ALMOST ANYONE CAN BE A FELON: THE TROUBLING SCOPE OF TAX OBSTRUCTION, PART II

Posted on **August 15, 2017** by **Jim Malone**

Part I of this Post, found here, discussed the background and holdings of *United States v. Marinello*, 839 F.3d 209 (2d Cir. 2016), *cert. granted*, No. 16-1144, 85 U.S.L.W. 3602, 2017 U.S. LEXIS 4267 (Jun. 27, 2017). This post focuses on the implications of the Second Circuit's construction of the omnibus clause of section 7212(a) of the Internal Revenue Code and on the potential ways in which the Supreme Court might narrow that construction.

To recap, Marinello was charged and convicted with a felony, known as "tax obstruction" under section 7212(a) (corruptly obstructing or impeding the due administration of title 26). His conviction was in part based on failing to: (i) maintain corporate books and records for his business; and (ii) furnish complete and accurate records to his accountant concerning his personal and business income.

The Implications of *Marinello*

Marinello is a particularly troubling application of section 7212(a) because the Second Circuit holds that inadequate recordkeeping can be prosecuted as a felony: "[A] defendant surely could be charged under section 7212(a) for knowingly failing to provide the IRS with materials that it requests, or, as in Marinello's case, for failing to document or provide a proper accounting of business income and expenses." 839 F.3d at 224 (footnote omitted). The court did indicate that "the scope of omissions on which an omnibus clause violation could be based is not limitless," but it offered no meaningful guidance on what those limits might be. *Id.* at 224 n.15 (citation omitted).

The Second Circuit's holding that deficient records can support a conviction for tax obstruction is disturbing because the extent to which taxpayers are required to keep records is unclear:

- Section 6001 of the Code grants the Secretary of the Treasury authority to issue regulations delineating the types of records that taxpayers must maintain. I.R.C. § 6001.

- The relevant Treasury Regulation provides that taxpayers "shall keep such permanent books of account or records, including inventories, *as are sufficient* to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information." Treas. Reg. § 1.6001-1(a) (emphasis added).

What records would be "sufficient" is obviously debatable. The problems associated with that vague standard are compounded by the fact many businesses, both large and small, have deficiencies in their business records for reasons that have nothing to do with an effort to cheat on their taxes. Typically, these businesses suffer the consequences when audited, as legitimate deductions are disallowed for lack of substantiation.

The Second Circuit's construction of section 7212(a) potentially exposes the owner of any business with incomplete records to felony charges of tax obstruction. This broad interpretation of the omnibus clause appears to be inconsistent with the Supreme Court's holding in *Spies v. United States*, 317 U.S. 492 (1943) that tax evasion, a felony, requires affirmative acts and that it is those affirmative acts that differentiate the felony charge from the misdemeanors of willful failure to file a return and willful failure to pay a tax when due. *See Spies*, 317 U.S. at 497-99. In that context, it is also worth noting that an existing Treasury Regulation equates the failure to keep adequate records with *negligence*. Treas. Reg. § 1.6662-3(b)(1) ("'Negligence' . . . includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly.").

And the Second Circuit's statement that a knowing failure to provide the IRS with documents that it has requested can serve as the basis of felony charges is also troubling. As the American College of Tax Counsel observed in its *amicus* brief in support of Marinello's petition for *certiorari*, "[l]awyers representing taxpayers in IRS audits frequently make good faith decisions to withhold from the IRS materials that it requests." Brief of the Am. College of Tax Counsel as *Amicus Curiae* in Support of Petitioner at 9, *Marinello v. United States*, No. 16-1144 (Apr. 21, 2017). The reasons for withholding information can vary from relevance to attorney-client privilege or the Fifth Amendment privilege against self-incrimination. *Id.* at 9-10. The broad language in the Second Circuit's decision in *Marinello* suggests that lawyers could be prosecuted for judgment calls made in the course of an audit.

The panel opinion in *Marinello* posits that the general *mens rea* requirement of section 7212(a) eliminates any overbreadth and vagueness concerns associated with the omnibus clause. *Marinello*, 839 F.3d at 221-22. Section 7212(a) requires that the defendant act "corruptly," a term courts generally interpret to mean that the defendant acted "with an intent to procure an unlawful benefit either for the actor or for some other person." *United States v. Floyd*, 740 F.3d 22, 31 (1st Cir. 2014) (citations omitted). In the tax context, that is a fairly easy allegation to make as the government can readily argue that reduced tax liability resulting from the alleged behavior is an unlawful benefit.

For support, the *Marinello* panel opinion noted that the Sixth Circuit construes the word "corruptly" in this fashion. *Id.* at 222 (citing *United States v. Miner*, 774 F.3d 336, 347 (6th Cir. 2014)). This description of the Sixth Circuit's approach is misleading: In *Miner*, the Sixth Circuit indicated that the overbreadth and vagueness concerns presented by the omnibus clause are overcome by *both* the requirement that the defendant have knowledge of a pending IRS action *and* the general *mens rea* requirement. *Miner*, 774 F.3d at 347. The two requirements are mutually reinforcing, as illustrated by the following hypotheticals:

- The chief financial officer of ABC Corporation, which is not under audit, directs her staff to destroy drafts of tax workpapers for several years in a routine records management exercise conducted in accordance with ABC's standard document retention policy. Subsequently, ABC is notified that the IRS will be auditing its returns for a series of years, including years for which documents were recently destroyed.

- After receiving a notice from the IRS that it will be auditing ABC's returns for 200x, 200y, and 200z, she orders her staff to destroy all drafts of tax workpapers for those years.

The behavior in the first hypothetical is plainly less culpable because it was done at a time when the chief financial officer was not aware that the IRS was planning to audit ABC. Her behavior in the second hypothetical is qualitatively worse, and the difference is the timing. Yet in either scenario, the chief financial officer's behavior can be portrayed as corrupt since she sought an advantage for ABC.

Potential Limits on Tax Obstruction

If the Supreme Court concludes that some restriction on the scope of the omnibus clause is appropriate, it seems to have two primary options:

First, it could adopt the approach that Sixth Circuit took in *Kassouf v. United States,* 144 F.3d 952 (6th Cir. 1998) and require the government to prove that there was "some pending IRS action of which the defendant was aware." *Id.* at 957. While this would dramatically limit a taxpayer's exposure to felony charges for obstruction, it would not disarm the government in its fight against cheaters: Conscious behavior designed to impede the ability of the IRS to assess or collect taxes that occurred when the taxpayer was not aware of any pending IRS action would still support a charge of tax evasion under section 7201 of the Code. The government would simply need to shoulder the burden of showing that the taxpayer acted willfully. I.R.C. § 7201 ("Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall . . . be guilty of a felony").[1]

Second, the Court could take a more moderate approach than *Kassouf*, making tax obstruction a viable charge in situations where the taxpayer either had actual knowledge of a pending IRS proceeding or where the taxpayer was on notice that one was highly likely to occur. This would address the difference between the following hypotheticals:

- The chief financial officer of XYZ Corporation orders his staff to destroy drafts of tax workpapers for several years in a routine records management exercise conducted in accordance with XYZ's standard document retention policy. After the documents are destroyed, XYZ is notified that the IRS will be auditing its returns for a series of years, including years for which documents were recently destroyed; and
- He orders his staff to destroy all drafts of tax workpapers for the current year, and XYZ is a large corporate taxpayer that is audited every year by the IRS.

Alternatively, the Court could impose a slight limit on the scope of the omnibus clause by requiring an affirmative act to support a conviction.[2] This limitation would be consistent with *Spies*, which held that an affirmative act was what differentiated tax evasion, a felony, from failure to file and failure to pay, which are misdemeanors. Such a construction would eliminate the prospect that a taxpayer could be convicted of a felony because his records were not "sufficient." While this approach would narrow *Marinello*, it would still leave a host of situations in which taxpayers would be exposed to a felony prosecution on the basis of tenuous evidence. For example, a taxpayer might destroy financial records when the special six-year assessment period under section 6501(e) of the Code expires; if the IRS then commences an audit on the theory that the taxpayer committed fraud (which is not subject to an assessment limitations period), his decision to dispose of the records could support a felony conviction, even if he had no clue that the IRS intended to audit.

Hopefully, the Supreme Court will impose meaningful constraints on the scope of the omnibus clause of section 7212(a), as taxpayers should not face felony charges because of sloppy recordkeeping. While

Kassouf appears to strike the fairest balance between permitting prosecution of tax cheats and protecting taxpayers from vague charges, any restriction on *Marinello* would be welcome.

Footnotes:

[1] Willfulness means "'a voluntary, intentional violation of a known legal duty.'" *Cheek v. United States*, 498 U.S. 192, 200 (1991) (quoting *United States v. Bishop*, 412 U.S. 346, 360 (1973)).

[2] The Supreme Court is free to resolve a case on the basis of issues that are subsumed within the questions presented to the Court in a petition for certiorari. *See City of Sherrill v. Oneida Indian Nation of N.Y.*, 544 U.S. 197, 214 n.8 (2005); *see also* Sup. Ct. R. 14.1(a) ("The statement of any question presented is deemed to comprise every subsidiary question fairly included therein."). As a consequence, an alternative approach to narrowing the scope of the omnibus clause appears to provide a potential basis for disposition in *Marinello*.

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