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Tax Loss – Credit for Unclaimed Deductions

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I am pleased to have the chance to testify once again on behalf of the Sentencing Commission's Practitioners Advisory Group. As members of one of the Commission's three standing advisory groups, we at the PAG appreciate the opportunity to provide the perspective of those in the private sector who represent individuals and organizations investigated and charged under the federal criminal laws.

A circuit conflict exists on the calculation of tax loss under §2T1.1 in those instances where the defendant identifies legitimate deductions, credits and exemptions were not claimed at the time return was filed. The Commission seeks comment on three options for resolving this conflict. These alternative approaches raise the questions of whether and under what circumstances a court should consider evidence of unclaimed deductions to determine the amount of tax loss under §2T1.1.

<u>The PAG recommends the following</u>:

First, the Commission should reject Option 2 because a categorical prohibition on considering previously unclaimed deductions would overstate offense seriousness in many cases and, as a result, produce identical guideline ranges for very different tax offenses;

Second, the Commission should adopt Option 1, which produces the most accurate tax loss amounts by measuring the real impact of a false return, while at the same time giving district courts sufficient discretion to develop and impose, on a case-by-case basis, reasonable proof requirements; and

Third, the Commission should articulate a clear distinction between the consideration of unclaimed deductions when determining an advisory sentencing range, and the use of such deductions to offset loss for the purpose of calculating criminal restitution. In cases where the tax remains unpaid and the court must determine the amount of tax owed for restitution purposes, there should be no limitations on the court's ability to consider unclaimed deductions for restitution purposes beyond those imposed by the relevant tax code sections and regulations; otherwise, the Sentencing Guidelines could cause unintended and inappropriate assessments of tax owed.

I. Background

Section 2T1.1 in pertinent part provides (with emphases added):

- If the offense involved tax evasion or a fraudulent or false return, statement, or other document, the tax loss is the total amount of loss that was the object of the offense (*i.e.*, the loss that would have resulted had the offense been successfully completed).

- If the offense involved filing a tax return in which gross income was underreported, the tax loss shall be treated as equal to 28% of the unreported gross income . . . *unless a more accurate determination of the tax loss can be made*.

- If the offense involved failure to file a tax return, the tax loss shall be treated as equal to 20% of the gross income… *unless a more accurate determination of the tax loss can be made*.

The Courts of Appeals differ on whether legitimate but unclaimed deductions can be used to establish a "more accurate determination of the tax loss." *Compare United States v. Hoskins*, 654 F.3d 1086, 1092 (10th Cir. 2011) (permitting credit for offsetting deductions); *United States v. Gordon*, 291 F.3d 181, 187 (2d Cir. 2002) (same) *with United States v. Psihos*, 683 F.3d 777, 781-82 (7th Cir. 2012) (disfavoring credit for offsetting deductions); *United States v. Sherman*, 372 Fed.Appx. 668, 676-77 (8th Cir. 2010) (same); *United States v. Yip*, 592 F.3d 1035, 1041 (9th Cir. 2010) (same); *United States v. Clarke*, 562 F.3d 1158, 1164 (11th Cir. 2009) (same); *United States v. Blevins*, 542 F.3d 1200, 1203 (8th Cir. 2008) (same); *United States v. Delfino*, 510 F.3d 468, 473 (4th Cir. 2007) (same); *United States v. Phelps*, 478 F.3d 680, 682 (5th Cir. 2007) (same); *United States v. Chavin*, 316 F.3d 666, 679 (7th Cir. 2002) (same).

We have found that in many cases this circuit conflict is more apparent than real, and more a difference in degree rather than in kind. For example, in *Psihos*, the Seventh Circuit purported to adopt a bright line test that disallows consideration of unclaimed deductions, but the court also noted with approval the district court's allowance of a deduction for cash payments that were clearly evidenced by contemporaneous records. *See Psihos*, 683 F.3d at 780. Conversely, in *Hoskins*, the Tenth Circuit explained why the court should have considered the defendant's assertions of unclaimed deductions, but ultimately rejected the argument that there was sufficient evidence in the record to substantiate them. *See Hoskins*, 654 F.3d at 1097-99. While these cases state different legal conclusions about the relevance of unclaimed deductions, they also largely reflect a shared willingness to consider such deductions when it would not result in a "nebulous [o]r complex" sentencing hearing. *Id.* at 1094.

II. Analysis – Tax Loss

Given the complexity of the tax code, there plainly is a tension between achieving accuracy in calculating loss for Guidelines purposes while preventing the sentencing proceeding from becoming the *de facto* equivalent of a lengthy civil IRS audit. The special Notes to §2T1.1 address this tension by permitting a court to apply a standard 28% rate to unreported income "unless a more accurate determination of the tax loss can be made." *See* §2T1.1(c)(1), Note A. This approach requires the sentencing judge to assess, based on the totality of circumstances, whether a more accurate determination of tax loss can reasonably be made. *See United States v. Sullivan*, 255 F.3d 1256, 1263 (10th Cir. 2001) (tax loss need not be found with "certainty or precision").

We believe that the Commission's approach to unclaimed deductions should likewise permit—and, in fact, encourage—district courts to strive for greater accuracy when doing so would not unduly burden the sentencing process. Categorically rejecting all consideration of unclaimed deductions, as proposed in Option 1, is neither necessary to achieve this result, nor consistent with the existing directive that trial courts make some effort to determine whether a tax loss more accurate than the default method is available. In short, Option 2 would sacrifice fairness on the altar of simplicity. The Commission should reject it.

Because §2T1.1 directs the sentencing court to determine the tax loss that is "the object of the offense," the relevance of any particular unclaimed deductions will depend on the nature of the offense, including how it was committed. In the PAG's experience, unclaimed deductions are often relevant in determining the intended tax loss. In fact, quite often a defendant's decision not to claim the deductions is, in a very real sense, intertwined with the "object of the offense" itself. Take the example of a restaurant owner who decides not to report large amounts of cash revenue as income. Even though some of the unreported revenue is used to pay operating expenses, which are deductible from income, the owner does not claim deductions for a large portion of those expenses for fear of alerting the IRS to the unreported cash receipts. The unclaimed deductions are an integral part of the offense. Failure to account for the impact of the unclaimed legitimate cash expenses would overstate the intended tax loss. By allowing a judge to consider unclaimed deductions, the Commission would be furthering its own efforts in recent years to have loss-related guidelines reflect the economic reality of the defendant's offense.

Option 1 and Option 3 would both allow sentencing courts to consider previously unclaimed deductions in determining tax loss. The biggest difference between these two options is in their presumptions and their evidentiary burdens. Option 1 presumptively includes any applicable deduction, while Option 3 presumptively excludes previously unclaimed deductions. As for the evidentiary differences, Option 3 imposes a requirement of "contemporaneous documentation" of the unclaimed deduction. Given the demonstrated ability of district courts to manage evidentiary proceedings in a manner consistent with the requirements of fairness and the unique demands of each case, the PAG sees no reason for the Commission to place artificial categorical limits on the type of evidence a court may consider when determining tax loss. Moreover, we think creating a presumption against including unclaimed deductions would be in tension with government's burden of proof to demonstrate tax loss at sentencing. Accordingly, the PAG recommends that the Commission adopt Option 1, which will allow district judges to take into account the economic realities of a case, while reserving to those judges their existing power to prevent sentencing proceedings from becoming overly complex or protracted.

<u>Other Issues for Comment</u>

1(a) – The Commission seeks comment on whether to require defendants to establish that legitimate deductions "would have been claimed" had there been no offense. The PAG believes that such a requirement would be unhelpful, confusing, and add a level of speculation that would only complicate the proceeding. It is unrealistic to ask what deductions a defendant "would have claimed" had the tax return been lawful. Although a defendant no doubt would have structured his or her affairs differently in the absence of an intent to commit a tax offense, in few cases will a defendant be able to show precisely what he would have done differently. We believe it makes more sense to focus on the economic realities at the time of offense, and ask simply whether a deduction was applicable and appropriate, and is supported by credible evidence. Proof of that sort could come in many forms, making Option 3's contemporaneous documentation standard unduly restrictive.

1(b) – The Commission seeks comment on whether an unclaimed deduction should be counted only if it is "related" to the offense. We recognize the force of the argument that the ability to present evidence of offsetting deductions might lead to a "second bite at the apple," where some defendants could seek out after-the-fact tax advice on entirely new or unrelated deductions that might have been available. On the other hand, categorically excluding consideration of unrelated deductions equates the absence of timely tax advice with greater criminal culpability. And it *quantifies* that additional culpability based on a purely fortuitous circumstance: the size of the deduction that the defendant unwittingly overlooked.

In the end, though, this is largely a philosophical debate with little practical consequence. It is our understanding that even in those circuits where unclaimed deductions may be considered, courts are not encountering this issue. That is, defendants are not flooding the courts with *post hoc* tax return calculations based on unrelated tax items. Consistent with the principle of simplifying the Guidelines wherever possible, the Commission should not address a largely hypothetical problem by adding yet another layer of complexity—in this instance, by opening the door to time-consuming litigation over the line between "related" and "unrelated" unclaimed deductions.

(2) – The Commission also seeks comment on whether the it should expand the language of the various options to clarify that all types of deductions are covered. The Commission should use broad language here. There is no basis for creating artificial distinctions in which a judge's consideration of the evidence turns on whether the tax code deals with a deduction "above the line" (*e.g.*, in determining adjusted gross income) rather than "below the line" (*e.g.*, an adjustment to taxable income). In either case, the defendant's culpability is the same.

III. Analysis – Restitution in Tax Cases

We suggest that the Commission add guidance that would avoid blurring the distinction between (i) calculating loss for offense level calculations and (ii) calculating loss for restitution purposes. It is one thing to cabin the sentencing hearing for purposes of determining culpability. It is quite another to require a defendant to pay more tax than is really owed in the name of saving time. This is not merely a theoretical concern. In the *Psihos* case, the Seventh Circuit affirmed a finding that the intended loss for Guidelines purposes was also the actual loss for restitution purposes. 683 F.3d. at 782-83.

The Commission should underscore the fact that a different loss calculation may apply when determining the government's out-of-pocket loss for restitution purposes, especially if the Commission does not follow the PAG recommended approach for addressing the circuit split. This clarification takes on added import because the Internal Revenue Code now requires the IRS to issue a tax assessment against a taxpayer equal to the amount of an order of restitution against the taxpayer in a criminal tax case, once all appeals of the restitution order have been exhausted in the criminal case. *See* 26 U.S.C. §§6201(a)(4)(a), (b) (eff. Aug. 16, 2010). The amount of the restitution-based tax assessment "may not be challenged by the person against whom assessed on the basis of the existence or amount of the underlying tax liability in any proceeding authorized under this title[.]" 26 U.S.C. §6201(a)(4)(c). As one commentator explains:

> The obvious design of this provision is to allow the IRS to collect on the sum in an award of restitution in a criminal case as an unassailable assessment. Thus it increases the need … to be aware of how Guidelines tax loss amounts can and should differ from restitution amounts in certain cases. For example, if the district court's Guidelines tax loss calculation does not take into account possible legitimate deductions that the defendant could have but did not claim at the time on the false tax return at issue, then the Guidelines tax loss can be higher than the actual tax liability that a traditional IRS assessment procedure would have determined. However, if the district court does not make such distinctions and issues a restitution order based directly upon that Guidelines loss calculation, then the defendant may find himself saddled with an artificially high restitution order, as well as an artificially high tax assessment, and subject to separate collection proceedings instituted by both the Office of the U.S Attorney and the IRS.

P. Hardy, *Criminal Tax, Money Laundering, and Bank Secrecy Act Litigation* at §II.B.3.e (Bloomberg BNA 2012 Supp.).

Whichever option the Commission adopts for purposes of determining tax loss under the Guidelines, the government should not be able to use that calculation to secure an inaccurate restitution amount. The Commission should clarify that the purpose of §2T1.1 is to assess the defendant's culpability for purposes of a suggested guideline range and not to supplant the need to calculate out-of-pocket loss for purposes of a restitution order.

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As always, I speak both individually and for the PAG as a whole when I say thank you for soliciting and considering our views on opportunities to improve federal sentencing.