

TAX LITIGATION ISSUES

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Criminal Fraud: Second Circuit Aligns With Other Courts

In the past year, the U.S. Court of Appeals for the Second Circuit has decided several cases addressing criminal tax fraud issues. Principal among them are *United States v. Stein*,¹ in which the court affirmed Judge Lewis Kaplan's dismissal of charges in light of the Department of Justice's conduct in the KPMG tax shelter, and *United States v. Shellef*,² which circumscribed the government's ability to try both tax and nontax offenses in the same case.

While *Stein* has been the subject of much discussion among commentators,³ and we and others have previously written about *Shellef*,⁴ in two recent per curiam decisions, the Second Circuit addressed matters of significance to criminal tax practitioners. In both cases, the court aligned itself with other circuits: first rejecting taxpayer challenges to summonses that had been issued during an Internal Revenue Service (IRS) examination, and then rejecting an argument that the government was obligated to establish a tax deficiency in a civil context before it can charge a taxpayer with a criminal violation.

'Adamowicz v. United States'⁵

Under the Internal Revenue Code, agents of the IRS are authorized to issue summonses to gather information in connection with civil examinations and



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criminal investigations. Such summonses are not self-executing. Rather, in the event of noncompliance, the government must go to court to seek an order enforcing the summons. In *United States v. Powell*, the U.S. Supreme Court held that, in order to obtain such an order, the IRS must make a prima facie showing that: "(1) the investigation will be conducted pursuant to a legitimate purpose; (2) the inquiry may be relevant to the purpose; (3) the information sought is not already within the [IRS's] possession; and (4) the administrative steps required by the [Internal Revenue] Code have been followed."⁶

Once the IRS has established these elements, the burden shifts to the taxpayer to disprove one of the four elements or demonstrate that judicial enforcement would be an abuse of the court's process.⁷ Such an abuse occurs "if the summons had been issued for an improper purpose, such as to harass the taxpayer or to put pressure on him to settle a collateral dispute, or for any other purpose reflecting on the good faith of the particular investigation."⁸ This is a "heavy burden" for the taxpayer who must disprove "the actual existence of a valid civil tax determination or collection purpose by the IRS."⁹

In *Adamowicz*, the executors of an estate challenged six summonses that an IRS attorney had issued in connection with an estate and gift tax liability investigation. After the executors moved to quash the

summonses that had been issued to third parties and refused to comply with the remaining two, the government moved to compel compliance with all of the summonses. The U.S. District Court for the Eastern District of New York denied the executors' petition to quash and ordered compliance.

On appeal, the Court of Appeals held that an affidavit submitted by the IRS attorney conducting the investigation sufficed to meet the IRS's burden of establishing the prima facie elements under *Powell*. The court then found that appellants had not met their "heavy burden" of disproving the *Powell* criteria. In assessing appellants' assertion that the summonses were overly broad rendering compliance unreasonable, if not impossible, the court noted that "an examination is unreasonable and impermissible if it is overbroad, out of proportion to the end sought, or if it is so unrelated to the matter properly under inquiry as to exceed the investigatory power."¹⁰ After discussing the standards applied in other circuits, and noting that over-breadth challenges are only successful in limited circumstances, the court held that the mere fact that the summonses sought a large volume of information did not render them overly broad.¹¹

The court also rejected appellants' argument that the summonses sought irrelevant information, noting that the IRS need only show that the information sought "may be" relevant to its investigation.¹² Similarly, the court held that the mere fact that the IRS may already have some of the documents sought in the summonses did not defeat the third *Powell* factor. Rather, a summons will be enforced so long as "the bulk of the information" requested is not already in the IRS's possession.¹³

The court then turned to appellants'

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argument that the summonses were issued in bad faith or for the improper purpose of harassing the executors. Specifically, appellants argued that disputes between themselves and the IRS attorney throughout the audit, combined with the IRS's conduct, demonstrated that the IRS attorney had acted with an improper purpose. In support of that claim, appellants noted (1) that the IRS had breached an agreement to discharge a tax lien, and (2) the IRS attorney had engaged in a pattern of misconduct throughout the audit.

The court found that although the parties had disagreed on numerous issues, "the fact of those disputes does not suffice to prove improper purpose on the part of the IRS." In fact, the court characterized the allegations of misconduct as "conclusory and not supported by the evidence proffered." Rather, the court viewed the record as evidencing "only a tax attorney attempting to do her job, faced with taxpayers who have been less than forthcoming throughout the process." The court also concluded that the record did not indicate that the IRS had acted in bad faith in maintaining the tax lien and that "[a]ppellants have failed to show how this event is tied to the summonses at issue beyond the fact that they are loosely all part of the same tax investigation."

Indeed, the court concluded that appellants had not even made the "substantial preliminary showing" of improper purpose necessary to warrant discovery and a hearing.¹⁴ Thus, notwithstanding years of public concern of over-reaching by agents resulting in the Webster Commission and restructuring of the IRS, the court in *Adamowicz* appears to have conscribed "bad faith" to conduct constituting harassment or pressuring a taxpayer to settle a collateral dispute.

Finally, the appellants argued that the summonses should not be enforced because the IRS had failed to follow proper administrative procedures. In all, appellants identified four purported violations of IRS procedures, and argued that these violations both demonstrated bad faith and served as an independent basis for quashing the summonses.

'Totality of Circumstances'

With the exception of one technical error, each of the purported procedural violations was unrelated to the summonses in question. While noting that it was a question of first

impression in the Second Circuit, the court followed other circuits that "have looked at whether the taxpayer suffered harm or prejudice and whether the mistakes made by the IRS were in good faith." Thus, the Second Circuit held that in determining whether the government's violation of the Internal Revenue Code or an IRS regulation affects the enforceability of a summons, courts should apply a "totality of the circumstances" test considering, "the seriousness of the infringement, the harm or prejudice, if any, caused thereby, and the government's good faith."¹⁵ Applying this standard to the purported procedural violations raised by appellants, the court stressed that appellants had not suffered any prejudice or harm and thus affirmed the district court's decision enforcing the summons.

'United States v. Ellett'¹⁶

To prove tax evasion, the government must prove willfulness, the existence of a tax deficiency and an affirmative act of evasion.¹⁷ In *Ellett*, the evidence at trial demonstrated that, after reading a tax protestor publication, Mr. Ellett directed his employer to stop withholding taxes from his income and failed to file income taxes for a number of years.

In defense, Mr. Ellett attacked the willfulness element of the tax evasion charge by testifying that he sincerely believed he was exercising a legitimate "nontaxable right" to engage in labor, and therefore that he had no known duty to declare his income. On cross-examination, Mr. Ellett acknowledged, however, that he knew any tax professional would have disagreed with his position. Additionally, the government demonstrated that both the IRS and the New York State Department of Taxation had notified Mr. Ellett that his legal position was frivolous.

Not surprisingly, the jury convicted Mr. Ellett on all five counts of income tax evasion and failure to file an income tax return. Mr. Ellett appealed the conviction, contending that due process required he be given the opportunity to litigate his tax position that there was no deficiency civilly or administratively before being prosecuted for tax evasion.

Without addressing the relationship between this argument and Mr. Ellett's trial defense of willfulness, the Second Circuit analyzed the due process argument in the context of the deficiency element of a tax

evasion prosecution. Acknowledging that the IRS had never formally audited Mr. Ellett and thus there had been no formal ruling on his liability, the court rejected Mr. Ellett's characterization of the tax deficiency element. "A tax deficiency arises by operation of law the date a tax return is due but not filed; no formal demand or assessment is required."¹⁸ In this regard, the court noted that it was joining the First, Sixth, Seventh and Ninth circuits in holding that due process does not require the government to adjudicate tax disputes civilly or administratively before proceeding with a criminal case. Accordingly, the conviction was affirmed.

While the argument raised by *Ellett* may seem far-flung, the court's conclusion that the existence of a tax deficiency is measured at the time the return is due is consistent with the Supreme Court's decision in *Boulware v. United States*,¹⁹ which held that the existence of a tax deficiency is measured by an objective test. Thus, as in *Boulware*, *Ellett* makes clear that the existence of a deficiency is predicated on the return as actually filed, or if no return was filed whether additional tax was due and owing when the return was due.



1. ___F.3d___, 2008 WL 3982104 (2d Cir. Aug. 28, 2008).
2. 507 F.3d 82 (2d Cir. 2007).
3. See, e.g., Elkan Abramowitz and Barry A. Bohrer, "Justice and Corporate Prosecutions: The Continuing Saga," *The New York Law Journal* (Sept. 2, 2008).
4. John J. Tighe Jr. and Jeremy H. Temkin, "When Can Feds Charge Tax, Nontax Crimes Together?" *New York Law Journal* (Jan. 17, 2008); Paul Schectman, "'Shellef': Rules 8(a) and 8(b) and Joinders of Counts," *New York Law Journal* (May 22, 2008).
5. 531 F.3d 151 (2d Cir. 2008).
6. 379 U.S. 48, 57-58 (1964).
7. *Mollison v. United States*, 481 F.3d 119, 122 (2d Cir. 2007).
8. *Powell*, 531 F.3d at 58.
9. *Mollison*, 481 F.3d at 122-23.
10. *Adamowicz*, 531 F.3d at 157 (quoting *United States v. Harrington*, 388 F.2d 520, 523 (2d Cir. 1968)).
11. *Id.* at 157-58.
12. *Id.* at 158-59.
13. *Id.* at 159.
14. *Id.* at 160.
15. *Id.* at 161.
16. 527 F.3d 38 (2d Cir. 2008).
17. *United States v. Plitman*, 194 F.3d 59, 65 (2d Cir. 1999).
18. *Ellett*, 527 F.3d at 40 (citing 26 U.S.C. §6151(a)).
19. 128 S.Ct. 1168 (2008); see John J. Tighe Jr. and Jeremy H. Temkin, "'Boulware': High Bar Set for Criminal Tax Prosecutions," *New York Law Journal* March 20, 2008).