

# Tax Crimes: Kicking the Hornet's Nest

## Both lawyer and client can be stung in an IRS investigation

BY ROBERT S. STEINBERG

**A** divorce case is often shrouded in a fog of anger and suspicion. Suspicion begets accusation, and truth frequently becomes a victim of mistaken memory or intentional distortion. Groping in the fog becomes dangerous for both spouses and lawyers when accusations involve the parties' tax filings. Family lawyers must be alert to potential tax crimes and understand that the objectives in the divorce proceeding may clash with protective measures designed to mitigate potential criminal tax violations.

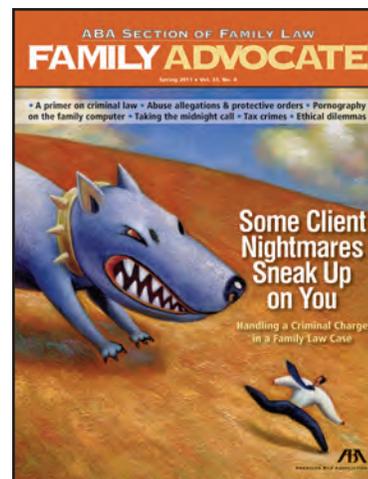
Accusations about tax matters may involve unreported income, claimed deductions for personal living expenses, false statements to tax authorities, unreported foreign bank accounts, and/or specific transactions or other tax-related items. The accusations may all have financial implications for the divorce case, affecting such issues as the amount of alimony and the distribution of assets, as well as the credibility of the spouses in the eyes of the court.

Implications on the tax side involve more than financial concerns, however. If accusations are provably true and become known to the IRS, the client may face incarceration and increased tax liability, plus civil and criminal monetary penalties. Although state divorce proceedings and mediation mandate disclosure of relevant information, criminal tax defense emphasizes legally limiting disclosure of potentially incriminating evidence. Thus, there is a conflict of purposes as well as a disharmony of consequences between divorce representation and a criminal tax defense.

### Divorce counsel for the accuser

Since spouses often harbor unfounded suspicions about a mate they are divorcing, counsel must initially ascertain whether an accusation of tax fraud merits further investigation. The naked statement, "My husband has a Swiss bank account," without the slightest corroborating shred of proof, may turn out to be true, but not provable, under even the civil burden of a preponderance of the evidence, much less beyond a reasonable doubt. The client's suspicions should therefore be vetted under the veil of the attorney-client privilege. After being retained, the lawyer can inquire into the client's concerns about previously filed tax returns or suspected tax indiscretions. The lawyer can probe why the belief is held and whether independent proof exists in documents and/or testimony of others.

The evaluation of accusations for the divorce case will most likely come down to a cost-benefit analysis. How much time should be expended to attempt to locate evidence of additional income and/or unreported assets, taking into account the cost of the investigation? From a tax vantage point, the deliberation is not cost related, but goes to protecting evidence and preserving privileges.



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## **The forensic accountant**

If the accusation of tax fraud appears to have merit, a forensic accountant should not be employed until tax issues are resolved. Instead, a tax lawyer should advise the client and supervise the conduct of a tax investigation for the specific purpose of determining if tax crimes have been committed and to mitigate the client's exposure. The other side should be advised of developments and that the divorce case should not continue until tax issues are resolved.

If the lawyer believes the accusation of tax fraud lacks merit, the divorce case can go forward, but the forensic accountant should be advised to immediately report to the lawyer any suspicions of tax improprieties and told not to discuss such matters with anyone, especially not the client. If evidence of tax crimes arises, consult a tax lawyer and initiate the process outlined above.

The forensic accountant has no client communication privilege because the CPA's tax advice privilege under I.R.C. section 7475 (Internal Revenue Code of 1986, as amended) evanesces in criminal tax matters. The attorney-client privilege will not cover a forensic accountant who is employed to give testimony in a divorce case. Moreover, it may be difficult or impossible to segregate consulting services from expert services. Documents created by the forensic accountant will not constitute attorney work-product because they will have been prepared in support of the expert's testimony and therefore are discoverable.

Documents given by the client to the expert will lose Fifth Amendment protection. Thus, the forensic accountant should not be employed in a tax investigation unless counsel wants to give the government a star witness. Instead, the tax lawyer should employ an accountant, often called a Kovel accountant for the named case, to assist counsel in rendering legal services to the client. The Kovel accountant should not prepare tax returns because tax preparation is not considered a legal service and information going into the tax return is therefore not attorney-client privileged.

## **The tax lawyer**

One tax lawyer should not represent both spouses in sorting out potential criminal tax issues. Although a joint defense agreement may preserve privileges, basic, inescapable conflicts-of-interest are inherent in the parties' divorce case, without taking into account that each spouse may bear a different level of knowledge and culpability concerning tax indiscretions. Even if equally culpable, the evidence may not be equally incriminating. A single lawyer may initially consult solely to explain to counsel certain tax matters, such as the workings of the IRS voluntary disclosure program. Keep the discussion hypothetical, however. This discussion may help counsel brief divorcing spouses and determine if formal tax representation is appropriate.

## **Informant spouse**

The accusing spouse will want counsel to threaten his or her spouse with disclosure. Such threats violate ethical cannons and may lead to bar disciplinary proceedings. The spouse with or without counsel's knowledge may call the IRS. The IRS receives many such calls, but does not commence a full-blown criminal tax investigation on every call. Such an investigation will not console the informant spouse, who also may become a target, absent an immunity agreement. Even then, marital assets may be substantially depleted by additional tax, a civil fraud penalty, and criminal fines. The informant spouse who escapes prosecution may not qualify for Innocent Spouse relief, because he or she had knowledge of the impure tax transaction or item and may even be asked to sign a closing agreement, accepting joint and several liability should the accused spouse enter into a plea agreement with the government. By that

time, practical considerations may have overcome anger in guiding decision making. At that time, the nonguilty spouse, in any event, should have separate tax counsel.

## **Common problems and mistakes**

The following common situations arise in a divorce case and are often mishandled without the guidance of a tax lawyer.

**1. Unfiled returns:** The knee-jerk reaction of most accountants is to file the returns as soon as possible. The error of acting quickly flows from the fact that a tax crime is committed or not committed as of the due date of the return for the year in question. Was a return due and was failure to file on that date intentional or negligent? Filing acknowledges that a return is due and leaves open only one question: On the due date, did the taxpayer know that a return was due and willfully choose not to file or was he or she merely negligent?

Accountants always say, "I've never had a client prosecuted for failure to file." Such anecdotal evidence is not comforting. In 2009, the government initiated 4,121 criminal tax investigations. Thus, how likely is it that one will be prosecuted? The answer is very likely if you are selected for the honor. In 2009, the government prosecuted 2,335 cases and obtained 2,105 convictions, with 81.2 percent resulting in prison time. Keep in mind that the consequence of being investigated, let alone charged, is horrendous and somewhat akin to playing Russian Roulette with a 1,000-chamber gun. The loaded chamber is unlikely to come up, but if it does, the game is over.

Moreover, willful neglect and willful criminal conduct are both defined as the intentional violation of a known legal duty. Thus, the difference between a civil penalty and criminal charge may come down to the more stringent burden of proof in a criminal case. That gives enormous discretion to the prosecution. Before returns are filed, a tax lawyer should investigate whether aggravating factors would prevent the filing from being accepted as a voluntary disclosure and to ensure that returns are accurate to a "punctilio of an honor."

**2. Error in previously filed joint return:** The considerations in amending returns are similar to filing returns late. An amended return admits that the original return was incorrect and that additional tax is due. To make a tax evasion case, the government must then prove that the falsity on the original return was material, known at the time of filing, and willful. These questions should be answered by tax counsel's investigation prior to filing the amended returns. The amended returns do not cure a tax crime, but if filed voluntarily, may cause the IRS to conclude that a conviction is unlikely.

**3. Offshore bank accounts and voluntary disclosure after October 15, 2009:** Taxpayers who did not come in from the cold before October 15, 2009, by making a voluntary disclosure, have a more complex minefield to traverse and potentially more expensive process to complete in coming clean. The considerations are multifaceted and beyond the scope of this article. See a detailed explanation in "The Cold Gets Colder," March 6, 2010, at [steinbergtax.law.com](http://steinbergtax.law.com). Also see, "IRS to Offer Second Amnesty for Hidden Accounts," NY Times, Jan. 24, 2011.

**4. Unreported cash and/or overstated deductions:** The considerations are the same as for amended returns.

**5. Eggshell audit in progress:** This is an audit in which the IRS auditor may potentially refer the case for criminal investigation, but there also is a reasonable possibility that the case can be closed civilly. A CPA alone should not handle this kind of audit, because this is an area in which tax accounting crosses over into tax law.

**6. Criminal grand jury or CID investigation in progress:** Obviously, the divorce case should take second seat, given the severity and potential consequences of these matters, and tax counsel should be in charge.

## **Tax crimes**

Following are some of the most commonly charged tax and tax-related crimes with the maximum sentence and fine noted in parentheses.

**1. Tax evasion (section 7201):** The elements of the primary tax crime are the existence of a tax deficiency, an affirmative act of evasion or attempted evasion of tax and willfulness. A good faith belief in an erroneous tax position is a defense to this charge because it negates willfulness (five years/\$250,000). This violation often, but not always, involves repeated tax fraud perpetrated over several years.

**2. Willful failure to collect or pay tax (section 7202):** The violation often involves an intentional failure to deposit withheld payroll taxes. A business spouse under financial pressure during a divorce will sometimes be tempted to finance his lifestyle by suspending payroll tax deposits. The government need not prove that a taxpayer had sufficient funds to make the deposit or that the taxpayer's lavish lifestyle caused the lack of funds. (five years/ \$250,000).

**3. Willful failure to file return, supply information, or pay tax (section 7203):** This is a misdemeanor tax crime for acts of omission, such as willfully failing to file a return, to pay estimated taxes, to keep records, or to supply required information. (one year/\$250,000). Willful omissions can be elevated to tax evasion in cases where the taxpayer has used fictitious names, nominees, concealed assets, or committed other overt acts to cover up the omission. Caveat: Using concealment tactics to hide assets from a spouse may be misconstrued by the IRS as concealment for tax evasion if returns have not been filed or return contains an intentional understatement of taxes due.

**4. False returns and aiding and abetting (section 7206):** The material falsity in the return under this tax crime need not result in a tax deficiency, as is the case for tax evasion. The declaration on the return expressly alerts one to the fact that he or she is signing under penalties of perjury. Innocent Spouse rules that relieve a joint-filing spouse from joint and several liability for the taxes due do not offer immunity from prosecution for a willfully made false statement in a return, because the false statement may not relate to the transaction causing the tax deficiency. The moral: Don't sign a return unless you reasonably believe that every statement in it is true and accurate (three years/ \$250,000). An aiding-and-abetting charge can relate to a return preparer or to an attorney.

**5. Submitting false documents (section 7207):** This violation most often occurs during an examination upon delivery of a document to an IRS agent known at the time to be fraudulent or false as to any material matter (one year/\$10,000).

**6. Attempts to interfere with administration of tax laws:** In addition to forcible threats, violations encompass broadly any act that corruptly obstructs or impedes or endeavors to obstruct or impede the due administration of the I.R.C.

**7. Conspiracy (18 U.S.C. section 371):** There are two distinct conspiracy offenses: (1) conspiracy to commit an offense against the United States, and (2) conspiracy to defraud the United States. A tax conspiracy involves an agreement to commit tax evasion, with knowledge and participation, and, an overt act in furtherance of the

scheme committed by at least one conspirator. The conspiracy, charge along with aiding and abetting, is used mostly to prosecute accountants and attorneys (if underlying crime is evasion, five years/\$250,000).

**8. Money laundering (18 U.S.C. section 1956):** Money laundering in relation to tax crimes may occur when one conducts certain financial transactions to promote or conceal the evasion of taxes (20 years/\$500,000 or twice the value of the financial instrument).

**9. Willful failure to file FBAR (31 U.S.C. sections 5321, 5322):** Willful violation of the FBAR (TDF 90.22-1) reporting requirement of the Bank Secrecy Act. (Generally five years/\$250,000; but, if combined with civil and criminal penalties, can be much higher. If other laws are violated, sentence can increase to 10 years.)

## Conclusion

Divorce cases are difficult and made more so when criminal tax issues are present. The family lawyer must be alert to the suggestion of criminal tax issues and know when to step cautiously, lest he or she unwittingly kick a hornet's nest. The divorce can be stung by a criminal tax investigation, or the lawyer may feel the personal sting of a tax conspiracy or an aiding-and-abetting charge. **FA**

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## Ultimate sting: Kicking the hornet's nest

Consider the following: Divorcing spouses are engaged in mediation and have resolved all issues except alimony. It is getting very late in the day, and everyone is weary of the process. The parties are stuck on alimony, which the nonbusiness spouse wants as nontaxable. To soften the financial blow and close the deal, the mediator suggests that the business spouse pay personal expenses of the nonemployee homemaker spouse from his business in lieu of paying direct alimony. In that way, it is suggested that the business spouse will obtain a tax deduction, whereas the homemaker spouse will have no taxable income.

The lawyers and parties agree to this approach and begin to incorporate language into the mediated marital settlement agreement. One of the lawyers asks during dictation whether claiming these deductions by the business is legal. The business spouse's accountant, also present, interjects, that, "although not technically legal, this sort of thing is common practice and no different from the spouse's already deducting his own automobile expenses, which also are personal." He adds, "The company has never been audited, and the expenses, although significant, are not large in relation to the company's gross revenue."

The agreement, including the expense payment provision, is signed and filed with the court. The accountant later prepares the tax returns, which the business spouse files. He or she claims the deductions, without attributing any income to the non-business spouse, who, in turn, fails to report these payments as income.

The parties, the mediator, attorneys, and accountant in so agreeing have turned collaborative law into putative conspiratorial conduct. Some or all of the conspirators may have together or alone committed other tax offenses under the Internal Revenue Code, including tax evasion, aiding and abetting, and filing a false return—all serious felonies.

## Divorce counsel for the accused

Discuss tax accusations with your client. Forcefully stress that false denials now could result in the unintended waiver of privileges, and the court later may order compulsory testimony at the request of the government. If accusations are true, make every effort to resolve the case outside of court and before discovery has been undertaken or mandated. If the case moves forward, some or all of the following may occur:

- The other spouse may become more frustrated and turn informant.
- The client will be deposed and may make cover-up false statements under oath, which become competing perjuries with false statements made in the tax returns.
- Mandatory disclosure and discovery will take place. Personal papers eligible for Fifth Amendment protection may be produced and lose the protection.
- Assertion of a Fifth Amendment privilege will almost certainly prejudice the asserting spouse in the divorce case because portions of state-required disclosure or requested discovery will not be provided.
- The IRS may become aware of the accusations and target one or both spouses for criminal investigation. This may occur when a civic-minded judge, upon hearing testimony, calls the IRS on his or her own initiative.
- The forensic accountant may overhear incriminating statements or come into possession of incriminating documents and be required to testify for the government.
- The client will have to file a financial affidavit under penalties of perjury. The affidavit will either be false or may conflict with previously filed tax returns, also filed under penalties of perjury, or may disclose assets and income sources not reported in previously filed returns.
- The outcome of the divorce case will damage the credibility of the accused spouse in the eyes of the court.
- The spouse who threatened disclosure may cause the IRS to view any corrective action as nonvoluntary.
- Evidence of crimes not immediately brought to the IRS's attention hangs out to dry like dirty laundry for years.

—R.S.S.