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

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

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

A person who is a subject or target of a criminal tax investigation cannot avoid various unpleasant circumstances. Dealing with the inquiry can be distracting and time-consuming. A broad range of family, friends, banks, accountants, business associates, and employees are likely to learn of the criminal inquiry because they are contacted by IRS Special Agents seeking information and documents. The IRS may ultimately recommend prosecution; the U.S. Department of Justice may authorize indictment; and a public trial may be on the horizon. Monitoring the investigation and mounting a defense generally involves substantial professional fees for lawyers, accountants, and investigators. When the case is over, there may be a

hefty bill for taxes, interest, and penalties. There is also the severe emotional and psychological strain that arises from the uncertainty, anxiety, public exposure, and embarrassment of being suspected of or charged with a crime.

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

Typical Circumstances

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

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

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

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

corporation that had been omitted from previously filed returns.

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

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

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

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

Fifth Amendment Returns

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

Even though an individual taxpayer may claim the privilege against self-incrimination to avoid making certain admissions on a tax return, there are limits to its availability. The privilege will not justify the failure to file a return or the omission of required information from a return. Nor will it justify any false, incomplete, or misleading statements on a

return.⁸ If a taxpayer claims the Fifth Amendment arbitrarily, or in response to most or all of the line items on a return, the IRS may not recognize the return as valid, in which case the taxpayer might be exposed to civil penalties⁹ or a criminal charge under IRC Section 7203 for willful failure to file.¹⁰ In addition, the IRS may take the position that such a return does not start the running of the statute of limitations for assessment of tax deficiencies.¹¹

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

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

