

Civil and Criminal Tax Considerations in a Marital Dissolution

by

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Having just been retained in a family dissolution proceeding by the soon to be ex-spouse of an extremely wealthy physician, the family law practitioner has finally discovered Nirvana. During the initial consultation, counsel was advised that the couple's federal and Hawai'i returns significantly underreported gross receipts from the medical practice and cash receipts from various rental properties. Counsel knows that the financial vulnerability of the physician should translate into a significant award of spousal and child support under threat of exposing the unreported receipts to the Internal Revenue Service or the Hawai'i Department of Taxation. A favorable resolution result is on the horizon!

To determine the appropriate amount of spousal support, counsel would typically engage the services of a forensic accountant to delve into the couple's financial affairs and transactions. The forensic accountant will thoroughly examine many different aspects of the couples' business activities and will review various financial and business books and records, bank accounts, retirement accounts, and the expenditure of business funds for personal items. Various expenditures will be traced to search for potentially hidden assets. During this process, substantial amounts of unreported income are often discovered even if one of the spouses happens to be completely unaware of such additional income. The discovery of the unreported income or hidden assets is often used as a sword to attempt to compel the other spouse to be forthcoming with additional financial support. However, it is not uncommon for the sword to become a financial guillotine!

In the dissolution proceeding, information discovered by the forensic accountant may be filed with the court in a declaration as the basis for an award of spousal and child support and a realistic division of the jointly held assets. If the physician failed to acknowledge the actual amounts of income, various witnesses, including the physician and forensic accountants for both spouses, could be required to testify in order to assist the court in formulating an appropriate level of support and a realistic division of the joint assets. How would counsel be rewarded as a result of the court awarding substantial support payments and a division of the joint assets based upon the actual - rather than reported - income and assets? Perhaps, counsel's reward may be a legal malpractice action at a later date!

Is Someone Going To Locate The Cemetery? The IRS has long proven itself extremely capable of investigating both civil tax fraud and criminal tax fraud. The investigation of tax fraud is one of the most important phases in the administration and enforcement of the Internal Revenue Laws. Certainly, the viability of every self-assessment, voluntary compliant system requires an effective enforcement mechanism as a strong deterrent to potential unlawful behavior. Various declarations are often filed in marital dissolution proceedings setting forth the

financial status of the marital estate, without regard to the potential impact the declarations may have in a subsequent tax related proceeding. It is not uncommon and should be anticipated that various court personnel, including judges and court reporters, may feel compelled to refer matters to the tax authorities based upon information generated during the marital dissolution proceedings on the theory that "I file my returns and pay my taxes and expect others to do the same!" It should be anticipated that all information provided during the course of a marital dissolution proceeding will be obtained and thoroughly reviewed by a government agent in a subsequent tax audit.

“Tax Gap” Enforcement. The taxing authorities have significantly increased their enforcement activities in an effort to reduce the “Tax Gap.” The Senate Finance Committee recently held hearings entitled "A Closer Look at the Size and Sources of the Tax Gap." Since the "Tax Gap" represents unpaid taxes any estimate is, at best, a WAG (wild-guess) although most believe the current federal net Tax Gap approximates \$257-298 billion dollars (based on data for tax year 2001) representing a non-compliance rate of 15%-16%. The Tax Gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. It represents, in dollar terms, the annual amount of noncompliance with our tax laws. Few other countries can boast of a tax *compliance* rate of approximately 84%! *However, all agree that a non-compliance rate of 15%-16% amounting to several hundred billion dollars is clearly unacceptable in our self-assessment tax system.*

The Tax Gap is mostly comprised of under-reporting of income, underpayment of reported taxes, and the non-filing of returns. It is believed that 82% of the Tax Gap is associated with under-reporting on filed returns; 8% is associated with non-filing; and 10% is associated with the non-payment of tax. The majority of the Tax Gap appears to relate to individual income tax (\$197 billion or approximately 57% - principally non-business income and business income) and employment tax (\$39 billion or approximately 11% - principally self-employment tax). The balance relates to corporate tax, estate tax and excise taxes.

The IRS made significant progress towards achieving its enforcement related goals in FYE September 30, 2006 (FY 2006) and has achieved increases in every major area of enforcement. They have increased overall individual audits by 6% to 1,293,681 in 2006 from 1,215,000 in 2005, the highest number since 1998. The number of field examinations - traditional “sit-down” audits - increased nearly 23% in 2006 over 2005, and increased more than 50% from 2004. Overall IRS enforcement staffing has been increased from 20,211 in 2005 to 21,185 in 2006 (*reduced* from 23,550 in 1998). Examining Revenue Agent staffing increased from 12,192 in 2005 to 12,778 in 2006 (*reduced* from 13,708 in 1998). Collection Revenue Officer staffing increased from 5,249 in 2005 to 5,627 in 2006 (*reduced* from 6,796 in 1998). Criminal Special Agents increased slightly from 2,771 in 2005 to 2,780 in 2006 (*reduced* from 3,045 in 1998).

The IRS has significantly enhanced its ongoing enforcement efforts since being unjustly attacked by Senator Roth and others in Senate Hearings held in 1997-1998. Increased information reporting to the IRS and expedited reporting by the IRS with state and foreign governments will have a significant impact on the federal and state versions of the Tax Gap. As a result of their

matching programs, the government can better identify taxpayers who have underreported or not reported income or have otherwise failed to file returns. With Congress now involved, hunting for under-reporters and non-filers will likely become the trophy sport for the IRS!

Few income tax audits are currently selected randomly. High audit potential taxpayers include high net worth individuals, attorneys, medical professionals, individuals involved in the health care industry, individuals required to report their business activities on a Schedule C, issues relating to bankruptcy fraud, and anyone involved in a cash-intensive business (restaurant, bar, etc.). The IRS is now "operating as a business" and has been successfully targeting particular issues and taxpayers involved in particular industries deemed to have a strong potential for significant audit adjustments.

Small business owners and self-employed individuals comprise a significant portion of the Tax Gap. As such, expect the IRS to aggressively increase the examinations of non-compliant taxpayers within these arenas. Typically, IRS conducts examinations using various indirect methods of determining income such as a net worth analysis, an expenditures analysis, a bank deposit analysis, and/or a method of determining whether the mark-up utilized by the taxpayer in their business is within a range common for similar businesses in the same industry and locality. These methods allow an examiner to approximate receipts and expenses without having to actually look to the tax return as filed. Taxpayers are essentially "profiled" through the gathering of sufficient information to determine whether the information set forth on the taxpayer's return is accurate. Agents have extensive training to focus on whether reported income is sufficient to support various financial aspects of a taxpayer's lifestyle or business activities and to search for unreported income. Depending upon the information developed during the course of the audit, these audits often generate increased criminal tax investigations and prosecutions.

Through the indirect methods examination process, agents are instructed to review court records for relevant financial information. An agent auditing a year where a couple filed a joint tax return is likely to discover that a marital dissolution occurred in another year. Similarly, an agent auditing a return of a single person reflecting payments or receipts of spousal support will likely search court records to determine the financial basis for the support. An inquisitive agent may become concerned if the spousal support payments seem disproportionate to the reported income of the other spouse. Often, courts are provided with substantial information that is not otherwise reflected on a tax return. This information can be expected to lead an agent to the discovery of substantial amounts of unreported income, to other potentially sensitive tax issues, and to audits of other related taxpayers.

During an audit, an IRS Revenue Agent may become aware of marital dissolution proceedings involving the taxpayer. Certainly, changes in filing status (joint vs. separate), payment or receipt of alimony or other support (as reflected on a return or as discovered through a review of the taxpayer's bank account information), payment of unusual legal fees, etc., will likely suggest that a Revenue Agent review the court records for financial information. Relevant inquiries include: Is the court-ordered or stipulated support reflective of the taxpayer's financial information set forth on the tax returns which have been filed? If not, what information is set forth in the court

files that may demonstrate a possible understatement of income? Did the forensic accountants or the taxpayer(s) testify or provide affidavits that might tend to impeach the tax returns? In a succeeding tax audit or investigation, how does tax counsel impeach the statements of the taxpayer's own accountant that occurred in conjunction with the marital dissolution proceedings? Is one of the spouses a potential witness in a succeeding criminal tax proceeding? Did the taxpayer's dissolution counsel assist in the preparation and filing of a false tax return?

Leave The “Back Door” Open. In certain situations, one spouse may be relieved of joint tax liabilities if they qualify as an “innocent spouse” under Internal revenue Code Section 6015 et. seq. Submission of a declaration of a non-earning spouse in a dissolution proceeding regarding knowledge of unreported income may preclude relief from the tax liabilities as an “innocent spouse” in a subsequent tax proceeding. The determination of whether an otherwise innocent spouse is entitled to relief depends, in significant part, upon their actual and/or presumed knowledge. A declaration setting forth a lavish lifestyle not otherwise supported by information set forth on the tax returns could be sufficient to deny innocent spouse relief in a subsequent tax proceeding. As a result, although the declaration may be important for purposes of determining an award of spousal or child support, it may be more beneficial to have that information generated from efforts of the forensic accountant or from information developed through testimony of the other spouse (and their forensic accountant).

Declarations regarding the receipt and use of currency might also pose significant non-tax-related problems for the spouses. Depending upon the use of the cash proceeds, the spouses may be exposed to various money laundering-related civil and criminal sanctions. If cash proceeds are utilized in a manner designed to avoid certain currency transaction reports or other similar reporting requirements, the government may institute criminal¹ and/or civil forfeiture² proceedings seeking the forfeiture of the amounts involved or items acquired with the cash proceeds

When potentially unreported income or hidden assets are discovered, counsel often anticipate the ability to use the information to increase the award of financial support for their client. Clients are often extremely anxious to have counsel rush into court to seek a support order as soon as possible without considering the various tax related implications associated with the public disclosure of this information. Instead, when sensitive information regarding potentially unreported income or hidden assets is discovered, prudent counsel should contact competent tax counsel for an evaluation of the potential tax implications that might arise as a result of a public disclosure of this information. Disclosures during the course of the dissolution proceeding will become a benchmark in any future tax proceedings.

Depending upon the nature and scope of the information provided, tax counsel may engage a separate forensic accountant in order to preserve the privilege of the information in any subsequent tax proceeding.³ During the period of marital separation, tax counsel will likely render advice regarding the filing of joint or separate returns. If joint returns are filed, separate returns may not be filed at a later date. However, if separate returns are filed, the spouses may subsequently decide to file joint returns without first satisfying their entire joint tax liability. If

joint returns are filed, the spouses would be held jointly and severally liable for potentially significant deficiencies for taxes, interest, and penalties.

Is Voluntary Disclosure A Possibility? It is not unusual for tax counsel to render advice on the tax implications of the discovery of the information to counsel for both spouses in order to potentially soften the tax-related impact of this information on the marital community. In certain situations, tax counsel might recommend immediately amending various federal and Hawaii tax returns to report the previously unreported income and other tax-related items associated with any previously undisclosed assets. Often, there may be a recommendation to amend returns for at least three and perhaps six or more tax years. There may also be a recommendation for the amendment of returns for a business entity in which the spouses may have been involved.

Civil tax fraud is a remedial action taken to assess the correct tax and to impose an addition to the tax in the amount of 75% as a civil penalty. Civil penalties are assessed and collected administratively as part of the tax. The tax and penalties may be assessed at any time. The normal three-year statute of limitations on assessment of a tax deficiency does not apply in the event there is a determination of civil tax fraud. The liabilities may be assessed at any time. However, the Internal Revenue Service has the burden of proving tax fraud.

Criminal tax fraud investigations and prosecutions are punitive actions with penalties consisting of fines and/or imprisonment. Criminal penalties are not only intended to punish the taxpayer but are intended to serve as a deterrent to other taxpayers. The statute of limitations for purposes of criminal prosecution (usually six years) runs from the time the offense was committed (usually the due date of the tax return).

One offense may result in both civil and criminal tax penalties. The primary difference between civil and criminal tax fraud is the degree of proof required and whether a stay in "Club Fed" may be on the horizon. In criminal cases, the government must present sufficient evidence to prove guilt beyond a reasonable doubt. In civil fraud cases, the government must provide "clear and convincing evidence" that some part of the tax deficiency was due to fraud. In a criminal case, all participants in the fraud may be prosecuted, even though their own tax returns are not involved. As such, anyone "aiding or abetting" in the preparation of false tax returns may also be criminally prosecuted.

For many years, the IRS has maintained an informal policy of not generally recommending a criminal tax prosecution if a taxpayer voluntarily disclosed previously undisclosed information prior to the commencement of a "triggering event." Information anticipated to be disclosed as a result of a marital dissolution, a business break-up, termination of a disgruntled employee, or other similar acts may constitute a triggering event. Currently the "triggering event" tends to be an initial contact by the government. Although a taxpayer may not generally rely upon the fact that the IRS will not recommend a criminal tax prosecution, a voluntary disclosure is a significant factor taken into consideration by the government in determining whether to seek the criminal prosecution of an individual for a violation of the tax laws.

Feel Lucky? If returns are not amended, both spouses must be advised of the significant potential civil tax and criminal tax exposure associated with the previously unreported income. However, for various reasons, it may be determined that it is in the economic best interests of the marital community (and counsel) for the tax returns to *not* be amended and the tax related liabilities to *not* be paid. In such event, spousal support would generally be based upon both reported and unreported income. As such, the earning spouse might feel forced to continue a pattern of failing to appropriately report their income in order to satisfy their now court-ordered support obligations. At a point in the future, the IRS may discover the unreported income either through informants, independent sources, as a result of an indirect methods examination, or otherwise.

If the returns are not amended, the earning spouse is “rolling the dice” in the hope that the government will not somehow discover the unreported income which has been utilized to satisfy the support obligations. If discovered, the earning spouse would not generally have the ability to recapture support already paid since, presumably, such amounts have been exhausted for housing, food, and other support-related expenses. It could be anticipated that the government might seize the wages, bank accounts, and even the support payments in order to satisfy the tax liabilities. If allowed to accrue, the tax liabilities might result in the financial insolvency of the earning spouse effectively “killing the goose that laid the golden egg!”

Think Tax. Diligent efforts to maximize an award of spousal support may have the unintended result of creating a substantial unexpected joint tax liability for both spouses and/or the possibility of a criminal tax prosecution. It is incumbent upon counsel to “think tax” from the inception of the initial client consultation. Is there a potential sensitive tax issue that could undermine the financial security of the marital community? Is there a potential sensitive tax issue that could result in a criminal prosecution - tax or otherwise? Is there a possibility that one of the spouses might be entitled to relief from any resulting tax liability as an “innocent spouse”? Is a spouse being forced to underreport their future income to be able to satisfy a support obligation? Certainly, the answers to these questions will not be forthcoming in the initial consultation. However, information developed from the outset can have a significant impact on any subsequent tax-related proceeding. Client’s must be appropriately advised of the significant potential adverse tax implications associated with information disclosed during a marital dissolution proceeding. Think tax and clean it up...before the government knocks on the door!

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1. 31 U.S.C. §§ 1956, 1957, and 5324.
2. 18 U.S.C. §§ 981 and 982.
3. U.S. vs. Kovel, 292 F.2d 918 (2nd Cir. 1961).