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TAX LITIGATION ISSUES

Expert Analysis

Second Circuit Tackles Required Records Exception

By
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Under the Bank Secrecy Act (BSA),[1] taxpayers must maintain records regarding their foreign financial accounts and file annual reports disclosing those accounts. As part of its recent attack on undisclosed accounts, the Department of Justice has issued numerous subpoenas requiring taxpayers to produce the records mandated by the BSA. Not surprisingly, several taxpayers who failed to comply with the reporting requirements have sought refuge in the Fifth Amendment privilege against self-incrimination.

Two years ago, this column addressed the then-conflicting body of case law addressing challenges to such subpoenas.[2] At that time, the one appellate court to address the issue had agreed with the government, while one district judge had ruled in favor of the taxpayer. In the interim, however, the courts have been virtually unanimous in rejecting the taxpayers' position.[3] On Dec. 19, 2013, the U.S. Court of Appeals for the Second Circuit joined with the five other circuit courts to address the issue in holding that the required records doctrine precludes application of the Fifth Amendment in these circumstances.[4]

Given that the Supreme Court has already declined to hear the issue on two occasions, the absence of a circuit split means that taxpayers facing subpoenas calling for records of their offshore accounts confront an increasingly difficult playing field.

Background

The Fifth Amendment provides, in relevant part, that "[n]o person…shall be compelled in any criminal case to be a witness against himself." This rule does not protect the incriminating contents of documents. Rather, it applies only to testimonial communications that are incriminating. However, compliance with a subpoena calling for the production of documents may implicate the Fifth Amendment, as "the act of producing evidence in response to a subpoena nevertheless has communicative aspects of its own, wholly aside from the contents of the papers produced."[5]

In *Shapiro v. United States*[6] and *Grosso v. United States*,[7] the Supreme Court developed the required records doctrine. In *Shapiro*, the petitioner, a produce wholesaler, sought to resist a subpoena calling for the production of sales records required to be maintained under the Emergency Price Control Act. The court rejected petitioner's reliance on the Fifth Amendment, holding that "the privilege that exists as to private papers cannot be maintained in relation to records required by law to be kept in order that there may be suitable information of transactions which are the appropriate subjects of governmental regulation, and the enforcement of restrictions validly established."

In *Grosso*, the defendant failed to pay a special wagering excise tax and to file a related Internal Revenue Service form. In defense of his criminal prosecution, Anthony Grosso argued that paying the excise tax would have required him to incriminate himself. The Supreme Court agreed, holding that the Fifth Amendment protected the disclosures called for in connection with payment of the excise tax. In doing so, the court identified three "premises" for the required records doctrine: (1) the purposes of the government's inquiry are essentially regulatory; (2) information is to be obtained by requiring the preservation of records of a kind which the regulated party has customarily kept; and (3) the records themselves have assumed "public aspects" that render them at least analogous to public documents.

'In re M.H.'

In August 2011, the U.S. Court of Appeals for the Ninth Circuit was the first circuit court to address the invocation of the Fifth Amendment in response

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to a subpoena calling for the production of offshore account records. In *In re M.H.*,[8] the court concluded that the required records exception supplanted the privilege against self-incrimination where the records at issue were created through "voluntary participation in a regulated activity." In reaching this conclusion, the court applied the three-prong test established in *Grosso*. First, despite the legislative history pointing to the value of offshore accounts records in criminal investigations, the court found that the BSA is "essentially regulatory" because it targets all foreign account holders, and not an inherently illegal activity or a group of people inherently suspect of criminal activity.

Second, the court concluded that taxpayers "customarily kept" information regarding offshore accounts so they can access those accounts and report information to the IRS every year. Third, the court rejected any consideration of "special privacy interests in bank records and tax documents," holding that the records have "public aspects" because the information was "compelled in furtherance of a valid regulatory scheme."

Decisions Favoring Taxpayers

Within months of the Ninth Circuit's opinion, district courts in Texas and Illinois rejected the appellate court's holding. While Judge Lynn Hughes of the Southern District of Texas agreed that the enforceability of the subpoena was governed by the Grosso test, he found that records of offshore accounts did not satisfy the required records exception.[9] Specifically, Hughes rejected the government's argument that the recordkeeping requirement is regulatory, finding the true aim and practical use of the statute to be criminal investigation of a select suspect segment—tax-evading foreign account holders. In addition, Hughes rejected the notion that the decision to hold a foreign account constitutes a waiver of the privilege against self-incrimination.

In contrast, in *In re Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011*,[10] Chief Judge James Holderman of the Northern District of Illinois noted that the required records doctrine was established under an evidentiary regime that barred private documents from being compelled.[11] Holderman recognized a shift in Fifth Amendment jurisprudence and distinguished between the "contents of the subpoenaed documents," which clearly "enjoy no Fifth Amendment privilege," and the taxpayer's "act of producing documents in response to a subpoena," which would "require [the taxpayer] to admit that the papers existed, were in [the taxpayer's] possession or control, and were authentic"—and hence is privileged under the Fifth Amendment.

Based on this analysis, Holderman identified two additional considerations in applying the required records exception. First, whether their production generally lacks testimonial significance because "'the only acknowledgement conveyed by [producing them] would be the existence and applicability of the regulatory program…,' an acknowledgement that is not incriminating." Second, whether the individual claiming Fifth Amendment protection voluntarily entered the field of regulation so as to waive Fifth Amendment protection. While the taxpayer conceded that the decision to put funds in a foreign account was voluntary, because compliance with the subpoena would result in the taxpayer admitting non-public incriminating facts, Holderman deemed the act of production a compelled testimonial admission privileged under the Fifth Amendment.

Other Circuit Court Decisions

The two district court victories won by taxpayers were short-lived. Not only did the Fifth and Seventh circuits reverse Hughes and Holderman respectively, but the three other circuits to consider the issue have joined the Fifth, Seventh and Ninth circuits in concluding that the required records doctrine precluded the assertion of the privilege against self-incrimination.

> Last month, the Second Circuit addressed the availability of the privilege against self-incrimination in the context of a subpoena calling for records mandated by the Bank Secrecy Act.

In *In re Special February 2011-1*,[12] the Seventh Circuit traced the history of both the act of production and required records doctrines, and noted that several previous appellate decisions concluded that the required records doctrine negates the act of production privilege. The Seventh Circuit stressed that to hold otherwise would frustrate the ultimate goal of allowing the government to inspect the records it requires an individual to keep and the policy dictating that when an individual voluntarily engages in an activity that imposes record-keeping requirements, he subjects himself to the "possibility that those records might have to be turned over upon demand, notwithstanding any Fifth Amendment privilege…aris[ing] by virtue of the contents of the documents or by the act of producing them."

In a cursory manner, the Seventh Circuit then agreed with the Ninth Circuit's analysis that the records at issue met all three prongs of the Grosso test.

In *In re Grand Jury Proceedings*, No. 4-10,[13] the U.S. Court of Appeals for the Eleventh Circuit joined the Seventh Circuit in rejecting a taxpayer's reliance on the act of production privilege. After finding that all three prongs of the Grosso test were met, the court found that voluntary participation in a regulated

activity may be deemed a waiver of the act of production privilege because it constitutes consent to keep and produce records as a condition of carrying on the activity.

Unlike their sister courts, the Fourth and Fifth circuits did not address either the act of production or waiver arguments. Rather, in *In re Grand Jury Subpoena*,[14] the Fifth Circuit reversed Hughes, concluding that the Grosso factors weighed in favor of applying the required records doctrine. And in *United States v. Under Seal*,[15] the Fourth Circuit rejected the argument that "[w]here documents are required to be kept and then produced, they are arguably compelled" by pointing out that "the privilege against self-incrimination does not bar the government from imposing recordkeeping and inspection requirements as part of a valid regulatory scheme."

The court went on to reiterate the three-prong test set forth in *Grosso*, rejecting arguments made by the taxpayer noting that for the most part, these were the "same arguments [that] failed to persuade the other appellate courts which have considered the issue, and do not persuade us either."

Second Circuit Weighs In

Finally, last month, the Second Circuit addressed the availability of the privilege against self-incrimination in the context of a subpoena calling for records mandated by the BSA. In *In Re: Grand Jury Subpoena Dated February 2, 2012*,[16] the taxpayer attacked the underpinnings of the required records doctrine, arguing that it arose during "exigent wartime conditions" as a limited "emergency statute" and that allowing the required records doctrine to trump the act of production privilege in the BSA context would create a "slippery slope" with the "potential to eliminate Fifth Amendment protections in a broad range of criminal investigations not limited to offshore banking."[17] In an opinion by Judge Richard Wesley, the court rejected this argument, asserting that the required records doctrine "abrogates the protection of the [act of production] privilege for a subset of those documents that must be maintained by law."

The Eleventh Circuit found that voluntary participation in a regulated activity may be deemed a waiver of the act of production privilege because it constitutes consent to keep and produce records as a condition of carrying on the activity.

The court also upheld the district court's application of the Grosso test. While the taxpayer had argued that the first prong of the test requires that a regulation must be "essentially non-criminal," and that it could not be satisfied since "one of [the BSA's] primary purposes is to aid in criminal law enforcement," the Second Circuit agreed with its sister circuits that the three Grosso factors were satisfied.

The taxpayer further claimed that engaging in a regulated activity does not necessarily constitute a deliberate waiver of his act of production privilege, because individuals with such accounts may not be aware of the BSA's recordkeeping requirements. The court rejected this assertion noting that the Supreme Court has "strongly hinted that…there is no requirement of 'knowing' and 'intelligent' waiver of Fifth Amendment rights" and that there is no risk of self-incrimination where an account owner is truly unaware of the BSA's recordkeeping requirements. Finally, the court dispatched the taxpayer's argument that the government may only compel privileged testimony by granting immunity, noting that it depended on the inapplicability of the required records exception.

Conclusion

Given the now unanimous line-up of the circuits, the Supreme Court remains taxpayers' last hope to reinvigorate the Fifth Amendment in the context of subpoenas seeking records of previously undisclosed offshore accounts. However, while Justice Samuel Alito has shown an intellectual interest in the issue,[18] the Supreme Court has already denied petitions for writs of certiorari filed by the unsuccessful taxpayers in both the Seventh and Ninth circuits. Thus, absent a contrary decision by one of the six circuits yet to consider the issue, attorneys representing taxpayers with undisclosed offshore accounts need to develop new strategies for responding to subpoenas calling for records required under the BSA.

1. 31 C.F.R. §1010.420 promulgated under 31 U.S.C. §5314.
2. Jeremy H. Temkin, "Fifth Amendment and the Government's War on Offshore Accounts," New York Law Journal (Nov. 10, 2011).
3. See *United States v. Under Seal*, 737 F.3d 330 (4th Cir. 2013); *In re Grand Jury Proceedings*, No. 4-10, 707 F.3d 1262 (11th Cir. 2013); *In re Grand Jury Subpoena*, 696 F.3d 428 (5th Cir. 2012); *In re Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011*, 691 F.3d 903 (7th Cir.) rehearing and rehearing en banc denied, (2012) cert. denied, 133 S. Ct. 2338 (2013); *In re M.H.*, 648 F.3d 1067 (9th Cir. 2011) cert. denied, 133 S. Ct. 26 (2012).
4. *In re: Grand Jury Subpoena Dated February 2, 2012*, No. 13-403-cv, 2013 WL 6670733 (2d Cir. Dec. 19, 2013).
5. *Fisher v. United States*, 425 U.S. 391, 408-10 (1976) (holding that "the Fifth Amendment would not be violated by the fact alone that the papers, on their face, might incriminate the taxpayer").
6. 335 U.S. 1 (1948).
7. 390 U.S. 62 (1968).
8. 648 F.3d at 1069.
9. *In re Grand Jury Subpoena*, Misc. Action H-11-174, Doc. 17 (S.D. Tex. Sept. 21, 2011).
10. 852 F.Supp.2d 1020, 1021 (N.D. Ill. 2011) rev'd, 691 F.3d 903 (7th Cir.) rehearing and rehearing en banc denied, (2012) cert. denied, 133 S. Ct. 2338 (2013).
11. This rule was set forth in *Boyd v. United States*, 116 U.S. 616, 630 (1886).
12. 691 F.3d 903.
13. 707 F.3d at 1270.
14. 696 F.3d 428.
15. 737 F.3d 330.
16. —F.3d—, No. 13-403-cv, 2013 WL 6670733.
17. Case No. 13-403, Brief for Respondent-Appellant (2d Cir.), filed May 16, 2013, at *18-23.
18. Samuel A. Alito, Jr., Documents and the Privilege Against Self-Incrimination, 48 U. PITT. L. REV. 27, 72-73 (1986).