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Tax Litigation Issues

Expert Analysis

The Government's Use Of Tax Returns at Trial

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In cases charging either tax evasion or filing false returns, the government will naturally offer the defendant's tax returns for the years charged in the indictment as part of its case-in chief, and the defendant will be hard-pressed to object to their admissibility. This, however, is not the only way the government uses the defendant's tax returns in criminal cases. Prosecutors in both tax and non-tax cases occasionally offer the defendant's returns to prove some other aspect of the charges. Thus, in tax cases the government may argue that returns for years not specifically at issue are relevant to the defendant's state of mind. And prosecutors in fraud and narcotics cases may offer returns that the defendant filed (or failed to file) either as circumstantial evidence of the charged conduct or to rebut some defense argument.

This article addresses the government's ability to access the defendant's returns for use in non-tax cases, as well as the evidentiary issues surrounding the admissibility of both "other year returns" in tax cases and any returns in non-tax cases.

Disclosure of Tax Returns

The confidentiality of individual tax returns is safeguarded by 26 U.S.C. §6103, which prohibits federal employees from disclosing tax information except in limited situations. Under §6103(h), the IRS may disclose tax returns or tax return information to Department of Justice attorneys engaged in proceedings or investigations involving "tax administration," which includes "the execution and application of the internal revenue laws."

The IRS is authorized to disclose tax returns to prosecutors either when it has referred a matter for investigation or in response to a written request. Tax returns may be disclosed in a federal or state proceeding pertaining to tax administration if the taxpayer is a party to the proceeding, or if the proceeding arose in connection with determining the taxpayer's civil or criminal liability.

Under §6103(i)(1), an assistant U.S. attorney may obtain tax returns as part of a non-tax criminal investigation or grand jury proceeding by submitting an ex parte application to a federal district judge. Taxpayers have no right to notice, a hearing, or disclosure of the application,[1] and prosecutors may file simultaneous motions to seal both the application and subsequent order granting or denying the application.[2] The district judge "may" grant the order if (1) there is reasonable cause to believe a criminal act has been committed, (2) there is reasonable cause to believe the tax return is relevant to the commission of the criminal act, and (3) the return is sought exclusively for use in a federal criminal investigation or proceeding and the information sought cannot reasonably be obtained from another source.[3]

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Other Year Returns

In a prosecution for federal tax offenses, the government might attempt to offer evidence regarding the defendant's tax compliance in years other than those charged in the indictment to satisfy its burden of proving that the defendant acted willfully.[4] In such cases, the prior year returns may be admissible under Rule 404(b) of the Federal Rules of Evidence to show either the defendant's awareness of his filing obligations or his intention to file fraudulent returns.

Thus, in *United States v. Schiff*,[5] the defendant was charged with willfully failing to file his personal income tax returns for 1974 and 1975. At trial, the government offered evidence that the defendant had filed personal income tax returns for years prior to 1974 as evidence of the defendant's knowledge of his filing obligations.

More recently, the U.S. Court of Appeals for the Fifth Circuit addressed a similar use of prior year returns in *United States v. Shows*.[6] In *Shows*, the defendant was charged with tax evasion for the years 1999 through 2001. At trial, the government established that Shows (a) had run into financial difficulties in 1997 and 1998; (b) had not paid any income taxes after 1996; (c) had filed his 1997 through 2001 returns in 2004; and (d) was also late in filing his 2002 through 2006 returns.

In an unpublished decision, the Fifth Circuit upheld the conviction finding that the evidence of the defendant's compliance both before and after the period covered in the indictment was properly admitted to establish "Shows' knowledge of his tax obligations and his willful intent to avoid such obligations" and that "it also was evidence that negated any argument that Dr. Shows had a good-faith belief that he was not obligated to file tax returns or pay taxes."[7]

But courts have also permitted prosecutors to offer evidence of the defendants' prior non-compliance to show that the conduct at issue was intentional. In *United States v. Bok*,[8] the defendant was charged with both tax evasion and filing false returns. At trial, the government offered evidence that, prior to the years at issue, the defendant had failed to file his federal and state returns. The U.S. Court of Appeals for the Second Circuit rejected the defendant's challenge to the introduction of that evidence holding that "[a]s a simple matter of logic, [the defendant's] failure to file state or federal

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returns…until told to do so by the IRS is indicative of an intent to evade the tax system."[9]

Narcotics Cases

While the admissibility of "other year" tax returns in criminal cases is governed by Rule 404(b), the use of the defendant's returns in non-tax cases is governed by Rules 401 through 403. In narcotics cases the government may offer the defendant's failure to report income on his tax returns to establish unexplained wealth. For example, in *United States v. Tavarez*,[10] the government offered evidence that the defendant reported no income in either 2012 or 2013 despite having made a series of substantial cash deposits and withdrawals during that period.

Relying on a line of Second Circuit cases, U.S. District Judge John G. Koeltl concluded that the "evidence of large amounts of 'unexplained wealth is relevant to create an inference of illicit gain,'" and that the tax return evidence "would not result in unfair prejudice because tax evasion is not more sensational or prejudicial than evidence of the narcotics conspiracy with which the defendant was charged."[11]

In *United States v. Carter*,[12] however, the U.S. Court of Appeals for the Sixth Circuit found that the district court had abused its discretion in allowing the government to introduce evidence of the defendant's financial situation, including evidence that he did not file federal income tax returns from 1985 to 1990, that he had applied for car loans that misrepresented his employment status, and that he had spent $3,000 on home appliances over a two-year period.

In holding that the evidence should have been excluded under Fed. R. Evid. 402, the Sixth Circuit noted that neither the appliance purchases nor the apparently false loan applications made it more likely than not that he had engaged in the narcotics transaction at issue, and that the evidence in question was insufficient to create an inference that the defendant had maintained an "unexplainably affluent lifestyle" such that his income must have come from narcotics trafficking. The court, however, was "most troubled by the government's use of the tax returns," which it found might lead the jury to conclude that the defendant had engaged in tax fraud.[13]

Non-Narcotics Cases

The use of tax returns in non-tax cases is not limited to demonstrating unexplained wealth in narcotics trials. Rather, the government may attempt to use the defendant's lack of income (as reflected in his tax returns) either to establish the falsity of some other representation by the defendant or to rebut a defense argument. Because the government in such cases is arguing that the returns accurately reflect the defendant's lack of income, this use of the defendant's tax returns puts the defense counsel in the unenviable position of arguing that his client may have cheated on his taxes, but did not commit the charged offense.

For example, in *United States v. Betea*,[14] the defendant was arrested in Florida where he had been lured and held hostage by a victim of his own currency alteration scam. In response to a question by law enforcement officers, the defendant claimed he was in Florida "to purchase a restaurant, a beauty parlor, and beauty supply materials." To contradict the defendant's story, the government introduced the defendant's tax returns which showed no taxable income in the preceding three years, thereby demonstrating that the defendant was in no financial condition to make the purported purchases.

In an unpublished opinion, the U.S. Court of Appeals for the Fourth Circuit rejected the defendant's unpreserved Rule 403 challenge concluding that district court had neither abused its discretion nor committed plain error in admitting the evidence.[15]

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And in *United States v. Valenti*,[16] the defendant was charged with having embezzled funds from a homeowners association. At trial, the government offered the defendant's 1991 and 1992 income tax returns to rebut his argument that the funds in question represented legitimate compensation. On appeal, the Second Circuit rejected the defendant's argument that the district judge should have excluded the returns under Fed. R. Evid. 403, concluding that "[t]he tax returns were obviously probative to refute [the defendant's] defense that the contested funds were legitimate compensation" and that "[a]ny arguable prejudice to [the defendant] was de minimis: it strains credulity to think that the jury might have believed [the defendant] innocent of transporting stolen goods, but voted to convict him anyway just because he failed to report income on his tax returns."[17]

There are, however, limits to the government's use of such evidence. In *United States v. Sullivan*,[18] the government charged two brothers, John and Dan Sullivan, with having conned numerous elderly homeowners into refinancing their homes and paying the proceeds to the brothers' home repair business for work they had no intention of performing. Prior to trial, the government moved to disclose the brothers' tax returns for 2001 through 2006. Specifically, the government sought to prove that John had failed to file tax returns after 2002, when he had been prohibited from engaging in home repairs, and offered Dan's returns to show that he had underreported his income from the home repair company.

The court held that evidence of John's failure to file was "probative of the fact that he reported income from the home repair business before he was prohibited from engaging in such work, but reported no income from the business after 2002." The court, however, rejected the government's attempt to introduce Dan's returns, concluding that because Dan was not prohibited from engaging in home repairs, his tax returns were not probative of whether he was attempting to conceal illegal activities.[19]

Conclusion

In preparing for trial, defense counsel in both tax and non-tax cases need to anticipate that the government might attempt to offer tax returns not directly at issue in the case to show knowledge and intent, unexplained wealth, or even the falsity of representations made in connection with a fraudulent scheme. While some courts have permitted the government to introduce tax returns as circumstantial evidence of some disputed fact, they have resisted the government's attempts to introduce returns that bear only tenuous connections between the charged crimes and have recognized the possible prejudice that will flow from allowing the government to lay defendant's financial history bare.

1. *United States v. Barnes*, 604 F.2d 121, 146 (2d Cir. 1979).
2. Dept. of Justice Manual: Criminal Resource Manual 506.
3. 26 U.S.C. §6103(i)(1)(B).
4. See *Cheek v. United States*, 498 U.S. 192, 200-01 (1991) (willfulness under the tax laws requires "'a voluntary, intentional violation of a known legal duty.'").
5. 612 F.2d 73 (2d Cir. 1979).
6. 307 Fed. Appx. 818 (5th Cir. 2009).
7. Id. at 822.
8. 156 F.3d 157 (2d Cir. 1998). The author was one of the prosecutors in the Bok case.
9. Id. 165-66; see also *United States v. Klausner*, 80 F.3d 55, 63 (2d Cir. 1996); *United States v. Ebner*, 782 F.2d 1120, 1126 n. 7 (2d Cir. 1986); *United States v. Magnus*, 365 F.2d 1007, 1011 (2d Cir. 1966).
10. 2015 WL 1137550 (S.D.N.Y. March 12, 2015).
11. Id. at *8-9; see also *United States v. Chandler*, 326 F.3d 210 (3d Cir. 2003).
12. 969 F.2d 197 (6th Cir. 1992).
13. See id. at 200-01.
14. 294 Fed. Appx. 25 (4th Cir. 2008).
15. Id. at *27-28; see also *United States v. Haischer*, 2012 WL 5199148, *3 (D. Nev. Oct. 18, 2012) (government permitted to introduce defendant's income tax returns to prove she inflated her income on mortgage applications; concluding that "the jury is unlikely to consider the tax returns for any other impermissible or prejudicial purpose, particularly since the government will not argue that Defendant cheated on her tax returns").
16. 60 F.3d 941 (2d Cir. 1995).
17. Id. at 946.
18. 2011 WL 4808118 (N.D. Ill. Oct. 11, 2011).
19. Id. at *11.