Strategies for Filing a Tax Return While Under a Criminal Tax Investigation

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Those persons or businesses targeted in a criminal tax investigation face a particular dilemma in filing a regular tax return that may provide leads to the IRS.

Each year, the Internal Revenue Service (IRS) investigates thousands of taxpayers who are suspected of having violated federal income tax laws. Most of these inquiries examine whether the individual has willfully underreported income, overstated deductions, failed to file tax returns or, in concert with others, acted to obstruct or impede the IRS in its role as the tax collector. The government's conviction rate in criminal tax cases exceeds 90%, and under the Federal Sentencing Guidelines, a convicted tax offender is usually incarcerated.

A person who is a subject or target of a criminal tax investigation cannot avoid various unpleasant circumstances. Dealing with the inquiry can be distracting and time-consuming. A broad range of family, friends, banks, accountants, business associates, and employees are likely to learn of the criminal inquiry because they are contacted by IRS Special Agents seeking information and documents. The IRS may ultimately recommend prosecution; the U.S. Department of Justice may authorize indictment; and a public trial may be on the horizon. Monitoring the investigation and mounting a defense generally involves substantial professional fees for lawyers, accountants, and investigators. When the case is over, there may be a hefty bill for taxes, interest, and penalties. There is also the severe emotional and psychological strain that arises from the uncertainty, anxiety, public exposure, and embarrassment of being suspected of or charged with a crime.

Of the sensitive issues that emerge during a criminal tax investigation, few rival the inherent complications presented by the simple truth that a taxpayer who is under investigation—like any other taxpayer—must prepare and file an annual tax return. This article will explore issues that arise when the filing deadline looms during an ongoing criminal tax investigation. It will analyze the types of criminal tax cases in which those issues become paramount, describe the limited extent of judicial direction, and focus on the tensions that sometime develop between clients, lawyers, and accountants when these issues emerge.

Typical Circumstances

Because most criminal tax investigations require the government to obtain and analyze voluminous financial information involving multiple years, the process usually takes more than a year to complete.

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Nevertheless, the Internal Revenue Code (IRC) requires that each year, every person with more than a threshold amount of gross income file a timely, accurate, and complete return that reports taxable income, deductions, and a tax liability. Thus, the target of a criminal tax investigation must go on filing, or in the case of a nonfiler, begin filing, current income tax returns during the course of the investigation.[1]

The target often faces a classic dilemma. Failure to file a return, or filing a return with material omissions or false statements, is a new criminal offense.[2] But a timely and accurate current return may hold real potential to incriminate the target or undermine a defense. This problem is most acute when IRS investigators have not yet zeroed in on all of the inaccuracies in prior returns. However, even if all of the alleged false items have been identified, a truthful return might still contain damaging admissions. Examples abound:

- If the taxpayer has omitted income from his return through a pattern of "skimming" cash receipts, an accurate current return will likely show an abnormal amount of receipts, giving rise at least to an inference, if not an explicit admission, of prior underreported income.
- A taxpayer may have omitted income from an undisclosed domestic or foreign bank or brokerage account. Schedule B to Form 1040 requires the taxpayer to itemize the source of all dividend and interest income, and inclusion of the account on a current return would lead an investigator to enquire whether it existed in prior years. If the secret account is a foreign account, the taxpayer may have additional filing requirements.[3]
- If a taxpayer has overstated deductions, a current return reporting the accurate amount will raise suspicions about the reason for a sharp drop in certain deductions and invite further scrutiny.
- A complete current return may disclose the taxpayer's beneficial interest in a domestic or foreign trust, partnership, or corporation that had been omitted from previously filed returns.

Corporate Entities. Where the taxpayer under investigation is a corporation or other taxable entity, there are similar problems. An accurate corporate return, for example, may show dramatically increased receipts or decreased expenses. In other cases, the return may provide an investigator a road map to income earned through a "shell" U.S. or foreign corporation, partnership, trust, or other such entity. A current return might also report a truthful inventory valuation, loss or credit carryover, or basis in an asset, any of which might be a damaging admission.

Nonfilers. Finally, when the IRS is investigating whether a person or entity willfully failed to file one or more returns, the potential damage from having to file a current return is especially serious. The return will provide the investigating agents with details about the taxpayer's sources of income and assets. It will be an admission that the taxpayer is aware of the filing requirement, which may help the government prove the element of willfulness. It will lock the taxpayer into a reporting position that may make it more difficult to raise a defense that certain transactions were not taxable events or that the taxpayer was not the beneficial owner of certain income producing assets.

There is no "audit lottery" when a taxpayer is under criminal investigation. The return will be examined, and there is no question that the government can use anything it contains as leads in the investigation and as evidence against the taxpayer if the criminal investigation matures into a trial.[4] Current tax returns are often indispensable to prosecutors in cases relying on an indirect method of proof, such as a proof of the taxpayer's net worth and expenditures, to establish unreported income in a prior year.[5] Such returns also may be disclosed for use in nontax criminal investigations.[6]

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Over the years, tax professionals have attempted to come up with devices that would permit a taxpayer under criminal investigation to fulfill the filing requirement without providing leads or jeopardizing defenses. Such approaches include: (1) Making an anonymous payment; (2) Sending a check to the IRS with a letter identifying the taxpayer and expressing a willingness to file, a concern that doing so will damage the client's defense, and a pledge to file the return when the criminal case is concluded; or (3) Filing a "John Doe" return with a statement to the effect that once the criminal case is over, the taxpayer will identify himself. However, the IRS does not recognize any of these approaches as valid, and the practitioner who recommends them arguably risks criminal or ethical scrutiny for assisting a client in skirting the obligation to file a truthful and complete return.

Fifth Amendment Returns

There is no magic solution for the problems of a taxpayer who faces the Hobson's choice of alerting the IRS to his prior fraud by filing accurate returns or compounding his criminal exposure by failing to file or filing falsely. Such a taxpayer can seek the maximum extension allowable by the IRC, but a return will be due eventually. An individual taxpayer then has the option to file a current return invoking the Fifth Amendment privilege against self-incrimination. This option is not available to a corporation, partnership, or other legal entity, however, because the Fifth Amendment protects only individuals.[7]

Even though an individual taxpayer may claim the privilege against self-incrimination to avoid making certain admissions on a tax return, there are limits to its availability. The privilege will not justify the failure to file a return or the omission of required information from a return. Nor will it justify any false, incomplete, or misleading statements on a return.[8] If a taxpayer claims the Fifth Amendment arbitrarily, or in response to most or all of the line items on a return, the IRS may not recognize the return as valid, in which case the taxpayer might be exposed to civil penalties[9] or a criminal charge under IRC Section 7203 for willful failure to file.[10] In addition, the IRS may take the position that such a return does not start the running of the statute of limitations for assessment of tax deficiencies.[11]

The taxpayer can validly assert the privilege against self-incrimination as to any line item on a return if there is a bona fide reason to anticipate that an accurate response might subject the taxpayer to criminal prosecution.[12] The taxpayer must assert the privilege explicitly, on the face of the return, with respect to each potentially self-incriminating item.[13] For example, the Fifth Amendment is clearly available to avoid disclosure of an unlawful or otherwise incriminating source of gross income reported on a return. It can also be invoked to avoid an incriminating declaration, such as in response to the question on Schedule B whether the taxpayer had signatory authority over any foreign bank accounts during the year.[14]

The circuit courts have disagreed about the extent to which the Fifth Amendment privilege can properly be invoked on a tax return. The Second Circuit has suggested in dicta that, under appropriate circumstances, a taxpayer can assert the privilege with respect to the amount of an item of income reportable on the return,[15] but other courts of appeal have made blanket statements that a taxpayer may not claim the Fifth Amendment to avoid disclosure of the amount of his or her taxable income.[16] In two decisions concerning tax protestors, the Ninth Circuit has rejected taxpayers' invocation of the privilege, but both cases involved unusual facts and the courts' opinions make clear that a taxpayer may claim the Fifth Amendment on a tax return when faced with a real and appreciable risk of self-incrimination.[17]

The Admittedly Incomplete Return

Another course followed by some practitioners avoids the invocation of the Fifth Amendment on an item-by-item basis. Instead, the target undertakes his or her best efforts to file a nonincriminating return that is as truthful and complete as possible. Usually, this means that certain items of income or expense are omitted or not reported in full, but the taxpayer includes with the return a statement designed to "fraud proof" the return.

The statement identifies the items that may not be accurate or complete and includes a narrative explanation that the taxpayer is under investigation and cannot provide all of the information requested on the return without revealing incriminating information or jeopardizing an available defense. The statement usually contains a pledge that, when the criminal matter is completed, the taxpayer will file complete amended returns and pay any additional tax due plus interest. The purpose of the statement is to render the return less useful to the government in the event the taxpayer is indicted and the government wants to use the return as evidence in the trial.

When undertaken in good faith, this approach may offer a rough tactical compromise of the target's dilemma—it avoids providing the government investigatory leads and diminishes the evidentiary value to the government of any admissions on the return. Although the government might theoretically try to prosecute the taxpayer for failing to file a complete return, or for filing a false return, the accurate disclosures in the statement should, as a practical matter, preclude a finding of criminal intent.

The Professional Dynamics of the Issue

The filing of a current return in the midst of an ongoing criminal investigation frequently introduces tension and disagreements among the client, the return preparer, and counsel. An attorney can ethically advise the taxpayer to use the Fifth Amendment privilege where appropriate. In all other respects, he should counsel the client to file a return that is truthful, accurate, and complete. Thus, a lawyer must advise the client to "turn square corners," even though the client will believe—in many cases correctly—that doing so will hurt his defense.

Any accountant preparing the taxpayer's current return will likely proceed with great caution. He may, for example, demand written confirmation from the client (or defense counsel) that the information provided for the preparation of the return is accurate and complete. He may also insist on taking conservative positions on any uncertain legal issue, as well as extraordinary steps to document deductions, credits, and other tax benefits.

If the accountant preparing the current return also prepared the returns under investigation, he will have an even greater incentive to act with care because his prior conduct will undoubtedly come under some scrutiny. It is a defense to a criminal tax charge for a taxpayer to demonstrate that he provided his return preparer with all relevant information and reasonably relied on the preparer with regard to the reporting of the item or items under scrutiny. Thus, the accountant who prepared the returns under investigation may be a witness—the government may seek to show that the preparer was not responsible for the improper return, or the defendant may attempt to prove that he was.

To complicate matters further, disclosures to return preparers are not protected under any evidentiary privilege. Thus, both the client and accountant must avoid communicating any fact to the accountant preparing the current return where that might entail making an incriminating admission about a prior return. One technique for accomplishing the investigative due diligence that is appropriate in such circumstances without prejudicing the interests of the client is to have the initial analysis of the taxpayer's current income

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and expenses performed by an accountant hired by defense counsel who can operate within the attorney client privilege.[18] The results of the initial analysis can then be passed on to the nonprivileged return preparer in a way that does not result in a general waiver of the attorney-client privilege.

In short, the problems created by the conflict between the client's obligation to file a return and his desire not to disclose damaging information by doing so often spill over to complicate the relationships among the professionals on the defense team. The best advice is to keep a cool head, acknowledge that there is no way to eliminate all of the client's risks associated with the requirement to file an accurate current return, and make sure that everyone involved is working to further the client's interest to the extent possible within the bounds of the law.

Conclusion

There is no simple solution to the dilemma presented when the annual filing requirement arises during a criminal tax investigation. Even though an individual target or subject of such an investigation may be able to claim the Fifth Amendment as to certain items on the return, in most cases he will have to file a return reporting the full amount of his taxable income. He may also be forced to make other damaging admissions. The careful professional must constantly remind his or her client that there is no risk-free solution to the predicament, and that, above all, the client should not compound the already severe situation by engaging in further criminal conduct. ■

[1]The pendency of the criminal investigation does not excuse the target from filing a return. United States v. Sullivan, 274 US 259 (1927).
[2]See IRC §§ 7201, 7203, 7206(1). Anyone who advises a target not to file or who assists in filing a false return has also committed a federal tax offense. See IRC § 7206(1); 18 USC § 2.
[3]Federal law requires any person with signatory authority over a foreign bank account to report such an interest to the IRS, not only on Form 1040, but on Treasury Form 90-22.1, the Foreign Bank Account Registration (FBAR). 31 USC §§ 103.24, 103.32. Failure to file this form is a separate violation of IRC § 7203.
[4]United States v. Dinell, 428 F. Supp. 205, 208 (D. Ariz. 1977), aff'd without op., 568 F2d 779 (9th Cir. 1978); United States v. Hornstein, 176 F2d 217, 220 (7th Cir. 1949).
[5]See, e.g., United States v. Mackey, 345 F2d 499, 504 (7th Cir.), cert. denied, 382 US 824 (1965).
[6]IRC §§ 6013(h), 6013(i).
[7]Curcio v. United States, 354 US 118 (1957). Thus, corporations and other entities generally have no option but to file an accurate and complete return. Depending on the facts, in some instances, a carefully drafted statement attached to the return can diminish the evidentiary value to the government of any admission on the return. But in general, the entity has no choice but to make potentially damaging disclosures, all of which may be developed as leads.
[8]See, e.g., United States v. Sullivan, 274 US 259 (1927); United States v. Raborn, 575 F2d 688 (9th Cir. 1978); United States v. Milder, 459 F2d 801 (8th Cir.), cert. denied, 409 US 851 (1972).
[9]Boday v. Comm'r, 759 F2d 1472 (9th Cir. 1985); Baskin v. United States, 738 F2d 975 (8th Cir. 1984).
[10]United States v. Daly, 481 F2d 28 (8th Cir.), cert. denied, 414 US 1064 (1973).
[11]Cf. National Contracting Co. v. Comm'r, 37 BTA 689, (1938), aff'd, 105 F2d 488 (8th Cir. 1939).
[12]United States v. Verkuilen, 690 F2d 648, 654 (7th Cir. 1982); United States v. Neff, 615 F2d 1235, 1238 (9th Cir.), cert. denied, 447 US 925 (1980).
[13]See Garner v. United States, 424 US 648 (1976); United States v. Jordan, 508 F2d 750 (7th Cir.), cert. denied, 423 US 842 (1975). Accordingly, the Fifth Amendment is of little use when the taxpayer is not under criminal investigation and his goal is to avoid IRS inquiry into a sensitive issue, or when the target is the subject of a nontax investigation but hopes to avoid detection of prior tax offenses.
[14]See supra note 3.
[15]United States v. Barnes, 604 F2d 121, 148 (2d Cir. 1979), cert. denied, 446 US 907 (1980).
[16]See United States v. Goetz, 746 F2d 705, 710 (11th Cir. 1984); United States v. Brown, 600 F2d 248, 252 (10th Cir.), cert. denied, 444 US 917 (1979); United States v. Johnson, 577 F2d 1304 (5th Cir. 1978).
[17]See United States v. Neff, 615 US 1235 (9th Cir.), cert. denied, 447 US 925 (1980); United States v. Carlson, 617 F2d 518 (9th Cir.), cert. denied, 449 US 1010 (1980).
[18]See United States v. Kovel, 296 F2d 918, 921 (2d Cir. 1961).