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TAX LITIGATION ISSUES

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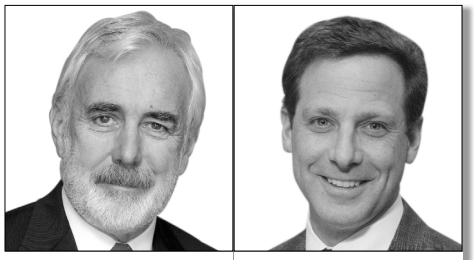
The Supreme Court's 2003-2004 Term

The U.S. Supreme Court has not addressed a significant criminal tax issue. This trend continued in the 2003-2004 term, when the Court decided only two tax-related cases, neither of which raised issues of criminal law. Rather, in one case, the Court held that a tax assessment against a partnership sufficed to extend the statute of limitations to collect the tax from its partners. And in the second case, the Court held that the Tax Injunction Act did not bar a taxpayer from challenging the constitutionality of a state statute permitting tax credits for contributions supporting parochial schools.

The decline in the number of decisions in the tax field — and the fact that there were no criminal tax opinions this term — may be explained by the fact that most of the issues regarding elements of tax offenses have already been resolved. One significant issue that remains in the criminal tax realm, however, is sentencing. In light of the Court's opinion at the end of the term in *Blakely v. Washington*,[1] which addressed the constitutionality of Washington State's sentencing guidelines regime, the constitutionality and application of the Federal Sentencing Guidelines have already been (and will continue to be) the subject of much judicial consideration. This will undoubtedly have a significant impact for defendants convicted of criminal tax violations. As we previously discussed, the guidelines in criminal tax cases provide a number of enhancements based on factors such as the amount of "tax loss," whether the offense involved "sophisticated means" and whether the defendant failed to report more than $10,000 from criminal activity.[2] In light of these enhancements, resolution of *Blakely*-related issues will have a particularly significant impact on the application of the guidelines in the criminal tax area.



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Partners and Partnerships

The first of the Court's tax opinions addressed the statute of limitations applicable when the government seeks to collect taxes owed by a partnership from individual partners. Section 6501(a) of the Internal Revenue Code states that, except as otherwise provided, "the amount of any tax imposed …shall be assessed within three years after the return was filed …and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period."[3] Section 6502(a), however, provides that, if a tax is properly assessed within three years, the statute of limitations for the collection of the tax is extended by ten years from the date of assessment.[4] In *United States v. Galletti*,[5] decided in March, the Supreme Court faced the issue of whether, in order for the United States to avail itself of the ten-year increase in the statute of limitations, it must assess a tax not only against a partnership but also against each partner who might be jointly and severally liable for the debts of the partnership.

In *Galletti*, a partnership failed to pay significant federal employment tax liabilities it had incurred from 1992 to 1995. Although the Internal Revenue Service timely assessed those taxes against the partnership in 1994, 1995 and 1996, the partnership never satisfied the debt. The four general partners of the partnership filed two joint bankruptcy petitions in 1999 and 2000. In connection with those proceedings, the IRS filed proofs of claim for unpaid tax liabilities assessed between 1994 and 1996. The general partners/debtors did not dispute that under California law that they were jointly and severally liable for the debts of the partnership or that the IRS had properly assessed the taxes against the partnership. Rather, they claimed that the timely assessment of the partnership extended the statute of limitations only against the partnership, and not against the partners, who had not been separately assessed within the three-year limitations period.

Unanimous Opinion

In a unanimous opinion by Associate Justice Clarence Thomas, the Court analyzed the issue in three parts. First, the Court tackled the partners' argument that a valid assessment would have had to name them individually because they were primarily liable for the tax debt as separate "taxpayer[s]" under section 6203 of the Internal Revenue Code.[6] This section provides that an assessment under section 6501(a) "shall be made by recording the liability of the taxpayer in the office of the Secretary [of the Treasury]." The Court found that, although an individual partner " 'can be a taxpayer,' the inquiry does not end there" because section 6203 "speaks of the liability of the taxpayer …which indicates that the relevant taxpayer must be determined." The liability here stemmed from the partnership's failure to pay employment taxes as required by the Internal Revenue Code.[7] The Court was persuaded that because the Code referred to the "employer" being required to deduct and withhold taxes and being liable for payment of those taxes, it was the employer — here, the partnership — who was the liable taxpayer.

The Court quickly dispatched the partners' second argument: that they were primarily liable for the partnership's tax debt because,

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under California law, partners are jointly and severally liable for the debts of the partnership. The Court's response was that, under California law, the partnership and its partners were also separate entities. Thus, imposing a tax directly on the partnership is not the "equivalent to imposing a tax directly on the general partners." Rather, the partners would be required to prove that "the tax liability was imposed both on the [p]artnership and the [partners] as separate employers" — a determination that has nothing to do with whether the partners are jointly and severally liable for the debts of the partnership.

The Court then reached the central issue of the case: "whether the Government must make separate assessments of a single tax debt against persons or entities secondarily liable for that debt in order for 6502's extended statute of limitations to apply to those persons or entities." The Court found that the Internal Revenue Code contains no such requirement, and thus the government was not required to take this additional step.

The partners, the Court observed, were laboring under a "mistaken understanding" that the "function and nature" of a tax assessment is "identical to the initiation of a formal collection action against any person or entity who might be liable for payment of a debt." With a "proper understanding," it becomes clear "that it is the tax that is assessed, not the taxpayer." The term "assessment" refers to "little more than the calculation or recording of a tax liability," generally based on a self-assessment. Once a tax has been properly assessed, the Court concluded, "nothing in the Code requires the IRS to duplicate its efforts by separately assessing the same tax against individuals or entities who are not the actual taxpayers but are, by reason of state law, liable for payment of the taxpayer's debt." Thus, in *Galletti*, since the tax was properly assessed, and the statute of limitations was thereby extended, the government could seek to collect the debt against the partners.

Private School Students

The Tax Injunction Act[8] prohibits federal district court(s) from restraining "the assessment, levy or collection of any tax under State law." In *Hibbs v. Winn*, decided last month,[9] Arizona taxpayers brought an action for declaratory relief in federal court challenging the constitutionality of an Arizona statute that authorizes income-tax credits for payments to organizations that award educational scholarships and tuition grants to children attending private schools.[10] The plaintiffs also sought to enjoin the law's operation on Establishment Clause grounds. They did not, however, contest their own tax liability, nor did they seek to impede the state's collection of tax revenues. The question presented to the Supreme Court was whether the Tax Injunction Act barred the suit. The Court, relying on "a near half century" of federal court decisions, held it did not.

In an opinion by Associate Justice Ruth Bader Ginsburg, the Court began its analysis by asking whether, "[t]aking account of the prospective nature of the relief requested," the suit was seeking, in violation of the Tax Injunction Act, "to enjoin, suspend or restrain the assessment, levy or collection of any tax under State law." As in *Galletti*, the Court found that the meaning of the term "assessment" was key to its answer, though here the term came out of the Tax Injunction Act, not the Internal Revenue Code. The Court, in reviewing the meaning of the word "assessment," however, looked to the Code and engaged in an even more in-depth study of the word than it had in *Galletti*.

After noting, as it had in *Galletti*, that an assessment involves a "recording" of the amount owed, the Court observed that the term must not be taken in isolation — "[i]n §1341 and tax law generally, an assessment is closely tied to the collection of tax, i.e., the assessment is the official recording of liability that triggers levy and collection efforts." The defendant below in *Winn*, the director of the Arizona Department of Revenue, argued that the term "assessment," by itself, signified the entire taxing plan. The Supreme Court's response was that, if that were the case, the Tax Injunction Act would not need the words "levy" or "collection;" the term "assessment," alone, would do all the necessary work. The Court used the federal government's words in its *Galletti* briefs to further support this definition of "assessment." The government, the Court noted, "thus made clear in briefing *Galletti* that, under the IRC definition, the tax assessment serves as the trigger for levy and collection efforts." The government did not, in its briefs, "describe the term as synonymous with the entire plan of taxation" or "disassociate the word 'assessment' from the company (levy or collection) that word keeps." Rather, the government in *Galletti* related "assessment" to the word's "collection-propelling function."

After reviewing the legislative history of the Tax Injunction Act and earlier Supreme Court cases applying the act, the Court concluded that in the past it had "interpreted and applied the TIA [Tax Injunction Act] only in cases Congress wrote the Act to address, i.e., cases in which state taxpayers seek federal-court orders enabling them to avoid paying state taxes." The remedy "was not one designed for the universe of plaintiffs who sue the State." Instead, "it was a remedy tailor-made for taxpayers." The Court also was persuaded by a line of Tax Injunction Act decisions by lower federal courts that interpreted the act to "restrain state taxpayers from instituting federal actions to contest their liability for state taxes, but not to stop third parties from pursuing constitutional challenges to tax benefits in a federal forum."[11] Moreover, the Court noted, a number of federal court decisions, including Supreme Court decisions, have reached the merits of third-party constitutional challenges to tax benefits without even mentioning the Tax Injunction Act. Thus, the Court held, "[c]onsistent with decades-long understanding prevailing on this issue, [the] suit may proceed without any TIA [act] impediment."

Associate Justice John Paul Stevens, in a brief concurring opinion, emphasized the importance of stare decisis, judicial restraint and respecting "prolonged Congressional silence in response to a settled interpretation of a federal statute," which "provides powerful support for maintaining the status quo."

Associate Justice Anthony M. Kennedy, in a dissent joined by Chief Justice William H. Rehnquist and Associate Justices Antonin Scalia and Thomas, lamented the Court's "great skepticism for the state courts' ability to vindicate constitutional wrongs" and its treatment of states as "diminished and disfavored powers" and "second rate constitutional arbiters, unequal to their federal counterparts." Justice Kennedy "disagree[d] with the majority's superseding the balance the [TIA] strikes between federal and state court adjudication."

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1. No. 02-1632, 2004 WL 1402697 (June 24, 2004).
2. See Tigue and Temkin, "Bad News for Tax Offenders," New York Law Journal, May 17, 2001.
3. 26 USC §6501(a).
4. 26 USC §6502(a).
5. 124 SCt 1548 (2004).
6. 26 USC §6203.
7. 26 USC §402(a)(1), 3403.
8. 28 USC §1341.
9. 124 SCt 2276 (2004).
10. Ariz Rev Stat §43-1089.
11. In a footnote, the Court abrogated a recent Fifth Circuit decision that agreed with the position of the director of the Arizona Department of Revenue taken in *Hibbs*. In *ACLU Foundation v. Bridges*, 334 F3d 416 (5th Cir 2003), the Fifth Circuit held that the Tax Injunction Act bars any federal suit seeking to have any portion of a state's tax system declared unconstitutional.