Pitfalls of Preparing Tax Returns For Potential Criminal Defendants

Illegal profit making activities are not exempt from tax. Taxpayers who engage in illegal activities have a problem filing their tax returns. If their activities are not yet known to the government, filing a return could trigger an investigation and be used to convict them. Preparers of tax returns for those individuals have three objectives: (1) compliance with the tax laws; (2) not damaging the client; and (3) not damaging themselves.

The first criteria, compliance with the tax laws, is actually quite simple. All you need is a document signed under penalties of perjury with sufficient information to compute the tax.[1] Satisfying the other two of the three objectives at the same time, that is much harder.

For example, the description of an illegal activity can legally be omitted from a valid tax return and this seemingly would not incriminate a client, but sometimes nothing means something. Prosecutors have argued to juries that, in conjunction with large income and other evidence of a crime, only the defendant's illegal activities could explain why he omitted the description of the taxpayer's business activity in the designated spot on the tax return. The same inference of illegal activity has been drawn from the not filing at all:

> ...the evidence of a lack of federal tax filing (or underreporting) in combination with proof of valuable tangible possession or extravagant purchases creates the inference that the defendant does not possess a legitimate source of income to report his affluent lifestyle, and therefore, the income must originate from narcotics operations. US v Carter, 969 F2d 197, 201 (CA6, 1992).

Asserting a "Fifth Amendment privilege against incrimination" on the tax return might avoid judicial inferences of concealed activity, but that assertion would likely cause an investigation.

In 1973, an attorney tried to solve the problem of filing a return without incriminating his client by filing an anonymous complaint in a Richmond, Virginia Federal District Court. His client had late 1970 and 1971 tax returns to file but was, as the attorney put it, "fearful of filing same upon the ground that the returns will be used and admitted as evidence against him in a non-filing charge." The attorney sought an order preventing the government from using his client's filed tax returns as evidence against the client in a criminal action. The court denied the request. The Court of Appeals for the Fourth Circuit affirmed saying:

> In the event of any subsequent criminal prosecution, the taxpayer may then assert what Fifth Amendment rights, if any, he may have against the prosecution's use of any return he may have filed. Doe v Boyle, 494 F2d 1279, 1280 (CA4, 1974).

Despite the proclamation in Doe v Boyle, the Fifth Amendment appears to offer no protection because disclosure of an illegal business on a tax return is not compulsory. Garner v US 424 US 648 (1976). In Garner, the court held that disclosure on the tax return of the taxpayer as a gambler was voluntary. Therefore, it was admissible as evidence of illegal gambling.

Suppose a taxpayer were to report illegal income on the front page of the 1040 form under "miscellaneous income." This was suggested as a solution in US v Johnson, 577 F2d 1305, 1311 (CA5, 1978). It didn't work to protect the client, for the same reason that putting nothing can create an inference of illegal activity. At least one time, a prosecutor successfully argued to a jury, over defense counsel's objection, that large amounts of income reported under "miscellaneous," can only be explained by an illegal source of drug income. US v Barnes, 604 F2d 121 (CA2, 1979).

Another problem is privilege. No federal accountant client privilege exists for tax returns in criminal matters and, for preparing tax returns, attorneys count as accountants. Statements made to an attorney or an accountant in the course of preparing tax returns are not protected by any privilege and can be obtained by the government from the preparer.[2] Once the client discloses an illegal activity to the preparer, the genie can't be put back in the bottle.

Worse, if a tax preparer conceals an illegal activity on a tax return, he or she is exposed to being accused of committing or conspiring to commit any one of the following crimes: (1) Money laundering (18 USC 1956); (2) engaging in financial transactions with the proceeds of specified unlawful activities (18 USC 1957); (3) a conspiracy to defraud the federal government (18 USC 371); (4) corruptly impeding the administration of the Internal Revenue Code (26 USC 7212); and (5) willfully aiding or assisting in the preparation of any fraudulent or false document relative to any matter arising under the revenue laws (26 USC 7206(2)).

Under certain circumstances concealment of an illegal activity can occur even though the tax return and the source of income listed on the return are truthful and complete. This happens when a decoy source of income is created, one that is true but is used to conceal an otherwise illegal source of income. This happened in a criminal case against an Atlanta tax

attorney and return preparer named Gerald Popkin. In March of 1985, Popkin got a call from a former client, Stephen Musick. Musick had served a prison sentence for drug dealing. While in prison, Musick made a deal with government agents to set up a sting on Popkin.[3]

Musick met with Popkin wearing a wire and told Popkin he had made around $200,000.00 selling cocaine in prison in 1983 and 1984. The money, according to Musick, was then held in an offshore account by a company called Mid-American Financial. Musick wanted to show the unreported cocaine money. Popkin recommended that Musick: (1) form a corporation to hold the money; (2) have Mid American transfer the $200,000.00 to the corporation in exchange for corporate stock; (3) buy the corporate stock from Mid American for $3,000 - $10,000.00; and then (4) liquidate the corporation in the year of his choosing to retrieve the money. Under the plan, Musick could report the income in the year of liquidation as capital gains from the sale of stock without having to mention that the money was from cocaine.

Popkin was convicted in the lower court for corruptly impeding the administration of the Internal Revenue Code under IRC §7212. The 11th Circuit affirmed. US v Popkin, 943 F2d 1535 (CA11, 1991) cert den 112 SCt 1760 (1991). In the absence of a money laundering statute,[4] the issue was whether the term "corruptly" covered Popkin's conduct. The Court said that corruptly "[forbids] those acts done with the intent to secure an unlawful benefit either for oneself or for another." (at 1540). The Court of Appeals said:

> The effect of all these maneuvers would be more than just to disguise the source of the money thus repatriated. It would also place in Musick's wholly owned corporation the power to determine when, if ever, the $200,000 earned in 1983 and 1984 would be reported for income tax purposes. The income tax laws require annual reporting of all income in the year earned. The entire system is built on the basis of annual reporting, and any arrangement that permits a taxable entity to avoid reporting income in the taxable year when earned has the effect of skewing the system and thus impeding or obstructing the due administration of the tax laws. (at 1541).

What Popkin did was create a second tax liability in a different year with a different source of income. This created the appearance of a decoy year that could be used as evidence of the fact that Musick had reported $200,000.00 of income from a legitimate source (capital gains from liquidation of a corporation versus money from illegal activity). This would be like taking any year, reporting $200,000.00 from whatever and saying, "There is the income. It's not from cocaine." From a practitioner's standpoint, Popkin was not getting his client in compliance by having Musick report his income in the correct years.[5]

The courts seem to be having it both ways. In tax cases when a criminal defendant claims he should be exempt from filing because of compelled incrimination, the claim is rejected, yet in non-tax cases the returns are always allowed in as incriminating evidence. This creates an ethical dilemma and a technical challenge for criminal lawyers and tax preparers who want their clients in compliance with the law. In one way, the issue is not complicated. Returns must be prepared with an eye toward their admission in court.

by Neal Nusholtz

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End Notes

1. Edward A. Cupp, 65 TC 68 (1975). Lies on a tax return, to be actionable, must be material and are considered material if they might interfere with an investigation. US v Fawaz, 881 F2d 259 (CA6, 1989).

2. United States v Lawless, 709 F2d 485, 487-88 (CA7, 1983); United States v Bornstein, 977 F2d 112, 116-17 (CA4, 1992); In re Grand Jury Investigation, 842 F2d 1223, 1224-25 (CA11, 1987); United States v Davis, 636 F2d 1028, 1043 [47 AFTR 2d 81-941] (CA5, 1981), Frederick v. US, 182 F3d 496 (CA7, 1999).

3. Popkin had misrepresented the source and amount of Musick's illegal drug income on Musick's 1977 return.. He also was selling illegal tax shelters. Popkin v US, 699 FSupp 893 (USDC No, Dist. of GA, Atlanta Div. 04/21/1988).

4. Money laundering was not a crime until 1986 (18 USC §1956)

5. Under a Treasury Regulation known as circular 230 (regarding practice before the Treasury Department) once retained a practitioner is to have told the client if he has not complied with the tax laws and (since 2002) the consequences of not fixing it. Failure to do so exposes the practitioner to possible censure, suspension or disbarment from practicing before the Internal Revenue Service (31 CFR Sections 10.21 and 10.50).