Between a Rock and a Hard Place: The Preparation and Filing of Sensitive Tax and Information Returns, and the Practitioner's Dilemma

*By Richard J. Sapinski and Eric L. Green**

Richard J. Sapinski and Eric L. Green discuss defending someone under investigation in a criminal tax case and examine how these cases can get complicated by "sensitive tax returns."

Introduction

Defending someone under investigation for any crime is a daunting task for defense counsel. The task is even harder in a criminal tax case because the suspected criminal conduct may have continued into part of the current tax year for which the tax reporting has not yet been done. Moreover, the criminal conduct (even if it has now stopped) impacts what will have to be reported on tax filings to be done for the past year that are coming due in the current year. Continuing the prior way of reporting (or nonreporting, as the case may be) adds potential additional criminal charges for the future false filings and is not an option. However, filing a truthful return for either the immediate past year or the current one may prove that the prior years were falsely filed or provide leads confirming the government's suspicions about the past reporting. Let us consider a scenario that may arise in a typical criminal tax case.

It is now August 2015. Joe (a landscape contractor) has just retained you because the IRS Criminal Investigation Division (IRS-CI) has opened a criminal tax

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investigation of him and his business. Joe has been paying cash wages to nine of the 12 employees in his landscaping business, and some of the cash is paid to undocumented aliens. Joe has neither reported the cash payroll on the Forms 941 he has filed nor issued his employees proper W-2s (no W-2s at all are issued to the undocumented aliens). The cash is generated by Joe cashing business receipts checks instead of depositing them in his business account. Because Joe did not deposit these checks, Joe's accountant did not see them and used the deposits shown on Joe's business bank statements to report Joe's Schedule C gross receipts. Joe's income and payroll tax returns are thus false for the last five or more years. The investigation seems to have started last month.

A taxpayer required to file a return during the pendency of a government investigation into her affairs faces a troubling dilemma, to which there is no clear solution.

Joe asks what to do about the current reporting. It is the middle of August, and both his 2014 Form 1040, *U.S. Individual Tax Return,* and third quarter 2015 Form 941, *Employer's Quarterly Federal Tax Return,* will be due in October. He has stopped the cash payroll and replaced the undocumented aliens, but for part of this quarter, they got cash wages and his regular employees also got part of their wages in cash until they went fully onto payroll last week. Should he file a third quarter 2015 Form 941 that reports the correct wages, or should he continue not reporting the cash already paid for this quarter and start fresh next quarter? What should he do about the 2014 Form 1040? Should he report the correct total gross receipts? Should he claim the cash payments to the employees? What about year-end W-2s?

These questions are particularly thorny in tax cases, because the investigating agency (the IRS) will also be the recipient of the future filings. It is thus easy to see why returns that come due while a taxpayer is under investigation are often dubbed "sensitive tax returns."

Essentially, someone in Joe's situation has three options—none of which, as we will discuss, provides everything Joe may want to achieve. Those options are: (1) not filing anything during the investigation; (2) continuing to report consistently with the past—at least for now; and (3) filing and asserting the Fifth Amendment as to potentially incriminating matters. As we will see, effective assertion of the Fifth Amendment privilege is more difficult than Joe (or any other layperson) may think. For Joe the issue is really one of damage minimization and not making things worse than they already are.

The tax practitioner assisting the target may face a similar dilemma. On the one hand, the practitioner wants to zealously defend his or her client, and is therefore loathe to counsel filing a current period return that might contain useful and/or incriminating information to the government. On the other hand, if the practitioner advises the client on how to diminish the evidentiary value of the return, then counsel might be both crossing the line ethically as well as potentially becoming a subject of criminal investigation.[1]

Looking at Alternatives

Refusing to File a Return at All

Many taxpayers' (and some practitioners') instinctive reaction has been to refuse to file a post-investigation return at all, or at least to defer filing one while the investigation is ongoing. This course of action has some arguable benefit, in that it deprives the government of whatever incriminating information might have appeared on the yet-to-be filed returns. However, deliberately not filing a return when one is due may lead to the imposition of civil penalties, and arguably also constitute a "willful failure to file" (a criminal violation) by the taxpayer. It may also have ethical and other implications for the practitioner who counsels the taxpayer in refusing (or deferring) to file a return.

Over the years, it has been suggested that all of these potential problems could be avoided if the taxpayer or his counsel were to send the IRS a letter on the due date. The letter would enclose a check and explain that there was an ongoing IRS-CI investigation, that the taxpayer has a Fifth Amendment privilege and that the taxpayer was not able to complete a truthful and accurate tax return for the current year "at this time" but was sending in a liberal estimate of his potential liability and would file "as soon as possible" (or as soon as the investigation was concluded, *etc.*).

When unpacked fully, the underlying premise of this approach seems to be that the taxpayer has a Fifth Amendment right to refuse to file a return that is required to be filed by law if the taxpayer believes that filing would either incriminate him/her or provide a lead to the government in the ongoing investigation into prior conduct. That is not the law. There is no blanket Fifth Amendment privilege to not file the next properly due tax return simply because IRS-CI is investigating the prior years and might get useful information from the new filings.

Proponents of this theory acknowledge that the taxpayer is basically ignoring his legal duty to file the currently due return(s) but argue that the willfulness necessary to criminally prosecute such a current year nonfiling is lacking because the taxpayer has alerted the government to his nonfiling by writing the letter announcing it and because the government timely received a liberal estimate (or over estimate) of the tax that would be due. In short, "no harm, no foul." Some found the Third Circuit's refusal to uphold the civil fraud penalty against a tax protestor who engaged in similar conduct as vindication of this approach.[2]

However, the Supreme Court has long held that the "willfulness" required to convict in criminal tax cases requires only that the nonfiling be an intentional violation of a known legal duty.[3] Bad purpose or evil motive, which once were thought to be part of the necessary proof were found by the Supreme Court not to be required.[4] Thus, the taxpayer knowing a return is due and deliberately not filing it satisfies the intent requirement for prosecution of the non-filing as a criminal failure to file case. The government only has to prove that a return was not filed and the taxpayer had the necessary minimal amount of gross income to require him/her to file for that year.[5] Whether the government would prosecute in such a case or not is not certain, but the risk is there; and prosecutors have, in some cases, brought additional charges related to the later nonfilings and succeeded. These convictions have been affirmed on appeal and a defense based on fear of incrimination in filing the returns for post-investigation has been expressly rejected.[6]

Moreover, numerous civil tax cases have upheld the imposition of failure to file and failure to pay penalties, which (over time) could amount to 67.5 percent of the tax due (and closely approximate the 75-percent civil fraud penalty without the need to prove intent). In such cases, the Tax Court has been similarly dismissive of "reasonable cause" arguments based on fear of self-incrimination.[7]

While the taxpayer might avoid criminal prosecution by asserting reliance of his/her counsel's advice not to file in such circumstances, the presentation of such a defense waives the attorney-client privilege and makes counsel a witness. It may also make the lawyer who gave the advice the subject of a criminal inquiry in the worst-case scenario and, even if not, such advice may subject counsel to an ethics investigation or client lawsuit for malpractice to recover the civil penalties imposed on the taxpayer for not timely filing. As noted, the Tax Court has consistently rejected such advice as satisfying the reasonable cause necessary for the taxpayer to avoid failure to file and pay penalties.

The Fifth Amendment has only been held to justify a blanket nonfiling of a tax return in cases involving tax regimes aimed at a suspect class engaging in nontax conduct of an illegal nature (gambling, sale of drugs, *etc.*).[8]

Aside from the unique circumstances of the taxpayers involved in those cases, there is (and never has been) a Fifth Amendment right not to file a return for the current period.[9] It is thus clear that, despite very thoughtful (but now dated) commentary,[10] which supported the idea of not filing but sending IRS a timely letter explaining that fear of self-incrimination was the reason for nonfiling, that approach also has substantial downsides for both the client and the counsel who gives the advice and no longer seems to be a viable solution in a mine-run case like our example. This is not to say that, where an accurate return cannot be completed for lack of the necessary information, an inaccurate (or false) one should be filed. To the contrary, option two (continuing the prior filing position) has worse consequences, and a letter with an estimated payment may be the only solution where a complete and accurate return cannot be prepared due to lack of information, although an imperfect one.

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Continuing the Historic Reporting

In our example, Joe cannot continue his filing of false payroll and income tax returns without simply making his situation worse. For the third quarter, he will have to file an accurate Form 941, and the 2014 Form 1040 will have to include his correct Schedule C income. Joe might well worry that these new filings will starkly contrast with his prior ones and provide a virtual roadmap to the IRS Special Agent, who is assigned to investigate the prior years.

"Don't I have a right not to incriminate myself?" Joe may ask. The answer is yes but, as with not filing any currently due return at all during an IRS-CI investigation, the Fifth Amendment's protections do not help Joe to avoid the dilemma completely. However, it may be possible for Joe, if he is entirely a self-employed Schedule C taxpayer (as in our example), to assert the Fifth Amendment privilege with respect to certain entries on his tax returns and possibly minimize the damage. Whether Joe could do this at all with respect to his Form 941 or business income tax reporting depends on his being a Schedule C taxpayer. This is because Fifth Amendment privilege applies only to individuals. Entities (including single-member LLCs, one-man corporations, *etc.*) do not have a Fifth Amendment privilege.

The question then becomes whether what can be filed will constitute a "return" sufficient to meet Joe's statutory filing obligation.

What Constitutes a "Return"

"What about filing anonymously?" Joe asks. "The government will get the money but won't know I sent it," he says. While this seems appealing, it is not helpful. Joe still has to file a return. What will that show? It seems manifest that the taxpayer's liability cannot be determined accurately if the taxpayer's very identity is withheld, so filing a truthful return in some fashion with the IRS without identifying Joe as the taxpayer filing it is not an option. Moreover, in order to constitute a "return," a document must be executed by the taxpayer under penalty of perjury,[11] which would be impossible with a "John Doe" return.

The task is even harder in a criminal tax case because the suspected criminal conduct may have continued into part of the current tax year for which the tax reporting has not yet been done.

In order for a document to constitute a "return," it must include sufficient information to enable the IRS to determine the taxpayer's liability. The courts, which have previously addressed the issue have held that a "return" must amount to an honest and reasonable attempt to comply with the tax laws.[12] The more extensive the Fifth Amendment claim and more limited the information provided is the more risk that the filing will not be seen as an honest effort to comply.[13]

How Can The Fifth Amendment Help?

By this point, Joe is probably thinking "It doesn't sound like there is anything I can do." That is not true. While there isn't much he can do to totally avoid the problems discussed above, he may be able to surgically use the Fifth Amendment privilege to avoid some of the incriminating disclosures in his current filings.

The Fifth Amendment provides, among other things, that: "[n]o person shall … be compelled in any criminal case to be a witness against himself." The privilege applies "in any … proceeding, civil or criminal, formal or informal, where the answers might incriminate [the witness] in future criminal proceedings."[14] More specifically, the privilege applies to a taxpayer's dealings with the IRS—including the filing of a tax return.[15]

In that vein, the U.S. Supreme Court has held that a valid invocation of the Fifth Amendment is a defense to criminal prosecution for willful failure to file a return under Code Sec. 7203.[16] Moreover, in situations where a taxpayer invokes the privilege in the good-faith but erroneous belief that it applies, this may negate the "willfulness" element of a criminal prosecution under Code Sec. 7203.[17] However, the scope of the privilege is limited.

As noted at the outset, the privilege generally cannot be invoked to justify the complete failure to file a return. The privilege also does not protect any false or misleading statements or omissions in a return.[18] Third, the privilege only applies to individuals. It does not protect artificial entities such as corporations, nor does it protect individuals acting as representatives of an entity, rather than in their individual capacities.[19]

Fourth, in order for the privilege to apply at all, the taxpayer must reasonably believe, based on the unique circumstances of his case, that the information to be provided on the return "could be used in a criminal prosecution or could lead to other evidence that might be so used."[20] In other words, "[t]here must be something peculiarly incriminating about [the taxpayer's] circumstances that justifies his reliance on the Fifth Amendment." The taxpayer must have "reasonable cause to apprehend such danger from a direct answer to questions posed to him" on the tax return. Such information need not be sufficient unto itself to support a criminal conviction, so long as it would "furnish a link in the chain of evidence needed to prosecute the [taxpayer] for a … crime."[21]

The taxpayer must walk a fine line in order to invoke the Fifth Amendment privilege properly on a return. The general rule is that the taxpayer must assert the privilege on the face of the return and in response to specific, line-item questions on the return.[22] However, even where a taxpayer does this, she may be treated as if she had filed no return at all (and thus lose the benefit of the privilege) where she objects to specific questions, but does "so on such a wholesale basis as to deny the IRS any useful financial or tax information."[23] Further, to the extent that the taxpayer voluntarily discloses information on the return, the privilege is lost.[24]

Let us consider how Joe might exercise the Fifth Amendment privilege in our example: Joe might consider filing his 2014 Form 1040 by including only a completed and signed Form 1040 with no attached schedules or possibly with only a completed Schedule A (assuming nothing is

implicated in filing Schedule A). On this return he might make (*e.g.*) an entry on line 22 representing his actual total income from all sources that would have been itemized on lines 7 through 21 and place an asterisk on each of these other lines. He would then complete the necessary calculations of his taxable income and tax liability from that point. Either on the bottom of the Form 1040 or on an attachment Joe could assert his Fifth Amendment privilege as the reason for his truncated filing.

He might do the same for the third quarter 2015 Form 941. He would calculate the correct withholding taxes that were due on all wages to all employees for the quarter and list that total on line 10 (total taxes after adjustments, put asterisks on the lines above and complete the rest of the form, sign it and remit the amount due.) A similar attachment explaining that the Fifth Amendment is the reason for the truncated reporting would be attached.[25]

One might argue that since a tax amount is reported that a "return" has been filed although perhaps one that cannot be vouched or audited.

This approach is not without risk either.

Indeed, there is a question as to whether the Fifth Amendment protects the amount of a taxpayer's income from disclosure at all. The Second Circuit has indicated that the privilege extends to reporting both the source and the amount of the taxpayer's income, if there is a sufficient risk under the circumstances that disclosure of that specific information might incriminate her.[26] The Eleventh Circuit, however, has held that "[t]he [F]ifth [A]mendment does not protect the amount of one's income from disclosure on tax forms."[27]

Even if not deemed a valid "return," it would seem that some attempt to file the document that the statute requires be filed is better than writing a letter saying one is not going to be filing anything on or before the statutory due date. To that extent, it seems that the potential for a criminal failure to file prosecution is lessened by a Fifth Amendment return even if it is not ultimately held to be a valid "return." However, the Tax Court decisions upholding civil penalties for not filing a "return" when due would appear to continue to apply as long as what is filed is not "a return."

Conclusion

A taxpayer required to file a return during the pendency of a government investigation into her affairs faces a troubling dilemma, to which there is no clear solution. If he/she refuses to file a return, or files an incomplete or misleading return, he/she may be penalized and prosecuted. If counsel assists in such conduct, then the practitioner may also be sanctioned, possibly sued and maybe even criminally prosecuted. One must also take a hard look at what the actual "incriminating" information or "lead" might be and determine if there is, in fact, a "lead" or incriminating evidence in the current filing or even if so, is it worth protecting by these means. For example, in Joe's case, for the year-end employment tax reporting, the same issues must be addressed and there is no similar option of truncated filing. All employees must receive truthful and accurate W-2s. Adding up those W-2s will provide the necessary roadmap to prove the first two quarters of 2015 were not correctly filed and will identify the persons who IRS-CI should speak to (if the special agent has not already figured it out by interviewing the employees who were paid by check). The value of the "lead" might be greater if (*e.g.*) the issue was the source and character of cash payments received in a kickback or political corruption investigation of Joe and (*e.g.*) a City Manager who hired Joe's company to do a City project. In such a case, the incriminating nature of the current filing might be a key fact in proving or disproving the allegation and more likely to provide the proverbial "link in the chain" of proof necessary to convict.[28]

As some commentators have noted, perhaps "[t]he best advice is to keep a cool head, acknowledge that there is no way to eliminate all of the client's risk … and make sure that everyone involved is working to further the client's interests to the extent possible, within the bounds of the law."[29]

ENDNOTES

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1 *See, e.g.,* Code Sec. 7206(2) (providing that any person who willfully aids or assists in the preparation of a return or other document that is materially false or fraudulent is guilty of a felony); Code Sec. 6701 (imposing penalties on persons who aid, assist, or advise with respect to the preparation or presentment of a return or other document that will result in the understatement of tax liability); Conn. R. Prof. Cond. 1.2(d) (providing that "[a] lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent," which would include advising the client to break the law by not filing a return or filing a false one); 31 C.F.R. §§10.50, 10.51(a)(7) (defining "incompetence and disreputable conduct," by one authorized to practice before the IRS, to include, *inter alia*, "[w]illfully assisting, counseling, encouraging a client or prospective client in violating, or suggesting to a client or prospective client to violate, any Federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof," and setting forth possible sanctions for such conduct).

2 *J.C. Raley*, CA-3, 767 F2d 980 (1982).

3 *C.J. Bishop,* SCt, 73-1 USTC ¶9459, 412 US 346, 93 SCt 2008; Good or evil motive is now irrel-

evant. *J. Asmus, Jr.,* CA-6, 85-2 USTC ¶9742, 774 F2d 722 (1985).

[4] *H. Murdock,* SCt, 3 USTC ¶1194, 290 US 389, 54 SCt 223 (1933) (which prior to *Bishop* had provided the definition of "willful" in tax cases).

[5] *E.E. Matosky,* CA-7, 70-1 USTC ¶9210, 421 F2d 410.

[6] *Josephberg,* CA-2, 562 F2d 478 (2009); *C.L. Poschwatta,* CA-9, 87-2 USTC ¶9565, 829 F2d 1477.

[7] *S. Gore Est.,* 93 TCM 1436, Dec. 56,986(M), TC Memo. 2007-169; *J.J. Kramer,* 72 TCM 1270, Dec. 51,657(M), TC Memo. 1996-513.

[8] *J. Marchetti,* SCt, 68-1 USTC ¶15,800, 390 US 389, 88 SCt 697.

[9] *M.S. Sullivan,* SCt, 1 USTC ¶236, 274 US 259, 47 SCt 607 (1927).

[10] J. Siffert & M. Saltzman, *Deferring Filing Income Tax Returns Pending a Criminal Tax Investigation; The Role of the Fifth Amendment and the Attorney-Client Privilege*, WHITE COLLAR CRIME REPORTER, Jan. 1990.

[11] *W.C. Hindenlang (In re Hindenlang)*, CA-6, 99-1 USTC ¶50,214, 164 F3d 1029, 1033 (quoting District Court opinion citing *R.D. Beard*, 82 TC 766, Dec. 41,237 (1984)).

[12] *Id.*

[13] *M.R. Smith, Jr.,* CA-5, 80-2 USTC ¶9476, 618 F2d 280 (1980); *R.M. Long,* CA-9, 80-2 USTC ¶9480, 618 F2d 74 (holding that a Form 1040 with $0 on each line was a "return"—albeit a false one).

[14] *Lee*, CA-3, 315 F3d 206, 211 (2003) (internal quotes omitted).

[15] *See R.D. Garner*, SCt, 76-1 USTC ¶16,218, 424 US 648, 662, 96 SCt 1178.

[16] *Id.*

[17] *J.L. Cheek,* SCt, 91-1 USTC ¶50,012, 498 US 192, 199, 111 SCt 604; *See Goetz*, CA-11, 746 F2d 710 (1984) (observing that "a good faith claim of privilege against self-incrimination, although erroneous, is a defense to the element of willfulness which is necessary for a conviction under 26 U.S.C. §7203"). However, as discussed *infra*, note 20, this may not offset other adverse consequences of failing to file a complete return, such as civil penalties, and the delay of the running of the statute of limitations on assessment.

[18] *E.E. Milder*, CA-8, 72-1 USTC ¶9407, 459 F2d 801, 803.

[19] *Curcio*, 354 US 118, 122–123 (1957).

[20] *See Hiibel v. Sixth Judicial District Court of Nevada, Humboldt County*, SCt, 542 US 177, 189–90 (2004) (nontax case, discussing general principles for determining when compulsory disclosure of information is "incriminating," so as to evoke the Fifth Amendment privilege); *see also R. Neff*, CA-9, 80-1 USTC ¶9397, 615 F2d 1235, 1239–40.

[21] *Neff*, *supra* note 20, at 1239–1240.

[22] *Neff*, *supra* note 20, at 1238; *D.D. Johnson*, CA-5, 78-2 USTC ¶9642, 577 F2d 1304, 1310–11; *see also Josephberg*, *supra* note 6, at 492–93.

[23] *See Neff*, *supra* note 20, at 1238.

[24] *See Garner*, *supra* note 15, at 654–57.

[25] This approach leaves uncorrected the prior two 2015 quarters and does not resolve the issue of what will be done in January 2016 when it is time to issue year-end W-2s, *etc.,* but, as noted several times herein, there is no completely good answer to Joe's problem.

[26] *See Barnes*, CA-2, 604 F2d 121, 148 (1979) (observing that "the right to make a [v]alid claim of privilege is available even as to amount of a taxpayer's income, as well as any other item on the return which could legitimately cause self-incrimination").

[27] *Goetz*, *supra* note 17, at 710 (noting, however, that erroneous but good-faith assertion of the privilege, even with respect to income, might negate the "willfulness" element of willful failure to file a return under Code Sec. 7203).

[28] *J. Hoffman,* SCt, 341 US 479 (1951).

[29] R. Timbie & S. Michel, *Strategies for Filing a Tax Return While Under Criminal Tax Investigation,* J. ASSET PROTECTION (Sept.–Oct. 1996).