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Practice Management

Pitfalls of Preparing Tax Returns for Potential Criminal Defendants

By Neal Nusholtz

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.

Compliance with the tax law is actually simple. All you need is a document signed under penalties of perjury with sufficient information to compute the tax. Satisfying the other two objectives at the same time is a much more difficult task.

For example, an illegal activity can be omitted from a valid tax return, but sometimes nothing means something. Prosecutors have argued to juries that, in conjunction with large income and other evidence of crime, only an illegal activity could explain the omission. The same inference, for one court, has been drawn from 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.

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 filed an anonymous lawsuit in a Richmond, Virginia Federal District Court. His client had late 1970 and 1971 tax returns to file but was, "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.

The Fifth Amendment appears to offer no protection because disclosure of an illegal business on a tax return is not compulsory and the Fifth Amendment only applies to compelled disclosures. In *Garner v. U.S.*, the Supreme 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 the case of *U.S. v. Johnson*. It didn't work. In the case of *U.S. v. Barnes*, 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.

Once the client discloses an illegal activity to the preparer, the genie can't be put back in the bottle. No federal accountant-client privilege exists in criminal matters. 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.

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:
- Money laundering;
- Engaging in financial transactions with the proceeds of specified unlawful activities;
- A conspiracy to defraud the federal government;
- Corruptly impeding the administration of the Internal Revenue Code; and
- Willfully aiding or assisting in the preparation of any fraudulent or false document relative to any matter arising under the revenue laws.

Under certain circumstances, concealment of an illegal activity can occur when the return and the source of income are truthful and complete. This happened in a criminal case against an Atlanta tax attorney 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.

Musick met with Popkin wearing a wire and told Popkin he had made around $200,000 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 to the corporation in exchange for corporate stock; (3) buy the corporate stock from Mid American for $3,000 - $10,000; 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 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 case was affirmed on appeal. In the absence of a money laundering statute, 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." 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.

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 that Musick had reported $200,000 of income from a legitimate source (capital gains from liquidation of a corporation). This would be like taking any year, reporting $200,000 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.

The courts seem to have 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 the tax practitioners 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.

About the Author

Neal Nusholtz has a broad tax, estate and corporate practice. He has represented hundreds of taxpayers in disputes with the IRS. In 1999, Corp! Magazine *listed Mr. Nusholtz as one of the Top Ten Business attorneys in Southeastern Michigan.*