6. *United States v. Hoskins*, 654 F.3d 1086 (10th Cir. 2011); *United States v. Gordon*, 291 F.3d 181 (2d Cir. 2002).
7. *United States v. Yip*, 592 F.3d 1035 (9th Cir. 2010); *United States v. Clarke*, 562 F.3d 1158 (11th Cir. 2009); *United States v. Blevins*, 542 F.3d 1200 (8th Cir. 2008); *United States v. Delfino*, 510 F.3d 468 (4th Cir. 2007); *United States v. Phelps*, 478 F.3d 680 (5th Cir. 2007); *United States v. Chavin*, 316 F.3d 666 (7th Cir. 2002).
8. U.S. Sentencing Commission, Proposed Amendments to Sentencing Guidelines (Jan. 18, 2013).
9. 291 F.3d at 185.
10. Id. at 187.
11. Id.
12. 654 F.3d 1086 (10th Cir. 2011).
13. Assumedly, the ultimate sentence imposed on Hoskins would have been lower had the starting point for the variance been lower.
14. Id. at 1094 (emphasis in original).
15. Id. at 1095-96 (citing *United States v. Gordon*, 291 F.3d at 187).
16. *Chavin*, 316 F.3d at 677 (emphasis in original).
17. Id.
18. Id. at 679. Arguably, however, the courts purporting to impose a categorical prohibition on unclaimed deductions are driven by concerns regarding the lack of evidence supporting the claimed deductions. Thus, courts apparently adopting a categorical position nevertheless consider the evidence presented by the defendants in support of their unclaimed deductions. See, e.g., *United States v. Yip*, 592 F.3d 1035, 1041 (9th Cir. 2010) (adopted limiting rule, but nevertheless analyzing the defendant's claim on its merits and rejecting his attempt to deduct previously unpaid state taxes); *United States v. Psihos*, 683 F.3d 777, 780 (7th Cir. 2012) (agreeing that the taxpayer had already appropriately received credit in the government's tax loss calculation for unclaimed deductions that were substantiated with written evidence, despite holding that such claims of deductible expenses were "irrelevant in determining the tax loss").
19. 562 F.3d 1158 (2009).
20. Id. at 1164.
21. Id. (emphasis in original).
22. Id. at 1165.
23. *Gordon*, 291 F.3d at 187.
24. Steven Toscher and Dennis L. Perez, "Recently Proposed Amendment to the Federal Sentencing Guidelines Affect Criminal Tax Cases," J. Tax Prac. & Proc. 47 (2013).
25. 18 U.S.C. §3553(a).

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