ANDREWS LITIGATION REPORTER

THOMSON WEST

White-Collar Crime

COMMENTARY

REPRINTED FROM VOLUME 19, ISSUE 3 / DECEMBER 2004

Criminal Tax Investigations and Current-Year Returns: New Thoughts on a Perennial Issue

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Criminal tax cases present many issues unique to the world of while-collar criminal practice, but perhaps the most complex and intriguing one arises from the annual requirement that every U.S. taxpayer file a timely, accurate and complete tax return, and the implications of this requirement for the target of the investigation.

Most criminal tax inquiries take more than a year to investigate, and thus persons under scrutiny by the Internal Revenue Service's Criminal Investigation Division have to "return to the scene of the crime" each year by confronting a filing likely to bear on one or more issues in the prior years' returns already under scrutiny.

The situation is fraught with peril for the target of the investigation — filing a complete and truthful return may provide important and incriminating leads to investigating agents; anything less risks expanding the inquiry to include the current year's filing as part of the criminal conduct.

For example, a taxpayer under investigation for having a previously undisclosed foreign bank account must still confront the question on the 1040 form asking whether, in the previous calendar year, he or she had signatory authority over or a financial interest in a foreign account. A "yes" answer, with the additional required information, would be a potentially incriminating admission. Failing to answer, or worse, a "no" answer, may be a new criminal offense.

Or, an accurate portrayal of a taxpayer's partnership or other holdings might reveal the existence of an entity not known to the IRS during previous years, in which the taxpayer might have attempted to hide substantial unreported income; yet failing to provide complete information on the current return may trigger additional charges.

Most starkly, an individual under investigation for failing to file a tax return in previous years confronts the annual dilemma every April 15 — not filing is a new offense, but any tax return will provide the investigating agent with important leads regarding issues relating to prior years.

For the lawyer, the situation is also complex. Advice to a client not to file, or to file anything other than a complete and accurate return, may run afoul of ethical rules or even prompt a view among federal prosecutors that the attorney has aided a client's submission of a false or incomplete tax filing.[1] Turning away from the issue is a disservice to the client and risks that the client will simply file false returns on counsel's "watch."

Inevitably, these issues create tension between the lawyer's obligation to turn square corners and the client's sheer disbelief not only that a return is required, but that it might have to contain admissions prejudicial to the defense of the criminal inquiry.

The current-return issue has been the subject of numerous previous articles[2] and is often discussed at programs relating to criminal tax fraud. This article will not rehash these old debates, but rather will describe some new case law and recent anecdotal experiences that suggest to this author that practitioners may wish to re-examine how they deal with the annual dilemma of advising a taxpayer under criminal investigation with regard to current filings.

Multiple Strategies

The U.S. Supreme Court ruled years ago that the Fifth Amendment was not a valid basis for simply failing to file a tax return.[3] Thus, over the years, criminal tax lawyers have developed creative approaches to this sometimes

confounding problem, and often disagreed with one another as to the right one. While some early strategies, such as filing an "anonymous return" or making an "anonymous payment," appear to have fallen out of favor, three general approaches appear to have emerged.

The first involves the selective assertion of the Fifth Amendment privilege on the return. It is well established that a taxpayer may assert the Fifth Amendment privilege on a tax return in response to one or more specific line items.[4] The privilege may not be used in response to every question on the return, nor can it be used arbitrarily.

Most circuits looking at the issue have ruled that the taxpayer must always report the total amount of taxable income, even if the privilege has been asserted as to the source or amount of a particular item.[5] For example, a taxpayer may decline to answer the question about foreign bank accounts or to identify the source of income earned in such an account, and instead may claim the privilege explicitly on the return as to those line items.

But because the taxpayer generally must provide a total amount for taxable income, the amount of income derived from any source as to which the taxpayer has asserted privilege may be apparent, if only by process of elimination.

To be sure, the assertion of the privilege and the inclusion of the income amount could provide important leads to an investigating agent, but providing materially incomplete information risks an allegation that no return was filed. The case law clearly recognizes the validity of an itemized and specific claim of privilege on a return, and such a claim will minimize the damage to a taxpayer under investigation while avoiding new offenses.

A second approach entails the filing of a return with an explicit disclosure statement noting the existence of the investigation and describing reporting decisions reflected on the return that relate to issues under scrutiny. Such disclosures may note, for example, why a taxpayer has reported one or more items in a manner consistent with prior years even though those very items are a subject of an investigation. Practitioners often advise taxpayers that such statements may operate to "fraud-proof" the return.

For example, a theme of some criminal tax investigations arises from a business owner's abuse of "shareholder loan" accounts, raising the question as to how to report such "loans" on a current return. The disclosure statement might note, in substance, that:

- The taxpayer's borrowings from his company are under criminal investigation as to previous years,
- The return reflects such transactions as they were on the company's books at year end; and
- If a final determination is made that those accounting entries are incorrect, the taxpayer will pay the additional tax and interest due.

In other instances, it may be that the mere mention of a particular transaction or entity might provide a valuable lead to an investigating agent. Here, a statement added to the return might, in addition to describing the investigation, contain a "buffered" Fifth Amendment claim, noting that the taxpayer has failed to provide information in response to certain line items because of the existence of the investigation.

In these circumstances, a practitioner may arguably be advising the client to file something slightly less than a complete return, but most experienced practitioners have believed that a prosecutor or investigator would be unlikely to make such a disclosure the focus of additional criminal tax charges and, in any event, no jury would likely convict a taxpayer for fraud arising from a return that explains why it is not complete. Whether these propositions have been put to the test in an intensive criminal tax investigation is not clear.

Third, some practitioners still advise their clients not to file returns during the investigation and instead to defer filing until the conclusion of the criminal case. Most (but not all) lawyers rendering this advice so inform the investigating agent or the IRS generally, with a promise that such returns will be filed when the investigation is concluded; many practitioners send a tax payment to the IRS with such a disclosure.

Tactics aside, though, the law is clear that the Fifth Amendment privilege against self-incrimination is not a valid basis for refusing to file a legally required form, and prosecutors have contended over the years that this strategy is improper. However, it is difficult to conceive of such advice as being sanctionable when appropriately disclosed, and to the extent the taxpayer relies in good faith, one would reasonably expect that the non-filings would not be deemed additional offenses.

New Questions

With this as a backdrop, recent developments in case law, and in certain situations observed by the author and others, call into question the viability of some of these various strategies.

First, it has become a well-accepted proposition that communications between attorney and client concerning

how items or transactions should be reported on a tax return are not protected by privilege.[6] The rationale is that such communications in the course of return preparation are not intended to be "confidential" because their underlying purpose relates to matter that will be disclosed to the IRS on the return.

Tax lawyers generally believe that certain conversations relating to returns not yet filed may nonetheless be subject to privilege; indeed, this is the underpinning of much of the privileged tax advice given in the commercial world.

Recently, however, in a series of cases in the tax shelter area, courts are emphasizing, and stretching, the concept of "return preparation," finding as non-privileged various pre-filing communications about items that may or may not appear on a tax return or some other required submission to the IRS, such as the investor list described in Internal Revenue Code Section 6112.[7]

With these new decisions, the application of the attorney-client privilege to pre-filing communications is increasingly doubtful, even as to clients under criminal investigation. Moreover, to the extent a taxpayer uses an accountant in the return preparation process, communications between the client and the accountant about the current filing, or, indeed, those between counsel and the accountant, are never privileged in the context of a criminal investigation.[8]

Second, the recent decision in the *Long Term Capital* case, even though it involved civil penalties, suggests that criminal tax investigators and prosecutors will be emboldened to investigate and reject potential "fraud-proofing" disclosures in future investigations.[9] Among the other issues raised in the case, the taxpayer attempted to assert a "reasonable cause" exception to civil penalties on the ground that it relied in good faith on certain legal opinions.

In response, the court held that good-faith reliance was absent when the attorney's tax shelter opinion was premised on "assumptions" and "representations" that the taxpayer should have realized were false. It is a small step from this proposition in a civil penalty case to a criminal tax investigation — a skeptical investigator may include an element on a current return as a criminal item, notwithstanding a disclaimer drafted by counsel, where there is strong evidence that the taxpayer should have known or probably did know better.

Indeed, investigators and prosecutors increasingly appear to be taking issue with the notion that one can "fraud-proof" a return by making a textual disclosure relating to the reporting of certain items. In one case, the government recently demanded as part of a plea agreement that the taxpayer acknowledge wrongdoing with regard to certain items on a return when the return contained a disclosure statement of the sort described above, and the reporting positions taken on the return were based on the advice of capable return preparers and counsel.

The items on the return at issue related to shareholder loans, and the prosecutor and agent argued the amounts of the "loans" in question were so egregious that no taxpayer signing the return could have believed in good faith that it was correct, regardless of any disclaimer.

Perhaps more important, there was evidence at the time the return was prepared that the taxpayer and his employees had not been candid with the professional advisers, diminishing the strength of the "reliance on professional advice" defense.[10] Given these views, the prosecutor and agent considered both the broad disclosure statement and counsel's role in advising on the reporting position to be irrelevant.

Third, in at least two cases known to the author, the government, as part of a menu of proposed felony charges, recommended failure-to-file or tax-evasion counts for one or more years during which the taxpayer under investigation failed to file a return *on the advice of his criminal defense counsel*.

In one case, the taxpayer had been under investigation for failing to report income earned on an undisclosed foreign bank account; in the other, the government claimed that the taxpayer had submitted a fraudulent offer in compromise in an earlier year. In both instances, the taxpayer's criminal lawyer had advised that returns not be filed during the investigation but did not disclose this to the investigating agents.

In the case over the foreign bank account, the taxpayer, apparently also with counsel's knowledge, had subsequently filed an amended return seeking a refund as to an earlier year, leading the government to believe that taxpayer and his counsel had decided that it was alright to file when the client might get money back, but not when he would owe tax.

In the second case relating to the potentially fraudulent offer in compromise, the government maintained that the non-filing was part of the overall fraud. Perhaps thinking that in failing to file, the taxpayer avoided disclosing to the IRS the magnitude of his actual income, his counsel was deemed an unwitting participant. In both instances, for these reasons the government dismissed the advice-of-counsel defense.

Not filing returns during a criminal tax investigation also runs the risk of complicating matters at the time of a pre-sentence investigation. In the post-conviction phase, the defendant almost always must submit recent tax returns to the Probation Office. A practitioner cannot knowingly submit a false tax return to a probation officer, since doing so obviously would be both unethical and a separate federal offense. Thus, if the returns submitted are those that were the focus of the criminal investigation, most lawyers will notify a probation officer that the returns are not accurate for the very reasons that led to the client's conviction.

However, if there are no recent returns to submit, this will quickly be made known to the Probation Office and may influence the court's sentencing decision. It may be that the court will not care that the taxpayer was advised by counsel not to file. What lawyer wants to be called before a U.S. district judge to explain that advice?

And if the taxpayer hurriedly prepares returns to file during the pre-sentence investigation, one can imagine that the special agent who worked the case will review them with great care to ascertain whether they present additional issues that ought to be raised prior to sentencing.

These developments taken as a whole reflect new perils for practitioners whose clients have to "return to the scene of the crime" every April 15.[11] It is apparent that notwithstanding counsel's best efforts to avoid compounding a client's difficulties when filing season rolls around, decisions made in one year may, months or even years later, increase the client's exposure and subject the practitioner's own conduct to scrutiny.

Implications

Practitioners advising clients in criminal tax cases generally know that they need to be deliberate and careful about decisions made and advice given when the time comes to file a current tax return. The lawyer who advises a taxpayer to file a false or incomplete return surely risks potential sanctions.

With the Justice Department's Tax Division, the IRS Criminal Investigation Division and the newly energized IRS Office of Professional Responsibility focusing more on practitioner conduct, making judgment calls as to advising a client on current-return issues may present increasing risks. There are at least three implications from these recent developments.

Always advise the client to file. It seems clear that, however expedient, telling a client not to file a timely return during a criminal investigation is not the right strategy. Tax Division prosecutors routinely take the position on panels and in speeches that the Justice Department's view is that there is no legal basis for a taxpayer under investigation simply to decline to file a return, and their position is supported by case law. (This position was reiterated quite clearly by prosecutors to the author in conferences on the recent cases referred to above.)

Even if the tax is paid and counsel's advice not to file is made known to the investigating agent, a new agent or an aggressive prosecutor may disregard that understanding when the time comes to prepare for trial, negotiate a plea or allocute at sentencing. Not having current-year tax returns to give to a probation officer at the beginning of a pre-sentence investigation may raise more questions than one wishes, and if returns remain unprepared at the time of sentencing, the strategy risks putting the taxpayer in a worse light before the court.[12]

Finally, the client must also confront the problem of filing state returns, risking the possibility of a separate inquiry for failing to timely file at the same time the client remains under federal scrutiny.

In the cases described above where taxpayers did not file based on the advice of counsel, various aggravating factors led prosecutors to discredit the "reliance" defense and include the years as part of the criminal referrals. Even without such aggravating factors, however, in the current climate — with increased scrutiny on practitioner conduct — it seems unwise to tell a client not to file a current return.

Recognize that advice concerning the current return may not be privileged. In light of the recent decisions in the tax shelter context, a court might find the attorney-client privilege inapplicable to conversations between lawyer and client relating to the return preparation, even in the midst of a criminal investigation. Thus, for the client's protection, counsel must be wary about such communications.

This will undoubtedly constrain the frank and open discourse one hopes to have between client and lawyer, but there is a risk that counsel might be made a witness against his client. Unfortunately, counsel's hesitance with regard to discussing the current-filing issue will exacerbate the client's anxiety in an already tense atmosphere. And in many cases, the accountant preparing the current return is also a witness in the investigation as to prior years, making it all the more difficult for counsel to obtain information about the pertinent issues.

It may be that these communications can be placed in a context that would be privileged, at least in large part.

After all, the client's criminal tax lawyer will undoubtedly be aware of the issues under investigation and how they might impact on certain items required to be reported on the current return.

Discussing the issues in the context of developing defenses, understanding what employees are likely to tell the government, reducing exposure under applicable sentencing guidelines and, if the situation warrants, preparing for a pre-sentence investigation should all fall within the ambit of protected communications.

Counsel might simply spell out options available to the client regarding the current return, such as selective assertion of the Fifth Amendment privilege or the filing of a detailed disclosure, without first undertaking a detailed factual inquiry in an unprivileged setting. If instructions need to be given to a return preparer, such instructions can be limited to the absolute minimum that the accountant needs to know, such as the language for the return and where it should go.

While the correct strategy is based on the facts and circumstances, assertion of the Fifth Amendment may create fewer problems than a "fraud-proofing" disclosure. What appears to emerge from these recent developments is that, when possible, the selective assertion of the Fifth Amendment on the tax return may be a better choice than struggling over a disclosure statement.

It would not be surprising if investigators or prosecutors, empowered by decisions such as *Long Term Capital*, undertook an inquiry into whether the taxpayer could reasonably believe — regardless of any disclaimer — that a particular item on the current-year return was in fact reported or characterized correctly. In a potentially unprivileged setting, such an inquiry would be unpleasant on any number of fronts.

Moreover, advising the client to claim the privilege against self-incrimination may avoid the need for counsel to undertake a more detailed inquiry necessary to draft an appropriate disclosure statement. One lesson from the cases described above may be that while a general disclosure statement may be discredited, a more specific one might be recognized as appropriate. However, to obtain the facts necessary for drafting an appropriately detailed disclaimer would require substantial communication over the subject in a potentially non-privileged setting.

The assertion of privilege on the current return should not prejudice the client in the pre-sentence investigation. By that time, the criminal case is over and the reason for the privilege claim will probably be obvious. Counsel can explain to the probation officer why the client took the Fifth Amendment on the return, and the issue can be dealt with during the inevitable civil examination that follows.

Having said all of this, however, the right tactic may depend on the return item at issue. In some contexts, the current-return item is straightforward and a privilege assertion is relatively simple. For example, the taxpayer under investigation for failing to disclose a foreign bank account can assert the privilege on the current return as to the foreign bank account question and the source of additional income.

Similarly, when the taxpayer is under investigation for skimming money out of a business or receiving funds in the guise of potentially sham shareholder loans, the amounts can be included in taxable income with an assertion of the Fifth Amendment privilege as to source. Under the case law, so long as the taxpayer reports the total amount of his taxable income, the return should be acceptable.

There will be times, however, that crafting a legally acceptable, specific assertion of the Fifth Amendment privilege may be difficult, particularly when the client seeks to omit amounts from taxable income so that his current return is consistent with positions taken during the years under investigation. If there is a valid reporting position for excluding the item(s) at issue, then a specific disclosure statement describing the basis for the omission(s) in the context of the criminal investigation would add some protection for the client.

Absent a valid basis to exclude an item, though, the options are limited. While the client is apt to resist the admissive implications of deviating from prior practice, an omnibus Fifth Amendment claim, to the effect that the return omits one or more items, but noting that further explanation would be self-incriminating, appears to violate the prohibition against a non-itemized assertion of the privilege.

Moreover, the Fifth Amendment privilege protects only individuals, and thus is not available for assertion on returns for corporations, partnerships and other entities.[13] Thus, when current filings entail more than a 1040 form, it may be that a specific, well-crafted disclosure statement is the only practical and arguably permissible available choice, even though it requires discussion in a potentially non-privileged environment and may have to reveal details of the investigation or particular reporting positions.

One final caveat: this entire article relates to clients who are already under criminal investigation. The choice of strategies with regard to current filings is vastly different for a client who may have committed tax fraud but is

under civil audit, not a criminal investigation (often called an "eggshell audit").

Obviously, the assertion of the Fifth Amendment on a current return likely to be submitted during the audit waves a red flag in front of the civil examiner and is a strategy to be avoided if at all possible. In such a case, a carefully worded disclosure statement may be the better choice, but counsel should continue to recognize that discussions with the client over the issue may not be confidential, and that if the case does turn criminal, the disclosure may not protect the client from an investigator's conclusion that the return should be part of the criminal case.

Selective assertion of the Fifth Amendment privilege, when possible, may offer the less risky approach to current-filing issues. It avoids the need for a prolonged set of discussions that might themselves be subject to disclosure. Often, the current-return issues arise before defense counsel fully understands the issues presented in the case, and thus it appears to be a safer course than making snap decisions on how to characterize items on a return in a high-pressure setting.

The claim of privilege itself may provide leads to a careful investigator, and in most jurisdictions the taxpayer must state his total taxable income, but a specific disclosure statement rarely presents any less prejudice to a client already under criminal scrutiny. The fact is that the Internal Revenue Code requires the taxpayer to file a timely, accurate and complete return, and it is not a perfect world.

Conclusion

When criminal tax lawyers congregate, this tactical issue often generates the most discussion. The problem drives a "wedge" between lawyer and client — the lawyer has to comply with legal and professional obligations, while the client cannot imagine that simply filing the current-year return may compound the problems presented by the investigation.

Lawyers who do not practice routinely in the criminal tax area should appreciate that the decisions with regard to the current filing are just as important, and subject to just as much scrutiny, as any other tactical decision made during an investigation. Experienced criminal tax practitioners may want to give a fresh look to their customary strategies.

And, not surprisingly, discussion about this difficult issue should continue, as we strive to develop the best approach aimed at helping our clients solve this delicate problem while still acting in compliance with the law.

Notes

[1] A filing that does not contain the information necessary for computation of a tax liability is not considered a tax return, and can be the basis of a prosecution for failure to file. *See, e.g., United States v. Jordan*, 508 F.2d 750, 752 (7th Cir.), *cert. denied*, 423 U.S. 842 (1975); *United States v. Daly*, 481 F.2d 28 (8th Cir.), *cert. denied*, 414 U.S. 1064 (1973). Aiding a client in this manner might violate 26 U.S.C. § 7206(2), or under the principles of 18 U.S.C. § 2, other sections of the Internal Revenue Code, *e.g.*, Section 7203 or 7201.

[2] *See, e.g.,* Richard E. Timbie and Scott D. Michel, *Strategies for Filing a Tax Return While Under A Criminal Tax Investigation*, 2 JOURNAL OF ASSET PROTECTION 34 (September/October 1996); John S. Siffert and Michael Saltzman, *The Fifth Amendment and Tax Returns: The Viability of the Deferred Filing/Current Payment of Tax Approach Pending a Criminal Investigation*, 4 WHITE COLLAR CRIME REP. 1 (1990).

[3] *United States v. Sullivan*, 274 U.S. 259, 263 (1927).

[4] Selective assertion of the Fifth Amendment privilege on the face of a tax return is appropriate in limited circumstances. *See, e.g., United States v. Verkuilen*, 690 F.2d 648, 654 (7th Cir. 1982); *United States v. Neff*, 615 F.2d 1235, 1238 (9th Cir.), *cert. denied*, 447 U.S. 925 (1980).

[5] *See United States v. Goetz*, 746 F.2d 705, 710 (11th Cir. 1984); *United States v. Brown*, 600 F.2d 248, 252 (10th Cir.), *cert. denied*, 444 U.S. 917 (1979); *United States v. Johnson*, 577 F.2d 1304, 1311 (5th Cir. 1978). *Cf. United States v. Barnes*, 604 F.2d 121, 148 (2d Cir. 1979), *cert. denied*, 446 U.S. 907 (1980).

[6] *United States v. Frederick*, 182 F.3d 496, 500 (7th Cir. 1999), *cert. denied*, 528 U.S. 1154 (2000); *United States v. El Paso Co.*, 682 F.2d 530, 539 (5th Cir. 1982), *cert. denied*, 466 U.S. 944 (1984).

[7] *See., e.g., United States v. BDO Seidman*, 337 F.3d 802 (7th Cir. 2003); *United States v. KPMG LLP*, 237 F. Supp. 2d 35 (D.D.C. 2002), *further proceedings*, 316 F. Supp. 2d 30, 42 (2004).

[8] Criminal tax lawyers often bring accountants under the attorney-client privilege through the use of *Kovel* engagements. *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961). However, such accountants are usually assisting counsel in developing defenses to the potential criminal charges, and the application of the privilege when such an accountant crosses over into return preparation is doubtful. Most practitioners in fact do not use the *Kovel* accountant to prepare returns, for this very reason. Moreover, the limited privilege afforded by Internal Revenue Code Section 7525 is inapplicable in criminal investigations.

[9] *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004).

[10] The defense of "reliance on professional advice" rebuts a claim of criminal intent where the practitioner was aware of all relevant facts, the practitioner rendered advice about the item in question and the taxpayer relied on that advice in good faith. *See., e.g., United States v. Charroux*, 3 F.3d 827, 831 (5th Cir. 1993); *United States v. Meyer*, 808 F.2d 1304, 1306 (8th Cir. 1987).

[11] Or more accurately perhaps, Oct. 15, as nearly all practitioners advise taxpayers under investigation to extend as far out as possible the deadline to file their 1040 forms.

[12] Having new or amended returns prepared in time for sentencing may seem a simple answer, but the complexities of a criminal tax case are often such that practitioners would much rather wait until the IRS conducts its civil examination, which comes following the closure of the criminal case, and proposes adjustments, instead of having the taxpayer take a position on a set of newly prepared returns.

13 *Curcio v. United States*, 354 U.S. 118 (1957).

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