

Why Litigators Need Tax Experts

By Robert W. Wood

Robert W. Wood practices law with Wood & Porter in San Francisco (<http://www.woodporter.com>), and is the author of *Taxation of Damage Awards and Settlement Payments* (3d ed. 2008) and *Qualified Settlement Funds and Section 468B* (2009), both available at <http://www.taxinstitute.com>. This discussion is not intended as legal advice, and cannot be relied on for any purpose without the services of a qualified professional.

Copyright 2009 Robert W. Wood.
All rights reserved.

Tax law is a subject that produces nearly universal groans from law students. All too frequently, the same groans emanate from associates in law firms when they are asked tax questions. Moreover, although specialization among lawyers is now nearly inevitable, fewer lawyers specialize in tax today than even several decades ago. There are many reasons for this. A major factor is the merciless pace of tax legislation, requiring specialists to relearn and retool their skills constantly. Tax law has become significantly more complex.

There has also been growth in many other practice areas that may seem more vital, profitable, and needed. Then there is the growth of accounting firms, which have often supplanted tax lawyers. Finally, there is even the social notion that tax lawyers are an odd lot. If you don't want to end up being viewed as an oddball, conventional wisdom suggests you may be better off in another area of law.

Nevertheless, like the nerds in the *Revenge of the Nerds* movies, tax lawyers may be more valuable in civil disputes — and even in criminal cases — than you ever thought. In fact, a recent federal court decision demonstrates that tax experts may even be essential in litigation. Before we get to that important decision, let's consider how tax experts are used.

Wide Variety

Expert testimony can be used in virtually any kind of case. The general rule, provided in Rule 702 of the Federal Rules of Evidence, is that an expert witness may testify about anything, provided his scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact at issue. The expert's testimony must be based on sufficient facts or data, be the product of reliable principles and methods, and the expert must have applied the principles and methods reliably to the facts of the case.

Qualification as an expert witness is contingent on the type of opinion to be offered. The witness must possess an expertise based on knowledge, skill, training, education, or experience regarding the subject on which he will testify. Once the witness is deemed qualified, broad discretion is granted to the trial court as to whether expert testimony will be admitted.

In state court, the standard is similar. For example, in California, an expert witness's testimony must be related to a subject that is sufficiently beyond common experience so that his opinion would assist the trier of fact. The expert's testimony must be based on his special knowledge, skill, experience, training, and education on the matter.¹

Tax experts are useful in civil disputes when their specialized knowledge may help explain tax issues that are central to the case, or that are important in assessing and evaluating damage claims. The latter means that a tax expert can be appropriate in virtually any civil case. After all, tax issues are so prevalent that almost any money we pay and any money we receive has tax consequences. However, let's first consider how to use a tax expert when tax issues are central to a case.

Tax Malpractice Actions

As our nearly decade-long run of tax shelter litigation has proved, businesses and consumers alike are preoccupied with saving taxes. I use the term "tax shelter" in a colloquial sense, meaning anything designed to ameliorate the size or timing of tax payments. Tax fashions ebb and flow, but the methods rarely vary.

In a typical fact pattern, an investor enters into a transaction or buys something purporting to have a particular tax result. The economics may or may not follow the tax consequences, but the tax consequences are usually calculated. When the transaction fails or goes awry, what are the client's damages?

A tax expert is usually necessary to make those determinations. In fact, the two sides will typically have competing tax experts. Far from merely crunching the numbers and testifying about the client's damages, the tax expert for the plaintiff is likely to explain how the tax shelter was supposed to work in the first place. There is usually a component of education and explanation necessary. The defendant's tax expert may or may not agree.

One or both tax experts should also address whether there was a reasonable possibility or probability that the transaction would work. Finally, the experts should describe any pertinent IRS or other agency guidance on point. Those transactions are typically not straightforward. Thus, the education function that tax experts serve

¹See Cal. Evid. Code section 801.

TAX PRACTICE

can be of enormous value, even when there is no dispute about the amount of damages.

Ancillary Tax Issues

Beyond cases in which tax issues are of central importance, the bulk of civil litigation involves tax issues, explicitly or implicitly. It is becoming common for plaintiffs to seek additional damages based on tax consequences. Conversely, defendants often ask for tax issues to be taken into account to reduce damages the plaintiff might be awarded.

For example, suppose you are a plaintiff suing a real estate broker and title company for not completing a real estate transaction within a contractual time frame. One consequence of that failure may be that you incurred additional income tax on the transaction. You would want to claim those additional taxes as part of your damages.

Another common example involves employment claims. A former employee calculating damages for a wrongful termination by his employer will often ask for a tax gross-up. The tax gross-up may compensate the plaintiff for the negative tax impact of receiving a lump sum damage award in one year. Had he been treated properly in the first place, he would have received wages payable over many years.

Jurisdictions vary in how they regard such claims. A recent Third Circuit Court case, *Eshelman v. Agere Systems Inc.*,² suggests a broadening of the circumstances in which such tax claims will be allowed. In *Eshelman*, the Third Circuit squarely held that a district court may, under the broad equitable powers conferred by the Americans With Disabilities Act, award a prevailing employee an additional sum of money to compensate for the increased tax burdens a back pay award may create. Without that equitable remedy, the court said, it would not be possible to restore the employee to the economic status quo.

Eshelman may be a watershed case, ushering in a new era of tax sensitivity. A type of tax damages renaissance may mean an easier time for plaintiffs to recover such damages. Like many remedies questions, whether a plaintiff or a defendant will have its version of the tax impact adopted by a court (increasing or decreasing damages because of tax effects) is likely to vary substantially depending on the jurisdiction, venue, applicable law, and other variables. One variable will be the use of expert witnesses who can explicate the intricacies of those doctrines.³

Both Sides Now

As a rule, when one side has an expert, the other side wants a rebuttal expert. In the case of tax lawyers, there is a bit more to this than merely the usual reciprocity. In fact, because of the calculation function, and particularly because of the education function, tax experts are usually quite important in resolving those matters.

All of this was on my mind as I read the recent district court decision in *Baxter v. United States*.⁴ In this case, the court vacated a two-year prison sentence given to a CPA who pleaded guilty to obstructing and impeding the administration of the federal tax laws. What was the reason for vacating the sentence? Ineffective assistance of counsel because Baxter's lawyer did not retain a tax expert. Just how essential a tax expert can be is made clear by the *Baxter* opinion. It gives a thorough review of constitutional standards as well as a good bit of tax law.

Right to Counsel

Laura Baxter was a CPA in Frankfurt, Ill. Unfortunately for her, one of her assignments was to prepare tax returns for clients who purchased trusts from Aegis Trust System, which was later shown to be an illegal tax evasion scheme. Baxter thought Aegis and its trusts were lawful at the time.

Baxter was indicted, engaged in plea negotiations, and eventually pleaded guilty. Significantly, her plea agreement with the government (also signed by her attorney, Keith Spielfogel) indicated that her offense involved a tax loss to the U.S. government of between \$550,000 and \$950,000. This figure was important under the prevailing sentencing guidelines, and Baxter's sentence was based on these figures.

The government, however, continued to assert that the tax loss to the United States was between \$5 million and \$6 million. After an evidentiary hearing regarding the government's objections to the presentencing report, the court concluded that the government had failed to meet its burden of proof about how much money Baxter's criminal act involved. Rejecting the government assertion of a \$5.5 million tax loss, for purposes of sentencing, the court simply accepted the \$576,000 loss to which she had acquiesced in the plea agreement.

However, it later became clear the court did not understand that the agreed \$576,000 tax loss figure appearing in the plea agreement was *part* of the \$5.5 million tax loss. The entire \$5.5 million tax loss, remember, was something the government had failed to prove.

After being sentenced to 24 months, Baxter filed a case under 28 U.S.C. section 2255. In essence, this statute allows a court to vacate a defendant's sentence and resentence her if the court finds that the defendant's constitutional rights have been violated. Baxter argued that the \$576,000 tax loss figure was erroneous. She contended that both of her criminal defense attorneys (Spielfogel and James Montgomery) failed to provide her with the effective assistance of counsel in violation of her Sixth Amendment rights.

Explanation

Her lawyers failed to retain a tax expert to determine the correct amount of tax loss attributable to her criminal conduct. Baxter also claimed that they failed to evaluate the correct tax ramifications of Baxter's criminal conduct for sentencing. These may sound like serious accusations,

²554 F.3d 426 (3d Cir. 2009), *Doc 2009-2478*, 2009 TNT 23-7.

³For more on *Eshelman*, see Wood, "Getting Additional Damages for Adverse Tax Consequences," *Tax Notes*, Apr. 27, 2009, p. 423, *Doc 2009-6560*, or 2009 TNT 79-11.

⁴No. 1:04-CR-00371 [2009 U.S. Dist. LEXIS 53800] (N.D. Ill., June 25, 2009), *Doc 2009-14910*, 2009 TNT 124-48.

and yet the court found itself noting that Spielfogel and Montgomery were both very good attorneys.

In fact, the court recited some of their accolades. Spielfogel had prevailed in the defense of another tax return preparer in a criminal case. Montgomery had a national reputation. Nevertheless, the court was bound to consider whether the criminal defendant's constitutional right to effective assistance of counsel had been violated.

Baxter had to show that:

1. her attorneys' performance fell below an objective standard of reasonableness; and
2. there was a reasonable probability that, but for her attorneys' errors, the result of the proceedings would have been different.⁵

The court said it was undisputed that Baxter's counsel did not think they needed to engage a tax expert as to the \$576,000 tax loss. Indeed, it was clear that Baxter's counsel adopted the government's tax loss theory. Did this conduct, asked the court, fall below the objective standard of reasonableness for counsel?

To answer this question, the District Court went through an exhaustive analysis of the conduct of Baxter's counsel and the nature of the tax issues in question. The court found it clear that Baxter's counsel simply accepted the government's position that she was responsible for a \$576,000 tax loss. They did so without analyzing the relationship between her conduct and the appropriate tax loss attributable to such conduct. That was a critical flaw, said the court.

In fact, Baxter's counsel was required to make "a good faith analysis of all the relevant facts and applicable principles."⁶ Here, the court said the standard required the attorney to analyze *independently* the tax loss attributable to the defendant's conduct in accordance with the applicable sentencing provisions. If the criminal defense lawyer involved was unwilling or unable to do this personally, he had a duty to engage the services of an expert who could do so.

Interestingly, the court went on to consider the question of what a tax loss is for purposes of the sentencing

guidelines. The court examined authorities on this issue that confirmed a tax loss refers to the amount of loss the defendant attempted or intended to create through the tax offense in question.⁷ As the court found, Baxter did not acknowledge intending any tax loss amount, either in her plea negotiation or sentencing.

Bottom Line

There's a great deal more in the *Baxter* opinion. Criminal defense lawyers, tax lawyers, and many others will want to read it carefully. In a criminal case, this is more than an academic exercise. Indeed, these issues have real-life consequences.

That is strikingly apparent by looking at the table in the *Baxter* opinion, in which the court juxtaposed sentencing guidelines for a tax loss of \$576,000 compared with one of only \$22,853. The latter was the figure Baxter's tax expert arrived at in the proceeding.

After a thorough discussion, the court admonished that it is not adopting a universal rule that a tax expert is needed in every criminal tax case, much less in every civil one. In fact, defense counsel in criminal tax cases do not always need to retain a tax expert, the court said.

However, the court did make painfully clear that when there is a tax question that is sufficiently complicated to require expert assistance, defense counsel must hire a tax expert. To be objectively reasonable, Baxter's attorneys should have retained a nongovernment criminal tax expert and gotten that tax expert's advice.

Conclusion

This involves a judgment call, pure and simple. Many lawyers, judges, jurors, and members of the public have a hard time with tax issues. Tax issues are thorny and easy to get wrong. Even in plain old civil disputes, the impact of tax law on a settlement or judgment, or punitive damages, structural settlements, the defendant's deductibility, and more, can be a morass. Hiring a tax expert is usually money well spent. Besides, as the court in *Baxter* recently held, sometimes tax experts are downright essential.

⁵See *Strickland v. Washington*, 466 U.S. 668 (1984).

⁶See *Moore v. Bryant*, 348 F.3d 238, 241 (7th Cir. 2003), quoting *Bridgeman v. United States*, 229 F.3d 589, 592 (7th Cir. 2000).

⁷See *United States v. Chavin*, 316 F.3d 666 (7th Cir. 2002), *Doc 2002-27408*, 2003 TNT 70-9.

SUBMISSIONS TO TAX NOTES

Tax Notes welcomes submissions of commentary and analysis pieces on federal tax matters that may be of interest to the nation's tax policymakers, academics, and practitioners. To be considered for publication,

articles should be sent to the editor's attention at taxnotes@tax.org. A complete list of submission guidelines is available on Tax Analysts' Web site, <http://www.taxanalysts.com/>.