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April 3, 2001

MEMORANDUM:

TO: Chair Murphy
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Susan Hayes
Charlie Tetzlaff
Ken Cohen
J. Deon Haynes
Sharon Henegan
Pam Montgomery
Lou Reedt
Judy Sheon
Susan Winarsky

FROM: Mike Courlander

SUBJECT: Public Comment – Department of the Treasury

Attached is a piece of public comment from the Department of Treasury that just came in the door.



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CHIEF
CRIMINAL INVESTIGATION

March 28, 2001

The Honorable Diana E. Murphy
Chair, U.S. Sentencing Commission
Suite 2-500, South Lobby
One Columbus Circle, NE
Washington, DC 20002-8002

Dear Madam Chairwoman:

I am writing, first, to express my appreciation to members of the Commission staff for meeting with several IRS and Justice Department representatives this week to discuss some of our continuing concerns about the pending guideline amendments as they relate to tax offenses. At the staff's suggestion I highlight herein our most significant remaining issues and hope that you will consider our views in your deliberations. In particular, I want to expand upon Commissioner Rossotti's testimony in which he registered the IRS's strong objection to the grouping proposal which eliminates, unintentionally I believe, any effect of a tax charge in most combined tax/non-tax prosecutions. I also want to reiterate briefly our concerns related to the consideration of state and local tax losses and corporate diversion tax loss calculation.

GROUPING AMENDMENT - Proposed Amendment (Part F) - §2T1.1, comment. (n.8)

The grouping rules of the Sentencing Guidelines seek to provide incremental punishment for significant additional criminal conduct, and, at the same time, prevent multiple punishment for substantially identical offense conduct (U.S.S.G. Ch. 3, Pt. D, intro. comment.). Achieving that dual objective, however, has not proved to be easy in tax cases. Indeed, the courts which have considered the question have struggled with the application of the grouping rules to tax offenses.¹

¹ See, e.g., United States v. Fitzgerald, 232 F.3d 315, 319-321 (2d Cir. 2000)(holding that tax evasion, fraud and conversion counts should be grouped under U.S.S.G. § 3D1.2(d) and the loss attributable to all of defendant's offenses aggregated); United States v. Petrillo, 237 F.3d 119, 124 (2d Cir. 2000)(same); United States v. Vitale, 159 F.3d 810, 813-15 (3d Cir. 1998)(rejecting claim that wire fraud and tax evasion counts should be grouped under U.S.S.G. § 3D1.2(c) as such grouping would result in no incremental effect on sentencing for tax evasion count); United States v. Haltom, 113 F.3d 43, 45-47 (5th Cir. 1997)(holding that tax evasion and mail fraud convictions must be grouped under U.S.S.G. § 3D1.2(c); United States v. Seligsohn, 981 F.2d 1418, 1425 (3rd Cir. 1992)(mail fraud counts and tax evasion counts could not be grouped together under § 3D1.2(d), cert. denied, 513 U.S. 1119 (1995); United

Although the proposed amendment might end the confusion, it will do so at the substantial cost of ignoring the need to provide incremental punishment for significant additional criminal conduct in many tax cases. The proposed amendment would require grouping a tax offense with an offense from which the defendant derived income under subsection (c) of §3D1.2 (Groups of Closely Related Counts) in all cases, even if the base offense level of the tax offense is not increased two points under §2T1.1(b)(1) for the failure to report the receipt in any one year of more than \$10,000 in income from criminal activity. In many cases, the offense level for the offense from which the defendant derived income will be higher than the level for the tax offense, even after the tax offense has been increased two levels to reflect the specific offense characteristic. The result of grouping will be that the offense level for the group is exactly the same as the offense level for the non-tax offense and the group offense level will not reflect the fact that the defendant has been convicted of serious criminal conduct in addition to the non-tax criminal conduct. In many cases, the effect will be to render the tax crime inconsequential. The IRS does not join investigations at random. Accordingly, tax charges are most often pursued when there is some distinct feature or aspect of the defendant's conduct or crime that calls for such charges and, we strongly believe, incremental punishment if convicted.

As we pressed upon the staff, grouping where the tax offense level is lower than the offense level for the other offense (usually some form of fraud), even after application to the tax offense level of the specific offense characteristic, produces the anomalous and unintended result that a grouping under §3D1.2(c) has no enhancing effect on the overall offense level of the group and totally eviscerates any sanction for the tax fraud. This anomalous result prompted the Third Circuit to refuse to group a tax offense and an offense from which significant amounts of income were realized. United States v. Vitale, 159 F.3d 810. In Vitale, where the defendant evaded taxes on \$12 million in income, the Third Circuit pointed out that if the specific offense characteristic is the mechanism by which the tax count is grouped with a higher offense level offense "the anomalous result [is] that an enhancement designed to increase a sentence has the effect of reducing it." *Id.* at 814. Even the Fifth Circuit in Haltom, although concluding that grouping was required under §3D1.2(c), noted that the decision to group "spare[d] [the defendant] any incremental punishment for his tax crimes" and that the result "may seem anomalous." 113 F.3d at 46. The spirit of the guidelines should ensure some additional punishment in a case such as Haltom. The Fifth Circuit's focus on what they

States v. Astorri, 923 F.2d 1052, 1055-1057 (3d Cir. 1991) (concluding that wire fraud and tax evasion counts were properly not grouped together under section 3D1.2(c), and adding that, under § 3D1.4, the court correctly added two units or levels to the fraud offense calculation); United States v. Morris, 229 F.3d 1145, *1 (4th Cir. 2000)(Table)(holding, based upon Vitale, that money laundering and tax evasion counts were not to be grouped under U.S.S.G. § 3D1.2(c), because the victims, harms, and conduct for the offenses were different), *cert. denied*, 121 S. Ct. 1216 (2001); United States v. McCormick, 1998 WL 799176 (S.D.N.Y. 1998)(declining to group conspiracy to commit mail fraud and tax evasion counts under U.S.S.G. § 3D1.2(c)).

characterized as the "quite distinct" feature of the tax offense is apt; a tax defendant's conduct with respect to his or her tax obligations cause the prosecutors to seek tax charges. Moreover, in many instances, there is not a clean overlap between the funds involved in the tax guideline and the fraud guideline, which causes further confusion if the amendment in its present form is adopted.

The Commission's proposed resolution of this conflict not only resolves the dispute in favor of the defendant by adopting the "anomalous" result described above, but goes even further than the extent caselaw to insulate criminal defendants from being held accountable for the tax offenses related to their other crimes. The proposed amendment would require grouping of tax offenses with the offenses from which the criminally derived income arose in *all circumstances, not only in circumstances when the specific offense characteristic applies*. Essentially, this result elevates the circuit conflict from anomalous to a counterintuitive notion at odds with sentencing guideline theory and eliminates any incentive to charge a tax crime when the crime from which the income or a portion thereof was derived is also charged.

Adoption of this amendment would have grave consequences to tax law enforcement. In addition to ignoring the well-stated philosophy of the Sentencing Commission that tax offenses are serious and that there should be incremental punishment for significant additional criminal conduct, this proposal treats as uniform every tax case that is prosecuted with a fraud from which the income was derived. In fact, there is frequently a unique or significant element to the tax component of the investigation that caused the IRS to become involved in the case. By adopting this amendment the Sentencing Commission sends an unintended message that anytime one commits a fraud offense you have a free pass to commit unlimited tax fraud. Furthermore, there is a danger that this amendment could be read to include not just tax crimes and the frauds from which the income was derived, but all tax crimes charged with other offenses. The unmistakable message of this amendment is that tax crimes are insignificant in relation to other offenses. This is precisely the message that Commissioner Rossotti indicated our system cannot countenance.

We are confident that solutions can be found to the problems that arise when trying to group tax and non-tax offenses. For example, providing a specific offense characteristic in the fraud guideline and other guidelines enhancing the offense level when income generated by the offense is not reported to the IRS may solve the problems in this area. Consequently, at a minimum, we strenuously urge that this amendment be delayed so that the staff can continue its very productive dialogue with IRS and DOJ and this issue be considered in conjunction with other grouping issues in the guidelines.

STATE AND LOCAL TAX LOSS - Proposed Amendment (Part F) - §2T1.1, comment. (n.1)

The proposed amendment, which seeks to eliminate state and local taxes from tax loss calculation, ignores the case law on this point that unanimously approves their

inclusion. See, United States v. Fitzgerald, 232 F. 3d 315, 318 (2d Cir. 2000); United States v. Powell, 124 F.3d 655, 663-4 (5th Cir. 1997), *cert. denied* 522 U.S. 1130 (1998). Furthermore, courts recognize that relevant conduct is not limited to consideration of only federal offenses. See, United States v. Newbert, 952 F.2d 281, 284 (9th Cir. 1991), United States v. Fuentes, 107 F.3d 1515, 1526(11th Cir. 1997). Contrary to the assertion in the proposed amendments that inclusion of state and local taxes would greatly complicate the guideline, there has been minimal appellate litigation on this point since the Fourth Circuit approved this as relevant conduct.

It is the government's burden to establish such a loss to increase the offense level. If it fails to do so, or does so in a manner that is complicated or unclear, the court may refuse to include the additional loss on a case-by-case basis. Furthermore, although this additional loss would not apply to defendants who commit their tax crimes in jurisdictions which do not have state income tax, it is also true that those defendants have committed a lesser magnitude of tax evasion than those defendants who willfully fail to pay both state and federal tax. Indeed, few individuals who criminally evade state and local taxes are ever held responsible for it by state courts.

The only existing precedent on this point, as well as the plain definition of relevant conduct, favors inclusion of state and local taxes in the calculation of tax loss. Courts should be permitted the discretion to determine whether it should be applied on a case-by-case basis. If the Sentencing Commission has concerns about difficulty of application it should not act precipitously to remedy what is now a non-existent problem. We propose that the Commission permit the Justice Department to develop a more comprehensive policy statement and monitor the application of state and local taxes for a sufficient period of time to determine whether there is, in fact, confusion and difficulty in application before instituting a change, which both experience and the courts have not deemed necessary.

AGGREGATE TAX LOSS CALCULATION - Proposed Amendment (Part F) - §2T1.1(c)(1)(D) and §2T1.1(c)(2)(B)

As we stated in our previous submission, the amendment which proposes the adoption of the Seventh and Second Circuit method for calculation aggregate tax loss in a corporate skimming case, the so called Harvey approach, confers an unfair advantage on convicted tax offenders because it calculates loss in a manner that ignores the reality of the criminal conduct. The proposed approach creates a legal fiction by calculating the tax loss as if the defendant paid the corporate tax before skimming the income. In the rare instance in which the corporate tax is paid, the courts should confer the benefit of reducing the tax loss by the amount the corporation paid on the income (assuming the reduced amount is the amount of income the defendant received). However, in the vast majority of cases the defendant ignores the corporation that he created and diverts the corporate income to himself. Thus, he should be held accountable for the entire amount of income he received. Indeed, on the civil side, the defendant would be taxed on the entire amount of the diversion unless he could establish that a part of the diverted income was non-taxable. A contrary result rewards

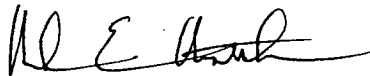
those tax evaders who are savvy enough to siphon their income from a shell corporation because they will be treated as if they legitimately paid the corporate tax on that income which of course, they did not. We urge the Commission not to adopt this proposed amendment which rewards a fiction unrelated to the real offense conduct.

However, because we anticipate other, future, more sophisticated uses of tax mechanisms to evade taxes, we urge the Commission, if it adopts the Harvey approach, to limit the impact of the clarification to the closely held corporate context. We would most respectfully urge a statement, in the "reason for the amendment" section along the following lines:

"The Commission makes this clarification in the context of the closely-held corporation because in most of these cases, the corporation shell is a simple alter ego of the individual. Courts considering more complex tax behavior and arrangements may reach different conclusions."

If you have any questions, please call me at (202) 622-3200.

Sincerely,

A handwritten signature in black ink, appearing to read "Mark E. Matthews", with a stylized flourish at the end.

Mark E. Matthews